



How To Protect Qualified Accounts from Predators, Creditors, Youth and Inexperience

By: Larry Hartley, Esq., CELA



The Problem – and the Opportunity

On a regular basis, estate planning attorneys encounter clients who have successfully accumulated large amounts in qualified retirement plans. These qualified monies may be sitting in individual retirement accounts (IRA's), or they may be held in company pension plans such as 401(k)'s. In most cases, the intent was to provide the owner with a secure retirement. Partly as a result of the tax-deferred growth within such accounts, many have grown over the years to become a significant asset in the client's portfolio. When a client has successfully amassed other wealth, he or she may be in the enviable position of no longer needing the money in qualified accounts for support, and is often loathe to take even the required minimum distributions when he or she reaches 70 ½. The concern – and one which is frequently put into play when meeting with us for estate planning – is how best to pass these assets onto the next generation without triggering the enormous deferred income tax inherent in such assets.

We find that most clients have designated the usual suspects as beneficiaries for qualified accounts – the spouse, if living, and, if not, the children or grandchildren. With this “default” beneficiary designation, problems are most likely to occur on the death of the surviving spouse, when descendants will have outright access to these funds. While we, as estate practitioners, believe in and preach deferral for such accounts, the world of a 25-year-old doesn't readily accommodate such concepts, and is more amenable to valuing the benefits of a great home theater system or the rumble of a large-bore V-8.

In addition, if the qualified account owner has a taxable estate, which in many cases they do, they soon become aware of the tremendous income tax bite which would result if a qualified account had to be liquidated to pay estate taxes. As estate planning attorneys, we often give clients advice about using non-retirement assets to pay estate taxes when

due, and we often work with the clients' tax and insurance advisors to establish strategies of turning taxable assets into non-taxable assets. However, in many cases there will be a substantial amount of retirement account assets left to pass onto family members after the death of the account owner.

How to Not Kill the IRA Goose

Due to the complex rules and regulations on the transfer of retirement account assets to other family members, difficult issues arise in passing these assets to beneficiaries. The threshold question is, if there is a surviving spouse, whether or not to leave the qualified account to him or her, or whether those assets should pass to descendants in some manner. In the modern age, issues such as children from prior marriages further complicate this decision. Even if the surviving spouse is the first spouse and shares all of the children in common with the qualified account owner, the surviving spouse's age must be taken into account.

Under a “second marriage” scenario (which includes third and subsequent marriages, as well), the qualified account owner will have valid concerns about the potential disinheritance of his or her own descendants over the descendants of his spouse. This alone may be a good reason not to leave a qualified account outright to the surviving spouse. At this point, it is logical to consider leaving such an account in trust.

Aside from the usual requirements for properly drafting any type of estate planning trust, IRS rules regarding qualified accounts held in trust are complex and treacherous. If such a trust is not properly drafted, all of the account may have to be withdrawn in as little as five years after the death of the owner, with the subsequent loss of tax-deferral and with likely imposition of income tax at the highest bracket. Combined federal and state income tax rates can easily reach 40%. To the owner of a qualified account who has frugally saved and invested retirement account assets, the thought of seeing his family lose nearly half the account

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within five years of his death is a bitter pill to swallow. The account could also be further reduced (70% to 80%) if it had to be plundered to pay estate taxes.

While there are many techniques to ensure that such assets are not used, this discussion will focus on how to protect a qualified account after the estate is settled. Because of the power of compound interest and tax-deferral, stretching out withdrawals from a qualified account is almost always a desirable goal. Because clients may have substantial assets in addition to any qualified accounts, it may make sense to have separate distribution provisions for tax-deferred and non-tax-deferred assets.

When More Is Better

We find that many clients have a Will or Revocable Living Trust that will receive non-retirement assets, and that the Will or Trust may be structured in such a way that only makes sense for non-tax-deferred assets. For this reason, it is often desirable to create a stand alone Revocable Living Trust to receive the proceeds of retirement account assets. These Trusts become irrevocable at death, but until then are revocable, and may be amended as the grantor wishes. These stand alone trusts are sometimes called “IRA Inheritance Trusts”, “Retirement Account Trusts”, or other different names, but they all describe a vehicle designed to receive retirement account assets and give the owner’s family the opportunity to benefit from stretch-out and deferral of withdrawals.

An IRA Inheritance Trust can be designed similar to trust shares for other beneficiaries outside retirement accounts, where someone else can be designated as trustee while a beneficiary is young. The trust share can even be given lifetime restrictions on the withdrawals, especially in the hands of a young beneficiary. This presents the opportunity for the young beneficiary to receive benefits over a long period of time based on their own life expectancy, and creates the opportunity for the original IRA benefit to payout multiples of the original value over the life expectancy.

