

Understanding IRA Beneficiaries

Clients often ask their advisors for input as to who should be designated as the beneficiary to their IRA. This is a great question, given the various tax implications that IRA beneficiaries have on a client's estate plan. In order to understand a beneficiary's tax implication we must first review the following benefits that IRAs provide.

1. IRAs provide tax-deferred growth over a client's accumulation period, and in the case of Roth IRAs, they may provide tax-free income to the account owner during retirement.
2. IRAs incorporate a stretch provision that aims to "stretch" the distribution of income payments over the lifetime of the account holder and their assigned beneficiaries.

Assigning the appropriate beneficiary is important because some beneficiary's actions may nullify these benefits. In other words, IRAs provide many tax benefits for the account holder that can continue beyond their lifetime. However, not all beneficiaries may take advantage of those tax benefits. With that in mind, here is a list of some of the more popular beneficiary options.

Spousal Beneficiaries

In many cases, designating a spouse as the primary beneficiary is the recommended option. A surviving spouse has the most flexibility with IRAs as they can rollover their deceased spouse's IRA assets into their own without triggering a taxable event and allowing the surviving spouse to continue accumulating growth in the IRA. A surviving spouse also has the option to open an

inherited IRA¹, giving them the choice to defer distributions from the inherited IRA or to take income distributions if needed before the age of 59 ½ without incurring a tax penalty. However, it should be noted that an inherited IRA has a particular risk associated with it; it may leave the surviving spouse open to creditor claims against the inherited IRA. (To learn more, please read our September 2014 Retirement Awareness white paper).

Non-Spousal Beneficiaries

A non-spousal beneficiary is a person of legal age who is not considered your spouse (adult children, parents, siblings, friends, etc.). A non-spousal beneficiary only has the option to liquidate the decedent's IRA, and forego the tax-deferred treatment, or open an inherited IRA. To clarify, a non-spousal beneficiary cannot rollover the decedent's IRA into his or her own IRA. Unlike a spouse, a non-spousal beneficiary will not be allowed to defer IRA withdrawals and will be required to take a yearly minimum distribution from the IRA, known as a Required Minimum Distribution (RMD). A non-spousal beneficiary still benefits from the stretch provision as they can elect to receive distributions over their lifetime. The "stretch" provision provides the beneficiary the opportunity to continue growing the assets on a tax-deferred (or tax-free in the case of a Roth) basis. It is important to note, even though Roth IRAs do not require RMDs from the original owner, the inheritor of an inherited IRA will be required to take RMDs at least annually.

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¹ Refer to IRS Publication 590 regarding *Inherited IRA*.

**Trusts as Beneficiaries**

A trust can be assigned as the beneficiary to an IRA, however a standard family trust may not always be the best option since the “stretch” provision does not apply to entities. In order for a trust to inherit assets held within an IRA, the trust needs to be created or amended with the stretch provision in mind. Simply naming a living trust as the IRA beneficiary without properly amending the trust can have expensive tax implications as the trust will be required to take distributions much faster and at a higher tax rate than a spouse or non-spousal beneficiary. The distributions will be treated as taxable events and may limit the opportunity to grow the IRA after the decedent’s passing. When assigning a trust as the beneficiary, it is important to review the trust with an estate-planning attorney to ensure it meets the requirements to accept IRA assets.

Sometimes a Trust Should be the Beneficiary

There may be situations when it is less than ideal for the intended beneficiary to directly receive IRA assets. Some of these situations may include minor children, someone with special needs, or a less than responsible person.

Second marriages may also create complex situations, especially if there is animosity between heirs. Keep in mind that once the surviving spouse inherits the IRA, they will have the ability to change the beneficiaries as they choose. This situation creates a potential conflict for the children or family of a prior marriage who could potentially become disinherited.

It is important to keep in mind that unique circumstances may require a specially designed

trust to appropriately address both the inheritance of the IRA assets and the instructions of the decedent in order to ensure the well-being of the intended beneficiaries.

Charities as Beneficiaries

Individuals with estates surpassing the estate-tax exemption, which is set at \$5.43 million for 2015, may find designating a charity as the primary beneficiary for their IRA advantageous. If an estate plan has already provided for the well-being of the IRA owner’s heirs, this option would create a taxable event for a charity that has a tax-exempt status. Meaning, taxes would not be assessed on the IRA. Choosing a charity as a beneficiary can also satisfy the decedent’s intent to leave a legacy in their family name, or anonymously, to a well deserving philanthropic cause.

Summary

This is not an all-inclusive list of the available beneficiary candidates that one can assign to their IRA. Instead, this is meant to show that different beneficiaries have different tax consequences. Given the importance of appropriately designating IRA beneficiaries, one should review their beneficiary options with both their financial advisor and their estate-planning attorney when significant life changing events occur.

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