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Wealth Management

Avoiding Detrimental Designations

Beneficiary designations are just as crucial to the estate plan as a properly drafted will

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Even though retirement account beneficiary designations are an important part of a client's overall estate plan, many attorneys leave beneficiary designations entirely in clients' hands, which can result in unintended consequences. It is important to recognize that beneficiary designations are just as crucial to the estate plan as a properly drafted will or trust agreement, and in some cases, more so.

For example, your client, Joe, decides to name his estate as the designated beneficiary of his IRA. In doing so, he has sabotaged the main advantage of having a retirement plan by drastically limiting the ability of his beneficiaries to defer income taxes. If Joe dies before age 70-1/2 (the age at which he must begin withdrawing "minimum required distributions" from his retirement plan), his heirs will have to redeem the retirement plan proceeds within five years after Joe's death. If Joe dies after age 70 -1/2, the proceeds will be paid out to his heirs over the remaining term of what would have been Joe's life expectancy. In contrast, naming specific individuals as designated beneficiaries rather than Joe's estate would allow his beneficiaries to take out distributions based on their own respective life expectancies. This is a great advantage to younger beneficiaries, since they can slowly realize the IRA as income over a longer period of time. Because IRA or qualified plan distributions to a beneficiary are generally "income in respect of a decedent" (IRD), the beneficiaries will not receive a stepped-up basis on Joe's death, and the distributions will be taxed in their respective top income tax brackets.

What if Joe simply says he wants to list his two children, Jon and Jen, as the beneficiaries. Who should receive Jon's share if Jon predeceases Joe, but Jen survives Joe? Joe should be sure to use a contingent designation. If Joe wants Jon's children to receive Jon's share of the account, Joe's beneficiary designation should specifically provide for Jon's lineal descendants to receive Jon's interest. Otherwise, depending upon the terms of the account agreement or qualified plan, the entire account may pass to Jen, or possibly to Joe's then-wife or his estate. Leaving such drafting up to Joe could spell disaster.

There is a middle ground, however, that would allow a client to complete the beneficiary designations on his own (if, for example, Joe is cost conscious and does not want to ask his attorneys to handle all of the designations for his various plans). Depending on the complexity of the contingencies, it may be preferable for a client's revocable trust to serve as the beneficiary of the retirement plan. In this way, all of the technical drafting would reside in the trust agreement, simplifying the form of beneficiary designation that is provided to the account custodian.

It should be noted that if a trust is designated as the beneficiary, there are many technical income tax, minimum required distribution and trust accounting rules to consider, a discussion of which are beyond the scope of this article.

In the next example, assume that Joe names his children, Jon and Jen, as

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equal beneficiaries of his IRA; at the time of Joe's death, Jon is 35 and Jen is 20. Using one beneficiary designation naming multiple beneficiaries can result in negative payout consequences — all beneficiaries would be required to receive distributions from the account based on the oldest beneficiary's life expectancy.

Due to the age difference, Jen could be shortchanged if the proper steps are not taken during the administration. Specifically, Jen would be required to receive distributions based on Jon's shorter life expectancy. To avoid this, one option is to split the account into separate accounts, either during Joe's lifetime or shortly after his death, allowing each child to take out the minimum required distributions based on his or her own life expectancy. Separate accounts must be established by December 31 of the year after Joe's year of death. A second option is to have the plan administrator distribute Jon's entire share to him before September 30 of the year after Joe's death, leaving Jen as the sole beneficiary. Jon could also decide to disclaim his interest in the IRA within nine months after Joe's death (which, unless Joe dies on December 31, will always meet the overlapping deadline of September 30 of the year after Joe's death), assuming the beneficiary designation or account agreement makes Jen the sole beneficiary were Jon to predecease Joe.

Next, assume Joe's second wife, Jana, explains that she does not want to name Joe as the beneficiary of any of her retirement accounts. Putting aside issues of joint representation (which are a separate discussion altogether), the concern here is that ERISA entitles Joe to at least 50 percent of all of Jana's "qualified plans" (including 401(k) plans but, importantly, *not* IRAs) unless he consents to the designation of another person as beneficiary. Such a consent must be made *after* the wedding date; a prenuptial agreement is insufficient as a form of consent. Although not available in all cases, Jana might be able to rollover her plan (if, for example, she is retiring or will be changing jobs in the near future) into an IRA, in which case she would be free to name whomever she wants as the beneficiary.

