

# **Using Trusts in Roth IRA Planning**

*Presented by*  
***Kristen M. Lynch, J.D., AEP, CISP, CTFA***  
***Fort Lauderdale***  
***&***  
***Linda Suzanne Griffin, J.D., LL.M., CPA***  
***Attorney at Law***  
***Clearwater***

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**Kristen M. Lynch & Linda S. Griffin      November 19<sup>th</sup>, 2010**  
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## ***TO ROTH OR NOT TO ROTH . . . THAT IS THE QUESTION***

- Beginning January 1, 2010, the \$100,000 Modified Adjusted Gross Income limit to convert to a Roth IRA is eliminated.
- If you convert in 2010, you have two years in which to pay the income tax on the 2010 conversion . . . 2011 and 2012.
- Benefits of a Roth:
  - No required distributions at age 70 ½ for the account owner or spouse beneficiary;
  - No income tax on contributions to the Roth;
  - Earnings can be withdrawn tax free as well if qualified (5 year rule is met, you are 59½, you are disabled, first time home purchase, death distribution to beneficiary).
- How do you convert?
  - Withdrawal followed by a rollover;
  - Trustee-to-Trustee transfer or direct rollover;
  - Re-designation of account.

### Additional considerations:

- Who are the intended beneficiaries?
  - Are they in a lower tax bracket?
  - Is any money going to charity? Charities pay no income tax as beneficiaries of IRAs.
- Where are the monies coming from to pay the income tax on the conversion?
  - If the IRA owner does not have funds outside the IRA to pay the taxes with, it may take too long to recover the funds spent from the IRA to make it worthwhile.
- This may make great sense for someone with a large charitable carryover, or someone planning to make a large gift to charity with non-IRA assets.

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- This may not make sense for someone on social security if their benefits are not normally taxable.
- This may not make sense for someone who anticipates moving into a lower tax bracket in the future, for example, retirement.
- Timing – ideal timing is when the market is low.

***IRA Rules that apply to Roth IRAs:***

- Underlying definition of a designated beneficiary;
- Required Minimum Distributions for non-spouse beneficiaries;
- Rules pertaining to trust beneficiaries.

***Required Minimum Distributions for Roth IRAs are different:***

- There are no Required Minimum Distributions when the IRA owner attains age 70 ½ or for the surviving spouse beneficiary of the IRA owner upon the death of IRA owner.
- The life expectancy available for continued tax-free growth purposes depends upon several factors:
  - Whether the IRA owner had reached age 70 ½ prior to death;
  - Whether the beneficiary is considered “designated” under the Code;
  - Whether the beneficiary is the spouse of the IRA owner.

***New IRA Distribution Rules: Death before  
“Required Beginning Date”***

**No “Designated Beneficiary”**

- All IRA assets must be distributed by the end of the fifth calendar year following the owner’s death (IRC § 401(a)(9)(B)(ii)).

**Individual Non-Spouse Beneficiary or Qualified Trust**

- The default is now distributions based on individual beneficiary’s life expectancy; however, distributions must begin by the end of the calendar year following the calendar year of the owner’s death (IRC § 401(a)(9)(B)(iii)) or it will be assumed that the five year rule is being used.

**Spouse as Beneficiary**

- Spouse can roll IRA into his or her own name.

***New IRA Distribution Rules: Death after  
“Required Beginning Date”***

**No “Designated Beneficiary”**

- All IRA assets may be distributed over the remaining non-recalculated single life expectancy of the deceased IRA owner (IRC § 401(a)(9)(B)(i)).

**Individual Non-Spouse Beneficiary or Qualified Trust**

- Distributions may be taken out over the life expectancy of each non-

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spouse beneficiary that is considered to have a separate share. Identification of these beneficiaries must be ascertained by September 30<sup>th</sup> of the year after the year of the IRA owner's death but the separate accounts do not have to be established until December 31<sup>st</sup> of the year after the year of the IRA owner's death. (IRC § 401(a)(9) – 4 (A-4)).

