

Price & Farrington's Estate and Tax Planning FastFacts

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Estate, Tax, Business and Wealth Planning for Advisors and Clients

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The IRA Inheritance Trust: A New Strategy to Protect Your Family



The IRA has become the asset of greatest value for many of our clients. Yes, your home is likely to be your other most valuable asset, but it no longer holds the #1 spot it consistently used to. If poor planning options are chosen, an IRA strategy which mismanages the distributions from your plan will lead to costly estate and tax planning consequences — for you and your beneficiaries. Let's take a look.

If an IRA is left directly to heirs, they might strip the account quickly and lose the benefit of long-term tax deferral and growth. Money in an IRA inherited outright might be subject to creditors and divorce proceedings, and any money withdrawn from that IRA will be exposed.

Leaving your IRA to a trust offers several advantages: an inherited IRA will be better protected from creditors and from reckless spending. Using a trust provides greater assur-

ance of long-term tax deferral. Leaving an IRA to a trust with a reliable trustee can ensure that only minimum required distributions (MRDs) are taken if there is no pressing need for cash. This will provide your heirs with extended tax deferral and the chance for superior wealth-building.

Is this a bad deal for heirs? Only if they want to spend even more of the money. But an heir who turns out to be profligate might not think a trust would have been such a bad idea after the money is gone. A trustee can be given the power to tap the IRA if necessary, but also the ability to pay out as little as possible, so a \$500,000 inheritance can wind up paying \$2 million, \$3 million or more to the heirs over time.

Trust troubles. There can be disadvantages to leaving an IRA to a trust. The IRS interprets the MRD rules strictly for trust beneficiaries, which can lead to shortened tax-deferral.

Example. You leave your IRA to a trust, naming your brother, Moe, as trustee. Moe will have discretion as to how much he distributes to your daughter, Molly, who is the primary trust beneficiary. This serves to protect the assets. Moe can take minimum distributions from the IRA and hold the money in trust if he wants to keep Molly from spending too freely or losing the money to creditors or divorce.

Here's the trap: The IRS views this arrangement as an "accumulation trust", where the *shortest* life expectancy of all the possible trust beneficiaries will be used to determine MRDs. Suppose that the IRA passes to the trust when Molly is 47, with a 37 year life expectancy on the IRS table. If her Aunt Millie, 70 years old with a 17 year life expectancy, is the oldest of the secondary beneficiaries, money must be with-



Glenn D. Price and Charles P. Farrington.

drawn from the IRA on a 17-year schedule.

Taking money from the IRA over 17 years rather than 37 years will shorten the tax deferral and reduce potential wealth-building. However, if Molly's siblings or her children are the secondary beneficiaries, her tax deferral might not be significantly — if at all — affected.

After eight years, we're changing our name from Price & Farrington's Estate and Tax Planning FastFacts (since we originally transmitted this newsletter by fax) to FastFacts. While the name has changed, the quality will stay the same. We hope our clients, colleagues and friends continue to enjoy this monthly publication.

Conduit. To assure long-term tax deferral, a "conduit trust" (rather than an accumulation trust) might be desirable in some cases. A conduit trust has a single person as a primary beneficiary. The trustee is required to take at least the MRD amount from an inherited IRA each year and *pass that amount through to the trust beneficiary*, whose life expectancy can be used to stretch out MRDs. Distributions cannot be accumulated in

IRA Planning Word Search

R	E	T	I	R	E	M	E	N	T
M	F	F	P	Q	M	Y	Z	R	D
Q	X	I	R	Q	C	J	N	U	I
W	G	T	O	D	O	T	P	X	I
O	J	B	T	Z	N	T	S	P	O
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L	D	Z	T	D	I	S	F	C	G
B	K	G	O	X	T	T	C	A	H
U	R	F	R	K	R	U	L	X	R

**Locate the following words:
Retirement, IRA, Conduit,
Trust, Protector.**

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the trust. They'll be passed through to the trust beneficiary, who may spend the money or lose it to creditors. However, the IRA principal can still be protected.

The IRA Inheritance Trust.

