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Individual Retirement Accounts and Living Trusts: An Uneasy Combination

By Bruce Givner and Jeff Munjack

In 1974, Congress passed the Employee Retirement Income Security Act (ERISA) to regulate employer-sponsored retirement plans. However, to encourage savings by individuals whose employers do not sponsor retirement plans, Congress created individual retirement accounts (IRAs). The initial deductible limits were small: the lesser of $1,500 or 100 percent of pay. But over time, the limits were increased; those covered by employer-sponsored plans became eligible to contribute, and Congress added variations on IRAs such as simplified employee plans and - in 1997 - the Roth IRA.

IRAs are attractive both on their own, for the deduction and tax deferred accumulation, and as vehicles to "rollover" accounts from employer sponsored plans. Also, they have a level of creditor protection both under state and federal bankruptcy law. See California Code of Civil Procedure Section 704.115(e) and Bankruptcy Code Section 522(n) for details.

Due to these favorable rules, many families hold much of their wealth in IRAs. They know that if there are funds left in the IRA after the account holder's death, the balance can be distributed to designated successor beneficiaries. Many of these families have adopted a "living trust" (also known as "revocable," "family" or "inter vivos" trust) as the vehicle to distribute their assets upon death. The question becomes: If the IRA permits the account holder to designate a successor beneficiary, and the "living trust" provides for the distribution of assets upon death, how should the designation of an IRA beneficiary relate to the "living trust?" Should the IRA beneficiary be the "living trust?"

There is a difference between naming a 'living trust' as the beneficiary of an IRA and transferring the funds to the trust's name.

In Private Letter Ruling 200620025, the decedent left an IRA outright to a disabled child who would lose Medicaid benefits due to the inherited IRA. The child's guardian obtained a court order to transfer the IRA to an IRA benefitting a supplemental needs trust of which the guardian, as trustee, had the discretion to distribute income and principal. This trust was ruled to be a "grantor trust" for income tax purposes as to the child. (Every "living trust" created for probate avoidance is also a "grantor trust" for income tax purposes.)

The IRS held that transferring an inherited IRA to an IRA benefitting a grantor trust did not result in the immediate recognition of income. The IRS also ruled that the distributions required by the IRA rules are to be calculated using the disabled beneficiary's age. The ruling's results were wholly favorable: The child did not lose qualification for Medicaid; the IRA was safely placed in a trust to be available to provide for the child's supplemental needs; and the trust could withdraw the IRA gradually over the child's life expectancy, thus allowing maximum income tax deferral. (Of course, it would have been less costly had the parent left the IRA to a supplemental needs trust in the first place.)

However, this case involved not just a sympathetic taxpayer, but also an inherited IRA, which was transferred to an IRA that named a special needs trust as the *beneficiary*. Would the Internal Revenue Service's relaxed attitude as to IRAs and a "living trust" apply to a transfer of the IRA itself to such a trust?

On April 29, 2011, the IRS issued PLR 201117042, which also involved a disabled person receiving Medicaid who later obtained a court order to establish a special needs trust. However, this court order was to transfer the IRA into an account set up in the trust's name. Once the financial institution transferred the funds, it issued a Form 1099 to the taxpayer reflecting a taxable distribution of the entire IRA. The taxpayer sought a waiver to allow an extra 60 days to rollover the funds into an IRA. The IRS granted the requested waiver, but noted that the financial institution's action - issuing the Form 1099 - had been correct "because an IRA cannot be set up and maintained in the name of a trust."

We must recognize that IRS private letter rulings are not precedent for other taxpayers. The IRS makes a special point about that at the end of each ruling. However, the contrast of these two rulings makes sense: There is a difference between naming a "living trust" as the beneficiary of an IRA and transferring the funds to the trust's name. The former action is permissible, often desirable and does not trigger the immediate recognition of the taxable income inherent in the IRA. The latter is a distribution triggering immediate taxable income.

It is common for the spouse who is the IRA account holder to designate the other spouse as the primary beneficiary. The complication arises when it comes to the contingent beneficiary. What if there are funds left in the IRA after both spouses have passed away? Should they name the children as the beneficiaries? At that point, many couples consider naming the "living trust" as the beneficiary.

But there are problems with simply naming the "Smith Family Trust" as the contingent beneficiary and assuming the IRA proceeds will be divided among the children and distributed in accordance with that trust's provisions. For example, the children will not be able to use their own life expectancies to calculate the required minimum distributions, and may be forced to withdraw the funds over a period of as

little as five years. The next best option, although it also has problems, is to name a specific subtrust in the living trust, e.g., "the children's trust established under the Smith Family Trust" as the contingent beneficiary.

The best option is to name a standalone IRA beneficiary trust as the beneficiary. See Private Letter Ruling 200537044, the seminal ruling obtained by attorney Phil Kavesh of Torrance. A standalone trust is designed to meet the requirements of a designated beneficiary trust; give each beneficiary the ability to use that beneficiary's life expectancy for purposes of "stretching-out" distributions; and make it less likely that the beneficiaries will immediately cash out the IRA or take other actions that may have adverse tax consequences.

IRAs and living trusts are not a marriage made in heaven. However, with care, they can make beautiful music for your beneficiaries.

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