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Structuring IRA Trusts in Estate Planning: Strategies for Minimizing Taxes and Preserving Assets

THURSDAY, SEPTEMBER 17, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Structuring IRA Trusts

Strategies for Minimizing Taxes and Protecting Retirement Plan Assets

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Agenda

I. Value of estate/IRA planning after ATRA
 - New opportunity (and danger) after-tax

II. Pros and cons of trusts/trusteed IRAs

III. Why ATRA suggests standalone trusts

IV. Conduit/accumulation trust

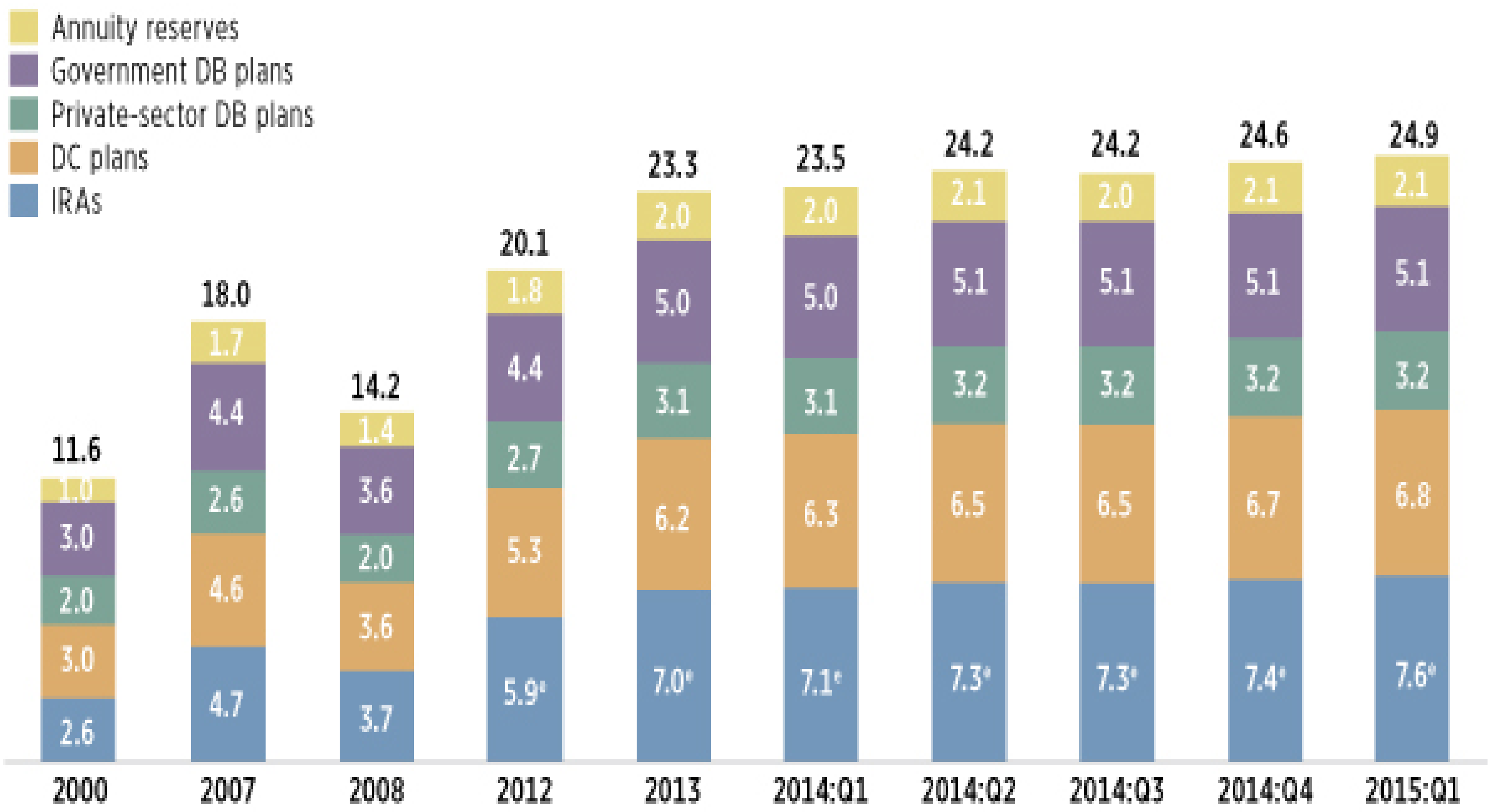
V. Integrating the designation form (BDF)

VI. Charities/CRTs as beneficiaries/Baucus

VII. Pre and post-mortem trust IRA checklist

I. Value of IRA Planning – "It's where the money is!"

U.S. Total Retirement Market (source: Investment Company Institute-www.ici.org)
Trillions of dollars, end-of-period, selected periods



I. Value of a "Stretch IRA"

" The most powerful force in the universe is compound interest."

