IRA Beneficiary Options

There are many considerations in deciding who the beneficiary of an IRA should be. This article briefly explains some (though not all) of the issues involved.

NAMING A SPOUSE AS A BENEFICIARY

For married couples, it is common that the spouse is individually named as beneficiary of an IRA. The estate and income tax laws often favor naming the participant's spouse as beneficiary. One of the benefits of naming a spouse is that if the Participant predeceases the spouse, the spouse can rollover the IRA to his or her name, and then choose a new beneficiary (usually a child or children). This type of rollover is only available to spouses.

However, in choosing the spouse as beneficiary, the spouse will have full control of the IRA assets after the death of the participant, and is under no obligation to follow the participant's wishes. This may not be what the participant wanted, especially if there are children from a previous marriage or the participant feels that the spouse may be too easily influenced by others after he/she is gone.

NAMING CHILDREN, GRANDCHILDREN, OR OTHERS AS BENEFICIARIES

If your spouse will have plenty of assets after you die, or if you have reason to believe your spouse will die before you, or if you are not married, you might name your children, grandchildren, or other individuals as beneficiary(ies).

Previously, this would let you stretch out your account distributions using the beneficiary's actual life expectancy. Under the SECURE Act of 2021, this changed significantly: all non-spouse beneficiaries must completely distribute the inherited IRA within 10 years of the owner's death with no required distributions in between. From an estate planning point of view, this is much less attractive than it used to be.

Any time you name an individual as beneficiary, you lose control over how the assets will be used or distributed after your death. After your death, your beneficiary can do whatever he/she wants with this money, including cashing out the full balance of the account and destroying your careful plans for long-term, tax-deferred growth.

The money could also be available to the beneficiary's creditors, spouses, and ex-spouses. If any of this concerns you, consider using a trust.

NAMING A TRUST AS BENEFICIARY

Naming a trust as beneficiary will give you maximum control over your tax-deferred money after you die. That's because the distributions will be paid not to an individual, but into a trust that contains your written instructions stating who will receive the money, how, and when.

For example, your trust could provide income to your surviving spouse for as long as he or she lives. Then, after your spouse dies, the income could go to someone else. The trust could even provide periodic income to your children or grandchildren, keeping the rest safe from irresponsible spending and/or creditors.

Unfortunately, the "stretch" provisions that used to be in effect went away with the SECURE Act, so the IRA will have to be fully distributed 10 years after death. During that time, the trustee can decide how much should be distributed each year. The trustee can withdraw more money if needed to follow your instructions, but the rest can stay in the account and continue to grow tax-deferred. You can name anyone as trustee, but many people name a bank or trust company, especially if the trust will exist for a long period of time.

NAMING A CHARITY AS BENEFICIARY OF YOUR IRA

If you are planning to leave an asset to charity after you die, a tax-deferred account can be an excellent one to use. That's 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 your family may have to pay in estate taxes.

SPLITTING YOUR IRA INTO SMALLER ONES

You don't have to choose just one of these options. You can split a large IRA into several smaller ones and name a different beneficiary for each one. (If your money is in a company plan, you can roll it into an IRA and then split it.) Under the old rules that allowed distributions based on a beneficiary's life expectancy, this kind of

planning made more sense; under the SECURE Act, this is no longer a particularly meaningful tool.

WHAT ARE ESTATE TAXES AND WHY SHOULD YOU CARE

Estate taxes are different from, and in addition to, income taxes. When you die, your estate will have to pay estate taxes if its net value (including your tax-deferred accounts) is more than the amount exempt at that time. The “estate tax exemption” is $12.92 million in 2023 and the State of Maine has a $6.41 million exemption.

Estate taxes must be paid in cash, usually within nine months of death. If money must be withdrawn from a tax-deferred account to pay the estate taxes, the result can be disastrous — because income taxes must be paid on the money that is withdrawn to pay the estate taxes. You actually pay (income) tax on money you pay in (estate) tax!

Although the vast majority of estates will not have an estate tax liability, some will, and there are planning strategies available to reduce or eliminate such taxes.

You can reduce your taxable estate by giving some assets to your loved ones before you die. You can buy life insurance within a special type of trust (so the insurance is not taxable in our estate) to pay estate taxes. And, if you are married, make sure you use both your estate tax annual exemptions of $17,000 per person.

Everyone is entitled to an estate tax exemption but many married couples waste one exemption when they leave all their assets outright to each other. Currently, you can leave your spouse an unlimited amount of assets when you die and there will be no federal estate taxes at that time. But when your spouse dies later, he or she will only be entitled to one exemption. That can cause your family to pay too much in estate taxes.

Any assets you own (including a tax-deferred account) that you leave to anyone other than your spouse (your children, grandchildren, or a trust) can use your exemption. Splitting a large IRA into smaller ones will make this easier to do.

Let’s say, for example, that most of your money is in one large IRA and you do not have enough other assets to fully use your exemption. If you split the large IRA into

smaller ones, you can name a trust as beneficiary of one of them. Then, if you name your spouse as beneficiary of this trust, the money from this IRA can provide for your spouse and use your exemption to save estate taxes.

IF YOU ARE NOT MARRIED

If you are single, naming a beneficiary will be less complicated because you have just one estate tax exemption and there will be no spousal rollover option.

CHANGING A BENEFICIARY

You can change your beneficiary at any time by filing the appropriate paperwork with the company. Your will will not govern who gets this asset, so make sure the beneficiary designation is current. Under IRS Regulations, your minimum distributions are not measured by who you name as beneficiary.

Some employer-sponsored plans (401(k), pension and profit sharing plans, etc.) have restrictions on beneficiary options. If your plan will not let you do what you want, consider rolling your money into an IRA as soon as you can. If your money is in an IRA and the institution will not agree to what you want to do, move your IRA to one that will.

Hopefully this complex issue will be less complicated from this reading. Before you make decisions in this area, it is wise to talk to an experienced financial advisor or estate planning attorney.

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