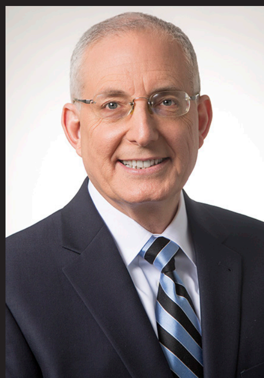

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Guest IRA Expert

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Practical Issues Involving Implementing IRA Trusts (from a State Trust Point of View)

IRA trusts are often used by practitioners in estate planning and asset protection planning. This article will focus on a number of technical issues that practitioners should be aware of in order to avoid headaches down the road when implementing an IRA trust. Whenever the term "IRA trust" is referenced in this article, it refers to an IRA trust other than an IRA qualified terminable interest property (QTIP) trust.

The definition of "income" under the UPAIA and under the Internal Revenue Code is often not the same.

Rules Are Important

Drafting an IRA trust is not an easy task for a practitioner unaware of both the IRS IRA compliance issues, as well as the state trust accounting rules as reflected in the Uniform Principal and Income Act (UPAIA).

It is extremely important that the practitioner become familiar with the UPAIA state trust accounting rules that apply to trusts, *especially when an IRA trust document is involved.*

I have found that there are not many continuing legal education (CLE) or continuing professional education (CPE) programs that cover the UPAIA rules. It is therefore important that practitioners learn the rules by reading the law and the commentary regarding the meaning of the provisions of the UPAIA. That is my approach.

There is a need for the practitioner to connect the dots of an IRA trust from an IRS compliance point of view as well as from the UPAIA. Often the practitioner focuses in on the IRS compliance point of view and fails to consider the UPAIA trust accounting provisions to any major extent, or not at all, in implementing an IRA trust document.

One of the key points that may not be necessarily understood by the practitioner who is engaged to implement an IRA trust is that the definition of income under the UPAIA and the definition of income under the Internal Revenue Code is often not the same.

For example, if an IRA distribution of a required minimum distribution (RMD) of $10,000 is made from the decedent's IRA to the IRA trust, then the $10,000 received by the IRA trust is ordinary income from an income tax point of view but is not trust accounting income from the UPAIA point of view. I discovered this issue while taking a CLE class on the UPAIA many years ago when New York State adopted the UPAIA, effective as of January 1, 2002.

So, if the IRA trust provides that Joey, the beneficiary of the IRA trust, is to receive net income each year, then Joey would not receive $10,000 under the UPAIA, but instead Joey would generally receive 10% of $10,000 or $1,000. The reason is that under the UPAIA only 10% of an RMD is considered trust accounting income. That is the rule in New York and in many other jurisdictions. In fact, Joey may not even receive $1,000 if there are expenses that are incurred when administering the IRA trust. Obviously, the IRA trust document provisions will determine what Joey receives, and the IRA trust document is generally governed by the UPAIA. However, the UPAIA need not apply if the terms of the trust provide otherwise. When implementing an IRA trust document, I generally provide otherwise.

Defining Income

As previously mentioned most states have similar UPAIA provisions regarding the 10% rule like New York State. In the event that the practitioner is implementing the IRA trust (a non QTIP IRA trust), the practitioner generally should *not* use the term "income." If Joey is paid $10,000 instead of $1,000 (assuming no expenses are incurred) by the trustee, then the trustee will have significant liability problems in a contested accounting. *This type of mistake does happen because trustees are often not familiar with the UPAIA.*

If the practitioner is implementing the IRA trust, the practitioner generally should not use the term "income."

Assume that the non-QTIP IRA trust uses terms like "net income," then we have to address how expenses for administering an IRA trust are handled. These expenses can be normal accounting fees, tax preparation fees and the portion of trustee commissions that are charged against trust accounting income. Under New York State law, annual trustee commissions are payable one-third from income and two-thirds from principal unless the trust instrument otherwise explicitly provides. Other states may use different allocation percentages regarding trustee fees.

Under New York law, in the event that the trust does ***not*** have sufficient income in a given year, the trustee is ***not*** allowed to receive a portion of the trustee commission that is charged to income to the extent of any shortfall. So, if the annual trustee commission in New York State is say $6,000, then $2,000 is charged against income. If the income is only $1,000, then the trustee receives only $1,000 and the balance of $1,000 cannot be paid to the trustee from income earned in a later year.

