Estate Planning for IRAs: The Selection of a Traditional IRA Beneficiary

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Introduction

As Individual Retirement Accounts (IRAs) have become an increasingly popular retirement savings tool, it is important for professional advisors to understand their place in clients' estate plans. Issues that may shape the overall estate plan, such as addressing estate and income taxes, providing for children from a previous marriage or supporting a child with special needs, may also affect how an individual chooses to pass on IRA assets at death.

IRA owners have several options when designating a beneficiary, including their spouse or another individual, a trust, a charity or other entity, or some combination of these options. Because the rules for inheriting IRAs can be complex, professional advisors can help clients understand IRA distribution requirements and opportunities for beneficiaries to extend tax-deferred growth.

This brochure addresses issues estate-planning professionals should consider when helping their clients select a beneficiary for an IRA. While the focus will be on traditional IRAs administered under a standard traditional IRA agreement, professionals may also need to help clients with a Roth IRA to designate a beneficiary.

The discussion includes an overview of the types of beneficiaries and their payout options when inheriting IRA assets, with an emphasis on the "stretch" IRA strategy.

The information discussed in this brochure regarding required minimum distributions (RMDs) and the various beneficiary options, as well as estate-planning strategies sometimes used with IRAs, is current as of the publication date of this brochure. However, such information and strategies may be affected by changes through legislation or from IRS guidance, so practitioners should always consult current IRS regulations and publications when advising their clients.

IRA Beneficiary Designation Basics

As an estate-planning tool, beneficiary designation can be an efficient, cost-effective method for transferring assets at death. Assets go directly to the beneficiaries, avoiding a potentially lengthy probate process. Beneficiary designation typically takes precedence if there are any conflicting instructions in the client's will or trust document, so it's important that clients keep these documents aligned. For instance, if the client updates the will but forgets to change a beneficiary designation on the IRA, someone unintended may inherit the IRA.

IRA owners typically document their beneficiary selections on a beneficiary designation form, though the process may vary by IRA custodian. Some institutions allow IRA owners or their attorneys to submit a custom beneficiary designation to provide instructions for special situations. Clients should check the requirements with the IRA custodian.

If an IRA owner forgets to designate a beneficiary, the IRA may be distributed based on the default method outlined in the custodial agreement, or in accordance with state law, which may not match the original owner's wishes. The IRA may be included in the owner's estate at death, subjecting it to probate delays and costs. Additionally, beneficiaries' options for taking distributions may be limited, and they could potentially miss opportunities to extend tax deferral on the IRA. Consequently, IRA owners should name a beneficiary to avoid these potential issues and ensure their wishes for the IRA assets are followed.

Primary and Contingent Beneficiaries

There are two basic types of beneficiaries for an IRA: primary and contingent. The IRA owner should name one or more primary beneficiaries to inherit their IRA and at least one contingent, or successor, beneficiary in case a primary beneficiary predeceases the owner. The payout arrangement for contingent beneficiaries may depend on the terms of the IRA agreement or beneficiary designation form, so a careful review of those provisions is important. Some estate planners may prefer to draft a written document for the IRA custodian rather than rely on the custodian's beneficiary designation form.

Common Estate-planning Tools

A carefully planned estate strategy can give individuals control over providing financially for their families, businesses or charities after death. Account titling, beneficiary designations and estate-planning documents should be reviewed periodically to ensure they are up-to-date and aligned. The tools below may generally be used as part of an estate strategy, depending on state law.

Transfer on Death/Payable on Death (TOD/POD) – A contract between the owner and the entity holding the account that allows the distribution of assets to beneficiaries upon the owner's death. As with beneficiary designation, the assets will not have to go through the probate process. The agreement is account-specific and generally applies to the transfer of bank and brokerage accounts.

Beneficiary Designation – Similar to the TOD/POD process. At the owner's death, his or her assets pass directly to the beneficiaries named, and the account avoids the probate process. Assets such as retirement plans, IRAs, life insurance policies and annuities can pass at death via beneficiary designation.

Will – A legal document that names a party responsible for administering an individual's probate estate. A will also directs what should be done with the assets of the probate estate and allows an individual to name a legal guardian for his or her minor children or dependents. The will only applies to assets that pass through probate and therefore would not apply to assets passing via TOD, beneficiary designation or trust.

Trust – A legal arrangement in which the creator (grantor) of the trust transfers assets to a fiduciary (the trustee). The trustee holds the assets based on the terms of the trust document on behalf of the beneficiaries of the trust. Trusts may provide the most flexibility for meeting legacy goals, particularly if an individual wants control over taxes or the beneficiaries' use of funds. Since a trust is a legal entity, trust assets do not generally have to pass through the probate process.

Beneficiary Selection Considerations

For some clients, selecting an IRA beneficiary may be a simple matter, while others may have special estate-planning goals to consider. Professional advisors can help their clients develop an estate plan that meets their specific needs and also help them understand the opportunities for naming certain types of IRA beneficiaries, particularly a "designated beneficiary."

Designated Beneficiary Status and Stretching an IRA

Individuals can name any person or entity to receive the benefits of the IRA after their death. However, only certain beneficiaries can qualify as a "designated beneficiary," including a spouse, another individual or a qualifying trust (generally a valid irrevocable trust with only identifiable individuals as beneficiaries). The requirements of a qualifying trust can be complex and are discussed in more detail on page 5.

One advantage for designated beneficiaries is that they can generally stretch out RMD payments from an inherited IRA. This means RMDs are calculated based on the beneficiary's life expectancy, not the deceased owner's, using the IRS' Single Life Expectancy Table. This can be advantageous when the beneficiary wants to continue tax deferral or a spouse beneficiary under the age of 59½ wants to take penalty-free withdrawals.

