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The IRA Protection and Maximization Trust

Maximizing Tax Deferred Growth and Asset Protection
For Inherited IRAs and 401K Plans

Introduction

Historically, parents often left their tax deferred retirement accounts to their children "outright" – free from trust. In other words, they named their children as direct beneficiaries of these accounts. This traditional method of dealing with retirement accounts often resulted in some unintended consequences.

- The child, without the proper guidance of a trust, decided to "cash in" the retirement account and was subjected to massive and virtually immediate tax liabilities.
- The child, without the proper guidance of a trust, lost out on the decades of "tax deferred growth" opportunities afforded to him by the IRS.
- The child, without the added asset protection of a trust, lost the retirement account balance to divorce, creditors, and predators.
- The child just happened to be a minor or was incapacitated at the time of the parent's death, resulting in the need to "probate" this otherwise non-probate asset.

These unintended consequences can be easily avoided by leaving your retirement account to your child (or grandchild) in a specialized ***IRA Protection and Maximization Trust***. This is a relatively unknown type of trust that comports with all the of the IRS requirements necessary so beneficiaries preserve or maximize the "stretch out" of your IRA. Beneficiaries are in essence "forced" into taking full advantage of the benefits to be achieved over decades with tax growth. The IRA Protection and Maximization Trust can further provide your child with a degree of asset protection otherwise unavailable when the child is named as a direct beneficiary.

Background on Inherited Retirement Accounts

First, let's discuss the benefits and legal requirements of "stretching-out" the required distributions of an IRA.

Although a spousal beneficiary can defer paying income taxes on the withdrawal by rolling the plan into an IRA, a non-spousal beneficiary (e.g. your children) cannot, and if they attempt to do so, the 401 (k) proceeds are immediately income taxable, and the beneficiary has made an illegal contribution to his IRA. All references to beneficiaries below will be solely to non-spousal beneficiaries.

If the retirement plan funds are in an IRA, the child can generally continue the IRA under your name. The account would be titled as follows: "John Doe, deceased; Jane Smith as beneficiary." If more than one child is named as beneficiary, the account can be divided into separate accounts, one for each beneficiary. The beneficiary can NOT make any contributions to the "inherited IRA," and is required to make distributions over the beneficiary's life expectancy.

Such distributions are required to commence in the calendar year following the plan owner's death. For example, a 40 year-old beneficiary would be required to withdraw a little over 2% in the year following your death, and a slightly higher percentage each year.

Because you subtract 1.0 from the divisor each year, the final distribution must be withdrawn at such time as the beneficiary attains 83 years of age. The beneficiary can always withdraw more at any time, but such withdrawals are immediately income taxable and the beneficiary loses the ability to have such withdrawn amounts to continue to compound tax deferred.

By way of example, if "Child A" (age 40) inherits a $100,000 IRA and withdraws it immediately, (affectionately known as the "blowout" option), s/he may have to pay up to 40% in federal and state income taxes. That leaves only $60,000 to invest. Whatever the $60,000 earns each year is taxable in that year. If s/he "spends" what would've been the required minimum distribution (after income tax), and assuming a 6% rate of return, "Child A" will only have expendable distributions of $134,237 over 30 years.

On the other hand let's say "Child B" withdrew and paid taxes only on the required minimum distributions. S/he decided to elect maximum deferral and let the remainder accumulate inside the IRA growing tax free. *The benefits are very clear.* Child B will ultimately have expendable distributions of $332,466, or almost three times more than child A.

What if your child dies before the complete distribution of the IRA? It can be passed to your child's children or other beneficiaries who can continue the same withdrawal schedule. Your grandchildren will benefit from the IRA which still retains your name after your child is deceased!

Alternatives to Direct Beneficiaries:

Let's examine the three alternative methods of leaving an IRA to your children (or grandchildren):

Alternative 1: Name your estate or living trust as beneficiary. This will generally not permit your children to maximize the withdrawal period, although it may offer them some asset protection, depending on the terms of your trust. If they receive their inheritance outright, there would be little or no asset protection for them once they are gone.

Alternative 2: Name your children as the beneficiary. Your children can benefit from maximum stretch-out if they divide the IRA in a timely manner and meet certain other legal requirements. But they run the risk of the "blowout" option or losing the inherited IRA to creditors, divorcing spouses, and the like.

