

Should Planners Recommend Trusts as IRA Beneficiaries?

by Cal Brown, CFP®, and Thomas Campbell, J.D.

There are numerous challenges to planning the post-mortem distribution of individual retirement accounts (IRAs). Financial planners who recommend naming a trust as beneficiary of a qualified retirement plan (QRP) or IRA are telling clients to cross a minefield. Yet financial planners can protect clients from getting hurt by keeping them on the right path. Competent counsel is extremely valuable in this situation, since errors can be quite costly to the client's family—and to the advisor.

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Trusts have many uses. They can manage property for people who are young or disabled, coordinate the disposition of assets, provide lifetime support of one beneficiary while protecting remaining property for other beneficiaries and implement transfer tax (estate, gift and generation-skipping) planning.

A trust is often valuable to use in an estate plan. We live in an age when defined benefit plans wane while significant assets accumulate in QRPs (qualified retirement plans) and IRAs (individual retirement accounts). What is a family's largest asset? It used to be a house; now it may be a retirement fund. Yet few financial planners fully understand the complexity surrounding the use of a trust as the beneficiary of an IRA. Complicated technical rules, income tax regulations regarding trust distributions affecting IRA distributions, and practical and administrative difficulties often cause a tremendous amount of frustration and confusion. A recent article in the *Journal of Financial Planning*, "Retirement Plan Distributions to Trusts" (Loftsgard [June 2003](#)), touted the advantages of naming trusts as IRA beneficiaries. While we recognize these advantages, there are additional considerations.

To help planners navigate the minefield, this article addresses

- Minimum required distributions (MRD) and designated beneficiaries
- Trust accounting rules
- Administrative issues
- Trust distributions
- Pros and cons of using trusts as IRA beneficiaries
- Various types of trusts

This subject is timely because tax law changes in 2001 and 2002 yielded new rules. They are complex and fluid and the planning considerations are not simple. In many cases, planners and clients will have to prioritize their objectives and realize they can't have it all.

Minimum Required Distributions and Designated Beneficiaries

The worst tax situation that could confront a client is if the entire IRA has to be distributed within five years of the owner's death. When could this happen? If the owner died before the required beginning date (RBD, usually April 1 of the year after the owner reaches age 70-1/2) and the IRA had no designated beneficiary.¹

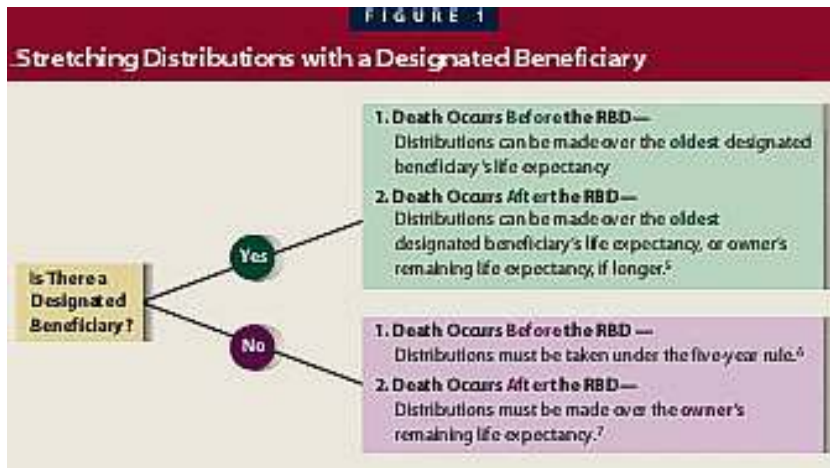
Many QRP's do not allow stretching out the distributions, so it is important to check the plan documents.

For a trust to be eligible to implement life expectancy distributions (stretch IRA), each of the trust beneficiaries must qualify as a designated beneficiary of the IRA. A word of warning: A single nonqualifying beneficiary means there is no designated beneficiary. The Internal Revenue Service (IRS) looks through the trust to determine the beneficiary and the oldest beneficiary determines the life expectancy calculations of MRD.