Benefits of Stretch IRAs

Traditional IRAs are tax-deferred accounts, so pre-tax contributions and earnings are generally not subject to income tax until distributions are taken. IRA owners typically must begin taking RMDs in the year they turn 70½ and each subsequent year. Following the IRA owner's death, the beneficiary's RMD is based on the following:

- Identity of the beneficiary (spouse, non-spouse, trust, etc.)
- Whether the beneficiary qualifies as a designated beneficiary
- Whether the IRA owner died before or after the Required Beginning Date (RBD), April 1 of the year after the account owner turns 70½

A beneficiary of an inherited IRA can generally take more than the RMD amount, including a withdrawal of the entire account, but from an income tax standpoint, many beneficiaries may prefer the smallest possible payment. A stretch IRA is a strategy that may allow a beneficiary to extend required distributions over a longer time based on his or her own life expectancy. This may limit a beneficiary's taxable income from the IRA in a given year and allow the IRA to continue growing tax deferred over several years.

Entities such as a non-qualifying trust, a charity or an estate do not qualify as a designated beneficiary. Their distribution options are more limited and are discussed on page 16.

The final determination of the beneficiary's identity and designated beneficiary status is generally not required until Sept. 30 of the year following the client's death (the "designation date"). The period before the designation date may provide the beneficiary and his or her professional advisors a valuable post-mortem planning opportunity. In situations with multiple beneficiaries, distributions may be used to satisfy or eliminate a certain beneficiary that cannot qualify as a designated beneficiary, allowing the remaining beneficiaries to benefit from further tax-deferral opportunities. For example, estate-planning techniques such as a qualified disclaimer may be used to allow certain beneficiaries to give up their rights to the IRA assets, providing a more tax-efficient distribution of the IRA to the other beneficiaries. If a trust is named as beneficiary, this period may provide the trustee with an opportunity to use distributions or estate-planning techniques that allow the trust to become a qualified trust.

Naming an Individual as Beneficiary

For most married people, the spouse is usually the first choice as beneficiary. A spouse who is the sole beneficiary with unlimited access to the IRA assets generally has more withdrawal options and tax-deferral opportunities than other types of beneficiaries. IRA owners should review their beneficiary designation if circumstances change, whether due to separation, divorce or death of the spouse.

It is also common for IRA holders to choose an individual other than their spouse as the beneficiary. A non-spouse beneficiary may have the opportunity to stretch distributions from an inherited IRA over his or her lifetime. This strategy could allow the IRA to grow tax-deferred for years or even decades, depending on the beneficiary's age and income needs.

If a designated beneficiary is a minor, a custodian or guardian may sometimes be required to act on behalf of the child. Selecting a custodian through a beneficiary designation process does not guarantee the individual will be the custodian, because this type of designation is subject to change through the court system. Professionals should discuss these potential issues with their clients and consider whether a trust may be a more appropriate solution.

IRA holders may also consider whether an individual beneficiary can manage the assets. If this is a concern, the account owner may consider naming a trust as the IRA beneficiary as opposed to naming the individual outright. A trust would enable the individual beneficiary to enjoy the benefits of the IRA while allowing the owner to put restrictions on withdrawals to ensure that the individual does not mismanage the funds. In addition, while an inherited IRA held by the individual may not be protected from creditors, an IRA that distributes to a trust for the individual's benefit may be protected.

Though a trust may be drafted to qualify as a designated beneficiary, the rules are complex, increasing the likelihood of inadvertently losing the tax-deferral opportunity. For that reason, clients may consider naming an individual beneficiary if there are no other compelling estate-planning reasons to name a trust.

Separate Account Treatment for Multiple Designated Beneficiaries

If the IRA owner names more than one designated beneficiary on the IRA, the RMDs will be calculated using the life expectancy of the oldest beneficiary. However, an opportunity may exist for some beneficial post-mortem planning using the separate account rules.

For example, if separate accounts are created for the designated beneficiaries prior to Dec. 31 of the year after the owner's death, each designated beneficiary may calculate RMDs using his or her own life expectancy. A spouse beneficiary would have the same options for the separate IRA as if he or she were the sole beneficiary. Separate accounts may be created by segregating assets within the single decedent IRA or, more simply, by dividing the decedent IRA into separate IRAs for each beneficiary.

The separate account rules are available only if the IRA's investment gains and losses accruing after the original owner's date of death are allocated pro rata among the beneficiaries' shares. Therefore, clients and their professional advisors should generally calculate the value of separate shares by using a percentage or fractional formula. Separate account treatment could be problematic if the shares' value is determined using a pecuniary formula and the beneficiary designation language does not specifically provide for pro rata allocations of investment gains and losses.

The separate account rules are not generally available to the beneficiaries of a trust. For example, if a trust is named as beneficiary of the IRA, and the trust agreement provides for distribution of the trust assets equally among three children, the IRA may be divided into separate decedent IRAs for the benefit of each child. However, the RMDs for all three decedent

IRAs are calculated using the life expectancy of the oldest trust beneficiary. The separate account rules cannot be applied to allow each child to calculate RMDs on his or her own life expectancy. The example on page 6 describes how an attorney may set up the beneficiary designation to treat separate trust shares for each beneficiary as the actual beneficiaries of the IRA. In this structure, the beneficiaries may receive separate account treatment and calculate their RMDs based on their own life expectancy.

If a client wishes to create a trust with multiple beneficiaries to receive the proceeds of the IRA, an attorney may consider creating and naming multiple conduit trusts in order to receive similar treatment as individuals using the separate account rule. Conduit trusts are discussed on page 8.

