

Naming A Minor as Your IRA Beneficiary

By Patti S. Spencer, Esq.

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Spencer Law Firm
320 Race Avenue
Lancaster, PA 17603
Phone 717.394.1131
Fax 717.509.2018
patti@spencerlafirm.com
www.spencerlawfirm.com

IRAs and qualified plans are great vehicles for saving for retirement. Contributions to the plans are not taxed, and the assets inside the plan enjoy tax free reinvestment and accumulation. The income tax is payable only when the assets are withdrawn from the plan.

Unfortunately, while IRAs and other retirement plans are great for retirement savings; they are not so great for passing wealth on to your beneficiaries. The assets in the plan are subject to federal estate tax (if your gross estate exceeds \$2 million in 2008, and \$3.5 million in 2009) and they are also subject to income tax when received by the beneficiary. If the beneficiary is a person two or more generations below that of the owner of the plan, it is possible for these plans to also be subject to generation-skipping tax. The net effect of all this taxation is that in the hands of the beneficiary, the IRA or retirement plan may be worth only a fraction (possibly one-fourth) of what it was to the original account owner.

Since the IRA beneficiary can make withdrawals over his or her life expectancy, naming a very young person or persons as beneficiaries can be very attractive. When the beneficiary inherits the IRA, he or she can stretch the required minimum distributions over his or her own life expectancy, deferring taxes until withdrawals are made. The younger the beneficiary, the longer the life expectancy, the less that has to be withdrawn each year, and the more time the assets can grow inside the plan, tax-deferred.

Here is an example. You leave a \$100,000 IRA to a grandson Jack born the year you die. Jack's life expectancy at age 1, according to the IRS life-expectancy table for inherited IRAs is 81.6 years. Jack could stretch the minimum required distribution over 82 years! The first year distribution would be only \$1,323. If the IRA has an average growth rate of 8% during his life expectancy, the account would wind up worth a cumulative \$8.8 million in total withdrawals by the time he has to empty it at age 83. That is not a misprint - a \$100,000 IRA results in over \$8.8 million in withdrawals by Jack!

The \$8.8 million in withdrawals depends on the assumed rate of return of 8%. Look at what happens at other rates of return. At an assumed 7% return, total withdrawals are 4.6 million, for 6% total withdrawals are 2.4 million, 5% - \$1.3 million, 4% - \$750,000. (Don't forget that the

average return numbers are net of fees.) At the other extreme, a return of 10% results in a total of \$32 million in withdrawals.

To get these kinds of returns, it is important that the beneficiary designations on the IRA are done correctly. One of the most common estate planning disasters I see in my years of experience is naming minors individually, i.e. as outright beneficiaries. Minors are not allowed to make property transactions in Pennsylvania until they attain the age of majority. Naming a minor can result in costly, time-consuming court proceedings, legal disputes, or holding estates open for years which ultimately dwindles the benefit of the accumulated IRA.

The significant returns illustrated also depend on the beneficiaries' discipline to withdraw only the minimum required distributions over their lifetimes. Beneficiaries are often tempted to simply withdraw the IRA and pay the tax in one lump sum shortly after attaining the age of majority. Fortunately, both pitfalls are easily avoided with proper estate planning and the full benefit of the IRA can be realized by your beneficiaries. Furthermore, only you are in the position to assure that the structure is in place to have your intent carried out.

You really shouldn't name baby Jack as the IRA beneficiary. Why? Because Jack, the babe-in-arms, can't make the required withdrawals. He lacks legal capacity. In fact, he won't have legal capacity until he attains the age of 18. The IRS doesn't care; baby or no, the minimum distribution rules still apply. When the minimum required distribution is not withdrawn, a very stiff 50% penalty applies.

There are three choices for properly designating a minor beneficiary of your IRA: 1) a legal guardian can be appointed for Jack (This is expensive and unwieldy - not a good choice.); 2) you can create a trust for the benefit of Jack that meets the IRS requirements for stretching out payments over Jack's, the beneficiary's, life expectancy; 3) you can name a custodian under the Uniform Transfers to Minors Act (UTMA) for the benefit of Jack to receive the IRA on his behalf until he is 21.

A trust specifically to receive the benefit is probably the best choice. It provides the most flexibility and will cover all possible contingencies. This alternative is the most expensive because of the need to create a trust before death, but it gives you the most control over making sure your wishes are carried out.

The most common type of trust used as an IRA beneficiary is a conduit trust. This type of trust requires the trustee to distribute the required distributions each year from the trust to the child so that the child pays the tax rather than the trust, which would generally owe more. The distributions can be made to a UTMA custodian for the minor.

Another type, called an accumulation trust, allows the trustee to stretch-out the IRA withdrawals over the child's life expectancy but the trustee could keep all, or part, of those withdrawals in the trust. Withdrawals kept in the trust would be taxed as income at the trust's income tax rate, and any amounts distributed to or for the benefit of the child would be taxed at his or her personal income-tax rate. An accumulation trust has the added benefit of giving you control of deciding

when your beneficiaries actually receive money from the IRA withdrawals. There is no requirement that the funds be distributed to the child upon attaining the age of majority.

The third option is a viable, low cost option of naming a minor as a beneficiary of an IRA. In the beneficiary designation of your IRA account you may designate a custodian, and even a successor custodian, under the Uniform Transfer to Minors Act, for the benefit of Jack (much like should be done in your will for any property passing to a minor). This named custodian receives the minimum required distribution annually, invests it in an account titled “Custodian’s Name, Custodian for Jack under PA UTMA” until Jack turns 21. The short-coming of this low-cost option is that Jack inherits both the accumulated funds and the IRA outright when he turns 21.

If the IRA you leave to Jack is a Roth IRA, then you have really hit the ball out of the park. If we assume an 8% return, the entire \$8.8 million in distributions to Jack will be federal income tax free.

When using any of these techniques, always get written acknowledgment from the plan custodian that they have accepted the beneficiary designation you have made. Keep a copy with your will and other important papers. If your custodian won’t cooperate, move your account to a custodian who will. This is much too important to let slide.