Principal Funds

Principal

Beneficiary Planning and Stretch IRA Investor Guide

Inside:

Why You Need a Beneficiary Plan

You've worked hard and created a good life—for you and your loved ones. But when you pass away will your wishes be followed? Or will red tape, taxes, and misunderstandings make things harder for your heirs?

A good beneficiary plan can help you: feel more at ease about the future and make sure your wishes are followed.

Help your heirs make the most of what they inherit by minimizing (or even avoiding) taxes and penalties.

Let's get started.

Start With Your Plan

Write down all your retirement accounts—like IRAs, employer-sponsored retirement plans [401(k)s, 403(b), etc.], bank accounts, stock or other assets—on the following pages. Make sure to include the company where the account is held, the account number, and the location of the paperwork.

Look over your beneficiary info

Each of your retirement accounts probably has a beneficiary listed. Check who's listed for each account. And make sure it's still correct.

Enter today's date:

__________ Month __________ Day __________ Year

This will remind you of when you updated your beneficiary designations. Ideally, you should review your beneficiaries whenever you or a loved one experience a life change (or at least every few years).

Think about your goal for your assets. Is it:

- Making sure your spouse or partner is taken care of?
- Creating a legacy for your children and grandchildren?
- Supporting a meaningful charity?
- Taking care of a family member with specific needs?

Think about the beneficiaries you've designated on each account. Ask yourself:

1. Have you or your beneficiaries experienced any big life events that might change the way you distribute your assets?

   ○ Marriage ○ Adoption ○ Death
   ○ Birth ○ Divorce
   ○ Job change ○ Change in health

2. Have you named your estate as the beneficiary of your retirement accounts?

   ○ Yes ○ No

3. Have you named both a primary (first to inherit) and contingent (secondary) beneficiary?

   ○ Yes ○ No

4. If you listed a charity or other entity as a beneficiary, do you still want to support it?

   ○ Yes ○ No

List Your Accounts Here

Type of asset:

Account/contract number:

Providing company:

Beneficiary(s): Primary: Contingent:

Location of paperwork:

I want the assets to be used to:

Type of asset:

Account/contract number:

Providing company:

Beneficiary(s): Primary: Contingent:

Location of paperwork:

I want the assets to be used to:

Type of asset:

Account/contract number:

Providing company:

Beneficiary(s): Primary: Contingent:

Location of paperwork:

I want the assets to be used to:

Type of asset:

Account/contract number:

Providing company:

Beneficiary(s): Primary: Contingent:

Location of paperwork:

I want the assets to be used to:

Type of asset:

Account/contract number:

Providing company:

Beneficiary(s): Primary: Contingent:

Location of paperwork:

I want the assets to be used to:

Contact the companies that hold your accounts and ask to update your beneficiary designation.

Naming a Spouse as a Beneficiary

Most married people name their spouse as their primary beneficiary. This is the least complicated option. And gives the spouse a lot of flexibility when handling the assets.

As your primary beneficiary, the surviving spouse gets the IRA. They'll have two options:

Assume ownership of the IRA

A spouse can do this by re-titling the account in their name. Or by rolling the assets over into their own IRA. (The spouse will need to follow the usual distribution rules for all IRA owners.

Remain a beneficiary

A spouse may choose to remain a beneficiary on an inherited IRA. This is often a good choice when the spouse is under age 59½ and wants to take distributions without an early withdrawal penalty. It's important to note that the spouse wouldn't be required to take distributions until the IRA owner had reached the age of 70½. At any time after reaching age 59½, they may consider assuming ownership of the IRA as described above. The spouse may assume ownership of the IRA at any time, but they'd be subject to normal IRA distribution rules.

If the spouse is the sole beneficiary and chooses to remain as a beneficiary (other than making it their own), then they must begin taking RMDs by whichever is later:

December 31 of the year the IRA owner would have turned 70½

or

December 31 of the year after the IRA owner's death

The spouse would take distributions as a beneficiary and can recalculate life expectancy each year, rather than reducing the first year's life expectancy by one every year. This allows the distributions to be stretched out a little longer. With this option, all distributions taken before the spouse is 59½ won't be subject to the 10 percent IRS penalty.

