

Law Offices of
Thomas J Bouman PLLC

ESTATE PLANNING • INHERITANCE PROTECTION

7650 E. BROADWAY BLVD. #108
TUCSON, AZ 85710

PHONE (520) 546-3558
TOM@TOMBOUMANLAW.COM

IRA Protection Trusts

1. What is an IRA Protection Trust?

The IRA Protection Trust is a sophisticated estate planning technique intended to coordinate the administration and distribution of IRA assets after death. While generally reserved for persons with more than \$200,000 in tax-advantaged retirement accounts, the IRA Protection Trust is fast becoming an integral component of comprehensive estate plans. The IRA Protection Trust formalizes the availability of the income tax-saving “stretch IRA” rules and permits extensive post-death contingency planning and asset protection planning.

Will-based estate planning fails to adequately address the issues relating to all tax-advantaged accounts, including the IRA, 401(k), and 403(b). The beneficiaries of an IRA are designated on a separate beneficiary designation form, not the Last Will and Testament. Even when completed accurately, the pre-printed options on a beneficiary designation form fail to provide all of the planning benefits available by law.

A comprehensive Revocable Living Trust can be used to address some of the issues, but not very well. Think of the difference between a mini-van and a Formula One racing car. The Revocable Living Trust is the mini-van. It is designed to be flexible and carry the entire family, pets, groceries, luggage, and furniture in a safe, reliable manner. The IRA Protection Trust is the racing car. It is designed to do one thing well. It has very specific design elements that make it a race car. No matter how good the engine, the mini-van is still not going to win races. If you try to retro-fit the race car into a vehicle that transports the entire family, pets, groceries, etc., then it will not function as well as the mini-van would (nor will it work as a race car).

The lesson here is to respect the unique nature of your tax-advantaged retirement accounts. Your estate plan may need a separate trust -- the race car -- to achieve all of your estate planning objectives.

2. What are the Benefits of an IRA Protection Trust?

(a) From the Owner’s Perspective

Depending on the specific trust provisions, an IRA owner may achieve the following benefits by establishing an IRA Protection Trust:

- Owner can compel long term income tax deferral, rather than hope the beneficiary or IRA custodian will not disrupt the plan.
- Owner can establish a post-death contingency plan for the IRA funds in the event of a frivolous lawsuit against the child, or the child's death, divorce, or extended incapacity.
- Owner can direct balance of IRA at surviving spouse's death to Owner's children from a prior marriage, rather than Spouse's children or new spouse.
- Owner can provide logical argument why an irresponsible child's inheritance has been restricted; especially when IRA Trust appears to treat all children equally.

(b) From the Beneficiary's Perspective

Depending on the specific trust provisions, a beneficiary may receive the following benefits by inheriting IRA funds through an IRA Protection Trust:

- Beneficiary receives a much larger inheritance by leveraging the income tax deferral over a longer period.
- Beneficiary receives an inheritance fund that is protected from frivolous lawsuits and ex-spouses.
- Beneficiary receives an inheritance fund that may pass to the Beneficiary's heirs free of estate tax at the beneficiary's death.
- Beneficiary with special needs will not lose eligibility for need-based government benefit programs.

3. Does this Work for Large 401(k) and 403(b) Accounts?

Maybe. Any qualified retirement plan may permit a nonspouse beneficiary to rollover a deceased employee's account to an Inherited IRA. However, many large employers refuse to offer the beneficiary rollover option. It's easier for the company to write a check to the beneficiary than to get involved with transferring funds to an Inherited IRA. For now, nonspouse beneficiary rollovers of employer sponsored accounts continue to be optional with the plan, and there are no plans to change that. The answer depends on whether your employer plan offers the nonspouse beneficiary rollover. This is usually determined by reviewing your plan summary document.

Of course most people don't die while they still have money in a 401(k) or 403(b). They will leave their employer for reasons other than death and have time to move their funds elsewhere. Although every situation is different, it is a good practice to transfer your

employer sponsored retirement account to an IRA when you are no longer working for the employer. The beneficiaries of an IRA can get a life expectancy payout and the IRA Protection Trust technique is almost certain to work the way you intended. The reason is because IRA custodians, in general, are more knowledgeable about these complex rules than are employers.

Unfortunately, if you have an employer sponsored retirement account and your employer's policy is to pay out a taxable lump sum immediately upon your death, then your children (or other heirs) will not be able to take advantage of the stretch IRA rules should you die before moving the funds to an IRA. Therefore, we must review the rules of your employer sponsored plan prior to naming an IRA Protection Trust as beneficiary.