### **Spouse as Beneficiary**

- Spouse can roll IRA into his or her own name.

### **Important Dates**

- The deadline for determining the identity of the “designated beneficiaries” of the IRA after the owner dies is September 30<sup>th</sup> in the year after the year of the owner's death.
- The date for establishing separate accounts for the separate shares of the IRA is December 31<sup>st</sup> in the year after the year of the owner's death.

### ***Who can be treated as a “Designated” Beneficiary?***

- Any legal entity can be a valid beneficiary of an IRA for the purpose of receiving the proceeds upon the IRA owner's death, but to be a “designated” beneficiary that meets the IRS requirements for taking death distributions based on individual life expectancy, the beneficiary must be one of the following:
  - any individual
  - any trust that meets the requirements specified by the Internal Revenue Service.
- An IRA owner may name a charity, their estate, or a trust not meeting the Internal Revenue Service requirements but it will not be treated as a “designated” beneficiary for life expectancy purposes.

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## *Spouse as Beneficiary*

- May roll over into his or her name and designate new beneficiaries regardless of their age when they inherit the account. There are no required minimum distributions for spouse beneficiaries.

## *Trust as Beneficiary*

### Why Designate a Trust as the Beneficiary of an IRA?

- The reasons are the same with IRAs and qualified plans as they are with other estate assets:
  - Minor beneficiaries (avoids guardianship);
  - Special need beneficiaries (avoids guardianship and can preserve Medicaid benefits);
  - Spendthrift beneficiaries;
  - Second or multiple marriages;
  - “Significant other” beneficiaries;
  - Beneficiaries with substance abuse problems;
  - Estate tax purposes (to preserve credit shelter or marital deduction).
- IRA owner must provide a list of the trust beneficiaries to the IRA custodian or Trustee has until October 31 of year after IRA owner’s death to provide trust document or list of beneficiaries, although to be practical the trustee or custodian should have the documentation prior to the September 30 determination date.
- Trust must be valid under State law.
- Trust must become irrevocable by its own terms upon the death of the IRA owner.

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- Beneficiaries must be easily identifiable through the trust document.

### ***QTIP Trust as Beneficiary***

- Desirable for second marriage situation;
- Spouse may not rollover;
- Rev. Rul. 89-89 required that for this to qualify for the marital deduction the language had to require that the greater of required minimum distribution or income must be payable to the trust, and that the spouse receive all the income earned annually. Rev. Rul. 2000-2 changes this by approving the marital deduction when the spouse has the right to all the income as opposed to receiving actual distribution of the income. Distributions of RMD must still be made from the IRA to the QTIP if RMD is greater than the income earned. See Uniform Principal and Income Act for trust accounting;
- To the extent funds are paid to the trust from the IRA they will not be taxable, although they will still have to be classified as trust accounting income or principal;
- At the IRA owner's death, distributions will have to begin the year after death and can, at best, be based on the spouse's life expectancy, which is shorter than the children's life expectancy; and
- The shorter deferral period will mean less tax free growth for the spouse during their lifetime than if the IRA were left directly to the spouse (where they would not have to take required minimum distributions, and it will mean less tax free growth available for the children.

### ***Credit Shelter Trust as IRA Beneficiary***

- This may be necessary where the owner does not have other funds available to use

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owner's remaining unified credit;

- It is generally better to use assets other than IRAs to fund a Credit Shelter Trust;
- The best way to use IRA assets for unified credit is to leave directly to children because of the tax free growth (although beware inherited IRA creditor issues);
- If the spouse will need some access to the credit shelter funds, then a credit shelter trust will be the best alternative but:
  - at the IRA owner's death, distributions will have to begin the year after death and can, at best, be based on the spouse's life expectancy, which is shorter than the children's life expectancy; and
  - the shorter deferral period will mean less tax free growth for the spouse during their lifetime than if the IRA were left directly to the spouse, and it will mean less tax free growth available for the children.