Naming a Trust as Beneficiary

Depending on their estate-planning goals, clients may consider naming a trust as beneficiary of their IRA to address situations such as the following:

- Concerns about the beneficiaries' ability to manage IRA investments or deplete the account too quickly
- Creditor protection concerns for any of the beneficiaries
- Providing assets for children from a prior marriage
- Providing funds for children with special needs
- Funding a credit shelter trust at the client's death

If a client's estate plan warrants designating a trust as beneficiary of the IRA, the attorney should take care in drafting the trust document. To ensure that a trust beneficiary can take advantage of the continued income tax deferral inside the IRA, the trust must meet certain requirements to be a qualified trust. The IRS must be able to "see through" the trust and treat the individual trust beneficiaries as if they were direct beneficiaries of the IRA for RMD purposes. If the trust is not a qualified trust, distributions from the IRA may be accelerated compared to the stretch payout options available when an individual beneficiary is named.

The requirements to be a qualified trust are:

1. The trust is valid under state law, or would be except that there is no corpus (principal or property).
2. The trust is or will become irrevocable upon the IRA owner's death. Generally, most revocable living trusts become irrevocable upon the grantor's death. However, a joint revocable trust should be carefully reviewed by an attorney to ensure that it, or another trust established under that document, meets this requirement. A testamentary trust, created at the client's death under a will, also meets this requirement.
3. The trust beneficiaries are identifiable from the trust document. The beneficiary does not need to be specified by name. Members of a class of beneficiaries capable of expansion or contraction are treated as being identifiable if it is possible to identify the class member with the shortest life expectancy. As discussed in more detail on page 6, there is some uncertainty regarding the extent to which future beneficiaries would be considered a part of this group. If the trust is not drafted carefully, the group of beneficiaries might be indeterminate, making it impossible to determine the beneficiary with the shortest life expectancy.
4. All beneficiaries of the trust are individuals. A trust with a charity or an estate as a beneficiary does not meet this requirement.
5. A copy of the trust document, or a summary listing all beneficiaries, is provided to the IRA trustee or custodian by Oct. 31 of the year following the account owner's death.

These requirements can be complex, so an estate-planning attorney should carefully review each provision of the trust document to ensure that it does not inadvertently fail to meet them. In addition, an attorney should review the current and remainder trust beneficiaries, because they could potentially receive IRA distributions accumulated inside the trust, or the earnings generated from those accumulations.

Examples of common trust provisions that could cause qualification issues include:

- A provision allowing for the payment of expenses or debts of the estate
- A power of appointment provision that includes a charity in the class of potential appointees
- A power of appointment provision that allows appointment to individuals older than the current beneficiaries

The first two provisions may allow for IRA proceeds to be distributed to an estate or a charity, while the third provision may make it impossible to identify the trust beneficiary with the shortest life expectancy. All three cases could disqualify the trust as a designated beneficiary.

To avoid such a problem, an estate-planning attorney may want to consider adding provisions to the trust to do the following:

- Prohibit the use of IRA proceeds for the payment of estate expenses
- Prohibit the payment of such expenses after the designation date
- Limit the class of potential appointees under a power of appointment to individuals
- Limit the class of potential appointees under a power of appointment to individuals with life expectancies that are longer than those of the current beneficiaries

Example

Mary, age 65, names her trust as the beneficiary of her IRA. Article II of her trust provides that upon her death, the trust assets are divided into three shares: one share for her son, age 40; one share for her grandson, age 10; and one share for her granddaughter, age 8. Each of these three shares will be held in a separate trust to be administered under Articles III, IV and V of Mary's trust, respectively.

Because Mary named her trust as the beneficiary of her IRA, the applicable life expectancy of each separate trust created for her son and grandchildren will be based on the life expectancy of the oldest beneficiary, the son. This arrangement could result in a substantial loss of tax savings for the shares of the IRA that distribute to the grandson's and granddaughter's trusts.

As an alternative, the IRA beneficiary designation could provide that upon Mary's death, the IRA is divided into three shares: one for the son, to be distributed to the trustee and held under Article III of Mary's trust agreement; one for the grandson, to be distributed to the trustee and held under Article IV of her trust agreement; and one for the granddaughter, to be distributed to the trustee and held under Article V of her trust agreement. Because each of these subtrusts is named directly in the IRA beneficiary designation, and because the beneficiaries of these subtrusts are a subset of the beneficiaries of the entire trust, each trust may be able to take distributions based on the respective life expectancies of the son, grandson and granddaughter.

The identity of the trust beneficiaries is relevant for determining the life expectancy factor used by the trust. The trustee calculates the RMD based on the life expectancy of the oldest trust beneficiary. Currently, regulations are somewhat unclear regarding who should be considered a beneficiary for purposes of determining the life expectancy factor. The regulations provide that a "mere potential successor" beneficiary should not be considered, raising the question of who is considered a potential successor beneficiary. For example, should contingent remainder beneficiaries be considered? To address this issue, an attorney should review the trust provisions regarding how much of the IRA must be distributed to current beneficiaries. The ability to accumulate assets of the IRA in trust for later beneficiaries may affect whether a future beneficiary is included in the group of beneficiaries.

Trust Principal and Income Rules

Before a trust is named as beneficiary of an IRA, a professional advisor should review the applicable principal and income rules to determine how RMDs will be treated under the trust accounting rules and ensure they are consistent with the client's intentions. The principal and income rules may be specified in the trust agreement, or they may be referenced under applicable state statutes. Under the principal and income rules, it may be possible for only a small portion of an RMD to be considered as trust income to be distributed to the income beneficiary.

For example, under some state statutes, only 10% of an IRA distribution may be considered income to the trust, with the other 90% characterized as principal. While the entire distribution is considered ordinary income for tax purposes, only 10% may be available for distribution to the income beneficiary of the trust. This may result in the trust's income beneficiaries receiving much less support than the client intended. As discussed on page 8, such a limit on income could also prevent the trust from qualifying for a marital or charitable deduction.