For purposes of this article, the author assumes you have a traditional IRA, although the technique may work for other types of retirement accounts.

4. What Typically Happens to an IRA After Its Owner Dies?

[Skip this section if you are already familiar with MRD rules]

Retirement accounts are not designed to serve as wealth transfer vehicles. They were created by Congress to encourage retirement savings, and lessen the burden on the social security system. Thus, the simplest distribution plan -- and the one the government wants you to use -- is to withdraw all of your retirement savings during your retirement years and then die when your account reaches zero. However, as tax-deferred retirement accounts have become more popular during the last 20 years, it is more likely that you will have money left in your retirement accounts when you die. From an estate planning perspective, it is important that you clarify how you want to leave these assets to your heirs after death.

Before proceeding further, a summary of the *lifetime* distribution rules is in order. During your working years, the Congress wants you to invest a portion of your earnings into retirement savings. The Congress has established a tax policy that encourages savings by giving various tax breaks to those who are able to save. The most valuable tax break is that money invested through an IRA (or 401k, 403b, etc.) may grow income tax-deferred. Investment profits are reinvested without having to pay income tax on that profit each year. This tax-free compounding can permit extraordinary increases in value over a long period of time. But there is a catch.

The Congress does not provide this tax break for free. Uncle Sam wants his share eventually. Basically, there are two choices. You can pay the income tax up front; i.e., when you deposit the money into the account (e.g., Roth IRA). Or you will have to pay income tax on the amounts you withdraw later (e.g., Traditional IRA, 401k). If you take the second choice, you cannot wait forever. In fact, you must begin to take withdrawals during the year that you attain 70 1/2 years of age -- even if you don't want or need to. This is called the Minimum Required Distribution or MRD for short. Each subsequent year the tax law requires you to take a taxable distribution from your account. The initial MRD is small (in percentage), but the distributions will increase in size as you get older.

The good news is that MRDs are usually small enough -- especially before you reach your mid-80s -- that with good investment returns your account may continue to increase in value even though you are taking out MRDs each year.

The tax laws for retirement accounts are very complex. You probably don't need to know many of the details. Here is what you should remember: MRDs are good. They achieve the Congress's purpose and prevent your retirement money from eroding too quickly. MRDs are so good that you should want your heirs to use them too. Unfortunately, it's not that easy. Remember that the Congress did not intend for tax-deferred retirement accounts to last forever. They were intended to supplement your Social Security income. In other words, if you end up being one of those people who still has a large amount of money in your IRA after death, then the Congress will want your heirs to withdraw the money you didn't need. The real question is *how* your heirs must take out this money. For most people, when completing the beneficiary designation for a retirement account, they focus on *who* is entitled to receive the account. Certainly that is important, but a comprehensive estate plan must also answer some additional questions:

- How quickly must the beneficiary withdraw the money?
- What are the tax consequences to the beneficiary?
- Who inherits the account if a beneficiary dies while receiving MRDs?
- Are the distributions received by a beneficiary protected in the case of divorce or lawsuit?

If you are concerned about these issues, then there are some general rules that you need to know:

(a) Life Expectancy Tables

The MRD rules are based on a life expectancy calculation for the beneficiary. Before your death, the MRD is calculated using your age and an IRS tax table that estimates your life expectancy. The older you are, the larger the MRD. After your death, the MRD is calculated using the age of a beneficiary. In general, the beneficiary must be an individual, although in some cases the IRS will permit the beneficiaries of a trust to qualify for this purpose.

For example, assume Dad dies and leaves a \$100,000 IRA to his 55 year old son. The IRS tax tables calculate the first year MRD using a 29.6 year life expectancy for the son. Thus, the MRD is \$3,378 ($\$100,000 / 29.6$). In other words, if the IRA investments achieve a return higher than 3.38%, then the IRA value will actually increase during the year. In year two, the son's MRD will be calculated by dividing the IRA value by 28.6 (29.6 less one each year).

(b) Benefits of Naming Spouse as Beneficiary

If you are married, there are three advantages to naming your surviving spouse as beneficiary. First, a surviving spouse can “roll over” your IRA into the spouse’s IRA. This permits the spouse to wait until age 70 1/2 before starting to take MRDs. Second, a surviving spouse calculates MRDs using a different, more favorable, IRS tax table. The MRDs will be smaller than they would be for a similar age non-spouse beneficiary. Third, the spouse’s life expectancy is recalculated each year so that MRDs increase at a slower pace than they would for a non-spouse beneficiary.