Who can be a designated beneficiary? One basic requirement is that the designated beneficiary be an individual with a birth date.² Non-individuals cannot qualify as designated beneficiaries of the IRA; thus a charity or "my estate" will not qualify.³ Haven't we all heard of people attempting to leave something to their dogs or cats? If a client wants to leave part of an IRA to a charity (or their pet!), separate it into another IRA account.

If there is a provision in place where the trust allows taxes, expenses or debts to be paid from the IRA benefits, this also could cause problems because these payments would be to a nonqualifying beneficiary.⁴

The possible scenarios are shown in Figure 1. Clearly, a designated beneficiary is the key to stretching out payments.



The five MRD trust rules. Five basic rules must be followed if beneficiaries of a trust are to be considered designated beneficiaries of an IRA and thus eligible for stretching the distributions.⁸ If the trust does not comply with these rules, benefits must be paid more quickly. For in-depth analysis, we recommend the book *Life and Death Planning for Retirement Benefits* by Natalie Choate.⁹ Here are the rules:

1. The trust must be valid under state law
2. The beneficiaries must be identifiable from the trust instrument
3. The trust must be irrevocable or become irrevocable upon the death of the participant
4. Certain documentation must be provided to the plan administrator
5. All beneficiaries of the trust must be individuals

We want to emphasize the fourth rule. When an owner dies and the beneficiary is a trust, the trustee should send a copy of the trust to the applicable plan administrator no later than October 31 of the year following the death of the owner.¹⁰ Old trusts that did not qualify solely due to lack of documentation may remedy this defect by providing a copy of the trust before October 31, 2003.¹¹

The trustee should include a cover letter stating that the trustee is providing a copy of the trust document to the plan administrator and the trust is named as the beneficiary. Neglecting this fine detail could cause the trust to fail the tests and the IRA balance to be distributed more quickly. The advisor should retain a copy of this letter on file. If the owner does not die before required beginning distributions, the trustee should provide a copy of the trust document to the custodian when the owner reaches RBD. This is important if the spouse is the sole beneficiary of the trust and more than ten years younger than the owner, but it also gets the documentation requirement out of the way.¹²

Trust Accounting Rules

Estate or trust accounting income. The rules of estate or trust accounting income (for convenience, referred to simply as trust accounting income) determine who is entitled to receive payments from the estate or trust. Principal is usually defined here as the property received from a transferor or a decedent's estate, although most people think of principal as the original funding of the trust.¹³ Income is defined as the receipt of earnings derived from the principal.¹⁴

Depending on the terms of the trust document or controlling law, the distinction as to what is principal and what is income may be critically important.

Taxable income. Taxable income is a familiar concept to most financial planners, as it is used to determine which receipts are reported as income for income tax purposes and who is to be taxed on that income. Receipts counted as income for one purpose do not necessarily count as income for another purpose, however. For example, when an IRA is forced to pay the MRD to a trust, some of the IRA distribution may be principal for trust accounting purposes, which in turn determines whether the trust or the beneficiary bears the income tax burden. Relevant documents or state law, or a combination of both, govern the decision as to what is trust accounting principal and what is income.

UPIA (Uniform Principal and Income Act). Almost all states have adopted one of the versions of the UPIA.¹⁵ The UPIA was first promulgated in 1931, with revisions in 1962 and 1997. However, not all states have adopted the UPIA, and only about three-fourths of the states that have adopted the UPIA have updated their laws to the most recent version. Therefore, a trust document may have different meanings, depending on which state's laws apply. An advisor should know which version of the UPIA applies in a particular circumstance. If the document does not specify which law applies, the law of the trustee's residence generally will apply.

The following discussion relates, for the most part, to the latest version of the UPIA. The property a decedent owns (or has right in) at the time of the decedent's death generally is trust accounting principal of the decedent's estate. The full value at the date of death of a participant's IRA constitutes trust accounting principal. In other words, if a trust is the named beneficiary of an IRA, the value of the IRA's investments as of the date of death is principal of the trust.

