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FEATURE ARTICLE

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Naming Trusts as Beneficiaries of IRAs

Overview: There are advantages to naming a trust as a beneficiary instead of an individual, such as more control of distributions. Following is a discussion of when it makes sense to name a trust as a beneficiary.

One of the most important estate-planning decisions for investors is how to properly designate beneficiaries of their retirement accounts. In most scenarios, the logical choice is to designate individuals as beneficiaries — as opposed to the estate — to allow for the IRAs, once inherited, to “stretch” the distributions for as long as possible. The longer the IRA is sheltered from taxes, the more potential it has to grow and accumulate wealth. Naming an individual is a simple and strategic method to stretch an IRA. However, the real world is not always simple, and there are often other factors to consider when determining beneficiaries.

Many times, it is in the account owner’s best interest to name trusts as beneficiaries of IRAs. If done correctly, this can preserve the stretch capabilities for the beneficiaries *and* allow the account owner to have control over the ownership and distributions after he or she is deceased. If done incorrectly, this can “kill the stretch” and force distributions to be made — and taxes to be paid — more quickly than what was intended.

As a result, it is critical that a competent attorney and tax professional be directly involved when deciding whether to name a trust as a beneficiary. An advisor may offer guidance in this area by identifying potential issues for an individual to share with his or her team of professionals.

Can a Trust Be Your Designated Beneficiary?

Almost anyone or anything can be the beneficiary of an IRA. However, if the beneficiary is not a person (meaning, the estate), then there is no life expectancy for the purpose of calculating the annual required minimum distribution (RMD). In this scenario, if the IRA owner dies before the required beginning date (RBD), the beneficiary is not eligible to use the life-expectancy method to calculate post-death distributions. The beneficiary must therefore distribute the assets within five years. If the IRA owner dies on or after the RBD, the distribution period may not be stretched beyond the remaining life expectancy of the deceased.

This rule for non-person beneficiaries also applies to trust beneficiaries, unless an exception applies, in which case the oldest underlying beneficiary of the trust is treated as the beneficiary of the IRA for the

purpose of determining the distribution options. In general, the exception applies if the following requirements are met:

- σ The trust is valid under state law.
- σ The trust is irrevocable or will, by its terms, become irrevocable upon the death of the IRA owner.
- σ The beneficiaries of the trust are identifiable.
- σ A copy of the trust documents is provided to the IRA custodian by October 31 of the year immediately following the year in which the IRA owner died.

Why Name a Trust as Beneficiary?

Naming a trust as a beneficiary will give an individual maximum control over his or her tax-deferred money upon death. That's because distributions won't be paid to an individual but will go into a trust that follows that individual's written instructions, including who will receive the money and when it will be distributed.

For example, a trust could provide income to the surviving spouse for as long as he or she lives. Then, upon the death of the surviving spouse, the income could go to someone else. The trust could eventually provide periodic income to children or grandchildren, protecting the remaining funds from irresponsible spending and/or creditors. In the event of a second marriage, the owner of the IRA may want his or her current spouse to receive distributions from the IRA for his or her life but restrict the spouse's ability to direct the remainder at his or her death.

How Do I Maximize the Stretch When Naming a Trust Beneficiary?

There are no tax advantages to naming a trust as a beneficiary of an IRA compared with directly naming an individual beneficiary. In fact, one of the major disadvantages of naming a trust as a beneficiary is that an individual may not be able to provide for his or her spouse *and* have the option to stretch out the tax-deferred growth beyond the spouse's actual life expectancy. That's because, as previously stated, an individual must use the life expectancy of the oldest beneficiary within the trust agreement, which, in this case, would probably be the spouse. However, the trustee can withdraw more money if needed to follow the trust's instructions.

One strategy that can get around this limitation is to set up separate trusts for each beneficiary. By naming each trust as a separate beneficiary, the inherited IRA can be split into separate shares for each trust and stretched over each separate trust beneficiary's life expectancy.¹

Creating separate trusts for each beneficiary would be especially effective if one of the beneficiaries is a charity. If a charity is named in a trust along with other "living" beneficiaries, then the charity's life expectancy, which is zero, will be considered in determining its stretch period, while each living beneficiary's stretch period will not be adversely affected.

Summary

There are many reasons why a trust may be the best option as the beneficiary of an IRA. In all situations, individuals should seek the assistance of a competent attorney and tax professional to determine if and when a trust is appropriate. This includes selecting the type of trust that ensures estate-planning needs are met.

¹ Natalie B. Choate, **Life and Death Planning for Retirement Benefits, 5th Edition**. (Ataxplan Publications, 2003).

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