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May 24, 2017
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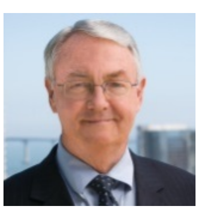
Tom Monson, Senior Partner, along with Michele Enger and Grace Wegrzyn were proud to attend the Pan Asian Lawyers of San Diego's (PALSD) Third Annual Reenactment of *The Constitution in a Time of War - The Trial of Minoru Yasui.* The Reenactment has been organized by Judy Bae for the past three years and involves the collaboration of other diverse legal organizations in San Diego. Judy is currently serving as PALSD's President. Participants included judges from the U.S. District Court and San Diego County Superior Court plus attorneys from the cosponsoring organizations. The Reenactment materials are the result of the work of the Honorable Denny Chin of the United States Court of Appeals for the Second Circuit, his wife, Kathy Hirata Chin, and attorneys with the Asian American Bar Association New York. The event reminded us of the important roles that Asian Americans have played in American legal history and how their civil rights struggles are often ignored or forgotten.



IRA BENEFICIARY TRUSTS:
Purposes and Structures

by Bradford N. Dewan, J.D., MBA

As more individuals roll out significant funds from their pension and retirement plans, the IRAs created with these rollovers are often quite large and constitute a substantial portion of these individuals' estates. A recent report indicated that there was $7.9 Trillion in IRAs. As a result, IRA owners have become more aware of the estate planning issues revolving around IRAs. For one, an IRA is not an asset that is transferred into the family revocable trust like most other assets. Instead, it stands apart and requires its own planning strategies.

PURPOSES OF IRA BENEFICIARY TRUSTS

Large IRAs do present some similar issues for the IRA owner trying to determine how best to pass down substantial wealth and assets to his or her children or grandchildren. Most parents want to avoid undercutting a child's motivation for being industrious by transferring a large financial sum to the child all at once at a young age or over a short period of time. Parents will often restrict distributions of the assets to a child until certain ages are reached. Sometimes the final distribution is not made until the child is in his or her forties or even fifties. Alternatively, the parents may decide to have the assets remain in trust for asset and divorce protection while allowing the children to become co-trustee and then sole trustee at certain ages. These restrictions are placed in the family revocable trust.

But how is this done with an IRA? Normally, the IRA owner would simply list the surviving spouse as the primary beneficiary and the children as the contingent beneficiaries if the spouse predeceases the IRA owner. For example, if there were three children and the spouse died before the IRA owner, then the three children could either only take the required minimum distributions each year in order to maximize the tax deferred growth of the assets held in the IRA, or pull out all of the funds in a single withdrawal. This second option is what many parents want to prevent, not only because of the adverse income tax consequences and loss of tax-deferred growth, but also because of the motivation concern noted above. Instead, because of the benefits of tax deferred growth, they want the distributions stretched out over the life expectancies of the three children.

In addition, as the goal of asset and divorce protection has become more important, parents now have to deal with the U.S. Supreme Court case, Clark v. Rameker, which held unanimously that inherited IRAs do not qualify for an exemption as a "retirement fund" under the federal Bankruptcy Code and thus inherited IRAs are not protected in bankruptcy.

The mechanism to achieve these goals of maximizing the tax-deferred growth and asset protection is a form of trust often referred to as an IRA Beneficiary Trust or an IRA Standalone Trust. This trust is named as the beneficiary of the IRA in lieu of naming the children personally. It is important to note that the traditionally drafted family revocable trust often have provisions that prevent the beneficiaries of the trust (i.e., the children) from qualifying as "designated beneficiaries" of the IRA, which results in loss of the deferral of payments over the life expectancy of a child. When certain requirements are satisfied, the IRS will "look through" the trust and the beneficiaries of the trust (i.e., the children), and not the trust itself will be treated as the "designated beneficiaries" of the IRA.

Specifically, there are several reasons why an IRA Beneficiary Trust should be created and listed as the beneficiary of a parent's IRA rather than the family revocable trust.

First, paying IRA distributions to a separate trust increases the likelihood that debts, taxes (e.g., estate taxes) and expenses of the deceased IRA owner will not and cannot be paid from the IRA Beneficiary Trust but will be paid solely from the family revocable trust. This helps prevent the loss of the ability of the children to be treated as the "designated beneficiaries" of the IRA since the payments described above would make the estate of the IRA owner a beneficiary. But an estate does not qualify as a "designated beneficiary" (only individuals do) therefore, having such a beneficiary eliminates the ability of the children to be treated as "designated beneficiaries".

Second, a separate IRA trust allows the family revocable trust to name older contingent beneficiaries, charities as beneficiaries and other commonly named beneficiaries, without the risk of adversely affecting the ability of the IRA funds to be preserved and stretched out over the life expectancies of the children as beneficiaries of the IRA Beneficiary Trust.

Third, using a separate IRA Beneficiary Trust allows the family revocable trust to contain broad testamentary general and limited powers of appointment, and other clauses such as lifetime powers of appointment, decanting powers and trust protector provisions that permit great flexibility to the beneficiaries of the family revocable trust. The above clauses, however, have proven to be very problematic in a trust intended to also serve as the beneficiary of an IRA and control the inherited IRA upon the death of the IRA owner. These provisions, when reviewed by the IRS, have very often eliminated the ability of maximizing the stretch out of the required distributions from the inherited IRA.