Under UPIA for trust accounting purposes, a minimum required distribution is considered to be 90 percent principal and 10 percent income.¹⁶ Distributions in excess of MRD are considered entirely principal.¹⁷ Furthermore, the principal is considered to be income in respect of a decedent (IRD) for income tax purposes. Thus, the trust bears the income tax if the MRD is not distributed to a beneficiary. The terms of the trust document determine how much of the MRD is to be retained in the trust and how much is to be distributed. Interestingly, 50 percent of an investment advisory fee is allocated to principal and 50 percent to income.

Income taxes. Generally, an irrevocable trust is required to file a separate tax return. However, it is well known that tax brackets for trusts are compressed, resulting in a much higher tax for trusts than for individuals. For

example, pursuant to the Jobs and Growth Tax Relief Reconciliation Act of 2003, the maximum marginal rate of 35 percent begins at taxable income of \$9,350 for a trust; for an individual, it does not apply until taxable income reaches \$311,951.

Required or discretionary trust distributions. An estate or trust that distributes income to a beneficiary is allowed a distribution deduction for the income paid.¹⁸ The recipient beneficiary is, in turn, required to report a corresponding amount of income.¹⁹ In other words, taxation on income can “flow through” the trust. The trust reports the income but takes a deduction for the amount distributed to the beneficiary. The beneficiary reports the same amount as income and pays the income tax on his or her personal return. Thus, if all trust accounting income completely flows through the trust to the beneficiary, the trust will pay no tax on that income, while the beneficiary is taxed at his or her marginal rate.

Income in respect of a decedent (IRD). If a person who is entitled to receive an income payment dies before the payment is made, whoever does receive the payment must include it when reporting gross income.²⁰ The payment is considered IRD. Inheritances are usually not included in taxable income;²¹ IRD is an exception.²²

For example, assume a decedent was entitled to receive retirement benefits (the balance of an IRA). Those benefits would have been taxable income to the decedent if the decedent had lived to receive payments. Thus, the payments are taxable income (IRD) to the IRA beneficiary who receives the payments after the decedent’s death. The decedent owned the right to receive the IRA balance at the time of death and the IRA balance is therefore a part of the decedent’s estate’s principal. The payments to the trust from the IRA are income (IRD) for income tax purposes, but (partially or totally) principal for trust accounting purposes. Confused yet?

Administrative Issues

Care must be taken in re-registering the IRA after the owner dies. A mistake here could inadvertently cause the IRA to be distributed with a corresponding tax liability. We surveyed several brokerage firms, mutual funds and other custodians, and received varying responses as to how the IRA custodian would register the IRA account after the owner died, if the beneficiary happened to be a trust.

An advisor should understand how the account will be registered by the IRA custodian. Be wary of the response you receive: we discovered that many retirement plan representatives employed by brokerage firms and mutual fund companies were quite uninformed as to the appropriate details.

The traditional way (still used by many IRA custodians) is to keep the registration in the name of the deceased, as follows: *IRA—John Doe, Deceased, FBO Jane Doe, Trustee of the Doe Family Trust, dated 1/1/99.*

The tax identification number of the deceased would be kept as part of the account registration. But a custodian can also register the IRA account in the name of the trust, as follows: *Doe Family Trust IRA, Jane Doe, Trustee or Doe Family Trust, IRA-BDA, Jane Doe, Trustee (BDA = Beneficiary Distribution Account).*

The tax identification number of the trust would be part of the account registration as well. We checked with Charles Schwab to make sure a 1099-R would not be issued. Schwab assured us they code the change as a “transfer” and not as a “distribution.” We would caution any advisor to make certain the custodian will process this correctly, using either of these registration methods. Either way, the IRA is considered part of the principal of the trust according to trust accounting rules.

A very costly mistake could be made if the IRA is re-registered improperly. For any IRA to be eligible for “stretch” treatment, it must remain in the name of the deceased or re-registered to the trust. The only other alternative is a

spousal rollover (the IRA would be eligible for stretched distributions when the spouse reached RBD or died). But if the IRA is re-registered in the name of any other beneficiary, it creates a taxable distribution and a 1099-R is issued.

