The Value of Advice

Naming Beneficiaries for IRAs and Other Retirement Plans

While most people are familiar with the need to name a beneficiary for a life insurance policy, it is also extremely important to name beneficiaries for annuities and all types of retirement accounts. The purpose of designating a beneficiary is to direct who will inherit a particular account after your death. Here we cover some of the common questions about what to consider when naming beneficiaries.

Who Can Be Named a Beneficiary?

Beneficiaries can be almost anyone with few restrictions. Examples would be a spouse, immediate family member or a trust. You should also name at least one contingent beneficiary as a safeguard in the event the primary beneficiaries are deceased.

What Could Happen If No Beneficiary Is Named?

If you do not name any beneficiaries, by default, you have named your estate as beneficiary. This means that the account could be subject to the probate process, depending on the value of the account and your state of residence. Going through probate is typically a slow and expensive process because of the many formal court procedures in place, and this results in the state determining who will receive your assets.

It is a common mistake to name an estate as a beneficiary. Because an estate is not a person, "life expectancy" is considered zero. In most cases, the beneficiary will be required to take withdrawals from the account and pay taxes on those withdrawals over a five-year period. At the end of the period, the account value must be reduced to zero.

Due to the possibility of going through probate, accelerating taxable events and the loss of the ability to extend an account over a beneficiary's lifetime, naming your estate is not advisable.

Does a Beneficiary Designation Supersede Instructions Included in a Will?

Beneficiary designations are legal designations that will override instructions outlined in a will, even if the will was written after the beneficiaries were named. For this reason, designations should be reviewed regularly.

How Often Should Beneficiaries Be Reviewed?

Accounts should be reviewed each year to make sure that no personal changes need to be made and the beneficiary information reflects what was submitted to each account custodian.

If you have any questions about completing a beneficiary designation or if you have inherited an account as a beneficiary, please feel free to contact your advisor.

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When you name your beneficiaries, you are personally directing who will receive a portion of your wealth. Considering the complex tax consequences, it is wise to consult a tax professional or your advisor with questions.

When Should You Name a Trust Instead of an Individual?

While children can be named as beneficiaries, a custodian will need to be assigned to manage the assets if a child is under the legal age of 18 or 21, depending on your state of residence. In some circumstances, it may be better to name children as beneficiaries through a trust.

For example, if a spouse is the primary beneficiary, a trust for minor children can be contingent. In the event the primary beneficiary is deceased and the trust inherits the account, it would be managed by the trustee and custodial supervision would not be required.

At the outset, a trust must be properly drafted and appropriately named to qualify as a beneficiary. Because of these strict requirements, it is prudent to speak with an attorney before naming a trust as a beneficiary.

When Should You Name an Individual Instead of a Trust?

It is generally better to name an individual instead of a trust if there is a surviving spouse or adult children who could potentially stretch the payment of taxes over their lifetimes. There are significant tax benefits if a surviving spouse can roll an IRA into his or her own IRA account while an IRA can become an inherited IRA with similar tax benefits for adult children.

What Happens When You Are Named as a Beneficiary?

With so much emphasis on naming beneficiaries, it is also important to address what happens when an account holder dies and an account transfers. For certain account types, a beneficiary will have a designated period of time over which he or she must accept the account holdings and pay taxes on those assets unless the account is "stretched."

When a retirement account is stretched, the assets continue to grow over the life of the beneficiary. This simplifies the transfer process for the named beneficiary and does not cause a concentrated taxable event over a short period of time. It is important for beneficiaries to review their options because failure to start taking distributions on a timely basis could accelerate the taxation of the account.

Conclusion

When you name your beneficiaries, you are personally directing who will receive a portion of your wealth. Consult a tax professional or your advisor if you have any questions about completing a beneficiary designation or if you have inherited an account as a beneficiary. It is important to understand the options for each account before making a decision.

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