- Albert Einstein

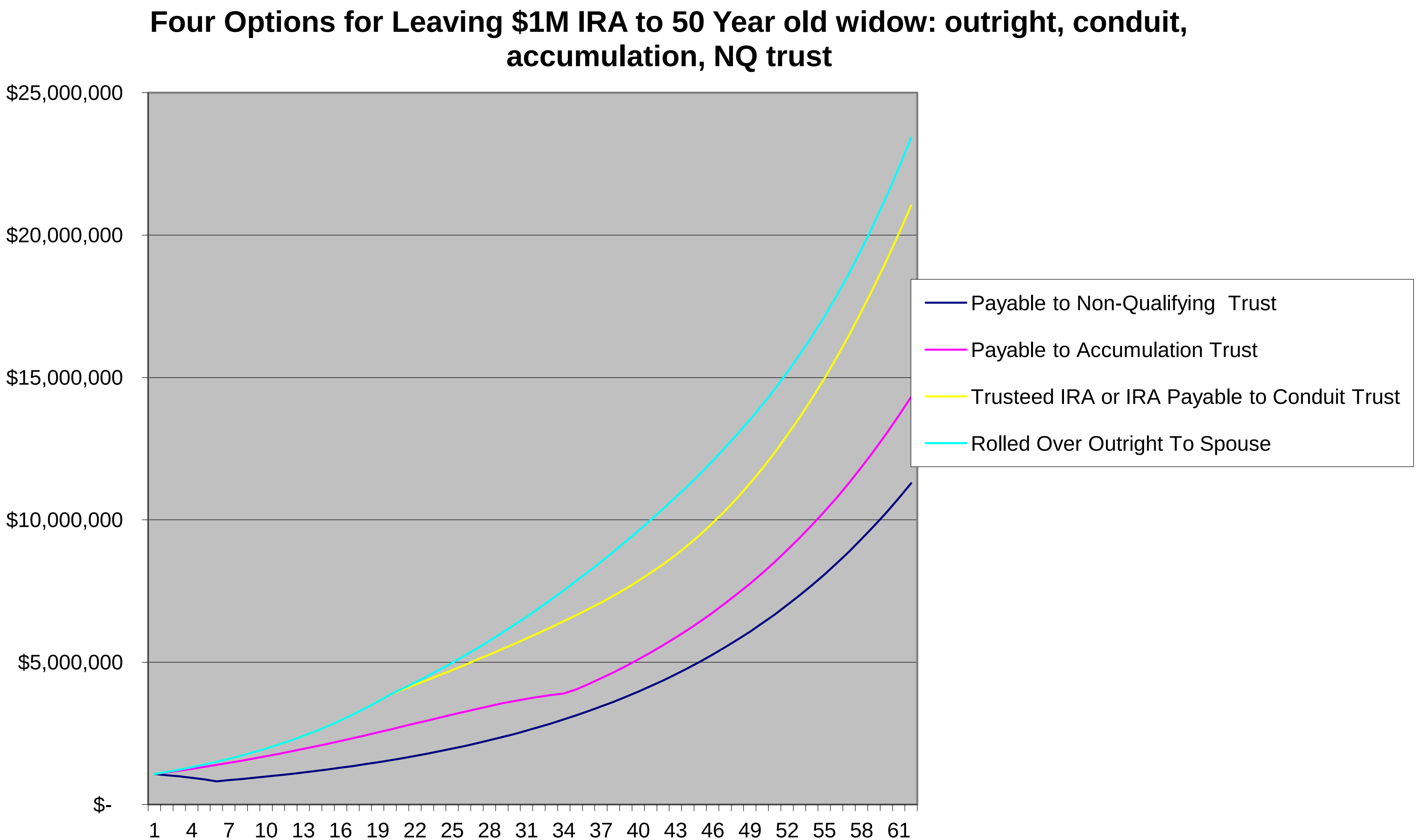
He should have added "tax free", or at least "tax deferred"….

IRAs are Worth Protecting

Growth	Cash-Out Scenario	Stretch-Out Scenario	Difference
0.0%	$382,382	$426,987	$44,605
2.0%	$782,909	$962,320	$179,411
4.0%	$1,606,325	$2,158,513	$552,188
6.0%	$3,296,518	$4,811,764	$1,515,246
8.0%	$6,756,189	$10,648,838	$3,892,649
10.0%	$13,810,650	$23,377,677	$9,567,027

Assumptions: 2% income; $300,000 IRA; 38 year old beneficiary; 31% Federal tax bracket; 4.4% MI; 15% Cap Gain

I. Value of a "Stretch IRA"



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I. IRS Notice 2014-54 After Tax Rollover

Unexpected Relief of IRS Notice 2014-54 (“Guidance on Allocation of After-Tax Amounts to Rollovers”), released September 18, 2014 (attached in handout)

Applicable to qualified plans under 401(a), but also 403(b), 457(b) plans
Most plans do not permit after-tax money (is not req.), but *this may change*.

Example: Chris earns $100,000 and works for an employer sponsoring a 401(k) plan that allows him to make after-tax contributions. He plans on making a full $17,500 deferral to his Roth 401(k) and expects to receive, another $17,500 in employer contributions.

That would give Chris a total of $35,000 of additions to his plan for 2014. Chris can contribute an additional $17,000 in after-tax funds to the plan ($52,000 overall limit minus $35,000 of other additions) for 2014 (amounts increase for inflation)
Chris quits/retires years later with $520,000 in 401k, comprising $350,000 in pre-tax 401k, $170,000 in after-tax. Now clear he can roll $350,000 to traditional IRA, $170,000 to Roth IRA *tax-free* (no pro ration)

I. IRS Notice 2014-54 After Tax Rollover

From an *estate planning with trusts* perspective, what does this mean?

Most trusts have no language about after-tax v. pre-tax qualified plans, Roth v. traditional, nor instruction regarding rollovers, net unrealized appreciation or the like. At most, they typically give the trustee the power to handle any such decisions and accounts.

Most trustees are family members and non-professionals and do not have the foggiest clue about any of these issues.

Hence, these are easy opportunities to miss (and, grounds for breach of fiduciary duty and malpractice lawsuits)! Yet they are differentiators for you to market your legal and tax services.

II. Ensuring, not Blowing, the Stretch

1. Trusts can control spending
2. Trusts can ensure asset protection -*Clark*
3. Trusts can avoid estate/inheritance tax
4. Trusts can avoid state income tax
5. Trusts can control “bloodline” inheritance
6. Trusts can be “de facto prenup”
7. Trusts can protect against mistakes
8. Trusts can fit “special needs”/benefits

II. Ensuring, not Blowing, the Stretch

Spending - Estimates are that 80% of IRA assets are withdrawn from custodial IRA accounts within 2 years of the original owner's death!

Source: *The Trusteed IRA: Helping to reverse an 80 percent failure rate*, IMCA Investments and Wealth Monitor, by Sharp, Holtby and Cassidy, citing studies by TD Ameritrade and Pershing, LLC, two of the largest IRA custodians

II. Ensuring, not Blowing, the Stretch

Clark v. Rameker:

The Supreme Court unanimous declares that the Bankruptcy Code does NOT protect inherited IRAs. Spousal inherited IRAs uncertain.

