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Trusts as IRA Beneficiaries

Things to Consider Before Naming Your Trust as Beneficiary of Your IRA

Prior to 2020, beneficiaries inheriting IRAs were often able to "stretch" distributions over their life expectancy. Since the passage of the Setting Every Community Up for Retirement Enhancement (Secure) Act, which became effective on January 1, 2020, a dramatic shift has occurred in the IRA distribution rules. Most beneficiaries inheriting IRAs are now required to withdraw the inherited IRA assets within 10 years of the IRA account owner's death. Because trusts are often named as beneficiaries of IRAs, it is worth considering what impact the Secure Act has on this strategy.

What types of trusts can be named as IRA beneficiaries?

Under the Secure Act, trusts that do not qualify as "see-through" trusts — vehicles by which individuals pass retirement assets to beneficiaries — must take distributions within five years of an account owner's death, or if the account owner had already reached their required beginning date, minimum required distributions (RMDs) can be taken over the deceased account owner's remaining life expectancy.[1] Conversely, beneficiaries of a see-through trust may be able to take distributions based upon the 10-year rule or, in limited situations, over the life expectancy of individual trust beneficiaries.

To qualify as a see-through trust, a trust must satisfy the following conditions:

1. The trust must be valid under state law.
2. The trust must be irrevocable or become irrevocable upon the death of the account holder.
3. All the trust's underlying beneficiaries must be readily identifiable. This generally requires that all beneficiaries be specifically identified or be part of an identifiable class of beneficiaries (e.g., all my children).
4. A copy of the trust must be provided to the custodian by October 31 the following year after the account holder's death.

If a trust meets the definition of a see-through trust, it is further classified as either a conduit trust or an accumulation trust:

1. **Conduit trust**. RMDs must be passed through to the trust beneficiaries. For creditor protection purposes, any RMDs paid out of the trust to individual trust beneficiaries can potentially be seized by the beneficiary's creditors but the undistributed IRA balance remaining in trust is protected from creditors. For income tax purposes, the individual trust beneficiaries pay income taxes on the RMDs at their own individual income tax rate, which is usually lower than the trust's income tax rate.
2. **Accumulation trust.** An accumulation trust is not required to pass through RMDs from the trust to individual trust beneficiaries. This means RMDs can remain inside the trust and prevent the trust assets from being seized by a trust beneficiary's creditors. However, income retained in the trust is taxed at trust income tax rates, which reach the maximum income tax rate of 37% at only $15,200 of income (in 2024).

[1] Although this may seem counterintuitive, the deceased account owner still has a life expectancy under IRS tables even though they have passed away.

Why use a trust as an IRA beneficiary?

If individuals are named as IRA beneficiaries, they have control of the IRA after the account owner passes. That means they can take a full distribution of the IRA and spend it however they desire. An immediate lump sum distribution to the beneficiary can result in an acceleration of income taxes and subject the assets to creditor claims.

Trusts can be used to control how individual beneficiaries receive IRA distributions from the trust. As a result, trusts enable an account owner to control how and when trust beneficiaries receive assets once the IRA owner passes away. For a disabled beneficiary, a trust can ensure the beneficiary remains eligible for government benefits. A trust can also ensure funds will be maintained for trust remainder beneficiaries, such as an account owner's children from a prior marriage. Because inherited IRAs are not protected from beneficiary creditor claims, trusts are sometimes used to maintain creditor protection. If the account owner has minor children, a trust eliminates the need for a conservator to be named to manage the IRA for the minor child.

Is there a downside to naming trusts as IRA beneficiaries?

Because RMDs are passed out to the trust beneficiaries when using conduit trusts, there is no creditor protection for the RMDs. As a result, the creditor protection available when using a conduit trust can be somewhat limited and may be outweighed by the increased administrative and tax reporting burdens required, especially when the reduced 10-year payout rule of the Secure Act is in effect.

Given the relatively low amount of income required to trigger the 37% maximum income tax rate for trusts, using an accumulation trust to maintain assets in trust can result in a higher income tax bill. The potential adverse income tax consequence of using an accumulation trust must be weighed against the benefits of maintaining IRA assets in trust for longer periods and possibly ensuring that assets can be passed on to trust remaindermen, such as children from a prior marriage.

How to determine whether a trust should be used?

The use of a trust as an IRA beneficiary generally requires an analysis of whether the benefit of control over how IRA distributions are passed out to individual trust beneficiaries outweighs any negative income tax consequences and the increased administrative burdens associated with use of a trust. The shortened 10-year payout period for many IRA beneficiaries, undercuts some of the potential benefits, but use of trusts as IRA beneficiaries may still be warranted in some situations.

If you have any questions about using a trust as an IRA beneficiary or questions about estate planning strategies in general, please contact our specialists in Estate Planning Services at EPS@ceritypartners.com.

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