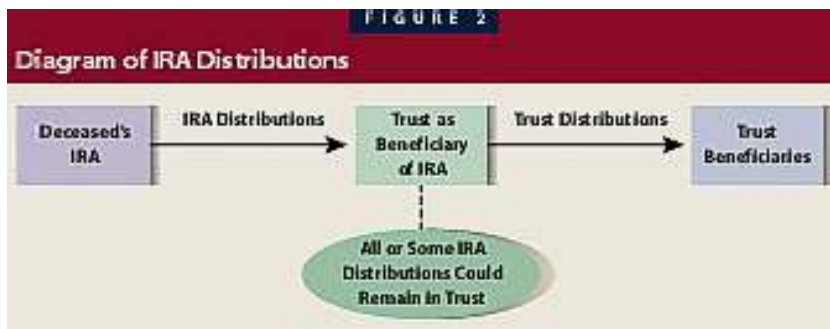
Trust Distributions

It is also important to understand the flow of distributions:

1. Distributions flow from the IRA to the trust (the trustee makes a withdrawal from the IRA). Distributions from the IRA to the trust are governed by the terms of the IRA agreement and MRD rules.²³
2. Distributions then flow from the trust to the beneficiaries of the trust (the trustee makes a payment to a beneficiary).
3. However, some or all of the IRA distribution may remain in the trust in an after-tax account.

These distributions are not necessarily equal and their income tax treatment may vary as well. It is important to be clear as to the technical definition and source of the distribution (IRA or trust). Distributions from the trust to the trust beneficiaries are governed by the language within the trust document.

Thus, it is possible for an IRA distribution to be paid to the trust, but not to the trust beneficiaries. Another possibility is that a portion of the IRA distribution could be paid to some but not all of the trust beneficiaries. It is also possible that the trust will pay some, all, or none of the income taxes due as a result of the IRA distributions. More potential confusion with all of these possibilities! Figure 2 is a diagram of distributions.



Trust Pros and Cons

Before we look at particular types of trusts, here is a general list of the advantages and disadvantages of naming trusts as IRA beneficiaries. These pros and cons hold true for most trusts. First, the advantages:

- **Control of the timing and amount of distributions to trust beneficiaries.** If one or more of the beneficiaries is too young, incapacitated, irresponsible, or beset with legal or debt problems, a trust can be very helpful in preventing dissipation of the money.
- **Plans for various “what-if” scenarios.** An IRA beneficiary form generally provides only for primary beneficiaries and contingent beneficiaries (the contingent beneficiary is considered only if the primary beneficiary is deceased at the time of the IRA owner’s death). On the other hand, trusts can contemplate many different “what-if” scenarios. For example, a client can consider, “What if one of my children dies and I want her share to go to her children, not to my other children?” or “What if all of my children are deceased and I want the money to go to my parents?” A trust can remain viable for many years, enabling the funds to be passed on to family members or non-family individuals in a carefully designed plan.
- **Astute management by trustee.** A trust can take the management responsibility away from the beneficiary and place it in the hands of someone more skilled or level-headed. Next, the disadvantages:

- **The potential for non-individual beneficiaries or contingent beneficiaries causing an accelerated payout.** If a non-individual is one of the trust beneficiaries and death occurs before the RBD, then the stretch IRA simply is not available; the entire IRA must be distributed within five years of the date of death. A typical situation that causes this problem is naming a charity as one of several primary beneficiaries of the trust. Also, if someone is a remote successor beneficiary, that person might be counted as the oldest person.²⁴ Limited post-death actions can help solve this problem (see below).
- **A failure to draft for trust accounting rules can result in income tax problems.** The distributions of trust principal to adult children can become quite complicated from an administrative standpoint. For example, suppose the trust specifies that a child will receive one-third of the trust principal at age 25, one-third of the remainder at age 30 and the balance at age 35. What happens to the IRA that is owned by the trust when the child is entitled to a distribution of his or her share? If the child wants the share, it may have to be redeemed from the IRA and taxes paid.
- **Only the age of the oldest living beneficiary will be used to determine life expectancy.** It is quite common to name parents or an older sibling as one of the beneficiaries of a trust. Federal regulations state the oldest beneficiary's age is used to determine the life expectancy payout calculation.²⁵ Thus, the IRA could be depleted rapidly if an older person is counted as a beneficiary of the trust. The regulations also contain rules concerning which contingent and successor beneficiaries are counted and which are ignored.²⁶ In a similar vein, if two or more children are the only beneficiaries of the trust, only the age of the oldest child will be the determinant of life expectancy distributions.