Lesson: if you want to protect the legacy of your retirement account from children's creditors, use one of two solutions:

1) A trusteed IRA
2) A separate trust as beneficiary. Best - discretionary.

- See LISI Asset Protection Newsletters plus chart

II. Ensuring, not Blowing, the Stretch

Estate/Inheritance Tax, State Income Tax

- Less a problem now with $5.34 million exclusion plus portability, but why add to a child's estate if they may be above exemption someday, or move/reside in a state with a much lower exemption?

- *State law case trend on trust income tax is favorable (and a good reason to avoid testamentary trusts!). This could add significant benefit in rare cases*

Bloodline Protection

Ray A. Campbell, deceased, age 73

Charlotte Gee, widow of Ray A. Campbell, age 51

$977,877.79	pre-age 59½ withdrawal from rollover IRA
$266,336.00	income taxes paid

IRS wants more:

$97,789.00	10% pre-age 59½ penalty
$19,558.00	20% accuracy-related penalty

Ray's Death
June 1998

Charlotte's rollover
$1,010,988
July 1998

Charlotte's change of
IRA custodian.
Account worth:
$2,646,797.89
November 2000

Charlotte's
remarriage
????

Charlotte's withdrawal
$977,877.79
2002

GMH GIARMARCO, MULLINS & HORTON, P.C.
ATTORNEYS AND COUNSELORS AT LAW

Charlotte and Charles T. Gee v. Commissioner of Internal Revenue
127 T.C. 1 (2006)

Bloodline Protection

U.S. Tax Court, Washington, D.C., July 24, 2006

Charlotte's Defense:

Withdrawal was from Ray's IRA and thus exempt from the pre-age 59½ penalty by reason of distribution on or after death.

Result: IRS WINS!!

IRS wins on the $97,789.00 pre-age 59½ penalty

Charlotte wins on the $19,558.00 accuracy penalty

Bigger Question:

IS THIS WHAT RAY WANTED?

Charlotte and Charles T. Gee v. Commissioner of Internal Revenue 127 T.C. 1 (2006)

II. Ensuring, not Blowing, the Stretch

De Facto Prenup for Inherited Assets

- In addition to *Gee*, see Leimberg Asset Protection Newsletter on the *Ferri* case. While not an IRA case, it's a lesson in how a properly drawn trust might save the day in a divorce.
- *While most states consider inherited property as "separate" – rules are not uniform, who knows where children may be - they may "commingle" assets*

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II. Ensuring, not Blowing, the Stretch

Special Needs Trust/Medicaid

- Generally, wholly discretionary third party created trusts not counted as a "resource" for gov't benefits
- *Administrative Mistakes by beneficiaries can blow the stretch*
- *"9100 Relief" often NOT available*
- *Professional administration can save the day (or be a "deep pocket"!)*

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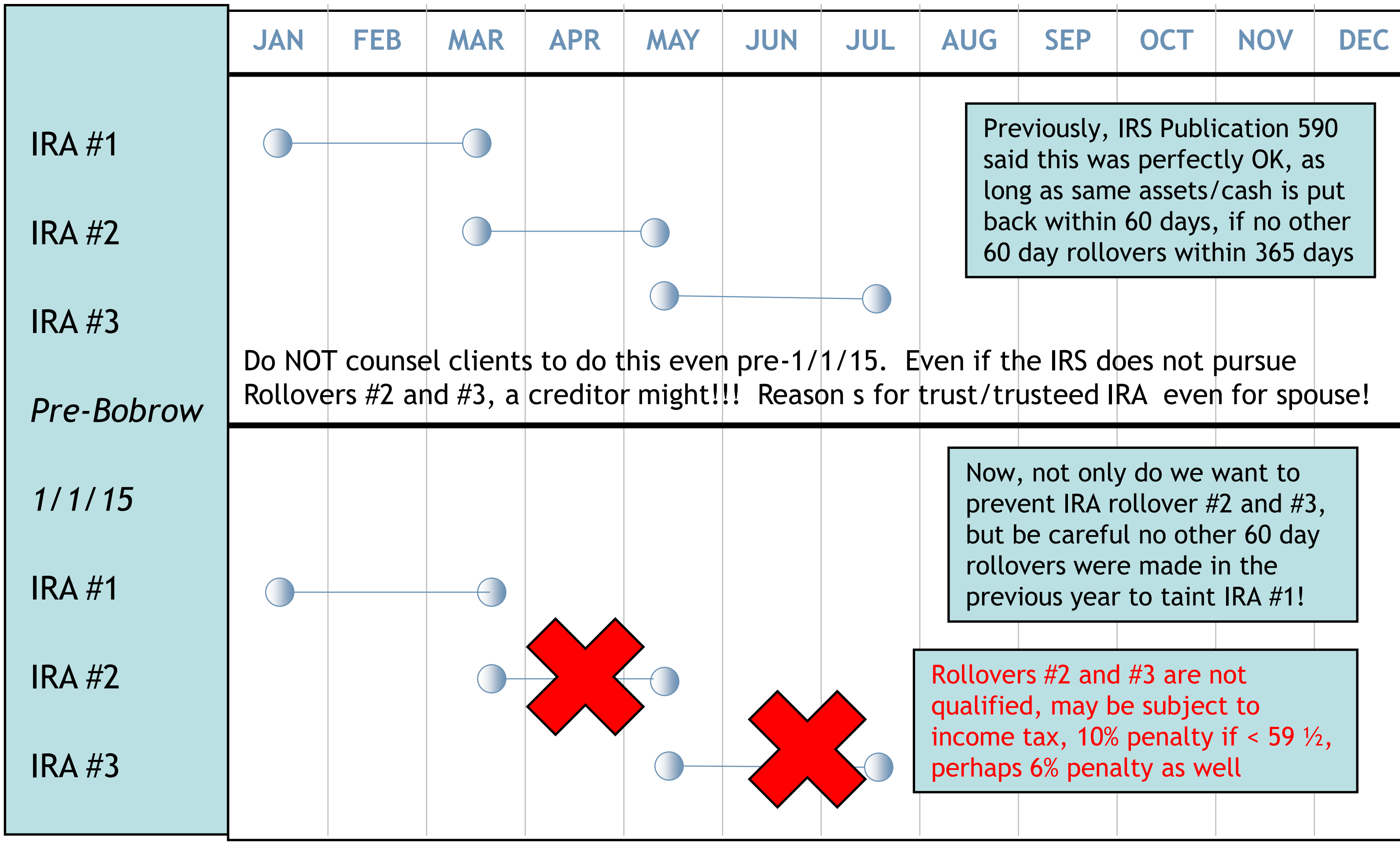
60 Day IRA Rollover Rules pre and post *Bobrow* Case and IRS announcement