*Two suggested ways to fund a Credit Shelter Trust:*

First (better for first marriages):

- Name the IRA owner's spouse as the primary IRA beneficiary;
- Name the IRA owner's revocable trust as the contingent beneficiary;
- Provide in the trust that if the spouse should disclaim the option to take the IRA outright, the retirement assets will be divided by a fractional formula;
- Benefits will then go to the credit shelter to the extent necessary to use up the unified credit (taking into account, of course, current estate tax issues);
- The balance will go to the Marital share, which could then be distributed outright to the spouse for rollover or held in further trust.

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Second:

- Designate marital trust as the primary beneficiary on the retirement assets;
  - Name credit shelter trust as the contingent beneficiary;
  - Put language in the trust document that allows the trustee of the marital trust to disclaim any amount of the IRA necessary to satisfy the available unified credit (or up to a specified dollar amount);
  - Have the trustee disclaim and then the remaining IRA assets would be payable to the credit shelter trust.
- \*\*\* It is always better, if possible, to name the sub-trusts themselves rather than naming the revocable trust so as not to run afoul of the “separate share” rules, for example, “The John Smith Marital Trust created under the John Smith Revocable Trust dated 1/1/03.” However, if the surviving spouse is a beneficiary of the revocable trust and all sub-trusts, the deferral will be limited to the surviving spouse’s life expectancy in either case.

### **Other Considerations in Naming a Trust as Beneficiary**

For treatment as separate shares, two requirements must be met:

1. The interests of the beneficiaries must be expressed as fractional or percentage interests as of the date of death of the IRA owner.
2. Separate accounts must be established by December 31<sup>st</sup> of the year after the IRA owner’s death.

This is important because without separate share treatment, the trust will be limited to using the life expectancy of the oldest beneficiary. If the goal was to pay the IRA to separate sub-trusts, this may be a trap for the unwary.

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The IRS has issued conflicting Private Letter Rulings (PLRs) on the subject. Although PLRs cannot be used as precedent unless your client has the exact same facts and circumstances as the taxpayer in the PLR, it is the closest thing we have to case law in regard to IRS interpretation issues.

PLR 200234074 was issued prior to but in the same month as the final regulations. In this PLR, the IRA was payable to a trust. Trust One was then divided into two subtrusts. Subtrust A was payable to the surviving spouse outright. Subtrust B provided for lifetime income to the surviving spouse, with the remainder paid outright and equally to three children beneficiaries. The trustee of Trust One then split the IRA into four separate inherited IRAs (one for Subtrust A and three for the children. At the time, the IRS ruled that each child could use his or her own life expectancy, as SubTrust B was viewed as a “look-through” trust.

Then came the final regulations:

The next series of PLRs on this issue had a completely different result. PLRs 200317041, 200317043, and 200317044 are eerily similar to PLR 200234074. In all three cases, the IRA was payable to a trust upon the death of the IRA owner. In each case, that trust was payable equally to the owner’s children, with no discretion in regard to the amount of the share each child would receive. In all three cases the IRS denied separate share treatment. The IRS position seems to hinge on a new sentence in the final regulations in Reg. § 1.401(a)(9)-4, A-5(c). The sentence reads, in part “the separate account rules under A-2 of § 1.401(a)(9)-8 are not available to beneficiaries of a trust with respect to the trust’s interest in the employee’s benefit.” In effect, the new position of the IRS is to “look no further than the beneficiary form,” much like the policy has been on estates. If an estate is the beneficiary of an IRA, it is made clear in the final regulations that even if the estate is then distributed out to the ultimate beneficiaries, there is no additional life expectancy gained by doing so. Because the estate is not considered a designated beneficiary, it does not matter who ultimately receives the IRA assets (other than for income tax purposes) because they will be limited to deferral based on the remaining single non-recalculated life expectancy of the IRA owner at the time of their death.

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It is equally clear from the regulations that a trust is considered to be a designated beneficiary if it meets the requirements we have already discussed earlier in this outline. It appears that the IRS' new position is that, as a designated beneficiary, the trust has a life expectancy of its own and that life expectancy is based on the life expectancy of the oldest beneficiary of the trust.

