Trust as IRA beneficiary

Naming the beneficiary to your IRA is an important step toward meeting your legacy goals. Unfortunately, many investors take little notice of this step in their financial planning. Consequently, they create situations that do not maximize the benefits their IRA savings might offer these beneficiaries.

Some investors have created trusts and feel they are the answer to all their estate planning concerns, including who to name as their IRA beneficiary. However, the trust is often named as the IRA beneficiary when there are no exceptional circumstances to do so. While there are certainly reasons, such as a special needs beneficiary, when it would be appropriate, in most instances a trust is a poor IRA beneficiary. In fact, the bias is in favor of leaving the assets outright to named individuals. That's because naming individuals as beneficiaries of retirement assets, as opposed to an entity such as a trust, offers greater flexibility in taking advantage of stretch IRA strategy.[1] Stretching an IRA simply refers to the ability for the beneficiary to just take required minimum distributions (RMDs) from both Inherited Traditional and Inherited Roth IRAs.

Qualified "look-through" trust requirements

The trust must meet the following requirements in order for it to qualify as a designated beneficiary and allow the life of the oldest trust beneficiary to be used in calculating post-death RMDs.

A trust is considered a qualified "look-through" trust if the following requirements are met:

- The trust is a valid trust under state law.
- The trust is irrevocable or will, by its terms, become irrevocable upon the IRA holder's death.
- The beneficiaries of the trust are identifiable from the trust instrument.
- Certain documentation has been provided to the IRA trustee, custodian, or issuer.

Once these rules are satisfied, the IRA custodian, under direction of the Trustee, can usually make the payments to the trust for distribution to the individual beneficiaries. If the trust fails to qualify as a designated beneficiary, the IRA will either be paid out under the five-year rule if the IRA owner dies before his or her required beginning date (RBD), generally April 1 after the year they turned age 70½, or over the remaining single-life expectancy (term-certain) of the IRA owner if the IRA owner dies after his or her RBD.

Distribution options

A brief overview of distribution options is below:

- **Lump-sum** — Distributing the entire account will create a taxable event for that tax year for the trust. It will also end the tax-deferral available in the IRA. Since the trust tax rates are higher than individual rates, more tax may be paid than if distributions were taken, by an individual, over a longer period of time.
- **Disclaim** — In some instances a trust may be able to disclaim (refuse) IRA assets within nine (9) months after the IRA owner's death.
- **Open an Inherited IRA** — An Inherited IRA allows beneficiaries a way to keep the funds growing tax-advantaged in an IRA while taking distributions. The account titling will always refer to the deceased IRA owner with the trust listed as the beneficiary. Since a trust isn't the owner, contributions may not be made and a 60-day rollover cannot be executed into this account. The benefit of this arrangement is that a trust has the option to distribute the funds over a longer period of time and is taxed only on that amount. The distribution options are:
  - **Life expectancy** — This option is available for both Inherited Roth IRAs and Inherited Traditional IRAs and is often referred to as the stretch IRA strategy. The trust will have to take annual RMDs over a single-life expectancy on a term-certain basis. Term-certain means that instead of using a new divisor from the single-life table each year one is subtracted from the original divisor in each subsequent year. RMDs will begin the year following the death of the IRA owner.
    - – If the trust is a qualified "look-through" trust, then the distributions are based on the oldest trust beneficiary's single-life expectancy (term-certain). This can result in loss of tax-deferred compounding of potential earnings for younger beneficiaries of the trust as they will not be able to use their longer life expectancies.
    - – If the trust is not a qualified "look-through" trust, then the distributions are based on the deceased IRA owner's single-life expectancy (term-certain).

- **Five-year rule —** This option is available for Inherited Traditional IRAs if the Traditional IRA owner died before meeting their RBD. This option is available for Inherited Roth IRAs because Roth IRA owners are considered to have died before their RBD. With this option, the entire balance must be distributed no later than five years from the end of the year in which the IRA owner died. This can help the trust avoid having to pay taxes on the entire amount in the first year, but requires larger distributions over a shorter time.

The following table summarizes the options if a trust inherits the funds and the IRA owner has passed away either before or after their RBD. Remember, the trust will need to take distributions whether a Roth or a Traditional IRA was inherited.

Trust beneficiary distribution options

	Lump-sum distribution	Disclaim	Life expectancy	Five-year rule
Qualified "Look-through" trust beneficiary – owner dies *before* RBD	X	*	X	X
Qualified "Look-through" trust beneficiary – owner dies *on or after* RBD	X	*	X	
Non-qualified trust beneficiary – owner dies *before* RBD	X	*		X
Non-qualified trust beneficiary – owner dies *on or after* RBD	X	*	X**	

*In some instances for a trust beneficiary.

**RMDs based on owner's age in year of death.

Key considerations

There are a few things to consider when naming a trust as an IRA beneficiary.