Remember, you can do unlimited trustee to trustee transfers (direct rollovers) – these do not count!
ALL post-mortem rollovers to inherited IRAs/trusts must be direct – no 60 day rollovers allowed!

III. Standalone IRA trusts post-ATRA

“A more cautious practitioner could go further and **<u>create separate complete trust instruments</u>**, one for each child or other beneficiary for whom separate account treatment is sought, **<u>rather than to use the shortcut of creating separate trusts under one master trust instrument</u>**. Separate trust instruments do require more drafting and paperwork at the planning stage, but making that effort has the benefit of presenting an even cleaner situation to an auditing plan administrator or IRS agent (two groups who have difficulty understanding trusts and other estate planning devices).”
- Natalie B. Choate, author of *Life and Death Planning for Retirement Benefits*, *“MRD Rule Reversal”,* Trusts and Estates Magazine, July, 2003, Pages 40 and 41.

“Although most attorneys think good estate planning can be done with only one master trust, there are various drafting, compliance and post-mortem administration problems that are minimized by segregating these assets and using a separate trust solely for retirement benefits.” – *Using Standalone or Separate Trusts Solely to Receive Retirement Benefits*

“Once it is decided that a trust will be the beneficiary of the IRA for retirement plans … **<u>the trust should be a separate trust</u>**, to inherit the IRA and only the IRA; not other non-IRA assets.”
- Ed Slott, *Ed Slott’s IRA Advisor,* July 2008, Page 2

III. Standalone IRA trusts post-ATRA

MORE compelling now post ATRA –

1. Powers of appointment and spray provisions are much more likely to be used in bypass trusts now for better income tax and basis planning. http://ssrn.com/abstract=2436964
2. Such provisions may be an income tax elixir, but are ***poison*** to "see through trusts", especially accumulation trusts
3. Conclusion – leave IRA assets outright or to separate trust or subtrust, don't mix, unless you are very careful (easier with conduits)

IV. Five ways to control IRAs

1. IRA Annuity with restricted payout options elected (uncertain creditor)
2. Trusteed IRA with trust distribution terms incorporated into the BDF (a simplified conduit trust saving 1041 filing)
3. **Conduit trust (Ex. 2 in 1.401(a)(9)-5)**
4. **Accumulation trust (Ex. 1 in 1.401(a)(9)-5**
5. Non-qualifying trust (which might even be a CRT), which only receives 5 yrs or "ghost stretch"

IV. Conduit and Accumulation Trusts

Trusts should be used to protect IRAs. . .
but not just any trust will work. . .
and many revocable trusts have problems.
The four criteria often cited from
Treas. Reg. 1.401(a)(9)-4, A-5(b)(1)-(4)
are completely useless in confidently drafting or evaluating an accumulation trust:

1) Valid under state law
2) Irrevocable (what about joint trusts?)
3) **Beneficiaries identifiable (and are individuals)***
4) *Trust documentation to cust. by 10/31/Y.O.D. + 1*

Accumulation Trust vs Conduit Trust

Year	RMD Taken from IRA and Paid to Trust	Additional Withdrawals from IRA Paid to Trust	Total Amount Withdrawn from IRA & Paid to Trust	Accumulation Trust Distribution to Beneficiary	Conduit Trust Distribution to Beneficiary
1	$ 100	$ 300	$ 400	$ 200	$ 400
2	$ 125	$ -	$ 125	$ 50	$ 125
3	$ 150	$ 25	$ 175	$ -	$ 175
4	$ 175	$ 100	$ 275	$ 600	$ 275
5	$ 200	$ 225	$ 425	$ 150	$ 425
6	$ 225	$ 50	$ 275	$ 200	$ 275

In the conduit trust, the distributions to the beneficiary are always the total of withdrawals from the IRA.

In the accumulation trust, it is up to the trustee.

IV. Conduit Trusts

1) Easy to draft (but see how even this could be botched in the checklist material)
2) Easy to administer, understand, account for
3) No 39.6% + state high income tax rate trapping
4) Trusteed IRA is basically a simplified conduit
5) Biggest Practical Use: When someone wants a charity as remainderman (e.g. I want to benefit my wife, then ~~University of Michigan~~ the Ohio State University after my wife dies).
6) Has a tax deferral advantage for married couples over accumulation trust, especially pre 70 ½.

IV. Accumulation Trusts

"It is recommended that practitioners **<u>use conduit trusts and O/R-2-NLP trusts as often as possible</u>** when drafting trusts that are to be named as beneficiary of retirement benefits, since these are among the few types of trusts where we have clear guidance that it 'works'."

- Natalie B. Choate, *Life and Death Planning for Retirement Benefits*, (6th edition), Ataxplan Publications, 2006, page 318.

