Selecting Beneficiaries Of Your Retirement Plan: Should You Designate Your Children or the Trust?

The distribution of your tax-deferred retirement plan (IRA, 401(k), etc.) is controlled by your beneficiary designation form on file with the plan administrator. If your retirement plan is to pass to your child, the simplest approach is to name your child as the direct beneficiary on the beneficiary designation form. This approach allows your child to take advantage of income tax deferral planning after your death via the so-called “inherited” or “stretch” IRA.

Using a traditional IRA as the example, your child, as the beneficiary, will be required to begin withdrawals from the IRA the year after your death. Your child may elect to withdraw the funds in a single lump sum or over his or her remaining life expectancy. A lump sum withdrawal will be taxed to the child entirely as ordinary income in the year of withdrawal. Alternatively, if the child chooses to roll the IRA into an inherited IRA, he or she may take annual minimum withdrawals over his or her life expectancy, allowing amounts retained in the IRA from year to year to continue to grow on a tax-deferred basis. For example, if your child’s life expectancy is 40 years, 1/40 of the IRA must be withdrawn in the year after your death. This amount will be taxed to the child entirely as ordinary income, but 39/40 of the IRA remains intact with no income tax consequences until the following year minimum withdrawal. You cannot require that your child choose the deferral option.

But what if your child is not yet age 18 or he or she is not responsible enough to manage the funds after you are gone? There are two types of trusts into which you can direct your retirement plan at your death: a “conduit” trust or an “accumulation” trust. While these trusts come with additional cost and complexity, they do allow you to appoint a trustee to control the retirement plan on behalf of your child while also taking advantage of continued income tax deferral after your death as described above. With a “conduit” trust, the trustee must pull from the IRA the annual minimum withdrawal amount determined under the life expectancy rules for your child. This amount must be immediately passed through the trust and distributed directly to your child, and income taxes must be paid on this amount. Of the two trust options, the conduit trust is simpler, but you must be comfortable having your child receive the minimum withdrawal amount each year. Even though your child will receive an outright cash distribution from the trust annually, he or she will not be able to elect a lump sum withdrawal of the entire IRA; this decision is in the control of the trustee.

With an “accumulation” trust, the annual minimum withdrawal amount determined under the life expectancy rules for your child must also be withdrawn by the trustee (and is subject to income tax), but funds withdrawn may be retained in the trust and controlled by the trustee for the child’s benefit. This type of trust is more challenging to draft because in order for it to work, generally, the trust may not have a beneficiary (even a contingent beneficiary) who is older than your child or that is charity. For example, if your “catastrophe clause” provides for your “heirs” (your parents perhaps) or a charity, this would need to be addressed at the drafting stage. This type of trust is a good option if your child must meet certain income and asset tests to remain eligible for public benefits.

Embarcadero Place | 2400 Geng Road, Suite 110 | Palo Alto, CA 94303
Phone: 650.328.7000 | Fax: 650.329.8925 or 650.327.2501 | www.lakinspears.com

If you direct your retirement plan into a trust for your child that is not a conduit trust or an accumulation trust, the income tax deferral opportunities described above will not be available, and the retirement account will likely need to be fully withdrawn within 5 years of your death. Note that the default 5-year rule still allows some income tax deferral planning.

If you name your spouse, a trust for your spouse or a charity as your beneficiary, or if you have multiple beneficiaries with significantly different ages, additional issues must be considered that are beyond the scope of this article. It is also important to note that not all plan administrators allow for life expectancy deferral. If this is the case, your child will first need to do a direct transfer of the retirement account to a plan administrator that allows for this type of planning.

Many of our clients have substantial wealth in their retirement accounts. Planning for the transfer of these accounts at death is an integral step in the estate planning process. Please contact us if you would like a review of your retirement account beneficiary designations.

Embarcadero Place | 2400 Geng Road, Suite 110 | Palo Alto, CA 94303
Phone: 650.328.7000 | Fax: 650.329.8925 or 650.327.2501 | www.lakinspears.com