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TO: OUR CLIENTS AND FRIENDS

FROM: JACKSON M. PAYNE

DATE: DECEMBER 15, 2021

RE: FINANCIAL STRATEGIES FOR YOUR LIVES AND BUSINESSES

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## **HAPPY HOLIDAYS**

As always, our staff joins with me in wishing you the very best for the holiday season. We have so much to be thankful for and are truly blessed in having strong client and professional relationships. For those who have stood by us over the years, we simply, but most sincerely, say thank you. You are the greatest and we welcome the opportunity to serve you in the upcoming year and beyond.

## **USING TRUSTS FOR TRANSFERS TO MINORS (CONTINUED)**

### **Incentive Trusts**

Incentive trusts, which are trusts structured for distributions to be tied to the beneficiaries' behavior or beliefs, have increased in popularity. Depending on the desires of the grantor and the behavior he or she hopes to encourage, an incentive trust may reward achievement of certain goals (e.g., completion of college, establishment of career, or community service). Alternatively, the beneficiary may be entitled to distributions only if certain behavior is avoided (e.g., using drugs or alcohol).

Incentive trusts often include specific binding provisions, such as a distribution to the beneficiary at college graduation or completion of military service. Some incentive trusts provide that the trust will match income (or some portion of it) earned by the beneficiary. Instruments may specify that principal withdrawals should be staggered over a period of time (e.g., when the

beneficiary is 35, 40, and 45), therefore increasing the likelihood that the beneficiary has developed the value system that the grantor hopes to reward. By including these specific provisions, the grantor has simplified trust administration for the trustee and clarified expectations for the beneficiary.

Nonbinding requests to observe a grantor's general philosophy may be included in the incentive trust instrument. For example, a grantor may desire a beneficiary to be gainfully employed, to marry, or to practice a specific religion. In that case, trustees are usually given broad discretionary distribution powers. This allows the trustee to react to a beneficiary's changes over time. However, a trustee with broad discretionary powers may unintentionally fail to observe the grantor's wishes. Therefore, the grantor should select a trustee who is familiar with the grantor's value system.

The grantor's intentions should be clearly communicated in the trust instrument. For example, a grantor may want to discourage a certain activity yet provide discretionary funds for education, medical care, or long-term care with no strings attached. The trust instrument should clearly state the behavior desired and the incentive available. This will give the trustee guidance about distributions to beneficiaries and will help prevent conflicts between the trustee and beneficiaries.

Finding an individual or especially, a corporate trustee for an incentive trust may be challenging. The potential trustees should be consulted during the drafting process to ensure they will be willing and able to serve under the terms the client desires to include in the trust. The more objective the standards, the more likely it will be to find a trustee willing to serve under the terms of the trust.

Some advisors are hesitant to recommend using incentive trusts due to the challenges associated with drafting, as well as the concern about using money as an external motivation to achieve personal goals. These planners encourage using a mission statement that set forth the client's values to provide guidance to the trustee in exercising discretion over trust distributions.

**TAX COURT: IRA DISTRIBUTION OF FUNDS  
ORIGINALLY FROM A 401(K) SUBJECT TO 10% ADDITIONAL TAX**

**Catania, TC Memo 2021-33**

The Tax Court has held that an IRA distribution was subject to the 10% additional tax even though the IRA funds originally came from an employer-sponsored 401(k) plan and taxpayer had separated from service with the employer when he was age 55.

Background. In general, distributions from retirement plans, including 401(k)s and IRAs, that are made before the participant turns 59½, are subject to a 10% additional tax under Code Section 72(t).

But, the additional tax does not apply to a distribution “made to an employee after separation from service after attainment of age 55.” The Code also specifies that this exception applies to distributions from IRAs.

Facts. A taxpayer participated in his employer’s 401(k). He retired from the company when he was 55 years old. He rolled his 401(k) account over to an IRA. When he was 57 years old, he took a distribution from the IRA.

He reported the IRA distribution as taxable income but did not pay the 10% additional tax.

He argued that the 10% additional tax should not apply because the IRA funds originally came from an employer-sponsored 401(k) plan and he had separated from service from that employer when he was 55. Hence, he argued, the exception should apply.

Decision. The Tax Court found that the 10% additional penalty did apply.

The Court said that, although the taxpayer had a 401(k) plan when he worked for the employer, he transferred the funds from the account to an IRA upon retiring. Because he withdrew the distribution from an IRA, the exception did not apply.

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