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Boldt: Stretching the benefits of your traditional IRA

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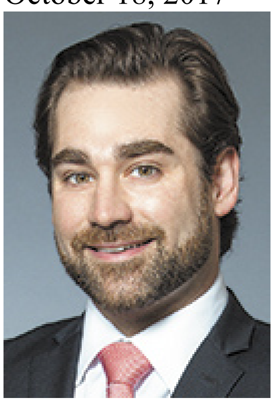
Boldt

By Matthew Boldt

Suppose a client, John, comes to you for estate planning advice and you learn that he is 67 years old, unmarried with two children (Amy, age 27; Brad, age 33), and the bulk of his net worth is in a traditional IRA currently valued at $2 million.

John wants to leave his estate to his children in a way that maximizes the value of his IRA. John asks you if there is any way he can control the timing and manner of IRA distributions that his children will receive after his death. One method you can discuss with John is the creation of separate trusts that will be designated as the primary beneficiaries of John's IRA. These trusts are commonly referred to as see-through trusts (hereafter "Inheritance Trust"). The "see-through" language derives from the fact that only an individual may inherit an IRA, but the IRS will look to the beneficiaries of the trust to make that determination as opposed to the trust entity itself. The same is not true for an estate or charity. The terms of the Inheritance Trust can be set forth in a stand-alone trust document, John's will or John's revocable living trust.

Before delving in to Inheritance Trusts, a mention of required minimum distributions from an IRA is in order. In simplified terms, by April 1 of the year after an IRA owner reaches age 70½, they must begin taking distributions from their IRA. Required minimum distributions are calculated per an IRS life expectancy table. RMDs for an inherited IRA may be calculated differently based upon the identity of the primary beneficiary of the IRA, or the fact that the owner of the IRA died before the required beginning date. After the IRA owner's death, the beneficiary must continue to take RMDs.

In order for John's intent to be carried out, the Inheritance Trusts must:

1. Be valid under state law;

2. Be irrevocable or become irrevocable at John's death;

3. Designate identifiable beneficiaries; and

4. Provide specific documentation to the IRA custodian no later than Oct. 31 of the year after John's death.

Each Inheritance Trust can also be a separate share trust. If specific requirements are met, Brad's life expectancy will determine the RMD schedule for his trust; the same applies to Amy, and if executed correctly, "stretches" Amy's RMD for an additional six years as opposed to Amy and Brad being the beneficiaries of a trust that inherited John's IRA, wherein Brad's life expectancy, as the oldest beneficiary, would determine the stretched RMD schedule for Amy too. The additional requirements are:

1. Creation of separate share Inherit-ance Trusts on or before John's death; and

2. Specific beneficiary designations at the IRA plan level that set forth:

    a. Fractional interests to be received by Amy and Brad;

    b. A directive that such interests shall be owned by the respective trustee of each specifically designated Inheritance Trust; and

    c. A directive that IRA assets shall be apportioned upon John's death into separate subaccounts, so that each beneficiary's investment net earnings, gains, and losses are determined separately after John's death.

See, Keith A. Herman, "How to Draft Trusts to Own Retirement Benefits," 39 ACTEC L.J. 207, 247–48 (2013). It is important to review the plan terms of John's IRA to ensure that stretch payments are permissible. If not, transfer the IRA to a plan that suits the goals of the Inheritance Trust.

If John's goal is to stretch the value of his IRA by restricting Amy or Brad's right to elect a lump-sum distribution of the IRA assets until they reach a specified age, he may elect to use a "conduit trust." A conduit trust states that the trustee shall pass all distributions from the IRA to the primary beneficiary. If the primary beneficiary is entitled to all distributions and net-income of the trust and the interest of any subsequent beneficiary is contingent upon the death of the primary beneficiary, only the primary beneficiary's life expectancy is used to determine required minimum distributions. The trust can be drafted to order the trustee to withdraw only the RMD or grant discretion to the trustee to withdraw an amount greater than the applicable RMD for the beneficiary's maintenance. The conduit trust is often referred to as the "safe harbor" form of trust based upon guidance from the IRS.

If John wants to grant the trustee discretion to accumulate RMDs or withdrawals from the IRA, he can use an "accumulation trust," often appropriate for a beneficiary with special needs, creditor problems or spendthrift tendencies. While accumulated funds are subject to income tax at the trust level, the stretch benefits can far outweigh the tax downside. Accumulation trusts require careful planning, particularly in regard to the designation of successor beneficiaries. Because the trustee has discretion to accumulate distributions, the life expectancy of successor beneficiaries, in addition to the primary beneficiary, must be taken into account. Suppose an accumulation Inheritance Trust is structured as follows: Owner has two siblings, ages 58 and 64, and one son, age 29. The trust provides discretionary distributions of income and principal to Son for life, with the remainder passing outright to Son's children in equal shares upon Son's death, but if Son has no children, to owner's heirs at law. In this example, if Son does not have any children at the time owner dies, the measuring life for RMDs will be the owner's 64-year-old sibling.

Certain "savings clauses" can be used to prevent the designation of a successor beneficiary that doesn't qualify as an individual or who has a shorter life expectancy than the primary beneficiary. Private letter rulings suggest the savings clause can be styled to account only for those beneficiaries who would become eligible to receive the IRA assets if the primary beneficiary predeceased the IRA owner. *Herman*, *Id*.

For a client who holds the bulk of their net worth in an IRA, an Inheritance Trust can be an effective estate planning tool. An Inheritance Trust may be particularly useful for a client with a special needs child, or who is concerned that a beneficiary will not use the inherited funds responsibly. Ultimately, each client's specific goals must be carefully evaluated in conjunction with their overall estate plan to ensure that their wishes are carried out.•

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