- The IRS has indicated that a trust that allows for the payment of debts and/or administration expenses of the estate may not be a qualified "look-through" trust. If those estate debts and expenses are paid off from the time of the death of the IRA owner up to September 30 of the year following death, the trust may be a qualified "look-through" trust.
- IRA owners may want to have the trust document examined to see if it would be a qualified "look-through" trust if they have already named their trust as beneficiary. If not, IRA owners may want to amend the trust or create a new one. IRA owners may want to seek tax or legal advice to determine what course of action is best suited to their individual needs since there are various options available for the trust document to avoid this pitfall.
- The many rules regarding using a trust as a beneficiary make this a cumbersome process. For instance, the use of a younger beneficiary's longer life expectancy for calculating RMDs can be negated in a trust that includes beneficiaries who are much older. Also, a trustee cannot disclaim unless state law authorizes and the beneficiaries consent to such a disclaimer.
- There may be family estate planning issues where it is appropriate that there be limitations for the beneficiaries for reasons such as age, health or mental health issues, or spend-thrift concerns. However, the use of multiple IRAs may be something to consider. A prudent strategy you could implement is to have one IRA at our firm with individual beneficiaries named, and a second IRA naming a trust as a beneficiary for the special needs heir. An IRA owner should seek tax and/or legal advice during the estate planning process.

Managing for taxes

When a trust becomes an IRA beneficiary, taxation is an issue that needs to be discussed with your tax advisor. Trusts are subject to a separate tax-rate schedule that applies only to trusts and estates, for income that is not paid out to the trust's beneficiaries. This can happen in certain complex trusts or in any cases where not all of the income received by the trust is paid out to beneficiaries in the current year. These trust income tax brackets on any undistributed income rise rapidly, reaching the highest tax rate of 39.6% for taxable income over $12,300. By contrast, when an individual is named IRA beneficiary, the top income-tax bracket of 39.6% applies only to taxable income over $464,850 for joint filers or $413,200 for single filers.

Naming individuals hypothetical example

Let's look at a hypothetical example to help illustrate this point. Jim Williams named his wife, Sybil, as his primary beneficiary and his two children, Olivia and Jeff, as his contingent beneficiaries. Jim dies at age 69 and Sybil, age 66, rolls Jim's IRA to her own. She begins taking RMDs in the year she turns 70½, using the Uniform Table to determine her life expectancy factor. Going forward she will continue taking annual RMDs based on the Uniform Table with recalculation.

Upon Sybil's death 5 years later, Olivia and Jeff will each establish their own Inherited IRAs. They will take annual RMDs based on their Single Life Table divisor on a term-certain basis. Olivia's divisor at age 48 will be 36.0 and Jeff's divisor at age 46 will be 37.9. Both Olivia and Jeff can stretch the Inherited IRAs for more than 30 years by taking RMDs. By only taking RMDs, the rest of the IRA assets can continue tax-deferred compounding of potential earnings. Of course, either could take more than the RMD if they wanted or needed to.

Naming a trust hypothetical example

If this same family had been faced with Jim naming a trust as beneficiary for this IRA, the scenario could change considerably. Here's how. Jim has named his family trust as his IRA beneficiary. The beneficiaries of the trust will include Sybil, Olivia, and Jeff. Under the same circumstances as listed above, upon Jim's death, an Inherited IRA for the Trust will be established. Since the trust and not the spouse was named as the IRA beneficiary RMDs will begin the year after Jim's death based on the age of the oldest trust beneficiary Sybil, who will be 67. The Single Life Table divisor for someone age 67 is 19.4 years. Which means in less than 20 years this Inherited IRA will be emptied.

As you can see in this scenario Sybil was not able to treat the IRA as her own delaying RMDs until she was age 70½. Olivia and Jeff were not able to use their own longer life expectancies allowing for many additional years of tax-advantage potential growth. The naming of the trust may likely negatively impact the resulting financial benefit for this family.

Talk to us

We suggest that IRA investors become educated on the various beneficiary-planning methods that are now available to determine whether a trust is necessary to meet their legacy goals. We welcome the opportunity to work with you and your tax and legal advisors to help create an IRA strategy designed to help you achieve your desired result.

With you every step of the way

Everyone has a different vision of retirement that requires a unique financial strategy. We can support you in your retirement planning process by providing the guidance needed to make better, informed choices. We will meet with you and help create a comprehensive plan that takes into account your complete financial picture. Your financial professional will be with you every step of the way to monitor your progress and adapt your plan as needed. Working together, we'll design and implement a retirement plan that will help you live out your unique vision of retirement.

[1] Stretch IRA strategies are designed for investors who will not need the money in the account for their own retirement. There is no guarantee that there will be assets remaining in the account at the time of the IRA owner's death.

INVESTMENTS AND INSURANCE PRODUCTS:

NOT FDIC INSURED	NO BANK GUARANTEE	MAY LOSE VALUE

Please Note: This material has been prepared for informational purposes only and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. Trust services available through banking and trust affiliates in addition to non-affiliated companies of Wells Fargo Advisors. Any estate plan should be reviewed by an attorney who specializes in estate planning and is licensed to practice law in your state. The accuracy and completeness of this information is not guaranteed and is subject to change. It is based on current tax information and legislation as of January 2015. Since each investor's situation is unique, you need to review your specific investment objectives, risk tolerance and liquidity needs with your financial professional(s) before a suitable investment strategy can be selected. Also, since our firm does not provide tax or legal advice, investors need to consult with their own tax and legal advisors before taking any action that may have tax or legal consequences.

Account(s) carried by First Clearing. First Clearing is a trade name used by Wells Fargo Clearing Services, LLC, Member SIPC.

© 2016 Wells Fargo Clearing Services, LLC 0115 ECG-3458601

CAR extension through March 2017