Example

The bulk of Anne's assets are held in an IRA. She decides to create an income-only trust for the benefit of her son, Jeff, because of concerns regarding his ability to manage money, and she names the trust as beneficiary of the IRA.

After Anne's death, the trust qualifies as a designated beneficiary, and the trustee begins taking RMDs based on Jeff's life expectancy. Under applicable law for this trust, only 10% of each RMD is considered income that can be distributed to Jeff from the trust, an amount far below what Anne had intended he receive. Although the trustee could withdraw more than the RMD, only 10% of each IRA distribution could be paid to Jeff. The remaining 90% of the distribution would be considered principal and retained in the trust.

The outcome of this example can be avoided by carefully reviewing the interaction of all trust provisions. An attorney can modify the definition of trust income in a trust agreement or provide for discretionary principal distributions to the beneficiary. The provisions of each trust agreement should be drafted in light of the client's unique situation.

Funding a Credit Shelter Trust

Clients should consult a professional advisor before using an IRA to fund a credit shelter trust, because it may not provide the most tax-efficient transfer of assets. However, if a married client holds the bulk of his or her net worth in an IRA, it may be necessary to use a portion of the IRA assets to fund a credit shelter trust for estate tax planning. In this case, a professional advisor should consider the use of a fractional marital formula to divide the account between the credit shelter trust and the marital trust (or outright distribution to a spouse). The use of a fractional formula may reduce the risk of triggering an immediate taxable event when distributing IRA assets to the trust.

A pecuniary marital deduction formula, which funds a specific dollar amount, may not be appropriate when a retirement plan or traditional IRA is involved. Retirement plans or IRAs (excluding Roth IRAs) are considered an item of income in respect of a decedent (IRD) and are generally taxed to the recipient when a distribution is taken. However, if an IRD item is transferred (as that term is defined in Code Sec. 691(a)(2)), the imposition of income tax can be accelerated. Accordingly, transfer of an IRD item in satisfaction of a pecuniary bequest may subject the item to income tax.

Funding a Credit Shelter Trust with a Disclaimer

A disclaimer can be an effective tool for post-mortem planning. One common technique is to name a spouse as the primary beneficiary of an IRA, and a credit shelter trust as the contingent beneficiary. The spouse, with assistance from a professional advisor, can then disclaim the least amount necessary to fund the credit shelter trust in the most tax-efficient manner. This technique may be advantageous if the future amount of the estate tax exemption is uncertain. A potential disadvantage of this technique is the risk that the surviving spouse may not disclaim as the decedent intended, because he or she is unaware of the option, unable to do so due to illness or unwilling to do so for other reasons. Consequently, in many situations, such as a client with children from a previous marriage or a spendthrift spouse, a disclaimer probably should not be relied on to achieve the client's estate- and tax-planning goals. See page 15 for further discussion of disclaimers.

Marital Trusts

Unless a client has specific concerns such as a spendthrift spouse or children from a prior marriage, it may be preferable to name a spouse as the IRA beneficiary outright rather than naming a marital trust. Naming a spouse is generally simpler and provides the spouse with more withdrawal options and less chance to inadvertently lose qualification as a designated beneficiary. If estate-planning factors support naming a marital trust as beneficiary, an estate-planning attorney must ensure that the marital trust also complies with the requirements to qualify for the marital deduction. Two types of trusts typically meet these requirements: a general power of appointment marital trust and a qualified terminable interest property (QTIP) trust.

Requirements for both types of marital trusts are found in the Internal Revenue Code. One requirement common to both types is that a surviving spouse must be entitled to all the trust income during his or her lifetime, but they differ in terms of who may control how the trust's assets are distributed following the death of the surviving spouse. With a general power of appointment, the surviving spouse can make this decision, while a QTIP trust allows the grantor to control the disposition of the trust's assets. A professional advisor should carefully consider how this requirement interacts with the RMD rules and the principal and income rules, so as not to interfere with any claim for a marital deduction.

Conduit Trusts

Many professionals consider a conduit trust to be a valuable estate-planning tool when a traditional IRA is involved. This type of trust is designed to avoid many potential obstacles that could prevent other types of trusts from being a qualified trust. For instance, a conduit trust may limit the universe of potential beneficiaries and exclude a power of appointment provision. Careful document review is still required to ensure that a conduit trust meets all the necessary requirements of a qualified trust.

A conduit trust is drafted specifically to receive RMDs and immediately distribute them to the trust beneficiary. The conduit provision must be effective immediately after the IRA owner's death to avoid the possibility of any accumulations in the trust. The trustee can prevent the beneficiary from receiving more than the RMD amount, which helps preserve the IRA and may address spendthrift concerns. Another potential benefit of passing the RMD out to the beneficiary is that it will not be trapped in the trust and subject to income tax at the compressed trust tax brackets. A potential drawback of a conduit trust is the lack of flexibility for the trustee to adjust distributions if the beneficiary's circumstances change. For example, it may not be consistent with the grantor's wishes or in the beneficiary's best interests for a trustee to be required to distribute funds to a beneficiary who is experiencing substance abuse or spendthrift issues.

Accumulation Trusts

An accumulation trust allows the trustee to have discretion over when to distribute income and principal to the beneficiary. Though the trust may receive RMDs from an IRA that names the trust as a beneficiary, the trustee is not required to distribute them annually to the current trust beneficiary. This type of trust could be used when an IRA owner wishes to limit the amount or purpose for which beneficiaries can withdraw assets from the IRA and the trust, perhaps in the case of a special needs beneficiary, a beneficiary with substance abuse issues or a spendthrift beneficiary.

