

IRA PROTECTION TRUSTS

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IRA Protection Trusts

Often parents leave their tax deferred retirement accounts to their children “outright” - free from trust. In other words, they name their children as direct beneficiaries of these accounts. This traditional method of dealing with retirement account may result in some **unintended consequences**, such as the following:

- ▶ **The child, without the proper guidance of a trust, may decide to “cash in” the retirement account and cause it to be subjected to massive and virtually immediate tax liabilities.**
- ▶ **The child, without the proper guidance of a trust, may lose out on the decades of “tax-deferred growth” opportunities afforded by the Internal Revenue Code.**
- ▶ **The child, without the added asset protection of a trust, may lose all or part of the retirement account balance to divorce, creditors and predators.**
- ▶ **The child may be a minor or incapacitated at the time of the parent’s death, resulting in the need to “probate” this otherwise non-probate asset.**

These unintended consequences can be easily avoided by leaving your retirement account to your child (*or grandchild*) in a specialized **IRA Protection Trust** - a trust that complies with all of the IRS requirements to permit your child to “stretch out” the tax deferred growth in the retirement account over decades. This trust further provides your child with a degree of asset protection otherwise unavailable when the child is named as a direct beneficiary.

Note: When we use the term “IRA” in this pamphlet we are also including many other types of retirement plans, such as 401(k)’s, 403(b)’s, Roth’s, and 457 plans.

The IRA Protection Trust - Getting Both Maximum Stretch-Out & Asset Protection

So what is this IRA Protection Trust and how can it help protect your beneficiaries?

Basically, it is a separate, “stand alone”, trust for your children, or others, created as part of your estate plan. The trust provides that upon your death, all or part of the inheritance will not be left outright to your child, but will be distributed to and through the IRA trust for their benefit. Your IRA names each child’s separate share as beneficiary.

This trust can continue during your child’s lifetime, and if your child dies prior to receiving all of their distributions, can pass to your child’s children or whomever you designate. Your child can even have the right to say how the remaining trust property will pass after his (or her) death. He can also create further trusts for the benefit of his spouse, children and grandchildren.

Your child will receive annual distributions from your IRA in the most tax advantaged manner. In the event of a significant financial need all of the income and even the principal can be used for his or her health, education, maintenance, and support. The funds are there if needed. Structured properly, the trust is protected in the event your child is sued by creditors or predators, such as being sued for divorce. This is true because the funds aren’t owned directly by your child, but by the trust.

A child cannot create this type of trust for his own benefit with his own assets and achieve the same tax benefits, creditor protections, and other advantages. You must do it for your child. You can create a trust which will **make their inheritance “bullet-proof”!** By doing so, you can better protect the potential inheritance ultimately for your grandchildren and from estate taxes on your child’s death. Use of this trust **removes the temptation on the part of your child (or grandchild) to squander the money in the IRA.**

Background on Inherited Retirement Accounts

Let’s discuss the benefits and legal requirements of “stretching-out” the required distributions of an IRA.

Although a spousal beneficiary can defer paying income taxes on the withdrawal from a 401(k) or similar account by rolling the plan into an IRA, a non-spousal beneficiary, such as a child, cannot, and if they attempt to do so, the proceeds are immediately income taxable, and the beneficiary has made an illegal contribution to his IRA.

Let's now discuss other beneficiaries, such as children or grandchildren.

If the retirement plan funds are already in an IRA, the child can generally continue the IRA under the parent's name. If more than one child is named as beneficiary, the account can be divided into separate accounts, one for each beneficiary

Distributions are required to commence in the calendar year following the plan owner's death. For example, a 40 year-old beneficiary would be required to withdraw a little over 2% in the year following your death, with a slightly higher percentage each year.

In this example, the percentage of the required distribution would increase slightly each year, and the final distribution must be withdrawn at such time as beneficiary attains 83 years of age. If there are significant needs the beneficiary can withdraw more. However, such withdrawals are immediately income taxable and the beneficiary loses the compound, tax-deferred earnings on those amounts.

For instance, if "Child A" (age 40) inherits a \$100,000 IRA and withdraws it immediately, he may have to pay up to 40% in federal and state income taxes. That leaves him only \$60,000 to invest. Whatever that \$60,000 earns each year is taxable in that year.

If "Child B" is permitted to withdraw (and only takes) the required minimum distributions, only those distributions are taxable, and the remainder can continue to accumulate tax-deferred.

If both children "spend" only the required minimum distribution (after income tax), and assuming a 6% rate of return, "Child A" who withdraws the IRA immediately will have been limited to only \$134,237 over 30 years.

Child B, who elects maximum deferral, will ultimately receive expendable distributions of \$332,466, or almost three times more than Child A.

Of course, larger amounts and better investment performance produce even **more dramatic results.**

Contact our office for more specific projections using your own IRA balances and family circumstances.

What if your child dies before the complete distribution of the IRA? It can be passed to your child's children or other beneficiaries who can continue the same withdrawal schedule. Your grandchildren will benefit from the IRA which still retains your name after your child is deceased!

Alternatives to Direct Beneficiaries

Let's look at the three alternative methods of leaving an IRA to your children (or grandchildren):

Alternative 1: Name your estate or living trust as beneficiary. This will generally not permit your children to maximize the withdrawal period, although it may offer them some asset protection, depending on the terms of your trust. If they receive their inheritance outright, there would be little or no asset protection for them once you are gone.

Alternative 2: Name your children as the beneficiary. Your children can benefit from maximum stretch-out if they divide the IRA in a timely manner and meet certain other legal requirements. *However, there is no guarantee that your children will not immediately "Cash out" the IRA resulting in immediate taxation, and costing themselves tens or hundreds of thousands of dollars. They also run the risk of losing the inherited IRA to creditors, divorcing spouses, etc.*

Alternative 3: Name a standalone, "IRA Protection Trust" as the beneficiary. Each child not only gets the benefit of receiving distributions over his or her life expectancy, but also gets the advantage of asset protection from creditors and divorcing spouses. By appointing someone other than the beneficiary as trustee, the child can be protected from creditors and predators.

A Few Final Thoughts

Many people give their children their inheritance directly. **We believe the wise ones often choose to leave it to them in trust.** Proper trust planning is a golden opportunity to do more for your children and grandchildren, including enhancing their inheritance, and protecting them from creditors, divorcing spouses, and others. There are many reasons why an IRA Protection Trust could be of benefit to your children. **Talk to us about the ideas in this memo, and talk with your children as well.**



The Law Offices of Richard J. Herndon are located in Kearney, Missouri, twenty minutes north of Kansas City. Rick has been helping clients in the areas of Estate Planning, Probate Avoidance, Living Trusts, and Estate Settlement since 1986. He received his Bachelor's Degree in Accounting from Northeast Missouri State University and his Law Degree from the University of Missouri at Kansas City. Clients include individuals with estates of all sizes as well as small business owners. He has taught classes on Estate Planning and Living Trusts for various organizations and has also presented his own seminars in those areas. Rick's practice philosophy centers on educating clients as to their options and implementing their wishes using team based approach which may involve other financial advisors and consultants.

Rick Herndon has been extremely active in civic affairs, having previously served on the Kearney Board of Education, as a Director of the Kearney Fire and Rescue Protection District, and on the Pastoral Council of the Church of the Annunciation. He is an active member of the Knights of Columbus and has coached youth baseball and softball for over fifteen years. Rick and his wife, Cheryl, have been married for 32 years and have three children and four grandchildren.