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Six Biggest IRA Beneficiary Form Mistakes

By: Robert A. Ross, J.D.

Americans hold nearly $15 Trillion in IRA's and other qualified plans. If you have a retirement plan you have made a series of very wise decisions. Now you must take steps to protect and preserve what you have worked so hard for.

Do you want your heirs to have to chase after the IRA money? Better make sure you have an up to date beneficiary form. On January 26, 2009, the United States Supreme Court unanimously ruled in the case of Kennedy vs DuPont that the plan administrator was not required to honor the divorce decree. William and Liz Kennedy were married in 1971 while William was an employee of DuPont and a participant in its Savings and Investment Plan. William designated Liz as the sole beneficiary of his plan benefits. When William and Liz divorced in 1994, the divorce decree terminated any of her rights to William's pension or retirement benefits. William never changed his beneficiary form. When William died in 2001, his estate demanded the plan funds based on the domestic relations order. The DuPont plan administrator refused and disbursed the funds to Liz, in reliance on William's beneficiary designation form. The ex-wife, who was still listed on the beneficiary form, gets the money, even though the divorce court ordered her rights terminated and she signed a waiver.

It is important to understand that your will does not control who gets your IRA.

The Beneficiary Designation Form trumps your will. Filling out the Beneficiary designation form correctly is critical. In my practice I see clients who come in with sophisticated wills or trusts. When I ask about the IRA it is often the largest asset. When I ask what the Beneficiary Designation form says they look surprised. They have no idea what the form says. Many cannot even find the form or remember when they last reviewed it.

So what are the Biggest mistakes?

Mistake #1. You cannot find the form. The Supreme Court made it clear, the beneficiary form rules. Without the form you are stuck with the default provisions of the plan. You may not like the result. Frequently it goes to your estate. This is the last place you want it to go. Make sure you and your family can find the form. Do not assume that the plan administrator will be able to find it either. In this time of companies merging, going out of business, getting sold, or moving, files get lost or misplaced. Do you think that when all those files are getting moved that someone takes the time to say wait a minute these Beneficiary forms are very important! Not likely. **Solution** Get an acknowledged copy of your beneficiary form from the IRA administrator. Make sure that you keep the forms in a place that you and family can easily find. All of your planning goes out the window if the form cannot be found.

Mistake #2. The form is out of date. Have there been any changes in your life, such as marriage, birth of a child or grandchild, divorce, job change, retirement, a death? Remember that your will cannot change the beneficiary of your plan! It is imperative that you review the beneficiary form regularly. This is basic, but unfortunately many get it wrong. In 2001 The New York Post ran a headline declaring a "Pension Pickle!" after Anne Friedman's $900,000 pension went not to her loving husband of nearly 20 years but to her sister, who refused to share her new found wealth. The beneficiary form Anne filled out in 1974 and never updated after she married was binding.

Another problem I have seen far too often is accidentally disinheriting a child's family. You name your three children as beneficiaries, intending each child to receive 1/3rd. Your oldest child predeceases you. At the time of your death your two surviving children receive 50% each instead of the 1/3rd you intended. Your oldest child's family gets nothing.

Solution. Review the form annually. Tax time is an ideal time since you are reviewing all of your financial records anyway.

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Mistake #3. You have not named a backup beneficiary. If you do not name a back up beneficiary then who knows who gets the money. The Probate Court will most likely be in charge. Example: you name your spouse as the only beneficiary. If your spouse dies before you, there is no beneficiary so your IRA will be liquidated, taxed and what is left will be distributed to your estate. It is a good idea to name someone, say your children, as contingent beneficiaries. If you name backup beneficiaries then the IRA has a chance of getting it where you want it to go.

A single person may name his parents first and then St Norbert College as the back up beneficiary. Naming a charity is a great planning idea but that is a topic for another day.

Mistake #4. Naming a minor as a beneficiary. A minor cannot control funds. Court appointed Guardians are in control. This will result in a trip to the Probate Court, and later, when the child turns 21 (18 in some states), to the Sports Car Dealership. The only question will be what color! **Solution** Set up a Trust so the funds are managed under your instructions, by people of your choice.

Mistake #5. Missing out on the Stretch IRA Opportunity. The Stretch IRA can turn a modest IRA into millions for your beneficiary. The Stretch IRA is not something that you can buy. Rather it is how you set up your beneficiary designation. Stretching the IRA payments over the lifetime of the beneficiary allows the IRA to grow tax deferred. Let's do some calculations. We have a $100,000 IRA go to a 30 year old child. If the funds earn an average of 7% over the life of the child which according to IRS tables is 53 years, the value would be $1,026,533. A $100,000 IRA has become a very significant asset. Naming an even younger grandchild can supercharge the result to over $2,000,000.

This is great but will it really happen? Probably not! Why? IRS statistics show us that 90% of IRA's are cashed out within 6 months of death. This is called the "Found Money" syndrome. This new wealth is unexpected gain to be spent.

Solution Something needs to be put in place to make sure that the funds will be used over a lifetime. This is a trust. It has lots of different names. IRA Stretch Trust, Retirement Benefits Trust, Stand Alone IRA Trust just to name a few. Regardless of the name the purpose is to preserve the Stretch Opportunity.

Mistake #6. Not providing Creditor Protection for the Beneficiary. Would you like to protect your child's inheritance from divorce, lawsuits, creditors, business failure, even bankruptcy grabbing the IRA? Some children suffer from poor money management skills and others have special needs. The divorce rate in this country is quite high. If your IRA is left to your child who later gets divorced who will end up with the funds? Would you like to protect assets and keep them in the family? Are you aware that you can do this? **Solution** In my office we build Castle Trusts. Historically why were Castle's built? Protection. We like to make sure that your loved ones have the Castle Trust protection. These are trusts that have special asset protection features built in to them that help preserve your wealth and safeguard your assets.

The Bottom Line

The difference between effective planning and getting it wrong can cost your family millions of dollars. Done correctly your retirement plan can preserve some significant funds for future generations to enjoy. Wouldn't it be great if everything always worked out the way you planned? In a perfect world it does. But I am sure you are aware ours is a world full of surprises where Murphy's Rule often jumps up to bite you. The rules surrounding retirement plans are complicated enough, don't compound the difficulty by messing up the beneficiary forms. When a good portion of your assets consist of a retirement plan you need expert help.

Important: The information in this article is for general information purposes only and is not, nor is it intended to be, legal advice, including legal advice for Internal Revenue Code purposes as described in IRS Circular 230. Tax law changes frequently, so please consult your financial advisor.

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