

Reasons to Consider an IRA Trust

Presented by:

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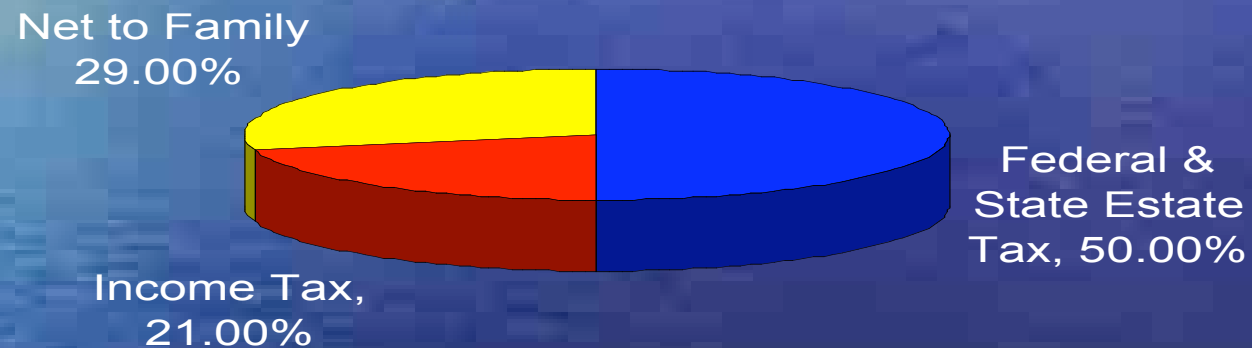
Why Retirement Distribution Planning is Important

Two important reasons that retirement distribution planning must be mastered :

- Mezzullo estimates that “qualified retirement benefits, IRAs, and life insurance proceeds may constitute as much as *75 to 80 percent of the intangible wealth of most middle-class Americans.*”*
- The law makes retirement benefits subject to *estate AND income taxes at death.*

* L. Mezzullo, *An Estate Planner’s Guide to Qualified Retirement Plan Benefits* (ABA Publications, 3rd ed. 2002) at 1.

Why Retirement Distribution Planning is Important



Potential tax exposure to IRA without planning

Goals of Retirement Distribution Planning are Important

- So, because the IRA or qualified plan is the *largest asset of the estate* :
 - to *minimize federal estate tax* , we want to *Maximize use of Unified Credit*
 - to *minimize income tax*, we want to keep the money *growing tax free in the IRA as long as possible* before distributions and avoid cashing in at death and thereby “*stretch out*” tax deferral

Goals of Retirement Distribution Planning are Important

- We also want to :
 - Coordinate the beneficiary designation with the estate plan under will or revocable trust to *insure the benefits go to intended recipients*
 - *Protect from creditors*, lawsuits, divorce, bankruptcy, mismanagement, govt. benefit recovery
 - Consider the perceived *need of surviving spouse* (roll over ? May not need ?)

Point:

Virtually every owner of an IRA worth more than \$300,000 should want protection from (1) taxes and (2) creditors or mismanagement but what is the best way to accomplish those goals ?

Trust INCOME TAX Planning Opportunity # 1
Opened by the IRS Final Required Minimum
Distribution (“RMD”) Regulations Under IRC
§401(a)(9), effective 1/ 1/ 2003:

- 1) Non-spouse beneficiary could then
“stretchout” RMDs over a much longer period
 - Utilizing his or her own life expectancy
 - The power of tax-free compounding - -
incredible numbers
 - Compounding takes place not only after
the owner’s death, but even while alive
and taking RMDs!

Stretch IRA Assumptions

• Parent's Current Age		65
• Assumed Age of Death		84
• Child's Current Age		35
• Assumed Age of Death		84
• Grandchild's Current Age	born in 5 years	-5
• Assumed Age of Death		84
• IRA Balance		\$250,000
• IRA Growth Rate (Pre-Tax)		6.00%
• Outside Account Balance		\$-0-
• Outside Account Growth Rate (After-Tax)		4.00%
• Income Tax Rate		25%

Stretch IRA Example #1

(IRA Payable to Child)

