

Choosing an IRA beneficiary



Wealth
Management

Who should be the beneficiary of your IRA? The simple answer to this question is the person or entity to whom you wish to give your money. However, it is important to look beyond the simple answer to determine the best way to confirm that your assets are distributed according to your wishes.

Four reasons why it is important to name a beneficiary on your IRA

1. Your beneficiary designation determines how your IRA assets will be distributed when you pass away.
2. Naming a beneficiary will help mitigate the risks of leaving your assets to unintended individuals or entities.
3. Your beneficiary designation may impact the distribution options available to your heirs.
4. Failing to name a beneficiary may result in unnecessary probate expenses or delays.

If you do not name a beneficiary for your IRA assets, your IRA custodian, through an IRA agreement, will provide for a “default” beneficiary. This default beneficiary may not be your intended beneficiary, may expose your heirs to an unnecessarily large tax bill, and may cost them years of tax-deferred growth.

The default beneficiary on your RBC Wealth Management IRA is your spouse. If you do not have a spouse, the default beneficiary is your estate.

You can, and usually should, name both primary and contingent beneficiaries for your IRA. If you

name multiple primary or contingent beneficiaries, you should indicate how much of your IRA each beneficiary should receive. As an account owner you may change your beneficiaries as often as you like. Keep in mind: You can make different beneficiary designations on each of your retirement accounts.

Types of beneficiaries

A primary beneficiary will be the first in line to receive your IRA assets. Contingent beneficiaries are also important because they will receive your assets if none of your primary beneficiaries survive you, or they disclaim the assets.

A beneficiary can disclaim all or a portion of his or her inherited IRA benefit. By disclaiming, the beneficiary is giving up rights to the assets, which then pass to the other beneficiaries. A valid disclaimer must meet specific requirements and generally must be executed within nine months of an account owner’s death.

There are three types of beneficiaries:

1. Eligible designated beneficiary
2. Designated beneficiary
3. Non-designated beneficiary

Beneficiary designations, for distribution purposes, do not become fixed until September 30 of the year following the year of an account owner’s death. No new beneficiaries can be named after the death of an account owner. But beneficiaries who disclaim, or have had their benefits paid out to them in full prior to this date, will not be considered when determining death distribution options.

Eligible designated beneficiaries

Under the new SECURE Act, eligible designated beneficiaries include spouses, minor children of the original account owner until they reach the age of majority, beneficiaries who are disabled, chronically ill, or not more than 10 years younger than the original account owner, and certain trusts. Eligible designated beneficiaries are still able to “stretch” the IRA over their own life expectancy rather than being subject to the SECURE Act’s new “10-year” rule. Most married account owners name their spouse as beneficiary of their IRA.

When a surviving spouse is the eligible designated beneficiary of an IRA, he or she can choose to take

ownership of the IRA by transferring it into an IRA in his or her own name. This gives them the right to name his or her own beneficiaries, delay distributions until age 72 and potentially make additional contributions to the IRA. However, the IRA will be subject to all traditional IRA rules, including the additional 10% penalty for distributions taken prior to attaining age 59½.

A spouse beneficiary also has the right to leave inherited IRA assets in “decendent beneficiary” status, and will not be required to begin taking required minimum distributions until the original owner would have reached age 72. If a surviving spouse is under age 59½ at the time of inheritance, this could be an attractive option, because distributions may be made from the decendent beneficiary IRA free of the 10% penalty that would otherwise generally apply to premature withdrawals taken from an IRA in the surviving spouse’s own name.

Designated beneficiaries

If non-spouse individuals are named as beneficiaries, they will be required to take distributions under the SECURE Act’s (enacted in 2020) new “10-year” rule. A separate account for each beneficiary will need to be established by no later than December 31 of the year following the year of the original IRA owner’s death. Additionally, due to the SECURE Act, non-spouse beneficiaries need to withdraw all assets from the inherited IRA within 10 years following the death of the original IRA account holder. If an eligible designated beneficiary is named, they do not have to withdraw assets within 10 years following the death of the original owner and instead have the option to take RMDs based on their own life expectancy.

A beneficiary has the right to take more than the minimum in any given year, including the right to take a complete distribution. All distributions are taxed at a beneficiary’s ordinary income tax

rate and are not subject to a 10% premature distribution penalty, regardless of a beneficiary’s age.

Upon inheriting an IRA, a beneficiary can name subsequent or “successor” beneficiaries. If a beneficiary dies before the assets are fully distributed, the successor beneficiary may take a lump sum distribution of the IRA assets. Alternatively, subsequent or successor beneficiaries of the original beneficiary will generally be subject to the “10-year” rule. If the original IRA owner died before 2020, namely, prior to the passage of the SECURE Act, and the original beneficiary dies in 2020 or thereafter, then the successor beneficiary will be subject to the “10-year” rule. However, if the original beneficiary also died before 2020, then the subsequent or successor beneficiary may continue the distributions over the remaining single life expectancy of the original beneficiary.

