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Steps to establish beneficiary-controlled inheritance trusts (with SECURE Act provisions)

Many comprehensive estate plans integrate irrevocable inheritance protection trusts that will be established after the death of the trustmaker for the named successor beneficiaries. An inheritance protection trust can be highly advantageous for a beneficiary because the assets of the trust are shielded from future threats against the beneficiary (ex-spouses, judgment creditors, etc.), even when the beneficiary serves as trustee. This memo describes the steps an administrative trustee must take after the death of the trustmaker in order to establish the inheritance protection trusts.

After payment of expenses, debts, and taxes, the trustee must pay out any specific distributions to individuals and charitable organizations named in the trust document.

The remaining trust assets should then be allocated among the named beneficiaries as provided in the trust document. The trustee is required to notify the beneficiaries regarding their interests in the trust, provide a copy of the trust document, and determine whether each beneficiary desires to take advantage of the inheritance protection trust or inherit outright.[1]

For each beneficiary who desires to take advantage of the inheritance protection trust, the trustee must prepare a certification of the trust that gives the trust a name (for example, "Thomas J. Bouman Irrevocable Trust") and obtain a tax ID number. The trustee of each trust (usually the beneficiary) then establishes an account at his or her preferred financial institution, which will receive distributions from the trustee.

If the deceased trustmaker named his or her trust as the beneficiary of a tax-advantaged retirement account, then the trustee must inform the custodian that the account will be allocated into separate shares payable either outright or to a trust. The custodian will need the name, contact information, account information, and either SSN or tax ID for each beneficiary.[2] Going forward, unless an exception applies, each beneficiary will have 10 years to liquidate the beneficiary's separate share.[3] Until fully liquidated, the beneficiary's separate share of the retirement account may continue to be held in an inherited IRA.

Going forward, an inheritance protection trust will likely have taxable income to report, either from taxable IRA distributions or from income earned by investments owned directly by the trust.

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[1] If the beneficiary is permitted to serve as sole trustee of the beneficiary's separate trust, the beneficiary has the option to take inheritance outright. In legal terms, the beneficiary has the right to become the sole trustee and then pay out the entire principal of the trust to himself on day 1.

[2] If a retirement account names a trust as beneficiary, then the trustee must supply a copy of the trust document to the account custodian.

[3] Under current regulations, the beneficiary must take a required minimum distribution each year based on the beneficiary's life expectancy if the deceased account owner had already attained his or her required beginning date (currently age 73, increasing to age 75 in 2033). If not, then no distributions are required at all until the end of the calendar year that includes the 10th anniversary of the account owner's death. Note: there is no required beginning date for Roth IRAs.

The trustee (usually the beneficiary) may either accumulate the income in the trust – and then the trust would report the taxable income – or pass through the income as part of a distribution to the beneficiary – and then the beneficiary would report the taxable income. Note that distributions from traditional IRA accounts are treated as taxable income, but distributions from Roth-qualified IRA accounts are not.

While the above description of the income tax consequences is traditionally correct, some newer trust documents include a provision that permits the beneficiary to report the income on his or her own personal tax return, even when not distributed to the beneficiary.[4] But if the trust document does not address this issue, Arizona law permits a trustee to "decant" a beneficiary's trust into a new trust that allows for the beneficiary to personally report the income tax on accumulated trust income (eliminating the need for the trust to report the income).[5] This is accomplished by preparing a new irrevocable trust document signed by the trustee. A secondary benefit of trust decanting is that each beneficiary can have his or her own separate trust document, which facilitates the retitling of assets. This optional step requires the assistance of an estate planning lawyer (usually with a substantial fee) but also makes for simpler administration of the beneficiary's trust going forward.

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[4] This technique - referred to as a beneficiary deemed owner trust – relies on IRC Section 678. A BDOT likely reduces the overall income tax burden because an individual beneficiary will likely report income at a lower marginal income tax rate than the trust would.

[5] See A.R.S. 14-10819 for details.