IRA inheritance trust: Understanding the basics

American journalist H.L. Mencken once said, “For every complex problem there is an answer that is clear, simple, and wrong.” This statement could not be more true when naming a trust as a beneficiary of an IRA. When naming a trust as a beneficiary there are some basic rules you must understand, or it may not fulfill what you are trying to accomplish. Let’s look at the basic requirements.

The first step to have a trust beneficiary treated as a designated beneficiary is to have the trust meet the rules to be a “see-through trust.” There are four requirements per Treasury Regulation 1.401(a)(9)-4, Q & A-5:

1. The trust must be a valid trust under state law.
2. The trust must be irrevocable, or by its terms become irrevocable upon the death of the original IRA owner.
3. The trust’s underlying beneficiaries must (all) be identifiable as being eligible to be designated beneficiaries themselves.
4. A copy of “trust documentation” must be provided to the IRA custodian by October 31 of the year following the year of the IRA owner’s death.

If all four requirements are met, a trust beneficiary can qualify to be treated as a designated beneficiary for an IRA. This allows the beneficiary to “stretch” the required minimum distributions (RMDs) over the oldest identifiable trust beneficiary’s life expectancy.

Determining the oldest identifiable trust beneficiary depends on whether the trust is classified as a conduit trust or an accumulation trust. Per Treasury Regulation 1.401(a)(9)-5, Q&A-7, a trust that requires all the required minimum distributions from an IRA to pass through directly and immediately to the income beneficiary (i.e., a conduit trust) need only look to the age of the oldest income beneficiary. One advantage of a conduit trust is that it creates a clear picture of whose life is used to stretch the IRA. Another possible advantage is that the RMD is included in the taxable income of the beneficiary rather than the trust. A disadvantage is that the RMDs are immediately paid to the income beneficiary, who may spend the money or lose it to creditors.

In contrast, any trust that has the discretion to accumulate the RMDs is considered an accumulation trust. With an accumulation trust, it is necessary to continue down the line of trust beneficiaries until the point where a distribution must be made, including most or all possible successor beneficiaries. However, even in an accumulation trust, certain possible successor beneficiaries may be excluded. These are beneficiaries that could become the successor to the interest of one of the trust beneficiaries after that beneficiary’s death, but have no other rights under the trust. Then, the age of the oldest beneficiary among all the beneficiaries that must be included, is used to determine the RMD amount. Some advantages of accumulating the distributions instead of paying them directly are continued asset protection, and avoiding distributions to a beneficiary with substance abuse problems or with spendthrift issues. A possible disadvantage is that the RMD is included in the taxable income of the trust. A complicated issue with this type of trust is identifying whose life is used to calculate the RMDs.

As you can see, leaving an IRA to a trust may or may not accomplish your goals. As with any complex estate planning situation, consulting with the attorney and CPA is always advised. If done properly, an IRA inheritance trust may be one solution that is clear, simple, and correct.

Chuck Ostrom, CPA/PFS
Senior Advanced Markets Consultant
Allianz Life Insurance Company of North America