Illustrations of Various “See-Through” Trusts as Beneficiaries of IRAs

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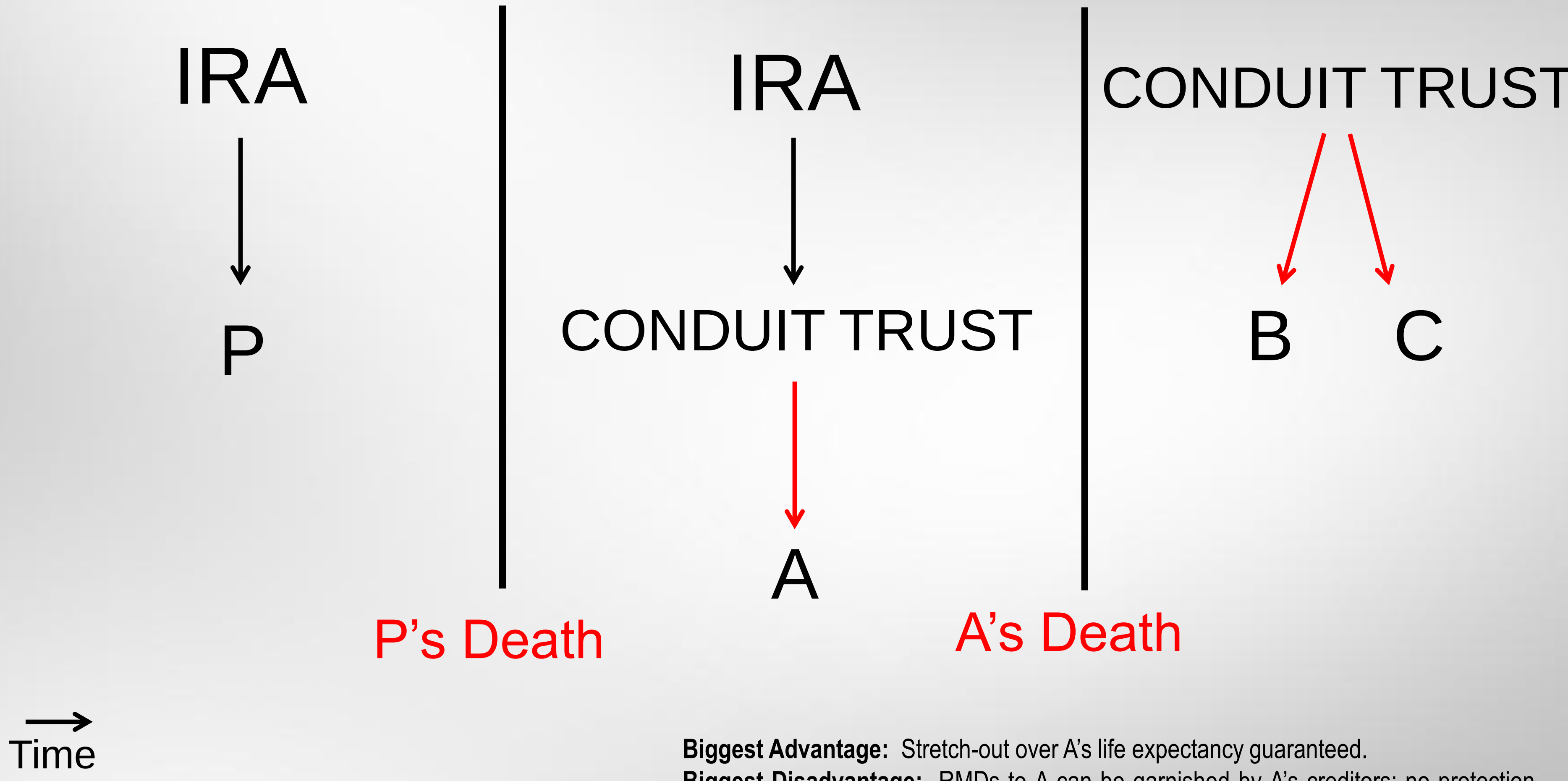
Assumptions

