

Designating a Trust as Beneficiary of Individual Retirement Account Benefits

The most commonly asked question we encounter is whether or not to designate your Revocable Living Trust as the beneficiary of a retirement account, and what the tax consequences of doing so are.

In the overwhelming majority of cases, it is our recommendation to our clients that they name their spouse as the primary beneficiary of their retirement and name the Trust as the secondary or alternate or contingent beneficiary. Financial Advisors frequently inform our clients that by doing so the entire balance in the retirement account will be taxable upon the participant's death. This is not the law, and it has not been the law for over 6 years.

The advantages of naming the trust as beneficiary, as opposed to naming your children directly as IRA beneficiaries include:

- 1 The trustee can control the age of distribution to the beneficiaries. This is especially important with minor children, young adults or spend thrift heirs. (Note that the taxable distribution occurs when the payment of the IRA is made to the trust, not when the trustee makes a distribution of the proceeds of the IRA to the beneficiary.)
- 2 The trust can define where any beneficiary's share will go if the beneficiary dies before receiving their entire share.
- 3 Keeping a beneficiary's share in the trust can preserve its status as their sole and separate property.
- 4 Keeping a beneficiary's share in the trust can protect it from creditors.
- 5 To solve the underfunded Bypass Trust we encounter increasingly often (see below).

A participant in a retirement account, whether it is an IRA, 401(k), 457, 403b, Profit Sharing Plan, Defined Benefit Plan, or any other Profit Sharing / Pension Plan may designate an individual, trust, estate or any other person as a beneficiary to receive the account balance on the death of the owner. The rules relating to trusts as "Designated Beneficiaries" changed substantially a few years ago. Until recently, if a Trust was named as beneficiary of a retirement account, the entire balance would be taxable in the year of the plan participant's death. That is because the general rule is that a trust does not qualify as a designated beneficiary for the minimum distribution purposes.

That portion of the 1997 Internal Revenue Service's Regulations dealing with trusts as "Designated Beneficiaries" was revised significantly in January of 1998, and these revised requirements were carried over largely intact into the final Regulations issued by the Internal Revenue Service on April 16, 2002.

If satisfied, these provisions allow the beneficiaries of a Living Trust that has been named as a plan beneficiary to be treated as "Designated Beneficiaries," and defer the taxability of their distribution in exactly the same manner as if they were named as beneficiaries individually. Under the 1997 Regulations, these requirements had to be met as of the participant's Required Beginning Date (RBD) and for all periods thereafter during which the trust is a plan beneficiary. Now, the final Regulations make clear that they need not be met until September 30, of the year after the year of the participant's death.

The requirements are as follows:

1. The trust must be valid under State law;
2. The trust must either be irrevocable, or become irrevocable upon the participant's death;

3. The trust beneficiaries who are beneficiaries with respect to the trust's interest in the plan must be identifiable from the trust instrument;
4. Either a copy of the trust instrument or a special affidavit must be filed with the Plan Administrator by December 31 of the year after the year of the participant's death.

Note that for tax purposes, because the trust is being ignored and the trust beneficiaries are being considered when determining whether they are the Designated Beneficiaries, all of the trust beneficiaries must be individuals, as opposed to charities, businesses, etc. However, under the Final Regulations, the beneficiaries are determined as of September 30 of the calendar year following the calendar year of the participant's death.

Just as when a participant names multiple individuals as plan beneficiaries, if there is more than one trust beneficiary, and if requirements are met, then the beneficiary with the shortest life expectancy (the oldest beneficiary) will be the Designated Beneficiary for purposes of determining the minimum distributions. The Final Regulations make clear that the "separate account" rules are not available for trust beneficiaries.

The fact that a trust has been named as a beneficiary does not result in the entire account being taxable upon the death of the participant. That would have been true under the old rules, that were first changed in January of 1998, and clarified under the 2001 rules.

Accordingly, the trust beneficiaries shall be considered plan beneficiaries upon the death of the participant, and the withdrawals from the trust shall be consistent with the legal requirements of withdrawals as if the trust beneficiary with the shortest life expectancy was the Designated Beneficiary for purposes of determining minimum distributions.

If the owner dies prior to his required beginning date (at 70½) with his trust designated as beneficiary, and there are non-spouse beneficiaries of the Trust, then the remaining amount in the IRA must be distributed, either by December 31 of the fifth year following the owner's death (Rule 1) or distributions may be made over the remaining life or life expectancy of the designated beneficiary commencing by December 31 of the year after the date of death (Rule 2). Minimum distributions are calculated by taking the account balance on December 31 of the prior year, divided by the remaining life expectancy of the oldest beneficiary. If the owner dies after his required beginning date, the five-year rule does not apply. The maximum payout period is the longer of 1) the remaining life expectancy of the designated beneficiary, or 2) the remaining life expectancy of the deceased IRA owner.

If the owner dies before his required beginning date (age 70½) with a trust as designated beneficiary, and his spouse is the sole beneficiary of the trust, the account balance may be distributed by December 31 of the fifth year following the owner's death (Rule 1) or distributions may be made over the life expectancy of the beneficiary/spouse. Distributions to a spouse beneficiary under the life expectancy method must commence by the later of 1) December 31 of the calendar year following the death of the IRA owner, or 2) December 31 of the calendar year in which the IRA owner would have attained age 70½ (Rule 2). If the owner dies after the required beginning date, with the Trust as designated beneficiary and his spouse is the sole beneficiary, the spouse must receive minimum distributions over the longer of 1) the remaining life expectancy of the designated beneficiary/spouse or 2) the remaining life expectancy of the deceased IRA owner. The five-year rule does not apply.

