

4 Mistakes Clients Make With Roth IRAs and Their Estate

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Roth IRAs are popular accounts for investors to leave to their heirs because of these accounts' tax-free status and lack of required minimum distributions (RMDs) during the original owner's lifetime.

Roth contributions are made with after-tax money, and any distributions you take are tax-free as long as you are at least 59½ years old and have had a Roth IRA account for at least five years.

Your beneficiaries can continue to enjoy this tax-free status for a period of time after they inherit the account. However, they will not be able to maximize their tax savings with the Roth account unless it's passed down in the correct manner. Here's what you need to know.

Key Takeaways

- By leaving your Roth IRA to your heirs, you can provide them with tax-free income for years to come.
- Make sure you designate your beneficiaries when you open the account and change them in the future if necessary.

- If you're planning to use a trust, consult a financial or legal professional who's familiar with the rules.

A Tax-Free Legacy

Roth IRAs can provide beneficiaries with a lasting, tax-free gift. Scott Sparks, a wealth management advisor with Northwestern Mutual in Denver, Colo., told *The Wall Street Journal*, “from a legacy giving standpoint, it’s one of the more beneficial gifts that a person can pass on to the next generation.” With that and other advantages for the account holders themselves, it's no wonder that Roth IRAs have become one of the most popular ways to save for retirement.

Pitfalls to Avoid

There are also some potential mistakes you'll need to be aware of and avoid making if your goal is to pass your account down to the next generation. According to financial advisors, the most common errors include the following.

Failing to name a beneficiary

This is probably the most obvious error that a Roth IRA owner can make. If you don't list a beneficiary, the account transfer may be determined by your will, which can be complicated, costly, and time-consuming. Roth IRA owners should name their beneficiaries as soon as they open the account, and change them, as needed, in the future.

This will ensure that the money in the account goes to the person for whom it was intended. Most financial institutions have separate Roth IRA beneficiary forms that you'll need to complete.

Choosing the wrong beneficiary

Married couples usually list each other as the primary beneficiaries of their Roth accounts. When one spouse dies, the other spouse inherits the money. Then it is passed on again to another beneficiary upon the death of the second spouse.

Thanks to the SECURE Act, most non-spouse beneficiaries can stretch the distributions out over a decade. Certain eligible designated beneficiaries can stretch distributions even further. In addition to surviving spouses, these include disabled or chronically ill individuals, individuals who are not more than 10 years younger than the IRA owner, or a child of the IRA owner who has not reached the age of majority.

Bobbi Bierhals, a partner at the law firm McDermott Will & Emery in Chicago, told *The Wall Street Journal* that “by far the biggest benefits of the Roth IRA after death are tax-free growth in the account and the fact that distributions can be made without income-tax consequences.”

However, leaving a Roth to a younger beneficiary may trigger estate or generation-skipping transfer taxes in some cases, so it's worth consulting a financial professional who is familiar with the rules.

Establishing a trust incorrectly

Pouring your Roth assets into a trust after your death can be a good idea—as long as you've chosen the right type of trust and your beneficiaries are specifically named in the trust. A conduit trust takes out the beneficiary's required minimum distributions (RMDs) each year. With a conduit trust, the individual or entity designated as the trust beneficiary is treated as the direct beneficiary of the Roth IRA.

However, the trust documents need to spell out all of the details pertaining to the distributions and beneficiaries. Otherwise, the IRS may require that the trust disperse all of the income in the account within five years, rather than the typical 10 years. This is another area where seeking professional help is advisable.

Let your beneficiaries know that although you didn't need to take required minimum distributions from your Roth IRA, they will generally have to.

Neglecting to take required minimum distributions (RMDs)

This is a mistake that beneficiaries can often make. Under the SECURE Act rules, most non-spouse beneficiaries have up to 10 years to fully disperse all funds in an inherited Roth IRA. There is no set RMD in any one year for these designated beneficiaries, and they may choose the frequency and timing of withdrawals. However, the account must be fully depleted by Dec. 31 of the tenth year following the account holder's death.

For those who fall into any eligible designated beneficiary category mentioned above, RMDs must begin as early as Dec. 31 of the year following the account holder's death. If the beneficiary fails to do this, there can be substantial tax penalties for failing to comply with the RMD rules.

What Happens If I Forget to Designate a Beneficiary on My Roth IRA?

If you fail to designate a beneficiary on your Roth IRA, the probate court will look to the designation in your will. If you do not have a will, state laws will determine the beneficiary of your Roth IRA, typically next of kin.

Will I Need to Update My Roth IRA Beneficiary With My Account Custodian After a Divorce?

Yes, you should update your Roth IRA beneficiary directly with your account custodian. Even if your divorce decree addresses your beneficiary situation, it's still important to go straight to the source. The beneficiary listed on your retirement account will be considered above any will or trust document.

How Can I Set Up a Trust to Ensure My Beneficiary Doesn't Squander Their Inheritance?

You can set up a conduit trust, which will identify annual distributions for the intended beneficiary. Post-SECURE Act, most beneficiaries will have to withdraw all funds within a 10-year period. This is true even if you have a trust doling the funds out over time. If your intended beneficiary does not fall into one of the eligible designated beneficiary categories, you should speak with a financial advisor on how to set up a trust to most effectively alleviate your concerns.