CHAPTER 69

The IRA Designated Beneficiary Trust – Saving Your Family Millions

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THE PROBLEM

Due to certain income tax rules enacted several years ago, your IRA, when inherited, may be the largest asset your loved ones receive from you. However, if you are not careful, your family will face significant income and estate taxes on this asset. Moreover, this asset can be completely lost to your beneficiaries' judgment creditors, divorce, inadvertent planning, financial irresponsibility, and the like. Therefore, it is incumbent upon you to consider all available alternatives to minimize income and estate taxation generationally while maximizing asset protection. One of these alternatives involves the use of a dynamic technique known as the IRA Designated Beneficiary Trust (DBT).

IRA beneficiaries who take advantage of deferring or "stretching-out" the taxable, required minimum distributions (RMDs) over their own life expectancies may compound income tax free for a much longer period than you (as the IRA owner) would be able to — allowing the IRA to grow to be worth millions of dollars. The problem is that this stretch-out does not happen automatically.

If you are like most people, you will name your children or other individuals as beneficiaries of your IRAs. Unfortunately, they may not necessarily obtain the income tax stretch-out, costing them and their heirs potentially millions of dollars. This outcome may happen because your beneficiaries are not aware of the tax and the timetables involved and their alternatives regarding distribution. Or, they may just get improper advice. Sometimes, beneficiaries are unduly influenced by a spouse or some unscrupulous third party with a hidden agenda.

All too often, IRA beneficiaries access the cash immediately, and in many cases, cash out the entire account immediately, only to foolishly spend the balance. They do this before they consult with family members, a financial consultant, or other advisor. Unfortunately, the IRA custodian does nothing more than offer a payment to the beneficiary, which results in financial disaster from the standpoint of tax-free compounding.

But even if your beneficiaries do correctly attempt to maximize the income tax stretch-out of the IRA, the inherited IRA may still be seriously exposed to additional risk of loss by virtue of: 1) an unintended beneficiary inadvertently inheriting the IRA; 2) estate taxation at the maximum rate; 3) your beneficiary's divorce; 4) poor money management skills (particularly if some of the IRA monies eventually pass down to your grandchildren or others who are young or financially inexperienced, or are spendthrifts); and 5) creditors of your beneficiaries seizing all of your IRA assets after your death.

THE SOLUTION

The obvious solution that comes to mind is to create a trust to be the beneficiary of your IRA. With a trust, a trustee can assure the beneficiaries properly withdraw the annual required minimum distribution. Another benefit of a trust is that it may protect against a beneficiary's poor spending habits or poor money management skills.

A trust can also preserve your beneficiary's needs-based government benefits, if applicable. This is not about Social Security or Medicare. Rather, it involves benefits such as supplemental or disability income or Medicaid, where need must be proved. If your beneficiary were to receive an inheritance from you, this could jeopardize his or her qualification for these benefits and possibly cut off your beneficiary's inheritance. Also, the IRA asset may be looked to for reimbursement of benefits provided during your beneficiary's life. A trust, properly structured, can allow your beneficiary to utilize the IRA account to supplement these other government benefits, rather than losing them or have them subject to reimbursement.

Also, a trust can ensure the right people will eventually inherit your IRA assets, rather than simply allowing either your surviving spouse, or more often, the beneficiary's surviving spouse, to then pass that IRA to a new spouse, or to children of another marriage. Additional trust provisions can be drafted to protect your child if he or she is in a high-risk profession, has known substance-abuse challenges, or has a troubled marriage.

Finally, a properly structured trust can provide you what is called "generation-skipping" for estate tax purposes. This means that when your child passes away, whatever remains in the trust will not be taxed again in your child's estate for federal tax purposes before it goes to your grandchildren.

But even if your family is highly educated and understands the consequences of cashing out the IRA account prematurely, there are still some very good estate and financial planning reasons for having a trust named as the beneficiary of your IRA account (either the primary beneficiary or a contingent beneficiary if you are married). As noted above, a trust can provide your beneficiaries with greatly enhanced protection against risk of loss of the IRA account due to lawsuits, creditors, divorce, and so forth.

Naming your traditional family living trust as the beneficiary of your IRA, however, will not work to minimize all of these problems and qualify for the maximum stretch-out of income taxes. Unfortunately, under the final IRS Regulations, a trust named as a beneficiary must pass a number of legal tests for the required minimum distributions in order to obtain the maximum stretch-out over the lifetime of the beneficiaries of the trust. There are numerous traps that are often unavoidable or overlooked when using a trust drafted for other purposes. See Internal Revenue Code (IRC) Section 401(a)(9); Treas. Reg Section 1.401 (a)(9)-4, Q&A 1. (Note that in 2005, IRS private letter ruling 200537044 clarified this area of the law and gave rise to an increased use of a standalone trust as a beneficiary of an inherited IRA.)

The required special IRA trust provisions set forth in the IRC and correlated Regulations allowing stretch-out contradicts many provisions in a traditional family living trust. If your retirement account is made payable to a non-qualifying trust, a tremendous amount of tax-deferred growth will be lost. Most traditional living trusts that are drafted for other purposes do not meet one or more requirements to be classified as a designated beneficiary. To ensure your estate planning goals are met without the loss of tax deferral, a "standalone" or separate trust should be implemented when making a retirement account payable to a trust. Moreover, from a practical standpoint, this separate DBT alerts your beneficiary to the different income tax treatment of your IRA after your death. This point is extremely effective in keeping your beneficiary from going in the next day and withdrawing the balance. It also makes it easier for the custodian to properly administer your beneficiary's IRA account.

A skilled estate planning attorney (experienced in the area of retirement planning) should be used to carefully draft a trust complying with the complex income tax regulations to qualify the trust as a qualified designated beneficiary — hence the name IRA "Designated Beneficiary Trust." Each trust share for each of your beneficiaries must be artfully drafted to afford the beneficiary a subtle blend of flexibility, control, and asset protection. Numerous planning issues need to be addressed, such as deciding: 1) whether or not the DBT should be the primary or contingent beneficiary; 2) the proper wording for the beneficiary designation form; 3) the degree to which assets of the trust share can be accessed by your beneficiary; 4) whether or not more than one DBT must be used; 5) how to address the sometimes conflicting needs of a surviving spouse and children born of another marriage; 6) the degree to which the DBT will adapt to the conditions existing at the time of your death; 7) whether to have all IRA distributions flow over into your DBT and then be immediately distributed out to your beneficiary, or whether to allow IRA distributions to flow to your DBT, but accumulate in the trust with distributions made to your beneficiary at the discretion of the trustee (see Example 2 of Treas. Reg 1.401 (a)(9)-5, A-7(c)(3); Treas. Reg. 1.401(a)(9)-5, A-7(s); See also PLR's 199931033 and 20010646); 8) how to implement the distribution provision and accumulation provision when needed and flipping over from one to the other depending upon your beneficiaries' needs; 9) how to provide for separate share treatment for your beneficiaries so each may use his or her own life expectancy for stretch-out purposes as opposed to using the life expectancy of the oldest beneficiary, thus maximizing tax deferral within the retirement account; 10) who to name as trustee(s); and 11) whether to have the DBT act as a credit shelter trust (otherwise known as a family trust or bypass trust) — just to name a few.

In summary, the IRA designated beneficiary trust (when drafted and implemented properly) is a solution that should be considered by anyone with an IRA of at least $200,000. It can certainly be an extremely powerful tool, combining wealth accumulation through income tax savings and asset protection at the same time.

The Law Offices of Stuart B. Kalb concentrates in estate and retirement planning to include asset protection, business, and tax planning through correctly implemented strategies and techniques.