How does one get around this disadvantage? If, instead of a trust, the children were simply named equal beneficiaries of the IRA directly, the account could be split into separate shares and each child could use their own life expectancy to calculate their separate distributions.²⁷

Current federal regulations allow an IRA to be divided into separate accounts, having only the beneficiaries of each separate account counted for the purposes of the distribution rules. The final regulations also state this is not available to beneficiaries of a trust with respect to the trust's interest in the IRA.²⁸ The trustee of a trust with multiple beneficiaries that is the named beneficiary of an IRA may not create sub-accounts post mortem to satisfy this separate account rule. Therefore, it is important to have the IRA designation refer to separate trusts if the main trust is to divide at the owner's death (for example, "To the Trustees of the separate trusts set forth in the Agreement of the John Doe Trust, in the proportions stated therein"). As a less satisfactory fall-back, the advisor should make sure separate trusts are created and IRA accounts are separated by the trustee by September 30 of the year following the year of the owner's death (and argue that as of the beneficiary determination date each trust does not have more than one beneficiary).²⁹

Various Types of Trusts

Let's look at the planning considerations for each of the typical trust documents used by most clients.

Testamentary trusts. A testamentary trust is created by the terms of a person's last will and testament. Since the will does not take legal effect until the testator dies and the will is probated, the trustee will not own property during the testator's lifetime. State law, in conjunction with the will, determines whether and to what extent the inventory, accounting, bonding and other probate oversights will apply on an ongoing basis, sometimes many years after the testator's death.

The testamentary trust cannot be used to provide management in the event of disability or incompetence during the testator's lifetime.

The real danger here is naming "my estate" as the IRA beneficiary, assuming it goes into the testamentary trust. Doing this means the IRA will not qualify for the desired stretched payments because "my estate" is a non-

individual beneficiary.³⁰

An advisor should make certain the trustee of the testamentary trust is named as the beneficiary of the IRA (for example, "Charles Doe, Trustee of the Trust established under my Last Will and Testament dated 1/1/1999"). If this is done, the trust rules discussed above would apply and stretching out is possible.

Living trusts. These trusts are created by a document other than the decedent's will during the decedent's lifetime. In most states, a living trust can be used to avoid probate. This results in the maintenance of privacy, the possible avoidance of court and probate costs, and also the management of assets in the event of incapacity during the person's lifetime. But if the person becomes incapacitated, an IRA cannot be managed by the trustee of a living trust during the owner's lifetime unless the trustee holds a durable power of attorney.

- **MRD:** To qualify for stretched payments after the IRA owner's death, a living trust must have a designated beneficiary.
- **Income taxes:** When there is no surviving spouse, trusts may be created for protection of young beneficiaries, among other reasons. The trustee may be given the power to pay or withhold income or principal during the term of the trust. This will determine how much of the income tax burden is borne by the trust and how much by the beneficiaries.

Credit shelter (bypass) trusts. For couples whose net worth exceeds the estate tax exemption, it is typical to have an estate plan use a credit shelter (bypass) trust. The optimum plan is for assets, in an amount approximating the applicable exclusion, to be set aside in a credit shelter trust, which is included in the estate of the first spouse to die. The balance of the property passes to the surviving spouse, either outright or in a marital trust. It is common for the trustee to be given the discretion to distribute income or principal of the credit shelter trust to the surviving spouse. Sometimes income is required to be distributed to the spouse, with only principal subject to the discretion of the trustee.

It is preferable to use non-retirement assets to fund the credit shelter trust because the trustee will not have to deal with the problems of trust accounting rules for MRDs. Also, the amount in the bypass trust would be reduced by the payment of income taxes on the IRA distributions. Because in many cases non-IRA assets are not sufficient to fully fund the credit shelter trust, retirement plan assets may be the only choice. Nevertheless, if a large IRA is the only asset available for funding the credit shelter trust, the trust should probably be the contingent beneficiary of the IRA, and the clients should be made aware of the tax consequences if the surviving spouse does not disclaim the IRA into the trust.

