Planning for Inherited IRAs – Using an IRA Trust as Beneficiary

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What is an Inherited IRA?

- IRA received after the death of the IRA owner by non-spouse individual beneficiary, for example, by child after parent dies
- IRA titled in name of deceased IRA owner for benefit of beneficiary
- Cannot be rolled over or combined with personal IRA
- No contributions can be made to inherited IRA
- Distributions are required

Case Study

- Dad dies at age 75, leaving his IRA worth $1.5 million to his son John, age 46. John decides to spread the payments over 5 years and starts taking distributions. Two years later, John's business fails and he is forced to file for bankruptcy.
- What happens to John's interest in Dad's IRA?

The Result

- Bankruptcy courts have ruled that state exemption does not apply to inherited IRAs. As a result, the entire IRA balance is part of the bankruptcy estate
- If John's creditors had sued in state court, the result would probably be the same

What should Dad have done?

- *Named an IRA Trust for John's benefit as beneficiary.*
- *In a properly structured trust, the trustee will determine the payout period using John's life expectancy*
- *Payments will be protected from John's creditors*

The IRA Trust Opportunity

- The IRA Trust is a great planning opportunity for clients with sizeable IRAs
- Opportunity to provide value added service to new and existing clients
- Include discussion of IRA Trust in review of client's situation
- Most advisors and attorneys are not presenting this concept

The IRA Trust Opportunity

- Most clients do not want their children to get a lump sum distribution and spend it immediately
- Keep assets under management longer
- The IRA Trust is in addition to other estate planning documents and techniques

Why Stretch?

- Benefit of tax deferral over stretch period
- John could stretch distributions for 37 years
- $100,000 IRA – lump sum $70,000 after tax compared with more than $205,000 total distributions over 37 years after tax (5% growth rate, 30% tax rate, take RMDs at end of year)

Asset Protection

- Protect from:
  - Bankruptcy
  - Mismanagement of asset
  - Healthcare costs
  - Lawsuits and creditor claims
  - Child’s divorce after a short marriage

Asset Protection

- Qualified Plans
  - Federal exemption under ERISA
  - QDRO in case of divorce to create separate shares for husband and wife
- IRAs
  - Not covered by ERISA
  - State law exemption for IRAs in most states
  - Most state laws do not explicitly provide protection for <u>inherited</u> IRAs

Asset Protection

- Bankruptcy
  - Exempt property based on state exemption list
  - Several recent Bankruptcy court decisions have concluded that state exemption statutes do not include inherited IRAs
  - Rationales:
    - State exemption was for retirement benefits
    - Beneficiary has unrestricted right to withdraw
    - Inherited IRA is significantly different from traditional IRA

Asset Protection

- Trusts
  - Spendthrift protection under state law
  - Distributions based on the trustee's discretion cannot be attached by creditors
  - Mandatory distributions can be attached by creditors when they are paid

IRA Distribution Rules

- After death of IRA owner - distribution rules for non-spouse beneficiary:
  - If there is a "designated beneficiary", default is to distribute the remaining balance over the life expectancy of the designated beneficiary
  - Distributions must start by 12/31 of the year following year of death of IRA owner based on life expectancy of designated beneficiary in year that distributions start

IRA Distribution Rules

- "Designated beneficiary" is a defined term and only includes:
  - Individuals
  - Certain trusts
- If multiple designated beneficiaries, then use life expectancy of oldest, unless divided into separate shares by 12/31 of year following year of IRA owner death

IRA Distribution Rules

- If there is no "designated beneficiary"
  - If IRA owner died before Required Beginning Date (RBD - April 1 of year following year in which turn 70 ½), then five year rule applies
  - If IRA owner died on or after after RBD, then payments are based on hypothetical remaining life expectancy of account owner in the year of death (13.4 years in Dad's case – Single life table, age 75))

