25TH ANNIVERSARY
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The CCCBA Estate Planning and Probate Section
proudly presents...

#9 IRA TRUSTS – CURRENT STRATEGIES AND DRAFTING TIPS TO REDUCE TAXES AND TO PRESERVE CLIENT OPTIONS

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AGENDA

- **The Problems With Retirement Accounts**
    - The Planning Mistakes To Avoid
    - Potential Taxes For The Next Generation

- **IRA's V. 401k's**
    - Defective Transfers
    - Flexibility Before Or After Retirement
    - Beneficiary Designations- Or Lack Thereof
    - Required Minimum Distributions
    - Supreme Court Case *Clark V. Rameker*- The Implications

- **IRA Trusts**
    - Conduit Trusts- Pros And Cons
    - Accumulation Trusts
    - Hybrid Trusts
    - Separate Trusts V. Single Pot Trusts
    - Important Provisions
    - IRA Conduit Trusts- Control And Stretch Planning Opportunities
    - Why Subtrusts Within Living Trusts Are Not Recommended
    - Separate IRA Trusts
    - Considerations For Spendthrifts, Minors, And Special Needs Beneficiaries
    - Sample Language

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Lisa is also an active member of The Rotary Club of Pleasant Hill. In her free time, she enjoys spending time with her family, being an active member of her community, and being a mother to two delightful children and one spunky Schnauzer named Zoom.

THE LATEST AND GREATEST IN IRAs AND IRA TRUSTS

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The Problems with Retirement Accounts
Planning Mistakes to Avoid

1. Failing to Consider Multiple Generation Tax Consequences.
2. Leaving It in a 401k.
3. Mistakes Transferring Between Accounts.
4. No Beneficiaries Designated.
5. The Wrong Beneficiary Designation.
6. Failing to Manage RMDs to Maximum Tax Effect.
7. Failing to Use Asset Protection Techniques.

The Problems with Retirement Accounts
Highest Potential Taxes for the Next Generation

- Balance Included in Estate Tax Calculations:
  - Highest Estate Tax Rate: 40.0%
- Beneficiaries Pay Income Tax on What's Left:
  - Highest Federal Rate: 37.0%
  - State Tax Rate: 13.3%
- Combined Income Tax Rate: 50.3%
- Combined Tax Effect:
  - Astronomical!
- And remember . . . $11,000,000+ estate tax exemption equivalent sunsets on December 31, 2025!

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The Problems with Retirement Accounts
Highest Potential Taxes for the Next Generation

Example: Requirement to take RMDs:

- Taxpayer Rate in Retirement: 15% or less
- Beneficiary Rate While Employed: Up to 50.3%
- Potential Tax Savings: 35.3%

IRA v. 401k
Defective Transfers

Rolling to an IRA:

- Gives you greater control over the account.
- Removes limits on investments that can be made.
- Removes limits on withdrawals and management.
- Provides more options for tax planning.

Caution!

- The IRA plan documents control.
- Should be checked carefully before engaging in any of the strategies we will discuss.

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IRA v. 401k
More Flexibility With IRAs After Retirement

Al works for the airlines as a highly skilled mechanic. The company has a pension and a 401k. Just as Al is getting ready to retire, there is talk of a merger, layoffs, even bankruptcy. Moreover, the returns on Al's 401k just haven't been that good.

What would you do?

How would you do it?

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IRA v. 401k
Defective Transfers

How to Do It:

- ❖Review IRA plan documents prior to choosing the target account.
- ❖Notify 401k custodian and IRA custodian and complete all forms necessary for a direct account-to-account transfer.
- ❖Verify that all IRA account forms have been completed, naming beneficiaries and contingent beneficiaries.
- ❖Request confirmation in writing from the custodians.
- ❖Begin annual RMD counseling sessions with the client(s).

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The Problems with IRAs
No Beneficiaries Designated

- ❖If no beneficiary, or the "estate" is the beneficiary:
  - ❖Entire account immediately deemed distributed on death.
  - ❖Immediately taxable at fiduciary rates.
- ❖If trust designated as beneficiary, the five year rule:
  - ❖Entire account must be distributed within five years of date of death.
  - ❖Taxable at fiduciary rates unless properly distributed and picked up on Schedule K-1.
- ❖Naming "proper" beneficiaries
  - ❖Spouse or children: No control over distributions.
  - ❖Remember: Average inherited estate gone within 30 months.
  - ❖Determining distributions? See Publication 590-B.

