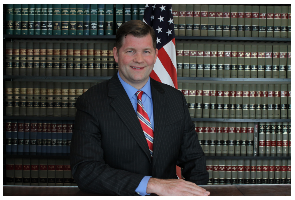

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Child, Grandchild, or Other Individual as Beneficiary of Traditional IRA or Retirement Plan

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What is it?

Naming a beneficiary for your traditional IRA or employer-sponsored retirement plan may be one of the most important financial decisions you ever make. The beneficiary (or beneficiaries) you name will receive the funds remaining in your IRA or plan after you die, so consider your loved ones' future needs. However, choosing the right beneficiary is often more complicated than that. Your choice could have an impact in one or more of the following areas:

- The size of the annual required minimum distributions (RMDs) that you must take from the IRA or plan during your lifetime
- The rate at which the funds must be distributed from the IRA or plan after your death
- The combined federal estate tax liability of you and your spouse (assuming you are married and expect estate tax to be an issue for one or both of you)

If you are married, your first thought may be to name your spouse as the primary beneficiary of your IRA or plan. Naming a spouse is very common because it often makes sense for several reasons . If you are not married, though, you will have to consider other possible beneficiary choices. (Even if you are married, naming someone other than your spouse may sometimes be a better beneficiary choice.) Children, grandchildren, other relatives, and close friends are popular beneficiary choices for IRA owners and plan participants. You must look closely at your situation and seek professional advice to make the right choice.

Caution: *This discussion applies only to traditional IRAs and employer-sponsored retirement plans. Choosing a beneficiary for a for a Roth IRA involves different considerations.*

Caution: *Federal law may require that you designate your spouse as the primary beneficiary of your 401(k) or other retirement plan account, unless your spouse signs a timely written waiver allowing you to name a different beneficiary. Also, if you live in a community property state, your spouse may have legal rights in your IRA regardless of whether he or she is named as the primary beneficiary.*

Caution: *In the case of minor beneficiaries (e.g., young children and grandchildren), it may be in your best interest to establish a custodial account or a special trust to receive the IRA or plan distributions on behalf of the minor. Consult a tax professional for details.*

Your beneficiary choice usually does not affect required minimum distributions during your life

Under federal law, you must begin taking annual RMDs from your traditional IRA and most employer-sponsored retirement plans [including 401(k)s, 403(b)s, 457(b)s, SEPs, and SIMPLE plans] by April 1 of the calendar year following the calendar year in which you reach age 72 — your "required beginning date." With employer-sponsored retirement plans, you can delay your first distribution from your current employer's plan until April 1 of the calendar year following the calendar year in which you retire if (1) you retire after age 72, (2) you are still participating in the employer's plan, and (3) you own 5% or less of the employer. Your choice of beneficiary generally will not affect the calculation of your RMDs unless your spouse is your sole designated beneficiary for the entire distribution year and he or she is more than 10 years younger than you.

Advantages of naming a child, grandchild, or other individual

The funds may be taxed at a lower income tax rate after your death

When you take a distribution from your traditional IRA or retirement plan, you generally have to pay federal (and probably state) income tax on all or a portion of it. For federal income tax, distributions are taxed at a certain rate according to your income tax bracket, which depends on your taxable income for the year. After you die, the distributions that your beneficiary must take from the IRA or plan will be taxed according to his or her income tax bracket. Choosing a beneficiary who is in a lower income tax bracket than you can reduce taxation of the IRA or plan funds after your death. This is one reason that many people name children, grandchildren, and other nonspousal individuals as beneficiaries.

But it may be many years before your beneficiary has to take post-death distributions from your IRA or plan, and his or her tax situation could be drastically different by then. For example, a college student who does not work is probably in a low income tax bracket now, but may be in a much higher bracket 5 or 10 years after graduation. The point is that it can be risky to base your beneficiary choice solely on someone's current income tax bracket.

