



ActionLine

A PUBLICATION OF THE FLORIDA BAR REAL PROPERTY, PROBATE & TRUST LAW SECTION

Vol. XXIX, No. 2
Winter 2007
www.rpptl.org



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About the Cover: While not the "official" state flower, orchids thrive and grow aplenty throughout the state. RPPTL Section officer, John Neukamm, captured the beauty of a winter white bloom.

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The deadlines for all submissions are as follows:

Issue	Deadline
Spring 2008	Jan. 31, 2008
Summer 2008	April 30, 2008
Fall 2008	July 31, 2008

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IRAs and Estate Planning: Creative Ways To Address the Tax Challenges

By Matthew T. McClintock, J.D., Director of Continuous Improvement and
Member Collaboration at WealthCounsel, LLC

When individual retirement accounts were first introduced in 1974 with the enactment of the Employee Retirement Income Security Act (ERISA), the oldest baby boomers were 28 years old. This year those baby boomers are turning 61, and the amount of money sitting in IRAs and other qualified retirement accounts is estimated at more than 25 trillion dollars. Because the account balances will be included in the owners' estates when they die, and because withdrawals will be income taxed to the beneficiaries as income in respect of a decedent ("IRD"), estate planners must find creative ways to minimize the tax hit and protect account balances from beneficiaries' creditors.

Over the past decade we have seen a marked increase in the number of clients with substantial assets in income-tax advantaged accounts. Often these assets comprise a significant portion of clients' overall estates. Because these accounts generally constitute IRD, they pose additional planning challenges. Not only is the account value includable in the client's taxable estate, amounts distributed to the beneficiaries after the client dies are subject to income tax. The conscientious planner must be familiar with the multifaceted tax issues, as well as traditional aspects of trust-oriented estate planning, to comprehensively meet clients' needs.

Because account distributions are income taxed, the longer the account remains intact for the beneficiary, the more the account can grow, and the longer the income tax is deferred. Assuming the account beneficiary qualifies as a "Designated Beneficiary" under the Regulations, the beneficiary may stretch the account distributions over the beneficiary's life expectancy.¹

But what assurances does the client have that the distributions will indeed be stretched out? What prevents the beneficiary from withdrawing the entire balance and walking away, triggering substantial income tax liability? If the beneficiary has creditor problems, how are account proceeds protected? If the client's spouse is the beneficiary and the client has kids from a prior marriage, how can planning ensure that those children ultimately receive the leftovers when the spouse dies?²

Considering the severity of the implications, it is essential to understand and balance not only the tax considerations that affect retirement accounts, but also the broader estate planning implications involved with getting the right property to the right beneficiaries the right way. Proper planning maximizes the total

benefit for the beneficiaries, combining the financial benefits of the stretch with the protection of careful trust planning.

Trusts can ensure the stretch and provide protection

There is little need to extol the protections trusts generally afford beneficiaries. No doubt trusts created for beneficiaries can provide greater protections for the beneficiaries than the beneficiaries can provide for themselves. Let us examine the spectrum of options available for structuring trusts that will not only ensure the stretch of retirement account distributions but also provide significant protections for the beneficiaries.

Conduit trust – Low/ No perceived need for protection

A "conduit" trust mandates that the trustee withdraw a required minimum distribution ("RMD") from the retirement account based on the primary beneficiary's life expectancy and immediately distribute that amount to the beneficiary. No amounts withdrawn from the account are accumulated in trust.

The trustee may withdraw additional amounts from the account to the beneficiary, if necessary. A conduit trust qualifies as a designated beneficiary under the Treasury Regulations, permitting the trustee to calculate the annual RMD based on the life expectancy of the trust's primary beneficiary.³

Although a conduit trust is eligible to stretch benefits over the beneficiary's life expectancy, we cannot ignore some important factors. Because the amounts withdrawn from the account cannot be retained in trust but must be distributed to the beneficiary, there is no hedge of protection for a beneficiary with poor spending habits, a bevy of creditors, or unsavory vices. Risk is compounded by the size of the account and by the age of the beneficiary. The older the beneficiary, the shorter the beneficiary's life expectancy is, and the greater the divisor for determining the RMD.

Because only the primary beneficiary's life expectancy matters for determining the RMD divisor, conduit trusts are appropriate when the trust benefits both charitable and individual beneficiaries. But because the RMDs cannot accumulate, conduits make sense only where asset protection is not a concern. A conduit guarantees the stretch, but works best for "perfect" beneficiaries with no creditor

What prevents the beneficiary from withdrawing the entire balance and walking away, triggering substantial income tax liability? If the beneficiary has creditor problems, how are account proceeds protected?

problems or when clients want the stretch with minimal trust administration.

