

Trust as IRA Beneficiary Fact Sheet

Naming the beneficiary to your IRA account is an important step toward meeting your legacy goals. Unfortunately, many investors take little notice of this step in their financial planning. Consequently, they create situations that do not maximize the benefits their IRA savings might offer these beneficiaries.

Many investors, in recent years, have embraced the concept of the Revocable Trust — sometimes called a Living Trust or Inter Vivos Trust — as the answer to all their estate-planning concerns.

While we won't discount the effectiveness of these trusts for certain estate issues (a special needs beneficiary or for unified credit purposes, for example), in most instances a trust is a poor IRA beneficiary. In fact, the bias is in favor of leaving the assets outright to the intended beneficiaries unless there are some exceptional circumstances compelling investors to leave the assets to a trust. That's because the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) rules naming individuals as beneficiaries offers greater flexibility for carrying on the life of the IRA through "Stretch IRA" techniques¹. Information regarding "Stretch IRAs" is available by calling your Wachovia Securities Financial Advisor.

The more limited options when a trust is your IRA beneficiary will include the following:

1. IRA OWNER DIES BEFORE THEIR REQUIRED BEGINNING DATE

- Lump-sum distribution.
- Five-year rule, which depletes the IRA during a five-year period that begins on December 31 following the death of the IRA owner. The entire account must be distributed by the end of the fifth year.
- Inherited IRA for the trust with distributions based on the age of the oldest trust beneficiary and using the Single Life Table. That life expectancy will be reduced by one in each subsequent year. Using the age of the oldest trust beneficiary is only available if the trust meets the requirements of a valid "look-through" trust.

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- Inherited IRA for the trust with distributions based on the age of the oldest trust beneficiary and using the Single Life Table. That life expectancy will be reduced by one in each subsequent year. Using the age of the oldest trust beneficiary is only available if the trust meets the requirements of a valid "look-through" trust.
- If the trust is not a valid "look-through" trust, then the distributions are based on the owner's single-life expectancy (term-certain).

The trust must meet the following requirements in order for it to qualify as a designated beneficiary and allow the life of the oldest trust beneficiary to be used in calculating post death required minimum distributions (RMDs):

The RMD rules permit this “look-through” if the following requirements are met:

- The trust is a valid trust under state law.
- The trust is irrevocable or will, by its terms, become irrevocable upon the IRA holder’s death.
- The beneficiaries of the trust are identifiable from the trust instrument.
- Certain documentation has been provided to the IRA trustee, custodian or issuer.

Once these rules are satisfied, the IRA custodian, under direction of the Trustee, can usually make the payments to the trust for distribution to the individual beneficiaries. If the trust fails to qualify as a designated beneficiary, the IRA will either be paid out under the five-year rule if the IRA owner dies before their required beginning date, or over the remaining single-life expectancy (term certain) of the IRA owner if the IRA owner dies after their required beginning date. The required beginning date is April 1 of the year after the year an IRA account holder turns age 70½.

The IRS has recently indicated that a trust that allows for the payment of debts and or administration expenses of the estate may not qualify as a “look-through” trust. If those estate debts and expenses are paid off from the time of the death of the IRA account holder up to September 30 of the year following death, the trust may qualify as a “look-through” trust.

The IRA account holder may want to have the document examined to see if it still qualifies as a “look-through” trust if they have already named their trust as beneficiary. If not, the IRA account holder may want to amend the trust or create a new one. The IRA owner may want to seek tax or legal advice to determine what course of action is best suited to their individual needs since there are various options available for the trust document to avoid this pitfall.

The many rules regarding using a trust as a beneficiary of an IRA make this a cumbersome process that will not allow beneficiaries to disclaim their interest in the IRA, to use their younger life expectancies for calculating RMDs or to have a hand in the management or investment choices of their inheritance. Granted, there may be family estate planning issues where it is appropriate that the management and investment choices by the individual beneficiaries should be limited. The IRA owner should seek tax or legal advice during the estate planning process.

When a trust becomes an IRA beneficiary, taxation is an issue that needs to be discussed with your tax advisor. Trusts are subject to a separate tax-rate schedule that applies only to trusts and estates, for income that is not paid out to the trust’s beneficiaries. This can happen in certain complex trusts or in any cases where not all of the income received by the trust is paid out to beneficiaries in the current year. These trust income tax brackets on any undistributed income rise rapidly, reaching the highest tax rate of 35 percent for taxable income over \$10,450. By contrast, when an individual is named IRA beneficiary, the top income-tax bracket of 35 percent applies only to taxable income over \$349,700.



Let's look at an example to help illustrate this point. The IRA owner (age 68) leaves the IRA to the trust with several beneficiaries instead of to the surviving spouse, decreasing the tax-deferred compounding, and growth of family wealth. When a non-spouse (the trust) inherits an IRA, RMDs begin the year following the year of the owner's death with the single-life (term certain) life expectancy. This means you never get a new divisor from the Single-Life Table each year; instead you subtract one from the original divisor. When a trust inherits an IRA and it is a valid "look-through" trust, distributions are based on the age of the oldest trust beneficiary, using the single-life table (term certain). The oldest beneficiary of the trust in this example is the spouse who is 70 years old the year following the owner's death. The single-life divisor is 17.0. This means the IRA inherited account will be emptied in 17 years ending tax-deferred compounding, because there are end dates in Inherited IRAs. The spouse could live more than 17 years and therefore outlive the IRA. If the spouse dies 10 years into it, the account will still be emptied in the next 7 years, not allowing the next generation, usually the children, to "Stretch" over their own single-life term certain life expectancy. If the spouse had instead inherited the IRA outright, they would take RMDs using the Uniform table. The Uniform table divisor for a 70 year old is 27.4, and you get a new divisor from the table each year. This would have left an IRA, not an Inherited IRA to the next generation. Those non-spouse beneficiaries would then set up Inherited IRAs and take RMDs based on **their** single-life (term certain) allowing them to "Stretch" the IRA over their usually longer life expectancies.

We suggest that IRA investors become educated on the various beneficiary-planning methods that are now available to determine whether a trust is necessary to meet their legacy goals. We, at Wachovia Securities, welcome the opportunity to work with you and your tax and legal advisors to help create an IRA strategy designed to help you achieve your desired result.

¹ "Stretch IRAs" are designed for investors who will not need the money in the account for their own retirement. There is no guarantee that there will be assets remaining in the account at the time of the IRA owner's death.

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