IRA beneficiary blunders

At least once a month, a client asks me to make sure the individual they have designated as their trust is the beneficiary of their individual retirement account. That could be a costly mistake — they may have just guaranteed to give nearly 40 percent of their IRA to the Internal Revenue Service. It is time to open a dialogue about the best way to bestow an IRA on a beneficiary.

You do not put your IRA in your trust during your lifetime like you would with your home. The government does not allow you to give away your IRA to another entity during your lifetime unless you withdraw all the funds and pay enormous taxes. Instead, you may choose to name your trust as your beneficiary; however, this has some additional consequences. Take Heidi’s situation:

Heidi has an $800,000 IRA and named her trust as the beneficiary of her IRA. Her trust was required to distribute the entire $800,000 within five years of her death. Have you seen the income tax tables for trusts? Wait, that isn’t a dinnertime topic at your home? In 2018, it hits 37 percent by $12,000 of income. At best, you are withdrawing $160,000 each year and paying 37 percent federal tax on most of it.

We get it, the taxes are horrific. What if we don’t use a trust? Let’s chat about Larry’s situation:

Larry’s three children were recently cut off from inheriting Larry’s $1,000,000 IRA. Why? Being disinherited is easier than you think. Larry has three children from a previous marriage. His spouse, Kelly, has two. Larry named Kelly as the primary beneficiary of his IRA and his three children as contingent beneficiaries. Larry passed away, and Kelly moved Larry’s $1,000,000 IRA to her IRA. A spouse can assume the IRA as his/her own. Guess who are the beneficiaries of Kelly’s IRA? Two of the five made the cut, but none of Larry’s children.

What do you do?
• First, you need to understand the basic issues.
• Second, you need to determine your priority based on your situation.
• Last, pick your option based on your situation and priority.

1. Understand the basic issues

The government has provided us with tax benefits for saving toward retirement — specifically, income tax deferral. Whether you contributed a portion of your income pretax to a 401(k) or you made a deductible IRA.
contribution, you have deposited money into a retirement account without paying income tax on those dollars. The tax-deferred “free lunch” will not last forever. The government requires taxable distributions from your retirement plans at the age of 70½. It also requires distributions from all inherited IRAs (with a few exceptions) regardless of the age of the beneficiary.

Normally you would be penalized for taking withdrawals from an IRA before the age of 59½; however, this penalty does not apply to inherited IRAs. This makes sense. It would be cruel to require a distribution and then penalize you for it. I can hear a few of my clients’ voices muttering “I wouldn’t put it past the government …”

2. Determine your priority
The option to give your IRA to charities is always on the table. It can be smart given that the charity will pay no income tax on distribution. However, today we are focusing on how to give your IRA to your designated individual beneficiaries. Is your priority controlling succession, tax minimization or simplicity?

Controlling succession
You only get to pick the first beneficiary of your IRA. If you want to control multiple layers, you need to involve a trust.

Sure, the custodian (the individual or organization safeguarding your financial assets) will allow you to pick contingent beneficiaries as well, but all bets are off as soon as the primary beneficiary inherits that money. The primary beneficiary will fill out a new IRA application.

Will the primary beneficiary copy your contingent beneficiaries as their primary beneficiaries? Of course they will! Families have never had a falling out over money — right?

A trust, with a competent successor trustee, will ensure that contingent beneficiaries maintain their place in line. This is especially important for second marriages and blended families. Relationships have a way of changing once you, the only common connection, are no longer around.

Another major reason for using a trust as a beneficiary of an IRA is to control the timing of distributions to minor children, dependent adult children, or spendthrift individuals. See Kathryn’s example:

Kathryn’s daughter was addicted to drugs, so she built in language requiring regular drug testing before distributions could be made. After she passed away, her brother, as successor trustee, followed through with this specific direction meticulously. Unfortunately, the surviving daughter never passed the tests so the assets passed to the next beneficiary in line at the deceased client’s request. Kathryn didn’t want to pay for her daughter’s drug habit with her IRA.

Tax minimization
They call it IRA stretching. While that sounds like a new type of yoga, it is merely the concept of stretching out the distributions as long as possible to continue deferring taxes. This allows those tax dollars to stay in your account and grow.