The main disadvantage of an accumulation trust is that contingent and remainder beneficiaries, as well as potential appointees under a power of appointment, need to be considered in whether the trust qualifies as a designated beneficiary under the RMD rules. The trustee will be required to use the life expectancy of the oldest beneficiary (current or potential) to calculate RMDs. If a remote contingent beneficiary is older than a primary one, this may force larger RMDs and limit tax deferral of the IRA.

If an accumulation trust does not qualify as a designated beneficiary, the IRA may need to be distributed over a shorter time period. Due to the complexity of creating accumulation trusts and ensuring that none of the potential beneficiaries might prevent the RMD stretch treatment, attorneys must fully understand the IRA rules and trust-drafting requirements when advising their clients.

Naming a Charity as Beneficiary

A client may want to consider naming a charity as the IRA beneficiary. If the charity is qualified as a tax-exempt entity, it can take an immediate distribution of the entire IRA balance without having to pay income taxes. This may allow the owner to transfer a greater value to charity than he or she could to an individual beneficiary, whose distribution would be subject to income tax. In addition, the client's estate would be entitled to an estate tax charitable deduction.

Example

A client died in 2018 with $1 million in an IRA and $1 million in a brokerage account. The client wanted half her assets to go to charity and the other half to go to her son. If she names a charity as the sole beneficiary of her IRA, and her son as the sole beneficiary of her brokerage account, each beneficiary receives $1 million in after-tax dollars. If she names the charity and her son as equal beneficiaries of both accounts, the charity receives $1 million, and her son receives $815,000 in after-tax dollars (assuming a maximum 37% total income tax liability applied to the son's portion of the lump-sum IRA distribution).

In some cases, a client may wish to leave IRA assets to multiple beneficiaries, including one or more charities. Under the multiple beneficiary rule, all beneficiaries of an IRA must be designated beneficiaries to allow for the life expectancy payout option. (See page 13 for details.) To ensure the individual beneficiaries can qualify for this option, the client could establish a separate IRA for the portion to be left to charity. The value of that IRA will likely change over time as investments fluctuate in value and RMDs are taken, so a client may not be able to leave a fixed amount, or an amount calculated under a predictable formula, for the charity.

Like a charity, a charitable remainder trust (CRT) is also a tax-exempt entity under special provisions of the Internal Revenue Code. Depending on the client's goals, a CRT may be a useful estate-planning technique and can be named as a beneficiary of an IRA. After the IRA owner's death, the trustee would generally take a total distribution from the IRA to fund the CRT without any immediate income tax consequences. The trustee distributes income to individual beneficiaries for a set number of years or over the beneficiaries' lifetimes and distributes the CRT's remaining assets to charity at the end of the trust's term. Before using this technique, an attorney should be familiar with the IRA rules and regulations, and the rules and regulations governing CRTs, including the special four-tier accounting treatment for distributions.

Complications can arise when a charity is a potential beneficiary of any trust named as a beneficiary of an IRA. The trustee may need to rely on post-mortem planning to preserve the tax deferral option for the other beneficiaries. That planning may involve distributing the charity's complete share by the beneficiary designation date or using the separate account rules.

Naming Another Entity or the Estate as Beneficiary

Individuals can also name an organization that is not tax-exempt as an IRA beneficiary. However, these entities have limited ability to stretch RMDs, so it may be more advantageous to designate another type of beneficiary that could benefit more from tax deferral opportunities.

When an estate is the beneficiary, the estate's executor will be responsible for carrying out any direction given by the IRA holder's last will and testament, and for handling the inherited IRA. The estate will be considered the beneficiary of the inherited IRA even if the will names a specific person to inherit the estate. Whether assisting the client during life or the executor following the client's death, the professional team should carefully review the facts, circumstances and applicable law when an IRA names an estate as beneficiary.

Beneficiary Payout Options

Once the IRA owner has died, the beneficiary determines how he or she will take distributions from the IRA. The options depend on the identity of the beneficiary, the type of IRA and whether the original account owner died before or after the Required Beginning Date (RBD). The RBD is April 1 of the year after the account owner turns 70½. Professional advisors can assist their clients with evaluating the alternatives, considering the client's need for income, tax situation and whether he or she can afford to pay any income tax owed as a result of the distribution.

The general options are:

- **Lump sum –** The entire account balance is distributed from the inherited IRA to the beneficiary over a period not to exceed one calendar year.
- **Five-year rule –** The entire balance must be withdrawn from the inherited IRA by Dec. 31 of the fifth year following the year the IRA owner died. Distributions are allowed at any time, in any amount, until the deadline. For example, if the account owner died on May 1, 2016, then year one is 2017 and year five is 2021. Therefore, all assets must be distributed by Dec. 31, 2021.

- **Transfer to own IRA –** A spouse beneficiary has the option to transfer assets from the deceased spouse's IRA into his or her own IRA.
- **Treat as own IRA –** A spouse beneficiary can treat an inherited traditional IRA as his or her own by naming himself or herself as the account owner and selecting new beneficiaries for the IRA.
- **Single life expectancy payments –** Commonly referred to as stretch IRA or RMD payments, distributions from the inherited IRA must begin no later than Dec. 31 of the year following the original owner's death.

Distributions are calculated by dividing the IRA's balance as of Dec. 31 of the prior year by the life expectancy factor, or "applicable divisor," based on the age of the beneficiary or, in some cases, the original owner. The applicable divisor can be found in the IRS' Single Life Expectancy Table.

The beneficiary can always withdraw more than the minimum amount. Required minimum distributions are calculated each year and may be classified as either recalculated or non-recalculated payments.

The option to recalculate the life expectancy each year is only available to a spouse beneficiary. If the spouse elects this option, he or she uses the Single Life Expectancy Table each year to determine the appropriate life expectancy factor.

