Retirement Planning

Reasons to consider naming a trust as beneficiary of your retirement assets.

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Traditional individual retirement arrangements (IRAs) can often comprise a substantial portion of individual balance sheets or taxable estates. While growth and income are generally tax deferred inside such accounts, assets must eventually be withdrawn and income tax paid on the distributions.

During life, the individual account owner takes distributions and pays the resulting tax. Any IRA assets remaining at the death of the owner pass to the designated beneficiary.

While a surviving spouse or children are typically named as beneficiary, there can be many reasons to consider a trust for their benefit instead. The advantages of using a trust to own IRA accounts include protection from mismanagement by spendthrift beneficiaries, enhanced creditor protection in many circumstances, and the ability of the account owner to control the ultimate disposition of the IRA for tax planning purposes.

The SECURE Act

The SECURE Act, enacted in 2019, changed many aspects of inherited IRAs for account owners who die after January 1, 2020. Prior to the SECURE Act, beneficiaries of IRAs could generally “stretch” distributions over their life expectancy. The SECURE Act introduced the category of “eligible designated beneficiaries,” those who are still eligible to stretch distributions. Beyond these exceptions, the general rule post-SECURE Act is that an IRA must be fully distributed by the end of the 10th calendar year following the death of the account owner.

Eligible designated beneficiaries include the account owner’s surviving spouse, minor children, disabled or chronically ill persons, or an individual who is no more than 10 years younger than the account owner. Eligible designated beneficiaries may take distributions over the longer period of either their own life expectancy or the remaining actuarial table life expectancy of the original account owner. Other beneficiaries who qualify as designated beneficiaries (generally individuals) are subject to the 10-year distribution rule of the SECURE Act.

Nondesignated beneficiaries (such as estates, non-qualifying trusts, and other entities) must withdraw all IRA account assets within five years of the death of the original account owner if the account owner died before the required beginning date for the required minimum distributions (RMDs). If the IRA was in the RMD period at the death of the account owner, the trust can use either the remaining actuarial table life expectancy of the original account owner or elect to use the five-year rule.

Trusts as beneficiaries

The SECURE Act changes make the differentiation between eligible designated beneficiaries and designated beneficiaries important because trusts with eligible designated beneficiaries can use similar "stretch" provisions under pre-SECURE Act rules, while trusts for other beneficiaries fall under shorter required distribution periods. In order for a trust for such beneficiary to qualify for such treatment, however, the trust must first qualify as a "see-through" trust by meeting the following requirements:

1. The trust must be valid under state law;
2. The trust must be irrevocable after the death of the account owner;
3. The beneficiaries must be identifiable from the trust document; and
4. The IRA plan administrator must provide required documentation to the IRS by October 31 of the year after the death of the account owner.

The requirement that beneficiaries be identifiable does not mean specific individuals must be named in the trust document. Classes of beneficiaries are allowable, such as "my children," as long as the membership in the class of beneficiaries is readily ascertainable at the death of the account owner.

The two types of see-through trusts are conduit trusts and accumulation trusts. To be considered a conduit trust, distributions from an IRA, including RMDs and other withdrawals, must be distributed by the trustee to trust beneficiaries immediately upon receipt. Income tax obligations pass through to the beneficiaries. An accumulation trust allows the trustee to accumulate IRA distributions instead of immediately passing them through, with the terms of the trust governing distributions to the beneficiary or beneficiaries.

While an accumulation trust has the advantage of preserving distributions received from the IRA inside the trust or limiting distributions to specific purposes (such as school tuition), it has the disadvantage of having to pay income tax at the compressed trust tax rates for undistributed income.

Multiple beneficiaries

These rules are modified when there are multiple beneficiaries of a see-through trust. If all of the trust beneficiaries are eligible designated beneficiaries, the required distribution schedule is based on the life expectancy of the oldest beneficiary. If there is a trust beneficiary who is a designated beneficiary but not an eligible designated beneficiary, the 10-year required distribution rule applies to all beneficiaries. If one or more trust beneficiaries are neither designated beneficiaries nor eligible designated beneficiaries, the five-year rule applies to required distributions. Separate share trusts may be established depending on trust terms to account for different classes of beneficiaries and varying RMD rules.

IRA accounts owned by both conduit and accumulation see-through trusts must distribute based on the status of the trust beneficiary/ies (e.g., fully distribute by the end of the 10th calendar year following the

death of the account owner where there are no eligible designated beneficiaries). While a conduit trust will pass through income and assets of the IRA account during this period, an accumulation trust does not necessarily terminate at the IRA closing, as the income and assets from the closed IRA may continue to be held as assets of the trust and distributed to the beneficiaries over a longer period of time.

New options for special needs trusts

Recent changes in the regulations allow a special needs trust to be a qualified designated beneficiary of an IRA. This permits the trust to receive distributions from the IRA over the special needs beneficiary's life expectancy rather than under the standard rules. Such special needs trusts may now have a charitable remainder beneficiary, a change from the prior rules when having a charitable beneficiary would accelerate required IRA distributions.

More changes coming

Since passage of "SECURE 2.0" at the end of 2022, the IRS has proposed new regulations regarding the use of trusts as IRA beneficiaries that appear to reduce some of the current restrictions, particularly regarding the possibility of decanting an IRA trust should the beneficiary situation change, and clarifying that see-through trusts can have more than one beneficiary, among other interpretive changes.

Having a trust as the beneficiary of an IRA account has a greater degree of complexity than naming individuals as outright beneficiaries, and it is important to consult with appropriate tax professionals regarding each situation.

Trusts can, however, provide solutions for blended families where the account owner may want to have a current spouse receive lifetime benefit while preserving assets for children from a prior marriage, limit a beneficiary's access to account assets while providing a source of ongoing income, provide a greater degree of creditor protection for beneficiaries, and control the ultimate disposition of the IRA account income and assets for tax reduction purposes.

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