IRA Trusts: Conduit or Accumulation?

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Recently, I've seen and heard a great deal of debate regarding the proper way to draft an IRA Trust (or what I call an IRA Inheritance Trust® and is also known as a Standalone IRA Trust and Standalone IRA Beneficiary Trust).

The debate centers around whether the individual beneficiaries' subshare trusts should, as a "default" position, be structured as conduit or accumulation trusts.

Before I address this issue, let's briefly deal with some background matters.

First, I know a handful of esteemed estate planning attorneys who have a difference of opinion as to whether an IRA Trust needs to be standalone at all (separate from the Living Trust). I believe there are a number of both technical and practical reasons why a standalone IRA Trust should be used (see "Using Standalone or Separate Trusts Solely to Receive Retirement Benefits" by Edwin P. Morrow, III and another article I co-authored with Ed, "Ensuring the Stretchout"). Regardless of whether an IRA Trust is contained in a Living Trust or is standalone, the decision to use either a conduit or accumulation trust for each individual beneficiary still arises.

Second, it's important to understand the objectives of an IRA Trust and how conduit and accumulation subshare trusts work to meet them, or not.

The two key intended benefits of an IRA Trust are: (1) to maximize the "stretchout" of taxable required minimum distributions or "RMDs" (thereby compounding money tax-free inside the IRA longer so more will be available later in life); and (2) to maximize the asset protection of inherited IRAs (which under federal and many state laws, alone, have very little protection).

A conduit trust requires that all IRA distributions (including RMDs) which are paid into the trust must pass out to the primary beneficiary. This entitles the primary beneficiary to utilize his or her life expectancy for stretchout purposes. However, the distributions to the beneficiary (and in some states a portion or all of principal as well) become subject to third party claims. A conduit trust is easy to draft and administer, but has an asset protection downside.

An accumulation trust permits distributions from the IRA to be retained in the trust. This clearly offers greater potential asset protection. However, an accumulation trust vastly complicates both drafting and administration, if maximum stretchout is to be achieved. That's because, in order to determine the measuring life for stretchout purposes, we must look beyond the primary beneficiary to other potential beneficiaries who may someday receive the accumulations (how far down the line of potential beneficiaries we must look is still somewhat an unanswered question). Should another potential beneficiary be older than the primary one, that other beneficiary's shorter life expectancy may force larger RMDs and loss of maximum tax-free compounding. (Potential beneficiaries could be limited by the trust document but this may be difficult to do and still carry out the trustor's intended distribution.) Moreover, if the RMDs paid to the accumulation trust are not distributed to the primary beneficiary within the calendar year of receipt by the trust plus 65 days after the end of the year (which often fails to get done timely or may not be the best option for asset protection reasons), these trust retained moneys will be taxable at a rate likely to be significantly higher than the beneficiary's rate.

In other words, there's a tradeoff between using a conduit vs. an accumulation trust. A conduit definitely achieves maximum income tax stretchout, whereas an accumulation likely achieves more asset protection.

Which Should Be Your "Default"?

The answer largely depends upon your degree of concern about stretchout vs. protection.

I would like, if possible, to give each beneficiary a shot at achieving the blend of objectives most fitted to them by building maximum flexibility into the IRA Trust provisions. Here's how.

If a beneficiary, at the time the trust is drafted, is already known to have a serious protection concern - - such as divorce, lawsuit, bankruptcy, creditor claims, drug or spendthrift habits - - then an accumulation trust should be used (that could be structured as a spendthrift or special needs trust). [Note: since a young individual's share can be a conduit trust payable to an UGMA or UTMA account until a certain age, and the RMDs are small anyway until the beneficiary becomes much older, that beneficiary's trust doesn't have to be designed as an accumulation trust.]

If a beneficiary, at the time of drafting, is not known to have an asset protection problem, I think it's better to utilize a conduit trust. Frankly, in my experience, only a small percentage of beneficiaries face asset protection issues whereas almost all want to minimize their income taxes. So I would rather set the conduit as my default.

But what if the primary beneficiary's situation should change over time? The one currently with protection issues is fine later and we don't want him or her stuck with a trust that may lose the maximum stretchout advantage. Or a beneficiary who gets a conduit trust later has divorce or other asset protection issues. This is why I also use a "toggle switch" (a technique approved in PLR200537044, the breakthrough IRA Trust ruling obtained by me and Bob Keebler).

A third party, not the beneficiary, such as a Trust Protector, can change the beneficiary's trust - - for a limited period after the IRA owner's death - - from a conduit to accumulation, or vice versa, depending on the situation, needs and circumstances of the primary beneficiary. This gives the trustee and beneficiary involved the benefit of "20/20 hindsight", as opposed to the attorney always having to guess at the drafting stage which type of trust is best for each beneficiary, at the risk of choosing the wrong stretchout vs. asset protection result.

Due to the space constraints of this article, I have obviously had to quickly summarize the issues and solutions when drafting a conduit vs. accumulation trust. For a more in-depth analysis, plus a closer look at the design and use of the toggle switch, as well as a number of other IRA Trust drafting problems and tips, check out my 90-minute teleconference entitled, "The Traps & Tricks of Drafting IRA Beneficiary Trusts".

To return to the online article, click here.

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Attorney Philip J. Kavesh is the principal of one of the largest estate planning firms in California - - Kavesh, Minor and Otis - - which has been in business since 1981. He is also the President of The Ultimate Estate Planner, Inc., which provides a variety of training, marketing and practice-building products and services for estate planning professionals.