

Who is the Beneficiary of Your IRA?

Properly naming beneficiaries to an IRA account is one of the most important estate planning moves you can make, and it is often overlooked. If you don't choose a beneficiary, someone else will and it may not have the intended consequences you wished. If a beneficiary isn't named, the IRA goes to the estate and the distribution is based on your will or by state law if you die without a will. What's the big deal? There are several reasons why the estate is the worst place for the IRA to go whether by default or specifically named as the beneficiary:

If the IRA beneficiary is the estate, then it is subject to probate; the legal process of administering and distributing one's estate. As part of the estate, the IRA can be subject to the claims of creditors as well. Probate can be time consuming and costly; delaying and eroding the value of the asset for the final recipient. Exposure to creditor's claims can potentially erode the value of the IRA as well. So in most cases, you want to take advantage of the probate avoidance by designating a IRA beneficiary that is an individual.

Loss of the "Stretch IRA": If the estate is the beneficiary, you lose a valuable opportunity to stretch the IRA for your final recipients over a potentially longer period of time. How so? Let's go through the distribution rules if the estate is the beneficiary of the IRA. If the owner dies before starting their required minimum distributions (RMD) at age 70 1/2, the five year rule applies. The final recipient will need to withdraw the assets from the IRA by the end of the fifth year following the year of the owner's death. If the owner dies after starting their RMD, then the recipient must withdraw amounts based on the deceased owner's life expectancy starting by the end of the year after the year of the owner's death. If the owner did not make their RMD for the year of their death, the recipient needs to make this RMD as soon as possible also. Failure to do this results in a 50% penalty in addition to the income tax from what should have been withdrawn and didn't occur. You can certainly take more than the minimum requirement, but you don't want to take less.

Now if the beneficiary is an individual, in most cases they can stretch distributions much farther than if the estate is the beneficiary. A spouse can roll over and treat a traditional IRA as their own (a Roth IRA can be rolled over into a spousal Roth IRA) and begin taking RMD when they turn 70 1/2. (No distributions will be required from the Roth until both spouses have died). The other option for the surviving spouse is they can leave it in the deceased spouse's IRA (acting as the beneficiary) and take the RMD based on their own life expectancy by the later of the end of the calendar year following the year in which the spouse died or the end of the calendar year when the deceased spouse would have turned 70 1/2). Non spousal beneficiaries simply take the RMD based on their own life expectancy. The only exception for a non spousal beneficiary is if the deceased began RMD and the beneficiary is older; in that case the beneficiary can use the deceased persons life expectancy to determine RMD.

Leaving the IRA to an individual can be particularly powerful when the beneficiary is a much younger. For example, say you name your 20 year old grandson as a beneficiary of an IRA. Based on using the IRS single life tables, the beneficiary would only need to take out slightly more than 1.7% of the account for the initial distribution year, gradually increasing throughout his lifetime. This is far better than having to distribute all within five years; allowing the IRA to grow and potentially last a lifetime in a tax advantaged manner. Second if it is a traditional IRA, withdrawing the funds within a five year time frame can potentially be far more costly for income tax purposes than if it is distributed in small amounts during lifetime.

IRA beneficiary designations are tricky and if you aren't comfortable with the process, whether naming a beneficiary or inheriting an IRA, I suggest seeking professional guidance. There are also some nuances

with the spousal options that should be reviewed as well. I encourage you to review the beneficiary designations within your IRA. It may be more important than what's dictated in your will.