Example

Bob died in 2015 at age 71. The IRA balance on Dec. 31, 2015, was $350,000. The IRA balance on Dec. 31, 2016 was $360,000. The beneficiary is Bob's wife, Janet, who turned 57 in 2016 and 58 in 2017. The RMD is calculated based on Janet's life expectancy:

2016 payment = $350,000 / 27.9 = $12,544.81

2017 payment = $360,000 / 27.0 = $13,333.34

Other beneficiaries may take non-recalculated payments. The beneficiary will use the Single Life Expectancy Table to determine his or her life expectancy factor for the first payment. Each subsequent year, the beneficiary will subtract one from the original life expectancy factor when calculating the next payment.

Example

Using the same facts about Bob's IRA above, assume he died in 2015 at age 80 and left his IRA to his son Jim. Jim is age 57 in 2016 and 58 in 2017.

2016 payment = $350,000 / 27.9 = $12,544.81

2017 payment = $360,000 / 26.9 = $13,382.90

The factor in the third year would be 25.9.

Original Owner Died before RBD (Traditional IRAs, SEP or SIMPLE IRAs, and Roth IRAs)

If an IRA owner died before his or her RBD, the beneficiary may have more options for withdrawing the assets. Successor beneficiaries who inherit an IRA after the original beneficiary's death must continue the same payout method chosen by the original primary beneficiary or take a lump-sum distribution.

When inheriting a Roth IRA, a spouse can treat the account as his or her own and is not required to take distributions. If the beneficiary is another individual, then a minimum amount needs to be withdrawn each year, though distributions can be stretched. Because distributions from a Roth IRA are generally tax-free to the beneficiary if the owner had the account for more than five years, the main benefit of stretching distributions is to allow more time for tax-free growth potential.

Spouse Beneficiary – A spouse beneficiary has more options than other kinds of beneficiaries:

- **Lump-sum**
- **Five-year rule**
- **Single life expectancy payments –** If the IRA owner died in the year he or she would have attained age 70½, the spouse must begin taking distributions from the IRA by Dec. 31 of the year following the original owner's death. Payments are calculated based on the spouse's life expectancy and recalculated each year.
- **Delayed single life expectancy payments –** If the spouse is the sole beneficiary of the IRA, he or she may choose to delay distributions until Dec. 31 of the year in which the original account owner would have attained age 70½. This may be beneficial if the IRA owner was younger than the spouse, allowing the spouse to defer taxable income and give the IRA assets time to potentially increase in value.
- **Transfer to own IRA or treat as own IRA –** A spouse may also choose to take ownership of the IRA assets, which has several potential tax advantages.

Instead of beginning distributions by the end of the year after the original owner's death, a spouse who takes ownership of the IRA assets may delay taking RMDs until he or she reaches age 70½. In some cases, this approach may allow the spouse to defer payments for several years, providing opportunities for tax-deferred growth of the account. Also, the spouse's RMDs are calculated based on his or her age using the more favorable Uniform Lifetime Table, which allows for smaller distributions than the Single Life Expectancy Table used for other beneficiaries of inherited IRAs. Additionally, after the spouse's death, the IRA can continue to stretch based on his or her own designated beneficiary's life expectancy, or the spouse's own life expectancy, if he or she died after the RBD.

Treating the IRA as the spouse's own may be a good choice when the spouse is over age 59½ or is younger than the deceased spouse. However, if the spouse is younger than 59½ and needs current income from the IRA, distributions from his or her own IRA would be subject to a 10% early withdrawal penalty tax.

One way to avoid the penalty is for the spouse to set up a series of substantially equal periodic payments using one of the IRS' approved methods. However, these arrangements can be complicated to administer, and the spouse's access to the IRA is limited. A way to avoid the penalty and preserve maximum flexibility for taking current distributions is for the spouse to treat the IRA as an inherited IRA rather than becoming the owner.

Example

Nick named his wife, Katherine, as the sole designated beneficiary of his IRA before dying in 2017 at age 66. Katherine can choose to begin distributions by Dec. 31, 2018, or by Dec. 31 of the year in which Nick would have turned 70½ (either 2020 or 2021, depending on Nick's birthdate). In either case, Katherine's RMDs may be calculated based on her single life expectancy.

Katherine may also choose to receive distributions under the five-year rule like any other designated beneficiary. Alternatively, she may also choose to roll over Nick's IRA to her own or treat Nick's IRA as her own.

Non-spouse beneficiary – Any individual who is not legally married to the deceased owner, or a qualifying trust with a single non-spouse beneficiary, qualifies for the following options:

- **Lump-sum distribution**
- **Five-year rule –** If the beneficiary is not a designated beneficiary, the balance of the IRA must be distributed under the five-year rule.
- **Single life expectancy payments –** A designated individual beneficiary may stretch the account balance over his or her lifetime by taking payments based on his or her life expectancy. Payments must begin by Dec. 31 of the year following the original owner's death. If the designated beneficiary fails to receive his or her initial RMD by that time, the entire IRA balance must be distributed under the five-year rule.

Example

Nick named his daughter, Joan, as the beneficiary of his IRA before he died in 2017 at age 66. Joan may choose the five-year rule and receive a distribution of the entire IRA balance by Dec. 31, 2022. She may also choose the life expectancy payout by taking her first distribution by Dec. 31, 2018. The RMD is calculated by dividing the balance of the IRA as of Dec. 31, 2017 by the applicable divisor for Joan's age from the Single Life Expectancy Table.

Qualified trust – Once the trustee has determined the trust is qualified, the following options are available for making IRA payments to the trust:

- **Lump-sum distribution**
- **Five-year rule**
- **Single life expectancy payments –** These are based on the oldest trust beneficiary's age, non-recalculated, and must begin by Dec. 31 of the year following the death of the original IRA owner.

