Choosing an IRA beneficiary

Wealth Management

Who should be the beneficiary of your IRA? The simple answer to this question is the person or entity to whom you wish to give your money. However, it is important to look beyond the simple answer to determine the best way to distribute your assets according to your wishes.

Four reasons why it is important to name a beneficiary on your IRA

1. Your beneficiary designation determines how your IRA assets will be distributed when you pass away.
2. Naming a beneficiary will help mitigate the risks of leaving your assets to unintended individuals or entities.
3. Your beneficiary designation may impact the distribution options available to your heirs.
4. Failing to name a beneficiary may result in unnecessary probate expenses or delays.

If you do not name a beneficiary for your IRA assets, your IRA custodian, through an IRA agreement, will provide for a "default" beneficiary. This default beneficiary may not be your intended beneficiary, may expose your heirs to an unnecessarily large tax bill and may cost them years of tax-deferred growth.

The default beneficiary on your RBC Wealth Management IRA is your spouse. If you do not have a spouse, the default beneficiary is your estate.

You can, and usually should, name both primary and contingent beneficiaries for your IRA. If you name multiple primary or contingent beneficiaries, you should indicate how much of your IRA each beneficiary should receive. As an account owner, you may change your beneficiaries as often as you like. Keep in mind: You can make different beneficiary designations on each of your retirement accounts.

Types of beneficiaries

A primary beneficiary will be the first in line to receive your IRA assets. Contingent beneficiaries are also important because they will receive your assets if none of your primary beneficiaries survive you or they disclaim the assets.

A beneficiary can disclaim all or a portion of their inherited IRA benefit. By disclaiming, the beneficiary is giving up rights to the assets, which then pass to the other beneficiaries. A valid disclaimer must meet specific requirements and generally must be executed within nine months of an account owner's death.

There are three types of beneficiaries:

1. Eligible designated beneficiary
2. Designated beneficiary
3. Non-designated beneficiary

Beneficiary designations, for distribution purposes, do not become fixed until September 30 of the year after an account owner's death. No new beneficiaries can be named after the death of an account owner. But beneficiaries who disclaim, or have had their benefits paid out to them in full prior to this date, will not be considered when determining death distribution options.

Eligible designated beneficiaries

Under the first SECURE Act of 2019, eligible designated beneficiaries include spouses; minor children of the original account owner until they reach the age of majority (21 years of age); beneficiaries who are disabled, chronically ill, or not more than 10 years younger than the original account owner; and certain trusts. Eligible designated beneficiaries are still able to "stretch" the IRA over their own life expectancy rather than being subject to the SECURE Act's new 10-year rule.

When a surviving spouse is the eligible designated beneficiary of an IRA, they can choose to take ownership of the IRA by transferring it into an IRA in their own name. This gives them the right to name their own beneficiaries, delay distributions until age 73 and potentially make additional contributions to the IRA. However, the IRA will be subject to all traditional IRA rules, including the additional 10% penalty for distributions taken prior to age 59½.

A spouse beneficiary also has the right to leave inherited IRA assets in "decedent beneficiary" status, and doesn't need to take the required minimum distributions until the original owner would have reached age 73. If a surviving spouse is under age 59½ at the time of inheritance, this could be an attractive option, because distributions may be made from the decedent beneficiary IRA free of the 10% penalty that would otherwise generally apply to premature withdrawals taken from an IRA in the surviving spouse's own name.

SECURE 2.0 Act modifies rules for spouse beneficiaries

On December 29, 2022, as part of the Consolidated Appropriations Act of 2023 (P.L. 117-328), President Biden signed the SECURE 2.0 Act into law.

Section 327 of the SECURE 2.0 Act (effective in 2024) provides for additional RMD calculation methods for surviving spouses previously only available upon timely transfers between an inherited IRA and a traditional IRA. If a decedent is younger than the surviving spouse beneficiary, it may be beneficial for the surviving spouse to assume assets into an inherited IRA where there is no RMD requirement until the year the decedent would have reached age 73. This strategy, known as "spousal delay," can help delay RMDs for surviving spouses where, if they would have assumed the assets as their own in a traditional IRA, they would begin RMDs on those inherited assets in the year following death.

