

Leaving IRAs to trusts — a good tax-minimizing device

By Reni Gertner
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As the baby boomers become the first individuals to retire with big IRAs, estate planning attorneys must be prepared to help clients minimize the tax burden on their beneficiaries by leaving their IRAs to trusts.

"As estate planning attorneys, we're going to run into more people who hold big retirement plans," said Lew Dymond, former CEO of WealthCounsel, a membership organization that provides services to estate planning lawyers.

In order to reduce income tax and protect an IRA from creditors after the owner's death, experts say, the best thing to do is leave it to a trust.

"[Given] that so many beneficiaries now have a target on their back, from a failed marriage to a failed business to unpaid creditor issues, we're talking about protecting a lot of money," said Matthew McClintock of Oklahoma City, who is the director of Continuous Improvement & Member Collaboration for WealthCounsel.

The key is that an IRA trust must be structured such that the required distributions are stretched out over time, allowing a beneficiary to defer income tax. The intention is to make sure the distributions are spread out over the life expectancy of the youngest beneficiary.

However, experts say that estate planners often avoid using this technique because it can be tricky and requires knowing a host of specific rules.

As a result, "this is a great opportunity for a lawyer who wants to step up to the plate and learn these rules," said Robert Keebler, a CPA and financial planner in Green Bay, Wis.

Cliff Rice, an estate planning attorney who is a partner with Rice & Rice in Valpariso, Ind., agreed.

But, he said, "there is a sharp learning curve and attorneys need to bone up on it."

Two types

An IRA can be left to one of two types of trusts: a conduit trust or an accumulation trust. An IRA trust can also be created with subtrusts for multiple beneficiaries.

While a conduit trust is easier to draft, it doesn't offer the same level of protection from creditors as an accumulation trust.

"You might select a conduit trust if you know with relative certainty that the beneficiary doesn't have and won't likely have creditor issues," said

McClintock.

He suggested assessing which type of trust to use on a sliding scale, based on the account value and the importance of protecting the IRA from creditors.

"A \$100,000 or \$200,000 IRA given to a beneficiary that is fairly safe from creditors could be left to a conduit trust," said McClintock. "But if you have a beneficiary with a gambling addiction or known creditors, a conduit might not make sense."

A conduit trust is simpler than an accumulation trust because you only have to look at the life expectancy of the primary beneficiary to calculate the applicable distribution period. It can be used whether the beneficiaries are

charities or individuals. However, it lacks protection from creditors because it requires the trustee to take minimum distributions from the trust and distribute them directly to the beneficiary.

An accumulation trust also provides greater protection from creditors because the trustee keeps the funds in the trust until he or she determines it is appropriate to make a distribution.

In addition, a third-party trust protector is given the power to restrict who can receive the property.

The difficult part, however, is that an attorney must be careful when drafting

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the trust because minimum distributions must be taken based on the life expectancy of the oldest beneficiary — including contingent remainder beneficiaries.

"You have to limit who the beneficiaries are and make sure that under no circumstance you will have a beneficiary who is older than the primary beneficiary of that trust," McClintock said, because then the money will have to be distributed too quickly.

Another option is to create a conduit trust set up in such a way that it allows a trust protector to strip it of certain provisions and turn it into an accumulation trust.

"If circumstances change after the trust is established, a trust protector can convert any portion of the trust from a conduit trust to an accumulation trust by stripping away provisions," such as a general power of appointment, McClintock said.

The IRS approved this technique in a 2005 private letter ruling, PLR 200537044. In that case, all of the IRA

subtrusts began as conduit trusts, but a trust protector was appointed with the power to modify the trust.

Although private letter rulings aren't binding in subsequent cases, practitioners look to them to understand the IRS's viewpoint on an issue.

McClintock said this strategy provides significant flexibility. He noted that creating a conduit trust first guarantees that the trust qualifies as a designated beneficiary of the IRA, but you can then reap the potential creditor-protection benefits of an accumulation trust by later converting.

"If you're doing an IRA trust, this is the best of both worlds," said Rice.

Designated beneficiary

A crucial step in the process is making sure the trust qualifies as a "designated beneficiary."

A conduit trust automatically qualifies as a designated beneficiary under a safe harbor provision in the IRS regulations.

But you have to be more careful with an accumulation trust.

"The regulations on how to draft an accumulation trust are pretty heavy reading," said Thomas Ray, an estate planning attorney with Ray Law Offices in Arnold, Mo. "There are a number of steps you have to walk through to make sure it qualifies as a designated beneficiary."

To qualify as a designated beneficiary, Keebler said a trust must:

- Be valid under state law,
- Be irrevocable upon death,
- Have "identifiable" beneficiaries, and
- Be provided to the plan administrator by Oct. 31 following the year of death.

Of all the requirements, "the big problem is the beneficiary being identifiable," said Keebler.

For example, if any beneficiary of an accumulation trust is a charity — which doesn't have a life expectancy — the IRA trust loses the benefit of stretching out the distributions.

The trust also fails to qualify as a designated beneficiary if a named beneficiary has a general power of appointment.

One way to make an accumulation trust more likely to qualify as a designated beneficiary is to leave the IRA to a stand-alone accumulation trust, which becomes irrevocable at the owner's death.

Given the complex requirements that must be met to make sure a trust qualifies as a beneficiary of an IRA, it's easier to use a stand-alone trust than to leave the IRA to an existing revocable living trust.

"When you have a stand-alone retirement trust, you reduce the likelihood of errors that can cause a trust not to qualify," said McClintock.

Experts also stressed the importance of making sure the beneficiary designation form is filled out properly, and that the documents are drafted to ensure that each beneficiary obtains his separate share of the IRA.

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