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Retirement fund beneficiary forms can be tricky

By Rita E. Luce

Rita E. Luce is a partner at Harrison & Held LLP. In addition to speaking and publishing on the topic of qualified plans, she has created numerous effective pre- and post-mortem qualified plan beneficiary designations.

The 401(k)s and IRAs are commonplace. They are simple to establish and many clients have them. And while most account-opening forms are understandable and seem innocuous, naming the beneficiaries of retirement accounts is often not straightforward.

Retirement account beneficiary designation forms offer little assistance and gloss over critical tax and administration issues by blithely advising “consult with your attorney.”

Prior to responding to a client’s inquiry on “how to fill in the form,” attorneys (and clients) should understand that crafting the right beneficiary designations for retirement accounts requires more than a quick or casual consult.

There is no “typical” designation that fits all clients. Significant amounts frequently are involved, making the wrong beneficiary designation costly. Additionally, beneficiary designation errors often are discovered after a client’s death — when few, if any, fixes are available and the fix itself may be expensive. Advising a client on retirement account beneficiary designations without understanding the applicable distribution rules and the client’s assets and objectives can result in unintended consequences that may be difficult to justify to the client’s heirs.

In general, the beneficiary designation controls to whom and how quickly the retirement account assets must be distributed after the account holder’s death. Different beneficiary designations have different distribution requirements under the Internal Revenue Code.

For example, if a client’s will or revocable trust governs distribution of a client’s other assets at death, naming a client’s estate or revocable trust as a client’s retirement account beneficiary seems logical enough. Doing so, however, may result in requiring the entire account to be paid out by the end of the fifth year following a client’s death.

Instead, naming a client’s spouse as beneficiary could postpone all distributions until the spouse reaches age 70½. For a client age 50 who dies leaving a spouse age 50, the difference is significant. If the value of the deceased client’s account is $500,000 and it grows at 5 percent annually, at the end of five years (without any withdrawals) the account value will be $638,141.

If the entire account must be withdrawn by Dec. 31 of the fifth year after a client’s death, all account growth will then cease and the entire $638,141 will be taxable income in that fifth year (no income taxes if a Roth). Assuming a flat 35 percent income tax applies, $223,349 will be paid in income taxes, leaving $414,792 for the estate or trust beneficiaries.

Comparatively, if a client's spouse is named as beneficiary, the account can grow, income tax free, for 20-plus years. At the end of 20 years (without any withdrawals) the account value will be $1,326,649. Additionally, when the spouse is age 70½, distributions from the account can be made over the spouse's life expectancy; lump sum distribution of the entire account is not required.

Using average life expectancies, this spreads the distributions out over approximately 17 more years, potentially qualifying the distributions for a lower income tax rate (no income taxes if a Roth), while leaving significant assets inside the retirement account for continued income tax free growth.

Despite this example showing that designating a client's spouse as beneficiary provides greater growth and income tax deferral potential, the numbers are not everything. A client may not care about the deferral and distribution periods or may want a beneficiary designation that maximizes both.

Safe practice procedures suggest memorializing the beneficiary designation decision process and distribution consequences in a written instrument shared with the client. Further, because of the myriad technical IRS rules and Treasury regulations applicable to retirement account beneficiary designations, obtaining experienced advice may be the best way to protect a client's (and practitioner's) interests.