Alternative 3: Name the individual trust created for the benefit of each child as the beneficiary. Each child not only gets the benefit of making withdrawals over his or her life expectancy, but also gets the advantage of asset protection from creditors and divorcing spouses. By appointing someone other than the beneficiary as trustee, the spendthrift beneficiary can also be protected.

You may have a living trust to protect your assets from a conservatorship if you become disabled and from probate on your death. Think of the IRA Retirement and Maximization Trust as a separate trust to protect your children and offer them the maximum value from your IRA.

The IRA Retirement and Maximization Trust – Getting Both Maximum Stretch-Out & Asset Protection per a new Private Letter Ruling issued by the IRS.

So what is this IRA Retirement and Maximization Trust and how can it help protect your beneficiaries? Basically, it is a separate trust for each child created as part of your estate plan. Your will or trust says that upon your death, all or part of your child's inheritance will not be left outright to your child, but will be distributed to the separate trust for the benefit of such child. Your IRA names each child's separate trust as beneficiary.

This trust can continue during your child's lifetime, and then on your child's death, can pass to your child's children or whomever you designate. Your child can even have the right to say how to remaining trust property will pass after his (or her) death. HE can even create further trusts for the benefit of his spouse, children, and grandchildren. Your child can even be the trustee of his trust, if you feel this is appropriate. As trustee, be signs all checks and does not have to get anyone else's approval.

In some cases, such as with the spendthrift child, you might want a sibling or even a bank or trust company to serve as trustee. If your child would invest all or most of his inheritance anyway, he can do so just as easily as trustee of his trust as he could in his own name. Your child can receive all of the income and can even use the principal for his health, education, maintenance, and support. So it is there if he needs it. Structured properly, the trust us protected in the event your child is sued by creditors or predators, such as being sued for divorce. You see, the assets aren't owned directly by your child, but by the trust. A child cannot create this type of trust for his own benefit with his own assets and achieve the same tax benefits, creditor protections, and other advantages.

Use a Trust Protector to Flip the Switch and Add Even More Flexibility

There are two basic types of Stand Alone IRA Retirement and Maximization Trusts. An Accumulation Trust is geared for the beneficiary who might need asset protection. The other type is a Conduit Trust. It is more flexible that an Accumulation Trust because it offers more options in how the Required Minimum Distributions are calculated with respect to remote beneficiaries, but doesn't provide any asset protection benefits. Both are great tools. Each has its own unique benefits, but at a minimum, ensures a stretch out of an IRA.

A Trust Protector is an independent person that is given the authority to turn a Conduit Trust into an Accumulation Trust or vice versa after the IRA owner's death. If an IRA owner sets up a Conduit Trust, but a beneficiary later needs asset protection, the Trust Protector "flips a switch" within 9 months of the IRA owner's death and solves the problem. This is possible without the intervention of court approval, but yet still meet the "irrevocable" requirement because each beneficiary's separate share is deemed established at the IRA owner's death. This means the IRA owner can set up a Stand Alone IRA Retirement and Maximization Trust with optimal flexibility.

Advantages of Using a Separate Trust to Receive Retirement Plan Assets

There are many reasons that justify a separate trust just to receive retirement plan assets. Though most attorneys think it CAN be done with only one master trust, there are various drafting problems and post-mortem administrative problems that are lessened by using a separate trust just for retirement benefits. Some benefits of a separate trust(s) established only to hold retirement plan/IRA assets after death include:

1) A separate trust increased the likelihood that the trusts will survive later planning by another attorney who does not understand or appreciate the complexities of estate planning with IRAs. Attorneys routinely revoke, restate or amend old trusts, but would take more care in doing with so a specially labeled trust.

2) A separate trust increases the likelihood of a successor trustee appreciating the complexities of administering separate trusts with IRAs and retirement plan assets. This is especially trust of individual trustees where this is more of a problem.

3) A separate trust increases the likelihood of the successor trustee not overlooking RMD issues, especially when the decedent was already in pay status.

4) A separate trust increases the likelihood that debts, taxes, and expenses will not and cannot be paid from the retirement plan trust, which helps to avoid losing Beneficiary Designation status. For the majority of attorneys who do not often customize their tax payment and apportionment clauses, this is an advantage.

5) A separate trust allows the Will and/or Living Trust to be simpler and less confusing to the client. This is especially true for the engineers and other clients who insist on understanding every word and paragraph of the trust.