Choose Someone Other than Your Spouse as Beneficiary—Stretch IRA

If your spouse doesn't need the IRA

Would your spouse have enough income from life insurance, pension benefits, etc.? If so, you could name another primary beneficiary.

Or you could name a contingent beneficiary. That gives your spouse the option of disclaiming the IRA assets and passing them on to the contingent beneficiary(s). Before disclaiming an IRA, consult with a legal professional. Please note that gift taxes may also apply.

Here are some things to think about:

Age—When you name a younger beneficiary, they can stretch distributions out for 30, 40, or even 50 years. Known as "stretching an IRA," it has a lot of advantages:

- The assets have the potential to keep growing—tax-deferred.
- The beneficiary could get income over many years.
- The beneficiary is taxed only on the amount they withdraw.
- There's no IRS early withdrawal penalty.
- The beneficiary can name a remainder beneficiary to get any assets left over at their death.

Take a look at the chart on the next page. It shows how stretching an IRA can provide income across the generations.

Naming a custodian for minor children—If you name a minor child as a beneficiary, think about also naming an adult custodian. If it's available in your state, a custodian account like a Uniform Transfer to Minor Account (UTMA) or a trust could be a good idea.

Skipping taxes—Think about the "generation-skipping" tax when naming grandchildren as beneficiaries. The tax applies to assets being passed more than one generation removed from the owner. Ask your tax professional for help.

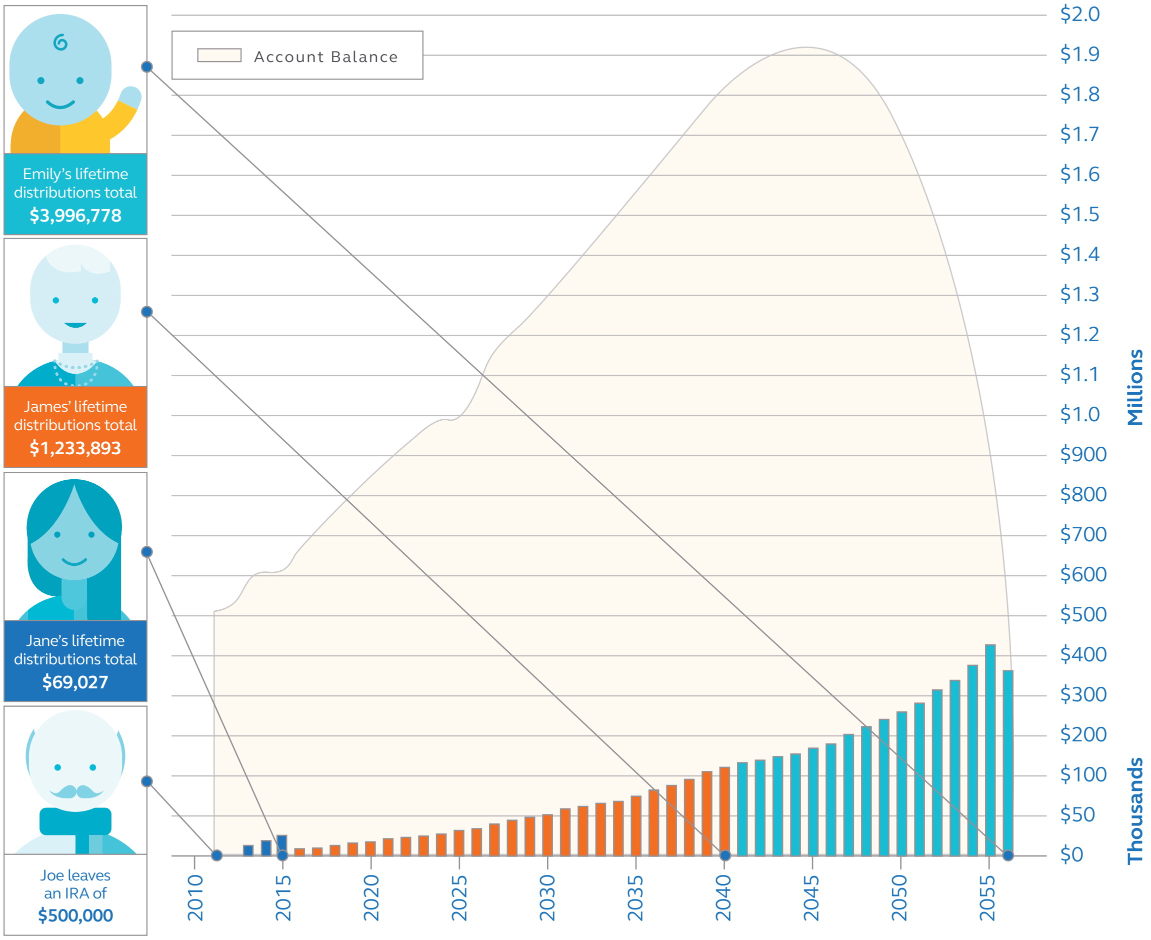
One IRA. Multiple beneficiaries.

