RETIREMENT PERSPECTIVES

Designating a Trust as an IRA Beneficiary

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Brian Dobbis, QKA, QPA, QPFC, TGPC
Director, Retirement Solutions

Such a strategy can be beneficial, but be sure to consult an experienced attorney and tax professional to navigate the maze of rules.

First of a two-part series

Increasingly, clients are relying on their advisors for advanced beneficiary-planning strategies, such as naming a trust as the beneficiary of a retirement account. Designating a "look-through" trust as an IRA beneficiary can be tricky and complicated, with potentially serious tax consequences if done incorrectly. Advisors and their clients need to be aware of the nuances and appropriateness of these arrangements.

Typically, qualified retirement plans and IRAs are not subject to probate. Instead, retirement assets are distributed according to account owners' current beneficiary designation. Naming rules are very liberal, thus offering IRA owners a number of options in designating a beneficiary; in fact, any individual and/or non-individual (charity, estate, or trust) can be a named beneficiary. But if IRA assets are moved into the trust, either while the account owner is alive or at death, a distribution subject to income tax has occurred.

Tip: Never move IRA assets into the trust. Doing so will result in a taxable event on the entire IRA balance. Instead, name a trust as beneficiary on the IRA beneficiary form.

Why would the owner of an IRA want or need to name a trust, rather than a person, as his or her beneficiary?

The primary reason is to exert control over post-death distributions, thus limiting access to an inheritance. You *do not* save on taxes by naming a trust. In fact, it's quite possible to pay more in taxes even if the trust is designed properly. Therefore, you would only use trusts for personal (non-tax) reasons.

Assuming that naming a trust fits a client's overall objective, advisors should verify (with an attorney) that the trust qualifies as a "look-through" or "see-through" trust. In other words, the IRS will "look through" the trust and treat the trust's beneficiary as the IRA's direct beneficiary, although the trust remains the direct owner of the IRA (actually an inherited IRA). This allows heirs to take advantage of favorable minimum-distribution rules that apply to individual designated beneficiaries (e.g., those beneficiaries that have a life expectancy).

To qualify as a look-through, the trust must meet *all* of the following requirements:

1) Must be a valid trust under state law.

2) Must be irrevocable upon death of the account owner or contains language to the effect it becomes irrevocable upon the death of the IRA owner. A revocable trust will *not* be able to utilize stretch provisions.

3) Individual beneficiaries of the trust must be identifiable from the trust document.

4) Required trust documentation must have been provided to the IRA custodian no later than October 31 of the year *following* the IRA owner's death. The trustee is responsible for providing trust documentation to the IRA custodian.

In addition to the above requirements, only individuals (i.e., those with a life expectancy) may be considered "designated beneficiaries" by the IRS for purposes of taking advantage of the stretch IRA provisions. A person who is *not* an individual, such as an estate or a charitable organization, may not be a designated beneficiary, and the option to stretch minimum payouts will be forfeited.

Tip: The trustee also is responsible for determining that the trust is a look-through trust. However, most likely, the trustee will need to hire a professional (e.g., attorney) for assistance.

Tip: Although naming a trust as an IRA beneficiary is permissible, not all IRA custodians permit trusts to be a named beneficiary. It is imperative that you receive confirmation from an IRA custodian that will allowi you to name a trust beneficiary.

A properly designed look-through trust is deemed a non-spouse beneficiary and thus must follow post-death required minimum distribution (RMD) rules. This is true even if the spouse is the sole beneficiary of the trust. Why? The trust inherited the IRA. After the owner dies, the IRA balance should *not* be distributed to a trust. Instead, after the IRA owner's death, only the RMD has to be paid from the (inherited) IRA to the trust.

In other words, when a trust is named beneficiary, then minimum distributions are required to be made from the IRA to the trust. Bypassing (the trust) is not allowed. Instead, distributions are then made to trust beneficiaries, following the rules set forth in the trust.

Suppose there are multiple trust beneficiaries. Whose life expectancy is used to determine minimum distributions? Separate accounts, also known as "splitting," generally cannot be created when a trust is named as an IRA beneficiary. Why? The trust itself is considered the beneficiary rather than the underlying individual trust beneficiaries.

Generally, unless separate trusts are established for each beneficiary, the oldest beneficiary—the one with the shortest life expectancy among the beneficiaries—will be used to determine the amount of the required withdrawal, which is then divided among the beneficiaries. This is why the IRA owner should name beneficiaries that are relatively close in age. Why? Because the life expectancy of the oldest beneficiary determines the "stretch" payout following inherited IRA RMD rules. In other words, naming a trust as beneficiary generally eliminates the ability for each trust beneficiary to use their own life expectancy when determining annual distributions. Notably, it may be possible to "split" beneficiary accounts if the trust created separate "subtrusts" for each trust beneficiary named on the beneficiary form.

What happens if the trust fails to qualify as a look-through? Generally, only a living, breathing person can "stretch" inherited IRA distributions; an exception would be a look-through trust, whereby the trust can "stretch" using the life expectancy of the oldest trust beneficiary. If the trust fails to qualify as a look-through, the trust then has no life expectancy, thus the IRA must be generally be paid in five years post death.

Next week's column will cover situations in which a trust may be warranted,;trust tax rules; and leaving a Roth account to a trust.

If you have any questions about this or another retirement topic, please e-mail me at **roadtoretirement@lordabbett.com**.

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GLOSSARY OF TERMS

Trusts are often written to provide flexible provisions of how trust assets may be distributed.

Traditional IRA contributions plus earnings, interest, dividends, and capital gains may compound tax-deferred until you withdraw them as retirement income. Amounts withdrawn from traditional IRA plans are generally included as taxable income in the year received and may be subject to 10% federal tax penalties if withdrawn prior to age 59½, unless an exception applies.

A **Roth IRA** is a tax-deferred and potentially tax-free savings plan available to all working individuals and their spouses who meet the IRS income requirements. Distributions, including accumulated earnings, may be made tax-free if the account has been held at least five years and the individual is at least 59½, or if any of the IRS exceptions apply. Contributions to a Roth IRA are not tax deductible, but withdrawals during retirement are generally tax-free.

A **SIMPLE IRA** plan is an IRA-based plan that gives small-business employers a simplified method to make contributions toward their employees' retirement and their own retirement. Under a SIMPLE IRA plan, employees may choose to make salary reduction contributions and the employer makes matching or nonelective contributions. All contributions are made directly to an individual retirement account (IRA) set up for each employee (a SIMPLE IRA). SIMPLE IRA plans are maintained on a calendar-year basis.

A **simplified employee pension plan (SEP IRA)** is a retirement plan specifically designed for self-employed people and small-business owners. When establishing a SEP-IRA plan for your business, you and any eligible employees establish your own separate SEP-IRA; employer contributions are then made into each eligible employee's SEP IRA.

A **401(k)** is a qualified plan established by employers to which eligible employees may make salary deferral (salary reduction) contributions on an aftertax and/or pretax basis. Employers offering a 401(k) plan may make matching or nonelective contributions to the plan on behalf of eligible employees and may also add a profit-sharing feature to the plan. Earnings accrue on a tax-deferred basis.

A **403(b) plan** is a retirement savings plan that allows employees of public schools, nonprofit, and 501(c)(3) tax-exempt organizations to invest on a pretax and or Roth aftertax basis. Contributions to a 403(b) plan are conveniently deducted directly from your paycheck. In addition, your employer may elect to make a contribution on your behalf.

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