Yr	P	Age C	GC	RMD Factor	Beginning IRA Balance	Required Distribution	Growth 6.00%	Ending IRA Balance	Outside Account	Total
1	65	35	-5		\$ 250,000	\$ -	\$ 15,000	\$ 265,000	\$ -	\$ 265,000
5	69	39	-1		\$ 315,619	\$ -	\$ 18,937	\$ 334,556	\$ -	\$ 334,556
10	74	44	4	23.8	\$ 361,066	\$ (15,171)	\$ 20,754	\$ 366,649	\$ 55,223	\$ 421,873
15	79	49	9	19.5	\$ 382,786	\$ (19,630)	\$ 21,789	\$ 384,945	\$ 139,195	\$ 524,141
20	84	54	14	15.5	\$ 383,815	\$ (24,762)	\$ 21,543	\$ 380,596	\$ 260,984	\$ 641,580
30	94	64	24	20.6	\$ 447,499	\$ (21,723)	\$ 25,547	\$ 451,322	\$ 536,085	\$ 987,408
40	104	74	34	10.6	\$ 412,372	\$ (38,903)	\$ 22,408	\$ 395,877	\$ 1,061,743	\$ 1,457,620
50	114	84	44	1.0	\$ 41,802	\$ (41,802)	\$ -	\$ -	\$ 2,031,054	\$ 2,031,054
60	124	94	54	1.0	\$ -	\$ -	\$ -	\$ -	\$ 3,006,456	\$ 3,006,456
70	134	104	64	1.0	\$ -	\$ -	\$ -	\$ -	\$ 4,450,289	\$ 4,450,289
80	144	114	74	1.0	\$ -	\$ -	\$ -	\$ -	\$ 6,587,515	\$ 6,587,515
90	154	124	84	1.0	\$ -	\$ -	\$ -	\$ -	\$ 9,751,132	\$ 9,751,132

Stretch IRA Example #2

(IRA Payable to Grandchild)

Yr	P	Age C	GC	RMD Factor	Beginning IRA Balance	Required Distribution	Growth 6.00%	Ending IRA Balance	Outside Account	Total
1	65	35	-5		\$ 250,000	\$ -	\$ 15,000	\$ 265,000	\$ -	\$ 265,000
5	69	39	-1		\$ 315,619	\$ -	\$ 18,937	\$ 334,556	\$ -	\$ 334,556
10	74	44	4	23.8	\$ 361,066	\$ (15,171)	\$ 20,754	\$ 366,649	\$ 55,223	\$ 421,873
15	79	49	9	19.5	\$ 382,786	\$ (19,630)	\$ 21,789	\$ 384,945	\$ 139,195	\$ 524,141
20	84	54	14	15.5	\$ 383,815	\$ (24,762)	\$ 21,543	\$ 380,596	\$ 260,984	\$ 641,580
30	94	64	24	58.9	\$ 557,779	\$ (9,470)	\$ 32,899	\$ 581,208	\$ 451,608	\$ 1,032,816
40	104	74	34	48.9	\$ 829,305	\$ (16,959)	\$ 48,741	\$ 861,087	\$ 785,411	\$ 1,646,498
50	114	84	44	38.9	\$ 1,181,446	\$ (30,371)	\$ 69,064	\$ 1,220,139	\$ 1,371,987	\$ 2,592,125
60	124	94	54	28.9	\$ 1,571,884	\$ (54,390)	\$ 91,050	\$ 1,608,544	\$ 2,405,855	\$ 4,014,398
70	134	104	64	18.9	\$ 1,840,955	\$ (97,405)	\$ 104,613	\$ 1,848,163	\$ 4,232,784	\$ 6,080,947
80	144	114	74	8.9	\$ 1,552,494	\$ (174,438)	\$ 82,683	\$ 1,460,740	\$ 7,468,164	\$ 8,928,904
90	154	124	84	1.0	\$ -	\$ -	\$ -	\$ -	\$ 12,721,678	\$ 12,721,678

Trust INCOME TAX Opportunity # 2 Opened by the
IRS Final Required Minimum Distribution (“RMD”)
Regulations Under IRC §401(a)(9), effective 1/ 1/ 03:

- 2) **Separate Share Rule:** In proper circumstances, the IRS allows the division of the IRA into separate shares per beneficiary
- Beneficiary of each separate share can use own life expectancy as the measuring life
 - Therefore, if two or more beneficiaries, younger beneficiaries can stretch out benefits longer

History of How the Separate Share Rule Has Worked

multiple trusts
are DBs of IRA (rarely happens)

—
Each trust named in
beneficiary designation form

—
IRA paid over each separate trust beneficiary's
life expectancy

History of How the Separate Share Rule Has Not Worked

single master trust creating separate shares
is DB of IRA (happens alot)

—
beneficiary designation form named master
trust but directed trustee to create separate
shares upon death

