

Naming Your IRA Beneficiary – More Complicated Than You Might Expect

Article Highlights:

- How Naming Beneficiaries Impacts Traditional IRA Distributions
- The Impact of Naming Your Trust as a Beneficiary
- IRA Beneficiary Taxation

The decision concerning whom you wish to designate as the beneficiary of your traditional IRA is critically important. This decision affects:

- The minimum amounts you must withdraw from the IRA when you reach age 70 ½;
- Who will get what remains in the account after your death; and
- How that IRA balance can be paid out to beneficiaries.

What's more, a periodic review of whom you've named as IRA beneficiaries is vital to ensure that your overall estate planning objectives will be achieved in light of changes in the performance of your IRAs and in your personal, financial, and family situation. For example, if your spouse was named as your beneficiary when you first opened the account several years ago and you've subsequently divorced, your ex-spouse will remain the beneficiary of your IRA unless you notify your IRA custodian to change the beneficiary designation.

The issue of naming a trust as the beneficiary of an IRA comes up regularly. There is no tax advantage to naming a trust as the IRA beneficiary. Of course, there may be a non-tax-related reason, such as controlling a beneficiary's access to money; thus, naming a trust rather than an individual(s) as the beneficiary of an IRA could achieve that goal. However, that is not typically the case. Naming a trust as the beneficiary of an IRA eliminates the ability for multiple beneficiaries to maximize the opportunity to stretch the required minimum distributions (RMDs) over their individual life expectancies.

Generally, trusts are drafted so that IRA RMDs will pass through the trust directly to the individual trust beneficiary and, therefore, be taxed at the beneficiary's income tax rate. However, if the trust does not permit distribution to the beneficiary, then the RMDs will be taxed at the trust level, which has a tax rate of 39.6% on any taxable income in excess of \$12,500 (2017 rate). This high tax rate applies at a much lower income level than for individuals.

Distributions from traditional IRAs are always taxable whether they are paid to you or, upon your death, paid to your beneficiaries. Once you reach age 70 ½, you are required to begin taking distributions from your IRA. If your spouse is your beneficiary, he or she can delay distributions until he or she reaches age 70 ½ if your spouse is under the age of 70 ½ upon inheritance of your IRA. The rules are tougher for non-spousal beneficiaries, who generally must begin taking distributions based upon a complicated set of rules.

Since IRA distributions are taxable to beneficiaries, beneficiaries usually wish to spread the taxation over a number of years. However, the tax code limits the number of years based on whether the decedent has begun his or her age 70 ½ RMDs at the time of his or her death.

To ensure that your IRA will pass to your chosen beneficiary or beneficiaries, be certain that the beneficiary form on file with the custodian of your IRA reflects your current wishes. These forms allow you to designate both primary and alternate individual beneficiaries. If there is no beneficiary form on file, the custodian's default policy will dictate whether the IRA will go first to a living person or to your estate.

This is a simplified overview of the issues related to naming a beneficiary and the impact on post-death distributions. Uncle Sam wants the tax paid on the distributions, and the rules pertaining to how and when beneficiaries must take taxable distributions are very complicated.

It should also be noted that some members of Congress have expressed their displeasure with stretch-out IRAs that have permitted some beneficiaries to extend for decades the payout period from the IRAs they inherited. These legislators would prefer that total distribution from inherited IRAs be made within five years after the IRA owner's death. So it is possible that we will see tax law changes in this area.

It may be appropriate to consult with this office regarding your particular circumstances before naming beneficiaries.