Accumulation trust – High need for preservation/protection

Unlike a conduit trust, an accumulation trust does not automatically distribute account withdrawals to the beneficiary.⁴ All distributions from the trust, including RMD withdrawals, are subject to the trustee's discretion. Because the trust is a discretionary trust, the beneficiary enjoys protection from the claims of judgment creditors or the influence of bad friends or bad decisions. Accumulation trusts can also be structured for special needs beneficiaries.

The accumulation trust is harder to qualify as a designated beneficiary under the Regs than the conduit trust. Instead of looking only at the age of the primary beneficiary to determine the RMD divisor, we must consider all trust beneficiaries and use the oldest beneficiary's life expectancy to determine the divisor.

This process can be more complicated than it appears. We must look beyond the named beneficiaries and consider contingent remainder beneficiaries, too. We must consider the scope of the beneficiary's powers of appointment, if any. If the trust contains a charitable or other non-identifiable beneficiary – even as a remote contingent beneficiary – or if a named beneficiary holds a testamentary general power of appointment over the trust then the stretch is blown; the entire balance of the retirement account must be withdrawn within five years of the account owner's death.

If any contingent beneficiary is older than the primary beneficiary, the trust is stuck with the life expectancy of the oldest beneficiary, even if that beneficiary's interest is quite remote. But a carefully structured accumulation trust can still qualify as a designated beneficiary eligible to stretch distributions from the retirement account. And, the trust affords the general protections that discretionary trust planning provides.

It is possible to structure different types of subtrusts within a single trust instrument. Depending on the beneficiaries' needs and the trustmaker's desire to provide protection, one trust instrument can contain a mix of conduit and accumulation subtrusts. This allows the trustmaker to customize the beneficiaries' protection as needed and ensure the stretch.

Mixing Techniques – Converting from Conduit to Accumulation Trusts

A final strategy worth examining is illustrated in PLR 200537044. Under this technique, all of the subtrusts begin as conduits, ensuring "safe harbor" qualification for the stretch. But the trust also appoints a trust protector with carefully-designed powers to modify the trust. If the trust protector believes it is in the best interests of the beneficiaries, the trust protector may convert any conduit subtrust to an accumulation subtrust.

This power can be tremendously effective when wielded by a skilled trust protector. If the protector believes that a beneficiary's trust interest may become exposed to credi-

tors' claims or the wiles of predators, the protector strips away the conduit provisions in the affected subtrust and any other provisions that would otherwise prevent the trust from qualifying as a designated beneficiary under the Regs. The trust gets stretch treatment for the retirement account, and the affected beneficiaries enjoy discretionary trust protection. Best of all, the availability of the trust protector's switch option allows custom-tailored flexibility when needed.⁵

It's worth remembering that the IRS is not bound to the effect of a PLR to anyone other than the taxpayer who obtained the ruling. Although the ruling may give an indication on how the IRS might rule in similar situations, it cannot be relied upon as binding precedent.⁶

Estate planners with a solid understanding of the options clients have when planning with retirement accounts will be well-positioned to set themselves apart from their colleagues. ■

Endnotes:

1 Treas.Reg. §1.401(a)(9)-5, A-5(c)(1)

2 Much more can be written on the implications of naming the client's spouse as the primary beneficiary under a retirement account than room allows here. The implications of effectuating a spousal rollover, structuring an inherited IRA for a spouse, or structuring a QTIP or bypass trust for the benefit of the spouse with IRA money are all essential issues for the planner to understand, but are beyond the scope of this article.

3 Because the conduit trust meets the IRS' "safe harbor" requirement to qualify as a designated beneficiary, we need only look at the life expectancy of the primary beneficiary of the trust for purposes of calculating the RMD; no other beneficiary matters. For a checklist of what is required for a trust to qualify as a "Designated Beneficiary" under the Regs, see Treas.Reg. § 1.401(a)(9)-4, A-5(b).

4 By definition, any trust that is not a "conduit" trust is an "accumulation" trust, granting the trustee discretion in whether or not a distribution will be made from the trust.

5 Under the PLR, the trust protector converted a conduit trust to an accumulation trust within nine months of the account owner's death and before September 30 of the year following the owner's death. Although not directly stated, the IRS suggests that the trust protector's action was analogous to the exercise of a disclaimer under applicable state law, rather than as a power to modify. It is therefore recommended that if the protector plans to convert a conduit trust to an accumulation trust, it should be done within the time permitted by state law for exercising a disclaimer (typically within nine months from the owner's death).

6 IRC §6110(k)(3).



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