

Retirement Plans – Beneficiary Designations

GUY GARNER (Arlington, Texas)

Retirement plan accounts, such as Individual Retirement Accounts (IRAs), 401(k), 403(b), and 457 plans, just to name a few, are types of assets most Americans will own at the time of their death. Retirement plan assets are often one of the largest assets individuals own at the time of their death, at times exceeding the value of their residence and their life insurance death benefits. Retirement plan assets, unlike all of the other assets you own, require special attention when you are planning your estate. This chapter will discuss some of the basic rules and principles applicable to your retirement plan accounts. If you follow these rules, your retirement plan assets can become a fortune. If you fail to follow the rules discussed in this chapter, your retirement plan account balances will most likely suffer a devastating loss of value after your death.



RETIREMENT PLAN RULES AND PRINCIPLES

Your retirement plan accounts need their own special “Will,” separate and apart from your other Last Will and Testament or revocable living trust.

This special “Will” for your retirement accounts is called a “beneficiary designation form,” which you must create to ensure your retirement plan benefits pass to whom you want, when you want, and in the manner you want, after you die. The terms and provisions of your Last Will and Testament or revocable living trust will not, and cannot, dictate where your retirement plan account assets will go after you die. You must have completed and signed a beneficiary designation form for each and every retirement plan account you own if you want to control the distribution of your retirement plan assets when you die.

If you have an IRA at Vanguard, an IRA at Fidelity Investments, and a 401(k) plan with your employer, you will need to complete and sign three different beneficiary designation forms in order to control the distribution of the assets in each of these accounts at the time of your death.

If you fail to complete and sign a beneficiary designation form for a retirement plan account you own, then the terms of what is called the “custodian agreement” or “plan agreement” will dictate by default where and how your retirement plan benefits will be distributed when you die. Every retirement account you own will have, in addition to the beneficiary designation form, a contractual agreement between you and the entity that is responsible for holding and, in some cases, managing your retirement plan assets.

These custodial or plan agreements specify who will receive your retirement plan assets when you die if you fail to have signed a beneficiary designation form. Suffice it to say, if you let your retirement plan agreement decide who will get your retirement benefits when you die, there is a very good chance that the “default” beneficiary named in your retirement plan agreement will be your “estate.”

Typically, if your estate is the primary beneficiary of your retirement plan when you die, the entire value of the retirement plan account will be subjected to federal income tax and state income tax (if you live in a state with state income tax). As a rule of thumb, whenever your estate is the beneficiary of one of your retirement accounts, at least $\frac{1}{3}$ of that retirement plan account balance at the time of your death will be lost due to income taxation of your entire retirement account balance. This tragic loss can be easily prevented simply by making sure you have completed and signed proper beneficiary designations for every retirement account you own prior to your death.

EXAMPLE: John rolled over his 401(k) plan from a previous employer into an IRA account at his bank. John’s personal banker, Sally, told John he would need to stop by the bank to sign the “paperwork” on his new IRA account. John was divorced and had two adult children, John Jr. and Jean, whom he had named as his primary beneficiaries on his 401(k) plan.

In spite of Sally’s pleas for John to come in to complete his IRA beneficiary designation form, John kept procrastinating and did not stop by the bank. On his way home from work one night, John’s car was struck head-on by a drunk driver, and John was killed. John’s Last Will and Testament left his entire estate to John Jr. and Jean equally. John had \$300,000 in his IRA account when he died.

Because John had never completed a beneficiary designation form for his new IRA with his bank, the default provisions of John’s IRA custodian agreement controlled whom John’s beneficiaries would be on his death. In this case the default primary beneficiary of John’s IRA account was John’s estate. Because John’s estate was not a “designated beneficiary” (meaning a person, or a special type of trust called a “qualifying trust”), the entire amount of John’s IRA had to be distributed in one lump sum when John died and income tax was due on the full \$300,000 IRA distribution, approximately \$100,000.

If John had completed his IRA beneficiary designation form before he died, naming his two children as beneficiaries of his IRA account, they would have ended up with an extra \$100,000! That is a huge, unnecessary waste.

Seek the help of a qualified estate planning professional to assist you in preparing all of your beneficiary designation forms.

