Standalone IRA Trust vs. The Living Trust

In contrast to the above discussion of standalone IRA trusts versus separate IRA subtrusts, the differences between these two solutions (standalone IRA trust Using Separate Trusts or separate IRA subtrust) and naming one master living trust as beneficiary are very significant. Note that appreciating and triggering many of these differences often requires the beneficiary designation form naming the separate IRA trust directly.

Some differences include:

1. A typical living trust allows for debts and liabilities of the decedent to be paid from the living trust. This can jeopardize asset protection when insurance and retirement plans are payable to the trust. These retirement assets typically have strong asset protection features and are protected by most state laws and certain provisions of ERISA and the federal bankruptcy law. In most states, revocable living trusts can be accessed by creditors of a decedent or grantor, and even in states like Ohio that do not currently permit this, a clause that allows payment of debts, taxes and expenses of a decedent probably turns these protected assets into non-protected assets.

   Example. John Dorian, a successful estate planning attorney with a $4M estate, including $1.5M in IRAs and $1M in life insurance, falls asleep on the road one night after a long late night meeting hashing out a family succession plan for a local engineering fi rm. The ensuing accident kills three people and John and injures three others. His liability insurance covers $1M, but the ensuing judgments ultimately total over $6M. The insurance and IRAs are payable to the John Dorian Living Trust. Will John's family see any of this money? The answer is state-specific and requires an extensive discussion beyond the scope of this article, but a reasonable attorney representing John's family would probably prefer that the IRA beneficiary designations had been payable to a separate IRA trust or subtrust that did not contain provisions for paying debts, expenses or taxes of the decedent.

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2. Paying IRA benefits to a separate trust increases the likelihood that debts, taxes and expenses will not and cannot be paid from the retirement plan subtrust, which helps to prevent the loss of designated beneficiary status.5 One solution for a master living trust is to include a provision that prohibits the use of retirement assets for such administrative expenses and taxes after September 30 of the year following the year of death (the cut-off date for determining the designated beneficiary). This will help in qualifying the trust as a designated beneficiary, but may create trustee liability where the beneficiaries of the IRA funds are not the same as the residuary beneficiaries of the master trust. Will negatively affected beneficiaries sue the trustee for not getting expenses paid from IRAs before that date? If there is enough at stake, probably. It is always well advised to act with care regarding tax apportionment and other issues when residuary beneficiaries are different from other specific or outside beneficiaries, including IRA trust beneficiaries.

3. A separate IRA trust allows the master testamentary trust or living trust to name older contingent beneficiaries, charitable beneficiaries and other commonly named beneficiaries without the risk of adversely affecting the ability of the IRA funds to be preserved and stretched out. It allows the master trust to contain broad 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. These clauses can be problematic in a trust designed to hold retirement plan assets (especially conduit trusts).

4. A separate IRA trust allows the living trust to have the broadest possible spendthrift, in terroram, incentive, or other clauses that act to restrict or eliminate income payouts to a beneficiary, which might be problematic in a trust designed to hold retirement benefits (especially conduit trusts).

5. A separate IRA trust might simplify the fiduciary accounting issues after death involving division between income and principal and separate share rules. For instance, it might be wise to opt out of the UPIA (Uniform Principal and Income Act) for a separate trust receiving IRA benefits. This is due to the unintuitive 10 percent income and 90 percent principal division of receipts from IRAs. The IRS has deemed this inadequate to qualify for the QTIP marital deduction.

6. A separate IRA trust simplifies tracing of the immediate payout of required minimum distributions (RMDs) to the beneficiary that may be the most wonderful cutting-edge trust document can be undermined by an improper or incomplete beneficiary designation form required in a

conduit trust. It is unclear whether such tracing is required (perhaps it is not since such practice is generally disfavored under Subchapter J), but it is still a concern if one wants to follow the safe harbor example.

Example. Trustee of conduit trust gets $50,000 in income from other sources, then pays out $30,000 to beneficiary, then gets a $40,000 RMD from the IRA. Does the trustee have to strictly follow the safe harbor by immediately distributing the $40,000 MRD, or can he satisfy the requirement with only $10,000? Does it matter whether the $30,000 is ordinary income or whether, for instance, it is dividends eligible for reduced taxation?

7. A separate IRA trust can simplify income tax filing and planning for the trust and beneficiaries because it becomes much easier to plan exactly how much IRD (Income in Respect of a Decedent) is left trapped in the trust at potentially higher brackets and where the Code Sec. 691(c) deduction will be used (i.e., by beneficiary or by trust itself).

8. A separate IRA trust allows the trustee of a conduit trust to make a Code Sec. 645 election to combine the probate estate with a master living trust and use a fiscal year without affecting the separate IRA trust. Combining an estate with a conduit trust and using a fiscal year may jeopardize a conduit trust from qualifying as a designated beneficiary. There is no case law to this effect, but the IRS may find the tax deferral to the beneficiary often generated by using a fiscal rather than calendar year to be offensive to its concept of immediate flow through concept of a conduit trust.