There are so many ways inherited IRA stretching can happen. We should talk if you have questions. The main things to understand are:

1. Options with a trust as an IRA beneficiary:
   a. May be disqualified from IRA stretching, requiring all assets to be distributed within five years (remember taxes).
   b. If the trust meets certain criteria, it may be able to stretch withdrawals over the life expectancy of the oldest beneficiary.

2. Options with a non-spouse individual as an IRA beneficiary (for example, a son, daughter or friend):
   a. May stretch withdrawals over their lifetime based on IRS tables.
   b. May choose to distribute assets sooner if desired.

3. Options with a spouse as an IRA beneficiary:
   a. May assume the IRA as their own, requiring no distribution until the surviving spouse reaches age 70½.
   b. May leave it in an inherited IRA, allowing penalty-free access to the IRA before age 59½. This almost always makes sense for young widows/widowers. They can always assume the IRA as their own after age 59½.
Simplicity

The structure of an individual owning an inherited IRA is much simpler. Brokerage firms don’t seem to be completely comfortable with trusts as owners of IRAs. Their technology doesn’t cooperate well with trusts. Here’s an example. The tax ID number for the account is the trust’s tax ID. However, the money is for the benefit of the beneficiary (a separate Social Security Number) and yet the trustee is the one who must log in online and administer the assets (introducing a third SSN). There is much less paperwork involved with individuals as inherited IRA owners compared to trusts as inherited IRA owners. You have introduced a third person (the trustee) to the party. Does the trustee split the IRAs in to separate IRAs all owned by the trust, but for the benefit of each beneficiary? Or do you pool the assets and require the trustee to account for equal distributions to beneficiaries from one pool of funds?

3. Pick your option based on your situation and priority

<table>
<thead>
<tr>
<th>Situation</th>
<th>Priority</th>
<th>Beneficiary Structure</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>-2nd marriages</td>
<td></td>
<td>Trust as the IRA beneficiary</td>
<td>-With a good successor trustee, you know your assets will flow as desired.</td>
<td>-The structure is much more cumbersome.</td>
</tr>
<tr>
<td>-Spendthrift children</td>
<td>Controlling Succession</td>
<td></td>
<td></td>
<td>-You may have forced a large tax bill in the first 5 years.</td>
</tr>
<tr>
<td>-Minor children</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Everyone loves to minimize taxes.</td>
<td>Tax Minimization</td>
<td>Individual as the IRA beneficiary</td>
<td>-More IRA stretch options -Simple account structure to administer</td>
<td>-While you list primary and contingent beneficiaries, you have no control after the primary receives the assets.</td>
</tr>
<tr>
<td>Everyone loves ease and simplicity</td>
<td>Simplicity</td>
<td>Individual as the IRA beneficiary</td>
<td>-More IRA stretch options -Simple account structure to administer</td>
<td>-While you list primary and contingent beneficiaries, you have no control after the primary receives the assets.</td>
</tr>
</tbody>
</table>

In summary

Most people choose individuals. I have my wife as my primary beneficiary and my trust as the contingent beneficiary. My children are still under 18. I’m crossing my fingers that all three of them turn out to be decent citizens and can be trusted with a few dollars. So far, we might be on the spendthrift path; my father-in-law pays them a couple dollars just for showing up to their recreation soccer games, and that money is burning holes in their pockets until they find the next Lego set to buy. If we can correct course, and if I can keep my sweet wife fooled into thinking she’s better off with me, I’ll switch the contingent beneficiaries to the children individually when they reach the age of 18... or maybe 25. 🙃
Disclosures

The content of this publication is meant for the intended recipient only and is not meant to be reproduced or distributed for any reason. Nothing in this publication should be considered a solicitation to buy or sell securities. This is for educational purposes only and should not be considered investment advice. All data contained herein is believed to be reliable at the time of writing but should not be relied upon as the basis for any independent decisions. All opinions expressed are the author’s own and are subject to change at any time.

Advisory services provided by Capita Financial Network, LLC., a SEC Registered Investment Adviser. Registration with the SEC does not imply certain training or skill.