(c) Payout Options for Non-Spouse Beneficiary

When a non-spouse individual is named as beneficiary, the individual has two basic choices for how to receive the IRA assets:

- Lump sum payment
- MRDs based on life expectancy (“Stretch IRA”)

A third option, called the Five Year Rule, is available when the IRA owner died before reaching age 70 1/2. Under this rule, annual distributions are not required. The only requirement is that the entire IRA must be distributed by December 31 of the year that contains the fifth anniversary of the IRA owner’s death.

The lump sum payout option means that the beneficiary will treat that amount as taxable income and pay income taxes on the entire amount immediately. The after-tax balance will be owned outright by the beneficiary. Future investment income is also taxable each year.

The Stretch IRA option means that the beneficiary will receive the MRD each year until the beneficiary dies or the IRA is depleted. The younger the beneficiary is, the smaller the MRD will be. Even if the Stretch IRA option is chosen, the beneficiary may choose to take out more than the MRD at any time. There is nothing to prevent the beneficiary from depleting the account.

Some retirement plans will not provide all the options available by law. Many employer sponsored plans will mandate the lump sum payment, even though they are permitted to offer the Five Year Rule or life expectancy. Others will permit “trustee-to-trustee” transfers to an Inherited IRA or IRA Protection Trust, but others will not. On the other hand, the author is unaware of any major IRA providers that do not offer the Stretch IRA option. Unfortunately, some IRA providers are more cooperative than others when evaluating customized beneficiary designations.

(d) Beneficiary Has Full Control

When you name an individual as beneficiary, the beneficiary has all of the control. Even if you know the Stretch IRA option is best, there is no way to compel a named beneficiary to choose this option. In addition, the beneficiary can spend your IRA money on whatever he or she chooses which might conflict with the customized distribution plan described in your Revocable Living Trust or Will.

5. Who are Good Candidates for an IRA Protection Trust?

(a) IRA Owner Has Large IRA

Your large IRA may be decimated by estate and income taxes. Even responsible children may not be able to resist the immediate gratification that comes from a lump sum inheritance, rather than choose the life expectancy payout which, over time, will produce a larger and safer inheritance. An IRA Protection Trust will assure that your heirs take full benefit of the Stretch IRA rules.

(b) IRA Owner Has Children from a Prior Marriage

If you have children from a prior marriage, and leave your IRA outright to your surviving spouse, you may want to assure that the balance of your IRA, after your spouse's death, is distributed to your children by your first marriage, not the children of the second spouse. An IRA Protection Trust can be designed to give your surviving spouse a lifetime income stream, but prevent changes to the ultimate beneficiaries.

(c) IRA Owner Has Taxable Estate, but Few Assets to Fund Credit Shelter Trust

If you are married and have more than \$2 million of assets, and they consist primarily of retirement assets, then naming your spouse as primary beneficiary is likely to create a larger estate tax burden at the survivor's death. An IRA Protection Trust can be designed to shield a portion or all of the retirement assets from estate tax.

(d) IRA Owner Wants to Treat Children Differently, Without Making it Obvious

Sometimes a parent wants to prevent one child from receiving a lump sum inheritance without penalizing the other more responsible children. The IRA Protection Trust permits a parent to accomplish this quietly. The trust can be drafted to appear like the parent is treating all children equally when actually it is just formalizing the Stretch IRA provisions for the less responsible child.

(e) IRA Beneficiary's Marriage is Unstable

If a beneficiary gets divorced, an inherited IRA may be treated as joint property that is available to the ex-spouse during settlement negotiations. Also, lump sum payouts and MRDs received by the beneficiary prior to the divorce are likely to be commingled with the other spouse's assets. An IRA Protection Trust will keep the IRA assets in your family and prevent an ex-spouse from controlling the ultimate distribution.

(f) IRA Beneficiaries are Minor Children

Regular IRA distributions to a minor child are usually subject to the custodianship rules (UTMA) in the state where the child resides. The child's guardian may choose a lump sum payment instead of the more favorable Stretch IRA rules. Under most state custodianship laws, a child is granted full control of the IRA upon attaining age 21. An IRA Protection Trust will continue to keep the money available for important needs, and retain the balance safely in trust, without the need for a custodianship.

(g) IRA Beneficiary is Eligible for Government Disability Payments

IRA distributions to a special needs child or grandchild will likely be counted as income when determining eligibility for low-income based government benefits. An IRA Protection Trust can be designed to supplement these government benefits without replacing them.