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The Problems with Traditional Beneficiaries
The Old Rules

- The problem with naming a special needs consumer or special needs trust:
  - Retirement account deemed available for Medi-Cal and SSI purposes.
  - Done incorrectly, the five year rule applies and the trust could be construed as requiring distribution to the special needs consumer.
  - Heavy taxation penalty if taxed at the trust level, and picking up on the individual return must be explained carefully.
- The problem with younger beneficiaries:
  - Gone in 30 months!
- New bankruptcy law places inherited IRAs at risk.

Proper Beneficiary Designations
The Wrong Beneficiaries Designated

- Name Individuals or Charities as Beneficiaries.
- "Stretch" by gifting to future generations:
  - 65 Year Old Child = 1/18 RMD
  - 25 Year Old Grandchild = 1/58 RMD
- Use Charitable Beneficiary Designations:
  - Removes the IRA from the taxable estate.
  - Example: Charity vs. Children.
- But What About Children or Spendthrifts?

Proper Beneficiary Designations
The Old Rules

Fred and Wilma are in their 90s. They have a sizeable estate ($8,000,000) which they will pass to their children. They would like to give something to their grandchildren to assist with school and to give them a head start on purchasing a home and starting their own families (10% of the total estate). Part of their net worth is $1,000,000 in their IRAs.

1. What should they do?
2. How would your answer change if they wished to give $1,000,000 to their favorite charity?

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Proper Beneficiary Designations
The Old Rules

Chip and Sandy have been active in their church all their married lives. They have a son, Chuck. They have a home worth $500,000 and a retirement account worth $100,000. On their deaths, their trust provides for a $100,000 gift to their church and leaves the rest to Chuck.

Result: Charity receives $100,000.

Chuck could pay as much as 50% income tax!

Solution: Make the Charity the beneficiary of the IRA.

Make Chuck the beneficiary of the trust.

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Remove the Shackles of RMDs
Use Parents' Lower Tax Rates!

- ❖Taking only the RMD subjects children to higher income tax rates when they inherit.
  - ❖ Example: Parents vs. Children
- ❖Solution: Take the highest amount possible without triggering the next higher tax bracket.
  - ❖ If Adjusted Gross Income = $38,000, an additional $35,300 could be taken while staying in the 15% tax bracket.
- ❖Solution: Accelerate Distributions in High Deduction Years.
  - ❖ Medical/Memory long term care needs.
  - ❖ A $6,000 monthly dementia care bill could result in being able to take up to $72,000 per year more!

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SUPREME COURT CASE ALERT!
New Law re Bankruptcy

Clark v. Rameker

- ❖Ordinarily, up to $1,000,000 of retirement assets may be protected in bankruptcy.
- ❖US Supreme Court determined that an inherited IRA is not afforded bankruptcy protection given to other retirement accounts.

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SUPREME COURT CASE ALERT!

New Law re Bankruptcy

Clark v. Rameker

- Reasoning:
  - Further contributions prohibited.
  - RMDs required regardless of the age of the beneficiary.
  - The holder of the Inherited IRA may withdraw the entire balance without a penalty.
  - Inherited IRAs not creditor protected because they are a “windfall” or an “inheritance”, not the product of the debtor’s personal thrift.
- Held: An inherited IRA is available to satisfy a debtor’s creditors in bankruptcy.

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SUPREME COURT CASE ALERT!

What Is Left After *Clark v. Rameker*

Individual IRAs:

- Unaffected by *Clark v. Rameker.*

Spousal Inherited/Rollover IRAs

- Although inherited, most writers believe that the Supreme Court would be loathe to strip a spouse – particularly in community property states – of bankruptcy protections for contributions made during the marriage.

SUPREME COURT CASE ALERT!

What Is Left After *Clark v. Rameker*

Individual IRAs vs. Spousal Inherited/Rollover IRAs

- Note the differences:
  - Spousal IRAs may become the surviving spouse's with no requirement to withdraw:
    - Inherited: May be withdrawn at the survivor's election before the decedent would have turned 70.5 without penalty regardless of when withdrawals taken.
    - Inherited: Must be withdrawn when the decedent would have turned 70.5.
    - Rollover: The recipient's ages will control withdrawals and penalties will apply if before 59.5.
  - Therefore, the differences cited in *Clark v. Rameker* are not present.

SUPREME COURT CASE ALERT!

