

Best and Worst IRA Beneficiaries

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When you choose beneficiaries for your IRA account, you insure out-of-probate transfers to those beneficiaries when you die.

But picking proper beneficiaries can be tricky. Here's a list of the best and worst IRA beneficiary choices:

BEST IRA BENEFICIARIES

1. Your Spouse

If you are married, it's likely that the first person you want to benefit is your spouse. Your spouse is the only person that the Internal Revenue Service allows to "rollover" the IRA participant's IRA to their own IRA account. The rollover will allow your spouse to then control your IRA assets, and to invest them as he or she likes.

If your spouse does not need the IRA funds immediately, he or she can keep them growing tax-deferred until April 1 following the year he or she reaches age 70 1/2. At that time, annual taxable Required Minimum Distributions (RMD) will begin. The remainder of the account not required to be distributed can continue tax-deferred growth.

2. Your Children, Grandchildren, or Younger Individuals

With the exception of your spouse, choosing an individual (or individuals) as your IRA beneficiary allows that beneficiary (following your death) to receive the money as an inherited IRA.

With the inherited IRA, Required Minimum Distributions (RMDs) will begin in the year following the original account owner's death. These RMDs are calculated based on the beneficiary's age-based actuarial life expectancy. The IRS provides a worksheet for calculating RMDs at <https://www.irs.gov/publications/p590b/index.html>

The younger beneficiary can pull out more funds than the annual RMD requires if needed, but the additional withdrawals will also be taxed.

If the younger beneficiary can afford to let the IRA principal continue to grow tax-deferred, the younger beneficiary's longer life expectancy can lower the annual RMD, and stretch the IRA's tax-deferred growth over a longer lifetime. Intentionally using this strategy to grow the IRA's tax-deferred principal from one generation to the next is called the "stretch IRA" concept.



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When used properly, growing your IRA by leaving it to a younger individual(s) who can afford to stretch out the inherited IRA's tax-deferred growth can provide significant returns to the beneficiary. Assuming a 7% return with only the annual RMD withdrawn, a \$100,000 IRA left to a 20 year old child or grandchild can provide \$1,765,731 in income over that child's expected 63 year lifetime. Please see the chart below:

TOTAL INCOME FROM IRA OVER BENEFICIARY'S LIFETIME

Age	Life Expectancy	Value of IRA When Inherited by Beneficiary		
		\$50,000	\$100,000	\$500,000
20	63	\$882,865	\$1,765,731	\$8,828,658
50	34.2	\$201,067	\$402,134	\$2,010,671

3. A See-Through Trust

A trust which qualifies as a "see-through" trust under IRS regulations can be an appropriate beneficiary for your IRA. There may be many practical reasons to employ a trust instead of giving IRA assets directly to a beneficiary. For example, a father wanting to leave a \$250,000 IRA account to his 14 and 16 year old children would be wise to protect the proceeds with a trust instead of directing the funds to his children directly.

In general, leaving an IRA to a non-human entity like an estate or a trust ruins "stretch IRA" optimization, because such beneficiaries must withdraw all funds within five years (instead of 63 years for a 20 year-old individual, for example.)

But under IRS regulations, the "see-through" trust is able to "see through" the trust entity to the individual life expectancy of the oldest beneficiary of the trust.

To qualify as a see-through trust, the trust must meet the following IRS rules:

- The trust must be valid under state law;
- The trust must be irrevocable following the IRA participant's death;
- Trust beneficiaries must be identifiable;
- The IRA plan administrator must be provided with proper documentation regarding the trust beneficiaries and/or the trust by October 31 of the year following the participant's death;
- All trust beneficiaries must be individuals.

Typical testamentary trusts (found in wills) or revocable living trusts become irrevocable after the death of the will testator or trust grantor. If properly drafted, and with proper beneficiaries, such trusts may qualify as see-through trusts under the above IRS rules.

4. A Charity

A tax-deferred account may be appropriate to give to a charity, if none of your human beneficiaries need the funds. You can transfer the full tax-deferred IRA value to the charity because the charity will pay no income taxes when it receives the money, and the account will not be included in your taxable estate when you die (reducing the amount that your family will have to pay in estate taxes, if applicable.)

WORST IRA BENEFICIARIES

1. Your Estate

Naming your estate as your IRA beneficiary is a bad idea. This insures that the IRA funds must now go through probate, increasing the time, complexity, and expense of your probate estate. The IRA's creditor protection will be lost, making your IRA funds newly eligible to pay estate debts. Your intended beneficiaries will no longer be able to stretch out their Required Minimum Distributions over their lifetimes (and save tax dollars) because the IRA funds will now be required to be fully withdrawn (and taxes paid on the withdrawals) within five years.

2. An Individual and an Entity

In order for tax-saving stretch IRA provisions to be available to your human beneficiaries, all of your IRA assets must go to human beneficiaries following your death.

For example, you may intend for your two children to be able to stretch out their Required Minimum Distributions over their lifetimes, leaving 95% of your IRA to them and 5% of your IRA to your church. But even this small bequest of your IRA funds to your church will trigger the five-year IRA distribution rule for your children. Having to fully distribute all of your IRA proceeds (and pay the associated taxes) over a short five-year period can greatly reduce the stretch IRA tax savings available to your children.

3. A Person who has Problems Managing Money or who is in Debt

A person who cannot manage money would withdraw the inherited IRA funds very rapidly, with income tax having to be paid on every withdrawal, negating the potential stretch IRA tax savings of an inherited IRA.

In addition, unlike with a traditional IRA, a 2014 U.S. Supreme Court decision held that the proceeds from an inherited IRA are fully available to creditors. Thus if you leave your IRA outright to someone in debt, they may lose all of that money to creditors in a short amount of time.

To protect your IRA assets directed to a beneficiary with money management problems, or with creditor or debt problems, consider setting up a see-through discretionary trust for the beneficiary. You could then choose another responsible family member to serve as trustee to manage the IRA funds, and to make the spending decisions on behalf of the encumbered

beneficiary.

4. An Older Individual

Leaving an IRA to an older person frequently insures that the Required Minimum Distributions will be accelerated, leading to increased taxes. If the beneficiary really needs the funds, however, and there are no alternative assets to transfer, the increased taxation rate may be less important than taking care of the beneficiary.

REFERENCES

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