If you have multiple beneficiaries on a single IRA, they'd likely have to take distributions based on the age of the oldest beneficiary. So if there's a big age difference between the beneficiaries, younger beneficiaries might have to withdraw larger amounts. That gives them less opportunity to defer taxes while letting the assets grow.

Each beneficiary could take distributions based on their own individual life expectancy. They'd have to notify the IRA custodian to establish separate accounts by December 31 of the year after the IRA owner's death.

Note: Taking only the required minimum distribution will make the most of the stretch IRA strategy. But larger distributions can be taken if needed. Sometimes a stretch IRA strategy isn't the best option, especially if there's an immediate need for the assets.

The Impact of Stretching an IRA



Joe dies at age 68 with a $500,000 IRA.
He leaves the IRA to his wife, Jane, also 68.

Jane rolls over the IRA into her own name and takes the Required Minimum Distribution (RMD) each year when she reaches age 70½. Distributions are based on the Uniform Lifetime Table. Jane dies at age 72. Her lifetime distributions from the IRA total $69,027.

Upon Jane's death, the IRA balance would be $660,258.
She leaves the IRA to her son, James, age 43.

James begins taking RMDs from the Beneficiary IRA at age 43 (based on his Life Expectancy factor of 40.7 years. The factor is reduced by one in each subsequent year.) James dies at age 67. His lifetime distribution would be $1,233,893.

Upon James' death, the Beneficiary IRA balance would be $1,874,334.
James leaves the Beneficiary IRA to his daughter, Emily, age 43.

Emily has to continue taking distributions based on the factor established when her father, James, inherited the IRA. She must continue to take the RMDs until age 59 (when her father would have been 84—his life expectancy). By that time, the IRA will have been fully distributed and Emily's distributions would be $3,996,778.

The amount distributed from Joe's $500,000 IRA would be $5,299,698 over 45 years.

Assumptions: Joe doesn't take distributions from the IRA. After Joe's death, the IRA doesn't receive any contributions and grows at a rate of 8 percent. The figures shown aren't adjusted for inflation, which could erode the purchasing power of the investment. Assumptions are hypothetical and for illustration purposes only. Investments in the IRA would be subject to market risk and the end balance may be higher or lower than the illustration. It assumes that the IRA owner or spouse wouldn't needthe assets in the IRA before or during retirement.

This hypothetical example doesn't depict the performance of any specific investment option. Individual results will vary.

Naming a Charity as a Beneficiary

Here's a way to help your favorite cause and maybe save on taxes. When you name a charity as your beneficiary:

- Your estate doesn't pay taxes on the IRA assets.
- The charity can use IRA assets—free of federal income taxes.
- The charity can take any remaining Required Minimum Distributions (RMD) for the year of death, free of federal income taxes.

