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Preservation Trusts: Protect Your Retirement Assets

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As we enter the early part of the 21st century, many individuals are fortunate enough to have accumulated substantial amounts of retirement assets. Some worked for companies who either established a defined benefit plan where a lump sum distribution was permitted, or a qualified defined contribution plan (profit sharing, money purchase, 401(k) and/or 403(b)). The company's plan may have also allowed them to contribute to these retirement programs, either a 401(k) or 403(b) deferrals. They may have also contributed to Individual Retirement Accounts (IRA). As these plan participants are retiring, they are trying to achieve their goal of securing a comfortable retirement income for themselves, while at the same time trying to ensure any assets that remain after their demise are paid to their designated beneficiaries in a manner that would not be quickly dissipated.

Much has been written about the advantages of being able to pay remaining retirement assets to the next generation over an extended period of time. This has been commonly referred to as a stretch out or elongated distribution method. The problem is not the theory behind this elongated distribution payout method, but the implementation of the concept. Previously, if benefits were not paid to a surviving spouse, designated beneficiaries, as a general rule, had to include these assets in their taxable income over a short period of time. However, there is now the opportunity for a designated beneficiary to establish an inherited IRA and receive the benefits over her lifetime.

As a general rule, trustees of qualified retirement plans do not want to keep qualified retirement money in their plan and pay it out to designated beneficiaries over an extended period of time. They want to distribute plan assets to the participant or designated beneficiary as quickly as possible.

We have seen many instances when a father and mother accumulated assets over a lifetime, the designated beneficiary received the assets after death and immediately withdrew the money, paid tax on the accumulated dollars and did not continue the payout in the tax shelter vehicle for an extended period of time.

One solution was to establish a very detailed beneficiary designation form which required the qualified plan or IRA custodian to keep the assets where they were previously and pay them out over an extended period of time. Unfortunately, many of the custodians refused to accept these forms because even though they were legally correct, they didn't comply with the internal rules of the custodian, or in many cases, simply didn't fit into the blank field on a computerized form where the beneficiary was to be named.

One way to fix this dilemma is the establishment of a single or joint preservation trust. This allows a plan participant, or holder of an IRA, to designate how and when the benefits are to be paid to himself and then to his beneficiaries. At the same time, the preservation trust allows the third-party administrators to accept a very simple beneficiary designation form. The preservation trust provides that upon the death of a plan participant or IRA holder, any retirement benefits on an annual basis will be paid to this trust, which will in turn pay out from the trust as the terms so designate.

Practitioners, in addition to establishing wills, powers of attorney, living wills and revocable trusts for their clients, should also be preparing either a preservation trust or a joint preservation trust regarding their qualified retirement assets.

Traditionally, many married couples leave their retirement assets to each other upon death and after the survivor's demise, equally to the children. In some instances, they leave a portion of these assets to their grandchildren. As a general rule, when a participant leaves the service of an employer, it is advantageous to transfer their retirement assets to an IRA. Distribution planning is a lot easier from an IRA than from a qualified plan. One of the major advantages of a qualified plan or an IRA is there is no constructive receipt. You generally have total access to the assets but at the same time are not taxed on those assets until you actually

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withdraw them.

To better understand this concept, let's look at the situation of Groucho, a 61-year-old attorney. Groucho previously worked for a medium-sized law firm and accumulated $1 million in his retirement account as of his 61st birthday, when he intends to retire. Groucho is married to Susan, age 60, and they have two children, Tim (age 35) and Tom (age 30). Both Tim and Tom are currently married. Tim has a daughter Jane (age two) and Tom has newborn twins (age six months).

At his separation from service, Groucho takes his qualified retirement plan in a lump sum and directly transfers it into a rollover IRA. There is no required distribution from his IRA until the April 1st of the year following his 70th birthday and he intends to defer all distributions until then.

Unfortunately, Groucho passes away prematurely with the $1 million in his IRA. He wants to leave the assets to his wife, Susan. If he leaves the assets outright to his wife, Susan, she can directly transfer or roll over assets to her own IRA, which would provide the greatest deferral opportunity for her and her family. Susan does that and now prepares a new IRA beneficiary designation form naming the preservation trust as the primary beneficiary. When Groucho initially left employment and rolled the money over to his IRA, he named his wife, Susan, as the primary beneficiary with the preservation trust as the contingent beneficiary. If Groucho had instead named a trust for the retirement assets for Susan, either a QTIP, credit shelter or disclaimer trust, Susan would not have had the right to roll over the assets to her own IRA. Distributions would generally have to be payable over a much shorter period of time.

As stated previously, the beneficiary designation forms are now very simple and should be accepted by institutions and custodians.

The terms of the preservation trust must be drafted in conjunction with Groucho and Susan's overall estate plan to determine how and when they want Tim and Tom and the grandchildren to receive the benefits.

Why do you need a preservation trust if Tim and Tom are over the age of majority? If the retirement assets are insignificant, you probably don't. Tim and Tom can be named as the beneficiaries and they will have access to those funds immediately. However, you might establish a preservation trust for the same reasons you might set up any other trust under Groucho and Susan's wills. Maybe they are not fiscally responsible, and Groucho is afraid they will immediately withdraw the money to buy new Corvettes and beach houses. Perhaps Tom is currently in the middle of a bitter divorce and Groucho and Susan want to make sure that Tom's soon-to-be ex-wife does not put in a claim for any of those assets.

One of the advantages of the preservation trust is that it is revocable until the second death of husband and wife. That means that Groucho and Susan can establish the preservation trust currently and complete the beneficiary designation forms naming the trust as the beneficiary (primary or secondary). If the parents decide to then change the terms of the preservation trust in the future, all they need to do is amend the trust and provide a new copy to the financial institution. Since the preservation trust was listed as the beneficiary, they do not have to change any of the IRA beneficiary forms.

If Groucho and Susan want to leave any portion of their IRA, or even better, a Roth IRA to the grandchildren, they can establish separate grandchildren's preservation trusts. Upon death, instruct the trustee to divide the assets equally between the grandchildren in separate preservation trusts. This prevents any one grandchild from using all of the assets. For example, if Jane decides to go to a state university, she may only need $40,000 a year for college. However, Tom's twins may decide to go to private, out-of-state schools, costing $75,000 a year. The separation of the trusts enables each grandchild to receive equal amounts. Each grandchild (or their trust) will receive, starting within one year after the death of the last remaining grandparent, their annual minimum required distributions over the grandchildren's life expectancy. Tim and Tom could be designated as trustees of each trust. The trustees should request accelerated distributions of their children's distributions in excess of the required minimum distribution as needed.

With more Roth IRAs being in existence, many clients are currently leaving their IRAs to their children and their Roth IRAs to their grandchildren utilizing a Roth preservation trust.

Remember: The primary or contingent beneficiary listing in the preservation trust has no bearing on the amount to be withdrawn by Groucho and Susan during their lifetimes. As a general rule, the Uniform Distribution Table is to be utilized for annual distributions. The only exception would be if the primary beneficiary was a spouse whose age was more than 10 years younger than the participant. If that was the case, the joint life tables in section 1.72-9 of the regulations would be substituted for the Uniform Distribution Table. After the death of the first spouse, if the assets were rolled or transferred to an IRA for the surviving spouse, the uniform table would still be utilized for annual distributions. After the death of the surviving parent, the single nonrecalculated life expectancy table found in section 1.72-9 would be utilized for the required minimum annual payment to the beneficiary.

In an ongoing effort to provide our clients with the best tools to direct their assets upon their death, the use of the preservation trust becomes an integral part of the estate planning process when substantial retirement assets have been accumulated. ■