

Top Five Reasons NOT to Name Your Children as IRA Beneficiaries

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For many people in, or approaching, retirement it is likely that their most significant asset outside of their home is their individual retirement account (“IRA”)¹. IRAs account for 30% of all U.S. retirement market assets and 11% of all household assets². It is common for many IRA owners to name their spouse and children as the primary and contingent beneficiaries of their IRA. Following the IRA owner’s death, the beneficiaries have some options with regard to the distribution of the balance of the inherited IRA, if the owner has not directed otherwise; these include: (1) taking a lump-sum payment, which may result in large income tax liability to the beneficiary; (2) taking the required minimum distributions, based on the beneficiary’s life expectancy; or (3) if the owner’s spouse is the named beneficiary, treating the inherited IRA as his or her own, thus deferring or extending the required minimum distributions, assuming that the spouse’s age allows for this. Without proper guidance, children may trigger massive income tax liability and also lose out on a lifetime worth of tax deferred growth. An IRA owner can avoid these problems by designating a child’s inherited IRA to an IRA Retirement Protection Trust (“RPT”). As discussed below, designating IRAs to a well drafted RPT can also avoid an inherited IRA from being depleted if a child: declares bankruptcy, becomes disabled, divorces his or her spouse, dies prior to complete distribution of the inherited IRA, makes bad financial decisions or has substance abuse issues. Even if these issues do not exist at present time, it is not possible to predict what the future may hold.

(1) Bankruptcy

The U.S. Supreme Court unanimously ruled that inherited IRAs are not protected from creditors in bankruptcy proceedings.³ In reaching this decision, the Court focused upon key distinctions between inherited IRAs and those created for the benefit of the IRA owner during his or her life. Specifically, the Court held that inherited IRAs are not retirement assets of the beneficiary. Therefore, inherited IRAs cannot be protected from creditors if left outright to a child. However, if the IRA is designated to a RPT for the benefit of a child, it would not subject to a child’s creditors because the IRA would be owned by the RPT—a separate legal entity.

¹ Reference to IRAs in the article also all IRS qualified retirement plans such as: 401(k), 403(b) and 457(b) plans.

² *American Society of Pension Professionals & Actuaries, ASPPANet*, February 12, 2015.

³ *Clark v. Rameker*, 134 S. Ct. 2242 (2014).

(2) Disability

An outright distribution of an inherited IRA can cause a disabled child to become ineligible for public assistance benefits. If an inherited IRA is designated to a RPT for the benefit of a disabled child, such a child would be eligible for public assistance benefits and could use the IRA proceeds to supplement any care needs not otherwise provided by public assistance benefits.

(3) Divorce

Statistically, 50% of all marriages in the U.S. end up in divorce. Without a RPT, a child may lose all or part of the inherited IRA to his or her former spouse depending on the state in which a divorce action is brought. Presumptively, this is not the desire of the IRA owner. Again, a RPT could insulate all or part of the IRA from a divorce action depending on the jurisdiction.

(4) Death

If a child dies before the inherited IRA is fully distributed in full, it will be distributed to a child's designated beneficiaries. Through the use of a RPT, the IRA owner can control to whom the IRA will be distributed in such a situation and thus allow the IRA to be "stretched" over future generations (e.g. grandchildren).

(5) Bad Decisions

Some children simply are not good money mangers. Furthermore, a child may develop a substance abuse problem at some point. A RPT can prevent a child from spending all of their inherited IRA.

The use of a RPT provides many benefits. However, the IRS requirements for a valid RPT are complex and require the assistance of a law firm that is well-versed in such requirements.