Who to Name as Your IRA Beneficiaries

Have you named beneficiaries in your IRAs, including primary and contingent beneficiaries? Primary beneficiaries are the first ones in line. If a primary beneficiary pre-deceased the IRA owner or wishes to disclaim his or her inheritance (which can be done through a properly executed disclaimer), the contingent beneficiaries will take possession. Beneficiary designation is critical to ensure that the right people end up inheriting your IRAs. Unfortunately, it does not get the proper attention that it deserves, resulting in accounts being disbursed to the wrong parties, causing not only family feuds, but also unnecessary taxes, costs, and expenses.

Why Beneficiary Designation Is Important

A common mistake in IRA beneficiary planning is not having named a beneficiary. This happens more often than is commonly realized. When you open an IRA account, the beneficiary designation form asks for the name, address, social security number, and percentage allocation for each named beneficiary. Oftentimes, the form is left blank because the information is not readily available at the time. And if you don’t follow through with completing that information, the account will have no beneficiaries.

Disclaimer: If no beneficiaries are named, while some IRA custodians may provide for a default beneficiary (such as the surviving spouse), others may distribute the IRA to your estate. This may cause distributions to unintended beneficiaries and may result in immediate taxation of the entire account. The easy fix is to make sure that you have named beneficiaries in your accounts. Reviewing your IRA beneficiary designation should be part of your regular routine.

Making Sure That Your Beneficiaries’ Children Get What You Intended for Them

If you have multiple beneficiaries, and you intend for each of your beneficiaries’ shares to go to his or her children (in case the beneficiary pre-deceased you), designate your beneficiaries per stirpes. Per stirpes is a legal term in Latin. It is also known as right of representation distribution.
Example: Henry names his two adult children (Jack and Noelle) as equal beneficiaries in his IRA. Jack and Noelle have children of their own. If either Jack or Noelle died before Henry, and Henry wants his kids’ shares to go to his grandchildren, a *per stirpes* designation would allow Henry to achieve that goal. In this case, Henry would simply designate beneficiaries as follows:

**Primary Beneficiaries:**
- Jack, per stirpes: 50%
- Noelle, per stirpes: 50%

If Henry or Noelle pre-deceased Henry, their respective shares would be inherited by their children.

**Naming a Trust as an IRA Beneficiary**

With living trusts gaining popularities, many people name their trust as the beneficiary of their IRA accounts. Although the logic behind it is understandable, they do so without the full knowledge of the potential pitfalls and limitations of naming a trust as an IRA beneficiary. Here is the logic behind why people would name their living trust as the IRA beneficiary: “Since beneficiaries are already named in the trust, with their allocation and distribution provisions spelled out, and since my IRA beneficiaries are the same as those named in the trust, wouldn’t it just make sense to name the trust as the beneficiary in my IRA? When I die, the trust inherits the IRA and makes distributions according to the provisions in the trust. What’s wrong with that?”

It makes perfect sense, doesn’t it? Except for the income tax consideration, which is *huge.* Unless all the rules are complied with, naming a trust as the beneficiary may trigger additional or even immediate taxation upon your death.
QUALIFYING AS A ‘SEE-THROUGH’ TRUST

To qualify as a ‘see-through’ trust, the trust must satisfy the following provisions:

a. The trust is a valid trust under state law.

b. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the IRA owner.

c. The beneficiaries of the trust are identifiable.

d. A copy of the trust documents are provided to the IRA custodian by Oct 31st of the year immediately following the year in which the IRA owner died.

First, when a trust is named as an IRA beneficiary, the IRA custodian would have to review the trust for being in good order before accepting it as an IRA beneficiary. To accomplish that, a copy of the trust must be submitted to the custodian by no later than October 31 of the year after the IRA owner’s death. Being “in good order” means the trust meets the requirements in order to qualify as a “see-through” trust—the trust is treated as a pass-through entity through which individual beneficiaries of the trust receive IRA distributions. In the “How to Inherit an IRA” section of this book, I wrote extensively about stretching IRA distributions to maximize income tax savings and continue building wealth inside an inherited, tax-deferred IRA. In order for the stretch option to be available to the individual beneficiaries inside an IRA trust beneficiary, the trust would have to qualify as a “see-through” trust. Otherwise, the IRA custodian would most likely treat the trust as a non-personal trust and accelerate distributions of the IRA, thus accelerating taxes.