What Is Left After *Clark v. Rameker*

- Inherited IRAs - Individual State Rules May Protect:
  - Some states (e.g., Texas) have enacted statutes specifically stating that "an inherited individual retirement account . . . Is exempt from attachment, execution, and seizure for the satisfaction of debts." Texas Prop. Code Ann. §42.0021(a). Upheld *In re Kara*, 573 B.R. 696, 702 (Bankr. W.D. Tex. 2017).
  - *In re Pacheco*, 537 B.R. 935, 941-942 (Bankr. D. Ariz. 2015) (an inherited IRA is protected because under Arizona law, it is precisely within the state's applicable creditor protection statute).
  - *In re Arehart*, No. 17-01678-TLM, 2019 WL 171466 at n.3 (Bankr. D. Idaho Jan 20, 2019) (Idaho's exemption statute held broad enough to encompass inherited IRAs).
  - *In re Hamm*, 586 B.R. 745 (Bankr. N.D. Ill. 2018) (applying *Clark v. Rameker* to Illinois creditor statute; protection denied).
  - In re Everett, 520 B.R. 498 (E.D. La. 2014) (protection denied).

SUPREME COURT CASE ALERT!

What Is Left After *Clark v. Rameker*

California Statutes:

- Neither California bankruptcy exemption specifically exempts inherited IRAs, and do not appear to be broad enough to satisfy the *In re Arehart* (Idaho) criteria. See, Cal. Code Civ. Proc. §§704.110; 704.115.

The Bottom Line

- Unless California enacts a statute like Texas, which specifically protects inherited IRAs from creditors, only an asset protection trust will protect our clients' heirs and beneficiaries!

IRA Trusts

The Solution!

- Permit control over beneficiaries.
  - Insures that beneficiaries receive proper tax and legal advice before withdrawals are requested.
  - Prevents beneficiaries from withdrawing all of the balance and incurring substantial income tax liability.
- Maximizes Wealth Accumulation.
  - No limit on the size of the trust ($1.0 million limit in Bankruptcy Court does not apply).
  - Rule of 72: Divide 72 by the rate of return to determine how long it will take for an investment account to double in value.
  - For inherited IRAs, gross rate of return minus RMDs equals the rate to be used.

IRA Trusts
The Solution!

- Avoid immediate taxation or the Five Year Rule.
  - Cures the defects of no beneficiary or a trust requiring distributions as beneficiary.
- Can be used in special situations:
  - Special Needs Trusts (use accumulation provisions).
  - Spendthrift spouses (use marital trusts and distribute RMDs; limit excess withdrawals)
  - Spendthrift or under-age children (use conduit, accumulation, or hybrid provisions to control).
    - Will require a guardianship for the minors' funds.
  - Protecting children from divorce or creditor proceedings.
- Provide spendthrift and bankruptcy protection, post *Clark v. Rameker.*

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IRA Trusts
The Solution! (Three Types)

Conduit Trusts:

- Require that RMDs are taken, then distributed to the beneficiary.
  - The trustee has no discretion to withhold payment.
  - Therefore, no asset protection planning is possible.
- Income taxation passes through to the beneficiary.
- May provide for larger withdrawals and distributions
- May specify conditions under which further withdrawals and distributions may be made.
- Note: The critical component is that no accumulation or taxation at the trust level is available in a Conduit Trust.

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IRA Trusts
The Solution! (Three Types)

Conduit Trusts:

- Special care should be taken for charitable beneficiaries.
  - Charities should not be named as a beneficiary.
  - Remainder beneficiaries in a conduit trust are considered “mere potential successors” and are disregarded for IRS purposes.
  - Because of the “oldest beneficiary rule”, if any accumulation or current distribution to a charity, the charity’s zero (0) life expectancy, will subject the trust to the five year distribution rule.
  - Therefore, a charity may be named as a remainder beneficiary after the death of the conduit beneficiary. However, the trust must be a conduit trust to avoid considering the charity’s zero life expectancy.

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IRA Trusts
The Solution! (Three Types)

The Drawbacks of Conduit Trusts:

- Minors.
- Immature (Spendthrift) Beneficiaries.
- Special Needs Beneficiaries.
- No Creditor Protection.
- Lack of Trustee Discretion:
  - Changed Circumstances.
  - Second Marriages.

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IRA Trusts
The Solution! (Three Types)

Accumulation Trusts:

- RMDs required to be withdrawn, but not required to be distributed to named beneficiary.
- Preferred over Conduit Trusts for special needs planning, spendthrift planning, and creditor protection planning.
- Requirements:
  - No charities.
  - Be sure to name contingent/remainder beneficiaries.
  - Limited testamentary powers of appointment may be granted.