The way to handle this issue in an IRA trust that is subject to New York law is to provide that any and all annual trustee commissions shall be paid from principal.

Further, in an IRA trust, I provide that all expenses shall be paid from principal and not from income in whole or in part. This is necessary since there is generally insufficient income earned by the IRA trust to provide a trustee with a source to pay the trustee expenses.

Also, covered in the IRA trust is what happens if the IRA trust beneficiary is required to receive RMDs during his/her lifetime and dies in a given year prior to receiving the RMD for that given year. This should be addressed in the IRA trust document in order to avoid problems.

An IRA trust has many moving parts and needs a great deal of thought ***before*** it is implemented.

Creditor Protection

Normally an IRA owner need not worry about creditors attacking the IRA owner's account during his/her lifetime. Under New York law, an IRA payable to a beneficiary is not subject to the claims of creditors of the deceased IRA owner.

That would ***not*** be the case if the beneficiary of the deceased IRA owner is his/her estate. The IRA owner should not select the estate as the beneficiary of his/her IRA.

Many practitioners often use revocable trusts in an estate plan. The practitioner may also use a revocable trust as the beneficiary of an IRA. An interesting case involving the use of a revocable trust as the beneficiary was decided in a Kansas court in 2007 of which practitioners need to be aware.

The following is an executive summary of the Kansas court case, **Commerce Bank v. Bolander, Kan. App. 2007**, involving the use of a revocable trust as the beneficiary of an IRA:

> *The IRA assets payable to a revocable trust are subject to the claims of Wanda's [the IRA owner's] creditors upon her death pursuant to Kansas law. Although Wanda's IRA benefits were not available to her creditors during her lifetime, they are available to her creditors upon her death because the IRAs were payable to an inter vivos revocable trust. Had Wanda named specific beneficiaries the IRA proceeds would have automatically passed to them upon her death and the result would have been (according to the court) a benefit. However, that is not the estate planning approach selected by Wanda. Instead Wanda named her revocable trust as the beneficiary of her IRAs, and the legislature has determined that assets in a revocable trust are subject to the claims of creditors of the settlor at the death of the settlor.*

A practitioner implementing an IRA trust should consider using an irrevocable trust instead of a revocable trust as the beneficiary of an IRA if the IRA owner is concerned about the possibility that his/her creditors may go after the IRA assets that are payable to the IRA trust after the IRA owner's death. This opinion is discussed in my ABA Guide entitled ***IRA Guide to IRS Compliance Issues – Including IRA Trust Violations***.

It is interesting to note that the Kansas court ignored the argument of the trustee – *that the trust became irrevocable after Wanda's death and should be exempt from any and all claims of creditors of the decedent.*

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The Kansas court opinion was based on the interpretation of the Kansas Uniform Trust Code which provides that during the lifetime of the settlor, the property of a revocable trust is subject to the claims of the settlor's creditors. Kansas law provides in part that:

"After the death of a settlor, and subject to the settlor's right to direct the source from which liabilities will be paid, the property of a trust that was revocable at the settlor's death is subject to claims of the settlor's creditors."

Many states (over 30 states) have adopted versions of the Uniform Trust Code. These states may or may not have included provisions similar to the Kansas Uniform Trust Code regarding creditors' rights and revocable trusts.

Practitioners implementing IRA trusts should look at the provisions under state law that apply to IRAs and retirement type assets that are payable to revocable trusts to play it safe.

It should be noted that the Surrogate's Court in New York County has taken the position that IRAs are protected from claims of creditors of a deceased IRA owner.

However, the case involved an IRA payable to an irrevocable trust. **See In Re Gallet, 190 Misc. 2d 303 (2003).**

An IRA trust could be an easy trust to contest if the terms of the trust are not carefully drafted or if the trustee administers the IRA trust in an improper or careless manner. ■

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Mr. Goldberg was formerly associated with the Internal Revenue Service (IRS). He conducted many continuing education programs with the IRS and other organizations on the retirement distribution rules.

He has written two books on IRA issues for the American Bar Association, which can be found in law school libraries throughout the United States. They are Inherited IRAs, What Every Practitioner Must Know, 2017 Edition and IRA Guide to IRS Compliance Issues, Including IRA Trust Violations. Call 800-285-2221 or visit shopaba.org for further details.

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