

# CHOOSING A BENEFICIARY OF A RETIREMENT ACCOUNT

By

**Karen Sinchak Higby**

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Choosing the appropriate beneficiary of a retirement account (IRA, 401K, pension, profit sharing, etc.) requires careful thought of all surrounding facts and circumstances. This paper deals only with the three most common choices; none of these choices may prove to be best in a particular situation.

Unless a spouse is mentally incapacitated or otherwise incapable of handling assets, naming the spouse as the **primary beneficiary** affords the best tax results - a surviving spouse has more tax options than any other person. When there are unique spousal circumstances, such as a second marriage with separate children, special considerations may apply.

The predominant question addressed here is how to designate the IRA for the final heirs - whether to name them directly as beneficiaries or whether to name the family trust. Below is a brief summary of the three basic choices:

1. **Name the heirs as beneficiaries.** The chief advantage of naming heirs as beneficiaries is that they can use the popular “stretch” rules for income tax planning. The result is that each heir can elect to pull money from the account (his or her share) over his or her lifetime, thus paying the income taxes over a prolonged period of time. Under the IRS tables, a 70 year-old person has a 17 year life expectancy; a 25 year-old has a 58 year life expectancy; a 40 year old has a 43 year life expectancy.

The government sets only the **minimum** required distributions from retirement accounts; there is no limitation on the **maximum** amount which may be distributed in any

year. When the heirs are named as direct beneficiaries, each may decide whether the minimum amount or more is withdrawn from the account in any given year. The amount withdrawn is subject to ordinary income taxes, payable with the heir's customary April 15<sup>th</sup> income tax return.

These "stretch" rules were designed to permit an heir to defer the income taxes over his or her lifetime, when desirable, so the assets remaining in the account (i.e., the amount not withdrawn) can continue to grow on a tax-deferred basis. In the absence of special circumstances, the use of the "stretch" rules is considered the most prudent way to deal with the taxation of retirement accounts.

2. **Name the IRA Conduit Trust as beneficiary.** When the heirs are minor children or young adults or adults who have not demonstrated financial responsibility, naming them as direct beneficiaries of a retirement account may not be the wisest choice. Although the attractive "stretch" rules will be available, the heir will not be **required** to use them; instead, he or she may at any time (after attaining age 18) withdraw all of the funds. For many young people, the temptation to take all of the money at once instead of deferring taxes, is too great to resist. Those heirs tend to take the money as soon as they can, in spite of the heavy tax burden; in a typical situation, all of the funds are spent in 18 months or less!

In the case when the heirs are not financially responsible, the "stretch" rules may nevertheless be utilized through the trust when the trust has a special "IRA Conduit" provision. This special type of trust permits the **trustee** (and not the heirs themselves) to determine how much to take out of the account in any given year - the minimum required amount or more. The life expectancy of the oldest heir is generally used to determine how long the "stretch" period will be; the trustee is usually given discretion to take additional amounts out of the account when desirable.

If this option is selected, the beneficiary on the retirement account will usually be “IRA Conduit Trust created under [Smith Family Trust]”. The most significant drawback to this option is that the trustee **must** distribute to the heirs each year the funds which are withdrawn from the retirement account in that year; there is no opportunity to hold back those funds for any reason.

**NOTE: When a charity or other entity is named as an heir of the estate, they will NOT be included in the IRA Conduit Trust (because that would destroy the “stretch” benefits). Other arrangements will need to be made, if necessary, to increase their share(s).**

3. **Name the trust itself as beneficiary.** In a few cases, it is desirable to name the family trust as beneficiary in order to have the retirement funds treated the same as all other assets, utilizing the trust’s restrictions or “safety nets” to protect the inheritances, even if it means sacrificing the “stretch” rules. The IRS has taken the position that a trust (other than a conduit trust) will not likely qualify for the “stretch” tax-deferral. Instead, the “default” tax rules will apply. Under those rules, the minimum required distribution (which dictates when taxes will be due) depends solely on the age of the account owner at the time of his or her death. The ages of the heirs is immaterial.

If the account owner dies before age 71 (approximately) the trust must pull out all of the funds (and pay taxes) in five years. Funds may be withdrawn in equal or unequal installments over the five year period, as long as they are fully withdrawn (and taxed) by the end of the fifth year.

If the account owner was over the age of 71 (approximately) at his or her death, the trust may use the account owner’s life expectancy at the time of death for purposes of determining how much must be withdrawn each year. The result is that the trust will have up to 16 years to pay the taxes (because life expectancy at age 71 is approximately 16

years). In this case the trustee must take a required distribution (set by the IRS tables) each year. More can always be withdrawn, if desirable.

The chief advantage to this option is that it permits the trustee of the family trust to decide what to do with the funds which are withdrawn; they do not have to be paid out to the heirs. If the trustee determines that it is best to keep the withdrawn funds in the trust, for later distribution, the trustee has that choice. The trust itself will pay the income taxes on the withdrawn funds; the after-tax amount may be re-invested in any manner the trustee desires prudent.

The chief disadvantage of this option is the shortened period of time in which the taxes must be paid. For example, if the account owner dies at the age 87, his or her life expectancy under the IRS tables is 7 years (approximately) and all of the income taxes will have to be paid over that period. On the other hand, if the account owner dies at age 75, the trust will have approximately 13 years to pay taxes. Because “stretch” is probably not available with this option, it should be selected only when the family circumstances require the trustee to have discretion to **not** pass the IRA funds on to the heirs each year. Examples are when an heir qualifies for SSI or other disability payments which might be forfeited because of the inheritance or when an heir has a substance-abuse problem which would make it undesirable to place funds in his or her hands.

In most cases, the first two options will meet the estate owner’s planning objectives, while taking advantage of the government’s tax-deferral opportunities using the “stretch” rules.