In these cases, one of the first practical problems involves the division of estate assets. Suppose there is only one large IRA that can be used to fund the credit shelter trust. Upon the decedent's death, the trustee is required to divide the IRA into the credit shelter share and the marital share. If the trustee withdraws the required amounts from the IRA and places the funds in the credit shelter trust, income tax will be due on the withdrawn amounts and the further benefit of the tax-deferred build-up inside the IRA will be lost.

The trustee should work with the IRA custodian to establish separate "deceased IRA" (traditional way) or "trust IRA" (new way) accounts for the benefit of each separate trust. This is the only practical solution because the trustee will have to administer separate trusts with separate tax identification numbers. The custodian will also need to know under which tax identification number the distributions are to be reported.

If disclaimers are used to create shares, the surviving spouse may have to disclaim twice. He or she would first disclaim the IRA as IRA beneficiary. Assuming the trust is the contingent beneficiary and the spouse is the trustee, the spouse would next disclaim the IRA from the marital trust into the credit shelter trust.

- **MRD:** If all trust beneficiaries are individuals, the MRD will be determined by the age of the oldest beneficiary.
- **Income taxes:** The terms of the trust and the decisions of the trustee will determine the income tax consequences. If all income must be paid out, the trust accounting rules will determine the receipts included in income and, therefore, required to be paid out. Trust accounting rules will determine the taxable income of the trust and the beneficiary.

For example, suppose the trust requires all income to be paid to the beneficiary and the trustee has discretion whether to pay out principal. The trust is the beneficiary of an IRA and the IRA owner has died. The MRD is \$10,000 and is withdrawn by the trustee. There are no other receipts for the trust in the year.

Under UPIA, the trustee has \$1,000 of income (10 percent of the MRD) and \$9,000 of principal (90 percent of the MRD). The trustee has \$10,000 of taxable income. If the trustee makes only the required income distribution (\$1,000), the trust will have a distribution deduction of \$1,000 and net taxable income of \$9,000, taxed at the trust rate. The beneficiary has taxable income of \$1,000, taxed at his or her marginal rate.

To avoid the high trust income tax rates, the trustee would have to exercise the discretionary right to distribute principal and distribute the other \$9,000 of the MRD to the beneficiary. Then the trust would have no net taxable income (\$10,000 income less \$10,000 distribution deduction) and the beneficiary would have \$10,000 in taxable income.

This illustrates the basic dilemma of the credit shelter trust as an IRA beneficiary. To avoid the high trust income tax rates, the MRD must be passed through to the beneficiary. If the MRD is paid to the beneficiary, the protection of the trust (management of assets or estate tax protection) is lost. If the beneficiary of the trust is the surviving spouse and the surviving spouse lives to normal life expectancy, all of the IRA will be paid out during the spouse's lifetime. This defeats the purpose of preserving those assets in the credit shelter trust. This is also the difficulty in using conduit trusts, which many financial planners recommend as a separate trust only for the IRA.

The other alternative is to distribute only the trust accounting income (ten percent of the MRD) and retain the balance in the credit shelter trust to avoid estate taxes on the trust assets in the surviving spouse's estate. But the trustee will have to pay income taxes at the trust rate on all retained assets, which also frustrates the estate plan, since taxes paid will deplete the amount remaining in the credit shelter trust. In this case, neither alternative is satisfactory: the advisor and client must prioritize the competing objectives.

