

Using Trusts to Protect Benefits from Beneficiaries' Creditors

By Bruce D. Steiner

As Thomas C. Foster points out in his companion piece to this article (see p. 54), the law governing the protection of inherited individual retirement accounts from creditors is uncertain at best. The statutes and court interpretations vary from state to state. For example, the Florida statute provides that "assets payable to an owner, a participant, or a beneficiary from, or any interest of any owner, participant, or beneficiary in" a qualified plan or IRA are exempt from claims of creditors of the owner, beneficiary or participant.¹ Nevertheless, in *Robertson v. Deeb*,² the Florida District Court of Appeals held that the statute didn't extend to inherited IRAs. To add to the confusion, bankruptcy courts may reach results that are different from those reached by state courts. And, an IRA owner may not know in what states his beneficiaries may reside, what future state laws will provide or how courts will interpret state laws.

Despite the uncertainty as to state law, an IRA owner can protect her IRA against her beneficiaries' creditors by leaving it in trust rather than outright. After the IRA owner's death, the IRA must be paid out over the life expectancy of the designated beneficiary. Only an individual may be a designated beneficiary. If an IRA is payable to a trust, the oldest beneficiary of the trust is treated as the designated beneficiary, assuming certain requirements are met. If a beneficiary fails to take a minimum required distribution, there is a 50 percent penalty on the amount not distributed, although the Internal Revenue Service may waive the penalty if the failure was due to reason-

able error and reasonable steps are taken to remedy the error (in other words, if the beneficiary belatedly takes the distribution).³

Conduit Trusts

The simplest way to comply with the regulations dealing with trusts as beneficiaries of retirement benefits is to prohibit the trustees from accumulating any IRA benefits in the trust. In other words, the trust would provide that each year's required distributions and any other distributions the trustees choose to take from the IRA, net of any trustees' commissions or other expenses, be distributed to the beneficiary of the trust. This type of trust is known as a conduit trust. Since none of the IRA benefits can be accumulated in the trust, the subsequent beneficiaries can be disregarded.⁴

The advantages of the conduit trust are that it's easier to draft, and it falls squarely within the safe harbor of the Treasury regulations.⁵ However, it offers very limited protection against a beneficiary's creditors. Assuming a beneficiary lives to life expectancy, which by definition will happen 50 percent of the time, no assets will remain in the trust at the beneficiary's death. All of the IRA's assets in the trust will have been paid to the beneficiary, where they will be subject to the beneficiary's creditors, including divorcing spouses and future spouses and will be included in the beneficiary's estate for estate-tax purposes.

A relatively simple way to improve on this result within the context of the conduit trust is to provide for a class of beneficiaries rather than a single beneficiary. That is, the trust could require that any IRA distributions, net of any expenses, be distributed on a current basis, but allow the trustees to sprinkle the distributions among a class of beneficiaries, such as the IRA owner's child and her issue. In this way, if it becomes inadvisable to make distributions to the child, the trustees can make distributions to the child's issue, assuming the child has any issue. However, it still requires the trustees to make distributions on a current basis, so that distributions in excess of the amounts needed for the beneficiaries' current living expenses will not be protected against future



Bruce D. Steiner is an attorney in the New York office of Kleinberg, Kaplan, Wolff & Cohen, P.C.

creditors (including divorcing and surviving spouses), and will be included in the recipients' estates for estate-tax purposes.

Discretionary/Accumulation Trust

To better provide against the beneficiaries' current and future creditors, the IRA owner could give the trustees discretion to distribute the income to or for the benefit of the beneficiaries or to accumulate the income. This type of trust is called a discretionary or accumulation trust. This would leave nothing for a creditor to reach. Since the trustees can accumulate the IRA distributions for distribution to a subsequent beneficiary, the


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subsequent beneficiaries must be taken into account in determining the identity of the oldest beneficiary of the trust, over whose life expectancy the distributions can be stretched.

The regulations permit discretionary or accumulation trusts.⁶ However, the IRS takes an expansive view of who is considered a beneficiary for this purpose. In Private Letter Ruling 200228025, an IRA owner left her IRA to her grandchildren, in separate trusts for their benefit. If both grandchildren died before age 30, the balance of the trusts was payable to contingent remainder beneficiaries, the oldest of whom was then age 67. Despite the remoteness of the contingency, the IRS treated the 67-year-old as a beneficiary, so that the IRA had to be paid out over the 67-year-old's life expectancy, rather than over the

life expectancy of the grandchildren, or at least the older grandchild's life expectancy.⁷

Shortly after issuing PLR 200228025, the IRS issued PLRs 200238035 through 200238038, which provide a roadmap for practitioners.⁸ In these PLRs, the IRA owner created trusts for his children. Each child had a testamentary special power of appointment over his trust. However, a child couldn't exercise the power of appointment in favor of himself or his estate or creditors, or a disqualified appointee, defined as "(1) any individual born in a calendar year prior to the calendar year of my oldest living issue at the time of my death, (2) any person other than a trust or an individual, or (3) any trust that may have as a beneficiary an individual born in a calendar year prior to the calendar year of birth of my oldest living issue at the time of my death." The IRS ruled that the oldest child would be considered the oldest beneficiary of the trusts, so that distributions could be stretched out over the oldest child's life expectancy.

In PLRs 200238035 through 200238038, each child received the income of his trust, and the trustees had discretion to distribute principal to the child for his health, maintenance, support and education. If the IRA owner were concerned about protecting the IRA benefits from the children's potential creditors, he could have given the trustees complete discretion to distribute the income and principal of a child's trust to or for the benefit of the child or his issue or to accumulate the income. 

Endnotes

1. Florida Statute Section 221.21(2)(a).
2. *Robertson v. Deeb*, 16 So.3d 936 (Fla. 2009).
3. Internal Revenue Code Section 4974.
4. Treasury Regulations Section 1.401(a)(9)-5 A-7(c), Example 2.
5. While it may be easier to draft a conduit trust, if that's the desired result, it may not be necessary to create a trust at all. If the custodian will so permit, the individual retirement account owner can accomplish the same result by providing in the beneficiary designation that the beneficiary can't receive more than the required distributions each year.
6. Treas. Regs. Section 1.401(a)(9)-5 A-7(c), Example 1.
7. Query why the 67-year-old didn't disclaim his interest.
8. A private letter ruling may not be cited as precedent. IRC Section 6110(k)(3).