STANDALONE RETIREMENT TRUSTS

WHY YOU SHOULD HAVE ONE
AND
WHAT HAPPENS IF YOU DON'T

OVERVIEW

Retirement funds make up a significant part of the tangible wealth of most Americans. Both the federal and state governments provide incentives for individuals to contribute to these funds, namely:

- current year reduction of taxable income when money is contributed to a qualified plan;
- beyond the reach of most creditors; and
- employers can deduct their contributions to employee plans.

Bottom line, retirement plans are very effective at accomplishing their primary objective to supplement the contributor's retirement. A person who starts saving at a young age can accumulate a sizable nest egg for retirement. And there should be an overall savings in income tax when the retiree withdraws money at a lower marginal tax rate thus realizing a significant lower overall income tax over his or her lifetime.

This is a great outcome if one retires and lives to a ripe old age and lives off the pension. But what if you prematurely die leaving behind sizable retirement account? What happens to this money?

The answer - a lot of things can happen and many of them are probably not what you would want if you were in control.

TICKING TIME BOMB

Funds held in government sanctioned retirement accounts are different than normal savings. The money hasn't been taxed, so there will be income tax due on distribution. And when one dies, the retirement funds are included in the decedent's gross estate - so estate tax may also be due. Yes - double taxation - potentially up to 70%. Even if the retirement funds are inherited, there are a myriad of complex rules determining when the money must be distributed - and draconian penalties if the rules are not followed.

This may not be a big problem for a surviving a spouse. The spouse has the unlimited marital deduction (to shelter estate taxes) and the option of rolling the retirement accounts into his/her personal IRA and using it for retirement, thus extending the time of income tax deferment.

But what if the decedent wasn't married or both spouses die simultaneously? Depending on the beneficiary designation on file with the plan administrator, the retirement funds may be distributed (and taxed) immediately, or there could be mandatory distributions within five years. Either way, taxable income must be recognized by unsuspecting beneficiaries. This could be a problem where it forces the recipients into a higher tax bracket, or

Law Office of John Roney Stubbs
1500 Rosecrans Avenue, Suite 500
Manhattan Beach, California 90266
310-406-0064

worse, where beneficiaries shouldn't receive a large lump sum distribution of cash due to age, physical or mental infirmity, financial immaturity, potential creditors, or predators lurking about.

The real issue is one of control. Does the owner of a qualified retirement plan want to determine what happens to the money going to non spousal heirs in the event of an untimely death, or simply roll the dice and hope for the best.

INHERITED IRAS

An inherited IRA is where a person acquires an IRA (or distribution from any qualified pension plan) on account of the death of the original owner. This money keeps some attributes it had as a retirement account. Specifically, income taxes are deferred until such time as it is distributed to a beneficiary. But there are new rules for required minimum distributions (RMD) that must be made to the beneficiary. Unlike a traditional IRA, money may be withdrawn at any time without an early withdrawal penalty - but of course, income taxes must be paid.

It is increasingly common for owners of retirement funds to conclude that if they can't use the money for their retirement, they would like to have it grow over many years in a managed tax deferred environment. Properly structured, this can be a powerful tool to accumulate and leave wealth for future generations.

But there is a hitch. A recent US Supreme Court decision in *Clark v. Rameker* (2014) determined that inherited IRAs, unlike normal retirement funds, can be reached by creditors in a bankruptcy proceeding - and presumably by other judgement creditors. The money is thus exposed to a myriad of potential claims - for example, a divorcing spouse, liability from a car accident, business failure, etc. And over a long period of time, it is likely that some sort of creditor problem will occur thus putting at risk the grantor's wealth accumulation strategy.

SPOUSAL ROLLOVER

A surviving spouse has a huge advantage. While the spouse can take an inherited IRA and try to stretch it out to maximize the long-term return, he/she also has the option to roll it over into their own IRA. It then becomes their own retirement plan - subject to the traditional rules regarding early and/or mandatory withdrawals. Upon roll over, the surviving spouse's age is used to determine when mandatory distributions begin. Additionally, the surviving spouse has the option to convert a traditional IRA to a Roth IRA.

There is no time limit on when a spouse can initiate the roll over. For example, a spouse can keep it as an inherited IRA till age 59½ then roll it over thus avoiding the normal penalties for early withdrawal.

But what if a spouse has an inherited IRA and is faced with a creditor claim. The inherited IRA is not exempt from creditors, but a "rolled over" IRA is. Can the spouse wait to the last moment and roll over the IRA and thus erect a shield to thwart any creditors? The answer is probably yes.

Normally, a transfer of assets with actual intent to hinder, delay, or defraud any creditor is a fraudulent conveyance and can be reversed or disallowed. California does not have any statutory protection, in bankruptcy or otherwise, for inherited IRAs. However, the law is not entirely clear on on whether a roll over is a transfer within the meaning of the fraudulent conveyance statutes. A reasonable argument for the spouse is that the roll over is not a "transfer" but rather the exercise of a federally granted right, thus avoiding the fraudulent conveyance issue altogether. But to be on the safe

side, a spouse should elect the roll over shortly after the death of the decedent spouse.