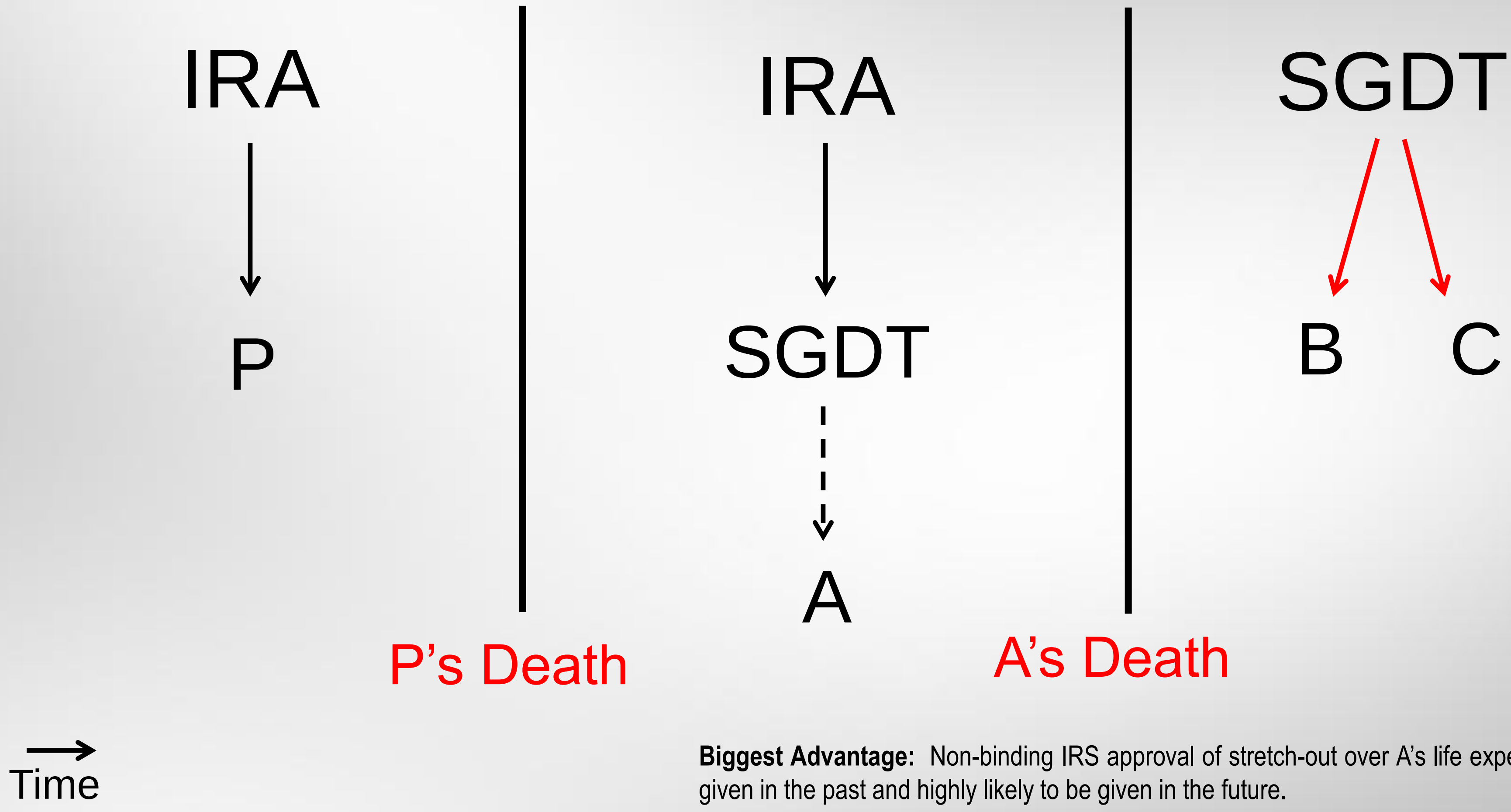
1. P = IRA plan owner
2. A = P's child
3. B & C = A's children
4. SGDT = Single Generation Discretionary Trust
5. LMST = Last Man Standing Trust
6. MGDT = Multi-Generation Discretionary Trust
7. Black solid lines with arrowheads (→) indicate required minimum distributions (RMDs). Red solid lines with arrowheads (→) indicate a mandatory trust or estate distribution.
8. Black dashed lines with arrowheads (⇢) indicate discretionary trust distributions. *As a general rule, the more black dashed lines with arrowheads pointing to the greater number of heirs, the better. This is because discretionary trusts provide greater creditor protection and greater protection for future generations against an ancestor's leaving assets to someone outside the family bloodlines.*
9. P is survived by A, B & C; A lives to life expectancy and is survived by B & C; B is survived by C.
10. For **traditional IRAs**, "IRS approval" = Stretch-out over A's life expectancy; "IRS disapproval" = **either** RMDs over 5 years (if P dies before April 1 of the year following the year P reaches age 70 ½) **or** RMDs over P's remaining life expectancy (if P dies on or after the April 1 date).
11. For **Roth IRAs**, "IRS approval" = Stretch-out over A's life expectancy; "IRS disapproval" = RMDs over 5 years.

Conduit Trust F/B/O A



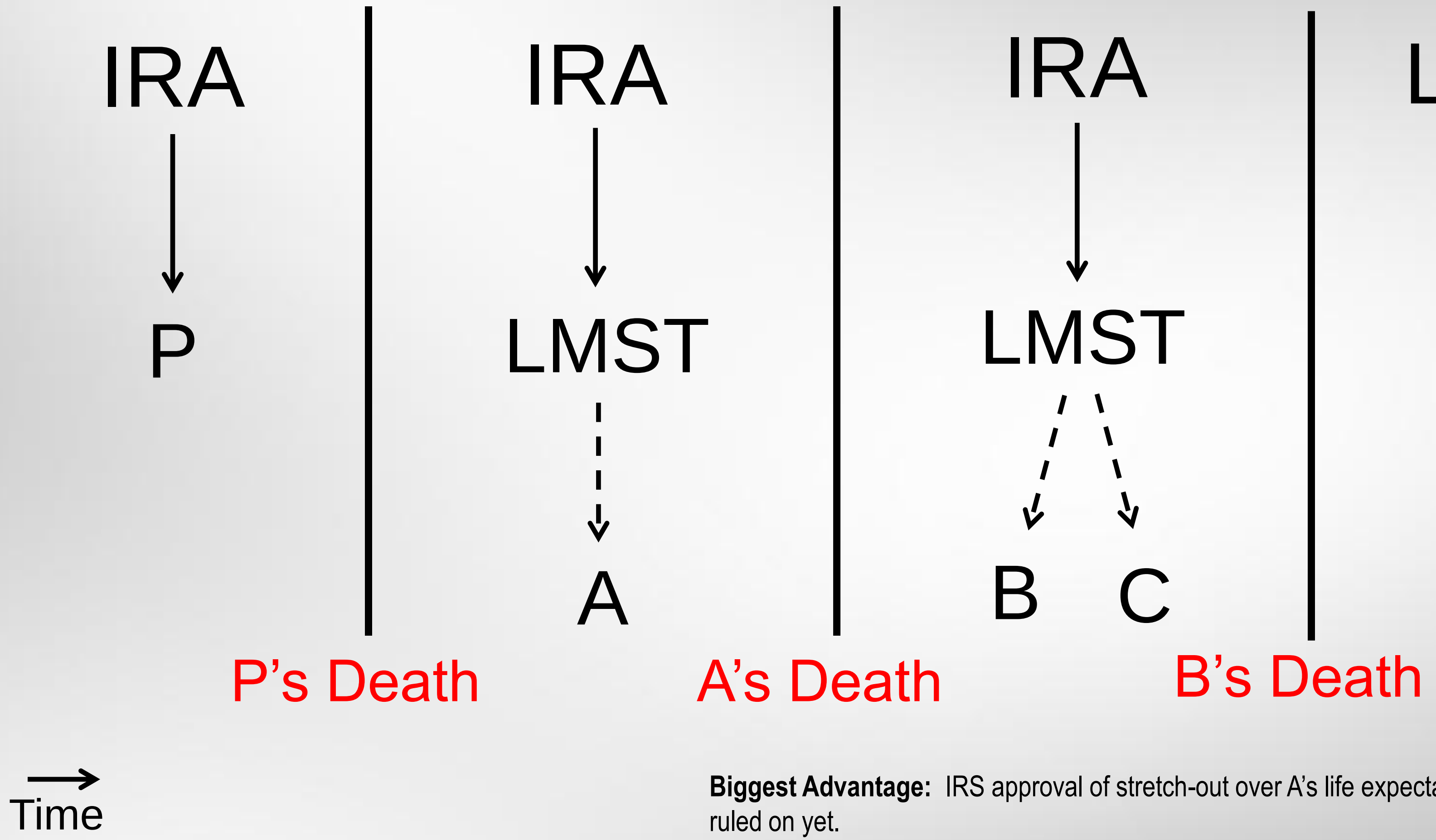
Biggest Advantage: Stretch-out over A's life expectancy guaranteed.
Biggest Disadvantage: RMDs to A can be garnished by A's creditors; no protection for entire plan if A lives to life expectancy.

