Naming A Trust As Beneficiary Of Retirement Benefit

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Under certain circumstances naming a conduit or “see-through” trust as the beneficiary of your 401(k) plan or IRA assets upon your death may be the best choice to make to ensure that after your death these retirement benefits remain available and continue to grow tax-free for your loved ones who might otherwise withdraw the funds immediately and dissipate them. Another reason to use a trust as beneficiary is to protect the retirement assets from the claims of creditors for those of your beneficiaries who do not reside in states like New Jersey, which has passed laws specifically exempting from creditors’ claims the assets in an inherited IRA or qualified retirement plan. See N.J. Stat. § 25:2-1. This blog will discuss how to use a conduit or “see-through” trust as the beneficiary of defined contribution plans, i.e., 401(k) plans, profit-sharing and money purchase pension plans, as well as IRA’s.

To understand why naming a conduit trust may be a good choice as beneficiary of retirement benefits, one must first understand the required minimum distribution rules that apply to the payout of benefits to the named beneficiaries after the account owner’s death.

Generally, an owner of either an IRA or 401(k) account must begin taking required minimum distributions (“RMD”) from these accounts in the year the owner attains age 70½, which may be postponed for that year only until April 1 of the following year (the “Required Beginning Date” or “RBD”). For each successive year during the owner’s life, the RMD must be taken by December 31. The RMD for any year is computed by dividing the account balance as of December 31 of the previous year by the individual’s life expectancy found in the IRS’s Uniform Lifetime Table or the Joint and Survivor Life Expectancy Table in IRS Publication 590.

If the account owner dies before his RBD (age 70½), and has no surviving spouse, each named beneficiary may demand immediate payment of the IRA or qualified plan benefits, or they may choose to receive the benefits over each beneficiary’s life expectancy while the undistributed funds continue to grow tax free. If the account owner dies after his RBD, then the IRA or qualified plan benefits may be paid over the longer of the account owner's life expectancy or the life expectancy of the named beneficiary.

If, on the other hand, the account owner has created under his Will (or revocable trust) a conduit "see-through" trust, naming individuals as the beneficiaries of the trust, the IRA or qualified plan benefits must be paid out over the life expectancy of the oldest of the beneficiaries of the conduit trust, or, if separate shares are created for individual beneficiaries, the amounts in each share may be paid out over each individual's life expectancy.

For example, assume John, age 53, is a widower with three children, ages 27, 14, and 11. On his IRA beneficiary designation form John named the conduit trusts created under his Will as the beneficiaries of his IRA with separate equal shares funding separate sub-trusts for each of his three children. Under the required minimum distribution regulations of Internal Revenue Code Section 401(a)(9), the children are referred to as "designated beneficiaries." Assume John dies at age 53. Within one year after the year John dies, each conduit sub-trust must take the RMD calculated for each of the children by using the life expectancy of each child whose separate share is funding a separate sub-trust for that child. Without the conduit trusts the benefits would have been paid out over the life expectancy of the oldest of the three children, which is 56.2 years, instead of over each child's separate life expectancy, which would be 56.2 years, 68.9 years, and 71.8 years, respectively. If John died after his RBD of 70 ½ the payout of the IRA benefits would still be over 56.2 years, which would exceed John's remaining life expectancy of 31.4 years. The use of the conduit trusts allows the undistributed IRA benefits to grow tax free for a substantially longer period of time, compared to John's life expectancy, while also protecting the benefits from the claims of creditors.

In the above example, to achieve the "stretch-out" periods for each child, the conduit trusts must satisfy the requirements in Treas. Reg. Section 1.401(a)(9)-5. These requirements are:

1. The trust must be valid under state law
2. The trust must be irrevocable or become irrevocable upon the death of the account owner
3. The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit must be identifiable from the trust instrument
4. The trustee must provide certain documentation to the plan administrator of a qualified retirement plan or, in the case of an IRA, to the IRA custodian or trustee

In addition, if the trust has multiple beneficiaries, each of the beneficiaries must be an individual in order for there to be a designated beneficiary under the minimum distribution rules to allow the payout over the life expectancy of the oldest beneficiary.

The conduit “see-through” trust may be used to safeguard the retirement benefits from a beneficiary’s creditors, future ex-spouses, and other predators for an extended period of time, at the same time giving the account owner peace of mind that the retirement benefits, after his or her death, will not be immediately dissipated by a prodigal beneficiary.