QTIP trusts. This is one type of trust used to defer or avoid estate taxes until the death of the surviving spouse (through the estate tax marital deduction) while gaining some sought-after benefits of trust ownership, such as protecting first-marriage children. For estate tax purposes, the QTIP election qualifies the trust for the marital deduction, while requiring the trust assets at the death of the surviving spouse to be included in the surviving spouse's estate.³¹ To qualify for the marital deduction, there must be no beneficiary other than the spouse during the surviving spouse's lifetime.³²

The IRS position is that when a trust is the IRA beneficiary, both the trust itself and the IRA must qualify.³³ This means the surviving spouse must currently receive all the income from the IRA. The trust document must require the trustee to withdraw all of the accounting income (interest, dividends and short-term capital gains) earned in the IRA, *even if the accounting income of the IRA is greater than the MRD in a year.*

- **MRD:** The spouse's age is used to determine the MRD. If the owner dies before RBD, the MRD beginning date cannot be delayed unless the spouse is treated as the sole beneficiary. This can be satisfied by requiring all IRA distributions to be paid to the spouse currently (a "conduit").³⁴

- **Income taxes:** The “pay all income” requirement and the IRS position mean that the greater of either all the accounting income of the IRA or the MRD must be distributed to the trust. The trustee must then pay all of the accounting income of both the IRA and the trust to the spouse. The trust gets a distribution deduction for the amount required to be paid to the spouse and the spouse pays income tax on that amount.

Naming the QTIP trust as the IRA beneficiary gives the protection that the trust intends, but at a high price. The dilemma of the credit shelter trust is also the dilemma of the QTIP Trust. Taxable income that is retained in the trust is taxed at high rates, but amounts paid out lose the benefits of the trust.

The QTIP presents further difficulties. First, accounting income is required to be paid out, thereby removing the option to maintain the trust protection on distributed income. Second, the beginning of the distributions cannot be delayed, as they could be if the spouse were the outright beneficiary. Third, the MRD is calculated using the spouse’s single life expectancy. This is a faster payout than if the spouse were the direct beneficiary—the spouse could roll the IRA over and use the Uniform Table (joint life) MRD calculation during the spouse’s life, then a new beneficiary’s life expectancy after the spouse’s death (named by the spouse).

Finally, the children may not get anything remaining in the IRA account if the spouse lives a long time. Why? Because the MRD is paid out over the spouse’s single life expectancy. In a conduit situation where the spouse lives to life expectancy, all of the IRA will be paid out to the spouse and nothing will be left for the kids.

One possible solution to protect the children is to set up two IRAs during the owner’s lifetime—one naming the spouse as beneficiary and one for the kids—and not use a trust at all. The problem here is there may not be enough to support the spouse.

Conclusions

The use of a trust as an IRA beneficiary should generally be avoided, due to the complexity of trust accounting rules, administrative hassles and taxation.

However, the use of a trust as an IRA beneficiary is indicated in the following situations:

1. When minor children are involved
2. When a subsequent marriage exists and the owner has children from a prior marriage
3. When adult children are financially irresponsible, immature, disabled, or if they have legal or debt problems, or any other control or distribution timing issue
4. When there are no children
5. When the size of the IRA is so large that ongoing professional advice is warranted, as well as a need to contemplate various “what-if” scenarios

The bottom line is that clients can’t have it all; they have to give up something. The trade-offs are between (a) control, (b) estate taxes and (c) stretching out the IRA distributions. As we said, naming a trust as the beneficiary of an IRA or QRP is like entering a minefield: a wrong step could spell disaster. Take another route if one is available. If the client absolutely has to cross this minefield, plan each step carefully! All of the above discussion leads us to the inescapable question: Why use a trust as beneficiary of an IRA? Sometimes it is the best option for a certain scenario, but we believe no advisor should name a trust as beneficiary of an IRA or QRP without a clearly compelling reason.

