

Trust Planning for Retirement Accounts

Using trusts to compel beneficiaries to utilize the stretch distributions provisions for retirement assets. There are more benefits than meet the eye.

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As wealth management practitioners, we have all had the disturbing realization that the beneficiaries don't always follow the proper path concerning the distribution of retirement assets. The 'stretch' option is routinely ignored, as beneficiaries regularly pillage inherited retirement accounts and deplete those accounts at a much faster pace than is financially prudent. Sometimes granting beneficiaries unfettered access to inherited retirement account balances can destroy the intentions of the individual who planned on passing his or her wealth to their children for the benefit of the long-term use of those financial assets. Other times, we believe that the flexibility of granting open access to inherited assets is the best course of action when the mere existence of that level of control unknowingly exposes those assets to the creditors and spouses of the beneficiary. In many cases the 'known' facts aren't the most dangerous part to any wealth transfer process. Planning for the 'unknown' is the most difficult part of our jobs as wealth managers.

The concept of utilizing stretch provisions and properly constructed beneficiary designation documents is nothing new. The younger beneficiaries will be allowed to take retirement plan distributions over many decades while older beneficiaries will be forced to take distributions over a much shorter period of time.

Is there a way to compel beneficiaries to mandatorily use the stretch provisions concerning retirement account distributions? It depends. If you name beneficiaries as outright beneficiaries, then the answer is 'no', you cannot force a beneficiary to take distributions over their life expectancy. It is up to the beneficiary in regard to the timing and amount of the distributions as long as they adhere to the required minimum distribution rules as prescribed by the IRS. They are permitted to take more than the required minimum distributions if they so desire but there is nothing that can be done by the decedent, their trust or personal representative to direct a such a beneficiary to 'stretch' their distributions when an individual is listed as the beneficiary of a retirement account. For those who have appointed a properly constructed qualifying trust as the beneficiary of their retirement assets, then the answer is 'yes.' The use of trusts has become a large part of virtually all wealth management practices. Trusts, while they have been commonly used to preserve the unified credit for a decedent's estate at death, they can also provide other benefits that should not be overlooked when structuring wealth plans for clients with substantial retirement account balances. Ensuring that the stretch provisions of an IRA account are followed can be a significant benefit for beneficiaries.

Trusts can, by specific design, allow for retirement assets to be structured in a way to protect and ensure that the stretch provisions of a distribution plan be honored. As noted in Table 1 at the top of page 2, you'll see the impact of distributing retirement assets over time, rather than through an accelerated method of distribution. In this case, we are assuming a 7% taxable rate of return, and a distribution over the life expectancy of a 31 year old beneficiary versus an accelerated distribution over a 9-year period. This yields a combined account value of an additional \$8.8 million when compared to an accelerated distribution schedule. Assuming that the stretch option can be preserved, the increased amount of income paid to a beneficiary (or a trust, as in our example) is vastly improved when compared to the alternative of heightened distributions taken on a more immediate basis. Forcing the utilization of the stretch distribution provision for a Roth IRA is even more beneficial for the beneficiary and truly takes advantage of the tax-free benefits of the Roth IRA. Granted, there are other considerations to take into account when beneficiary distributions are structured; however, most practitioners take the stance that inherited retirement accounts are to be treated in a similar vein as the intent behind the creation of the original account – it is meant to be a structured private pension plan in order to produce income during the lifetime of the beneficiary. Trusts, as qualified beneficiaries, can be used to enforce these provisions while giving additional potential protections to the beneficiary against divorce, creditors and certainly their own spendthrift behaviors.

Let's first examine the use of two types of trusts in the wealth management plan for a client with adult children. For this summary, we'll assume that client A has effectively created a Roth IRA over the past decade with a balance of \$1 million. This has been created through a series of conversions over the years taking full advantage of a lower income tax bracket for the owner when compared to the tax bracket of the children. This, in its own right, has created a nice inheritance for the children without the negative implications of the income tax applied to the asset upon distribution. Upon the death of the client the assets traditionally pass to the children (assuming no surviving spouse) through a beneficiary IRA arrangement. They have full control over the assets and can take distributions as needed or desired regardless of their needs. In a case such as this, there is no requirement that a stretch provision be honored and the child may take as much of the retirement account asset as he or she wants, without any limitation other than the balance within the account. The account owner could create a '**conduit trust**' as the beneficiary

