Don't Overlook Your Clients' IRA Beneficiary Designations!

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The beneficiary designation forms for qualified retirement plans and individual retirement accounts (collectively "IRAs") can be the most overlooked part of a client's estate plan. In many instances, the beneficiary designation forms will control more assets than pass under one's Will. A client may have a very elaborate Will and/or revocable living trust that contains highly detailed and carefully thought-through trust provisions for the management and preservation of wealth for children, grandchildren and more remote descendants. But if the IRA beneficiary designation form provides, for example, that all property goes outright to children (instead of to trusts for their benefit that are to be established under the client's Will and/or revocable living trust), the IRA will fail to link to such trusts, and the children will inherit the IRA outright and not in trust.

In planning for IRAs, the most important tax attribute to consider (except in the case of Roth IRAs – which have already been pre-taxed) is that the IRA generally represents a large bucket of taxable income that has not been previously taxed. If the beneficiary's circumstances permit, "the name of the game" from an income tax planning perspective is to "stretch out" the payment of the IRA as long as possible. This is significant because to the extent that the IRA continues to hold assets, the income earned on the IRA will be income tax deferred. This allows tax-free compounding to occur within the IRA. In contrast, to the extent that the IRA is distributed to its beneficiaries, it is subject in the recipient's hands to immediate taxation as ordinary income (although it is exempt from the tax on net investment income under IRC § 1411).

The Tax Code recognizes that tax deferral is a very powerful financial tool that negatively impacts government revenues, and strikes a compromise by requiring that certain minimum annual distributions ("required minimum distributions") be made from IRAs depending on the relevant person's age. If the person who establishes the IRA (the "participant") is still alive, required minimum distributions generally can be deferred until after the participant has attained age 70½. In contrast, if the participant has died, required minimum distributions will often need to be made beginning in the year immediately following the participant's death. In addition, where the participant has died prior to attaining age 70½ and the IRA is payable to the participant's estate, the IRA will need to be liquidated (thereby subjecting the participant's estate to tax) by no later than the end of the year that contains the fifth anniversary of the participant's date of death (although in such case annual distributions are not required).

This is where the identity of the beneficiary named in the beneficiary designation form is so extremely important. All other things being equal, the three most desirable classes of beneficiaries of an IRA are the surviving spouse, young beneficiaries (including certain qualifying "see-through trusts" established for their benefit) and charity.

A surviving spouse is the only beneficiary who possesses the ability to "roll over" an IRA and make it her or his own. By so doing, the surviving spouse can delay having to take any required minimum distributions until attaining the age of 70½ irrespective of the age of the IRA participant at the time of death. Moreover, when the surviving spouse starts to take the required minimum distributions, a much more favorable IRS actuarial table applies to her than for any other beneficiary. In addition, the surviving spouse can designate her own beneficiary upon her death for her rollover IRA and have required minimum distributions span that beneficiary's actuarial life expectancy based on IRS tables. So, all other things being equal (and recognizing that many times they will not be equal particularly if there has been a second marriage and there are children from a prior marriage), it will often be desirable to name one's surviving spouse outright as the primary beneficiary of the IRA. This is in contrast to naming as beneficiary a trust for the surviving spouse's benefit, which generally will not enjoy any of these tremendous tax benefits that the surviving spouse possesses.

A young individual can be a very effective beneficiary of an IRA because the required minimum distributions can potentially extend over such person's lifetime based on published IRS tables. Depending on the age of the young beneficiary, this could potentially span several decades. Certain trusts for the benefit of young individuals (which are commonly referred to as "see-through trusts" and contain IRS sanctioned provisions) can be integrated into the estate plan to allow the asset protection and management benefits of a trust to be interwoven with the beneficiary designation form. But this is where one needs to be extremely careful – because if the beneficiary designation form has not been carefully crafted to serve as a "bridge" that links up to the see-through trusts established under the client's Will and/or revocable living trust, the needed coordination will not occur and the client will fail to attain his or her objective of having trusts receive the IRA that will extend for the beneficiary's life expectancy.

Finally, the client's charitable aspirations should be carefully integrated into the IRA beneficiary designation form. As earlier mentioned, except in the case of Roth IRAs, the IRA generally represents a bucket of taxable income that has not been previously subjected to tax. Thus, assuming a combined 40% federal and state income tax rate, a $1,000,000 IRA will effectively shrink to $600,000 upon distribution to non-charitable beneficiaries. However, if the beneficiary is a tax-exempt organization (such as a U.S. tax-qualified charity), the $1,000,000 in the IRA will remain at $1,000,000 because no income taxes will be imposed on the charity. So a well-structured estate plan for a client who wishes to provide for both charitable organizations and non-charitable beneficiaries (e.g., family members) would entail giving the IRA to charity and giving other assets (such as non-IRA brokerage accounts) to individuals. By so doing, the client's total wealth passing to beneficiaries upon death will go much further than it otherwise would have net of income taxes.

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