—
IRA paid over oldest life expectancy because
IRA passed through one master trust

POINT:

An inherited IRA not only needs to take advantage of the stretch out but needs protection too. Therefore, individuals may not always be the best choice as a designated beneficiary

This Stretch Out is Not Automatic Merely By Naming Individuals as Beneficiaries

- Beneficiaries can decide to cash out too early and result in “blowout”!
- Or a work plan can force them to!
- Early cash out can lose up to 1/3 of future wealth, possibly millions!
- A trust set up as IRA beneficiary (after corporate plan rollover) can help guarantee the “stretchout” and future family wealth accumulation

Even if beneficiaries *intend to stretch out*, they still may cash out.

Why ?

- **not aware of the RMD rules and their choices**
- see themselves listed as beneficiaries and **impulsively transfer into their own names**
- go to the **plan administrator** asking what to do, are given a check and immediately cash and deposit it
- attempt to **roll over** themselves but do so **incorrectly**
- are **influenced by spouse or 3P to spend** the benefits
- a **work plan may force them to cash out early**

Even if beneficiaries do stretch out, a lot can still go wrong:

- The wrong people may inherit the IRA when the beneficiary names his spouse as the next beneficiary who then names his/her children by prior marriage
- The beneficiary has poor spending habits
- The beneficiary lacks good investment skills
- Loss of the IRA to divorce of the beneficiary
- Improper management by beneficiary who is a minor, elderly or disabled

Even if beneficiaries do stretch out, a lot can still go wrong:

- The beneficiary now or later receives needs based governmental benefits like Medi Cal nursing care benefits, may not qualify because of the IRA payments or Medi Cal may then recover from the IRA benefits after they are paid out
- IRAs in California are exempt from creditors ONLY to the extent necessary for support of participant at retirement. [CCP § 704.115 (a)(3) & (e)] IRAs are also exempt from bankruptcy up to \$1M or for an unlimited amount on roll overs from qualified retirement plans = NOT UNLIMITED PROTECTION

History of Trusts as Beneficiaries

Four Requirements for all Trusts to qualify oldest “individual” beneficiary as measuring life:

1. Trust is valid under state law

Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(1)

2. Trust is irrevocable upon death of owner

Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(2)

3. Beneficiaries of the trust are identifiable from the trust instrument. ***(THIS IS THE TRICKY ONE !)***

Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(3)

4. Documentation requirement is satisfied

Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(4)

History of Trusts as Beneficiaries

Two Types of Trusts

- Conduit Trusts
(IRA distributions paid out)
- Accumulation Trusts
(IRA distributions accumulated)

Treas. Reg. § 1.401(a)(9)-4, Q&A 4
requirements apply to both types

History of Trusts as Beneficiaries

Advantages of Conduit Trust

- Eliminates Difficult Rules of Qualifying Trust as Identifiable Beneficiary – only current benefits counted
- Benefits Stretched to LE of PB and eliminates cash out
- No income tax at trust level

Disadvantages of Conduit Trust

- Does Not Offer Additional Asset Protection
- Loss of Trustee Discretion as to IRA Withdrawals
- Uncertainty of Future of RMDs

History of Trusts as Beneficiaries

Accumulation Trust (*most trusts*)

Advantages of Accumulation Trust

- More Asset Protection
- Necessary for Beneficiaries with Certain Needs
- Mandates Stretch Out

Disadvantages of Accumulation Trust

- More Difficult to Qualify as Designated Beneficiary as Identifiable Beneficiary – all benefs usually counted
- Some Income Tax at Trust Level is Possible

History of Trusts as Beneficiaries

Needs of Beneficiaries Determine Type of Trust

Conduit Beneficiaries

Perfect Child

Financially Astute

Mature/Adult

No Asset Protection Needs

No Special (disability) Needs

Non Exempt GST

Strong Marriage

Older Remainder Benefers

Accumulation Beneficiaries

Troubled Child

Financial Difficulty

Immature/Minor

Needs Asset Protection

Special (disability) Needs

Exempt GST

Marital Issues

Spendthrift

* NOTE: Conduit Benef can become Accumul Benef over time so wouldn't it be nice if you could convert type of trust ?

History of Trusts as Beneficiaries

Issues with Revocable Living Trust Qualifying as “Designated Beneficiary”

1. Unanticipated unidentifiable beneficiary status due to:
 - a. the inclusion of power of appointment (general or limited) in an accumulation trust which makes it impossible to determine who is the oldest beneficiary
 - b. Estate, charity, pet or other non individual cont. benef.
 - c. Expenses of estate, administration or taxes paid by trust, making the estate a de facto beneficiary by some PLRs.