Other Entity – Entities such as a charity, estate or any nonqualified trust listed as beneficiary on the IRA have the following options:

- **Lump-sum distribution**
- **Five-year rule**

Multiple Beneficiaries – An IRA with multiple beneficiaries must be distributed under the five-year rule if any single beneficiary does not qualify as a designated beneficiary by the designation date.

Example

A client died in 2017 with an IRA that named his daughter, Maria, and his church as co-beneficiaries. Maria and the church remain co-beneficiaries as of the designation date, Sept. 30, 2018. Because a beneficiary without a life expectancy, such as a church, generally cannot qualify as a designated beneficiary, Maria will also be disqualified as a designated beneficiary. If the church had instead taken a lump-sum distribution or disclaimed its portion of the IRA before the designation date, Maria would be treated as a designated beneficiary who could take RMDs based on her life expectancy.

If all the beneficiaries qualify as designated beneficiaries by the designation date, the RMDs must be calculated using the oldest designated beneficiary's life expectancy. A discussion of possible post-mortem planning opportunities under such circumstances is found on page 4. If a qualifying trust is a designated beneficiary, the RMD must be calculated using the life expectancy of the oldest trust beneficiary.

Owner Dies on or after Required Beginning Date (Traditional, SEP or SIMPLE IRAs Only)

If an IRA owner dies on or after his or her RBD, the RMD for that year is calculated as it would have been had the owner lived. Any amount of the RMD not distributed before the owner's death must be distributed to the beneficiary by Dec. 31 of that year. For the year following the owner's death, the RMD amount will depend on the identity of the beneficiary.

Spouse Beneficiary – A spouse who is the sole designated beneficiary may choose from the following:

- **Lump-sum distribution**
- **Transfer to own IRA -** The spouse also has the option to elect a spousal rollover of the IRA or open a traditional IRA in his or her own name. All IRA assets become the spouse's assets, and he or she is treated like the original owner for distribution purposes.
- **Single life expectancy payments –** When calculating payments, the surviving spouse can use the life expectancy either for his or her own age or for the original owner's age at death, whichever is longer. Payments must begin by Dec. 31 of the year following the death of the original owner. Subsequent payments will be recalculated if based on the spouse's life expectancy or non-recalculated if based on the original IRA owner's age at death.

Non-spouse Designated Beneficiary

- **Lump-sum distribution**
- **Single life expectancy payments -** RMDs must begin by Dec. 31 of the year following the account owner's death, and payments are non-recalculated. The designated beneficiary will calculate the payments based either on his or her life expectancy or on the owner's remaining life expectancy in the year of death, whichever is longer.

Qualified Trust – A qualified trust is a "see-through" trust, and many of the rules are applied as if the trust beneficiaries were the direct beneficiaries of the IRA. Thus, if a qualified trust is the designated beneficiary of the IRA, the trustee may take a lump-sum distribution. Alternatively, the trustee can stretch the IRA by calculating payments using either the life expectancy of the oldest trust beneficiary or the original owner's life expectancy, whichever is longer. Payments must begin by Dec. 31 of the year following the original owner's death and use the non-recalculated method.

Example

Clara names her son, Juan, as the beneficiary of her IRA before dying in 2018 at age 75. She did not receive her RMD for 2018 prior to her death, so that distribution will be calculated as if she were alive and must be made by Dec. 31, 2018. Juan must begin receiving RMDs by Dec. 31, 2019. His RMDs are calculated by dividing the IRA balance as of Dec. 31, 2018 by the applicable divisor for Juan's age from the Single Life Expectancy Table.

If Clara instead selects her husband, Miguel, as the sole designated beneficiary, he may choose to begin RMDs by Dec. 31 of the year following Clara's death, just like any other designated beneficiary. He may also choose to receive RMDs over the longer of either his own recalculated single life expectancy or Clara's non-recalculated single life expectancy. Miguel also has the option to roll over Clara's IRA to his own IRA or elect to treat Clara's IRA as his own.

Entity – This includes any nonqualified trust, charity or estate listed as beneficiary on the IRA. The following options are available:

- **Lump-sum distribution**
- **Single life expectancy payments -** based on the original account owner's age in the year of death. Payments are non-recalculated and must begin by Dec. 31 of the year following the original owner's death.

Multiple Beneficiaries – If all the beneficiaries qualify as designated beneficiaries, the RMDs may be calculated using either the oldest beneficiary's life expectancy or the original owner's life expectancy, whichever is longer. If one or more of the beneficiaries are not designated beneficiaries by the designation date, the IRA is treated as having no designated beneficiary. The account then must be distributed over a period no longer than the original owner's remaining life expectancy.

If the IRA Beneficiary Does Not Want IRA Assets

Some beneficiaries may prefer not to receive IRA assets. When inheriting a traditional, Roth, SEP or SIMPLE IRA, the beneficiary can disclaim their interest in the IRA and give up their rights to the property. This may happen for estate-planning purposes, such as a spouse (primary beneficiary) disclaiming so the IRA can benefit a credit shelter trust (contingent beneficiary). Another example may be a beneficiary who has a high level of income already and would prefer to make a tax-free gift to the contingent beneficiary, perhaps the IRA owner's child passing the assets to the grandchild.

Disclaiming may be an option if the beneficiary has not accepted any of the assets and does not have the ability to designate a beneficiary to receive the assets in his or her place. The beneficiary may still disclaim the IRA assets after he or she has received the RMD due for the year of the account holder's death. Generally, a disclaimer must be received no later than nine months after the original account owner's date of death or nine months after the beneficiary turns 21.