of the IRA required minimum distributions. The trust will receive the income, which in this case is tax free, and make a tax-free distribution to the beneficiary of the trust. This type of trust prohibits the trustee from accumulating any benefits from the IRA distributions within the trust, with a requirement to immediately distribute those assets to the beneficiary. This serves as a ‘conduit’ for IRA distributions to be passed through the trust and then to the beneficiary. The required distribution amounts are calculated using the life expectancy of the oldest primary beneficiary of the trust regardless of the existence of contingent beneficiaries named within the trust document. Since none of the benefits received from the IRA can be accumulated within the trust, the life expectancies of other contingent beneficiaries can be disregarded. Over time as the uniform lifetime table is applied to the retirement account balance there is theoretically nothing left in the IRA at the time the beneficiary passes away since the IRA asset was required to be exhausted during the lifetime of the beneficiary. Since no assets are to be accumulated within the conduit trust the conduit trust too will terminate with no assets held for the benefit another beneficiary or the creditors of the first child.

While a conduit trust serves to protect the intention of the decedent in *requiring* the stretch provision to be honored, it also required the beneficiary to be the recipient of *all* the distributions from the IRA. This is now considered to be the property of the beneficiary and is open to the distributions being claimed in the beneficiary’s estate for estate tax purposes, is open to discovery by creditors, and is an asset that could fall into the wrong hands during a divorce settlement. This is a major weakness for using a conduit trust. While many estate plans tend to focus on the estate tax benefits of creating trusts, the asset protection of assets as they pass to beneficiaries can be a an additional reason for the construction of trusts. It is no longer just an estate tax issue. Something else to note is that the laws governing *inherited* IRA accounts and *contributory* IRA accounts may be substantially different in terms of asset protection for purposes of divorce, bankruptcy, or creditor’s claims. In many cases clients have appointed children as beneficiaries of their retirement accounts. Even though state statutes have indicated that contributory IRA accounts are not within the reach of creditors, inherited IRA accounts may not benefit by the same protections under state statutes. IRA assets through distribution and subsequent accumulation to a trust may serve to protect those distributions from the reach of a creditor or a divorcing spouse.

If distributing retirement assets to a beneficiary through a conduit trust is an unacceptable result, there is another type of trust might serve as a better option. An **‘accumulation trust’**, as the name implies, does have the ability to retain IRA distributions in trust, where a conduit trust does not. In an accumulation trust distributions to the trust from the IRA are still at a level consistent with the required minimum distribution of the IRA based on the life expectancy of the oldest beneficiary of the trust. However, when the distributions are done they can be retained within the accumulation trust and then distributed at the discretion of the trustee. The trustee may, at their discretion, distribute all, some or none of the IRA distribution to the beneficiary. Additionally, this discretion can be based on an ascertainable standard such as health, maintenance, support, and education with the potential for additional discretionary powers granted to the trustee for additional distributions.

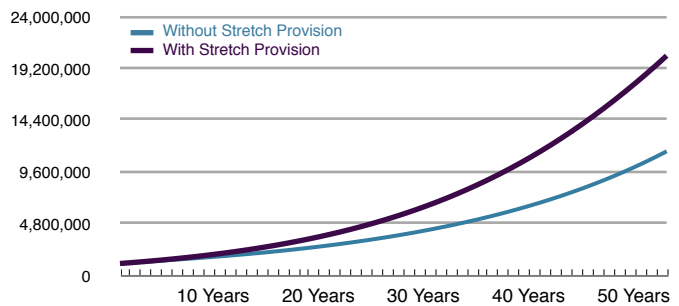
There are two important considerations when using an accumulation trust. First, it permits the trustee to accumulate the required IRA

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Hypothetical Example - Table 1, Roth IRA

Review Period	Without Stretch	With Stretch
5 Years	\$1,338,360	\$1,393,618
10 Years	\$1,693,875	\$1,922,894
15 Years	\$2,115,931	\$2,628,479
30 Years	\$4,124,413	\$6,356,767
Life	\$11,476,646	\$20,345,645

Review period provides the end of period value of the required minimum distributions from a Roth IRA account in addition to the value of any remaining retirement account balance. For purposes of this illustration, the non-stretch accelerated distribution schedule was conducted over a period of 9 years, with the stretch distribution schedule conducted over the remaining 52 years of the life expectancy of the beneficiary. Funds invested after distributions, were compounded using an after tax rate of return of 4.55%. Funds within the retirement account were compounded at 7% annually.



