



Understanding Who Should Be the Beneficiary of Your IRA

1. Introduction

How would you like to turn your modest tax-deferred account into millions for your family? Depending on whom you name as beneficiary, you can keep this money growing tax-deferred for not only your and your spouse's lifetimes, but also for your children's or grandchildren's lifetimes. That can turn even a modest inheritance into millions.

2. Don't I have to use this money for my retirement?

When you reach a certain age, usually April 1 after you are 70 1/2, Uncle Sam says you must start taking some money out. (This is called your required beginning date.) But if you do not use all this money before you die, naming the right beneficiary can keep it growing tax-deferred for decades.

3. How much will I have to take out?

Calculating the amount you must withdraw each year (your required minimum distribution) is much easier now than it used to be. Each year, you divide the year-end value of your account by a life expectancy divisor from the Uniform Lifetime Table (provided by the IRS). The result is the minimum you must withdraw for that year. You can always take out more.

For example, the divisor at age 70 is 27.4. If your year-end account balance is \$100,000, you divide \$100,000 by 27.4, making your first required minimum distribution \$3,650. Each year the divisor is smaller, but it never goes to zero. Even at age 115 and older, the divisor is 1.9. "To recalculate or not recalculate" is no longer an issue. Everyone now gets the benefit of recalculating his/her expectancy.

4. Doesn't my beneficiary affect my distribution?

Not any longer. Now, almost everyone uses the same chart to calculate distributions, even if you have no beneficiary. After you die, distributions are based on your beneficiary's life expectancy (or the rest of your life expectancy if you die without one.) Naming the right beneficiary is still critical to getting the most tax-deferred growth. That's much easier to do now, because you are no longer locked into the beneficiary you name when you take your first distribution.

5. Whom can I name as beneficiary?

You have five basic options: your spouse, if married; your children, grandchildren or other individuals; a trust; a charity; or some combination of the above.

6. Option 1: Spouse

Most married people name their spouse as beneficiary. That's because 1) the money will be available to provide for the surviving spouse and 2) the spousal rollover option can provide many more years of tax-deferred growth.

Also, if your spouse is more than ten years younger than you are, you can use a different life expectancy chart that makes your required distributions even less. (This lets the tax-deferred growth continue longer on more money.)

7. How does the spousal rollover option work?

If you die first, your surviving spouse can "roll over" your tax-deferred account into his/her own IRA, further delaying income taxes until he/she must start taking required minimum distributions on April 1 after age 70 1/2.

When your spouse does the rollover, he/she must name a new beneficiary, preferably someone much younger, as your children and/or grandchildren would be. After your spouse dies, the beneficiary's actual life expectancy can be used for the remaining required minimum distributions. The results, shown in the chart below, can be phenomenal.

Gregorek and Associates PLLC

10604 NE 38th Place, Suite 225
Kirkland, Washington 98033

Phone: 425-880-9066

Email: info@rjglegal.com

Website: www.rjglegal.com

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For example, let's say your grandson is 20 when he inherits a \$100,000 IRA from your spouse. Over the next 63 years (the life expectancy of a 20-year-old), the \$100,000 IRA can provide him with over \$1.7 million in income!

Under current IRS policy, your spouse can do this rollover and stretch out the IRA even if you had started taking required minimum distributions before you died.

TOTAL INCOME FROM IRA OVER BENEFICIARY'S LIFETIME*

Age 20, Life Expectancy 63.0 Years

Value of \$50,000 IRA When Inherited by Beneficiary = \$882,865

Value of \$100,000 IRA When Inherited by Beneficiary = \$1,765,731

Value of \$500,000 IRA When Inherited by Beneficiary = \$8,828,658

Age 30, Life Expectancy 53.3 Years

Value of \$50,000 IRA When Inherited by Beneficiary = \$526,612

Value of \$100,000 IRA When Inherited by Beneficiary = \$1,053,225

Value of \$500,000 IRA When Inherited by Beneficiary = \$5,266,128

Age 40, Life Expectancy 43.6 Years

Value of \$50,000 IRA When Inherited by Beneficiary = \$321,210

Value of \$100,000 IRA When Inherited by Beneficiary = \$642,421

Value of \$500,000 IRA When Inherited by Beneficiary = \$3,212,106

Age 50, Life Expectancy 34.2 Years

Value of \$50,000 IRA When Inherited by Beneficiary = \$201,067

Value of \$100,000 IRA When Inherited by Beneficiary = \$402,134

Value of \$500,000 IRA When Inherited by Beneficiary = \$2,010,671

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** Assumptions: 7% annual return; only required minimum distributions withdrawn. Income subject to income taxes.*

8. What happens if my spouse dies first?

If you don't remarry, you lose the rollover option. This used to be a problem, because distributions after your death would still be based on your and your deceased spouse's life expectancies. But now you can name a new beneficiary, and after you die the distributions will be based on the new beneficiary's life expectancy.