Importance of Reviewing Beneficiary Designations

Because changes in tax laws or life events can impact an individual's estate plan, professional advisors should encourage their clients to periodically review their estate strategy with their professional team. Examples of major life changes include marriage, divorce, the birth or adoption of a child or grandchild, or the death of a spouse. Unless the client updates account beneficiaries as major life changes occur, assets may not pass as the client intended. For example, a client might designate his or her spouse as beneficiary, but later divorce. If the client does not update the beneficiary designation, the former spouse could inherit those assets. Similarly, a client might name his or her firstborn child as beneficiary but forget to update the beneficiary designation for any subsequent children.

The review should include legal documents, such as a will and trust, beneficiary designations and asset titling, to ensure they reflect the client's wishes and conform to federal and state law. Clients should keep copies of their estate-planning documents and ensure their loved ones know where they are located.

Summary of IRA Beneficiary Payout Options

Beneficiary	Owner Died before RBD	Owner Died on or after RBD
Spouse	Total distribution (taxable in year distributed)	Total distribution (taxable in year distributed)
	Transfer to own IRA or treat as own (if spouse is at least age 59½); if less than 59½, may incur penalty if taking distributions	Transfer to own IRA or treat as own (if spouse is at least age 59½); if less than 59½, may incur penalty if taking distributions
	5-year rule (IRA distributed no later than Dec. 31 of fifth year following year of owner's death)	N/A
	Single life expectancy based on spouse's age, recalculated. Distributions must begin by the year in which the original IRA owner would have reached age 70½, unless owner died that year, in which case distributions must begin by Dec. 31 the year after death.	Longer of: • Single life expectancy based on spouse's age, recalculated, beginning by Dec. 31 of year following IRA owner's death • Single life expectancy based on owner's age at death, non-recalculated, beginning by Dec. 31 of year following IRA owner's death
Non-spouse beneficiary or qualified trust with a single beneficiary	Total distribution (taxable in year distributed)	Total distribution (taxable in year distributed)
	5-year rule (IRA distributed no later than Dec. 31 of fifth year following year of owner's death)	N/A
	Single life expectancy based on beneficiary's age, non-recalculated, beginning by Dec. 31 of year following owner's death	Longer of: • Single life expectancy based on beneficiary's age, non-recalculated, beginning by Dec. 31 of year following owner's death • Single life expectancy based on owner's age at death, non-recalculated, beginning by Dec. 31 of year following owner's death
Estate, charity or nonqualified trust	Total distribution (taxable in year distributed)	Total distribution (taxable in year distributed)
	5-year rule (IRA distributed no later than Dec. 31 of fifth year following year of owner's death)	N/A
	N/A	Single life expectancy based on owner's age at death, non-recalculated

Beneficiary	Owner Died before RBD	Owner Died on or after RBD
Qualified trust with multiple beneficiaries	Total distribution (taxable in year distributed)	Total distribution (taxable in year distributed)
	5-year rule (IRA distributed no later than Dec. 31 of fifth year following year of owner's death)	N/A
	Single life expectancy of the oldest beneficiary, non-recalculated. If subsequent qualified subtrusts are established under the original qualified trust, each beneficiary will use the single life expectancy of the oldest trust beneficiary, non-recalculated.	Longer of: • Single life expectancy based on the age of the oldest trust beneficiary, non-recalculated, beginning by Dec. 31 of year following IRA owner's death • Single life expectancy based on IRA owner's age, non-recalculated, beginning by Dec. 31 of year following owner's death
Multiple beneficiaries (spouse and non-spouse), shares not segregated by Dec. 31 of year after owner's death	Total distribution (taxable in year distributed)	Total distribution (taxable in year distributed)
	5-year rule (IRA distributed no later than Dec. 31 of fifth year following year of owner's death)	N/A
	Single life expectancy of oldest beneficiary, non-recalculated	Single life expectancy of oldest beneficiary, non-recalculated
Multiple beneficiaries (including estate, charity or nonqualified trust), shares not segregated by Dec. 31 of year after owner's death	Total distribution (taxable in year distributed)	Total distribution (taxable in year distributed)
	5-year rule (IRA distributed no later than Dec. 31 of fifth year following year of owner's death)	N/A
	N/A	Single life expectancy based on IRA owner's age at death, non-recalculated

Conclusion

While individuals typically designate their spouse or children as beneficiaries of their IRA, there are other options. IRA beneficiary designation should be considered within a client's comprehensive estate plan based on his or her unique goals and IRA rules and regulations. Professional advisors should carefully review their clients' estate-planning documents and beneficiary selections, considering these complex rules and striving for an appropriate balance between multiple estate- and tax-planning interests.

How Edward Jones Can Help

Edward Jones is committed to a team approach when it comes to meeting client needs. Edward Jones financial advisors collaborate with our clients' tax advisors and attorneys to help clients preserve, manage and distribute their wealth while meeting their financial goals. Working with investment, tax and legal professionals within Edward Jones, the financial advisor can help clients develop and implement strategies for objectives such as retirement, preparing for the unexpected, planning a legacy and paying for education. To learn more about how this team approach can help you serve your clients' best interests, contact an Edward Jones financial advisor today.

For clients using trusts in their estate planning, the financial advisor can partner with the Edward Jones Trust Company to administer and manage the clients' accounts. Edward Jones Trust Company can serve as trustee, co-trustee or managing agent on a variety of account types, including trusts and IRAs.

Building a Team of Professionals to Help Provide Solutions for Our Clients

At Edward Jones, we believe that when it comes to financial matters, the value of professional advice cannot be overestimated. In most situations we recommend that clients assemble a team of professionals to provide guidance regarding their financial affairs: an estate-planning attorney, a tax professional and a financial advisor.

The legal, accounting and financial services industries are governed by complex laws and regulations. By working together as a team, professionals in a variety of financial fields can use their knowledge and skills to assist mutual clients in planning for today's financial, tax and estate-planning challenges.

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