IRA Trusts
The Solution! (Three Types)

Hybrid Trusts:

- May switch between Conduit and Accumulation Trusts.
- May be used for special needs beneficiaries.
- Clearly beneficial for minors, younger beneficiaries, and spendthrift beneficiaries who mature and will be able to handle their own affairs in the future.
- Consider:
  - Trustee discretion language.
  - Trust protectors.
- Review: PLR200537044.

IRA Trusts
The Solution! (Three Types)

Separate Trusts vs. Single Pot Trust:

- Single Pot Trusts use the age of the oldest beneficiary to determine RMDs
  - May not be an issue if all beneficiaries are close in age.
- Separate Trusts permit different RMDs, terms and conditions, and remainder beneficiary options
- Separate Trusts may isolate planning mistakes, which reduces drafter liability.
- Conduit and Accumulation in a Single Pot Trust is difficult to administer and more likely to be misinterpreted.
- Drafting Note: I may use IRA trust language in a Single Pot Trust for clients with minor/younger beneficiaries, but not where a “permanent” solution is required

IRA Trusts
The Solution! (Three Types)

Separate Trusts vs. Single Pot Trust:

- Beneficiary Statement: Single Pot Trust:
  - “The Jane Doe Revocable Trust dated April 1, 2001, fbo John Doe”.
- Beneficiary Statement: Separate Trust:
  - “The John Doe IRA Trust dated April 1, 2001”.

IRA Trusts

The Solution! (Three Types)

Important Provisions (More on This Later!):

- Spendthrift Language.
- Distribution After Death of Trustor.
- Separate Shares of Named Beneficiaries.
- Accumulation Language.
- Discretionary Withdrawal/Distribution Language.
- Trust Protectors.
- Final Distribution of Trust.
- Limited Powers of Appointment.

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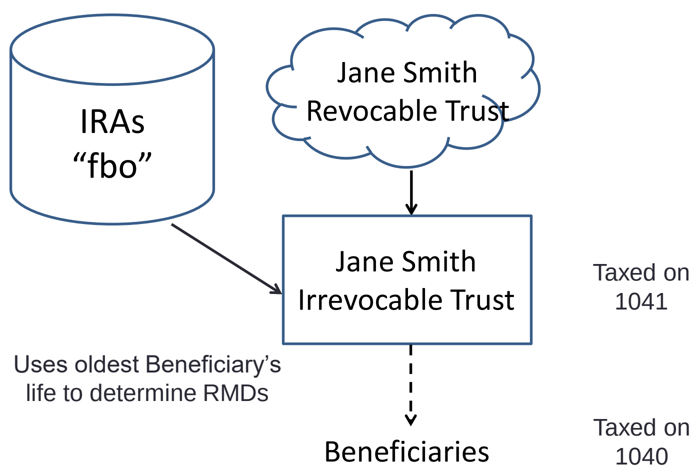
IRA Conduit Trusts

Incredible Control and Stretch Planning Opportunities!

Requirements
Treas. Reg. §1.401(a)(9)

1. Must be valid under State law
2. Must be irrevocable or become irrevocable upon Grantor/Owner's death
3. Must have ascertainable, non-charitable beneficiary(ies)
4. Trust must be delivered timely to IRA custodian (10/31 of following year)



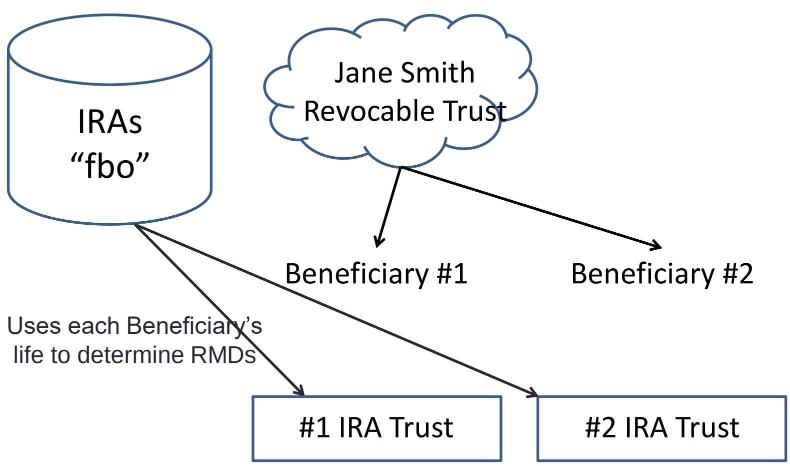
IRA Trusts
Why Subtrusts Within Living Trusts Not Recommended

- Distributions by age or milestones are prohibited.
- Many living trusts require immediate distribution, which could be interpreted as requiring immediate recognition of income.
- Payout based on oldest beneficiary's life.
- Charitable beneficiary will defeat the use of IRA trust concepts.

