LENNINGTON LAW FIRM, PLLC WEALTH PRESERVATION & ESTATE PLANNING

Centennial Lakes Center ● 7701 France Ave. S., Suite 200 ● Edina, MN 55435 ● (952) 837-2580 (ph) ● (651) 846-5558 (fax)

Baker Court Building ● 821 Raymond Ave., Suite 220 ● St. Paul, MN 55114 ● (651) 641-0741 (ph) ● (651) 846-5558 (fax)

PETER@LENNINGTON.COM

The IRA Legacy Trust

Maximizing Tax Deferred Growth and Asset Protection
For Inherited IRA's

Historically, parents often left their tax deferred retirement accounts to their children "outright" – free from trust. In other words, they named their children as direct beneficiaries of these accounts. This traditional method of dealing with retirement accounts often resulted in some unintended consequences.

- The child, without the proper guidance of a trust, decided to "cash in" the retirement account and was subjected to massive and virtually immediate tax liabilities.
- The child, without the proper guidance of a trust, lost out on the decades of "tax-deferred growth" opportunities afforded to him by the IRS.
- The child, without the added asset protection of a trust, lost the retirement account balance to divorce, creditors and predators.
- The child just happened to be a minor or was 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 Legacy Trust*** – a trust that comports 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.

Background on Inherited Retirement Accounts

First, let's discuss the benefits and legal requirements of "stretching-out" the required distributions of an IRA.[1]

---

[1] Initially, it is important to note that the IRA concepts discussed in this report also apply to 403(b) and 457 plans, but generally NOT to 401(k) plans. Almost all 401(k) plans require the account to be paid out in full within 1 to 5 years of death (most plans indirectly require one year). This disadvantage to your beneficiaries is often the most compelling reason for rolling over a 401(k) plan into an IRA. A good financial adviser can advise you whether it's best to keep the funds in a 401(k) or roll them over into an IRA.

Although a spousal beneficiary can defer paying income taxes on the withdrawal by rolling the plan into an IRA, a non-spousal beneficiary (*e.g.* your children) cannot, and if they attempt to do so, the 401(k) proceeds are immediately income taxable, and the beneficiary has made an illegal contribution to his IRA. All references to beneficiaries below will be solely to non-spousal beneficiaries.

If the retirement plan funds are in an IRA, the child can generally continue the IRA under your name. The account would be titled as follows: "John Doe, deceased; Jane Smith as beneficiary.") If more than one child is named as beneficiary, the account can be divided into separate accounts, one for each beneficiary. The beneficiary can NOT make any contributions to the "inherited IRA," and is required to make distributions over the beneficiary's life expectancy.

Such 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, and a slightly higher percentage each year.

Because you subtract 1.0 from the divisor each year, the final distribution must be withdrawn at such time as beneficiary attains 83 years of age. The beneficiary can always withdraw more at any time, but such withdrawals are immediately income taxable and the beneficiary loses the ability to have such withdrawn amounts to continue to compound tax-deferred.

By way of example, 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 spend only $134,237 over 30 years.

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

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 examine 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. But they run the risk of losing the inherited IRA to creditors, divorcing spouses, and the like.

Alternative 3: Name the individual trust created for the benefit of each child as the beneficiary. Each child not only gets the benefit of making withdrawals 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 spendthrift beneficiary can also be protected.

You may have a living trust to protect your assets from a conservatorship if you become disabled and from probate on your death. Think of the IRA Legacy Trust as a separate trust to protect your children and offer them the maximum value from your IRA.

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

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

Basically, it is a separate trust for each child created as part of your estate plan. Your will or trust says that upon your death, all or part of your child's inheritance will not be left outright to your child, but will be distributed to the separate trust for the benefit of such child. Your IRA names each child's separate trust as beneficiary.

This trust can continue during your child's lifetime, and then on your child's death, 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 even create further trusts for the benefit of his spouse, children and grandchildren.

Your child can even be the trustee of his trust, if you feel this is appropriate. As trustee, he signs all checks and does not have to get anyone else's approval.

In some cases, such as with the spendthrift child, you might want a sibling or even a bank or trust company to serve as trustee.

If your child would invest all or most of his inheritance anyway, he can do so just as easily as trustee of his trust as he could in his own name. Your child can receive all of the income and can even use the principal for his health, education, maintenance, and support. So it is there if he needs it. Structured properly, the trust is protected in the event your child is sued by creditors or predators, such as being sued for divorce. You see, the assets 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.

Therefore, you can do something for your children that they are not able to do for themselves. 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.

Most individuals choose to give their children their inheritance directly. 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. You can provide both your children and grandchildren with significant protection from creditors, predators (divorcing spouses), and from estate taxes on your child's death.

As you can see, there are several reasons why this IRA Legacy Trust could be of benefit to your children. This is true even if YOU do not have a taxable estate. I would urge you to discuss the ideas expressed in this memo with your children.[2]

[2] This Memo is offered as an informational summary only and does not discuss all the specific drafting options or complete tax, legal, and other aspects of the IRA Legacy Trust. We offer a free consultation to discuss this special trust or other estate planning techniques which might benefit both you and your family.