Nationally renowned CPA and retirement account planning expert, Robert Keebler, began his retirement benefits estate planning course with the following statement: “All retirement plan estate planning begins at the beneficiary designation level.”

If you will memorize and utilize this one rule, and follow the advice that follows, you will optimize the uses, benefits, and increases in the value of your retirement plan benefits after you die.

How to properly prepare and complete your individual retirement plan beneficiary designations is beyond the scope of this chapter. There are many ways to complete your retirement beneficiary designations depending on your estate planning objectives. Questions such as: “Whom do you want to receive your retirement plan death benefits when you die? When and how do you want your retirement plan benefits distributed to your beneficiaries?” must be addressed in your retirement plan beneficiary designation forms.

You and your loved ones will best be served if you consult with a qualified estate planning attorney for assistance in reviewing and drafting all of your retirement plan beneficiary designation forms. There are many legal and tax considerations that go into designing the best possible beneficiary designation for your needs. Remember, just because an advisor is sincere doesn't mean his or her advice is correct; he or she could be sincerely wrong.

EXAMPLE: Frank had \$500,000 in his IRA account. Frank's two adult children, Mary and Jane, were poor money managers and spent everything they got their hands on. Frank had read a book about “stretching IRA benefits” for adult children upon a parent's death. Frank decided he wanted an IRA stretch for his IRA so that Mary and Jane wouldn't take a lump sum distribution when Frank died and lose a substantial amount to the IRS in income taxes.

Frank told his IRA account broker that he wanted to make sure his daughters would have “stretch IRAs” when Frank died. Frank's broker said Mary and Jane would have a stretch IRA merely by putting their names on Frank's IRA beneficiary designation. Frank followed his advisor's advice and named his daughters as the primary beneficiaries on his IRA. When Frank died one year later, both of his daughters requested and received lump sum distributions of Frank's IRA account. In the process, Mary and Jane ended up paying over \$166,000 in federal income tax!

What went wrong? What Frank's advisor told Frank was correct. His daughters had the opportunity to stretch out Frank's IRA if they chose, but they were not required to do so. If Frank had worked with an estate planning attorney experienced in drafting IRA Trusts, Frank could have legally forced his daughters to stretch his IRA over their lifetimes. If he had done so, Frank's IRA would have ultimately distributed several million dollars to Mary and Jane over their lifetimes.

Keep a copy of every retirement plan beneficiary designation you have in a safe place, and have your retirement plan beneficiary designations reviewed by your estate planning attorney on a regular, ongoing basis.

Keep a copy of all of your retirement plan beneficiary designations in a safe place.

Never assume the companies and financial institutions serving as your retirement plan's custodian or administrator have on file a copy or the original of the beneficiary designation form you signed. Retirement account beneficiary designation forms do get lost, misplaced, or are sometimes inadvertently destroyed. The IRS has taken the position that if one of your retirement plan beneficiary designation forms cannot be retrieved after your death, it will be assumed you died without having completed a beneficiary designation form! In that case, the default provisions of your retirement plan contract will dictate who your primary beneficiary will be. If the default primary beneficiary happens to be your "estate," your entire retirement plan account balance will be taxed as ordinary income in the year of distribution, and most likely $\frac{1}{3}$ of that account's value will be lost before your loved ones receive a penny!

Estate planning should be an ongoing process rather than a onetime transaction. Laws change, family situations change, wants and needs change, and your net worth can change. Schedule an appointment to meet with your estate planning attorney at least every couple of years and have your retirement plan beneficiary designations periodically reviewed along with your estate planning documents.

When it comes to estate planning involving your retirement plan accounts, there is no substitute for qualified professional assistance. Being informed yourself should also be a priority, because proper estate planning is really a joint effort between you, your estate planning attorney, your accountant, and your financial advisors.

The author recommends the following books written by CPA and author Ed Slott as excellent sources of information about retirement plans and estate planning, as well as the topics discussed in this chapter: *The Retirement Savings Time Bomb... and How to Defuse It*; *Parlay Your IRA into a Family Fortune*; and *Your Complete Retirement Planning Road Map —The Leave-Nothing-to-Chance, Worry-Free, All-Systems-Go Guide*.

Guy B. Garner, III, P.C. offers customized estate and asset preservation planning services to individuals and families wanting superior service and "state of the art" legal representation.