SGDT F/B/O A



Biggest Advantage: Non-binding IRS approval of stretch-out over A's life expectancy given in the past and highly likely to be given in the future.
Biggest Disadvantage: Upon A's death, all assets must be distributed to B and C, thus no trust protection for B and C after that time.

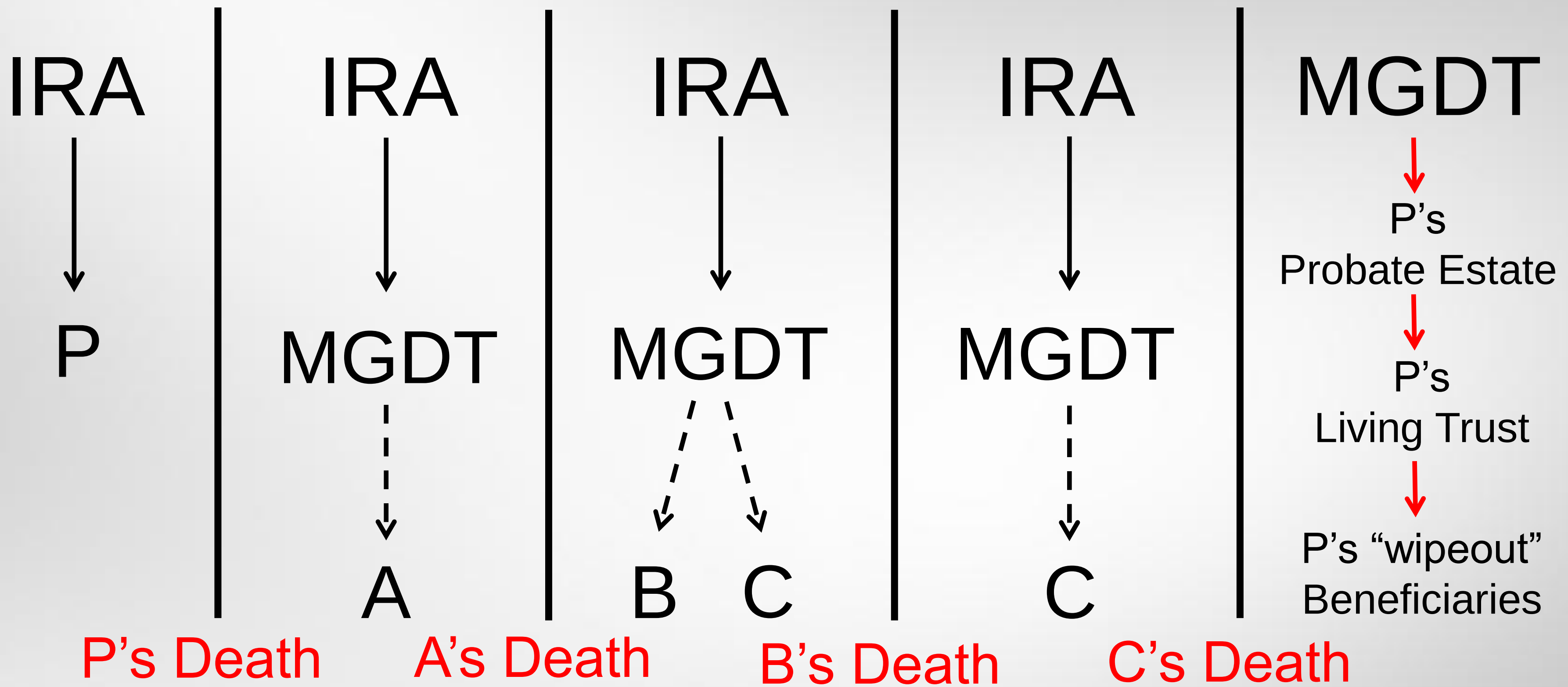
LMST F/B/O A



Biggest Advantage: IRS approval of stretch-out over A's life expectancy likely, though not ruled on yet.

Biggest Disadvantage: Unless more heirs are born before B's death, no trust protection for C and C's future children (if any).

MGDT F/B/O A



Time

Biggest Advantage: Trust protection for all of P's heirs, no matter when they are born.
Biggest Disadvantage: Non-binding IRS approval of stretch-out over A's life expectancy of similar format given in 2013. Yet, if IRS disapproval occurs, courts would likely agree that decision.

IV. Accumulation Trusts

When do we stop looking to identify beneficiaries?

Contrast PLRs 2002-28025, with the recent taxpayer friendly PLR 2013-20021.

Both included in attached material.
There are still unanswered questions surrounding accumulation trusts – why would the IRS not consider default beneficiaries by law but consider those named in the document?

Case Study #1

Facts: Client (age 83) has a large IRA and is worried about his daughter's (age 55) leaving her share to her husband and his son's (age 51) losing his share to already known business creditors. Client has grandchildren, ages 16 and 13.

