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Trusting Trusts to Maximize Benefits to Heirs

By **John Goralka**
March 9, 2016

Retirement accounts are often the most significant assets that clients own. As many may worry that their children will be less financially successful than they are, planning for retirement is more important now than ever before. But what is the best way to ensure that heirs will obtain the maximum benefit from your clients' retirement assets? A trust could be the appropriate beneficiary for your clients' IRAs.

In 2003, the rules for inherited IRAs were changed to factor a non-spouse beneficiary's age into the required minimum distribution calculation, allowing them to "stretch out" minimum distributions over their lifetime.

For example, a 50-year-old child who inherits a $200,000 IRA can withdraw more than $700,000 in required minimum distributions and $300,000 would still remain in the account, based on an 8% rate of return. As a general rule, an increase in value of four to five times can be expected from a transfer from one generation to the next. Skipping a generation with transfers to grandchildren can result in an increase in value of 12 times or more. The potential increase in wealth can be staggering.

Yet, an inherited IRA is unforgiving. The amount of each distribution is taxable for a spousal IRA. An erroneous distribution can be generally replaced within a 60-day period. There is no grace period for an inherited IRA.

In 2006, a similar stretch-out adaption was implemented for corporate and governmental retirement accounts. Most corporate plans require payout to a non-spouse beneficiary within one year of the participant's death, regardless of the IRS tax deferral stretch-out rules—limiting the ability of a non-spouse beneficiary to defer tax on an inherited 401(k).

A typical revocable trust generally does not qualify for the maximum deferral of income tax; however, a properly drafted and funded retirement inheritance trust will qualify as a designated beneficiary. The rules are both technical and unforgiving for the trust to qualify for that treatment.

PROTECTION BENEFITS

Trusts can be a beneficial option, since passing on an inherited IRA outright offers little to no protection against:

- The wrong people eventually inheriting the IRA. This can be problematic with a blended family or children from a prior relationship.
- Poor spending habits and money management skills of the beneficiary.
- A beneficiary's spouse taking money in a divorce. Spouses often go after retirement funds, because the Internal Revenue Code provides that an ex-spouse can take half the value of the retirement account on a tax-free basis through a qualified domestic relations order (QDRO).
- A beneficiary losing the funds in order to qualify for needs-based governmental benefits such as supplemental SSI.
- A beneficiary losing the benefits due to a lawsuit, creditors or bankruptcy.
- Estate tax when the beneficiary passes the IRA to the next generation.

A properly formed and funded retirement inheritance trust can provide significant protection from the risk of creditors, divorce and bankruptcy.

A retirement inheritance trust is particularly appropriate for minor beneficiaries. The trust ensures that a proper election is made and the funds are used in the best way. A trust also facilitates planning for grandchildren. A child named as a beneficiary can disclaim to provide for his or her children for a substantially greater tax deferral and increase in value and wealth.

A retirement trust is a tax-efficient tool to help children prepare for retirement and to better protect retirement assets from lawsuits, creditor claims, divorces and the other issues that may arise in the future. Protecting your clients' assets with a retirement inheritance trust may be the most secure option for them and their family.

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