Intro:
Welcome to the Paragon Financial Partners podcast, where we discuss the markets, our strategies, and how to live better today while planning for tomorrow.

Elean:
Hello and welcome to the Paragon podcast. I'm Elean Mendoza and I'm here with Evan Shorten, the firm's founder, and principal.

Evan:
Hello, I'm Evan Shorten and I want to thank you for listening in. To stay up to date with our podcast, you can subscribe through the Apple Podcast App or Stitcher Radio. Also, if you would like to stay up to date with our insights, like our White Papers and Financial Guides, please sign up to our email list by visiting our homepage at paragonfinancialpartners.com.

Elean:
So this week we want to discuss a topic that doesn't get too much attention and is oftentimes forgotten about. This week, we're going to focus on IRA beneficiary designations. Now most married clients, by default, list their spouse as their primary beneficiary and their children as their contingent beneficiary. Another popular request is to list a trust as the primary beneficiary. Given that each type of beneficiary may receive a different tax treatment, it's important to understand the advantages and disadvantages of assigning certain beneficiaries. Now, before we dive into the details of each beneficiary type, we're also going to define a few key things surrounding IRAs to make the conversation easier to understand.

IRA is an acronym for Individual Retirement Arrangement, and yes, that is the actual name used by the IRS for what we commonly refer to as an Individual Retirement Account. Evan, do you want to start by explaining what primary and contingent beneficiaries are?

Evan:
A primary beneficiary will be the immediate beneficiary who inherits your assets in the event of your death. You can assign one or multiple primary beneficiaries. A contingent beneficiary is the alternate choice to inherit your assets if the primary beneficiary is no longer alive. Again, you have the freedom to designate single or multiple contingent beneficiaries.

Now, I want to quickly touch on a few key concepts regarding IRAs and their benefit. Using an IRA as a retirement savings vehicle aims to provide you with two major benefits. One, they provide tax-deferred growth over the years you accumulate the savings in your IRA, meaning the account is not subject to taxation on the gains, income, or growth of the account. In the case of Roth IRAs, they also provide you tax-free income when you withdraw funds after a few qualifying events, but specifically at age fifty-nine and a half or older. Second, IRAs incorporate what is called a stretch provision that aims to stretch the distributions of income payments over your lifetime as well as your beneficiary's. The reason designating the right beneficiary

is so important is because IRAs provide many tax benefits for you that may continue onto your beneficiary as well. However, not all beneficiaries may take advantage of those tax benefits.

Elean:
One last item you'll hear us mention, and that I want to clarify ahead of time, is RMD. RMD is the acronym for Required Minimum Distribution, and it's also commonly referred to as MRD or Minimum Required Distribution. If you have a traditional IRA, and you hit age seventy and a half, you'll be required to take a distribution from the account or face penalties. That required distribution will be a minimum amount based on your current age, the previous year's closing balance of your IRA and your life expectancy, which is actually based on an actuarial table published by the IRS. With that, let's go ahead and discuss four popular beneficiary designations: spousal beneficiaries, non-spousal beneficiaries like your children or other relatives, trusts as beneficiaries, and charities as beneficiaries. So Evan, what are some of the advantages of designating your spouse as the primary beneficiary to your IRA?

Evan:
A surviving spouse has the most flexibility with an IRA. Your spouse can take ownership of your IRA when you pass, or roll over your IRA into their own without triggering a tax event, and they can continue accumulating growth in the IRA. They could continue to make annual contributions if they continue working and they are not required to take distributions until age 70 and a half if it's a traditional IRA. If it's a Roth IRA, then they are not required to take RMDs at all according to the current tax code. If a surviving spouse rolls over the decedent's IRA into their own they have to follow the normal rules for IRAs that we're familiar with. Meaning, any withdrawal prior to age 59 ½ would incur an early withdrawal penalty, annual contribution limits of $5,500 or $6,500 at age 50 or older, and so on.