IRA Distribution Rules - Trusts

- Can qualify as a "designated beneficiary" and use life expectancy of beneficiary for IRA distribution purposes
- Required trust documentation must be provided to IRA Custodian or IRA Trustee by October 31 of year following year of IRA owner's death:
  - Trust is valid under state law
  - Trust is or became irrevocable at death of IRA owner
  - All beneficiaries are individuals
  - Trust beneficiaries are identifiable from trust document

IRA Distribution Rules - Trusts

- Trusts typically have multiple beneficiaries, including provisions in the event of the death of the primary beneficiary
- Do contingent beneficiaries have to be considered for distribution purposes?
  - Maybe – it depends on the type of trust

IRA Distribution Rules - Trusts

- Conduit Trust
  - Each trust requires that any distribution from the IRA will be paid by the trustee to the beneficiary and no accumulation or retention of any amount is permitted. This type of trust does not require that contingent trust beneficiaries be considered for purposes of determining the life expectancy payout.
- Accumulation Trust
  - An accumulation trust permits the trustee to accumulate or distribute the IRA distribution in its discretion. This type of trust provides much more flexibility in making distributions but the IRS requires that the life expectancy of the oldest possible beneficiary (including all contingent beneficiaries) be used to determine the distribution period.

IRA Distribution Rules - Trusts

- When trust has multiple beneficiaries, goal is to establish trusts that are separate share trusts or “subtrusts” so that each trust can use life expectancy of respective beneficiary
- According to IRS, option to divide IRA into separate shares does not apply when “master” trust is named as beneficiary.
- Most attorneys are not familiar with these rules
- Standalone IRA Trust is recommended to ensure subtrust qualification

The IRA Trust

- Create a separate trust that is or becomes irrevocable at the death of IRA owner.
- Trust provides subtrusts for each beneficiary
- Each subtrust is either a conduit or accumulation trust.
- Conduit trust requires specific trust language to ensure that the RMD is distributed to the beneficiary
- Accumulation trusts will have to consider all possible beneficiaries carefully

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- IRS approved using life expectancy of respective primary beneficiary of each subtrust for distribution period purposes
- IRS required that each subtrust be named as a beneficiary of IRA
- Private Letter Rulings apply only to the taxpayer who applied for the ruling and cannot be cited as precedent. PLRs are, however, an indication of how the IRS might rule on similar cases

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- What are the planning opportunities?
  - Ability to use each beneficiary's life expectancy for purposes of determining the distribution period
  - Ability to switch on and off certain beneficiary protection features if circumstances change between trust creation and death of the grantor
  - Ability to treat beneficiaries differently
  - Use of trust protector to preserve flexibility and make subsequent changes to the trust based on changing tax laws and beneficiary needs.

Pension Protection Act of 2006

- Permits non-spouse beneficiaries to rollover qualified plan amounts to inherited IRA
- Previously many qualified plans only offered an immediate lump sum payout to the beneficiary
- Questions about whether this provision was optional were resolved in the Worker, Retiree and Employer Recovery Act of 2008 which requires plan amendments to incorporate the rollover provision as a distribution option
- Use IRA Trust as beneficiary of qualified plans

Inherited IRA Roth Conversions

- IRS Notice 2008-30
  - In explanation of PPA provision regarding rollovers to IRAs, the IRS stated that a beneficiary can convert amount to Roth IRA at the time of the rollover
  - There are currently no restrictions on who can do Roth conversions
  - Since qualified Roth IRA distributions are income tax free, this could represent a significant opportunity for beneficiaries if the income tax liability can be paid from other assets, such as life insurance

Inherited IRA Opportunities

- Planning opportunities for Inherited IRAs have significantly increased
- Use IRA Trust to protect beneficiaries and maximize payouts
- Talk to new and existing clients about these opportunities – *before someone else does!*

Conclusion

- Asset protection is becoming the main function of estate plans as concern over estate taxes diminishes
- The IRA Trust as a beneficiary of your client's IRA can be part of the solution