DESIGNATED BENEFICIARY

A "designated beneficiary" is any individual identified as a beneficiary by the plan owner (e.g., spouse, child, parent, niece/nephew, neighbors…). The following do not qualify as designated beneficiaries: charities, estates, partnerships, corporations, LLCs, and most trusts.

Qualified retirement accounts have a plan administrator who manages the fund and distributes the money. Even self directed IRAs will be at a financial institution where distribution is subject to the control of the bank. When the owner of the retirement account dies, the plan administrator will distribute the money according to the designated beneficiary(s) on file with the plan. Most noteworthy, this will happen regardless of what is written in a will, trust or any other estate planning document.

All too often, a missing or defective beneficiary designation will be on file and not discovered till after the plan owner dies. This is not a good time to sort things out since post mortem problem resolution is vastly more expensive than getting it right when the plan is established - and the plan owner is still alive. Accordingly, it is critical that the objectives set forth in an estate plan are synchronized with the retirement plan's beneficiary designation.

With a traditional retirement plan where the plan owner is still living, there are restrictions which must be followed, such as a 10% penalty on withdrawals before age 59½ and mandatory withdrawals after 70½, etc. But when the plan owner dies, new rules apply to the inherited IRA. The designated beneficiary can withdraw any or all the money at any time without a penalty. Further, there are mandatory minimum distributions (MRD) that are determined using the estimated life span of the designated beneficiary.

If the objective is to stretch out the inherited IRA allowing long term growth in a tax deferred environment, then it is best to minimize the MRD by using the life of a young person for the calculation. Where there are multiple beneficiaries, the actuarial life span of the oldest will be used to determine the MRD. But be careful. If just one beneficiary doesn't qualify, such as a charity, then the required payout reverts to five years. This result can be ruinous to the stretch out plan and definitely not conducive for transferring wealth to future generations.

The personal representative (e.g., executor of the will) has until September 30 of the year following death to sort out any issues with the designated beneficiary. For example if the beneficiaries are the decedent's children and a charity, the presence of the charity will trigger a mandatory five year payout. Accordingly, the personal representative should negotiate with the charity and pay them off before the September 30th deadline, thus eliminating them as a beneficiary and allowing the MRD to be determined based on the qualifying individual beneficiaries.

USING A TRUST AS THE DESIGNATED BENEFICIARY

Many financial professionals, especially inexperienced bank officers, believe that a trust cannot be an IRA beneficiary. That isn't true. Yes, the traditional revocable living trust is not an appropriate retirement plan beneficiary. This is because a trust has no life expectancy and thus cannot be used to determine the MRD. But trusts can be structured to "see through" to individuals who do have a life expectancy and therefore can be a designated beneficiary when the following requirements are met:

- the trust is a valid trust under state law (it is in California);

- the trust is irrevocable, or will, by its terms, become irrevocable on the death of the plan owner;
- the beneficiaries of the trust are individuals identifiable from the trust instrument; and

Appropriate documentation (a copy of the trust instrument and a list of all of the beneficiaries of the trust) has been provided to the plan administrator by October 31 of the year following the year of death.

If a trust has multiple beneficiaries, the age of the oldest beneficiary is generally used to calculate minimum distributions. While the IRA can be divided into separate accounts if the trust is to be distributed to multiple beneficiaries in equal shares, the division will not be recognized for purposes of calculating minimum distributions. Therefore, it is usually desirable to designate subtrusts as beneficiaries of separate accounts, rather than name a single trust with multiple beneficiaries. However, if the trust has only one beneficiary and that beneficiary dies, the IRA will cease to have a designated beneficiary. In that event, the entire IRA must be distributed within five years after the plan owner's death.

Care must be taken in drafting both the trust and the plan's beneficiary designation. If the trust and/or beneficiary designation are not properly structured, the distribution may be immediately taxable or taxable over five years. For example, if the IRA is used to satisfy a pecuniary obligation to fund another trust, the result could be immediate recognition of the IRA income.

STANDALONE RETIREMENT TRUST

There is a relatively straight-forward solution to the problems surrounding inherited IRAs where the objectives are to maximize wealth accumulation for future generations and have reasonable asset protection. It is the Standalone Retirement Trust (SRT). It is designed to be funded only with retirement assets, qualifies as a "see-through" trust to individual beneficiaries, and provides spendthrift provisions to provide protection against creditors or divorce.

There are two types of SRTs: conduit and accumulation trusts.

Conduit Trust

In a conduit trust, all required distributions from the IRA are immediately distributed to the trust beneficiaries. Where the objective is to stretch-out minimum distributions over the individual heir's life expectancy, the "conduit trust" is probably the least complex to draft and most certain to comply with MRD Rules. Where there are multiple beneficiaries, each can have their own conduit trust so long as the death beneficiary designation directs the division of the plan into separate accounts.