Keep in mind, naming a charity and an individual as beneficiaries on the same IRA can get a little tricky.

If you want a charity and your heirs to receive a portion of your inheritance, consider leaving your IRA to a charity and non-IRA assets to your heirs. Your financial or tax advisor can help you understand your options.

Naming a Trust as a Beneficiary

Naming a trust as a beneficiary gives you more control. You can restrict access to the money for beneficiaries who are too young, for instance. Or because you need to protect your assets from creditors. Trusts can also keep the assets invested and growing for the beneficiary.

Trustee—You'll need to name a trustee to manage the trust. This person will invest the assets, take care of paperwork, and disburse funds to your loved ones.

Tax treatment—Trust tax rates go up faster than personal tax rates. So the trust will pay a higher tax rate on earnings than an individual with the same earnings would pay.

Limited flexibility—If the trust provides for a stretch IRA option, the age of the oldest beneficiary will determine the amount of the RMD. If there's a big age difference, that means less flexibility to grow the assets and less opportunity to plan for tax deferral.

Still, if you need to provide ongoing care and support for a family member, a trust may be the best choice. Your financial professional can help you decide.

Stretching through a trust

Make sure the trust document meets the requirements:

- The trust must be a valid trust under state law. Contact your legal advisor for help.
- The trust must be irrevocable upon death.
- The beneficiaries of the trust must be identifiable.
- The IRA trustee, custodian, or plan administrator must be provided a copy of the trust document by October 31 of the year following the IRA owner's death.

Distribution options for different types of beneficiaries

This chart is a quick reference to compare how different beneficiaries are affected by their choice of distribution when the IRA assets are transferred.

Distribution Option	Beneficiary Considerations	Spouse	Non-Spouse	Trusts	Charity	Estate
Available regardless of the owner's age at death						
Lump-sum distribution with no rollover	The entire balance is distributed at one time or over the course of a single tax year.	X	X	X	X	X
Owner dies BEFORE the required minimum distribution date (generally age 70½)						
Five-year distribution option	Allows the beneficiary to take distributions at any time, but the entire balance of the accounts must be distributed prior to the end of the fifth year following the owner's death.	X	X	X	X	X
Inherited account with life expectancy	Commonly referred to as "stretch," this may allow beneficiaries to take distributions for a longer time period based upon their own life expectancy.	X[1]	X	X[2]		
Owner dies AFTER the required minimum distribution date (generally at age 70½)						
Inherited account using the life expectancy of the beneficiary	Commonly referred to as "stretch," this may allow beneficiaries to take distributions based upon their own life expectancy.	X[3]	X	X[2]		
Inherited account using the life expectancy of the IRA owner	Beneficiaries may continue distributions based on what would've been the owner's life expectancy. This life expectancy is determined by the age the IRA owner would've been at the end of the year of death.	X	X	X	X	X
Special option for spouse						
Transfer assets into their own IRA	The spouse will be subject to the same distribution rules as if the IRA had been theirs originally.	X				

[1] The spouse beneficiary can defer distributions until the owner would have reached age 70½. The required minimum distribution will be based on the beneficiary's age at that time and will be adjusted each year.

[2] Must be a qualified trust. Distributions are based on the life expectancy of the oldest beneficiary of the trust.

[3] For a spouse beneficiary, the factor is re-calculated each year based on their age.

Help Beneficiaries Minimize Taxes

Someone who inherits an IRA may have to pay federal and state taxes on the money they withdraw. But they usually don't have to pay an IRS early distribution penalty of 10 percent—unless a spouse is younger than 59½ and makes the account their own at the time of distribution.

Lump-sum distribution

If the beneficiary needs the money right away, a lump-sum payment may make the most sense. But there are some things to consider:

- The distribution may increase the beneficiary's taxes in the year they're taken.
- The beneficiary will lose the tax-deferral advantage of the IRA.
- They could end up with a hefty tax bill.

