Attorney at Law

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Estate Planning | Wills & Trusts

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## Naming the Right Beneficiary for Your IRA

One of the benefits of Estate Planning is that it forces people to organize their assets, often realizing that they have additional planning needs or that they overlooked a significant detail that may have serious tax consequences. One such detail may be that the individual forgot to designate a beneficiary for an account that allows such a designation or that the wrong person or entity is named as beneficiary.

Retirement accounts are unique assets because variables such as the beneficiary designation, the age of the owner at death and the type of account will have a significant effect on how the asset is treated for tax purposes. Without proper planning for such assets, your account's beneficiaries may end up losing a large portion of your hard-earned retirement assets to the IRS.

*This article will focus mainly on Individual Retirement Account ("IRA") assets. Rules for other types of retirement accounts often differ.*

### ***How an IRA Works***

The primary benefit of a traditional IRA (as opposed to a Roth IRA) is that no income tax is due on the principal or income until the assets are withdrawn from the account. In other words, the $5,000 (current annual limit) that an individual invests into his IRA in 2011 is deducted from his taxable income for 2011 and will grow, tax-deferred, until the assets are withdrawn, at which time the principal *and* income will be included in his taxable income. This tax-deferred growth, combined with the possibility of a lower income tax rate during retirement, can significantly increase the value of those investments.

For Estate Planning purposes, an IRA is included in the owner's taxable estate but is not included in the owner's probate estate unless the owner names his estate as beneficiary or fails to designate a beneficiary altogether.

## ***Withdrawals***

Assets from a traditional IRA may be withdrawn by the owner beginning in the year in which the owner reaches age 59 ½. Early withdrawals are subject to penalty of 10%. Although contributions to an IRA are tax deductible as detailed above, all withdrawals are subject to income tax. Since the IRS wants to collect its tax and does not want to allow the assets to grow tax-free indefinitely, owners must begin taking Required Minimum Distributions ("RMD") no later than April 1st of the year after the owner reaches age 70 ½ (the Required Beginning Date or "RBD"). The amount of the RMD for each given year is determined by using life expectancy tables provided by the IRS.

## ***Inherited IRAs***

When the owner passes away and leaves an IRA to his beneficiaries, those beneficiaries must abide by complex distribution requirements. The timing and amount of distributions from the inherited IRA depend on the age of the deceased owner, the life expectancy of the beneficiary and the size of the account.

If the owner of the IRA had reached his RBD prior to his death, the beneficiary of an inherited IRA must begin taking RMDs by the end of the year after the owner's death. A beneficiary may stretch-out these RMDs over his own life expectancy based on IRS tables. If the owner had not yet reached his RBD at the time of his death, then the RMDs will be based on the longer of (a) the deceased owner's life expectancy at the time of his death or (b) the beneficiary's life expectancy.

## ***Spouse as Beneficiary***

A spouse who is the beneficiary of an IRA may rollover the account into his or her own IRA. This is a privilege that is exclusive to the surviving spouse. The benefit is that unlike other beneficiaries, the spouse is not required to begin withdrawing assets by the end of the year after the owner's death. Instead, the surviving spouse can postpone RMDs until he or she reaches age 70 ½.

On the other hand, if the IRA beneficiary is a trust of which the surviving spouse is the oldest beneficiary, then there is no rollover option and the assets must be withdrawn based on the spouses life expectancy starting the year after the owner's death.  In other words, the owner may think that he is doing the right thing by naming his Revocable Living Trust as the beneficiary of his IRA, but this decision has significant tax consequences that must be considered.

***No Beneficiary Designated***

Failing to designate a beneficiary of an IRA or naming your estate as beneficiary can have serious income tax consequences as well.  This oversight is far too common with IRAs because accounts are often opened hastily and the individual intends to complete the designation later but never does so.  Additionally, if the sole beneficiary predeceases the owner, then the owner's estate will be deemed to be the beneficiary of the IRA, which is the equivalent of not designating a beneficiary at all.

If the owner of an IRA dies without a beneficiary designation and the owner had reached his RBD prior to his death, then the balance of the IRA assets must be distributed based on the decedent's life expectancy.  On the other hand, if the owner had not yet reached the RBD at the time of his death, then all of the assets must be withdrawn within five years of the owner's death—a very short time period in which the beneficiaries may incur a large income tax bill.

Needless to say, what may seem like a minor oversight of failing to complete the beneficiary designation form can lead to increased taxes on the IRA assets and the loss of tax-deferred growth to the beneficiaries.

***Example***

Martin, the owner of an IRA, dies at the age of 65 and is survived by his wife, Janet, 60, and his two children, Charlie, 40, and Emilio, 38.

***Scenario 1:*** Martin's IRA names Janet as the primary beneficiary.  Janet may rollover Martin's IRA into her own IRA and not be required to take any distributions until she reaches age 70 ½, allowing continued growth and deferred taxes for the next ten years.

***Scenario 2:*** Martin fails to designate a beneficiary of his IRA.  Since Martin had not yet reached his RBD at the time of his death, all assets of the IRA must be distributed to the beneficiaries of Martin's estate, including his children who may be in high income tax brackets themselves, within five years after Martin's death.

***Scenario 3:*** Martin's IRA names his Revocable Living Trust as the primary beneficiary.  The beneficiaries of Martin's Trust are Janet, Charlie and Emilio.

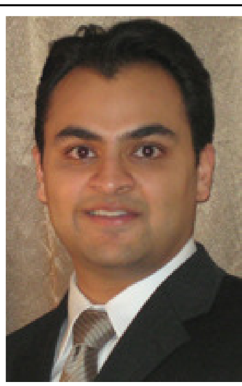
Since there are multiple beneficiaries, the life expectancy of the oldest beneficiary (Janet) will be used to determine the RMD. Charlie and Emilio's shares must also be distributed based on Janet's life expectancy rather than their own, much longer life expectancy.

***Scenario 4:*** Janet predeceases Martin. Martin's IRA names his Revocable Living Trust as the primary beneficiary. The beneficiaries of Martin's Trust are Charlie and Emilio. If the Trust remains a pot trust for the benefit of both Charlie and Emilio, then the life expectancy of the oldest beneficiary (Charlie) will be used to determine the RMD. However, if the Trust is divided into two separate shares, one for Charlie and one for Emilio, then the trustee of Charlie's Trust will be able to use Charlie's life expectancy to determine the RMDs for his share of the IRA and the trustee of Emilio's Trust will be able to use Emilio's longer life expectancy to determine the RMDs for his share of the IRA.

## ***Designating the Right Beneficiary***

Primary and secondary beneficiaries of your IRA can be designated or changed by completing a beneficiary designation form provided by the financial institution where the account is held. If you are unsure of your existing beneficiary designation, you should request a copy of your completed beneficiary designation form from your agent immediately.

As indicated above, in most cases, naming the spouse as sole beneficiary of the IRA followed by the owner's Revocable Living Trust will provide the most beneficial tax treatment as well as giving the estate flexibility in determining the needs of the beneficiaries. However, your particular family and financial situations as well as your Estate Planning goals will determine the ideal beneficiary designation for your IRA.




Manish C. Bhatia is an Illinois attorney focusing his practice in the area of Estate Planning. Manish has focused his education and practice on Tax Planning, Estate Planning and Business Succession Planning since the first year of law school. He has also added Asset Protection, Elder Law and Nonprofit Organizations/Charitable Giving to his fields of practice. Manish is also a member of the Chicago Bar Association, the Asian American Bar Association of Chicago and the Indian American Bar Association.

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