

Good news: IRS improved the IRA trust rules. Bad news: they still don't work



Trusts remain lousy IRA beneficiaries, says tax expert.

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Has your client named a trust as the IRA beneficiary, or is considering doing so? That could be a problem. In the **FINAL Secure Act Regulations-7-18-24.pdf** IRS made several user-friendly improvements to the RMD (required minimum distribution) tax rules for naming trusts as IRA

beneficiaries. But these changes don't alter the fact that trusts remain lousy IRA beneficiaries.

Here's why:

10-year rule accelerates taxes, especially for trusts

The original SECURE Act changed the game for payouts for most IRA beneficiaries, including trusts. Congress eliminated the stretch IRA deferral advantage and replaced it with a 10-year rule, requiring all remaining inherited IRA funds to be withdrawn by the end of the 10th year after death.

In addition, the final regulations (issued July 18, 2024) confirmed that if the IRA owner died on or after his RBD (required beginning date) for starting RMDs, the beneficiary must continue annual RMDs for years 1–9 of the 10-year term.

Exceptions: EDBs (eligible designated beneficiaries)

EDBs still qualify for the stretch IRA, but, other than a spouse, most beneficiaries are not EDBs. EDBs also include minor children of the deceased IRA owner (up to age 21 only, but not grandchildren), disabled, chronically ill, or other non-spouse beneficiaries who are not more than 10 years younger than the deceased IRA owner.

What's the problem with naming a trust as the IRA beneficiary?

There are two problems: high taxes and less trust protection, depending on what type of trust is being used. There are generally two types of trusts for inheriting IRAs (or other retirement plan funds):

Conduit trusts – where all RMDs pass through the trust and are paid out to the trust beneficiaries

Discretionary (Accumulation) trusts – where the trustee can use discretion as to whether the RMDs will be paid out to the trust beneficiaries, retained in the trust for further protection, or held for successor beneficiaries

In each case, the inherited IRA funds will usually have to be paid out to the trust by the end of the 10th year after death. If the funds pass through the trust to the trust beneficiaries (a conduit trust), the trust beneficiaries must pay the tax at their own personal rates. If the funds are retained in the trust for protection (a discretionary trust), the trust will pay the taxes at high trust tax rates. In a trust, once income exceeds \$15,200 (in 2024) tax rates reach the current top tax rate of 37 percent. (An individual would not reach that 37 percent top tax rate until income exceeds \$609,350.)

In either case, there will be a big tax bill at the end of the 10-year term.

Do the IRS trust improvements from the Final Regulations help?

Generally, no.

The IRS made two changes. First, the IRS eliminated the trust documentation, which previously had to be submitted to the custodian by October 31st of the year after death. But this requirement was retained for company retirement plans, like 401(k)s.

Second, the IRS allows qualifying (see-through) trusts to be split into sub-trusts after death, allowing RMDs to be based on the beneficiaries of the separate sub-trusts. Allowing the separate account rule for IRA trusts can be a benefit if the beneficiary of one sub-trust is a spouse (or other EDB) and the other trust beneficiary is an adult child (or other non-EDB) subject to the 10-year rule. Separate accounting allows the stretch IRA to be preserved for the EDB through the trust.

However, even with these improvements, conduit trusts will still be a problem. They will not only create a deluge of taxes but the trust protection will be lost. Many clients who currently have conduit trusts set up (from when the stretch IRA was allowed) will need to make changes (described below).

Discretionary see-through trusts established to keep IRA funds protected also have problems. The funds would still have to be paid to the trust by the end of the 10 years, and any funds retained in the trust would be taxable at

high trust rates, gaining control and protection but losing even more in taxes.

How can these IRA trust tax problems be avoided?

Easy. Don't leave traditional IRAs to trusts. But if a trust is needed for control reasons, there are two workarounds.

Use Roth IRAs

Have your clients convert those IRA funds to Roth IRAs and leave the Roth IRA to the trust.

The inherited Roth funds are still subject to the 10-year rule, but when the inherited Roth funds are paid out to the trust, the distribution will be income-tax free. Now the client can name his discretionary trust as the Roth IRA beneficiary, and the inherited Roth funds can remain protected in the trust (even after the 10 years) without any tax liability to the trust. And because this is a Roth IRA, there are no annual RMDs for years 1–9 of the 10-year term.

Life insurance

Using permanent life insurance is an even better, more flexible asset to use to fund the trust. After death, the life insurance paid to the trust will be income-tax free and can remain protected in the trust. Life insurance has no RMDs or other complex IRA trust or beneficiary rules.

How does this get done?

Like a Roth conversion, have the client withdraw his IRA funds and pay tax at today's low rates, and then use those funds to purchase the life insurance. In the end, the beneficiaries will receive more funds, with less tax and more trust protection. Warning: An IRA distribution before age 59½ could be subject to the 10 percent early distribution penalty.

These moves work equally well for special needs trusts for disabled or chronically ill beneficiaries.

Don't hesitate to contact clients who have named a trust as their IRA beneficiary and have this conversation before Uncle Sam ends up being the biggest beneficiary.