Additional beneficiary election

When designating non-spouse beneficiaries, there are options available to you regarding the methods of distributing retirement assets should one of the beneficiaries predecease you:

- Pro rata designation: Your IRA assets are divided among the surviving beneficiaries only, with no representation by the descendants of the deceased beneficiary. This is commonly referred to as a “pro rata” beneficiary designation.
- Per stirpes designation: “Per stirpes” is a Latin phrase which means “by the branch in equal shares.” If a beneficiary predeceases an account owner, that beneficiary’s share goes to his or her lineal descendants. The descendants do not need to be individually named on the beneficiary form. This can be an advantage if the beneficiaries are young and are still having children. The beneficiary forms would not need to be updated each time a child is born.

The following scenarios will help illustrate how each is applied:

Yvette has an IRA with three beneficiaries: Ahmet, Isla and Mia. Each of Yvette’s beneficiaries is to inherit equally. Ahmet, Isla and Mia each have two children. One of Yvette’s beneficiaries, Isla, predeceases her. How does the beneficiary designation affect the children’s inheritance?

- In the standard pro rata designation, Isla’s share will go to the remaining named primary beneficiaries. Her two siblings, Ahmet and Mia, will each inherit half of Yvette’s IRA.
- If Yvette’s IRA passes per stirpes, Isla’s one-third share will go to her children equally (one-sixth each) and her two siblings each get their one-third. Isla’s share of the IRA stays with her family, namely, with her own children.

To provide you with greater flexibility in your estate planning, the RBC Wealth Management IRA agreements allow you to choose between a standard “pro rata” designation (this is the default under our agreements) and a “per stirpes” designation when naming non-spouse beneficiaries.

Non-designated beneficiaries

Under the new SECURE Act, non-designated beneficiaries include charities, the original account owner’s estate, and non-qualified or non-“look-through” trusts. Entities may be entitled to IRA proceeds as beneficiaries, but they cannot be considered “designated” beneficiaries because they are not people and, therefore, do not have a life expectancy. As a result, they are referred to as “non-designated” beneficiaries. If one of these entities is listed as the IRA beneficiary and an account owner dies before they were required to begin taking minimum distributions from an IRA (April 1 of the year following the year an account owner reaches age 72), the IRA must be distributed within five years. If death occurs after an account

owner was required to begin taking minimum distributions, the IRA must be distributed to the beneficiaries over the account owner's remaining single life expectancy commencing in their year of death.

Estate

Leaving your IRA to your estate has the additional disadvantage of subjecting the IRA assets to probate. Probate can be expensive, time consuming and leave your assets inaccessible for a period of time. Also, it is a matter of public record. Even if your spouse or children are the heirs of your estate, they will not have the same distribution options available to them as they would if they had been the actual designated beneficiary(ies) of your IRA. Being forced to withdraw the money at a faster rate could severely penalize a beneficiary who would have kept the assets growing tax-deferred in an IRA, at least for the duration of the new "10-year" distribution period.

Organization

Naming a charity as beneficiary will remove the IRA assets from your taxable estate for estate tax purposes. Also, neither your estate nor heirs will be subject to income taxes on the amount the charity receives.

If a charity or an estate is a beneficiary of only a portion of an IRA, the other beneficiary(ies) of the IRA may be the "designated" beneficiary(ies) if by no later than September 30 of the year following the year of the IRA owner's death:

- The charity or estate "cashes out" its share of the IRA
- The IRA is divided into separate accounts for each beneficiary

Trust

A trust as beneficiary can be a useful estate-planning tool if properly structured. A trust, as beneficiary, can provide control over how IRA assets are managed and distributed after an account owner's death.

Even though a trust is a non-living entity, a special rule may be applied to certain trusts, notably, "special needs" trusts established for the benefit of either a "disabled" individual, as defined under Tax Code Section 72(m)(7), or a "chronically ill" individual, as defined under tax Code Section 7702B(c)(2). Under this rule, the "special needs" individual who is the trust beneficiary will be treated as the eligible designated beneficiary and be permitted to "stretch" RMDs over their own single-declining life expectancy if the following regulatory requirements are met in order to also create a valid "look-through" trust:

- The trust is valid under state law and is irrevocable or will, by its terms, become irrevocable upon the death of the IRA owner
- The trust beneficiaries must be individuals clearly identifiable (from the trust document) as "designated beneficiaries" as of September 30 following the year of the IRA owner's death
- The IRA custodian is provided with a list of beneficiaries

(including contingent remainder beneficiaries) along with a written certification that the list is accurate and the trust is a valid "look-through" trust by meeting the above requirements by October 31 of the year following the year of the IRA owner's death

- A copy of the trust instrument is provided to the IRA custodian upon demand

Additional guidance from the IRS/ Department of Treasury is still needed regarding trusts named as beneficiaries of IRAs which name the three other categories of "eligible" designated beneficiaries, namely, a surviving spouse, a minor-aged child until the age of majority, and an individual not greater than ten (10) years younger than the original IRA owner. These trusts may also be permitted to allow such an "eligible" designated beneficiary to "stretch" RMDs over their own remaining single life expectancy.

Conclusion

Your beneficiary designation can make a significant difference in your IRA's effectiveness over the long run. It is important to periodically review your beneficiary designations to confirm that they meet your wealth planning objectives. Your RBC Wealth Management financial advisor can work with you and your independent tax/legal advisor to maximize the benefits of your IRA for you and your beneficiaries.



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