Fourth, an IRA Beneficiary Trust allows the family revocable trust to have the broadest possible spendthrift, in terrorem, incentive (and disincentive), or other clauses that act to restrict or eliminate income distributions to a beneficiary. This could be problematic with a trust intended to direct the trustee as to the distributions to the beneficiary of the annual required distributions receives from the inherited IRA.

Fifth, an IRA Beneficiary Trust will likely simplify the fiduciary accounting issues after the death of the IRA owner involving the division between income and principal and separate share rules. For example, the terms of an IRA Beneficiary Trust will typically opt out of the Uniform Principal and Income Act (UPIA) since the intention for this trust is to receive distributions from the IRA. This issue is due to the unintuitive 10% income and 90% principal divisions of receipts by a trust of required distributions from an IRA.

STRUCTURES OF IRA BENEFICIARY TRUSTS

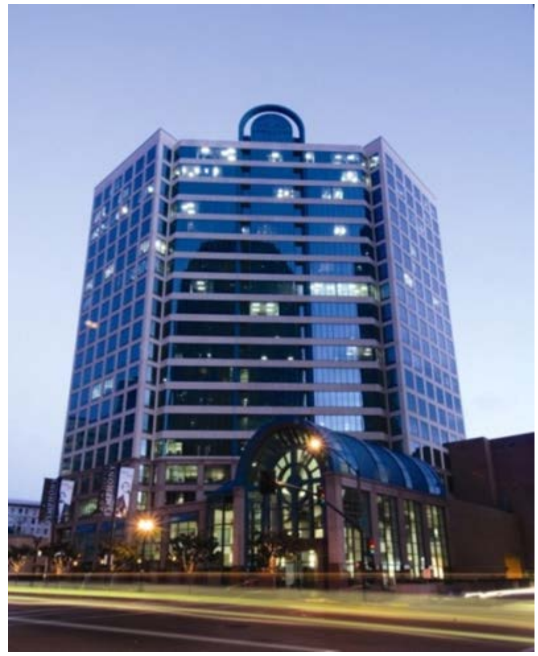
After deciding to use a separate trust in the above manner instead of the family revocable trust, the IRA owner must select between two basic structures for such a trust: a “conduit” trust or an “accumulation” trust. The choice will ultimately depend either on how restrictive the IRA owner wants to be or how concerned the IRA owner is about the child who is to benefit from the IRA.

With a “Conduit Trust”, the trustee is obligated to receive the required distributions from the inherited IRA and then to immediately pass such distributions (and any other withdrawals from the IRA) on through the trust to the child. The child/beneficiary has no power to demand any more from the trust than the required distributions (which distributions are based on the remaining life expectancy of the child). The IRA owner could give the trustee the power to make additional distributions if the trustee, in its discretion, determines that the child needs additional financial resources. Since, potentially, only the required distributions are taken from the IRA, the payments from the IRA may well be stretched out over a long period of time, thus realizing the benefits of tax deferred growth. Very importantly, if the trust is a Conduit Trust then only the primary beneficiary will need to be considered in determining if there is a “designated beneficiary”, and if so, what is the life expectancy of that designated beneficiary. As a result, with a Conduit Trust, the IRA owner has greater flexibility in naming contingent and successor beneficiaries who would receive the distributions upon the death of the primary beneficiary.

However, an IRA owner may determine that the child cannot be relied upon to appropriately use even the required distributions, or that the child’s life style or profession poses a high risk for judgment creditors in the future. In this case the IRA owner wants to insert the oversight of the trustee. Under the terms of this trust, the trustee is given the discretion to either make distributions to the child, the beneficiary of the trust, or to accumulate the required distributions, and any other withdrawals from the IRA and other income of the trust. Thus, this type of trust is called an “Accumulation Trust.”

In considering whether to use an Accumulation Trust, there are a couple of factors that need to be considered. First, the income tax rates for trusts are compressed as compared to those for an individual. For example, in 2017, the maximum tax rate of 39.6% applies to taxable income of a nongrantor trust over $12,500. In comparison, the 39.6% tax rate applies to taxable income over $470,701 for married individuals filing jointly. Additionally, the 3.8% net investment income tax kicks in at this same “top” level for a trust. This typically results in higher income taxes for income retained in the trust versus income distributed to the beneficiary. But potentially more important is the need to be very clear as to who the primary and successor beneficiaries are. For example, what if the IRA owner lists his child as the primary beneficiary of the trust but the IRA owner then names his (the IRA owner’s) brother or sister to be the beneficiary of the trust in the event the child dies before receiving all of the funds from the IRA? In this instance, the much shorter life expectancy of the IRA owner’s brother or sister might have to be used to determine the required distributions, rather than the longer life expectancy of the child. Consequently, with an Accumulation Trust, the IRA owner is very limited regarding who can be named as the contingent or successor beneficiaries since those beneficiaries have to be included in the determination of who is the oldest beneficiary whose life expectancy must be used in calculating the RMDs. If a much older individual is inadvertently or mistakenly named as a contingent beneficiary, then the ability to maximize the “stretch-out” of the RMDs over the life expectancy of the younger primary beneficiary will be lost. Therefore special caution is needed in drafting an Accumulation Trust.

In summary, IRA standalone Trusts as beneficiaries of an IRA are being used more frequently now in order to better assure the IRA owner that his or her wealth transmission goals for the IRA will be achieved.



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