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The Heritage Trust

(An IRA Dynasty Trust which offers Flexibility and Asset Protection for your Children)

I frequently suggest that all or most of the inheritance left to children not be left to them outright, but be left to them in what I call a Dynasty Trust. Here are just a few examples of the beneficiaries who can benefit from such a trust:

1) The successful child, who perhaps already has a taxable estate. Don't forget that your child's life insurance death benefit, IRA, and 401(k) are generally included in his (or her) taxable estate.

2) The child who will inherit enough to have a taxable estate, such as the only child of typical middle class parents, or perhaps a child who married into "money," or is likely to inherit.

3) A child in a bad marriage or one that may become bad. This trust can protect your child against claims in divorce.

4) A child in an occupation in which he or she may be sued. We live in this litigious society. Although anyone can find himself being sued, this aspect is even more significant if your child is in a high risk business or profession.

5) A child who already has financial problems due to lawsuits, divorce, or foolish spending habits. You want to provide for your child, but don't want the inheritance to be attached by the child's creditors or be spent foolishly.

6) The child who will inherit your IRA and would benefit from making withdrawals over his or her life expectancy. Just as you benefitted from allowing these funds to build tax deferred (or tax free in a Roth IRA), your children can continue this practice after your death, but only if you have the proper beneficiary designations AND the children (or Trustee) are aware of this alternative.

You can achieve many of the asset protection aspects through a specially designed subtrust in your will or living trust, although many experts feel a separate trust is more likely to achieve the maximum protection for a number of reasons. More importantly, by naming a separate trust as the beneficiary of your IRA, your children are more likely to be legally allowed to make the least amount of annual withdrawals and extend the IRA over the greatest period of time.

Let's discuss the benefits and legal requirements of "stretching-out" the required distributions of an IRA.

First of all, the IRA concepts discussed in this report also generally apply to 401(k), 403(b), and 457 plans.

There are often excellent reasons for rolling-over a 401(k) plan into an IRA, or converting a traditional IRA into a Roth IRA, and you may wish to discus these with your financial adviser.

A spousal beneficiary can defer paying income taxes on the withdrawal by rolling a 401(k) plan into his or her IRA. A non-spousal beneficiary (e.g. your children) cannot do this, 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 or her IRA. A non-spousal beneficiary can, however, roll a 401(k) into an "inherited IRA" as described below.

If the retirement plan funds are already in an IRA, the child can generally continue the IRA as an inherited IRA.

All references to beneficiaries below will be solely to non-spousal beneficiaries.

For example, an inherited IRA 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. The divisor which is required to be used can be obtained from IRS Publication 590.

Because you subtract 1.0 from the divisor each year, the final distribution must be withdrawn at such time as beneficiary attains 84 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 inherits the same $100,000 and withdraws only 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 spent only $134,237 over 30 years. Child B, who elects maximum deferral, will ultimately receive $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 your child’s same withdrawal schedule.

Your grandchildren will benefit from the IRA which still retains your name after your child is deceased!

Let's review the alternatives:

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.

Although your child could serve as the trustee of his or her trust, appointing someone other than the beneficiary as trustee may offer greater asset protection I those situations where such protection is likely to be needed.

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

So what is this Dynasty 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 or she makes investment decisions, 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.

The trust can also be structured such that all or a portion of the trust assets will not be part of your child's taxable estate when your child dies. With estate taxes of 35% (2011) on amounts over $5 million, this aspect of the Dynasty Trust is becoming increasingly important.

A child cannot create this type of trust for his own benefit with his own assets and achieve the same estate 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 married couples can leave up to approximately $10,000,000 (2011) to their children in this type of trust without incurring any estate or other transfer tax. Proper drafting of the parent's estate plan and/or filing a timely estate tax return after the first death is necessary to achieve this maximum amount as it is not automatic.

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.

In summary, there are several reasons why this Dynasty IRA Inheritance 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.

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 Dynasty IRA Inheritance Trust. We offer a free consultation to discuss this special trust or other estate planning techniques which might benefit both you and your family.

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