Passing Thoughts

10 Things to Know About 'Scary' Retirement-plan Beneficiaries

By ANN I. WEBER, Esq.

The terrific thing about retirement plans (including individual retirement accounts) is that they grow income-tax free within the plan. The price of this benefit is that, upon distribution, income tax is assessed on the entire amount distributed. At the death of the plan participant, individual plan beneficiaries can stretch out the distributions over their life expectancy and defer income taxes until a distribution is actually received.

Minimum distributions (MRDs) are required over this period, and spouses have special rules applying to them, which allows them to add 10 years to the payout period. This works wonderfully for most beneficiaries because it allows income taxes to be paid over time with all taxes on the amount not distributed deferred.

However, this may not be such a great benefit if a minor, disabled individual, or otherwise scary person is named as a beneficiary of the plan, because the plan participant may not want such an individual to receive their distributions outright. Here are 10 things to think about if you have potential plan beneficiaries in this situation.

Minors. Many parents do not want their children to receive a large sum of money outright. In Massachusetts, the age of majority is 18, but many parents would tell you that maturity arrives much later.

Disabled Persons. For persons under a legal disability who are receiving public benefits such as Medicaid or Supplemental Security Income (SSI), any mandatory income payment will be considered countable income for purposes of any benefits to which they might otherwise have been entitled. The value of the entire plan will be considered a countable asset if the disabled person can access the plan proceeds on his or her own. As a result, an individual on Medicaid or SSI who is the named as a beneficiary of the plan could very likely lose his or her medical or supplemental assistance as a result. The retirement benefits would then be spent down to pay medical and other expenses until the disabled individual was impoverished and could reapply for benefits.

Otherwise scary persons. These may include, among others:

- **Business owners.** Many business owners have personally guaranteed business debts and do not want any retirement benefits they receive from their parents (or any other plan participant) to be subject to claims of their creditors.
- **People who are or may be going through a divorce.** Most plan participants do not want their retirement funds going to an ex-spouse.
- **Technical adults.** Many people do not mature at 18, and parents may be concerned that a child might not have the skills to handle a significant sum of money, leading to some unwise decisions.
- **Individuals in risky occupations**. Doctors, lawyers, and maybe even Indian chiefs may be concerned about possible malpractice or other claims of unknown amounts and, consequently, do not want to have the outright ownership as a plan beneficiary.
- **Temporary situations.** An individual may be in a precarious situation at the present time, but is likely to resolve it sometime in the future.

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Conventional Trusts. Most conventional trusts are tricky to use as retirement-plan beneficiaries because retirement-plan benefits paid to a trust are subject to income tax in full upon receipt. Thus, if such a trust is named as a beneficiary of the plan, the plan benefits would ordinarily be distributed to the trust in full, and would be subject to income tax in the year of receipt.

When a Conventional Trust Is a Good Idea. Where the plan beneficiary is very young or under a legal disability and receiving needs-based public benefits such as Medicaid or SSI, the payment of tax might be an acceptable price to pay for the security of having the asset managed by a trustee and distributed to the beneficiary only at the trustee's discretion.

When a Non-conventional Trust is Better. Special trusts blessed by the IRS can protect the undistributed portion of the plan benefits while allowing a trust beneficiary to receive minimum required distributions (MRDs) annually. They work well when the plan participant is concerned about naming the beneficiary outright.

'See-through Trusts' Great for Scary Beneficiaries. A see-through trust can be created by the plan participant and named as the beneficiary of the plan. At the death of the plan participant, the trustee receives from the plan and distributes to the trust beneficiary only the mandatory annual MRD. For scary beneficiaries, these trusts can be a home run, and the trustee can be empowered to reach the rest of the plan asset in its discretion.

Discretionary Trusts. Though not as clearly blessed by the IRS, it is also possible to name a trust with multiple beneficiaries as the named beneficiary of a retirement plan. The advantage here is that the trustee can decide how to apportion the MRD (and additional principal payments, if desired) among trust beneficiaries. The measuring life for the MRDs is the life expectancy of the oldest beneficiary. Note, however, that these trusts are more technical, and stricter rules apply regarding remainder beneficiaries.

Trustee Must Be an Independent Third

Party. The beneficiary may not be named as a trustee because the discretionary ability to reach the principal of the trust may render all the plan assets subject to the claims of creditors, divorcing spouses, etc.

Trustee May Name the Beneficiary Trustee at a Later Date. In circumstances where the plan participant wishes to limit access to the plan for a limited period only, the trustee may be given the authority to name the plan beneficiary as successor trustee at a certain point or at the trustee's discretion. This works well for individuals whose financial situation or level of maturity is likely to change for the better — for example, when an individual undergoing a divorce is no longer subject to claims of the spouse, or when a child reaches a certain age.

Although there are no perfect solutions in this situation, with a little pre-planning, retirement plans can be transferred to these special beneficiaries in an optimal fashion. ■

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