Analysis: If client uses a conduit trust for his daughter, his objective will be defeated piecemeal over time to the extent funds not spent. If client uses a conduit trust for his son, his objective will be partially defeated each time another distribution is made. However, a conduit trust for his daughter would serve his goal should she die young or need funds for spending anyway, and a conduit trust for his son would preserve the balance of the IRA until his son's creditors are paid off or have to go away. Ed- In some states, trust can pay mandatory distributions "for the benefit of" debtor, despite creditor. If son files bankruptcy, any current or 180 day past payments may be included in BK estate, but not the future payments. Not optimal, but much better than no trust!

If client uses an O/R-2-NLP accumulation trust for each child (life estate for child 1 followed by life estate for child 2 followed by outright distribution to grandchildren) he must be willing to live with the possibility of his grandchildren inheriting a large IRA at very young ages should both of his children die prematurely. On the other hand, his objectives for both children will be met. He is willing to take this risk and opts for accumulation trusts for each child.

Case Study #2

Facts: Client, age 63, has one son, age 28, and no grandchildren. She would like to ensure that her son stretch-out her IRA but that what may remain of it at his death not pass to his spouse, preferring to leave it to other beneficiaries that she selects, each of whom is significantly older than her son (or a charity).

Analysis: If client uses an O/R-2-NLP accumulation trust for her son, her son's life expectancy will not be used because her contingent remainder beneficiaries will "count". Therefore, her stretch-out goal will be mostly defeated. She will have to settle for a conduit trust for her son for now. As with the daughter above, this does not solve the in-law "problem" completely, but it will allow her to name her own remainder beneficiaries, which to her is a good enough deal for now. She will revisit the matter as soon as her first grandchild is born.

Case Study #3

Facts: Client, age 71, has two sons, ages 42 and 39, respectively, and two grandsons, ages 6 and 4, respectively. Client would like to leave his IRA directly to his grandchildren to get a "super stretch-out". His sons, who are already well off, will receive the other assets of his estate.

Analysis: If client uses conduit trusts for his grandchildren, he is free to name any one or more of his sons or his other grandchildren as contingent remainder beneficiaries without losing the "super stretch". However, RMDs, though relatively small when compared to later years, to minors will require a custodianship.***(Ed- instruct the trustee to appoint and pay to UTMA custodian (**not** 2503(c)), which can delay an minimal access until age 21 or 25.

If client uses an O/R-2-NLP accumulation trust, he will be limited to naming his other grandchild the contingent remainder beneficiary in order to preserve the "super stretch" (giving a few years away in case of the 4 year old) but a custodianship would be avoided. On the other hand, a grandchild's premature death would result in an outright distribution to a minor. For this last reason, client opts for conduit trusts for each of his grandchildren, remainder to his sons, but with plans to revisit the situation when the grandchildren reach adulthood.

V. Integrating the BDF

1. See Section in the Outline on Beneficiary Designation Form quirks and traps.
2. ***The BDF is just as important as the trust itself – do not trust to client or financial advisor ("trust, but verify")***
3. Naming sub-trusts, or separate trusts rather than the master living or testamentary trust can yield benefit, especially where different generations named, or large differences in age of benes, but it depends on trust design!

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IRAs are Worth Protecting

Not using the "separate accounts rule" can hurt too!

IRAs are Worth Protecting

Growth	Single Account Scenario	3-Separate Acc'ts Scenario	Difference
0.0%	$498,743	$510,038	$11,295
2.0%	$880,303	$925,820	$45,517
4.0%	$1,633,397	$1,774,488	$141,091
6.0%	$3,149,494	$3,545,131	$395,637
8.0%	$6,242,084	$7,293,915	$1,051,831
10.0%	$12,600,476	$15,302,030	$2,701,554

Assumptions: 2% Income, $300,000 IRA; 38, 36, and 34 year old beneficiaries; cumulative pre-tax distributions

IRAs are Worth Protecting

Bad:

"John Doe Revocable Living Trust, dated June 15, 2008"…100%

Better:

"Sub-trust #1 under the John Doe Revocable Living Trust, dated June 15, 2008"… 50%

"Sub-trust #2 under the John Doe Revocable Living Trust, dated June 15, 2008"… 50%

Better Still:

"John Doe Revocable IRA Trust #1, dated June 15, 2008"… 50%

"John Doe Revocable IRA Trust #2, dated June 15, 2008"… 50%

IRAs are Worth Protecting

<u>Best</u>:

“John Doe Irrevocable IRA Trust #1, dated June 15, 2008”… 50%

“John Doe Irrevocable IRA Trust #2, dated June 15, 2008”… 50%

<u>Ultimate (Unrealistic)</u>:

“John Doe Irrevocable Trust #1, dated June 15, 2008”… 100% of IRA #1

“John Doe Irrevocable Trust #2, dated June 15, 2008”… 100% of IRA #2

V. BDF - Minors as beneficiaries

Why force probate court guardianships of a minor's estate?

1) Use UTMA/UGMA custodians, not 2503(c) trusts
2) Consider alternate custodians
3) Consider alternate dispositions on the beneficiary designation form itself (after date xx/xx/xxxx, etc)

(sample language in material)

VI. Charities/CRTs as Beneficiaries

1. Beneficiary Designation Form BDF issues
2. Advantages to Direct Bequest in BDF
3. Even better for NQDC, NQDA assets!
4. Charities pay no tax! (absent UBTI)
5. Add “boilerplate” to have charitable bequests paid from IRD
6. CRTs don’t need to be “see through trusts” to qualify for stretch – they have their own separate rules!

Key Private Bank

VI. CLTs as Beneficiaries

1. Lousy idea!
2. Charitable Lead Trusts (CLTs) are *NOT* tax exempt
3. Amounts above charitable unitrust/annuity payout trapped at 39.6% plus state tax >$12,300
4. Unlikely to be as much remainder passing to family as other CLT assets
6. Would *never* qualify as “designated beneficiary” – 5 yr or “ghost” LE rule

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VII. Retirement/Estate Plan Checklists

- See “Checklist Manifesto” by Atul Gawande
- Because of the many additional complexities, a checklist, both pre and post-mortem, can help immensely to identify critical issues so that planning does not “fall through the cracks”
- We will only have time to go through a few highlights from the two checklists