Although this is a troubling interpretation and certainly not what the professional community was lead to believe would be the IRS position in the final regulations, it is not a complete disaster. What this does require is some creative drafting.

- Be sure to designate subtrusts specifically on the beneficiary form. Do not make the IRA payable to the master trust but rather list specific subtrusts and the percentage or fraction that each subtrust will inherit.
- Plan for contingencies. Leave an exit strategy. If the plan is to leave it to a trust with income for life to the surviving spouse and then to children, specify on the beneficiary form "If my spouse survives me, I designate the John Smith Trust as beneficiary of my IRA. If my spouse does not survive me, then I designate my children as beneficiaries of my IRA in equal shares."
- Allow for disclaimers. It is a gift that the IRS has specifically endorsed the use of qualified disclaimers in order to determine designated beneficiaries. Name as many contingencies as possible. That way, it may be possible to fix an outdated beneficiary form post-mortem and still achieve the desired result.
- Beware of the contingent beneficiaries of any trust that you name on the beneficiary designation. PLR 200252097 had a troubling result in that it was possible pursuant to the terms of the trust that someone older than the primary beneficiary of the trust might inherit the IRA proceeds. This being the case, the IRS ruled that the older contingent beneficiary's life expectancy had to be taken into account. To avoid this potential pitfall until the IRS clarifies its position, be sure that the benefits of any subtrust

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named directly as an IRA beneficiary will not revert to someone older than the beneficiary whose life expectancy you want to be able to use.

### *Estate as Beneficiary*

As discussed earlier, estates are not considered designated beneficiaries. Even so, there is good news within the final regulations. Under the new rules, an estate may use the remaining single non-recalculated life expectancy of the IRA owner if the IRA owner died after attaining age 70½. The old rule was that the IRA had to be distributed by December 31<sup>st</sup> of the year after the IRA owner's death. This new rule means that even if some disaster occurs where disclaimers and distributions will not work to fix a bad beneficiary designation (or perhaps no designation at all!), there is still some time for deferral.

Be aware:

- PLR 200013041 concluded that when the trust that was the beneficiary of the IRA terminated, the trust could distribute share of the IRA to the subsequent beneficiaries and there would be no change in the tax status of these accounts. The new accounts were funded as a result of the trustee assigning the interests in the IRA to the subsequent beneficiaries and trustee to trustee transfers being executed. The IRAs were set up in the name of the decedent for benefit of (FBO) the beneficiary. There was no additional deferral or acceleration of tax liability.
- Likewise, PLR 200234019 reflects the same result with regard to estates.
- Be aware that although the IRS will most likely allow these transfers without any tax implications, it is sometimes difficult to find an IRA trustee or custodian who is willing to divide the IRA and allow continued

deferral.

### ***Practical Problems***

Who is going to be responsible for making sure all this happens according to schedule?

The post mortem planning opportunities occur with the ability to disclaim, distribute or divide the assets.

To disclaim, it must be done in compliance with section 2518 and must generally be done within nine months of the decedent's date of death — this is not extended to the September 30<sup>th</sup> beneficiary determination deadline.

To distribute to a beneficiary that is not a “designated” beneficiary and not have it throw off everyone else in the mix, this must be done prior to September 30<sup>th</sup>.

If the accounts are going to be set up in separate accounts, the accounts must be set up by December 31<sup>st</sup> of the year after death but must be determined by the September 30<sup>th</sup> deadline.

### ***Other things to keep in mind:***

- There is a good bit of confusion in the professional community.
- No matter what, the IRA document is a contract and the contract rules.

### ***Some Important Recent PLR's***

- 2006-16039, 2006-16040, 2006-16041 – Series of PLRs for the same taxpayer, where the IRS recognized a court-ordered reformation of a beneficiary designation form.
- 2006-10026 – The IRS approved of individuals named on a beneficiary form as

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designated beneficiaries even though the beneficiary designation form contained survivorship requirements, much as in a trust or a will.