Note that if there is no designated beneficiary, and the owner died prior to the required beginning date, the balance must be distributed by December 31 of the fifth year following the death of the IRA owner. If the owner died after the required beginning date the account balance must be distributed over a period of no longer than the remaining life expectancy of the IRA owner (rather than the life expectancy of the oldest beneficiary).

Most Estate Planning attorneys not normally recommend naming a trust as the primary beneficiary if an IRA owner has a living spouse. The surviving spouse should almost always be named the primary beneficiary with the trust designated as a contingent or secondary beneficiary because of the surviving spouse's opportunity to elect a Spousal Rollover and treat the distributions as an owner rather than a beneficiary?

- 1 A spouse/beneficiary frequently elects to receive post-death distributions from the deceased/spouse's IRA as owner rather than as beneficiary, because the surviving spouse may delay receiving required minimum distributions until April 1 of the year following their attainment of age 70.5. (Taking as beneficiary, the surviving spouse must commence receiving distributions by 1. December 31 of the year following the death of the IRA owner, or 2. December 31 of the calendar year in which the IRA owner would have attained age 70.5.)
- 2 The surviving spouse can also designate a new beneficiary for the IRA after the death of the spouse beneficiary.
- 3 The payout period may be longer for a spouse who takes as owner than for the spouse who takes as beneficiary.
- 4 The surviving spouse may roll over the IRA into an IRA in his or her name.

If this is a second marriage and the participant wishes for the retirement account proceeds to be payable to the children as opposed to the second spouse, then we would not advise naming the spouse as the primary beneficiary.

A surviving spouse may not elect to treat the IRA of the IRA owner as the surviving spouse's IRA if a trust is the designated beneficiary. This rule applies even if the surviving spouse is the sole beneficiary of the trust and receives distributions directly from the IRA.

Note also that if a primary beneficiary disclaims his or her benefits and the IRA passes to a trust as a result of either 1) state law or 2) provisions in the deceased IRA owner's Will, the trust (its beneficiaries) is not considered a designated beneficiary for purposes of the required minimum distributions. The lesson here is that one should never name the estate (as opposed to the trust) as the contingent beneficiary because that will cause the account balance to be distributed as if the IRA owner had no designated beneficiary.

In conclusion, most Estate Planning attorneys normally recommend that IRA participants designate the spouse as the primary beneficiary and designate the trust as a secondary or contingent beneficiary for the best results.

An increasing problem we encounter has to do with what is generally known as the Underfunded Bypass Trust issue. More and more of our clients have a larger and larger portion of their estate in tax-deferred retirement accounts. If that participant spouse dies first, naming the surviving spouse as the beneficiary, all of those dollars will be included in the surviving spouse's taxable estate, and may result in the deceased spouse's Bypass Trust being grossly underfunded. This can result in significant Federal Estate Taxes due on the surviving spouse's death, even though the "AB Trust" allows each spouse to take advantage of the maximum amount that can pass free from Federal Estate Taxes.

Consider the following example:

Let us assume that the current law that provides that the unified credit against Federal Estate and Gift Taxes will return to \$1 million for persons dying after 2010 remains in effect. Assume that we have a couple with a \$2 million estate consisting of a home valued at \$600,000, investments and savings valued at \$600,000 and Husband's retirement account valued at \$800,000. They have created an AB Trust which allows each of them to take advantage of the \$1 million exclusion. Husband dies first naming Wife as the primary beneficiary on his IRA. The Trust assets consist of the house (\$600,000) and the investments (\$600,000) for a total of \$1.2 million. Half of those assets will go in Husband's A Trust and half will go in Wife's B Trust. Since we almost always put the house in the surviving spouse's Trust (to preserve the exclusion from capital gains taxes for sale of a primary residence owned two of the last five years), the house will go in Wife's B Trust and the investments will go in Husband's A Trust. Wife as beneficiary of Husband's IRA, does a Spousal Rollover. Husband's Bypass Trust is underfunded by \$400,000. Wife's taxable estate is now \$1.4 million. Upon her death, only the first \$1 million is excluded from Federal Estate Taxes and the \$400,000 excess amount (that could have gone into Husband's Bypass Trust) is subject to taxes of

\$166,000.

If Husband named Wife as the primary beneficiary on the IRA and named the Trust as the alternate beneficiary on the IRA, then Wife could have disclaimed half of Husband's IRA upon his death. If the Trust was named as the contingent beneficiary, then that \$400,000 would roll over to a "look through" IRA account owned by the Trust. It would be includable in Husband's estate. The remaining half of the IRA would go into Wife's Spousal Rollover IRA account. In the "look through" retirement account held by Husband's Trust, Wife is the measuring life for Minimum Mandatory Distribution calculations. She is the Trustee and she is the beneficiary. She will control how much of the IRA she takes. She will manage the investments. But it will be includable in Husband's estate, which is \$1 million. \$1 million is exempt from Federal Estate Taxes. Upon Wife's death, only the house and her half of the IRA is includable in her taxable estate, totaling \$1 million. Since the first \$1 million in each estate is exempt, there are no Federal Estate Taxes and we have saved the children \$166,000.

Had Husband named Wife as the primary beneficiary and the children as the alternate beneficiary of his IRA, Wife probably would not have done the disclaimer, because that would have meant \$400,000 of Husband's IRA being payable to the kids while mom is alive. Wife might need those dollars while she is alive, so it would not be our advise for her to make that kind of a disclaimer, but it would be our advice if the Trust is named as the contingent beneficiary.

Underfunded Bypass Trusts are one of the biggest problems we encounter in estates that we administer. Naming the spouse as the primary beneficiary and the Trust as the contingent beneficiary gives us one huge planning option which in most cases saves the family hundreds of thousands of dollars in Federal Estate Taxes.

If you have any questions concerning the beneficiary designation, please give us a call.