

401(k)/IRA Beneficiary Information

UNDERSTANDING DISTRIBUTIONS

What happens to the assets in a 401(k) or IRA with a named Beneficiary. Once deceased the account is transferred into a IRA Beneficiary Distribution Account. The person named as beneficiary generally has a few options. They can elect receive the entire balance immediately in a total distribution. This results in a taxable event and eliminates that tax deferred nature of the account. So unless there is an immediate need for the money, it's generally better to leave it in the IRA as long as possible to defer taxation and prolong the period of tax-deferred growth.

The IRA distribution options available generally depend on whether the IRA owner dies **before or after** April 1st of the year following the year in which he or she turned age 70 1/2. That's when the owner would have been required to start taking minimum distributions from the account. This is often referred to as the "required beginning date."

Options for Surviving Spouses

A surviving spouse who is named the beneficiary of an IRA generally has the same options available to non-spouse beneficiaries... and then some. A surviving spouse has an additional option -- he or she can avoid the post-death minimum distribution rules **completely** by electing to treat the inherited IRA as his or her **own** IRA.

If this election is made, the surviving spouse is treated as the IRA owner for all purposes and becomes subject to the minimum distribution rules only after reaching age 70 1/2. The surviving spouse also has the opportunity to name another beneficiary and receive distributions based on the joint life expectancy with the new beneficiary, under the general rules applicable to all IRA owners.

Options for the Non-Spouse Beneficiary

Beneficiaries that are not the surviving spouse of the deceased IRA owner (relative, children etc) are required to take distributions depending on the age the owner became deceased.

IRA Owner Dies *After* Required Beginning Date

If the IRA owner had *already begun to receive* minimum required distributions, the remaining distributions generally must be paid out at least as rapidly as they would have been under the method of distribution in effect before his/her death.

This means that the options available to you are limited, because you generally can't lengthen the distribution schedule selected by the IRA owner on his required beginning date.

IRA Owner Dies *Before* Required Beginning Date

If the IRA owner dies *before* the required beginning date, the beneficiary has a few more options. The general rule is that the entire balance of the IRA must be distributed under the five-year rule.

The five-year rule basically requires that the entire amount in the IRA be distributed no later than December 31st of the fifth year after the IRA owner's death. In this case, the only question is when and how to take the distributions during the five-year period. Waiting until the end maximizes the tax deferral, but spreading distributions out over all years avoids bunching income for the recipient.

However, beneficiaries can take advantage of an exception to the five-year rule and elect to receive distributions over a period not exceeding their life expectancy -- a better option for most people. If the

Disclaimer: This above is for information purposes only and should not be construed as advice for you specific situation. We believe it to be accurate but is not guaranteed. Please consult a financial advisor or attorney to find out what is best for your specific situation.

401(k)/IRA Beneficiary Information

beneficiary decides to take this option, it's vital that they elect a method of distribution and that they take the initial distribution by the end of the year following the year of the IRA owner's death. Why? Because, unless the IRA agreement provides otherwise, distributions to a non-spouse beneficiary must be made under the five-year rule if no election is made. If a beneficiary fails to make the election and take the appropriate distribution at the appropriate time, they'll lose this option and will be required to take distributions using the five-year rules. In effect, if you snooze, you lose.

One option **not** available to non-spouse beneficiaries is rolling over the inherited IRA account into an existing IRA they own. (**Only** spouses have this option, and we'll discuss it in a bit more detail below.) If a non-spouse beneficiary **does** roll over the inherited IRA into his or her own existing IRA, the rollover is treated as a distribution, and the proceeds must be included in the beneficiary's income in the year the rollover occurs.

Using Separate Shares for Multiple Beneficiaries

Multiple beneficiaries of an IRA can elect individually to apply the five-year rule or one of the exceptions when the IRA owner dies before beginning to receive distributions. In other words, each beneficiary can decide how quickly to receive distributions. That's the good news.

The bad news is that generally the individual having the shortest life expectancy must be used to determine the required distribution amount. Given this restriction, there may be little advantage to naming multiple beneficiaries if there are vast age differences among them. The *younger* beneficiaries will be required to take distributions based on the life expectancy of the *oldest* beneficiary.

