The Basics of Beneficiary IRAs

One of the major benefits of a traditional IRA and other employer-sponsored retirement plans is that there is no federal tax on growth inside the account until the funds are distributed.[1] This deferral of taxes generally allows for faster growth than would be possible if taxes had to be paid each year. Federal law does not allow this tax-deferral to come forever; certain mandatory distributions (known as Required Minimum Distributions, or RMDs) must be made from these accounts once the owner reaches a specified age.

For these accounts, distributions must generally begin the year the owner reaches age 72.[2] Funds distributed from an account are generally taxable as ordinary income in the year received. Failure to make the minimum distributions when required can result in a significant income tax penalty.

The Beneficiary IRA – Extending the Period of Tax-Deferral

The term "beneficiary IRA" or "stretch IRA" refers to a wealth-transfer strategy that, after the death of the account owner, seeks to extend the period during which the assets in an IRA or other employer-sponsored retirement account continue to grow tax-deferred. This concept is most often of interest to those who do not need extra income in retirement, or who wish to leave a legacy to heirs in an income tax-efficient manner.

The Impact of the SECURE Act on the Beneficiary IRA Concept

For account owners dying after December 31, 2019, new federal law, part of the SECURE Act, changed the allowable period of time over which distributions from an inherited account may be made, particularly for non-spouse beneficiaries. Under prior law, generally, distributions could be made over a beneficiary's *lifetime;* for a child or grandchild, for example, this might mean

---

[1] The term "traditional IRA" includes SIMPLE IRAs, and SEP IRAs. Other employer-sponsored retirement plans include defined contribution plans such as 401(k) plans, 403(b) plans, and 457(b) plans.
[2] The age 72 "trigger" date applies to distributions required to be made after December 31, 2019, to individuals who reach age 70½ after that date. Under prior law, age 70½ was the mandated age for beginning RMDs.

distributions made over decades. Under the new law, with certain exceptions, distributions may generally be made over *no more than 10 years*.[3] This change significantly reduces the tax-deferral benefit of the "stretch" concept. For some individuals, the new law will require a revision to their estate plans.

The Pros and Cons of Beneficiary IRAs

Benefits:

- **Minimize tax liability:** The income tax bite may be lessened by taking smaller distributions over a period of years, rather than as a single, large lump sum. As a reminder, a full distribution must be completed in a 10-year period.
- **Continued tax-deferred growth:** Giving the beneficiary a 10-year period to make distributions continues the benefits of tax-deferred growth, potentially increasing the wealth that can pass to the beneficiaries.

Risks:

- **Tax laws may change:** Tax laws or regulations may change, as they did in December 2019, to the detriment of an IRA owner and/or beneficiaries.
- **Poor investment returns:** Investment losses and inflation can both erode, or even eliminate, the value of future IRA distributions.

Spousal Beneficiary and Inherited IRAs

An IRA owner, age 68, makes his spouse, age 62, the sole beneficiary of his IRA. They have two adult children, ages 35 and 25.

When	What Happens
During the IRA owner's life	Beginning at age 72, the IRA owner takes his RMDs
IRA owner dies at age 75	Surviving spouse rolls the IRA over into her name. She names her children as beneficiaries.
Surviving spouse reaches age 72	At age 72, the surviving spouse begins taking RMDs.
Surviving spouse dies at age 80	The children inherit the IRA assets in beneficiary IRAs. Each child must distribute the full IRA account within 10 years.

[3] Generally, for spouses, minor children, those disabled or chronically ill, or those no more than 10 years younger than the account owner are exceptions to the 10-year rule. A minor child is subject to a 10-year distribution requirement once he or she reaches the age of majority.

Post-Death Beneficiary Planning

The previous beneficiary IRA example illustrates situations in which the beneficiary planning took place prior to the account owner's death. However, IRS regulations allow for certain amount of post-death planning. From a pool of potential beneficiaries, those who will ultimately receive the assets must be identified by September 30 of the year following the owner's year of death. This time delay allows or the removal of a potential beneficiary either through a qualified disclaimer, a cash distribution, or by dividing the IRA into separate accounts. Any separate accounts must generally be established by December 31 of the year following the year of the account owner's death.

Setting up a beneficiary IRA requires careful consideration of a number of issues including possible changes in tax law, the impact of inflation, uncertainty of future investment results, the need to integrate the beneficiary IRA into the overall estate plan, and the risks inherent in the planning for an extended period into the future. Changes that came with the SECURE Act at the end of 2019 also complicated beneficiary planning. Your Jacobi Capital team is available to discuss these changes and help implement any changes or plans for your financial future.