(h) IRA Beneficiary Has Substance Abuse, Gambling, or Criminal Problems

Any inheritance left to beneficiaries with drug addictions or trouble with the law carries the risk of hurting the beneficiaries instead of helping them. This type of beneficiary is likely to choose a lump sum distribution and then use the windfall to finance a bad decision. An IRA Protection Trust transfers control to a responsible trustee.

(i) IRA Beneficiary Works in High-Risk Profession

Inheritance left outright to anyone is available to a judgment creditor after a successful lawsuit. If your beneficiary works in a high risk profession (e.g., business owner, doctor), then an IRA Protection Trust will protect the IRA from judgments and put the beneficiary in a better settlement negotiating position.

(j) IRA Beneficiary Lacks Money Management Skills

A naïve beneficiary may not realize the complex factors involved when choosing how to receive an Inherited IRA. An IRA Protection Trust permits the trustee and estate planning attorney to educate the beneficiary.

6. I've Heard it's Wrong to Name a Trust as Beneficiary. Why?

The rules for post-death distribution of retirement plans are complex, especially when trusts are involved. This decision should be made only after obtaining counsel from an estate planning attorney who is familiar with these issues. In general, a trust does not qualify for the Stretch IRA option because it is not an individual with a life expectancy. In order to make a trust qualify, the trust must meet specific requirements. If they are met, then the IRS permits the IRA custodian to “look through” the trust to the beneficiaries and use their life expectancies to calculate the MRDs. When drafted correctly, it is perfectly acceptable to name a trust as beneficiary. The document must comply with all the appropriate tax rules, but otherwise there are no restrictions on what it may provide, other than what the IRA custodian will approve.

7. How Does the IRA Protection Trust Work?

The IRA Protection Trust is a legal document which establishes the framework for post-death contingency planning, tax planning, and asset protection planning. The trust is designed to give your successor trustee specific instructions about how to handle your retirement accounts and coordinate their distribution with the rest of your estate plan. The trust will address more contingency options than a standard beneficiary designation. For example, you can designate your grandchildren to inherit the IRA in the event your daughter dies while receiving MRDs, instead of giving your son-in-law the opportunity to direct it somewhere else.

The IRA Protection Trust will give instructions regarding how and when withdrawals should be made from the IRA and then to your beneficiaries. The trust will also include successor trustee provisions so you know who will be carrying out your wishes.

When your IRA becomes payable to the trust, the trustee will make sure that all requirements are met for having an IRA payable to a trust. If there are multiple beneficiaries of the trust, then the trustee will instruct the IRA custodian to create separate sub-accounts according to the distribution plan that is described in your trust agreement.

Eventually the IRA custodian will begin to calculate MRDs and send them to the trustee of each sub-account. The trustee will then forward the money to the beneficiary or retain it in trust, depending on the provisions in your trust agreement.

8. Who Manages the IRA Account After my Death?

Every trust is managed by a trustee. The IRA Protection Trust is no different. In the trust agreement, you will need to name a successor trustee who will be responsible for carrying out your wishes. You may also nominate your own financial advisor to continue servicing the account. The most important task of a successor trustee is to communicate with the IRA custodian in order to set up the long term investment and distribution plan.

You may appoint anyone as successor trustee. The trustee is responsible for choosing the investment strategy, insuring that proper distributions are made, and completing the trust's annual tax returns.

Most IRA owners appoint a trusted family member or friend from a younger generation who is financially savvy and comfortable working with service professionals in the financial industry. Alternatively, you can appoint a bank, trust company, or lawyer as trustee. Family members and friends may receive compensation for their work, although often they choose not to. Professional trustees will charge a fee based on the value of the IRA account. During your lifetime, your successor trustee has no control over your IRA.

After the investment and distribution plan is established, your trust agreement might appoint the beneficiary as trustee of his or her own trust. This would be appropriate for responsible adult children without unusual creditor concerns. For younger children, you might include a provision that permits them to become trustee of their own trusts when reaching a specific milestone, such as age 25 or graduation from college.

9. Do I Lose Any Control of my IRA Before I Die?

No. The IRA Protection Trust will not change any aspects of your retirement planning until after your death. If you are married, nothing will change until both you and your spouse have died. While you are living, you retain total control over the IRA investments, distributions, and choice of beneficiaries. You may withdraw all of the money and spend it on whatever you want. There are no restrictions.

10. Can I Make Changes to the Trust after it is Established?

Yes. The IRA Protection Trust is revocable and amendable. As long as you are alive and mentally competent, you can make changes to your IRA Protection Trust.

