

Designating IRA Beneficiaries for Maximum Stretch

IRA owners who want account distributions to be stretched as long as possible should be careful when naming trusts as beneficiaries in order to avoid a mandatory five-year distribution period.

This article focuses on how to tie traditional and Roth IRAs into an estate plan without triggering unintended tax consequences.

A critical issue is how to ensure that IRA assets are protected for future beneficiaries, such as a surviving spouse, children, or grandchildren. If it were as simple as writing the desired individual's name on a beneficiary designation form, there would be no issue. But it is not that simple. Consider these examples:

- (1) An IRA owner wants to leave the IRA to his or her spouse but worries that on the surviving spouse's death, the IRA assets will pass to beneficiaries chosen by the spouse, not the beneficiaries chosen by the IRA owner (a common concern with children from different marriages).
- (2) A spouse is named as the IRA beneficiary. Does doing this forfeit the ability to "stretch" the IRA distributions over the IRA owner's children's lifetimes?
- (3) An IRA owner desires to stretch the IRA distributions over his or her children's lifetimes, but needs a trust to protect the IRA proceeds from a child's ex-spouse or the child's frivolous spending. Does a trust preclude the "stretch" aspect of the IRA?
- (4) An IRA has multiple beneficiaries, one of whom is not an individual (e.g., a charity). Does that jeopardize the right of the individual beneficiaries from stretching the portion of the IRA that they receive by triggering a five-year dis-

tribution requirement?

- (5) An IRA owner wants to designate more than one beneficiary. Do those named beneficiaries forfeit the ability to use each of their own life expectancies to take advantage of the stretch feature? If the oldest beneficiary's life expectancy applies, this can be a significant problem.

These are a few of the complex issues resulting from the overlap between IRA distribution rules and estate planning objectives. Although distributions from a Roth IRA are nontaxable, and thereby avoid many of the income tax problems associated with traditional IRAs, some issues pertaining to the proper beneficiary designations apply to both types of IRAs.

Estate Planning

Coordinating IRA financial objectives with estate planning goals can be complex. An understanding of the rules set forth below is essential to accomplishing this goal.

To illustrate the rules, consider the following family: a father named Frank, a mother named Mary, a daughter named Dorothy, and a son named Sam. Dorothy is 15 years younger than Sam. Frank's net worth consists largely of his traditional IRA. (Frank also has a smaller Roth IRA, and where the planning is different, it is noted below.)

Frank wants to arrange his estate to maximize the amount that he can leave to his wife and children while minimizing tax liability. On the one hand, he wants the simplicity and tax

advantages of naming an individual as the beneficiary of his IRA. On the other hand, Frank realizes that there are estate planning advantages that can be achieved only through the use of a trust.

Frank's simple solution is to name a trust as the beneficiary of the IRA, thereby killing two birds with one stone. Although Frank is on the right track, improper planning could cause major problems for Frank and his beneficiaries.

Distribution: Five-Year vs. Stretch

In a traditional IRA, the owner may take money out of his or her IRA without penalty beginning at age 59 1/2, but he or she must begin to take a minimum amount out of the IRA after reaching age 70 1/2. One of the major advantages of Roth IRAs is not being forced to abide by this minimum distribution requirement.

The minimum amount that must be distributed is called the "required minimum distribution" (RMD) and is calculated based on the asset balance in the IRA and the beneficiary's remaining life expectancy. The RMD is only the minimum amount required to be distributed and, once RMDs begin, the beneficiary is permitted to remove a greater amount from the IRA without penalty. Restricting withdrawals to only the RMD amount, however, can have pronounced benefits for the IRA owner's beneficiaries.

The distribution rules differ depending on the identity of the IRA owner's beneficiaries. If an IRA owner dies without ever having taken distributions from an IRA, the default distribution scheme is called the "five-year rule." The five-year rule, as its name implies, requires that all of the IRA's assets be distributed within five years of the participant's death. Because five years is a relatively short period, the application of this rule could be very costly in that it prevents an IRA owner's beneficiaries from fully maximizing the benefits of extended income tax deferral.

If the five-year rule is one end of the spectrum for mandatory distribution of IRA assets, then "stretch" distributions are the other end. Stretch distributions attempt to maximize the benefits of extended income tax deferral by stretching out the IRA distributions over the beneficiary's lifetime. The longer the period over which the distributions are stretched, the longer the beneficiary defers the income taxes that must be paid on the distributions. Further, with stretch distributions, the beneficiary withdraws only the minimum amount required from the IRA each year, allowing as much as possible to remain in the IRA to con-

tinue growing tax-free.