9. Are there any disadvantages of naming my spouse?

Your spouse will have full control of this money after you die and is under no obligation to follow your wishes. This may not be what you want, especially if you have children from a previous marriage or feel that your spouse may be too easily influenced by others after you're gone.

Also, if your spouse becomes incapacitated, the court could take control of this money. It could be lost to your spouse's creditors. And, finally, naming your spouse as beneficiary can cause your family to pay too much in estate taxes. (More about this later.) If any of this concerns you, keep reading.

10. Option 2: Children, Grandchildren, Others

If your spouse will have plenty of assets after you die, if you have reason to believe your spouse will die before you, or if you are not married, you could name your children, grandchildren or other individuals as beneficiary(ies). Because the distributions can be paid over your beneficiary's life expectancy after you die, the tax-deferred growth can continue even without the spousal rollover.

11. Are there any disadvantages?

Anytime you name an individual as beneficiary, you lose control. After you die, your beneficiary can do whatever he/she wants with this money, including cashing out the entire

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account and destroying your carefully made plans for long-term, tax-deferred growth. The money could also be available to the beneficiary's creditors, spouses and ex-spouse(s). And there is the risk of court interference at incapacity. If any of this concerns you, consider using a trust.

12. Option 3: Trusts

Naming a trust as beneficiary will give you maximum control over your tax-deferred money after you die. That's because the distributions will be paid not to an individual, but into a trust that contains your written instructions stating who will receive this money and when.

For example, your trust could provide income to your surviving spouse for as long as he or she lives. Then, after your spouse dies, the income could go to someone else. The trust could even provide periodic income to your children or grandchildren, keeping the rest safe from irresponsible spending and/or creditors.

While you are living, the required minimum distributions will still be paid to you over your life expectancy. After you die, the required distributions can be paid to the trust over the life expectancy of the oldest beneficiary of the trust.

The trustee can withdraw more money if needed to follow your instructions, but the rest can stay in the account and continue to grow tax-deferred. You can name anyone as trustee, but many people name a bank or trust company, especially if the trust will exist for a long period of time.

13. Are there any disadvantages?

You will not be able to provide for your spouse and stretch out the tax-deferred growth beyond your spouse's actual life expectancy. That's because you must use the life expectancy of the oldest beneficiary of the trust which, in this case, would probably be your spouse.

Also, many trusts pay income taxes at a higher rate than most individuals, but this only applies to income that stays in the trust. Distributions from your tax-deferred account that are paid to the trust are subject to income taxes and if the money stays in the trust, the higher tax rates would apply. But usually this is not a problem because the trustee has authority to

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distribute the money to the beneficiaries of the trust, who pay the income taxes at their own rates.

Finally, the trust must meet certain IRS requirements, including that it is a valid trust under state law. It is advantageous to create an irrevocable Retirement Benefit Trust, also called a Stand-alone Retirement Trust, and to name this trust as the beneficiary on your beneficiary designation form.

14. Option 4: Charity

If you are planning to leave an asset to charity after you die, a tax-deferred account can be an excellent one to use. That's because the charity will pay no income taxes when it receives the money, and the account will not be included in your taxable estate when you die, reducing the amount your family may have to pay in estate taxes. (More later.)

15. Option 5. Some or All of the Above

You don't have to choose just one of these options. You can divide a large IRA into several smaller ones and name a different beneficiary for each one. (If your money is in an employer's plan, you can roll it into an IRA and then split it.)

If you name several beneficiaries for one IRA, the oldest one's life expectancy will determine the payout after you die. But with separate IRAs (one for each beneficiary), each life expectancy will be used, providing the maximum stretch out.

This is especially important if a charity is involved. It has a life expectancy of zero, so the IRS would consider it the oldest beneficiary. Depending on when you die, this could cause the entire IRA to be paid out in just five years.