History of Trusts as Beneficiaries

Issues with Revocable Living Trust Qualifying as “Designated Beneficiary”

2. Entire trust may not be entirely irrevocable at death
3. Failure to provide trust document to custodian by October 31 of year following year of death

POINT: If any trust does not qualify as designated beneficiary, must distribute entire IRA within 5 years of death before required beginning date or based upon participant’s life expectancy if death after required beginning date, **so either way, not stretched out; to the contrary, if trust satisfies the 4 rules, 5 year rule does not apply.**

History of Trusts as Beneficiaries

Other Issues with Use of Revocable Living Trust as “Designated Beneficiary”

4. Recognition of income in respect of a decedent (IRD) if pecuniary funding clause is utilized
5. Even if the above is drafted into Revocable Living Trust so that it will qualify as DB of RP, those provisions may conflict with client’s objectives or what is best for non IRA assets
6. Cannot convert from conduit to accumulation trust
7. No separate share treatment usually means cannot stretch over LE of each child beneficiary & must use parent’s LE

IRA Trusts as Beneficiaries

Isn't it about time that someone solved all of these problems ?

1. Suggested Perspective:

a. IRA assets deserve special treatment because:

- (1) most heavily taxed assets
- (2) usually one of the largest assets in the estate
- (3) subject to different rules than non IRA assets
- (4) maximum return on investment requires max stretch out

2. Suggested Solution:

a. Trust Specifically designed for IRA(s) as DB to:

- (1) max stretch out and (2) protect from creditors

PLR 200537004

Changed the Rules as of 9/16/05

Separate Share Rule in PLR 200537004

**Ruling #1: EACH BENEFICIARY'S SUBTRUST SHARE
IN ONE TRUST QUALIFIED FOR MAXIMUM STRETCH.**

Upon the death of the Settlor, ONE IRA STAND-ALONE TRUST created separate shares for each beneficiary (9 beneficiaries), each trust share “treated effective ab initio to the date of the Decedent’s death” and each share functioned as a “separate and distinct trust” for the beneficiary.

**KEY: THE BENEFICIARY DESIGNATION FORM NAMED EACH
SEPARATE SHARE AS A PRIMARY BENEFICIARY OF THE IRA.**

Held: SEPARATE ACCOUNT TREATMENT PERMITTED; MRD of the
IRA for each separate trust share measured by the lifetime of its sole
beneficiary = MAXIMUM STRETCH OUT IN ONE TRUST

Separate Share Rule Works Better Under PLR 200537004

single master IRA trust creating separate subtrust
shares is DB of IRA

—
beneficiary designation form named each separate
subtrust share as a primary beneficiary of IRA

—
IRA paid over each separate trust beneficiary's life
expectancy thus creating maximum stretch out for
all beneficiaries

PLR 200537004

Changed the Rules as of 9/16/05

Ruling # 2: The Trust is allowed to switch each beneficiary's share from a Conduit to an Accumulation Trust, to best suit the needs and circumstances of each beneficiary and therefore a more protective accumulation trust can be used when appropriate

–The trust provided for an independent 3rd party, as “trust protector” to transform each sub-trust to an accumulation trust in the protector’s sole discretion by voiding the conduit provisions *ab initio* and, after Participant’s date of death, Trust Protector exercised “toggle” and converted one share to an accumulation trust.

PLR 200537004 Allows Switch from Conduit to Accumulation Trust

Why is This Valuable and How Does it Work ?

VALUE: ALL beneficiaries MAY require more protection from creditors or mismanagement in the future. The power to switch from a conduit to an accumulation trust allows easier qualification as a designated beneficiary initially and more protection later if needed.

HOW: Trust Protector voids conduit provisions after death of trustmakers and amends remainder benef of accumulation trust to those younger than primary benef.

When is an IRA Trust Appropriate ?

- As a “rule of thumb”: When IRAs in total equal or exceed \$300,000 and represent large % of estate:
 - Both husband and wife’s together
 - Plus any moneys soon to be rolled over from 401(k)s and other corporate plans
- After counseling of all factors in this presentation, client believes that additional assurance of stretch out and/or additional creditor protection of IRA necessitate more planning for IRA that is different from planning for non IRA assets in revocable living trust
- If IRA balance is relatively small and/or is not a large % of total estate and/or can accomplish the same assurance and protection using the RLT as DB, then not the right case

What does an IRA Trust Look Like ?

