IRA Beneficiaries

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Spouse Beneficiary

If you designate your spouse as the primary beneficiary of your IRA, your spouse will be able to rollover your IRA into an IRA of their own and can continue to contribute to it. There is no difference in how the inherited IRA by a spouse is treated by the IRS from one a spouse opens on their own.

However, under the IRA distribution rules passed in 2002, there is now more flexibility for spouses in terms of estate planning. The inheriting spouse, as the primary beneficiary, has up to nine months after the IRA owner dies to accept or disclaim the inherited IRA. When the IRA is disclaimed by the primary beneficiary it then passes to the contingent beneficiary. The benefit here is that the spouse can disclaim the IRA in favor of a younger contingent beneficiary (such as a child or grandchild). The contingent beneficiary can take the RMD (required minimum distribution) from the IRA over his or her life expectancy and therefore significantly enhance the benefits of tax deferred growth.

The worst thing you can do is not name an IRA beneficiary, including your contingent beneficiary. For example, if you named your spouse as your primary beneficiary but did not name a contingent beneficiary and you and your spouse die at the same time, then the IRA passes to your estate. In that event, and if you had not yet reached your required beginning date for RMDs, the account would have to be paid out to your estate by December 31 of the fifth year following the year of your death. If you die after RMDs have begun, then the account can be paid to your estate over time, based on your remaining life expectancy as calculated as of the year of your death.

An IRA owner's estate is the worst possible choice as IRA beneficiary. Not only are the assets paid out more quickly than leaving it to an individual, but the IRA as part of your estate is now subject to your creditor’s claims.

Non-Spousal Beneficiaries

Any non-spousal beneficiary, including children, cannot contribute to an inherited IRA. They must keep the inherited IRA separate and must take distributions from the inherited IRA which will be taxed as ordinary income. They have two distribution options;

1. They can take the distributions based on their life expectancies beginning no later than December 31 of the year following the year the IRA owner died.
2. They can also take a lump sum distribution as long as it is taken no later than the fifth year following the IRA owner’s death. They can cash in the IRA without penalty and keep what ever is left after they pay the ordinary income taxes due.

If you inherit an IRA from a parent or someone other than your spouse and do not disclaim the IRA or you only disclaimed part of the IRA then you must roll whatever you inherited from the IRA into an account which is titled “Inherited IRA “ or “Beneficial IRA”. It will remain an IRA, with both your name on the account as beneficiary and the deceased person's name as the original account holder. Example: "John R. Smith IRA (deceased May 1, 2005) FBO (for the benefit of) Kerry Smith, beneficiary". Make certain the financial institution does not put the inherited IRA directly into your name. Doing so would make the inherited IRA fully taxable in one year.

An IRA owner can also name an entity, charity, or non-qualifying trust as a beneficiary. When the owner died if he or she was younger than 70-1/2 (the year RMDs are required to begin) the assets must be completely distributed by December 31, of the fifth year following the year of the IRA owners death. If the owner was living on April 1 of the year after turning 70-1/2, the RMDs are based on the remaining life expectancy of the IRA owner as if he or she were still alive.

If the intended beneficiary is a minor child or someone not capable of managing the IRA then a qualified trust might be appropriate. In this case a trustee would actually manage the IRA through the trust for the benefit of the beneficiary.

If the beneficiary is a qualified trust, the trust itself must be properly planned. To qualify as a beneficiary, your trust must meet four very specific criteria.

Must be valid under state law
Must be irrevocable (it can be revocable while the IRA owner is alive, but upon his death it must become irrevocable)
Must have identifiable beneficiaries
Must provide the plan administrator or custodian with a copy of the trust documents

Only a qualified trust may take full advantage of the stretch permitted by the required minimum distribution rules. A qualified trust may stretch distributions out over the single life expectancy of the trust beneficiary, or in the case of multiple trust beneficiaries for RMD purposes the eldest beneficiary is considered the designated beneficiary and his life expectancy is used for the RMD calculation.

As you can see, all of these issues entail more thought than just writing down a name for beneficiary. It is important to seek advice about the beneficiary options available to you from us or your estate-planning attorney.