Naming a Trust as the Beneficiary of an IRA

Even the best estate planners can be tripped up when it comes to leaving an IRA to a trust

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My wife and I are 65, and we are doing some estate planning. We have a family revocable living trust and have transferred the title of our jointly owned assets into the trust. However, we’re not quite sure who we should name as beneficiary of our IRA accounts. Should we name each other as primary beneficiary and our two children as contingent beneficiaries? Should we name each other as primary beneficiary and the trust as contingent beneficiary? Or should we name the trust as primary beneficiary? Would you please provide some guidance and let us know of any issues we should be aware of in making this decision? This is all very confusing!

This is a copy of a recent email I received from a client. It is a very common question and an important decision that shouldn’t be overlooked. The consequences of an incorrect IRA beneficiary designation can have severe implications on your estate planning, especially when trusts are involved.

The objective of the beneficiary designation for most people is to ensure that the assets in the IRA can be “stretched” over the life expectancy of the beneficiaries. This ensures that taxes are deferred as long as possible and the assets are preserved for the benefit of the beneficiaries. For typical family situations, making your spouse the primary beneficiary and your children as contingent beneficiaries is the recommended structure. However, there are times when you may have good reason to prevent beneficiaries from receiving payments directly – such as if the beneficiaries are minor children, have special needs, are spendthrifts or are involved in a difficult marital situation, to name a few. Second marriages may also cause problems for the typical recommended beneficiary designation, especially in cases where the spouse doesn’t get along with the children (remember, the spouse will have the ability to change beneficiaries).

Naming a trust as the beneficiary of the IRA may seem like the most practical and logical alternative. A trust will allow you to control the distribution of the assets and ensure the IRA meets your “stretch” objectives. However, naming a trust as an IRA beneficiary raises a number of potential traps for the unaware and should be taken with great care. Let’s look at a few of these traps in more detail below.

Only individuals may be considered “designated beneficiaries” by the IRS for purposes of taking advantage of the stretch IRA provisions. A person who is not an individual, such as an estate or a charitable organization, may not be a designated beneficiary. If a person other than an individual is named as a beneficiary of the trust, then the IRA is treated as having no designated beneficiary. The IRA would be considered to have no named beneficiary, and thus the entire IRA would be required to be distributed within five years of the date of death of the IRA owner (if the owner had not yet reached the age of 70½) or over the remaining life expectancy of the IRA owner (if the owner had reached the age of 70½). Therefore, a trust named as beneficiary of an IRA should never provide for a charity as well as the children – for example, 45% each to your two children Susie and Billy and 10% to your alma mater.

Another trap involves the requirement that the trust be considered a conduit trust in order to take advantage of the stretch IRA provisions. In order to be considered a conduit trust, the trust should mandate that amounts distributed from the IRA as required minimum distributions be distributed and paid out by the trust to the trust beneficiaries. If this trust provision is not included, the trust is assumed to be able to accumulate the IRA distributions instead of paying them out. This can cause numerous issues. The IRS will count all potential beneficiaries of the trust as beneficiaries of the IRA for purposes of determining the life expectancy to use when calculating IRA distributions. The IRS may have to look far down the line of trust beneficiaries. If an individual in the line of trust beneficiaries is much older than the others, it may cause distributions to be taken out over that person’s shorter life expectancy. As an example, let’s say a trust names two children, ages 13 and 15, as 50% beneficiaries. The trust will hold the assets for the benefit of the children until they reach the age of 30, at which point they will receive the full distribution of
their trust share. If the children are not living, the trust assets pass to Uncle Joe, who is 67 years old. In this case, the IRS would pass by the children and use Uncle Joe’s age of 67 to determine the appropriate IRA distribution.

Trusts are often written to provide flexible provisions of how trust assets may be distributed. In the case of a trust that has the ability to accumulate IRA distributions (i.e., no conduit trust provisions), this could become a problem. If one of the trust provisions allows for charitable giving, even if no specific charities are listed, these charities would most likely be considered by the IRS as contingent beneficiaries of the IRA. Since charities are not individuals, the IRA would be treated as having no designated beneficiary, and distributions would need to be taken within five years of death or the life expectancy of the IRA owner, as described earlier.

In conclusion, it may be permissible, and necessary, to name a trust as the beneficiary of an IRA account. However, great care should be taken in making this decision. Never assume it is OK to name the trust as your IRA beneficiary without first reviewing the decision with your attorney and discussing it with your financial advisor.

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