Choosing Beneficiaries for Your IRA

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Like many Americans, you may retire or reach retirement age with an unexpected windfall — a large retirement plan account balance. Whether it's a 401(k) plan, a defined benefit plan, or some other type of individual retirement plan, your objective in making contributions was to take advantage of the tax-deferral benefits that such plans offer. However, once you reach retirement age, the fruits of your savings are subject to mandatory distribution requirements and possible taxation that many people overlook. Making sure that you have made plans ahead of time for your retirement assets is crucial to a comprehensive financial and estate plan. Such planning can help ensure that you are able to meet your financial needs after you retire. In addition, should you die before reaching retirement age; you can ensure the financial well-being of your surviving beneficiaries. The most common vehicle for shifting retirement plan assets at retirement is an individual retirement account (IRA). Upon reaching retirement, you can roll over your retirement plan assets into an IRA. If you die before reaching retirement age or before you establish an IRA account, your designated beneficiary of your retirement plan may be able to roll the assets into an IRA as well. Typically, an IRA owner may name a spouse, child, trust, or charity as a beneficiary of his or her IRA.

Required Minimum Distribution Rule may affect your beneficiary choices
All IRAs are subject to Required Minimum Distribution (RMD) Rules, which means that you will be penalized if you do not make the required minimum distribution in any calendar year. The penalty imposed is a 50% excise tax on the difference between the amount required to be distributed and the amount actually distributed. Generally, the IRA account assets must be distributed by April 1st of the calendar year following the year in which the individual becomes 70-1/2 or retires, whichever is later. The distribution period may be over the life of the individual, or over the joint life expectancies of the individual and his or her designated beneficiary. The distribution rules differ depending upon whether you die before or after you begin taking your required distributions.

(see next page)

Surviving Spouse as Beneficiary

When you name your surviving spouse as the designated beneficiary of your IRA, he or she can rollover the assets tax free into an IRA in his or her own name (IRA Rollover) or claim your IRA as his or her own account. If your surviving spouse elects to treat your IRA as his or her own account, he or she will not be required to commence distributions until April 1st of the calendar year in which he or she turns 70-1/2. Your spouse may continue to make contributions to this IRA account until distributions are required. Also, by having the surviving spouse claim the IRA as his or her own, he or she has the opportunity to choose his or her own beneficiary. By doing so, required minimum distributions will be calculated using the combined life expectancies of your surviving spouse and his or her newly designated beneficiary. While the dollar amount of each payment during the lifetime of the surviving spouse may be less by using the joint life expectancy method (also known as the "stretch" IRA strategy), this method of distribution planning extends the distribution period and may allow substantial amounts of cash to build up the in the account.* If your spouse needs income immediately, he or she may take distributions from a rollover IRA account. However, distributions made before he or she reaches age 59-1/2 will be subject to income tax and possibly penalty taxes for early withdrawal. It may be better therefore to have distributions made directly from your account to your spouse since distributions made upon your death will be exempt from penalty taxes. If you die before the age at which you are required to start taking distributions, your surviving spouse will be required to take minimum distributions calculated over his or her own life expectancy beginning on or before the later of: 1. December 31 of the calendar year immediately following the calendar year in which the IRA owner dies, **or** 2. December 31 of the calendar year in which the IRA owner would have become 70-1/2. Your surviving spouse will be required to take required minimum distributions at least as often as under the distribution method you had been using prior to your death.

Non-Spouse Beneflciary

You may wish to name a beneficiary other than your spouse. In such cases, if you die before the date you are required to start taking distributions, distributions must commence on or before December 31st of the calendar year immediately following the calendar year in which you die, but no later than December 31st of the calendar year in which the fifth anniversary of your death occurs. Distributions to your non-spouse beneficiary would be similar to those of a spousal beneficiary and, therefore, must continue to be made at least as rapidly as under the distribution method you were using prior to your death.

Multiple Beneficiaries and Segregated Accounts

You may wish to name more than one beneficiary for your IRA, or segregate your account into separate accounts and name a different beneficiary for each account.

(see next page)

Generally, if you name more than one beneficiary as of the date distributions must commence, the oldest beneficiary will be the designated beneficiary used for purposes of determining the distribution period.

Trust as Beneficiary

If you name a trust as designated beneficiary, distributions from the IRA account to the trust will be treated just as if they were distributions from the trust to its beneficiaries. Therefore, trust beneficiaries will be treated as designated beneficiaries of the IRA, and the distribution period will be determined based on the age of the oldest beneficiary.

Spouse as Primary Beneficiary and Family Trust as Secondary Beneficiary

You may name your surviving spouse as the primary beneficiary of your IRA account and a family trust as secondary beneficiary. Under this type of designation, your surviving spouse can disclaim part or all of the IRA in order to fund the family trust. In turn, the family trust can name all the children as beneficiaries and calculate the required minimum distribution for the oldest beneficiary. This strategy would allow the assets to continue to build up in the account and defer the income tax until a later date (again, this is known as “stretching” the IRA*). Using a trust, however, will preclude your surviving spouse from making a tax-free rollover of the IRA assets into an IRA in his or her own name and, if necessary, gaining access to that money immediately. However, the trust can be carefully drafted to ensure that the surviving spouse who receives proceeds from the trust will be able to roll over the proceeds into his or her IRA account without triggering excise tax and income taxes. Making your retirement planning choices, particularly determining the beneficiaries for your retirement assets, is a crucial part of a comprehensive estate plan. Check with your financial consultant about the beneficiary options that are right for your own financial and estate planning.