9. A separate IRA trust might simplify or make more efficient use of the GST exclusion (currently $2,000,000), because it is usually well advised to apply the GST exemption for the non-IRA assets left in the standard living trust. Generally, the GST allocation would be less valuable to a separate retirement plan trust due to heavier taxation and/or leakage as the MRD percentage increases. It is therefore more valuable to a trust holding other assets. GST allocation will be more valuable if applied to Roth IRA accounts and younger beneficiaries than to a trust with older beneficiaries.

10. Coinciding with the last points about GST, the related issues surrounding the granting of limited and general powers of appointment are also clearer with separate IRA trusts. It may be desirable to grant a general power of appointment to avoid a generation skip as to some subtrusts and not others. In the event that an accumulation trust is used, one

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should be careful to avoid either a general or broad limited power of appointment.

11. A separate trust can more easily segregate Roth IRA and 401(k) assets that have completely different tax planning involved. For instance, the GST allocation issue noted above involves quite different considerations for Roth assets. Accumulation trust provisions may be less desirable when the ordinary income is trapped in a trust at higher tax rates but less odious when receiving Roth IRA distributions. Conduit trust provisions might be more common for ordinary IRA distributions, where the trustee would probably distribute the income anyway for tax reasons, but this rationale would obviously not be there for Roth distributions.

12. A separate IRA trust avoids the tremendous danger of having a pecuniary bequest in a master trust triggering the immediate recognition of income (IRD). This applies not only to marital deduction/bypass (A/B) trust splits, but may apply to other such trust divisions as well. Obviously this can be a disaster of tremendous proportions for any large plan. A separate IRA subtrust that is not a standalone trust would have to be named as beneficiary directly in order to avoid this. See the discussion in the later section of this article.

13. A separate IRA trust avoids the confusion of working with both an administrative trust and the subtrusts created under a master living trust. Generally, while settling an estate and paying bills, taxes, etc, a trust has one EIN, and then when marital/bypass (A/B) or children's trusts are funded there is generally one or more new trusts (and taxpayer ID numbers) for tax purposes. Every time a trustee-to-trustee transfer or rollover is made, chances for major titling errors increase. Using Separate Trusts receiving retirement benefits in the administrative trust poses complications for many reasons (e.g., the Code Sec. 645 election mentioned above, payment of debts/taxes/expenses, complications of in-kind transfers of IRAs). Avoiding these pitfalls and tracking the IRD, principal/income and DNI flow from one trust to another is difficult for many tax preparers.

14. A separate IRA trust can more easily avoid prohibited transactions. For instance, a related party may be acceptable as a trustee or cotrustee of a trust holding assets other than IRAs. However, there is some risk that a related party taking a trustee fee that is wholly or partially attributable to IRA assets could be a prohibited transaction. Since it is quite common now for beneficiaries or their family members to serve as trustee, this would not be a rare occurrence. Separate IRA trusts allow one to choose a different trustee for the IRA assets or make clear that the related party

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trustee shall serve without fee as to the IRA trust. Alternatively, the trust might prohibit such fees without a U.S. Department of Labor (DOL) exemption letter or other documented authority and permit trust expenses to be used to hire an attorney or other agent to obtain the authority.

15. Separate IRA trusts, if coordinated with a division at the level of the IRA beneficiary designation form, enable the beneficiaries to qualify to use the life expectancy of each beneficiary, as opposed to using the life expectancy of the oldest beneficiary of the master living trust. There are multiple, inconsistent and unclear private letter rulings that address which beneficiaries of a master trust must be counted, and whether or when allocation of the IRA benefits to only certain subtrusts makes any difference. If the maximum stretch-out is desired, naming the master revocable living trust as beneficiary of the retirement account creates substantial uncertainty as to whose life expectancies must be considered.

    Example. John Cannon names the John Cannon Revocable Trust (or the John Cannon Testamentary Trust) as beneficiary of his $1.5M IRA. If the trust splits into three shares for 40-, 45- and 50-year-old beneficiaries, the life expectancy of the 50-year-old will probably have to be used. If there is a 10 percent share for a 75-year-old sibling, that 75-year-old beneficiary's life expectancy may have to be used for all four subtrusts as well.

Using the oldest beneficiary's life expectancy often has only a small impact, unless there are substantial differences in the ages of the trust beneficiaries. For example, the divisor for the ages above are 43.6, 38.8, 34.2 and 13.4 respectively, creating a first-year percentage withdrawal of approximately 2.3 percent, 2.6 percent, 2.9 percent and 7.5 percent.15 But even small percentages may lead to larger savings if extrapolated over a lifetime.