When designing IRA Inheritance Trusts, it is vital to explain to the client the impact of the increasing age of the trust beneficiaries on required minimum distributions over the life of the Trust. Typically, of course, the required minimum distributions for a young beneficiary will be very small, but as time goes on, the percentage that has to be

withdrawn each year grows. Many IRA Inheritance Trusts use “conduit trust shares” so that the individual beneficiary’s life expectancy can be used to calculate the minimum distributions, while still permitting contingent beneficiaries who may be older than the primary beneficiary, or may even be institutions such as charities who do not have a specific life expectancy. In later years, as the required distributions have grown to substantial levels, conduit trust shares will, however result in larger and larger amounts being distributed to the beneficiaries.

If, however, the client determines that the distributions required under conduit share provisions are not desirable, then the trust share will need to be designed as an “Accumulation Trust”, so that required minimum distributions may remain in trust. If so, then the Trust must be carefully designed so that the Internal Revenue Service does not require the IRA asset to be liquidated within five years. Even with an Accumulation Trust, there can be substantial tax deferral and distributions over a beneficiary’s life expectancy at the time of the account holder’s death. In order to ensure the beneficiary’s life expectancy is used in an Accumulation Trust, the identity of the remote contingent beneficiaries is crucial – no charity and no beneficiary who is older by a certain number of years than the primary intended beneficiary can be named. If the Trust is properly designed, it may still receive minimum distributions from the IRA based on the primary beneficiary’s life or someone close to the primary beneficiary’s age, and not end up trapped having to withdraw assets according to the hypothetical life expectancy of the deceased owner or based on some other potential beneficiary’s age, such as a brother of the decedent or a grandparent. The dilemma for the IRA owner during the planning process is that certain desirable beneficiaries may have to be eliminated from the IRA Inheritance Trust in order to achieve a maximum deferral of distributions of the qualified assets. If the elimination of those potential beneficiaries is particularly undesirable to the client, of course, the other option is that the tax-deferral of the retirement account may simply have to be lost after his or her death. This is a counseling issue that will come up in almost every case where there are large qualified accounts in the estate plan.

Keeping Options Open

Fortunately, because IRA Inheritance Trusts are typically revocable trusts created during the client’s lifetime, there

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are often opportunities to design such a trust with one particular goal in mind and still have the ability to change directions in the future. The IRA Inheritance Trust can be designed to have a “toggle switch” to give one last opportunity to switch from an accumulation share to a conduit share after the IRA owner’s death by including provisions for a “Trust Advisor” or “Trust Protector”. A Trust Advisor or Trust Protector is typically a disinterested third party, such as the client’s attorney or tax advisor, who has the power to switch the IRA Inheritance Trust from either an Accumulation Trust to a Conduit Trust or from a Conduit Trust to an Accumulation Trust, based on circumstances at the time of the retirement account holder’s death.

For example, if the qualified account holder had designed a trust share for the benefit of his son as a conduit share, and at the time of account holder’s death that son was going through a bankruptcy proceeding or subject to a large unpaid judgment, then it might be desirable for the Trust not to have the requirement to make distributions to the son, as such distributions would be prey for the creditor, the bankruptcy trustee, or in some cases could cause the beneficiary to lose government benefits such as Medicaid or SSI. If such circumstances were present at the time of the IRA owner’s death, the Trust Advisor or Trust Protector could “toggle” the trust in a timely manner and switch the share to an accumulation share. Although maximum deferral of distributions from the account might be lost, the after-tax distributions could potentially be reinvested in the trust share and could continue to be protected from the beneficiary’s creditors or other problems. On the other hand, if the Trust had been designed as a accumulation share and if the conditions that necessitated the creation of an accumulation account have evaporated at the time of the owner’s death, then the Trust might be toggled to a conduit share, which might allow for a longer stretch-out and, thus, a more advantageous tax deferral period over the life of the beneficiary.

The benefit of a stand alone IRA Inheritance Trust is that these changes can be made for the benefit of the beneficiary of just the qualified account assets, leaving full discretion and control of non-retirement assets in a separate revocable trust. An additional benefit is that the estate can provide the custodian of the qualified account with a specifically designed Trust that is easier for the custodian to understand. The specialized nature of the IRA Inheritance Trust

can give both the family and the advisor an added level of comfort in dealing with the rules imposed by the IRS and Internal Revenue Code.