A surviving spouse also has the flexibility to move the decedent's IRA assets into what's called an Inherited IRA. To be clear, an Inherited IRA is not the same thing as a Spousal IRA. Inherited IRAs have different rules associated with them published by the IRS. With the Inherited IRA, the surviving spouse has the option to take withdrawals prior to age 59 ½ without incurring a tax penalty or they can defer taking distributions. However, in 2014 the U.S. Supreme Court ruled that Inherited IRAs are not considered retirement accounts, and that brings up two important caveats. One, because an Inherited IRA is not a retirement account, the surviving spouse cannot make additional contributions to it. And two, because the inherited IRA is not a retirement account, it is not protected from creditor claims, meaning, unlike traditional and Roth IRAs, Inherited IRAs are not protected in bankruptcy.

Elean:
Tune into our next episode, where we'll discuss the Supreme Court's decision in opening Inherited IRAs to creditor claims. For now, let's move on and discuss non-spousal beneficiaries. To clarify, a non-spousal beneficiary is a person who is not considered your spouse, such as your children, your parents, siblings, friends, and so on.

Evan:
Non-spousal beneficiaries also have two options when named as a primary beneficiary in the event of the original IRA owner's death. The first option is to simply liquidate the decedent's IRA. Now, it's important to keep in mind, there may be a tax liability upon liquidating. The second option is to open an Inherited IRA and roll over the decedent's IRA assets. This option maintains the benefit of tax deferment. Rolling over the decedent's IRA into an Inherited IRA is not a taxable event and the funds may continue to grow without incurring income or capital gains taxes on that growth. However, as we mentioned before, Inherited IRAs are not considered to be retirement accounts and therefore, the account owner cannot make contributions into the Inherited IRA and they may be subject to creditor claims.

Now, unlike a spousal beneficiary, non-spousal beneficiaries must take a yearly minimum distribution from an Inherited IRA, regardless of age. They do not have the option to defer distributions past age 59 ½. Your RMD will be calculated based on the previous year's closing balance, your current age and life expectancy tables published by the IRS. It's important to keep in mind that the required minimum distribution may come from either the corpus or from income. Depending upon asset allocation, it's very possible the Inherited IRA can grow in size despite taking minimum distributions. As we have mentioned in the beginning of this podcast, the stretch provision aims to distribute income payments over your lifetime and your beneficiary's lifetime, thus potentially giving the opportunity to continue to grow the assets on a tax-deferred basis; tax-free in the case of an inherited Roth IRA.

Elean:
That also brings up a point we need to make. Even though Roth IRAs do not require minimum distributions for the original account owner, your beneficiary will be required to take RMDs. Now, we also get asked a lot about assigning a family trust as a beneficiary. This can be done, but you have to focus on the trust's details.

Evan:
So essentially, the issue with many family trusts, especially if it's revocable, is that the stretch provision does not apply to entities. Simply naming a living trust as an IRA beneficiary can have expensive tax implications as the trust will be required to take distributions much faster and at a higher tax rate than a spouse or non-spousal beneficiary. If you want to assign a trust as a beneficiary to your IRA, it's important to review your plans with your estate planning attorney as your trust may need to be amended or completely restated to ensure the stretch provision language is applicable to your trust. I want to point out that you can add a family trust as your IRA beneficiary, however most often we see family trusts not designed or written to accommodate the stretch IRA provisions, and again, that can have very expensive consequences.

Elean:
Finally, every once in a while we get asked about donating IRA assets to a charity. Even though the stretch provision doesn't apply to entities, charities can actually make very good beneficiaries.

Evan:
So if your estate surpasses the estate tax exemption, which is currently $5.49 million for 2017, you may find designating a charity as the primary beneficiary advantageous if you're charitably inclined. If your estate plan already provides well for your heirs this option creates a taxable event for a charity that has tax-exempt status, meaning taxes will not be assessed on the IRA distribution upon your passing.

Elean:
Now, this is not an all-inclusive list of possible beneficiary candidates that you can assign to your IRA. Instead, our goal was to discuss how different beneficiaries can have different tax consequences. Given how important beneficiary designations are, you should review your beneficiary options with both your financial advisor and your estate planning attorney.

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