Tip: *If you have ever made nondeductible contributions to your traditional IRA or after-tax contributions to your retirement plan, those contribution amounts will be free from income tax when distributed to you or your beneficiary.*

Post-death distributions can sometimes be taken over more years

For decedents dying before 2020, if you name an individual other than your spouse as beneficiary of your IRA or plan, that individual will generally be able to take required post-death distributions over his or her remaining single life expectancy. (Your beneficiary can always take more than required in any year, but not less.) The younger an individual is, the longer his or her life expectancy according to the IRS tables. This means that choosing a young beneficiary (a grandchild, for example) could increase the payout period for post-death distributions. There are two important reasons why a longer payout period can be advantageous.

First, it maximizes the growth potential of the funds. The longer funds remain in an IRA or plan, the longer the investment earnings can compound tax deferred. Depending on the size of the account and investment performance, just a few more years of tax-deferred growth could produce thousands of dollars of additional earnings. The other advantage of a long payout period is that it spreads out your beneficiary's income tax liability on the funds. Your beneficiary is able to pay less income tax each year, since the annual minimum required distribution amounts are smaller. With a short payout period, the larger distributions increase your beneficiary's taxable income each year, possibly even pushing him or her into a higher income tax bracket.

Caution: *If there is more than one designated beneficiary, the oldest beneficiary's life expectancy must be used for purposes of calculating post-death distributions from the IRA or plan. However, this outcome can be avoided if separate accounts are established within the required time frame. Consult a retirement plan or tax professional.*

Caution: *For decedents dying after 2019, the life expectancy method can only be used if the designated beneficiary is an eligible designated beneficiary. An eligible designated beneficiary is a designated beneficiary who is the spouse or a minor child of the IRA owner or plan participant, a disabled or chronically ill individual, or other individual who is not more than ten years younger than the IRA owner or plan participant (such as a close-in-age sibling). Other beneficiaries are required to liquidate the account within ten years. This is also true for minor children and grandchildren once they reach the age of majority.*

Caution: *With employer-sponsored retirement plans, the plan may generally decide whether to permit or require the life expectancy payout for beneficiaries taking post-death distributions. Consult your plan administrator about the distribution options available.*

Naming a nonspousal beneficiary may minimize estate tax

When you die, the funds remaining in your IRA or plan will be included in your taxable estate to determine if federal estate tax is due. (Your state may also impose an estate or death tax.) This is generally a concern if the value of your taxable estate exceeds the federal applicable exclusion amount. Even if your taxable estate exceeds this amount, though, the unlimited marital deduction allows you to pass unlimited assets to your surviving spouse free from estate tax at your death. This may seem like a compelling reason to name your spouse as beneficiary of your IRA or plan, but there is more to the story.

If you have a large estate that you leave entirely to your spouse, the combined federal estate tax liability of you and your spouse may be higher than necessary. The reason? Leaving everything outright to your spouse may waste your applicable exclusion amount. If you leave a portion of your assets to someone other than your spouse (or in a credit shelter trust for your spouse), you can take advantage of your applicable exclusion amount. The remainder of your estate can be left to your spouse, sheltered by the unlimited marital deduction. When your spouse dies, your spouse's applicable exclusion amount will shelter at least a portion of his or her taxable estate. By utilizing both spouses' applicable exclusion amounts, this strategy can minimize your combined estate tax liability. IRA or plan funds can be used for this purpose if you name a nonspouse as beneficiary.

Caution: *Estate planning for retirement assets is a highly technical area. The right approach depends on your financial and personal circumstances. Be sure to consult a tax professional.*

You will be providing for your loved ones

You want to make certain that all of your relatives and loved ones will be financially secure after your death. Depending on your situation, providing for everyone's needs can become a challenge when questions arise as to who should receive which assets. With IRA and retirement plan benefits, it is common to designate your spouse as primary beneficiary (assuming you are married) and children or grandchildren as secondary beneficiaries. Your surviving spouse may be able to roll over the inherited IRA or plan into his or her own traditional IRA (see below), and designate your children or grandchildren as primary beneficiaries of the new IRA. When your spouse dies, the children or grandchildren will receive the funds remaining in the IRA.