The benefit in using a trust to preserve the stretch provision for retirement account distributions is significant. In the above example, maintaining funds within the retirement account for a longer period of time delays distribution and allows for the Roth IRA to potentially earn returns in excess of the Required Mandatory Distribution. Over time, this benefit will become significant since delaying the distribution from the Roth IRA will also delay the taxation to the trust for dividends, interest, and other earnings to be used for the benefit of future beneficiaries.

distributions in trust and also requires IRA distributions to be done in accordance with the minimum distribution rules as prescribed under the IRS tables. But, the most significant benefit may be in the accumulation of IRA distributions within the trust that will be unreachable by a beneficiary’s creditor or by a divorcing spouse. Additionally, since this asset is held in trust while providing the beneficiary limited access through the discretion and powers of a trustee, the accumulated IRA distributions are not considered a part of the beneficiary’s estate for estate tax purposes. Testamentary limited powers of appointment may be exercised by the beneficiary at death with some limitations, giving the flexibility to appoint assets to anyone other than themselves, their estate, their creditors or other beneficiaries that may be older than themselves. The existence of this power will not cause the corpus of the trust to be included in the beneficiary’s estate. There are special considerations when using this power that should always be discussed with legal counsel.

There are other considerations when naming a trust as a beneficiary. In the case where you are naming a trust as a beneficiary and that trust names multiple beneficiaries, you need to pay special attention in the calculation of the required minimum distribution. In naming a trust as beneficiary, the IRS requires you to calculate the required minimum distribution amount based on the age of the oldest beneficiary under the trust agreement. For those who may have

children along with grandchildren as beneficiaries of their trust, this can cause accelerated required minimum distributions to be taken to the detriment of the younger beneficiaries. In the case of a conduit trust, the age of the oldest beneficiary is the only determinant in the calculation of the required distribution amount since all retirement account distributions are effectively passed through the trust to the beneficiaries of the trust. In the case of an accumulation trust, the required distributions from the IRA will be based on a variety of different beneficiaries, both present and remaindermen beneficiaries and their respective ages. Take for example a trust that exists for the benefit a 40-year old individual, with the remainder interest potentially benefiting the 70 year-old sister of the grantor. In this case, the IRS has taken the position that the age of the 70 year-old should be used in the calculation of the required minimum distribution since they, too, are considered to be a beneficiary under the trust document. This significantly increases the amount of the required minimum distribution thereby reducing the long-term benefits of stretching the distributions of the retirement plan assets over longer periods of time. In the case of a regular IRA this can accelerate taxes paid, and in the case of a Roth IRA, this can significantly reduce the amount of time the Roth IRA will have to produce tax-free earnings and ultimately tax-free distributions to the trust. In the case of a Roth IRA, compelling the trustee to exercise the stretch provisions through a trust is a *significant*.

Once the decision has been made to utilize a specific type of trust instrument for this purpose, it is important to select a trustee in order to carry out the provisions within the trust document. Conduit trusts do not allow for discretion to be utilized by the trustee, since the entire amount of the retirement account benefits pass through the trust directly to the beneficiary. An accumulation trust will rely heavily upon the potential use of discretion in order to exert a level of protection over future discretionary distributions to the beneficiary. In many cases, finding a trustee that can work well with the family is very important. Having a good understanding of the needs of the beneficiary, their spending habits, and the potential risks for distributed assets is a very important part of the overall process. Depending on the type of firm, advisors may or may not have a long list of different options for corporate trustee solutions that can fit the specific needs of the trust document. Either way, the selection of the trustee can make or break a successful long-term relationship.

We recognize that there are a myriad of different aspects to the use of trusts for retirement plan assets that involve the creation of an additional trust, selection of a suitable trustee, tax and investment management complexities. The tax implications of trusts holding net distributable income on the investment earnings from retirement plan distributions in addition to the distributions themselves can be another lengthy topic. Tax rates on trusts that choose to hold net income as a credit to the trust's corpus can be rather high, with income tax rates as high as 35% on modest levels of trust income. This is certainly a consideration in making this decision and should be discussed at length with your wealth manager and appropriate tax and legal counsel.

Our clients have gone through the tremendous time, effort and expense to save through the use of the retirement accounts we presently have at our disposal. We applaud those who have taken

their retirement planning one-step further and incorporated Roth conversions into their wealth management plan. This may have come at a significant tax burden and potential sacrifice during the account holder's own financial life so that beneficiaries can benefit from the tax-free growth mechanism within the Roth IRA. No matter whether a Roth IRA was utilized or if a regular IRA was the primary funding vehicle for their retirement, there is supplemental planning that is required so that those assets can be transferred efficiently at death without the improper enrichment of divorcing spouses or within the reach of creditors. Trusts can prove to be a useful tool beyond what is traditionally known as 'estate planning', landing solidly within the environment of efficient wealth transfer and asset protection for inherited retirement account assets.

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