Leaving Retirement Benefits in Trust for Minor Children

These are the options available for parents who want to leave an IRA in trust for the benefit of a minor child.

Natalie Choate
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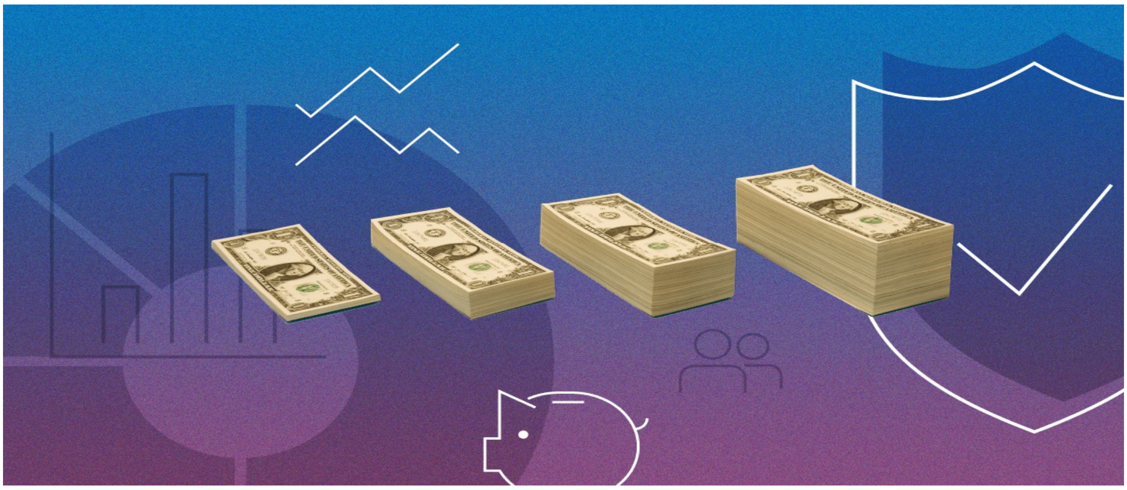

Before 2020, a client's IRA could be left in trust for their children, with the benefit of a long â€œlife expectancy payoutâ€ enabling the IRA to be liquidated gradually over the multidecade life expectancy of the young beneficiary. The combination of long deferral and small annual distributions effectively lowered the family's income tax burden. The Secure Act of 2019 abolished these â€œstretch IRAâ€ estate plans, eliminating the life expectancy payout for most beneficiaries. After 2019, only five classes of â€œeligible designated beneficiariesâ€ can still take inherited retirement benefits over some type of life expectancy period. A newly imposed 10-year rule applies to mere designated beneficiaries who are not EDBs.

A â€œminor child of the employeeâ€ or IRA owner (the participant) is an EDB. Unfortunately, that does not mean back to â€œbusiness as usualâ€ in planning for minor children. Their status as EDBs ends when they reach majority, and all benefits must be distributed within 10 years after that point (instead of over the 50-plus years of the child's actual remaining life expectancy). The IRS' proposed regulations define â€œreaching majorityâ€ as attaining age 21, regardless of educational status or applicable state law. So effectively, the life expectancy payout for a minor child EDB is a â€œlife-expectancy-until-age-31â€ payout, since 100% distribution of the inherited retirement plan is required no later than age 31.

The proposed regulations provide some sensible and helpful interpretations to facilitate setting up trusts for minor children while still qualifying for the LE-to-age-31 payout. Unfortunately, when the dust settles, striving to qualify for that semistretch payout will not produce the best estate plan for many parents of young children.

Here, in very brief summary, are the options available for parents who want to leave an IRA in trust for the benefit of their minor child in such a way that the IRA will qualify for an LE-to-age-31 payout:

- **Trust providing for outright distribution by age 31.** An IRA left to a trust for the sole benefit of the minor child EDB will qualify for the LE-to-age-31 payout as long as the entire IRA will be distributed to the child no later than age 31. The payout period will be over the child's life expectancy, with 100% distribution required 10 years after child reaches age 21â€”that is, at age 31. The trust can be either a â€œconduit trustâ€ (all IRA distributions must be passed out to or for the benefit of the child as soon as the trustee receives them), or an â€œaccumulation trustâ€ (trustee can hold IRA distributions in the trust for later distribution to or for the benefit

of the child) (though not past age 31). Since either structure qualifies for the LE-to-age-31 payout, there is no reason to use a conduit trust. The conduit trust would eliminate the trustee's ability to take distributions from the IRA and hold them in trust for later use, without providing any benefit under the minimum distribution rules.
- **Trust providing for outright distribution later than age 31.** Suppose the parent thinks age 31 is too young and wants the funds held in trust until the child reaches age 40. If the trust provides that the trust will terminate and be distributed to the child at any age later than 31, it can still qualify for some type of life expectancy payout depending on who gets the fund if the child dies before reaching the trust termination age.

