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Be Careful When Passing Down a Roth IRA

Roths are increasingly popular in legacy planning. But heirs won't reap full benefits if the account is passed down incorrectly

By ANNA PRIOR

By the end of 2015, Roth IRAs had accumulated an estimated $660 billion in assets, according to the Investment Company Institute. *ILLUSTRATION: JON KRAUSE FOR THE WALL STREET JOURNAL*

The allure of tax-free growth has made the Roth individual retirement account an increasingly popular investment vehicle to leave to children or other loved ones. But heirs won't reap the full benefit of a Roth if it isn't passed down correctly.

Roth IRAs are different from traditional IRAs in that contributions are made after taxes instead of before. Withdrawals from a Roth in existence for five years or more after age 59½ are income-tax-free, and beneficiaries of an inherited Roth also don't have to pay income taxes on withdrawals and additional growth in the account.

"From a legacy giving standpoint, it's one of the more beneficial gifts that a person can pass on to the next generation," says Scott Sparks, a wealth-management adviser with Northwestern Mutual based in Denver.

By the end of 2015, Roth IRAs had accumulated an estimated $660 billion in assets, up from $354.9 billion five years earlier, according to fund-industry trade group Investment Company Institute. But as they gain in popularity and more people are set to inherit them, experts say it's critical to avoid common mistakes that can knock the wind out of a Roth's sails.

Here are four common mistakes made when planning to pass along a Roth—and how to avoid them.

1. Not naming a beneficiary

It might seem obvious, but when planning to leave a Roth IRA to heirs, it is critical that the account holder actually name the beneficiaries.

That means account holders generally have to fill out forms in addition to their will, spelling out who—or what trust—is going to get the Roth when the account holder dies.

It is important to make sure the account is titled correctly. If a beneficiary is someone other than a spouse, for example, it must be made clear that the heir owns the Roth and that it was inherited from the original owner.

"You have to preserve the title," says Diana Zeydel, global chairman of the trusts and estates department at law firm Greenberg Traurig LLP in Miami. Otherwise, your heirs may not be permitted to stretch out required distributions across their life expectancy, which is what gives

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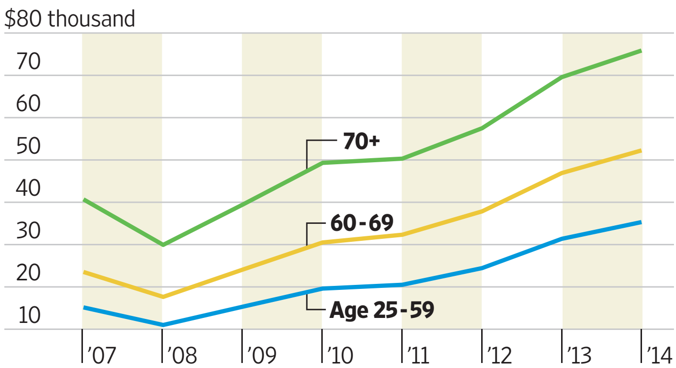
Account Amounts

Average Roth IRA balance for consistent Roth investors



Source: Investment Company Institute

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the remaining assets more time to grow tax-free.

"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," says Bobbi Bierhals, a partner at law firm McDermott Will & Emery in Chicago.

2. Choosing the wrong beneficiary

While it's common for Roth owners to choose their spouse as a beneficiary, experts say careful thought should be given as to any additional beneficiaries. (Once the spouse dies, for instance, the Roth can be passed along one more time to another beneficiary or group of beneficiaries.)

Choosing a grandchild or great-grandchild, to be the additional beneficiary can maximize the amount of time Roth assets have to grow income-tax-free.

Here's why: Roth beneficiaries who aren't spouses generally must begin taking annual required minimum distributions by Dec. 31 of the year following the year in which the account holder dies. However, they can use a formula set by the IRS to stretch these withdrawals over their life expectancy. The younger a beneficiary is, the longer his or her life expectancy is and the smaller the required minimum distribution is going to be.

"You can potentially stretch that income tax-free growth for 50, 60 or even 70 years," says Ms. Bierhals.

Keep in mind that leaving a Roth to a grandchild or great-grandchild could trigger estate and generation-skipping transfer tax for some, experts say.

3. Forgetting to take required minimum distributions

Unlike with traditional IRAs, owners of Roth IRAs don't have to take required minimum distributions, or RMDs, while they are living.

When spouses inherit Roths, they can roll the account into their own names and continue to defer RMDs, says Cathy Schnaubelt, a senior wealth strategist at Atlantic Trust in Houston. But a non-spouse heir or anyone who inherits the Roth from the spouse generally has to start taking annual distributions.

Heirs must be proactive about this, she says. Failing to take distributions as required by the IRS can result in the money having to be withdrawn in five years, depriving the beneficiary of a lifetime of tax-free growth.

"Brokerage houses don't always remind you of them," warns Boston-based CPA Scott Kaplowitch, so it's up to the heir to stay on top of RMDs.

4. Making mistakes with a trust

In some cases, especially if the beneficiaries are young, it might make sense to use a trust to pass along a Roth IRA to the next generation. But experts warn that this can open up a minefield of mistakes.

"Within the trust you have to have specific named beneficiaries [for the Roth], and it generally has to be what's called a conduit trust," says Ms. Schnaubelt. "That trust, then, has to make out the required minimum distributions every year."

Most situations will require very particular terms in the trust, says Ms. Bierhals, adding that "if you do it wrong, the IRS can cause you to distribute the entire IRA within five years."

Anna Prior is a writer in Michigan.

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