The primary disadvantage of the conduit trust is that all distributions from the retirement plan (MRDs plus any other distributions) must be distributed from the trust to the individual, regardless of whether the individual beneficiary wants to receive them. However, this may not be a big deal since actual MRDs for a young beneficiary will be very small. For example, an individual who turns 5 years old in the year following the plan owner's death would receive a distribution of 1/78th (approximately 1.25 percent) of his or her account that year. Further, the funds that actually reach the beneficiary may be less than the MRD due to the payment of legitimate trust expenses, such as trustee's fees, tax return preparation management fees, or other expenses.

The advantages of a conduit trust include:

- certainty (supported by Treasury Regulations);
- use of the "separate share rule" allowing division of the IRA into separate shares per beneficiary;

- simplicity - only the named beneficiaries as of September 30 of the year following death are considered in determining the MRD - i.e., contingent beneficiaries and permissible appointees don't count;
- flexibility - permissible appointees may include charities, other types of trusts, an estate, older individual, etc.;
- easy to achieve grantor's stretch-out objectives.

The major disadvantage is the lack of creditor protection for the inherited IRA. But there is a reasonable answer to a potential creditor problem - the accumulation trust.

Accumulation Trust

An accumulation trust is one where distributions from the IRA are allowed to accumulate within the trust. Income tax will be paid by the trustee - at the tax rate of the trust. Since the trustee has no obligation to pay any distributions to beneficiaries, the accumulation trust provides excellent protection against the beneficiary's creditors.

The primary disadvantages are:

- income taxes on distributions are paid at the trust's tax rate, which may be greater than the marginal rate for the individual beneficiaries;
- unlike the conduit trust, the MRD is based on the eldest of the current and potential reminder beneficiaries;
- since contingent beneficiaries must be counted, if a charity is a contingent beneficiary, it will trigger the five year rule; and
- higher administration costs.

Toggle Power

Clearly, from the reasons stated above, its always best to designate an IRA beneficiary as a conduit trust - at least initially. An innovative toggle power concept has been approved by the IRS in a private letter ruling that allows an independent trustee to switch a conduit trust into an "age-restricted" accumulation trust. This is inventive planning, and the logic of the technique is compelling, since no matter what happens, the trust will fall within either the "conduit" or the "age restriction" methods of complying with the MRD Rules to allow distributions over the "target life" (normally that of the primary beneficiary). But this is a one-time switch and most likely would only be used with creditors knocking at the door.

Typically the power to switch from a conduit to an accumulation trust is vested with a trust protector. This is a person who watches over the trust and is empowered to make certain high-level decisions, such as firing a trustee, resolving disputes, and changing the nature of the trust (i.e., exercising the toggle described above).

LEAVING RETIREMENT FUNDS TO A CHARITY

One important point should be clarified. Leaving retirement funds to a charity is only a problem when the charity is one of several in beneficiaries (e.g., children) and the plan owner wants to stretch out the inherited IRA to selected individuals.

Distributing retirement money to a charity will trigger immediate recognition of the income tax due. But who cares? Qualified charities don't pay income tax. And while the retirement money is part of the taxable estate contributing to the estate tax, there is an immediate deduction for the charitable gift effectively washing out the incremental estate tax.

Where there is an philanthropic objective, the best possible source of money for a post mortem charitable gift is from a qualified retirement fund. This allows the owner of the retirement plan to make the charitable donation while avoiding any and all taxes. In fact, one would always want to use retirement funds for charitable giving before considering any other assets (which have already been taxed).

SO WHAT'S AN OPTIMUM STRATEGY FOR RETIREMENT PLANS?

Of course, the best outcome is living to a ripe old age and fully utilizing your hard earned retirement savings down to the last penny. However, a premature death leaving a sizable retirement account can result in unintended consequences - or in some situations, havoc. And, most importantly, objectives such as maximizing the stretch-out period for tax deferred growth and asset protection will not be achieved.

If the owner of a retirement plan is married, the best choice is to list the spouse as the primary designated beneficiary. Then create a Standalone Retirement Trust for the next level of beneficiaries, such as children. If there are multiple beneficiaries, the SRT should have subtrusts for each individual beneficiary.

This approach provides a surviving spouse several options:

- roll over the retirement funds into the spouse's own IRA;
- hold the money as an inherited IRA - with the option to roll over at a later date; or
- disclaim the IRA thus transferring the money to the SRT.

If the spouse predeceases the plan owner (i.e., simultaneous death), the retirement funds will go to the beneficiaries named in the SRT according to the trust's terms. This provides the plan owner and successor trustee the maximum flexibility and control of the retirement funds. The initial SRT will be a conduit trust which must pay out the minimum required distribution to each beneficiary every year. However, if creditor problems arise, a trust protector can trigger the one-time switch to an accumulation trust to move the money out of harms way.

When doing IRA planning, creating the SRT is only the first step. It is critically important that the beneficiary designation on file with the financial institution holding the retirement funds be synchronized and coordinated with the SRT and other estate plan documents. Sometimes inexperienced bank officers will balk at naming a trust as a designated beneficiary. If some education won't persuade them to conform to the estate plan, it would be best to move the retirement funds to a different financial institution.