Best Practices for Naming an IRA Beneficiary

By Julius Giarmarco

For many clients, their most valuable asset is their individual retirement account (IRA). This is due in part to the tax-free or tax-deferred growth that IRAs enjoy. Therefore, choosing the right beneficiaries of their IRAs is of critical importance. Most married couples name their spouse as the sole beneficiary because of two unique options not available to other beneficiaries: the surviving spouse may roll over the decedent's IRA into an IRA established in the spouse's own name (spousal rollover) or elect to treat the decedent's IRA as the surviving spouse's own IRA (election). However, when a rollover or election is not desirable—e.g., the primary beneficiaries are minors, spendthrifts, or a spouse of a second marriage—consideration should be given to naming an IRA trust as the primary beneficiary. Even when a rollover or election is desirable, an IRA trust may be advisable as the contingent beneficiary.

See-through trusts

If properly drafted and administered, an IRA trust allows the oldest trust beneficiary to be treated as if he or she were named directly for purposes of determining the required minimum distribution (RMD) according to IRS tables. By using a separate trust for each beneficiary, distributions from the IRA can be stretched over that beneficiary's life expectancy. IRA trusts must qualify as "see-through" trusts for the benefits to be stretched. Otherwise, the beneficiary must receive the entire balance of the account by the end of the fifth year of the IRA owner's death (the "5-year rule").

The following requirements outlined in IRS Regulation Section 1.401(a)(9)-4, A-5 create a see-through trust:

- The trust is valid under state law.
- The trust is irrevocable or it becomes irrevocable upon death.
- The beneficiaries of the trust are identifiable.
- The required documentation has been provided by the trustee to the IRA custodian no later than October 31 of the year following the year of the IRA owner's death.

In addition, all beneficiaries must be individuals; otherwise, there will be no designated beneficiary and the stretch option will be lost.

Designated beneficiary

A designated beneficiary, as defined by Treas. Reg Section 1.401(a)(9)-4, may be a trust if all beneficiaries who must be considered are individuals who are alive on the date of the IRA owner's death and the oldest beneficiary can be determined (a "qualifying" trust). An estate, charity, non-qualifying trust, non-individual other than a qualifying trust, or an individual born after the date of the owner's death cannot be designated beneficiaries. If there is a designated beneficiary of the IRA trust, his or her life expectancy is used to determine RMDs in years following the year of the IRA owner's death.

The Single Life Expectancy Table is used by non-spouse beneficiaries to compute RMDs on inherited retirement accounts. This table is accessed only in the year following the year of the IRA owner's death to determine the beneficiary's life expectancy factor. This factor is then reduced by one in each successive year until it is fully exhausted. This allows the IRA to be distributed over several decades, resulting in maximum stretch out and tax deferral.

If there is no designated beneficiary and the IRA owner died before his or her required beginning date—April 1 in the year following the calendar year in which the IRA owner reaches age 70½—the account must be completely distributed by December 31 following the fifth anniversary of the owner's death. If there is no designated beneficiary and the IRA owner died on or after his or her required beginning date, the RMD is determined using the Single Life Expectancy Table as if the owner were still living (the "ghost life expectancy rule").

> Albert Einstein is said to have called the power of compound interest "the most powerful force in the universe."

"Best Practices" is a regular column of the *Michigan Bar Journal*, edited by Gerard Mantese and Theresamarie Mantese for the Publications and Website Advisory Committee. To contribute an article, contact Mr. Mantese at gmantese@manteselaw.com.

Why use an IRA trust?

There are basically three reasons for paying IRA benefits to a trust. The first is to force the beneficiary to stretch the payments over the longest period by only distributing the RMDs. Albert Einstein is said to have called the power of compound interest "the most powerful force in the universe." The longer the funds remain in the IRA, the more tax-deferred compounding, which results in more funds being available to the beneficiary. Without a trust, a beneficiary could take larger distributions or even cash out the IRA, destroying the tax-deferred growth and possibly increasing the income taxes that would be due on a lump-sum distribution.

The second reason for naming a trust as a beneficiary is to preserve and protect the IRA. The United States Supreme Court in *Clark v Rameker*[1] decided that inherited IRAs are not protected in bankruptcy. In contrast, IRAs payable to a trust that contains a spendthrift clause are protected in bankruptcy.

The third reason is for the grantor to preserve and maintain a degree of control over the IRA. For example, by using a trust, conservators are not needed for minor beneficiaries; there is no risk of court supervision if the beneficiary becomes incapacitated; a beneficiary with special needs would not lose valuable government benefits; successor beneficiaries can be named in the trust agreement to control who receives the benefits if the initial beneficiary dies before the account is fully paid; successor trustees can be named to manage the IRA if the initial trustee dies, resigns, or becomes incapacitated; funds can be secured for payment of estate taxes; and the IRA owner's generation-skipping tax exemption (which is not portable) can be secured.

Conduit trusts versus accumulation trusts

There are two types of IRA trusts: conduit trusts and accumulation trusts. Both types must receive RMDs from the inherited IRA, and both can qualify as see-through trusts if they meet the requirements; otherwise, there is no stretch IRA. Depending on the trust terms, distributions from either type of trust can exceed the RMD (e.g., distributions for the beneficiary's health, education, maintenance, and support).

A conduit trust requires that all IRA receipts, including RMDs, be distributed to the beneficiary. A benefit of a conduit trust is that the life expectancies of other, possibly older, remainder beneficiaries can be ignored in satisfying the designated beneficiary requirement. The downside is that the distributions become subject to creditors' claims and the beneficiary's spending habits. While easy to draft and administer, conduit trusts have an asset protection downside.