11. How Can I Get the Best Asset Protection for my Heirs?

There are two types of IRA Protection Trusts: conduit and accumulation. While both include asset protection features, the accumulation trust is stronger. Here's why:

The conduit trust requires that the trustee forward the MRDs from the IRA to the beneficiary each year. The trust actually serves as a flow-through -- conduit -- when MRDs are paid out.

The accumulation trust permits the trustee to retain -- accumulate -- the MRDs inside separate account owned by the trust instead of giving them outright to the beneficiary. The accumulated money is secure from creditors.

The trustee of a conduit trust does not have any discretion about whether a trust distribution is appropriate. In fact, the trustee must distribute at least the amount of the MRD each year. However, the trustee of an accumulation trust will use its discretion when choosing whether to distribute trust funds to the beneficiary. You may want to include guidelines in the trust agreement to help the trustee know what kinds of distributions you would approve.

Based on a recent IRS ruling, it is possible to give an independent advisor (e.g., attorney, financial advisor) the power to change a trust from a conduit trust to an accumulation trust. This “toggle” concept requires precise drafting, and removes some flexibility when choosing contingent beneficiaries. However, it may be very useful when naming young children, grandchildren, or unborn heirs as potential beneficiaries of your retirement accounts.

There are many factors to consider when choosing between a conduit or accumulation trust, which should be part of a careful discussion with your estate planning attorney.

12. What is the Process to Set Up an IRA Protection Trust?

First, retain an estate planning attorney experienced with IRA Protection Trusts to design a comprehensive trust agreement along with a customized beneficiary designation.

Second, choose an IRA custodian that will accept your customized IRA beneficiary designation.

13. Why Not Incorporate These Provisions into my Revocable Trust?

Most Revocable Living Trusts fail to consider all of the complex rules regarding retirement accounts payable to trusts. They are focused on dealing with assets otherwise eligible for probate, like your real estate and bank accounts. For example, if your Revocable Living Trust agreement could potentially direct inheritance to an accumulation trust (meaning that the trustee has the power to accumulate distributions in the trust), then the MRDs must be calculated based on the life expectancy of the oldest beneficiary. Unfortunately, even potential beneficiaries count, so for example, even naming your parent as contingent beneficiary of your assets is enough to trigger use of the parent’s life expectancy instead of a younger, primary beneficiary’s life expectancy. Revocable Living Trusts are rarely drafted with the necessary precision to avoid problems like this.

Another reason why a separate IRA Protection Trust is preferred to a Revocable Living Trust as beneficiary of retirement accounts is that a trustee may find it difficult to transfer an IRA directly to the individual trust beneficiaries, where the IRA was payable to a trust that was to terminate immediately upon the IRA owner’s death and be distributed outright to the beneficiaries. Some IRA custodians refuse to permit this type of transfer,

although others will permit it upon receipt of a legal opinion letter. Your Revocable Living Trust might have staged distributions for children. After the children reach the maximum age for trust retention, your trustee might run into this problem if you fail to revise the trust agreement.

Although commonly found in Revocable Living Trust agreements, there are no boilerplate provisions that can assure that the trust will qualify as a “look through” trust to allow the use of its beneficiaries’ life expectancies. Because custom drafting is required, estate planning attorneys who are familiar with these issues generally prefer to isolate treatment of retirement assets from the rest of the IRA owner’s assets in order to treat them more intentionally.

14. Why Not Use a Trusteed IRA?

A few select IRA custodians offer a technique called the Trusteed IRA (aka individual retirement trust). This is similar to an IRA Protection Trust because it gives you additional control over the choice each beneficiary makes regarding the distribution plan. It is better than naming a beneficiary outright because you can limit the beneficiary’s access to the IRA assets. The owner can also exercise more control over contingency planning.

Here are the drawbacks when compared to the IRA Protection Trust:

- Trusteed IRA does not permit accumulation feature, so its usefulness is limited to situations when all beneficiaries are mature, responsible, financially astute, and relatively safe from potential creditor and divorce problems.
- Loss of trustee discretion, so there is no flexibility to turn on accumulation feature in case of major anticipated tax increase or change in MRD rules.
- Trusteed IRA does not allow highly customized trust provisions, which are often desired for large IRAs and complex family issues.
- The only established provider of Trusteed IRAs has a \$500,000 account minimum.

One way to think about this comparison is to use the Three Little Pigs folktale. Which do you want to build your house on?

- Straw Name your child as the outright beneficiary
- Sticks Name your child as beneficiary of a Trusteed IRA
- Bricks Name your child as beneficiary of an IRA Protection Trust

As the mother of the little pig who built his house upon the bricks said, “You see it is just as I told you. The way to get along in the world is to do things as well as you can.”