If you are employing this "spousal delay" strategy, it is important that, before January 1 of the year in which the decedent would have reached 73, you transfer the inherited IRA proceeds to a traditional IRA in the sole name of the surviving spouse. This is so when RMDs are required, they are based on the Uniform Lifetime Table (Table III). If you do not timely transfer the inherited IRA to a traditional IRA, the first year RMD will be based on the more accelerated Single Life Table (Table I).

Section 327 (effective 2024) removes the onerous timing component of transferring assets and allows for the surviving spouses inherited IRA RMD to be based on the Uniform Lifetime Table (Table III) and not the accelerated Single Life Table (Table I). Section 327 of the Act continues this same treatment (if the surviving spouse assumes as an inherited IRA, it is treated as assuming in a traditional IRA) so that in the event of death of a surviving spouse who assumed assets into an inherited IRA, the beneficiaries are treated as original beneficiaries, not successor or subsequent beneficiaries, therefore affording them SECURE Act distribution rules.

Designated beneficiaries

If non-spouse individuals are named as beneficiaries, they will be required to take distributions under the SECURE Act's new 10-year rules. A separate account for each beneficiary needs to be established by no later than December 31 of the year after the original IRA owner's death.

Under the SECURE Act, non-spouse designated beneficiaries who are not EDBs are required to withdraw all assets from the inherited IRA within 10 years following the death of the original account owner.

To determine whether or not annual RMDs are additionally required during this 10-year period, review the decedents age at death, namely, either pre-RBD or post-RBD (required beginning date). The RBD is the date that an IRA owner must begin taking required minimum distributions (RMDs)—specifically, April 1 of the calendar year after an account owner reaches age 73.

For pre-RBD decedents: if a non-spouse designated beneficiary is named and is not considered an EDB, they will be subject to the SECURE Act's 10-year rule, where annual distributions are not required. The SECURE Act's 10-year rule stipulates that the beneficiary IRA account must be fully withdrawn within 10 years and by no later than December 31 of the tenth year after the original IRA owner died.

For post-RBD decedents: if a non-spouse designated beneficiary is named as the beneficiary and is not considered an EDB, they will be subject to the SECURE Act's 10-year rule, where annual required minimum distributions are required based on the beneficiary's actuarial single-declining life expectancy (employing IRS Table I). In addition, all assets must be withdrawn by no later than December 31 of the tenth year after the original IRA owner died.

A beneficiary has the right to take more than the minimum in any given year, including the right to take a complete distribution. All distributions are taxed at a beneficiary's ordinary income tax rate and are not subject to a 10% premature distribution penalty, regardless of a beneficiary's age.

Upon inheriting an IRA, a beneficiary can name subsequent or successor beneficiaries. If a beneficiary dies before the assets are fully distributed, your subsequent beneficiaries may take a lump sum distribution of the remaining assets if they so desire.

Otherwise, the successor beneficiaries of the original beneficiary are generally subject to the 10-year rule.

Successor beneficiaries of a pre-SECURE Act decedent beneficiary are generally subject to the SECURE Act's 10-year rule. However, since the first pre-SECURE Act beneficiary was subject to annual RMDs, the successor or subsequent beneficiary will also be subject to RMDs during this 10-year period. The RMD requirements during this new 10-year period will continue to be based on the first beneficiary's life expectancy.

Successor beneficiaries of a post-SECURE Act decedent beneficiary would "step into the shoes" of the first beneficiary's 10-year rule finishing out their required distribution period, while additionally satisfying RMDs based on the first beneficiaries life expectancy.

Note: If the original pre-SECURE Act beneficiary also died before 2020, then the successor beneficiary may continue taking RMDs according to the schedule of the remaining single life expectancy of the first beneficiary.

Additional beneficiary election

When designating non-spouse beneficiaries, there are options available to you regarding the methods of distributing retirement assets should one of the beneficiaries predecease you:

- Pro rata designation: Your IRA assets are divided among the surviving beneficiaries only, with no representation by the descendants of the deceased beneficiary. This is commonly referred to as a "pro rata" beneficiary designation.
- Per stirpes designation: "Per stirpes" is a Latin phrase which means "by the branch in equal shares." If a beneficiary predeceases an account owner, that beneficiary's share goes to his or her lineal descendants. The descendants do not need to be individually named on the beneficiary form. This can be an advantage if the beneficiaries are young and are still having children. The beneficiary forms would not need to be updated each time a child is born.

