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Designated Beneficiary Trust for IRAs

One of the most significant challenges in estate planning is the nomination of beneficiaries for Individual Retirement Accounts (IRAs) upon the death of the owner, due primarily to the income tax implications of the person or entity selected. In a typical case, a retiree who moves his or her 401(k) or pension plan to a roll-over IRA transfers a lifetime of tax-deferred savings – oftentimes more than half of one's total estate. Thus, whether there is an estate tax liability or not, the income tax liability which would result from a lump sum distribution of the entire account to a non-spouse beneficiary (payable at maximum individual rates) requires that careful planning be considered and implemented.

A brief sampling of three typical beneficiary designation scenarios is instructive:

* **Your Spouse**. When a spouse is named as beneficiary, then that survivor may "roll over" the IRA into his or her own IRA account, continuing to defer income tax liability until withdrawals are made for the required minimum distributions.

* **Your Child**. Where individual children are named as beneficiaries, statistics show that the majority of beneficiaries redeem the entire IRA, spend it down quickly and, without adequate withholdings, suffer the income tax liability in the following year. Before the changes to the Internal Revenue Code, if the owner tried to avoid this harsh result by naming a trust as the IRA beneficiary, the distribution to trust was treated as a lump sum withdrawal. The taxes - equal to around 40% of the entire IRA account – had to be paid within five years of the withdrawal. Thus, one was forced to choose between the diminution of their retirement plan assets through financial folly or total taxation.

* **Your Favorite Charity**. Some IRA owners prefer to name a church, charity, college or other tax-exempt entity as the designated beneficiary of their IRA, thus avoiding estate taxation and income taxation to the beneficiary upon payout. Of Course, this means that IRA does not pass with the rest of the estate to the children. Although many consider their children to be their favorite charities, the little darlings do not enjoy tax-exempt status.

The Designated Beneficiary Debuts

In 2007, the IRS issued final regulations for the calculation of required minimum distributions (RMDs), enabling retirement plan owners to allow for the deferral of required

distributions to beneficiaries over a longer period of time. This technique also defers the income tax liability, a vast improvement over the five-year schedule for these payments. Commonly known as the "stretch" IRA, this tax planning tool facilitates the transfer of an IRA from one generation of beneficiaries to the next, using the continued tax deferral to allow for maximum growth – so long as the child does not check the box labeled, "Lump Sum Distribution," on the claim form before getting some good advice.

Designated Beneficiary Meets Trust

Enter the Designated Beneficiary Trust, a highly effective legal vehicle for transferring wealth to a non-spouse beneficiary by "stretching out" the taxable "required minimum distributions" over the lifetime of the trust beneficiary. This process works because the designated beneficiary of the IRA is the Trustee, who knows to select the "stretch" payout plan for the IRA at the death of the owner and to deposit the income stream to the Designated Beneficiary Trust account for further disbursement. As the IRA payee, the Trustee may also withdraw additional amounts from the IRA for specific needs of the Trust beneficiary. Although the optimal vehicle for this strategy is a stand-alone DBT for each beneficiary, a Family Trust or other similar trust for one's children can qualify for the "stretch" payout treatment if the trust establishes separate shares for each beneficiary, as explored further below.

How It Works

In order for a trust to qualify as a Designated Beneficiary Trust, five requirements set forth in the Treasury Regulations must be met:

1) The trust must be valid under state law;
2) The trust must be irrevocable, or must become irrevocable upon the death of the retirement plan owner;
3) The beneficiaries of the IRA must be identifiable from the trust;
4) The retirement plan account administrator must receive certain required documentation; and
5) All trust beneficiaries must be individuals.

If these requirements are met and the trust receives designated beneficiary status, the trustee can use the life expectancy of the beneficiary to determine his or her future required minimum distributions form the IRA. The effect, again, is to enable the trustee to extend the distribution of the IRA corpus so that it will build on a tax-deferred basis for the heirs of the original owner. Of course, the IRA beneficiary change form requires careful drafting in order to enable the "stretch" payouts to the DBT; in fact, it is such an important element of the plan that we view the beneficiary change form document to be an essential element of the trust. In the case of a combined trust with separate shares for each beneficiary, the trust division formula language must comply with the Regulations in order to stretch the payout of the IRA to each beneficiary. It follows, then, that the designated beneficiary form for an IRA payable to a combined trust also requires special terms to ensure that separate accounts are established for tax-advantaged payouts to each trust share.

Of course, if the trust fails to qualify as a DBT, the trustee must distribute the entire balance of the decedent's IRA in accordance with the five-year rule or the decedent's remaining life expectancy rule, either of which will substantially decrease the income tax deferral and investment growth period. Even though the tax result would be a negative one under these circumstances, the

trust provisions would nonetheless serve the purpose of asset protection for the benefit of a spendthrift child.

As with any strategy of estate and tax planning, clients and counsel must consider carefully the effects of a trust from the other perspectives motivating the plan. Our experience, the Designated Beneficiary Trust provides an excellent solution to multiple issues for many clients who have (i) substantial IRA accounts and (ii) family circumstances calling for management of those assets by a trustee. If one's estate is substantial enough to provide a "reasonable" current inheritance for children beyond the IRA, then the benefits of income tax deferral, investment growth and creditor protection combine to mandate serious considerations of the Designated Beneficiary Trust as a key component of a comprehensive estate plan.

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