If you divide your IRA now, you will need to calculate a distribution for each one, but it can be worth the trouble. However, you can also “wait-and-see” because under the new rules, your IRA can be divided even after you die.

16. What are estate taxes and why should I care?

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Estate taxes are different from, and in addition to, income taxes. When you die, your estate must pay estate taxes if its net value (including your tax-deferred retirement accounts) is more than the amount exempt at that time. The federal exemption is currently \$5.49 million (for deaths during 2017 - the amount adjusts annually for inflation under current law). Every dollar over the exempt amount is taxed at 40%. Some states also have their own estate/inheritance tax, so your estate could be exempt from federal tax but not from state tax.

Estate taxes must be paid in cash, usually within nine months of your death. If money must be withdrawn from a tax-deferred account to pay the estate taxes, the result can be disastrous - because income taxes must be paid on the money that is withdrawn.

17. What can I do about estate taxes?

You can reduce your taxable estate by giving some assets to your loved ones now, often at discounted values. You can buy life insurance to pay estate taxes at a reduced cost. And, if you are married, make sure you use both your estate tax exemptions.

There are two ways to use both spouses' estate tax exemptions: (1) "portability" or (2) traditional trust planning. When one spouse dies, "portability" permits the executor of the estate to transfer any unused exemption of the deceased spouse to the surviving spouse. But potential problems remain. For example, say Sue marries Tom after Bob dies; if Tom dies before Sue, she will lose all of Bob's unused exemption. In addition, by leaving everything to Sue, Bob has no control over his share of their estate; Sue can do whatever she wants with the assets, including disinheriting Bob's children from a previous marriage. Also, an estate tax return must be filed, generally within 9 months of death, to use portability. For these and other reasons, traditional trust planning, which uses both spouses' estate tax exemptions, remains an attractive option for most married couples.

18. How can splitting my IRA help?

Any assets you own, including a tax-deferred account, that you leave to anyone other than your spouse (your children, grandchildren or a trust) can use your exemption. Splitting a large IRA into smaller ones will make this easier to do.

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19. What if I'm not married?

If you are single, naming your beneficiary(ies) will be less complicated because you have just one estate tax exemption and there will be no spousal rollover option to consider.

20. When can I change my beneficiary?

You can change your beneficiary at any time while you are living, and the distributions after you die will be paid over that beneficiary's life expectancy (unless they cash out).

It is very important to name both primary and contingent beneficiaries while you are living to allow for greater flexibility and "clean up" after your death. For example, your spouse could disclaim some benefits so a grandchild could inherit. No new beneficiaries can be added after you die (unless your spouse names new ones with a rollover), so make sure you include all appropriate ones.

Some employer-sponsored plans (401(k), pension and profit sharing plans, etc.) have restrictions on beneficiary distribution options. Now, any beneficiary may now inherit employer plan assets and roll them into an IRA in the name of the decedent, continuing the tax-deferred growth over the beneficiary's own life expectancy. Of course, some restrictions apply, so always check with your attorney and financial advisor before completing any paperwork.

If your plan will not let you do what you want, rolling your account into an IRA will usually give you more options. If your money is already in an IRA and the institution will not agree to your wishes, move your IRA to one that will.

21. What about a Roth IRA?

If you qualify, you may want to convert some or all of your tax-deferred money into a Roth IRA, but you'll have to pay taxes on the amount you convert. Also, if you qualify, you can make after-tax contributions to a Roth IRA.

Unlike a traditional IRA that requires you to start taking money out on April 1 after age 70 1/2, there are no minimum distributions required during your lifetime with a Roth IRA. And, generally, after five years or age 59 1/2 (whichever is later), all withdrawals are income tax-free. So you can leave your money there, growing tax-free, for as long as you wish.

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You can stretch out a Roth IRA just like a regular IRA. After you die, distributions can be paid over the actual life expectancy of your beneficiary. Your spouse can even do a rollover and name a new beneficiary. And, remember, all distributions to your beneficiaries will be income tax-free.

22. Do I need professional assistance?

Yes. Even though the rules are now simpler, they are still loaded with potentially devastating tax traps and penalties. Make sure you get expert advice, regardless of the amount in tax-deferred plans or if the estate is large enough to pay estate taxes.

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