1. Revocable until death

2. Standalone Trust because:

a. Expenses and taxes cannot be paid from IRA Trust which helps to avoid DB status

b. All Beneficiaries must be identifiable: Allows revocable living trust to name older or charitable beneficiaries and use the normal definition of descendants which includes married and adopted beneficiaries that, if named in the IRA Trust, could eliminate the stretch out. Similarly, RLT may contain GPOA or LPOA which are problematic in IRA trusts.

What does an IRA Trust Look Like ?

- c. Standalone trust allows RLT to have the broadest language that acts to restrict or eliminate income payouts to a beneficiary, which would be problematic in an IRA Trust seeking to qualify for maximum stretch out under conduit provisions.
- d. A separate trust avoids the tremendous danger of having a pecuniary bequest in a master trust which triggers IRD.
- e. A separate trust makes it easier to do later amendments when tax law or retirement asset mix changes the dynamics of the planning.
- f. A separate trust is easier to get the IRA custodian to read, understand and implement.

What does an IRA Trust Look Like ?

3. Established now but not funded until death
 4. DB of IRAs alone
 5. Significant feature: can be structured to hold back MRDs (in accumulation trust) to offer much increased asset protection
 6. Typical Designation of Beneficiary IF Spouse a DB:
 - a. PB: S (for possibility of roll over)
 - b. SB: Bypass under IRA Trust
 - c. TP: Separate Share Trusts under IRA Trust
- * If Spouse rolls over, he or she can name separate shares under IRA Trust as DB which preserves separate share rule at his or her death

What does an IRA Trust Look Like ?

7. Reasons not to use Spouse as DB:

- a. RMDs to spouse may exhaust IRA
- b. If anything left to kids after spouse's death, must use S's LE as measuring life (if spouse did not roll over)

8. How to Designate Beneficiary of Separate Shares:

- a. "The IRA shall be divided into three equal shares for the A subtrust, B subtrust and C subtrust under the IRA Trust dated 1/1/01 and be paid to the trustee of said subtrusts, to constitute three separate shares under Code § 401(a)(9) and the Regulations thereunder."

9. Trust Protector power to convert Conduit to Accumulation Trust

Advantages of Trust Specifically Designed as the Beneficiary of an IRA

1. Qualifies as Designated Beneficiary under Treas. Reg. §1.401(a)(9)-4

- a. irrevocable**
- b. identifiable beneficiaries**
- c. prevents application of 5 year payout rule**

2. Income Tax Stretch Out

- a. guarantees separate share rule treatment**
- b. compel stretch out after death and prevent common occurrence of beneficiary cashing out**

Advantages of Trust Specifically Designed as the Beneficiary of an IRA

- c. power of compound interest
- d. Important for Roth IRAs as well as traditional IRAs because non spouse beneficiaries of inherited Roth IRAs must take RMD

3. Estate Tax Protection

- a. fully fund Credit Shelter Trust
- b. make sure that estate tax not paid by IRA

4. More Asset Protection

- a. spendthrift clause protection of trust
- b. creditor protection

Advantages of Trust Specifically Designed as the Beneficiary of an IRA

- c. divorce protection: QDRO Rules make it easy to transfer the IRA to the other spouse and the divorce rate is over 50%**
- d. Can limit payout to special needs beneficiaries to insure ongoing benefits & inheritance**
- e. needs based governmental benefits qualification & prevention of recovery**
- f. lawsuits**
- g. bankruptcy**

Advantages of Trust Specifically Designed as the Beneficiary of an IRA

5. Other Additional Protection and Control
 - a. protects young, elderly or disabled beneficiaries
 - b. professional Investment management through trustee
 - c. conversion of conduit trust to accumulation trust
 - d. GST planning
 - e. client can establish the post death contingency plan allowing for more disclaimer planning
 - f. advisors can control client's overall planning objectives better

Advantages of Trust Specifically Designed as the Beneficiary of an IRA

- g. proper distribution to participant's intended beneficiaries and not to e.g., spouse's new spouse or spouse's children by prior marriage after roll over
- h. coordination with other estate planning documents and avoids potential conflict of planning for non IRA assets in revocable living trust
- i. prevent control of plan administrator, influence of spouse or 3P or beneficiary to cash out beneficiary
- j. Endorsed by Ed Slott, Robert Keebler C.P.A. and Natalie Choate for the right case



**Thank you for Considering
Something New and Different**