The person or entity who inherits the trust if the child dies before the stated age for outright distribution of the trust fund is called a â€œsecondary beneficiary.â€ The proposed regulations ignore the secondary beneficiary if the age for trust termination is 31 or younger. But if they are older than age 31, the secondary beneficiary counts for purposes of determining the distribution period for the retirement benefits payable to the trust. If the secondary beneficiary is a nonindividual (such as a charity), the trust will not qualify as a designated beneficiary; it will not even qualify for the 10-year rule. If the secondary beneficiary is an individual, then we step into the somewhat elaborate scheme the U.S. Treasury came up with for this form of trust for a minor child EDB. Remember, we have a trust for the sole benefit of the participant's nondisabled minor child which will continue until the child reaches age 40 (or any other age older than 31), at which time it will terminate and be distributed outright to the child; if the child dies before reaching the specified age, the trust is distributed to another individual (the secondary beneficiary).

1. Because there is at least one minor child EDB who is a beneficiary of the trust, the trust will use a life expectancy payout instead of the 10-year rule. But the life expectancy used will be the life expectancy of the oldest designated beneficiary, who may or may not be the minor child EDB. For example, under a trust providing for the participant's minor child, to terminate when the child reaches age 40, but which will be distributed to Uncle Oscar now age 73 if child dies before 40, the countable beneficiaries are child (age 13) and Uncle Oscar (age 73), so Oscar is the oldest *designated beneficiary,* and his life expectancy (16.4 years) will be used to measure required distributions instead of the child's (71.9 years). This payout pace will continue until the â€œouter limitâ€ distribution year.
2. The outer limit year, when 100% distribution of the IRA is required, will be the year the minor child reaches age 31, about 18 years from now in the case of this 13-year-old child.

Note: The fact that the IRA must be distributed to the trust in the year the child reaches age 31 does not mean the IRA proceeds must be paid out to the child at that point. The trust will continue, in accordance with its terms, until the child reaches age 40, as specified by the client who created the trust.

What this is telling us is, if you want the IRA funds to be held in trust for the child beneficiary past age 31, the client needs to choose the trust's secondary beneficiary carefully. The client cannot choose a charity (because that would disqualify the trust), and should not choose an elderly person (because their life expectancy will dictate the annual distribution rate), if the client wants the trust to get the benefit of the LE-to-age-31 payout for the child's trust.

The above rules seem a bit awkward, but at least they are reasonably simple and clear and in some ways favorable. For example, clients willing to allow outright distribution to the child at age 31 can easily qualify for the LE-to-age-31 payout. They don't have to use a conduit trust and can choose any secondary beneficiary.

However, in real life, the choices can be complicated and unclear. For example, if the client has multiple children, the structure of the proposed regulations encourages using separate trusts (one for each child) rather than a pooled or â€œpotâ€ trust format that many parents might prefer. If one pooled trust is used for all the children, the life expectancy and age-31-payout year of the oldest child will dictate the distribution rate, and the longer life expectancy and later age-31-payout date of the youngest child will be â€œwasted.â€

Even if the planner devises a pot trust as the parents want, and the plan is perfectly constructed so that if the parents died right now the IRA payout would be â€œstretchedâ€ over the oldest child's life expectancy, if the oldest child were to die a year after the parents, the payout deadline that was supposed to be based on attaining age 21 would suddenly accelerate to 10 years after their death. So not even the â€œto oldest child's age 31â€ stretch can be guaranteed.

Before spending hours trying to thread the maze of the proposed regulations, hoping to maximize the quasi-stretch payout available for minor children of the participant, perhaps the planner should look up how likely it is that a person of the parent's age will die before their youngest child reaches age 21. The chances are it's not likely at all. The odds are huge that the children will be through graduate school and well past age 21 before the parent dies.

All parents of course should create proper estate plans to provide for their children in case both parents die while the children are still minors. But instead of trying to twist their desired plan to accommodate the proposed regulations' rules in order to (perhapsâ€”provided people die in the â€œright orderâ€) get a few years' longer payout, why not just draft the trust the way the parents want it to be written? Urge the parents to buy some term life insurance with the money, thereby saving on legal fees, to ensure their children will have enough money to safely raise them to adulthoodâ€—regardless of how quickly or slowly the retirement accounts are distributed to the trust after their deaths.

Natalie Choate is a lawyer in Wellesley, Massachusetts, who concentrates on estate planning for retirement benefits. The 2019 edition of Choate's best-selling book, Life and Death Planning for Retirement Benefits*, is available through her website, www.ataxplan.com, where you can also see her speaking schedule and submit questions for this column. The views expressed in this article do not necessarily reflect the views of Morningstar.*