Know the rules before listing beneficiaries to IRA account

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As the baby boomers retire, they are the first generation that will retire with large IRA accounts. When the boomers do their estate planning, one of the considerations in such planning is who to name the beneficiary of the large IRA account. One consideration for such a choice is certainly to try to minimize the tax burden on their estates.

Most boomers do not realize that the money that they have saved in their employee benefit accounts or IRA accounts are subject to income taxes by the recipient, as well as estate taxes on the account upon the death of the IRA owner. If both the estate of the IRA holder and the recipient of the balance of the account are in the maximum tax brackets for federal estate taxes and income taxes, the employee benefit account or IRA account could be taxed up to 85 percent of the total value of that account.

One option is to leave the IRA (or separate the IRA into several IRA accounts and leave one of the IRA accounts) directly to charity upon the death of the IRA holder. Under the current tax law, the estate should be entitled to a charitable tax deduction for the amount in the account.

In order to reduce or defer income tax and protect an IRA account from creditors after the owner's death, the best thing to do may be to leave the account to a trust. Since so many beneficiaries are targets of potential creditors from failed marriages to failed businesses to unpaid creditor issues, the IRA owner may well wish to protect the beneficiary from the loss of the IRA account to these creditors by leaving this IRA to a trust.

With respect to reducing or further deferring income taxes on the account, the key is that an IRA trust must be structured such that the required distributions are stretched out over time, allowing a beneficiary to defer income taxes. The goal should be to spread the distributions over the life expectancy of the youngest beneficiary, which should allow for the longest deferral time.

The IRA owner can designate either a conduit trust or an accumulation trust as the "designated beneficiary" of the IRA account. A conduit trust automatically qualifies as a designated beneficiary under the IRS safe harbor provisions. If you have a beneficiary who has a gambling addiction or existing known creditors, a conduit trust may not be adequate to protect the beneficiary. Instead, your choice might be an accumulation trust, in which case you need to find an attorney who knows the rules, i.e. the trust must be valid under state law, be irrevocable upon death, have identifiable beneficiaries and be provided to the plan administrator by Oct. 31 following the year of death.

The biggest problem is the beneficiary being identifiable. If any beneficiary of an accumulation trust is a charity, the trust cannot stretch out the distributions over time, as the IRS deems that charities do not have a life expectancy. If the named beneficiary holds a power of appointment under the trust, the trust also fails to qualify. It is more likely to have an accumulation trust qualify if the IRA is left to a standalone accumulation trust which becomes irrevocable at the owner's death, preferably a trust for one beneficiary.

Leaving an IRA account to someone whom the owner wants to protect is a whole lot more than filling out a beneficiary designation form. It requires an estate planner with expertise in the complex rules that the IRS has concerning IRA account beneficiary designations.

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