The following scenarios will help illustrate how each is applied:

Yvette has an IRA with three beneficiaries: Ahmet, Isla and Mia. Each of Yvette's beneficiaries is to inherit equally. Ahmet, Isla and Mia each have two children. One of Yvette's beneficiaries, Isla, predeceases her. How does the beneficiary designation affect the children's inheritance?

- In the standard pro rata designation, Isla's share will go to the remaining named primary beneficiaries. Her two siblings, Ahmet and Mia, will each inherit half of Yvette's IRA.
- If Yvette's IRA passes per stirpes, Isla's one-third share will go to her children equally (one-sixth each) and her two siblings each get their one-third. Isla's share of the IRA stays with her family, namely, with her own children.

To provide you with greater flexibility in your estate planning, the RBC Wealth Management IRA agreements allow you to choose between a standard "pro rata" designation (this is the default under our agreements) and a "per stirpes" designation when naming non-spouse beneficiaries.

Non-designated beneficiaries

Under the new SECURE Act, non-designated beneficiaries include charities, the original account owner's estate, and non-qualified or non-look-through trusts. Entities may be entitled to IRA proceeds as beneficiaries, but they cannot be considered "designated" beneficiaries because they are not people and, therefore, do not have a life expectancy. As a result, they are referred to as "non-designated" beneficiaries. If one of these entities is listed as the IRA beneficiary and an account owner dies pre-RBD, the IRA must be distributed within five years. If the death was post-RBD, the IRA must be distributed to the beneficiaries over the account owner's remaining single life expectancy, commencing in their year of death.

Estate

Leaving your IRA to your estate has the additional disadvantage of subjecting the IRA assets to probate. Probate can be expensive, time consuming and leave your assets inaccessible for a period of time. Also, it is a matter of public record. Even if your spouse or children are the heirs of your estate, they will not have the same distribution options available to them as they would if they had been the actual designated beneficiary(ies) of your IRA. Being forced to withdraw the money at a faster rate could severely penalize a beneficiary who would have kept the assets growing tax-deferred in an IRA, at least for the duration of the new 10-year distribution period.

Organization

Naming a charity as beneficiary will remove the IRA assets from your taxable estate for estate tax purposes. Also, neither your estate nor heirs will be subject to income taxes on the amount the charity receives.

If a charity or an estate is a beneficiary of only a portion of an IRA, the other beneficiary(ies) of the IRA may be the "designated" beneficiary(ies) if, by no later than September 30 of the year after the IRA owner's death:

- The charity or estate "cashes out" its share of the IRA
- The IRA is divided into separate accounts for each beneficiary

Trust

A trust as beneficiary can be a useful estate-planning tool if properly structured. A trust, as beneficiary, can provide control over how IRA assets are managed and distributed after an account owner's death.

Even though a trust is a non-living entity, a special rule may be applied to certain trusts, notably, special needs trusts established for the benefit of either a disabled individual, as defined under Tax Code Section 72(m)(7), or a chronically ill individual, as defined under tax Code Section 7702B(c)(2). Under this rule, the special needs trust beneficiary will be treated as the eligible designated beneficiary and be permitted to "stretch" RMDs over their own single-declining life expectancy if the following regulatory requirements are met to also create a valid look-through trust:

- The trust is valid under state law and is irrevocable or will, by its terms, become irrevocable upon the death of the IRA owner
- The trust beneficiaries must be individuals clearly identifiable (from the trust document) as designated beneficiaries as of September 30 following the year of the IRA owner's death
- The IRA custodian is provided with a list of beneficiaries (including contingent remainder beneficiaries) along with a written certification that the list is accurate and the trust is a valid look-through trust by meeting the above requirements by October 31 of the year following the IRA owner's death
- A copy of the trust instrument is provided to the IRA custodian upon demand

Additional guidance from the IRS/Department of Treasury is still needed regarding trusts named as beneficiaries of IRAs which name the three other categories of eligible designated beneficiaries, namely, a surviving spouse, a minor-aged child until the age of majority and an individual not greater than ten (10) years younger than the original IRA owner. These trusts may also be permitted to allow such an eligible designated beneficiary to "stretch" RMDs over their own remaining single life expectancy.

Conclusion

Your beneficiary designation can make a significant difference in your IRA's effectiveness over the long run. It is important to periodically review your beneficiary designations to confirm that they meet your wealth planning objectives. Your RBC Wealth Management financial advisor can work with you and your independent tax/legal advisor to maximize the benefits of your IRA for you and your beneficiaries.

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