IRA Conduit Trusts
The Better Solution – Separate IRA Trusts

Requirements
Treas. Reg. §1.401(a)(9)

1. Must be valid under State law
2. Must be irrevocable or become irrevocable upon Grantor/Owner's death
3. Must have an ascertainable, non-charitable beneficiary(ies)
4. Trust must be delivered timely to IRA custodian (10/31 of following year)



IRA Conduit Trusts
Planning Hints

- Do not merely designate "the trust" without particular beneficiary designations.
  - Example: Residuary bequests to children and charities.
- Use separately drafted trusts or subtrusts for each beneficiary.
  - Avoids the "oldest beneficiary" problem.
  - Example: Three Children, 60, 50, 40.
- Include spendthrift controls over distributions.
- In special needs situations, use "to or for the benefit of" language.
- Choose wisely: Conduit, Accumulation, or Hybrid.

IRA Conduit Trusts
Example #1 – Spendthrift Spouse

Jack and Jill are married. Jill has accumulated a large 401k plan which she rolled out into a traditional IRA. Jack is a second spouse, and Jill is concerned that Jack will "blow through" the IRA and other estate assets, so she wants some controls over his ability to draw down on the IRA.

What do you recommend?

IRA Conduit Trusts
Example #1 – Spendthrift Spouse

Jack and Jill are married. Jill has accumulated a large 401k plan which she rolled out into a traditional IRA. Jack is a second spouse, and Jill is concerned that Jack will "blow through" the IRA and other estate assets, so she wants some controls over his ability to draw down on the IRA.

What do you recommend?

Solution: "The Jones Family Marital (QTIP) Trust for the Benefit of Jack Jones"

IRA Conduit Trusts
Example #2 – Younger Beneficiaries

Peter and Patty Parent have three children, Paul (30), Peggy and Patsy (8 year old bonus baby twins). They are concerned that Paul has gone through an ugly divorce, and will probably have to file for bankruptcy protection, and that Peggy and Patsy will not be able to handle an inheritance of the IRA outright, and have heard about IRA trusts.

What do you recommend?

IRA Conduit Trusts
Example #2 – Younger Beneficiaries

Create different trusts/subtrusts for the benefit of Paul, Peggy, and Patsy. Beneficiary designations will be:

- Spouse = Primary Beneficiary (100%).
- Secondary Beneficiaries in Equal Shares:
  - The Parent Family Trust fbo Paul Parent.
  - The Parent Family Trust fbo Peggy Parent.
  - The Parent Family Trust fbo Patsy Parent.
- OR:
  - Create standalone, unfunded IRA trusts for the benefit of each of the children (much better option for asset protection planning, just in case).
- *Be sure that appropriate distribution and spendthrift limitations are drafted into the trusts!*

IRA Conduit Trusts
Example #3 – Special Needs Trusts

Dan is an adult with Down Syndrome. He is able to do a lot on his own, but cannot manage his own money. Further, he is on both SSI and Medi-Cal and is dependent upon both.

His parents want to provide for him but are concerned about his eligibility for public assistance benefits. They know they will need a third party special needs trust, but they have heard horror stories about the taxation of IRAs within a special needs trust.

What do you recommend?

IRA Conduit Trusts
Example #3 – Special Needs Trusts

- Create IRA Conduit Provisions within Dan's standalone Special Needs Trust:
  - The Dan Smith Special Needs Trust fbo Dan Smith
- Authorize the trustee to accumulate, and not distribute, RMDs, if necessary
- Authorize the trustee to take more than RMDs if necessary
- Restrict ability to distribute directly to Dan
- When reporting on Form 1041, K-1 all payments made to health care providers under the theory that the distribution was made "to or for the benefit of Dan Smith"
- On Dan's Form 1040, claim the medical deduction for the payments made

  Note: This will require further attorney involvement to explain to SSI and Medi-Cal authorities that the beneficiary actually received no direct payments.

IRA Trusts
Sample Language – A Discussion

- Spendthrift Language.
- Distribution After Death of Trustor.
- Separate Shares of Named Beneficiaries.
- Accumulation Language.
- Discretionary Withdrawal/Distribution Language.
- Trust Protectors.
- Final Distribution of Trust.
- Limited Powers of Appointment.

Questions?