PRIMARY BENEFICIARY ELECTION

If you are married, electing the owner's spouse as the primary beneficiary is often required. To do otherwise usually requires an opt-out form signed by spouse. If the owner is not married, then the advantages / disadvantages described in the Contingent section below apply.

Advantage of naming Spouse (rather than a trust) as primary beneficiary

- If you are married, the biggest risk in naming a trust as beneficiary is that your spouse cannot automatically roll over your IRA into an IRA in his or her own name when you die. For a spouse to be able to do that, the spouse -- not the trust -- must be the beneficiary. Being able to roll over a deceased spouse's IRA is a huge advantage and one an owner should think twice about giving up.

Advantage of naming Spouse (rather than a trust) as primary beneficiary

- The spouse has control over the distribution of the assets and can distribute the money at their own discretion.

CONTINGENT BENEFICIARY ELECTION

Electing the appropriate beneficiary is probably the most important of any new account application. There are several alternatives to choose from if you wish to leave your 401(k)/IRA to a minor beneficiary including naming the minor as the direct beneficiary or naming a trust as the beneficiary.

Disclaimer: This above is for information purposes only and should not be construed as advice for you specific situation. We believe it to be accurate but is not guaranteed. Please consult a financial advisor or attorney to find out what is best for your specific situation.

401(k)/IRA Beneficiary Information

Advantages and disadvantages for naming a Minor as beneficiary of an IRA

- The assets transfer to an IRA Beneficiary Distribution Account in accordance with the percentages elected. This option avoids the potential legal costs of dividing the assets once they have been placed in a trust.
- More importantly, young beneficiaries get the benefit of a lower required minimum distribution (RMD) over their lives. This is because the life expectancy of the beneficiary is used when calculating their RMDs.

For example, if you died and left \$100,000 of IRA money to a one-year old granddaughter this year, her current life expectancy would be 81.6 years. Assuming that the money in the account grows at 8-10% per year, she could withdraw several million dollars from the account over her life.

Disadvantages/Problems with Minor Ownership

- Common law dictates that certain legal measures must be taken to protect minors in these circumstances. Minors cannot own legal property of any kind in their name; a guardian must be appointed to manage the property on their behalf until they reach the age of majority. Appointing a guardian is the owner's responsibility; if you do not do this, then the court will appoint one for you - one who may have very different ideas about how the account should be managed and invested.

There is no escaping this appointment since the law prohibits IRA custodians from dealing directly with minors in any capacity.

Advantages and disadvantages for naming a Trust as beneficiary of an IRA.

Advantages

- One is to maintain control -- to ensure that the assets of the IRA are distributed according to the same plan that is set up in your trust. Such control may be important if, for example, the beneficiary is a child or has special needs.
- Another reason is to fund a bypass trust -- that is, to make sure that you can make optimum use of your estate tax exemption amount.

Disadvantages

- You will be funding the trust with pretax money. So, say you direct \$500,000 of IRA money into the trust. The trust will not actually be funded with \$500,000. It will be \$500,000 minus the taxes owed on the IRA when the money is distributed. By contrast, if you put \$500,000 of cash in the trust, the trust is funded with the full \$500,000, because the cash is after-tax money.
- There are additional legal costs associated with separating the assets once they have been placed in the trust.

SUMMARY

In the majority of cases, owners should name their spouse as a primary beneficiary of their retirement accounts. The naming of a contingent beneficiary is often dependent on the beneficiary's age and required control over the funds. If the contingent beneficiary is a minor or a young adult and the owner

Disclaimer: This above is for information purposes only and should not be construed as advice for you specific situation. We believe it to be accurate but is not guaranteed. Please consult a financial advisor or attorney to find out what is best for your specific situation.

401(k)/IRA Beneficiary Information

wishes that the funds be managed and distributed in a specific fashion then naming the Trust as the contingent beneficiary is probably most appropriate. If the contingent beneficiaries are grown adults and little "control" is required, then naming them individually as contingent beneficiaries is probably most appropriate and cost effective.

Everyone's situation is different so it is best that you contact your financial advisor or estate planning attorney for which selection best fits your specific situation.

Disclaimer: This above is for information purposes only and should not be construed as advice for you specific situation. We believe it to be accurate but is not guaranteed. Please consult a financial advisor or attorney to find out what is best for your specific situation.