



Naming a QTIP Trust as the Beneficiary of an IRA

TRUSTS: Using a Trusted IRA May be a Better Option for Your Clients

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There are some situations in which the owner of an individual retirement account (IRA) would want to name a qualified terminable interest property (QTIP) trust as the beneficiary of the account. For example:

- The owner of an IRA believes that the surviving spouse is not capable of handling the asset; or
- Perhaps the surviving spouse is the spouse from a second marriage, and the owner of an account has children or other beneficiaries to whom he would like to leave the remainder of the account, while the surviving spouse can enjoy the income from the IRA during her life.

There are a number of potential tax issues involved in naming a QTIP trust as a designated beneficiary of an IRA. However, if there are nontax reasons to justify this action, careful execution is needed to avoid problems.

Trust Named as Beneficiary

Generally, only individuals can be named designated beneficiaries of an IRA. In order for a QTIP trust to be respected as a designated beneficiary of an IRA, the following four requirements must be met:¹

1. The trust is a valid trust under state law;
2. The trust is irrevocable;
3. The trust beneficiaries are properly identified in the trust document; and
4. Proper documentation is provided to the plan administrator of the IRA by October 31 after the participant's year of death.

Estate Tax Consequences

For estate tax purposes, under IRC §2056, a marital deduction is allowed against the gross estate in an amount equal to the value of property included in the estate that is transferred to the surviving spouse.

Under IRC §2056(b), QTIP property means property that passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and to which a QTIP election applies. The surviving spouse has a qualifying income interest for life if the surviving spouse is entitled to all the income from the property and no person has a power to appoint any part of the property to any person other than the surviving spouse.

If the four requirements listed above are met, for a QTIP trust to be respected as a designated beneficiary, distributions to the QTIP trust will be treated as paid directly to the surviving spouse. The balance of the IRA account will qualify for the estate tax marital deduction, even though the remainder interest is payable to nonspouse beneficiaries.

Rev. Rul. 2006-26, 2006-22 I.R.B. 939 clarifies the circumstances under which a surviving spouse will be considered to have a qualifying income interest for life.

In each of the three situations described in the ruling, the spouse has the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to the income earned on the IRA assets during the year and to distribute that amount to the spouse. If the spouse exercises that power, the trustee must withdraw the greater of the IRA income or the required minimum distribution (RMD) and must distribute at least the income to the spouse.

Income Tax Consequences

Taxable distributions from an IRA are generally treated as ordinary income. Distributions from IRAs to a trust are included in distributable net income, but the trust is entitled to an income distribution deduction for income distributions it makes to a beneficiary, and the income will be reported on a Form 1041, Schedule K-1, to the surviving spouse.² The QTIP trust acts as a conduit for payment of the income earned in the IRA.

Potential Pitfalls

The benefits of being able to stretch the income tax deferral of an inherited IRA account are substantially forfeited when naming a QTIP trust as the beneficiary of an IRA account. Furthermore, if a QTIP trust named as the IRA beneficiary does not meet the criteria of a "qualified trust," then the taxability of the IRA distributions are greatly accelerated. For these reasons, it is generally not advisable to name a QTIP trust as a beneficiary of an IRA.

An IRA naming a QTIP trust as a beneficiary is not as tax-efficient as using a trustee IRA.

- If a QTIP trust is funded with an IRA under a pecuniary share formula, immediate income tax may be triggered.
- The allocation between trust income and principal on IRA distributions can result in the RMDs being taxed at higher rates if taxed at the trust level rather than being treated as distributable net income and taxed at the beneficiary level. In a trustee IRA, all distributions are taxed to beneficiaries.
- The trust beneficiaries are considered the designated beneficiaries for RMD purposes if the QTIP trust is a "qualified trust." Thus, the RMD is computed based on the life expectancy of oldest beneficiary (i.e. surviving spouse's life). In a trustee IRA, IRA distributions are made to beneficiaries based on the life expectancy of each beneficiary independently.
- The surviving spouse's failure to withdraw annual income resulting in a lapse of withdrawal rights can create gift tax and generation-skipping transfer tax issues.

Conclusion

As you can see, although it is possible to name a QTIP trust as the beneficiary of an IRA, getting an IRA and a QTIP trust qualified is fairly complex and requires careful planning and ongoing attention. Each year, the income of the IRA must be reviewed and this information is not always readily available. Nevertheless, if this is the only way to accomplish the wishes of an IRA owner, it can be done.

Footnotes:

¹ Treas. Regs. §1.401(a)(9)-4, Q&A 5 and 6

² IRC §661

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