RETHINKING BENEFICIARIES FOR YOUR ESTATE

Given recent legislative changes, you might want to review, and potentially update, your estate plan. The SECURE Act of 2019 has changed how efficiently you can leave IRAs to certain heirs including children, family members or other individuals. Taking time to review your estate plan can help ensure your wishes match your plan.

Prior to the SECURE Act's passage, when an individual passed away and left his or her IRA to an heir, that heir could take distributions from the IRA spaced out over his or her lifetime based on age. This strategy was commonly known as the "Stretch IRA." Under current law, if you leave your IRA to non-spousal beneficiaries, the full balance of the IRA must be distributed to the beneficiary or beneficiaries within 10 years following your death.[1] If your IRA represents a major portion of your assets, that could create a tax burden on your heirs during their prime earning years when they're in higher tax brackets. Below are some factors to think about when selecting a beneficiary for your IRA.

IRA Left to a Spouse

It's important to note that, under current tax code, from the perspective of tax efficiency, leaving an IRA to a spouse is a reasonable way to transfer assets in the event of your passing. Your spouse can roll over your IRA into their own account, keep the account by designating themselves as the account owner, or leave the account as is while remaining a beneficiary of the account. These options apply to a spouse, and similar rules exist regarding leaving your IRA to children under age 18, individuals who are disabled or chronically ill, or anyone who is not more than 10 years younger than you when you die.[1] From a tax perspective, it might make sense to leave assets to individuals in these categories, but there are other important factors to consider in making that decision and how your IRA fits into your overall estate plan.

IRA Left to a Charity

Even before the SECURE Act changes, leaving all or a portion of your IRA to charity was, and still is, a great way to leave a legacy if philanthropy is important to you. The reason for that is because certain assets that you may leave to your heirs, including a home, personal property or taxable investment accounts, will get a step-up in their tax basis to a value equivalent to the day you passed away. An IRA, by contrast, will provide taxable income to individual beneficiaries.

Your heir could immediately sell the inherited asset without recognizing any kind of capital gains tax, making those assets more preferable for a beneficiary from a tax perspective. Conversely, leaving an IRA to an heir other than your spouse will cause that beneficiary to take the full balance of the IRA within 10 years, potentially paying a significant amount of income tax in the process. What seems like leaving a $1,000,000 IRA to a child may actually come out to be somewhere around $600,000 after taxes are paid.[2]

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Rather than subject your heirs to income taxes from an inherited IRA, if you're planning to give a portion of your estate to charity, give some serious thought to leaving all or a portion of your IRA to charity and dividing other assets among your heirs.

IRA Left to a Trust

The final type of beneficiary for an IRA is a trust. While historically this was a decent option for leaving an IRA to certain types of beneficiaries, this strategy currently only makes sense in very specific scenarios. The challenge with leaving any asset to a trust is that trusts have their own income tax brackets that are much more aggressive compared to those of individuals. However, trusts only pay taxes on income that's retained in the trust, meaning income distributions made to the trust beneficiaries are not taxed at the trust level but rather at the beneficiary level on their own personal tax return.

Trusts that are the beneficiary of an IRAs are typically referred to as either "conduit" or "accumulation" trusts. A conduit trust will take whatever distributions are made from the IRA and pass it along directly to the beneficiary. In doing so, the amount distributed is taxed to the beneficiary not the trust.

An accumulation trust does the opposite, because it holds distributions made by the IRA within the confines of the trust, thereby subjecting that income to trust taxation.[3]

So why would anyone choose an accumulation trust over a conduit trust and pay all that tax? In instances in which the beneficiary of a trust is a minor or has a hard time managing money, an accumulation trust might make sense to essentially protect that beneficiary from receiving large amounts of money all at once. The cost of that control, however, is a large tax burden, so if this strategy is chosen it's important to consider any alternatives that may be available.

Consult With Your Advisor

Consider consulting with your advisor as you navigate your financial future and how you will leave assets to your beneficiaries. At Mariner Wealth Advisors, we have an experienced estate and trust team who will collaborate with your advisor on ways to structure your IRA and other assets you wish to leave to your beneficiaries.

[1] "Retirement Topics: Required Minimum Distributions," irs.gov.
[2] "How to Reduce the Tax Bill on Your IRA to $0," irahelp.com.
[3] "Insight: Planning Considerations Regarding the SECURE Act," bloombergtax.com.

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