The Caveats

The IRA Inheritance Trust has become more viable in recent years with the passage of the Pension Protection Act and the issuance of certain Private Letter Rulings, such as PLR 200708084, that have indicated the IRS’s acceptance of the techniques used in these Trusts. While Private Letter Rulings can only officially be used by the individual party who sought the Ruling, they do give the practitioner more comfort in creating plans designed using the same pattern as the plan on which the Private Letter Ruling was sought. Certainly, if we had a client who was concerned that the Private Letter Ruling issued to other parties would not be followed in his particular circumstances, the client certainly has the opportunity to request and obtain a Private Letter Ruling for his own particular situation. In fact, it might be deemed advisable for attorneys counseling clients to insert such cautions in their Engagement Letters with the clients. If the IRA is large enough and the client’s tolerance for fees required to obtain a Private Letter Ruling is not an issue, then the client could obtain a better level of comfort that the plan will achieve his goals.

Clients also need to be counseled that beneficiaries can achieve individual life expectancy treatment for the required minimum distributions if the IRA is divided into separate shares for each intended beneficiary. On one level, separate account treatment for each beneficiary can be obtained through careful trust design. However, an additional level of protection can be given through proper beneficiary designations on the IRA account itself. In general, the practice should not be to merely name the master trust as the beneficiary of the retirement account. The preferred method is to name as beneficiary each individual trust share and the percentages of the account which go to such share. It is important to consider the use of contingent beneficiaries so that disclaimer planning can be employed, if necessary. Because most custodial account beneficiary designation forms have extremely limited physical space within which to spell out such designations, it is often advisable to design a custom beneficiary designation form that can be attached to the custodian’s standard form containing cascading disclaimer language and contingent beneficiaries.

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In planning for qualified accounts, the attorney should also discuss with the client any non-IRA accounts such as 401(k)s or profit sharing plans (or other qualified accounts) and the reasons why the client may want to transform those accounts into IRAs during the his or her lifetime. Some company accounts such as 401(k)s, may not by their terms, allow the maximum deferral of distributions from such accounts after the account holder's death. Employers often do not have a desire to deal with the family members of a deceased employee on a long-term continued basis. Therefore, these accounts may have rules inside the plans that do not provide the optimal stretch-out by their own terms. If this is the case, then the account holder may be well advised to roll the retirement into an individual retirement account where the account holder can make sure a custodian is chosen which permits the maximum stretch-out. With an IRA account and the new Pension Protection Act rules, if the maximum stretch-out is not available with one particular IRA account custodian, the trust beneficiary or the trustee of the Trust can instruct the original custodian to execute a direct trustee to trustee transfer to a new company that will honor the maximum stretch-out possible.

The IRS has flip-flopped recently as to whether or not pension plans such as 401(k)s are required to offer this rollover opportunity. Because this issue remains unsettled, clients may be well-advised to get qualified accounts transferred to IRA's during their lifetime so they can ensure maximum deferral. One must be careful using the word "rollover" with regard to inherited IRA's, as the rollover of such accounts is not the same type of rollover that can be used by a deceased beneficiary's spouse. It must also be distinguished from a rollover IRA opportunity that a living retirement account owner may have. For example, the 60-day put back rule available to an account holder with his own individual retirement account during his lifetime does not apply to an inherited IRA.

A non-spouse retirement account beneficiary is also not allowed to roll an account into his or her own name. Instead, the rollover from a deceased owner's account to a beneficiary must be done as a direct transfer from one institution to another without passing through the beneficiary's hands.

The new account must be titled in the name of the deceased account holder for the benefit of the new beneficiary. If the transfer is not done properly, it will be deemed to be a complete distribution to the beneficiary and income taxes will be due immediately and the stretch-out and tax deferral of the account will be lost.

Summary

The benefit of careful planning for qualified accounts is that the intended beneficiaries can be protected from divorce, lawsuits, bankruptcy, youth, inexperience, and bad habits. Use of an IRA Inheritance Trust can also prevent dissipation of assets by beneficiaries uneducated about the options available to them. That having been said, planning for qualified accounts is complex. Attorneys who only occasionally practice in the area of estate plans involving large dollar amounts of qualified accounts are well advised to co-counsel with attorneys who concentrate a large portion of their practice in the area of retirement asset planning. The consequences of an improperly designed estate plan can easily include substantial loss of tax-deferral and loss of benefits to the remaining family member or other beneficiaries. The estate planning community, including attorneys, CPAs, and financial advisors, need to work closely together to create solutions that meet the client's goals and needs. With proper planning, qualified retirement plan assets can be worth many times more than their original value to the beneficiaries; without proper planning, the beneficiaries may receive only a fraction of the original value of these accounts.

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