

Designated Beneficiary Trusts 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:

1. **One’s Spouse.** When a spouse is named as beneficiary, then that survivor may “roll over” the IRA into his or her name, continuing to defer income tax liability until withdrawals are made for the required minimum distributions.
2. **One’s 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 either financial folly or lump sum taxation.
3. **One’s 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.

Enter the “Stretch”

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,

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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.

The Designated Beneficiary Trust is Born

The Designated Beneficiary Trust (DBT) is a highly effective tax planning 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 authorizes the establishment of separate shares for each beneficiary. Both the DBT and the IRA Beneficiary designation are revocable during the grantor / owner’s lifetime.

The Designated Beneficiary Trust provides an excellent solution to multiple issues for 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 continued income tax deferral, investment growth and creditor protection combine to mandate serious consideration of implementing a Designated Beneficiary Trust as a key component of a comprehensive estate plan.

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