Talk to a tax professional before you make a decision.

Five-Year Distribution Option

This option is available only if the IRA owner dies prior to their required beginning date (RBD). That's April 1 of the year after they turn 70½.

If the option is available, spreading distributions out over a five-year period could have tax advantages for the beneficiary. Plus, the assets have the potential to continue to grow on a tax-deferred basis.

Inherited account with life expectancy

Beneficiaries have to take minimum distributions from their inherited IRA each year. Failure to do this (correctly and on time) can lead to a 50 percent IRS penalty on the amount that wasn't withdrawn.

When a beneficiary inherits the IRA, distributions can be based on their life expectancy. If they only take the RMD, this can keep most of the assets growing longer in a tax-deferred account.

RMDs are calculated using the Single Life Expectancy Table to determine the beneficiary's life expectancy based on their age at the end of the year following the year of death. Here's an example:

Prior year's 12/31 account value
Divided by
Single life expectancy factor
= RMD

Example of how to calculate inherited RMD

John, age 55, has an inherited IRA valued at $100,000 as of December 31 of last year. He calculates his RMD by dividing $100,000 by 29.6 (the life expectancy factor from the IRS Single Life Expectancy Table). John's RMD would be $3,378.

$100,000
Divided by
29.6
= $3,378

This amount must be taken out by December 31 of the year after the IRA owner dies. Yearly RMDs for subsequent years are calculated by subtracting 1 from the life expectancy factor used for the first year's RMD. Additional amounts can be withdrawn at any time, but the RMD must be calculated and taken each year.

Your financial professional can help with this. If the account wasn't divided into separate accounts by 12/31 following the year of death and there are several beneficiaries on the IRA, the age of the oldest will be used to calculate the RMD.

Deciding What to Do With the IRA

Before you decide how to take distributions from inherited IRAs , think about these questions:

- Is money needed now to cover final expenses and the owner's debts?
- Do you need income more than you need the growth opportunities of an IRA?
- If you need income now, how much do you need?
- What are the tax impacts if you take a lump sum now?
- Would you like to put off taxes on some of the inheritance?
- Did the owner discuss how they wanted the assets distributed? Do you need help to carry out those wishes?

Remember that IRAs aren't governed by the owner's will. And they're not subject to probate (unless the estate is named as the beneficiary).

There are Some Important Dates

After you've identified all IRA assets, contact the companies (custodians) as soon as possible after the owner's death to discuss how distributions will be made. Keep in mind:

- **To elect a life expectancy distribution for individual beneficiaries if a charity is also named as a beneficiary on the same IRA—** There are two options. The charity can take its entire share by September 30 of the year following the owner's death. Then the individual beneficiary can receive a life expectancy distribution. Or if separate accounts are established by September 30 of the year following the year of death, the remaining individual beneficiaries could take life expectancy distributions.
- **If a trust is the beneficiary—**The trustee has to file a copy of the trust documents with the IRA custodian by October 31 of the year following the IRA owner's death.
- **Life expectancy distributions—** Accounts must be separated and taken by December 31 of the year following the IRA owner's death.

Make your own plan

No one likes to think about death. But preparing your own beneficiary plan can help make sure your wishes are carried out. And it can help your heirs through a tough time. Talk to your financial advisor to get started.

Share Your Wishes

Do you want to make sure your spouse is financially taken care of? Are you making your daughter your beneficiary so she has the funds to start a business? Do you want your son to get his master's degree? Now's the time to make these feelings known.

Think about holding a family meeting. You can talk about these and other end-of-life issues. The meeting will make your beneficiaries better prepared when the time comes. And it may be a smart financial move. Your financial advisor will help you with the meeting.

Review the plan each year

Remember to check and update your asset list and beneficiaries at least once a year. Or if there are any life changes like marriage, divorce, births, or health issues.

Work with your financial advisor on a beneficiary plan. You and your beneficiaries will be glad you did.

Principal℠

principalfunds.com