Because the five-year rule is the default, it can sometimes apply despite the wishes of the IRA owner. For example, even after Frank decides that he wants his beneficiaries to take advantage of stretch distributions, his IRA could still be subject to the five-year rule. A very simple way that an IRA can fall prey to the five-year rule is the lack of a "designated beneficiary." An IRA that does not have a qualifying designated beneficiary must be distributed in compliance with the five-year rule.

In general, the designated beneficiary must be an individual named by the IRA. Thus:

- If Frank names a beneficiary for the IRA in his last will and testament, but never names the beneficiary on the appropriate beneficiary designation form, the IRA will not have a designated beneficiary because the beneficiary was not named on the form.
- If Frank names his estate, a trust, or a charity as his IRA's beneficiary, the IRA will not have a designated beneficiary because the beneficiary is not an individual.

An important exception to this general rule, however, allows a trust's beneficiaries, in certain circumstances, to be treated as the IRA's designated beneficiaries.

Stretch Distributions for Individuals

Once an IRA owner has taken the necessary steps to make his or her beneficiaries eligible for stretch distributions, how those distributions will proceed depends in part on the identity of the designated beneficiary.

Surviving spouse. If the owner decides to leave his or her entire IRA to a surviving spouse, then the spouse will have two options:

- (1) The default option is for the spouse to take distributions from the IRA. Under this option, the rules are slightly different from other designated beneficiaries. As with the individual designated beneficiary, the spouse's life expectancy would be used to determine the RMD. However, instead of beginning within one year of the participant's death, the distributions must begin on or before the *later* of: (a) December 31 of the year immediately following the year of the participant's death; or (b) December 31 of the year in which the participant would have reached age 70 1/2. The

spouse would be required to take at least the RMD, but she would remain free to take out larger amounts if she chose to do so.

(2) The surviving spouse's second option would be to roll the IRA assets into an IRA of her own. The rollover can be to an existing IRA or a new one created for this purpose. If the surviving spouse chooses this rollover option, he or she will be able to treat the assets like they were always his or her property. Thus, the surviving spouse may defer withdrawals until reaching age 70 1/2, using his or her own life expectancy to determine payouts, and name new designated beneficiaries. This option is called "spousal rollover" and is available to only a surviving spouse.

For Frank's family, a spousal rollover could be a good or a bad thing. Mary could benefit greatly from the ability to use her age instead of Frank's to determine when RMDs must begin, especially if she is substantially younger than Frank. Mary could name Dorothy and Sam as her designated beneficiaries, but she could also name anyone else (e.g., a new husband she marries after Frank's death). This concern about spousal rollover motivated the first case study, discussed below. If Dorothy and Sam are named as the designated beneficiaries of Mary's IRA (an option available if Mary elected a spousal rollover), although they would not be able to roll the IRA over into their own IRAs after Mary's death, they could still take advantage of stretch distributions from her IRA. This concern about stretch distributions from a spouse's IRA motivated the second case study, discussed below.

Individual other than surviving spouse. If the IRA owner names one person other than his or her surviving spouse as the designated beneficiary, the IRA will be distributed using the beneficiary's life expectancy. Distributions are required to begin no later than one year after the date of the IRA owner's death. The designated beneficiary must withdraw at least the RMD, but would be free to choose to take a larger distribution.

For example, if Frank names Dorothy as his designated beneficiary and Dorothy is 20 years old when he dies, then the IRA will be distributed over Dorothy's remaining 63-year life expectancy. Dorothy would be able to stretch the distributions, but would not be required to do so. She could choose to take a single distribution of the entire value of the account as soon as she inherits it,

forfeiting the benefits of stretch planning for a quick influx of cash. This freedom to exhaust the account is precisely the concern that gave rise to the third case study, discussed below.

Multiple designated beneficiaries. If a participant names more than one designated beneficiary, the rules become more complicated, and there are two potential pitfalls.

(1) The first potential problem occurs when one beneficiary fails to meet the requirements of a "designated beneficiary." This failure will result in the IRA not having a designated beneficiary. If, for example, the participant names five beneficiaries and one is not an individual (e.g., a charity), the IRA does not have a designated beneficiary. The entire IRA, including the portions that go to the four individuals who would have otherwise qualified as designated beneficiaries, must be distributed under the five-year rule.

(2) Naming multiple beneficiaries could have negative consequences for stretch distributions. When an IRA has multiple designated beneficiaries, it is distributed to all of the beneficiaries using the life expectancy of the oldest designated beneficiary. If one designated beneficiary is significantly older than the others, the younger beneficiaries lose the ability to take years or decades' worth of stretch distributions. This problem motivated the fifth case study, discussed below.

