



BENEFICIARIES OF IRAs OR RETIREMENT PLANS

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A. Who should be the beneficiary of my IRA or Other Retirement Plan?

A.1 Who should be the beneficiary of an IRA or of my qualified plan? The answer is very personal for each individual, and the answer for you depends on your priorities and your objectives.¹ The rules discussed here reflect the adoption of the SECURE Act, which became effective January 1, 2020.²

A.2 Before trying to answer the question, it is important to understand that whoever receives a traditional IRA (not a Roth IRA) will pay income taxes when distributions from the IRA are made. The IRA will be subject to the federal estate tax if the participant's (account holder's) taxable estate exceeds the estate tax "applicable exclusion" and the beneficiary is someone other than one or more qualified charities and/or the account holder's surviving spouse.

A.3 If the IRA is distributed in a lump sum and is subject to the estate tax, the combination of the estate tax and income tax can take 70% of the IRA. If that scenario applies to you, you may wish to consider naming one or more qualified charities as the beneficiary of your IRA. Roth IRAs are usually not subject to the income tax, but they are still subject to the federal estate tax laws.

B. "Stretch IRAs" and RMDs.

B.1 One significant benefit of an IRA, regardless of whether it is a traditional IRA or IRAs, is the ability to accumulate income in a tax-free environment. Although distributions will eventually all be taxed, the investments can compound tax free until the distributions are actually made. Because of that, it is prudent for a beneficiary of an IRA to take only the minimum distribution required by law each calendar year, which is called the "required minimum distribution" or "RMD".

B.2 For most individual beneficiaries, there is no RMD for the first 10 years, but 100% must be distributed after 10 years. In this memo, these beneficiaries are called "10-year beneficiaries".

B.3 For spouses, minor children³, beneficiaries less than 10 years younger than the IRA participant, and disabled beneficiaries, the RMD is based on the recipient's life expectancy, and distributions can be "stretched" over that period. In this memo, these beneficiaries are referred to as "lifetime beneficiaries".

B.4 It is possible for a lifetime beneficiary to become a 10-year beneficiary, such as when a minor child becomes a legal adult or when a disabled beneficiary ceased to be disabled.

C. Using A Trust as an IRA Beneficiary.

C.1 While it may be prudent to use a "stretch IRA" technique, some beneficiaries do not have the self-discipline to receive the IRA in installments when they have the power to take it in a lump sum. An IRA payable to a beneficiary who has unpaid creditors may lose the IRA to

¹ For simplicity, the remainder of this article refers to IRAs, but the same general concepts apply to benefits payable under certain qualified retirement plans, including 401(k) plans and other qualified pension plans.

² The official title of the "SECURE ACT" is the "Setting Every Community Up for Retirement Enhancement Act of 2019".

³ Note that a minor child is a lifetime beneficiary, but other minors, such as grandchildren, are not.

those creditors in legal proceedings. So, if you want to use a "stretch IRA" (either a 10-year stretch or a lifetime stretch, depending on the beneficiary's classification) with impatient, imprudent, or debt-burdened beneficiaries, it might be appropriate to designate a trust as the IRA beneficiary.

C.2 It is possible to do that, but to qualify for optimal income-tax treatment, the trust must be a "qualified trust" that meets these requirements:

- (a) The trust must be a valid trust under state law;
- (b) The trust must be irrevocable on or before death of the owner of the IRA;
- (c) The trust beneficiaries (as to the IRA) must be living human beings who are readily determinable from the trust instrument; and
- (d) A copy of the trust document must be provided to the IRA plan administrator.

C.3 If the trust does not qualify, then the income tax on the IRA must be paid within five years of the participant's death.

D. Conduit or Non-Conduit Trusts.

D.1 If the trust meets the minimum tests mentioned above and the Trustee takes the RMD each year, the next question is how much the beneficiary is entitled to receive.

(a) For 10-year beneficiaries, nothing needs to be withdrawn from the IRA, and no distribution needs to be paid from the trust. Ideally, the beneficiary will not need distributions, and the income from the investments of the IRA can allow the IRA to grow in a tax-free environment. For flexibility, it is common to allow or require the trustee to make withdrawals and make distributions to or for the beneficiary. If a trust does not permit distributions other than the RMD, there will be no trust distributions until the tenth year, when everything must be distributed. If the trust permits the trustee to make withdrawals that exceed the RMD and to make distributions of the amounts withdrawn, discretionary distributions can be made to 10-year beneficiaries.