You should ensure that Jana is aware that the most tax efficient beneficiary designation is to name her spouse, Joe, as the beneficiary. Upon Jana's death, the retirement assets will qualify for the marital deduction and Joe can put the assets into an IRA in his own name (known as a "spousal rollover"), taking distributions over his own life expectancy and designating his own beneficiaries upon his death. As one can imagine, this strategy is not a good match for every situation since Joe's power to designate beneficiaries may contradict Jana's ultimate goal (i.e., passing assets to her daughter from her first marriage, Johanna.)

There is a strategy that allows Jana to achieve both tax efficiency and to provide cashflow for Joe and a later interest for Johanna. In doing so, Jana can also provide Joe with cashflow during his life. Jana (either in her revocable trust or under her will) can create a QTIP trust for Joe's benefit and name the QTIP trust as primary beneficiary of her retirement account. The QTIP trust must be drafted to ensure that Joe not only receives all income from the QTIP trust, but also that he is "entitled" to all income from the retirement account. Conceptually, the QTIP serves only as a conduit connecting the account to Joe. To qualify the retirement assets for the marital deduction, Jana's executor must be sure to make a QTIP election with respect to both the QTIP trust and the account. Importantly, Joe would still have to consent to the QTIP trust as the beneficiary if Jana's retirement account is a "qualified plan" such as a 401(k).

What if Jana wants to name charities as the beneficiaries of part of the account? For philanthropic-minded clients, naming a charity as the recipient for all or a portion of a retirement account can be the most powerful use of those assets. Assume Jana wants Tulane and Rutgers universities to each receive $500,000 and would like the rest of the account to pass to her daughter, Johanna. Payouts from retirement accounts are worth less to noncharitable beneficiaries (Johanna) than they are to qualifying charitable organizations, such as the universities Jana favors. This is so because although Johanna may be able to defer the income tax on distributions from the account, those funds will eventually be subject to tax at her income tax rate, while a university, as a tax-exempt organization, will not incur an income tax. Using this strategy, Jana can augment her charitable gifts as compared to making gifts in the same amount under her will.

To achieve this goal, Jana's beneficiary designation cannot be drafted as simply as she might hope. Leaving $500,000 to each of Tulane and Rutgers would cause a capital gain (or loss). Why? If Jana's executor were to satisfy a pecuniary bequest under her will with assets in kind, the transaction would be deemed to be a sale, causing gain for which the charitable contribution deduction is not available. Without getting into the technicalities, the same thing happens here. Thus, Jana should create two retirement accounts, one for the universities and one for Johanna. The designation for the charitable account should list the two universities as the beneficiaries in equal shares, and the designation for the second account should list Johanna as the beneficiary (along with appropriate contingent beneficiaries). Jana should monitor the relative values of the accounts during her lifetime and transfer funds between the accounts as she desires to ensure that the charitable account has the level of funding she would like.

The above suggestion also avoids administrative annoyances when a charity "shares" a beneficiary designation with individuals. If an account is divided among charities and noncharities, it is imperative that each charity receive its entire distribution before September 30 of the year after the decedent's death, and that separate accounts be established for all remaining beneficiaries by December 31 of the same year.

If these deadlines are missed, the beneficiaries will be required to with-

draw all plan proceeds within five years of the decedent's death, if Jana dies before reaching age 70-1/2 or over Jana's remaining life expectancy if she dies on or after age the date she turns 70-1/2. Thus, if Jana decides (in spite of the above suggestions) to leave her IRA to Tulane, Rutgers, Johanna, Jon and Jen and the deadlines are missed, then Johanna and her step-siblings would lose the opportunity to establish separate accounts that enable them to stretch payouts over their respective lifetimes.

Perhaps the most important aspect of establishing beneficiary designations is bringing the retirement plan administrators into the conversation. Plan administrators vary with their levels of tolerance for complex beneficiary designations. For example, some plan administrators might reject pecuniary designations (i.e., $500,000 to Rutgers University) and only accept designations based on fractional shares (i.e., one-half to Rutgers University). Other plan administrators may not want to create separate accounts for multiple beneficiaries, which could significantly change how you and your client formulate the client's beneficiary designations as a part of their overall estate plan. In such a case, the client might consider moving the account to a more amenable custodian, if possible. ■