Accumulation Versus Conduit Trust

Another important consideration is whether the IRA beneficiary trust is an accumulation trust or a conduit trust, and who are named as beneficiaries inside the trust.
When a trust is named as an IRA beneficiary, minimum required distributions are paid to the trust’s individual beneficiaries computed on the life expectancy of the oldest beneficiary (or the shortest life expectancy of all the beneficiaries). Again, the trust must first qualify as a “see-through” trust. So if your daughter and her son (your grandson) are both named as beneficiaries in the trust, and the trust is the named beneficiary of your IRA—assuming the trust qualifies as a “see-through” trust—your grandson would have to take distributions based on your daughter’s life expectancy (instead of his own single life expectancy), resulting in excessive distributions and therefore excessive income tax. And if the trust is an accumulation trust (i.e., distributions are paid into the trust, but they accumulate inside the trust and are payable to the trust’s beneficiaries some time in the future), the life expectancy of ALL potential beneficiaries, including contingent beneficiaries, are scrutinized for the oldest trust beneficiary test. But if it is a conduit trust (i.e., distributions to the trust are passed through directly to the trust beneficiaries without accumulation), then only the life expectancy of the trust primary beneficiaries are considered for the oldest beneficiary test. This is important because the naming of a non-person beneficiary (such as your alma mater) even as a tertiary contingent beneficiary in an accumulation trust may negate the stretching of inherited IRA distributions by the individual beneficiaries in your IRA.

Unless controlling your IRA distribution after death is the objective, consider naming individuals as beneficiaries of your IRAs instead. This will allow the IRA to be split up proportionately to the named individuals so each may take distributions either as a lump sum or stretch according to their individual preference. If you wish to name an entity as your IRA beneficiary, set up a separate IRA for that entity so that your individual beneficiaries will not be “tainted” for the stretch IRA distribution option.

There are times when naming a trust beneficiary in your IRA is appropriate, especially if distributions to trust beneficiaries are to be made according to certain terms and conditions (such as reaching the age of majority).

Oftentimes though, the same goal can be achieved by naming a custodian on the IRA beneficiary form for your minor children. For example, the following language is provided for reference: Primary Beneficiary: Taylor Smith Jr. However, if Taylor Smith is under the age of twenty-five, then his interest shall be distributed to [name of custodian], as custodian for Taylor Smith under the California Uniform Transfers to Minors Act until age twenty-five.
What You Must Know as a Spousal Beneficiary

Most married couples name each other as the beneficiary on their individual retirement accounts. While this seems to make sense and has wide applications, special rules do apply to spousal inheritance of IRAs.

A spousal beneficiary can inherit an IRA either as a beneficiary or can roll it over to his/her own IRA. A spouse is the only kind of beneficiary that has the rollover privilege. Non-spousal beneficiaries cannot roll over an inherited IRA. For example, your children cannot roll over an inherited IRA. They either have to take a lump-sum distribution or inherit the IRA as beneficiaries and stretch out the distributions.

Age is an important factor in deciding whether the inheriting spouse should keep the IRA as a beneficiary or roll it over to his/her own IRA. If the spousal beneficiary is under fifty-nine and a half and needs to withdraw from the inherited IRA to meet her needs, then the spousal beneficiary should keep the IRA as an inherited IRA and stay on as the beneficiary on the account. This will allow the inheriting spousal beneficiary to withdraw from the IRA before age fifty-nine and a half without the 10 percent penalty. But if the account is rolled over, it becomes the inheriting spouse’s personal IRA. He or she is no longer a beneficiary, and all the IRA rules will apply as if the account was his or hers from the beginning. So if the spouse is younger than fifty-nine and a half and rolls over the inherited account and takes distributions, the 10 percent early-withdrawal penalty tax will be triggered, unless exceptions apply.

A spousal beneficiary can choose to first inherit an IRA as a beneficiary (instead of exercising the spousal rollover privilege). At a later date, say after the spouse turns fifty-nine and a half when the 10 percent early withdrawal penalty provision no longer applies, he or she may then roll over the inherited IRA to his or her own IRA.