- (b) As to lifetime beneficiaries:
 - (i) The trustee must withdraw the RMD each year.
 - (ii) If the trust requires that the trustee pay out the minimum required distributions to one designated beneficiary each year, it is considered a "conduit trust", and the age of contingent beneficiaries will not be taken into consideration in determining the RMD.

D.2 Sometimes it is not prudent to give the full RMD to a lifetime beneficiary.

(a) If the trust gives the trustee the discretion to pay the designated beneficiary or beneficiaries less than the RMD, then it is an accumulation trust and not a conduit trust, and the ages of all contingent beneficiaries will be considered in determining the amount of the RMD. This means that the age of the oldest beneficiary who MIGHT receive payments from the IRA will be used to determine the RMD. In such trusts, it is common to include a clause saying that as to the IRA, only beneficiaries who are younger than the primary beneficiary can take if the primary beneficiary dies before the account is fully distributed.

(b) It is common to allow (but not require) the trustee to make withdrawals that exceed the RMD and to make distributions of such withdrawals to or for the beneficiary in addition to the mandatory distributions.

E. Marital Deduction Planning.

It requires special planning to receive the marital deduction for an IRA that pays out installments to a surviving spouse.

F. Minor Beneficiaries.

It may be appropriate to designate your revocable trust as the beneficiary of an IRA if your beneficiaries are minors and you are not particularly concerned about implementing a stretch IRA. Only children are lifetime beneficiaries, but grandchildren and other minors can continue to benefit from the IRA funds even after the IRA has been fully distributed.

G. Charitable Beneficiaries

If you intended to have your IRA proceeds distributed to one or more charities, we usually recommend that the charities be designated as the beneficiaries and not a trust, except in special, exceptional circumstances.

H. Summary.

H.1 If you are married and you want your spouse to have the IRA without restrictions, consider naming your spouse as the sole primary IRA beneficiary.

H.2 If you are married and you want your spouse to have the income or required minimum distribution (whichever is greater) from the IRA, then the beneficiary might be a QTIP (marital-deduction) trust that is coordinated with the IRS' requirements to qualify for the marital deduction when an IRA is involved.

H.3 If you are unmarried or you do not want your spouse to be the beneficiary:

(a) If you want a "stretch" IRA (either for 10 years or for the beneficiary's lifetime, depending on eligibility) and the intended beneficiaries are disciplined to take out only the required minimum distributions over their lifetime and have no significant risks for claims by creditors (including ex-spouses), then consider designating the intended beneficiaries by name.

(b) If you want a "stretch" IRA (either for 10 years or for the beneficiary's lifetime, depending on eligibility) but the beneficiaries might be tempted to take early withdrawals or may be vulnerable to creditors' claims, then consider naming as the IRA beneficiary a trust that is established as a qualified beneficiary that will provide for the trustee to take the required minimum distributions each year and distribute them in accordance with your wishes. Consider giving the trustee discretion to withdraw and pay out more than the RMD if the trustee determines it is in the beneficiary's best interest to do so. This is particularly important for 10-year beneficiaries because without such a provision, 10-year beneficiaries would get nothing for 10 years.

(c) If a "stretch" IRA is not important to you, then it is probably best to name your revocable trust as the beneficiary of your IRA. The trust should contain alternative



beneficiary designations and options that a normal beneficiary designation for an IRA would not contain.

(d) If you are married and the IRA contains community property, designating a beneficiary who is not the participant's spouse may require the spouse's written consent.

H.4 If you have an existing trust but it does not have IRA provisions, your trust will probably have to be modified to provide a "stretch IRA" or marital deduction. Never assume that your trust has been designed to be a "qualified beneficiary" of an IRA without confirming it with the attorney who drafted the trust or some other qualified trust and estate attorney.

H.5 Unless you are willing to gamble as to the tax consequences, do not make a final decision regarding the designation of a beneficiary for your IRA without consulting with your certified public accountant and/or attorney.

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