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NEWSLETTER

501 WEST BROADWAY, SUITE 700
SAN DIEGO, CALIFORNIA 92101-3563
TELEPHONE: (619) 239-7777
FAX NUMBER (619) 238-8808

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IRA TRUSTS: TO CONDUIT OR ACCUMULATE, THAT IS THE QUESTION

BRADFORD N. DEWAN, ESQ.

As more individuals roll out significant funds from their pension and retirement plans, the IRAs created with these rollovers are often quite large and constitute a substantial portion of these individuals' estates. As a result, IRA owners have become more aware of the estate planning issues revolving around their IRAs. Unlike most other assets, IRAs are typically not transferred into the family revocable trust.

Although the IRA stands apart and requires its own planning strategies, large IRAs also present estate planning issues for the IRA owner trying to determine how best to pass down substantial wealth and assets to his or her children or grandchildren.

Most parents want to avoid transferring a large financial sum to that child all at once or over a short period of time due to the concern that such a transfer could undercut a child's motivation for being industrious. With a family trust, parents will often restrict distributions of the assets to a child until certain ages are reached. Sometimes the final distribution is not made until the child is in his or her forties or even fifties.

Normally, the IRA owner would simply list the surviving spouse as the primary beneficiary and the children as the contingent beneficiaries in the event the spouse predeceases the IRA owner. For example, if the couple had three children and the spouse died before the IRA owner, then the three children could either: (1) take only the required minimum distributions each year, or (2) pull out all of the funds in a single withdrawal. This second option is what many parents want to prevent, not only because of the adverse tax consequences but also because of the motivation concern noted above. Instead, because of the benefits of tax deferred growth, the parents want the distributions stretched out over the life expectancies of the three children.

How can such restrictions be included with an IRA? The mechanism to achieve this result is an irrevocable trust that is named as the beneficiary of the IRA in lieu of naming the children personally. It is important to note that not all such trusts will qualify as a "designated beneficiary" to allow for the deferral of payments over the life expectancy of a child. However, when certain requirements are satisfied, the IRS will "look through" the trust and find the children as the beneficiaries of the trust for

minimum distribution purposes. This will suffice in order to treat the trust as a "designated beneficiary."

After deciding to use a trust in the above manner, the IRA owner must select between two basic structures for the trust: a "conduit" trust or an "accumulation" trust. The choice will ultimately depend either on how restrictive the IRA owner wants to be or how concerned the IRA owner is about the child who is to benefit from the IRA.

With a conduit trust, the trustee is obligated to receive the required distributions from the IRA and then to pass such distributions on through the trust to the child immediately. Thus, the descriptive term "conduit trust" is used to denote this type of trust. The child/beneficiary has no power to demand any more from the trust than the required distributions (which distributions are based on the remaining life expectancy of the child). The IRA owner could give the trustee the power to make additional distributions if the trustee, in its discretion, determines that the child needs additional financial resources. Since only the required distributions are taken from the IRA, the payments from the IRA may well be stretched out over a long period of time, thus realizing the benefits of tax deferred growth.

However, an IRA owner may determine that the child cannot be relied upon to spend the required distributions appropriately. In this case, the IRA owner wants the oversight of a trustee. Under the terms of this type of trust, the trustee is given the discretion either to make distributions to the child (the beneficiary of the trust), or to accumulate the required distributions and other income of the trust. Thus this type of trust is called an "accumulation trust."

In considering whether to use an "accumulation trust," there are a couple of income tax factors that need to be considered. First, the income tax rates for trusts are very compressed as compared to those for an individual. This results in higher income taxes for income retained in the trust versus income distributed out to the beneficiary. Second is the need to be very clear as to who are the primary and successor beneficiaries of an "accumulation trust". For example, what if the IRA owner names his child as the primary beneficiary of the trust, but also names his older brother or sister to be the beneficiary of the trust in the event the child dies before receiving all of the funds from the IRA? In this instance, the much shorter life expectancy of the IRA owner's brother or sister might have to be used to determine the required distributions rather than the longer life expectancy of the child. So, special caution is needed in drafting an "accumulation trust."

In summary, trusts as beneficiaries of an IRA are being used more frequently now in order to assure the IRA owner that his or her wealth transmission goals for the IRA will be satisfied. With properly structured trusts, these goals can be achieved.

QUALIFIED CHARITABLE CONTRIBUTIONS

BRADFORD N. DEWAN, ESQ.

A previous MMPPH newsletter article described the opportunity provided by the Pension Protection Act of 2006 with respect to making charitable contributions directly from an individual's IRA. Those IRA owners who have started taking required distributions from their IRAs may avail themselves of this strategy. However, since this strategy will terminate as of December 31, 2007, we wanted to briefly review some of the mechanics.

As noted, for the remainder of this year, IRA owners and beneficiaries age 70 ½ or older may make tax-free distributions (up to a maximum of $100,000 annually), directly to charitable organizations. These are known as qualified charitable distributions ("QCDs"). This rule, however, does not apply to ongoing SEP and SIMPLE IRAs (i.e., those that receive a tax-year contribution for the year in which QCD is distributed).

A QCD applies only to the taxable portion of a Traditional IRA withdrawal; it does not apply to any nontaxable portion (i.e., basis). If any of the individual's IRAs contain basis (that is, after-tax funds such as nondeductible IRA contributions), the QCD is deemed to come first from the taxable

portion, thereby leaving the maximum amount of after-tax funds in the IRA.

PROCESSING

Importantly, QCDs must be paid directly from the IRA to the charity (but the check may be delivered by the IRA holder). Accordingly, the IRA owner needs to provide the IRA sponsor or custodian with the name of the charity, and other information the IRA sponsor or custodian may need. In addition, because QCDs must be made to charities described in the Internal Revenue Code section 170(b)(1)(A) (Note: donor advised funds and supporting organizations are not included), it is the responsibility of the IRA owner to ensure that the charity is a qualified charity. Qualified charities include organizations commonly called "public charities," such as hospitals, churches, and educational organizations.

QCD DISTRIBUTIONS SATISFY RMD

A QCD counts towards satisfying "required minimum distributions" for the year. This is true for both IRA owners and IRA beneficiaries who are required to take minimum distributions.

REPORTING

Even though a QCD is made payable to the charity, it is reported as if the distribution had been made to the IRA holder. Therefore, the IRS Form 1099-R that is received by the IRA holder will report that the distribution is taxable even though, in fact, it is not. The declaration that the distribution qualifies for tax-free treatment, as a QCD, will be made on the IRA holder's federal income tax return.

IRA owners and beneficiaries should act quickly if they are interested in this strategy as it will terminate on December 31, 2007.

If you would like to receive further information regarding the topics in this newsletter, or if you would like to let us know any issues or topics you would like to see addressed in future newsletters, please contact us at (619) 239-7777 or newsletter@mmpph.com.

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THOMAS M. MONSON
MARY J. PESHEL
TIMOTHY C. POLACEK
WILLIAM D. HOSHAW†
ROBERTA D. REPASY
SUSAN L. HORNER
RAY W. RIDLON
BRADFORD N. DEWAN
PHILIP R. FREDRICKSEN†
JUDY S. BAE
†OF COUNSEL

501 WEST BROADWAY, SUITE 700
SAN DIEGO, CALIFORNIA
(619) 239-7777
FAX (619) 238-8808
http://www.mmpph.com

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