But this strategy may carry a risk. Once your surviving spouse rolls over the inherited funds, he or she may be free to choose any beneficiaries for the new IRA (and can typically change beneficiaries right up until his or her death). You may implicitly trust that your spouse will follow your wishes, especially if the two of you have discussed and planned for the future. But circumstances may change after your death, and there is often no legal obligation for your spouse to name (or keep) your children or grandchildren as beneficiaries. The risk is especially great if your surviving spouse remarries and names the new spouse as the primary beneficiary. One way to avoid such an outcome might be to name your children or grandchildren as primary beneficiaries, and use other assets to provide for your spouse.

Tip: *If you have multiple heirs to provide for and are concerned that your desired results may not be achieved after your death, you should seek professional advice from an estate planning attorney.*

Disadvantages of naming a child, grandchild, or other individual

Naming your spouse may be a better beneficiary choice

Naming your spouse as beneficiary often makes more sense than naming another individual. The main reason is that after your death, your surviving spouse will probably have greater options and flexibility than other beneficiaries. In addition to taking distributions over his or her remaining life expectancy, your surviving spouse can typically roll over inherited IRA or plan funds into his or her own traditional IRA. Your spouse can choose the beneficiaries for the new IRA, and can delay taking distributions from it until after age 72. (Other beneficiaries must start taking distributions from an inherited IRA or plan by December 31 following the year of your death.) Your surviving spouse may also be able to treat an inherited IRA as his or her own IRA without rolling it over. Both of these post-death options are unique to surviving spouses.

Caution: *Nonspouse beneficiaries cannot roll over inherited funds to their own IRA or plan. However, a nonspouse beneficiary can make a direct rollover of certain death benefits from an employer-sponsored retirement plan to an inherited IRA (traditional or Roth).*

Naming your spouse as beneficiary can also have a positive impact on your lifetime RMDs, but only if he or she is more than 10 years younger than you are. In that case, the distribution payout period can be extended longer than it would otherwise be, allowing you to take smaller distribution amounts each year (as described above).

You should carefully weigh these issues against the perceived advantages of naming a child, grandchild, or other individual as beneficiary of your IRA or plan. An estate planning attorney and/or tax professional can help you make the right beneficiary choice.

You may have limited control over the funds after your death

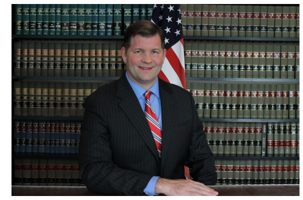
If you want to retain control over your IRA or plan funds after your death, naming a child or other individual as beneficiary may not be the best choice. Even if your beneficiary is young and able to take post-death distributions over a long period (using the life expectancy payout), he or she may not exercise this option. Your beneficiary might instead take larger distributions than required, or even take a one-time distribution of the entire amount. Such decisions may have adverse tax consequences for your beneficiary, especially if the money is all spent before paying the tax bill. Large distributions will also deplete the funds more rapidly, leaving your beneficiary with less money for the future. Finally, the distributed funds will miss out on further income-tax-deferred growth opportunities.

These risks are greater with grandchildren or other young beneficiaries, who may be more likely to squander the inherited funds. However, you can often minimize the risk and retain some control after your death by setting up a trust for the benefit of your intended beneficiaries. You then designate the trust itself as primary beneficiary of your IRA or plan, allowing your chosen trustee to manage the funds after your death. The drawback is that trusts tend to be costly and complicated to set up. For more information, consult an estate planning attorney.

Naming a grandchild or other young beneficiary may raise additional death tax issues

If you expect to have a large estate when you die, naming your grandchild (or other individual two or more generations younger than you) as beneficiary of your IRA or retirement plan may raise additional death tax issues. This is because federal law currently imposes an extra "generation-skipping transfer tax" on transfers of assets in excess of $12,060,000 for 2022 to an individual who is two or more generations younger than you. For more information, consult an estate planning attorney.

IMPORTANT DISCLOSURES This presentation is not intended to and does not provide investment, tax, legal, or retirement advice or recommendations. The information presented here is not specific to any individual's personal circumstances. To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances. These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable — we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.



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