Stretch Distributions for Trusts

The general rule is that trusts do not meet the definitional requirements of a designated beneficiary because they are not individuals. If a trust meets certain requirements, however, the beneficiaries of the trust are treated as the designated beneficiaries of the IRA. Thus, using a trust allows the IRA participant to combine the benefits of stretch distributions with the asset protection provided by trusts.

Qualifying trusts. Five requirements must be met for a trust's beneficiaries to be treated as designated beneficiaries:

- (1) The trust is valid under state law.
- (2) The trust is irrevocable or becomes irrevocable at the participant's death.
- (3) The trust beneficiaries are identifiable from the trust instrument at the time of the participant's death. (The beneficiaries

need not be named explicitly in the trust instrument as long as they are identifiable (e.g., "the grantor's children"). If the beneficiaries are not identifiable at the time of the participant's death, however, the trust's beneficiaries will not qualify as designated beneficiaries, and retroactive modification of the trust will not fix the problem. Even though trusts may sometimes be modified under state law after the grantor's death, the IRS recently ruled that it will not allow retroactive modification of a trust to identify designated beneficiaries of an IRA.

(4) Certain documentation, such as the trust instrument or a list of all beneficiaries, is provided to the plan administrator or IRA custodian by October 31 of the year following the participant's death.

(5) All of the trust beneficiaries are individuals whose ages can be identified.

Even if all of the above requirements are met, pitfalls still could hamper the beneficiaries' ability to take stretch distributions. Just as an IRA with multiple beneficiaries does not have any designated beneficiaries if the IRA has a single non-individual beneficiary, a trust that has a single non-individual beneficiary is not a qualifying trust. Even if all of the trust's income beneficiaries qualify as designated beneficiaries, including a non-individual as a remainder or contingent beneficiary will prevent the trust from being a qualifying trust. In that case, none of the trust's beneficiaries will be treated as a designated beneficiary and the IRA will be distributed under the five-year rule. (However, a "conduit trust," which is discussed below, is a method of avoiding this pitfall). This concern is explored in the fourth case study, discussed below.

Another potential pitfall is the age of the beneficiaries. Just as with multiple designated beneficiaries, the oldest beneficiary of the trust will be used to calculate the RMD and stretch period for all the beneficiaries of the trust. This applies even if the oldest beneficiary is only a contingent beneficiary. For example, if Dorothy is the income beneficiary of the trust and Sam is only a contingent beneficiary, Sam's age would be used to calculate the stretch period, depriving Dorothy of 15 years of potential stretch distributions.

Conduit trusts. In order to solve some of the problems facing qualifying trusts, the IRS allows for the use of conduit (or flow-through) trusts,

which are specifically designed for IRAs. A conduit trust is one that requires the trustee to pay the RMD to the income beneficiary as soon as the trustee receives the RMD from the IRA custodian. This type of trust contrasts with a qualifying trust, where the trustee would be allowed to accumulate the RMD within the trust. If a trust meets the requirements for a conduit trust, the income beneficiaries will be treated as the sole beneficiaries for the purpose of determining the designated beneficiary. Residuary or contingent beneficiaries will be disregarded, allowing the oldest income beneficiary's age to determine the period of the stretch distributions. Thus, conduit trusts are a valuable tool for participants whose primary concern is ensuring that their beneficiaries take advantage of stretch distributions.

On the other hand, conduit trusts do not allow for the continued accumulation of IRA assets once they are distributed to the trust. Therefore, whether a conduit trust is appropriate for Frank and his beneficiaries depends on which concern is dominant for them.

Practical application

The following case studies provide solutions to Frank's various problems by setting forth examples of how Frank can provide for his spouse, Mary, and his two children, Dorothy and Sam, depending on their particular circumstances.

Case Study 1: Trust vs. individual as the beneficiary. Frank desires to leave his IRA to Mary but he is worried that, on Mary's death, the IRA assets will pass to beneficiaries chosen by Mary, who may not necessarily be Frank's chosen beneficiaries.

In our hypothetical family, Dorothy and Sam are Frank and Mary's biological children. Thus, it is not expected that Mary would disinherit her own children. Therefore, Frank would name her as the primary beneficiary of his IRA in order to provide her with the greatest flexibility and income tax advantages. Mary could then take advantage of the spousal rollover rules described above and defer withdrawals until she turns 70 1/2.