6) A separate trust allows the main Will and/or Living Trust to easily name older beneficiaries, charitable beneficiaries, and allow for normal marriage and adoption provisions. It allows the main trust to contain broad general and limited powers of appointment, and other clauses that permit great flexibility – clauses that are problematic in a trust designated to hold retirement plan assets.

7) A separate trust allows the living trust to have the broadest spendthrift, in terroram, incentive/disincentive or other clauses that act to restrict or eliminate income payouts to a beneficiary, which would be problematic in a trust designed to hold retirement benefits.
8) A separate trust simplifies the fiduciary accounting issues after death involving division between income/principal and separate share rules.

9) A separate trust simplifies tracing of the immediate payout of RMDs out to the beneficiary that is required in a conduit trust.

10) A separate trust can simplify income tax filing and planning for the trust and beneficiaries because it becomes much easier to plan exactly how much IRD is left trapped in the trust at potentially higher brackets and where the IRC 691 deduction will be used.

11) A separate trust might prevent the executor/trustee from commingling retirement plan assets in a conduit trust from making a Section 645 election to use a fiscal year, which may jeopardize a conduit trust from qualifying as a Designated Beneficiary.

12) A separate trust might simplify and/or make more efficient use of the GSTT exclusion, as it is usually wise to use GST exemption for the non-IRD assets left in the standard living trust. Generally, but not always, GSTT exemption would be less valuable to as separate retirement plan trust and more valuable to a trust holding other assets.

13) A separate tryst can more easily segregate Roth IRA/401(k) assets that have completely different tax planning involved. For instance, the GSTT allocation issue noted above involves quite different considerations for Roth assets.

14) Coinciding with the last points about GSTT, the related issues surrounding the granting limited and general powers of appointment are also clearer with separate trusts. This is because it may be desirable to grant a general power of appointment via formula to avoid a generation skip as to some assets and not others, or, in the even that an accumulation trust is used, it is impermissible to use either a general or broad limited power of appointment. In other words, the criteria and use of LPOA/GPOAs are different and using separate trusts makes the practitioner and client see them as such. In addition, the trustee administering

the trust would have clearer guidelines.

15) A separate trust allows clearer directions to trustees to exhaust assets in order of tax preferred priority without worrying about diversification rules overriding tax preferences. For instance, discretionary distributions come out of the trust holding ordinary assets first, then retirement plan assets, then IRAs, then Roth IRA/401(k) trust assets.

16) A separate trust avoids the tremendous danger of having a pecuniary bequest in a master trust triggering IRD in such plans. See IRS Chief Counsel Memorandum (CCM) 200644020.

17) A separate trust makes later amendments when tax law or retirement asset mix changes the dynamics of the planning. Especially where trusts are designed to potentially accumulate retirement plan assets (aka accumulation trusts) – the state of the tax law us ever evolving with PLRs still coming out to explain the 2002 Regulations. Changing just the beneficiary designation or separate trust years later when things change is easier than reworking the entire master trust.

Many of the problems noted above are also solved through using a trusteed IRA, which as noted above can have even greater administrative simplicity and advantages. But trusteed IRAs are only available for larger accounts through a handful of wealth management firms. They cannot be of help when working clients have significant retirement plan assets that cannot be rolled over. Nor are they a solution when a client does not want to change IRA custodians or their current investment advisor. Nor do they provide the maximum restrictions on beneficiaries needed for special needs trusts or other extreme situations. For these situations you need a separate trust. Consider a separately drafter trust apart from the master living trust for the reasons noted above.

Summary

Therefore, you can do something for your children that they are not able to do for themselves. You can create a trust which will make their inheritance safe. By doing so, you can better protect the potential inheritance ultimately for your grandchildren.

Most individuals choose to give their children their inheritance directly. The wise ones often choose to leave it to them in trust. Proper trust planning is a golden opportunity to do more for your children and grandchildren. You can provide both your children and grandchildren with significant protection from creditors, predators (divorcing spouses), and from estate taxes on your child's death. As you can see, there are several reasons why this IRA Retirement and Maximization Trust could be of benefit to your children, This is trust even if YOU do not have a taxable estate. We generally recommend IRA Retirement and Maximization Trusts for client with IRA assets approaching the $100,000 figure or above.