Endnotes

1. Treasury Regulation Section (Reg.) 1.401(a)(9)-2, A-2; Reg. 1.408-8, A-3.
2. Reg. 1.401(a)(9)-4, A-1.
3. Reg. 1.401(a)(9)-4, A-3. It is possible to “clean up” problems by satisfying the share of nonqualifying beneficiaries by September 30 of the year following the year of the owner’s death. Reg. 1.401(a)(9)-4, A-4 (a).
4. Private Letter Ruling 9809059.
5. Before RBD: Reg. 1.401(a)(9)-3, A-4(a)(1). After RBD: Reg. 1.401(a)(9)-5, A-5(a)(1).
6. Reg. 1.401(a)(9)-3, A-4(a)(2).
7. Reg. 1.401(a)(9)-5, A-5(a)(2), A-5(c)(3).
8. Reg. 1.401(a)(9)-4, A-5(b).
9. Ataxplan Publications, Boston, MA 4th Ed. (2002) (herein “Choate”).
10. Reg. 1.401(a)(9)-4, A-6(b).
11. Reg. 1.401(a)(9)-1, A-2(c).
12. If the spouse is the sole beneficiary of the trust and the documentation has been provided, the longer joint life expectancy period can be used for lifetime MRD. Reg. 1.401(a)(9)-4, A-6(a); Reg. 1.401(a)(9)-5, A-4(b) (1).
13. Uniform Principal and Income Act (1997), Section 102(10), 404(1).
14. UPIA (1997), Section 102.(4).
15. See legislative Fact Sheet for UPIA at www.nccusl.org/uniformactfactsheets/uniformacts-fs-upia.asp.
16. UPIA (1997), Section 409(c).
17. UPIA (1997), Section 409(c).
18. If the income is required by the document to be paid out, the distribution deduction and income inclusion is also required. IRC Section 651(a), 661(a)(1).
19. IRC Section 652(a)(1).
20. IRC Section 691(a).
21. IRC Section 102(b).
22. IRC Section 102(b).
23. These are set forth in the regulation under Section 401(a)(9) of the Internal Revenue Code, which was finalized April 17, 2002.
24. Reg. 1.401(a)(9)-5, A-7(c)(1). The rule is that if the successor beneficiary’s only interest is the right to receive benefits upon the prior beneficiary’s death, the successor beneficiary is not counted. In PLR 200228025, the IRS interpreted this exception very narrowly under the proposed regulations (successor beneficiaries would almost never be disregarded). Despite the IRS’ intent to clarify this point in the final regulations, the scope of this exception is still not clear.
25. Reg. 1.401(a)(9)-5, A-7(a)(1).
26. Reg. 1.401(a)(9)-5, A-7(b) and (c).
27. Reg. 1.401(a)(9)-8, A-2(a)(2).
28. Reg. 1.401(a)(9)-4, A-5(c).
29. Reg. 1.401(a)(9)-8, A-2(a)(2).
30. Reg. 1.401(a)(9)-4, A-3.
31. IRC Section 2044(b)(1)(A).
32. IRC Section 3056(b)(7)(B)(ii).
33. Rev. Rul. 89-89, 1989-2 CB 231 (1989).
34. Reg. 1.401(a)(9)-5, A-7(c)(3)

Sidebar: Example 2. The Short Rule Book

1. **MRD and designated beneficiary.** If a trust is the beneficiary, IRA distributions can be stretched (life expectancy distributions) if certain rules are followed. If not followed, the IRA must be distributed over a much shorter time. The most important rule is to make certain all trust beneficiaries qualify as designated beneficiaries of the IRA. Mistakes in this area include naming a charity or the estate as a beneficiary.

Also, if one of the beneficiaries is much older, the required withdrawals will be more rapid than desired.

2. **Trust accounting rules.** Trust accounting income may be different from taxable income. An advisor should be aware of UPIA (the Uniform Principal and Income Act) and whether it applies to a particular client. If it does apply, 90 percent of the MRD is principal and only 10 percent is income. This could result in higher taxes and lower trust distributions than desired.
3. **Administrative issues.** Upon the death of the IRA owner, the account will be re-registered if a trust is the beneficiary. It will either be registered in the name of the trust (new way) or in the name of the deceased (traditional way). Mistakes could trigger taxation. Also, depending on mandated trust distributions, separate trust accounts for different trust beneficiaries may be required.
4. **Trust distributions.** Distributions from the IRA and distributions from the trust may differ significantly, both in amount and in tax treatment.
5. **Various trusts.** Different types of trusts have unique pros and cons of which financial planners should be aware. Estate tax benefits can be lost if the surviving spouse lives to life expectancy, causing the entire IRA to be distributed out of the credit shelter trust. QTIP (qualified terminal interest property) trusts are particularly troublesome.