In contrast, if Mary is a second spouse, or if Dorothy and Sam are not Mary's biological children, Frank may want to name a trust as the designated beneficiary. The trust would provide greater control over the IRA assets. The trust would allow Mary to enjoy the benefits of the IRA during her life, but would ensure that the assets remaining in the IRA on her death pass according

to Frank's wishes as set forth in the trust. If the trust is structured as a conduit trust, then Mary could take the distributions over her life expectancy. Although the trust would deprive Mary of enjoying the spousal rollover advantages, she would avoid the five-year rule. If the Trust is used, what then happens to distributions to Dorothy and Sam on Mary's death? That is Case Study 2.

Case Study 2: Distributions after the primary beneficiary's death. If Frank designates as his IRA beneficiary a trust that names Mary as the primary beneficiary, then Dorothy and Sam are precluded from stretching the IRA over their lifetimes following Mary's death. Thus, although Frank obtains the control advantages of naming a trust as his IRA beneficiary, it comes at a price for his children. Any assets remaining in the IRA at Mary's death will be distributed to Dorothy and Sam (via the trust) based on Mary's life expectancy at her death. On the other hand, if Frank trusted Mary to carry out his wishes and forgoes a trust, then Mary could have elected the spousal rollover. In that situation, the IRA assets in Mary's name could have passed to the children over their lifetimes.

Case Study 3: Qualifying vs. conduit trusts. What if Frank desires to stretch the IRA over his children's lifetimes, but he is concerned that the assets would be lost due to a child's frivolous spending or divorce? The obvious solution is a trust.

Although the general rule is that the designated beneficiaries of Frank's IRA must be individuals, if the trust meets the five requirements described above, the trust's beneficiaries are treated as the IRA's designated beneficiaries. Two types of trusts are available to Frank: qualifying trusts and conduit trusts. A qualifying trust is a trust that meets the five requirements discussed above. A conduit trust meets the five requirements *and* requires the trustee to pay each IRA distribution the trust receives directly to the trust's income beneficiary or beneficiaries. Because of the unique advantages and disadvantages of each type of trust, the type of trust Frank may choose should depend on the specific circumstances of his family situation.

A qualifying trust might be appropriate if Frank believes he needs to place restrictions both on the distributions made to the beneficiaries from the trust and the manner in which the distributed funds may be spent. Frank may choose a

qualifying trust for Dorothy's share if he is concerned about her spending habits and possible claims against the assets from creditors. As long as the trust meets the five basic requirements, Frank may structure the trust to meet his needs.

For instance, he could set up the trust so that the trustee only takes the RMD out of the IRA each year. Thus, instead of allowing the IRA distributions to flow through the trust to Dorothy, only to have Dorothy immediately spend the money, Frank could allow the trustee to accumulate the IRA distributions in the trust, reinvesting the funds and allowing the account to grow. Frank could further direct the trustee to distribute funds from the trust to Dorothy only in specific circumstances, such as for her medical or educational needs. Finally, Frank could include a spendthrift provision in the trusts that restricts Dorothy's ability to transfer her interest in the trust and the ability of Dorothy's creditors to reach trust assets to satisfy her debts. Such a trust would allow Frank to ensure that Dorothy receives the benefit of stretching out the IRA as long as possible and that she does not waste the distributions once she receives them.

The biggest disadvantage to this type of trust, however, is that all of the trust's beneficiaries— income beneficiaries, remainder beneficiaries, and contingent beneficiaries (i.e., "default takers")—will be taken into account when calculating the age of the IRA's designated beneficiary. (A similar disadvantage is discussed in-depth in Case Study 5.) This disadvantage may or may not be important to Frank, depending on whether he wants to name remainder beneficiaries and default takers, and whether the beneficiaries are older or younger than Dorothy.

By contrast, Frank may choose a conduit trust for Sam. Assume that Sam is fiscally responsible and understands the benefits of stretch distributions. Nevertheless, Frank knows that unforeseen circumstances, such as a divorce, may jeopardize Sam's IRA assets. A conduit trust would require the trustee to take only the RMD each year and pay the funds directly to Sam, but Sam would not be able to obtain the IRA assets directly. Removing Sam's ability to receive assets from the IRA, other than the RMD, would remove any temptation to raid the IRA to pay off a divorce settlement. A conduit trust would also have the advantage of allowing Frank to set up contingent beneficiaries. In con-

trast to a qualifying trust, in which all of the trust's beneficiaries are considered in calculating the IRA distribution period, only the income beneficiaries are considered in a conduit trust. All other beneficiaries are disregarded for purposes of calculating the RMD and stretch period.

The fact that remainder and contingent beneficiaries are not considered would give Frank the freedom to include these types of beneficiaries in the trust, allowing him to prepare a more flexible estate plan. Thus, Frank may prefer a conduit trust over a qualifying trust for Sam. The conduit trust would allow Sam to stretch the IRA distributions without placing any further restrictions on how Sam spends the distributions and allow Frank to include contingent beneficiaries without triggering the problems discussed in Case Study 4.

