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**Re: Retirement Plans and your Trust**

We at the law office of Morrison, Gilger & David, APC, are dedicated to keeping you informed as to any changes in law that might affect your estate plan.

This memo addresses recent changes in law that are relevant to an Individual Retirement Accounts, 401(K), Defined Benefit Pension Plan, and other similar estate planning tools (collectively referred to as "Retirement Plans"). More specifically, this memo will first focus on income tax ramifications associated with Retirement Plans. Second, this memo will address minor children who have been designated as beneficiaries of Retirement Plans.

**Retirement Plans in General**

A Retirement Plan is generally a tool designed to compound money on a tax deferred basis. In a typical Retirement Plan, funds initially placed in the Retirement Plan are not taxed. After several years of contributions and prudent investing, Retirement Plan funds will continue to grow in value. This period of growth is the key to a Retirement Plan, as all the growth occurs tax-free. When one retires, the individual will begin to slowly withdraw funds from their Retirement Plan. At that time, income tax will be assessed on the amount withdrawn. In other words, money in the Retirement Plan is money that you can invest and earn a return on tax free until it is withdrawn, which triggers income tax.

**Income Tax Ramifications Associated with a Retirement Plan**

**A. Original Retirement Plan Beneficiary Designation**

Retirement Plans are never held in a Trust. Revocable trusts specify the beneficiary of each asset held in the trust, and provides for successor beneficiaries in the event that the initial beneficiary is unable to take. Similarly, a Retirement Plan designates a beneficiary and successor beneficiaries for assets held within the Retirement Plan. Since the IRA already states its own beneficiary designation, there is no need for the Retirement Plan to be placed in a revocable trust.

Typically, Retirement Plan beneficiaries are designated in the following order:

1. Spouse
2. Children
3. Revocable Trust

This specific order is advised primarily for income tax reasons. Upon the passing of a Retirement Plan owner, the Retirement Plan can be distributed to the beneficiaries stated above. Since assets held within a typical Retirement Plan have yet to be taxed, if the beneficiary decides to withdraw the entire amount held within the Retirement Plan, the beneficiary will be assessed income tax on the entire amount for that year. This is a scenario most individuals would like to prevent.

In order to avoid an income tax assessment on the entire Retirement Plan amount, a beneficiary may elect to “stretch” the Retirement Plan. Stretching a Retirement Plan allows a beneficiary to withdraw only the minimum amount required by law. As a result, assets inside the Retirement Plan continue to grow tax-deferred over the lifetime of the named beneficiary. Essentially, this stretches a Retirement Plan over the life of the initial Retirement Plan owner and the named beneficiary.

The key to stretching a Retirement Plan is that the beneficiary must be a named beneficiary. According to the Internal Revenue Service (“IRS”), a Retirement Plan cannot be stretched to a non-designated beneficiary, such as a trust.

Since a trust is not considered a named beneficiary for stretching a Retirement Plan, the trust would be assessed income tax for the entire amount of the Retirement Plan as it would be forced to withdraw the entire Retirement Plan amount in one lump sum.

Although a sizeable amount of tax would be imposed on the trust, at the time this was the only viable solution available in order to make Retirement Plan assets available to the estate and beneficiaries named in the trust.

## **B. Conduit Language Allowing for a Stretch Retirement Plan**

Based on recent changes in the law relating to stretching Retirement Plans, what was once disallowed by the IRS, is now permissible. The IRS still requires the beneficiary of a stretch Retirement Plan to be a named beneficiary, however conduit language can now be added to the revocable trust in order to treat beneficiaries named in the revocable trust as named beneficiaries of the Retirement Plan.

This conduit language would only be added to the revocable trust, as the last beneficiary named in the Retirement Plan would remain the same. By updating your trust with this conduit language, those beneficiaries named in your trust would be able to stretch the original Retirement Plan over their life and would not be forced to pay income tax in one lump sum.

## **Minor Children as Beneficiaries of a Retirement Plan**

As has been discussed earlier, after an individual's spouse, children are usually the next named beneficiaries for a Retirement Plan. Like a spouse, children are able to stretch a Retirement Plan over their life expectancy, allowing the Retirement Plan assets to grow tax-deferred.

However, there are special rules associated with beneficiaries of a Retirement Plan who are minor children. Since the Retirement Plan is not held in trust, it is possible that your estate planning documents, including your trust, does not address a scenario in which a minor child becomes a beneficiary of a Retirement Plan. Due to the child being a minor, California Law requires that a conservator be appointed by a court. A conservator is an individual responsible for the assets and finances of a person deemed incapable of providing these necessities for himself or herself. Appointing a conservator is a lengthy, complex, and at times costly procedure which should be avoided.

In order to avoid the appointment of a conservator, conduit language can be added to the trust. This conduit language will insure that if a minor child is the beneficiary of a Retirement Plan, the Trustee will be responsible for the financial well-being of the minor child. Thus, a conservator will not need to be appointed and the Trust will remain the controlling document.