Don't Forget to Check the Beneficiaries on Your Retirement Plans

Get Your Legacy to the Right Person

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When was the last time you checked the beneficiaries of your retirement plans? We ask our clients to contact the custodian for their plans annually and get a written record of their beneficiaries for each plan. Some custodians provide this automatically each year, but many don't. Once you receive this information, we suggest you put it in a file with your other estate-planning documents.

Recently we had two situations that brought home to us the importance of doing this. In one instance, the two equal beneficiaries of the Individual Retirement Account were the client's sister and his life partner. But the custodian misspelled the first name of the second beneficiary so that Joan was named instead of John. In another case, a client had redone his estate plan fairly recently and was advised to name his trust as the beneficiary. He did this for one of his IRAs but not for the other two, thus not accomplishing his estate-planning goals.

In both cases the errors were discovered after the person died. The first error was because of the custodian's mistake, the second due to the client's error. These two cases illustrate the need to make sure your beneficiary designations are up to date, understood, made as you wish and verified.

Retirement Assets Are Governed by Beneficiary Designations

We find that many people don't realize that when you name an individual or trust beneficiary on your retirement accounts, the beneficiary designations you made on these accounts supersede your will in determining to whom assets in these accounts are transferred. Upon your death, these beneficiary designations override bequests you made in your will or trust and the assets transfer directly to your designated beneficiaries.

Beneficiary designations may seem straightforward, but the estate and income tax consequences can be complicated. Understanding the implications of beneficiary designations is critical. An improper beneficiary designation may produce some unforeseen surprises, such as probate and tax liability. Let's elaborate:

Types of Beneficiaries

Primary and Contingent Beneficiaries

- The primary beneficiary is the person or legal entity designated to receive your account assets upon your death.
- May be more than one person or entity.
- Must be a person or qualifying trust.

> "In both cases, the errors were discovered after the person died."

- If a primary beneficiary predeceases you, his share is distributed to any remaining primary beneficiaries per capita unless a per stirpes designation (see definitions in the section below) is indicated.
- In the event that all the primary beneficiaries predecease you, death benefits will pass to any designated contingent beneficiaries; that may be more than one person or entity but must be a natural person or qualifying trust.
- If no contingent beneficiary is named and there are no living primary beneficiaries, the beneficiary designation is no longer valid and the assets will be distributed by state law.

Per Stirpes Versus Per Capita Beneficiary Designations

There are two types of beneficiary designations available when you designate multiple primary beneficiaries: per capita and per stirpes.

- **Per Capita — as per the head**
  Most financial firms automatically assume your assets are to be distributed per capita to your beneficiaries. If you name your two children as primary beneficiaries and one of your children predeceases you, your remaining child would inherit 100 percent of your account balance and the children of your deceased child would inherit none of the proceeds.
- **Per Stirpes — as per the stem**
  If a beneficiary designation is made per stirpes and that beneficiary dies leaving children of his/her own, the deceased beneficiary's share of the death benefit would be paid to these living children. If you use a per stirpes designation, you must indicate the words "per stirpes" after the beneficiaries' names.

Making a Spousal Beneficiary Designation

As with any beneficiary designation, there are advantages and disadvantages of naming your current spouse as your beneficiary.

Advantages

- Your spouse has immediate access to the money.
- Your spouse can delay taking distributions until the date you would have reached age 70½.

- Your spouse may name new beneficiaries.
- Spousal beneficiaries have the option of rolling these assets to another retirement plan account or IRA.

Disadvantages

- Your retirement account assets typically become part of your spouse's taxable estate upon his or her death. If your estate is large enough to trigger state or federal estate taxes, be sure to consult with your attorney or tax professional no matter who the beneficiary is.

Nonspousal Beneficiary Designation

You may leave your retirement account assets to someone other than your spouse. There are considerations to keep in mind when doing so:

- Nonspouse beneficiaries have the option of rolling these assets to an inherited IRA, taking it out in a lump sum or distributing it over five years.
- If the nonspouse beneficiaries roll over the assets to an inherited IRA, they're generally required to begin taking distributions the year after your death based on their ages and thus will have to pay income tax on those distributions. If the nonspouse beneficiary doesn't make this election, the five-year distribution window is automatically assumed for IRAs.
- Your retirement plan assets will always be included in the value of your estate for federal estate tax purposes, potentially increasing your estate tax liability.

Trust Beneficiary Designation

A trust transfers the legal rights of your assets to a trustee who manages those assets for the beneficiaries named in your trust.

Trusts are attractive for families with large estates, complicated bequests or minor children or for supporting family members who are unable to handle their own financial matters.Since a recent court ruling explained that an inherited IRA isn't protected against creditors, some may wish to explore this option. Although trusts have many benefits, they're also generally more complicated and costly to set up and require the expertise of an attorney. A trustee has to be paid to manage the assets.

Divorce

In the event of dissolution of marriage, some states revoke the beneficiary designation naming your former spouse unless the divorce decree provides otherwise. You need to check with your state laws. Even better, make a new beneficiary designation immediately after a divorce is final.

Why You Don't Want to Make Your Estate the Beneficiary

We usually recommend that you not make your estate the beneficiary of any account, as that requires it to go through probate to be distributed. Probate can be a lengthy, complicated and expensive process.

When retirement benefits are payable to the estate instead of to individuals or to a qualifying trust, the beneficiaries lose the ability to stretch the IRA distribution over the life of the beneficiaries.

The life expectancy payout is available only to individuals or the qualifying trusts. The estate isn't an individual or an appropriate trust.

To make sure the trust is appropriate, please review it with an attorney specializing in estate planning. Losing this ability can require the beneficiaries of an estate to distribute IRAs over five years or 401(k) assets immediately in a lump sum. There are serious adverse tax ramifications to accelerating the distribution, as they're taxed when distributed.

Charitable Beneficiary Designation

Your estate may receive an estate tax deduction for assets that are gifted to charity. Care must be taken that the charity is clearly identified by its proper name and is sufficiently specific. For instance, you may want to designate the Red Cross of Washington, D.C., versus the national Red Cross. We encourage you to discuss this type of beneficiary designation and how it affects your estate with your estate attorney.

As always, we recommend you talk to your estate-planning attorney for the best strategy involving your own situation and how your beneficiary designations should be worded. But as we said at the beginning of this article, it's very important that you verify all your beneficiary designations to make sure they're recorded correctly.

This article is meant to be for general education only. It isn't meant to be interpreted as specific legal or tax advice, as that must be sought from appropriate counsel. ■

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