If Frank uses a properly drafted trust, his beneficiaries can stretch their IRA distributions. In fact, as this case study shows, a trust may be the only way to ensure that the beneficiaries actually stretch the IRA distributions.

Case Study 4: Non-individuals as beneficiaries. What if Frank names a beneficiary who is not an individual (e.g., a charity) as a default taker? Does that jeopardize the ability to stretch the IRA and thereby trigger a five-year distribution requirement?

Frank knows that he can use a trust to ensure that his children take stretch distributions without triggering the five-year rule. He sets up a trust to protect the IRA from imprudent spending and creditors. In the trust agreement, however, Frank names a charity as the trust's default taker. Frank also includes a provision that allows the trust to pay the debts and expenses of his estate if his probate estate does not contain sufficient liquid assets.

After Frank's death, the trustee asks the IRA custodian to pay the RMD to the trust each year. The custodian refuses, stating that the trust beneficiaries do not meet the requirements for being designated beneficiaries, so the IRA must be distributed under the five-year rule. Where did Frank go wrong?

If the trust is a *qualifying* trust, and not a conduit trust, then Frank's inclusion of a charity as the default taker triggered the five-year rule. Including the charity as a beneficiary violated the fifth requirement, which mandates that all of the trust beneficiaries are individuals whose ages can be identified. When determining who is a


beneficiary of the trust, the administrator looks at every possible person or entity who may receive distributions under the trust document. The likelihood (or unlikelihood) that a default taker will actually receive anything from the trust is irrelevant. As default taker, the charity was a beneficiary of the trust and the trust would not meet the requirements. Because the trust was not a qualifying trust, Dorothy and Sam could not be treated as the IRA's designated beneficiaries, resulting in the IRA having no designated beneficiaries. Without designated beneficiaries, the IRA had to be distributed under the five-year rule. However, if the trust was structured as a conduit trust, the charity, as the default taker, would be ignored because only the income beneficiaries (Dorothy and Sam) are treated as the sole beneficiaries for purposes of determining the designated beneficiary.

Even if Frank does not include a charity as a beneficiary of the trust, his IRA would still fall victim to the five-year rule. Frank's estate is not an individual, and the fact that it may receive funds from the trust makes it a beneficiary. If an estate is a beneficiary of the trust, the trust has violated the fifth requirement and cannot be a qualifying trust. If the trust is not a qualifying trust, then the IRA will be distributed under the five-year rule. In order to avoid this result, the trust should contain language that prohibits the use of IRA proceeds to pay any expenses of Frank's estate.

Case Study 5: Multiple trust beneficiaries. What if the trust has two or more income beneficiaries? Do those beneficiaries forfeit the ability to use each of their own life expectancies to take advantage of the stretch feature?

Frank creates a trust in which Dorothy and Sam are the beneficiaries during their lifetimes. The trust meets the five requirements, so Dorothy and Sam will be treated as the IRA's designated beneficiaries. After Frank dies, Dorothy and Sam are treated as the IRA's designated beneficiaries and the IRA pays the RMD to the trust each year. At first glance, it may seem that Frank has achieved all of his goals related to stretch distributions and creditor protection. However, he has unintentionally cost Dorothy tens of thousands of dollars in potential stretch distributions that she will be unable to take.

To understand Frank's mistake, recall that Sam is 15 years older than Dorothy. If Sam is 35 and Dorothy is 20 at the time Frank dies, then Sam's remaining life expectancy is 48.5 years while



Dorothy's remaining life expectancy is 63 years. The RMD is calculated using the life expectancy of the oldest beneficiary; thus, Sam's life expectancy would be used to determine the RMD paid to the trust each year. This is a detriment to Dorothy because she is much younger than Sam and has a longer life expectancy.

Even if Frank created two separate trusts, one for Dorothy and one for Sam, this problem could still occur if Sam is a remainder or contingent beneficiary of Dorothy's trust. If Dorothy's trust is a qualifying trust, then all of the trust's beneficiaries are taken into account when calculating the stretch period. Because Sam is a contingent beneficiary and is older than Dorothy, his life expectancy would be used. However, if Dorothy's trust is a conduit trust, then Dorothy, as the sole income beneficiary, is treated as the sole beneficiary of the trust and her life expectancy is used when calculating the RMD.

Conclusion

The financial decisions pertaining to IRAs are complicated. Participants must determine how to invest their IRA, when to take distributions, how much to withdraw, and whether a Roth conversion makes sense. The decisions are no less complicated when it comes to determining the beneficiary designations for IRAs and how they fit in an estate plan.



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