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WHO SHOULD I NAME AS BENEFICIARY OF RETIREMENT ASSETS

by Marvin E. Blum, J.D./C.P.A.

Deciding who to name as the beneficiary of retirement accounts is not always a simple process, but it is a very important aspect of creating a sound estate plan. Indeed, for many people, retirement accounts make up a substantial part of their net worth and, accordingly, also make up a significant part of their children's inheritance. So, what is the best way to pass down the retirement plans to which you have so diligently contributed over the years? **Typically, the best option will be a trust that includes specific provisions to qualify for the tax benefits available for retirement plans.**

If you have named your children as outright beneficiaries of your retirement plan, you may not be ensuring the best protection of your retirement accounts. Funneling the retirement benefits through a trust supplies the retirement benefits with the general protections inherent to trusts—like protection from creditors, protection during a divorce proceeding, and avoidance of estate tax. However, the trust you name as beneficiary must include certain **special provisions** in order to qualify as a designated beneficiary.

A trust places the retirement benefits out of the reach of creditors of the trust's beneficiaries. Creditors' claims or judgments from lawsuits will not place the retirement accounts in jeopardy of being seized. Additionally, in the event a beneficiary of the trust goes through a divorce, the assets held in the trust will be unreachable by the former spouse. Finally, any retirement funds remaining in the trust when the beneficiary of the trust dies may not be subject to estate taxes.

Another advantage of naming a trust as the beneficiary is the ability to use a trust which contains specific provisions to take advantage of the "stretch-out," which allows the person inheriting the retirement fund the option to receive distributions from the retirement fund over the course of his or her life rather than through an accelerated payout of the account. In most instances, it is generally preferable to receive distributions under the stretch-out method because it maximizes the tax deferral benefits of the IRA. Only "designated beneficiaries" can utilize the stretch-out method. With careful drafting, a trust can qualify as a designated beneficiary. The length of the stretch-out period is generally determined using the life expectancy of the oldest beneficiary of the trust.

A trust specifically written to qualify for this stretch-out (*a qualifying trust*) may be referred to as a Conduit Trust or an Accumulation Trust. A *Conduit Trust* contains the specific provisions to stretch out the distributions and also provides protection from creditors, a divorcing

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spouse, and estate tax. As a Conduit Trust receives each year's minimum required distribution, the trustee immediately distributes the funds to the beneficiary. The Conduit Trust is aptly named because it essentially serves as conduit for the funds and does not accumulate income. An *Accumulation Trust* is similar to a Conduit Trust in that it also contains specific provisions to qualify for the stretch-out and also provides protection from creditors, a divorcing spouse, and estate tax. However, unlike with a Conduit Trust, funds in an Accumulation Trust are not required to be immediately distributed to the beneficiary. Instead, those funds can remain protected in the Accumulation Trust until needed.

As the retirement plan administrator makes distributions to the Accumulation Trust, the funds are held by the trustee in accordance with the terms and provisions of the trust agreement. Because the client gets to determine the trust's distribution standard, the client has greater control over how and when his children ultimately receive the retirement funds. For example, the distribution standard can be broad, providing for the general health, education, maintenance, and support of the beneficiary, or it can be narrow, with special guidelines limiting or preventing distributions in certain circumstances (like problems with substance abuse or failing to be a productive member of society). Moreover, clients can also appoint an independent third party to serve as trustee of the trust, which in many cases grants the client peace of mind that the trust assets will be dealt with objectively for the primary benefit of the trust beneficiaries.

Another unfavorable consequence of naming a child as the outright beneficiary of a retirement plan is that the retirement account may not be protected should the child file for bankruptcy. Texas law specifically exempts "inherited" individual retirement accounts from the reach of creditors, whether or not the debtor is in bankruptcy. In most states, however, inherited retirement accounts are not exempt from creditor's claims. Therefore, naming a child as an outright beneficiary of a retirement plan is really an all-in bet that the child will always be a resident of Texas or another state that protects inherited retirement accounts. Naming a qualifying trust as a beneficiary, however, eliminates the need to worry about what state your children will live in.

Although many people believe it is easier to simply name a child as an outright beneficiary of a retirement fund, naming a trust that includes specific provisions to qualify for certain tax benefits is the most effective way to ensure the retirement funds actually end up in the hands of the beneficiary. **Leaving the retirement benefits to an Accumulation Trust eliminates many of the questions and what-ifs that plague clients: What if my child gets divorced? What if my child gets sued? What if my child is not financially responsible enough to manage the benefits? What if my child moves out of Texas and loses bankruptcy protection?** These questions are common, and they can all be soundly answered through the use of a qualifying trust.