Up to now, leaving an IRA to a trust has meant having to choose between (a) the maximum protection of an *accumulation* trust or (b) the maximum tax deferral of a *conduit* trust. Here's the news: Last year the IRS issued a Private Letter Ruling (PLR 200537044) approving an "IRA Inheritance Trust".

With this new strategy, a benefactor begins by creating either an accumulation or conduit trust that will inherit his/her IRA. After death, an independent party can "toggle" from one of these types of trust to the other, depending on the beneficiary's needs. This strategy calls for the creation of a revocable trust to inherit the IRA. (It could, for example, be a testamentary trust designed in your will which springs into existence on your death.) It should be a one purpose trust. If you also have a revocable trust to hold other assets during your lifetime, a separate revocable trust should be set up to inherit your IRA. At

your death, the IRA Inheritance Trust will divide into smaller trusts, one for each intended beneficiary.

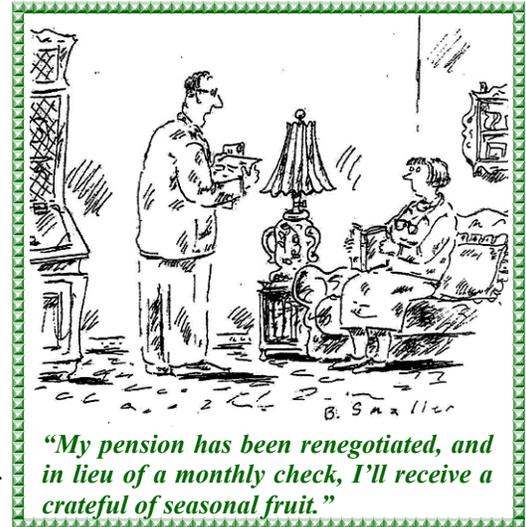
Example. You want to divide your IRA among your three children. At your death, the IRA Inheritance Trust (which becomes irrevocable at your death) will divide into one trust for your son Albert, one for your daughter Babs, and one for your daughter Cathy.

"Toggle" switch. The ideal situation, of course, is where you have full confidence in your children's ability to handle their inherited IRAs. If this is the case, each of the smaller "subtrusts" can be structured as conduit trusts for maximum tax deferral and protection of principal. During your lifetime you can change the plan if you determine that one of your children needs the protection of an accumulation trust.

"Protector" planning. What happens after your death? This point has now been clarified by the PLR described above. The ruling approves an arrangement in which each subtrust can have a "trust protector", who must be unrelated by blood to the trust beneficiary, but may be a financial advisor, CPA or friend, for example.

If the circumstances warrant a change (for instance, the beneficiary has marriage or creditor problems) the trust protector can change a conduit trust to an accumulation trust by voiding the provision that requires the immediate payout of IRA distributions to the primary trust beneficiary. The trustee will gain the discretion to accumulate funds, and better asset protection is provided to the beneficiary. Or, the trust protector might switch an accumulation trust (set up for a beneficiary with current problems) to a conduit trust by requiring full payout of Minimum Required Distributions. This might be desirable if the primary trust beneficiary, previously threatened by creditors, is now in the clear.

One-shot deal. The toggling can be done once, no matter which direction the switch is made. According to the PLR, the one switch can be made within nine months of the IRA



owner's death. (It might be argued that, following the letter of the law, a switch is permitted until September 30 of the year following the year of the owner's death, but such a deadline has not yet been approved by the IRS.) The trust protector can make this decision for each individual beneficiary after the IRA owner's death.

Use caution. The IRA Inheritance Trust has been approved in a Private Letter Ruling, which technically applies only to the taxpayer who has requested the PLR. Although the PLR shows the reasoning of the IRS as it applies to these facts, you should always work with an experienced estate planning attorney or accountant if you are interested in naming such a trust as the beneficiary of your IRA. ■

We wish you good planning. As always, please let us know how we may help you or your clients.



LAUGH LINES

I used to have a handle on life, but it broke.

You're just jealous because the voices talk only to me.

Being "over the hill" is much better than being under it.

The gene pool could use a little chlorine.

Wrinkled was not one of the things I wanted to be when I grew up.

The trouble with life is that there's no background music.

Consciousness: the annoying time between naps.

Out of my mind. Back in 5 minutes.

Procrastinate now!