In contrast, an accumulation trust permits all IRA receipts, including RMDs, to be held in trust. While this affords greater asset protection, accumulation trusts are complicated to draft and administer. The see-through trust requirement that is most troublesome for accumulation trusts is the one dictating that beneficiaries be identifiable as of the date of the IRA owner's death. The goal is to know who the oldest beneficiary is so withdrawals can be based on that person's life expectancy. As a practical matter, though, it's possible that the oldest beneficiary might not be identifiable. If so, the trust could flunk the test and the IRA would be treated as if there were no designated beneficiary. For example, powers of appointment could cause a trust to violate the rule because older beneficiaries could conceivably be added to the trust. For the same reason, "sprinkling" powers, authorizing the trustees to distribute principal among a class of beneficiaries when appropriate, could also cause a trust to flunk this test if it permits older beneficiaries to become members of the class.

Equally problematic is the fact that the regulations define an identifiable beneficiary as a human. Accumulation trusts with a beneficiary that, however remote, is not a person (e.g., a charity or the estate of the IRA owner) won't qualify for see-through treatment. This is a problem for an IRA owner who wants to name a charity as the ultimate remainder beneficiary to take upon failure of all descendants to survive. An added problem with accumulation trusts is that all accumulated receipts from the IRA

> Leaving an IRA to a trust is much different from putting other assets into a trust after death. The attorney setting up the trust must be familiar with the rules and terminology specific to inherited IRAs.

will be taxed at the trust's compressed tax bracket (39.6 percent for the top tax bracket starting at $12,500 in 2017).

Choosing the right type of trust

Following are primary considerations for deciding whether to use a conduit trust to minimize income taxation or an accumulation trust to maximize asset protection:

- Use an accumulation trust if the primary beneficiary is known to have creditor concerns (e.g., divorce and lawsuits), spendthrift habits, or substance-abuse problems.
- Use a conduit trust for grandchildren or great-grandchildren, since the RMDs will be small and can be payable to an UTMA (Uniform Transfers to Minors Act) account.
- Use an accumulation trust (structured as a special needs trust) for a beneficiary receiving government assistance. The trustee can use discretion and provide for certain supplemental needs of the beneficiary as they arise.
- Use a conduit trust when the beneficiary has no asset protection concerns, is financially responsible, and is not abusing substances.
- Use an accumulation trust when not certain. The trustee can then either accumulate the RMDs or distribute them to operate like a conduit trust. An accumulation trust is also a better choice when the beneficiary is in the highest tax bracket so any accumulations would not create additional tax loss.

It may be possible to convert a conduit trust to an accumulation trust or vice versa for a limited period after the IRA owner's death (see PLR 200537044). Thus, if the primary beneficiary's situation changes over time, a trust protector could convert the trust from conduit to accumulation (or vice versa) depending on the beneficiary's situation and needs. This power is analogous to a trustee's ability to disclaim benefits by September 30 of the year following the year of the IRA owner's death. If converting from a conduit trust to an accumulation trust, the trust protector must also eliminate remainder beneficiaries who would jeopardize the designated beneficiary status of the trust.

Disadvantages of IRA trusts

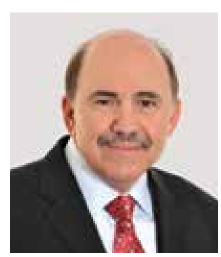
As with most estate planning techniques, there are disadvantages to using IRA trusts. As mentioned above, there are compressed tax rates for income retained in the trust. There are also the added complexity and costs to create and maintain the IRA trust (e.g., annual tax returns and administration). In addition, there are no separate account rules. RMDs are based on the shortest life expectancy if all trust beneficiaries are individuals; however, separate trusts can be created for each beneficiary to avoid this problem.

Standalone IRA trust vs living trust

While it is possible to create either a conduit trust or an accumulation trust within a living trust, there are technical and practical reasons why a standalone IRA trust is preferable. A number of regular provisions in a living trust will disqualify it as a see-through trust (e.g., payment of debts, expenses and taxes, accounting for principal and income, and charitable beneficiaries). Although it is possible to firewall some or all of these provisions with a conduit trust, that process is much more complicated for accumulation trusts. And a standalone IRA trust is much easier for the custodian to understand and implement, making it less likely the custodian would delegate the matter to the legal department (which could hold up the process of implementing the trust in a timely manner).

Conclusion

Leaving an IRA to a trust is much different from putting other assets into a trust after death. The attorney setting up the trust must be familiar with the rules and terminology specific to inherited IRAs. Don't overlook the benefits of a spousal rollover, which can preserve the tax benefits of the IRA for generations. Smart planning uses a cascading beneficiary system. Consider naming the spouse as the primary beneficiary and the see-through trust as the contingent beneficiary. This arrangement allows for more flexibility, since the spouse can choose to roll over the account or disclaim all or a portion of the account to the trust within nine months of the IRA owner's death. ■



Julius H. Giarmarco, JD, LL.M, is chair of the Trusts and Estates Practice Group at Giarmarco, Mullins & Horton, PC. He has lectured before ALI-ABA, the State Bar of Michigan, the Ohio Bar Association, and the AICPA. He has published numerous articles on estate planning and authored the chapters on succession planning appearing in Advising Closely Held Businesses in Michigan *and* The Michigan Business Formbook*, published by ICLE.*

ENDNOTE

1. *Clark v Rameker*, ___ US ___; 134 S Ct 2242; 189 L Ed 2d 157 (2014).