Leaving Retirement Plans to Heirs

By Christopher Hardman

Retirement plan assets, whether held in Individual Retirement Accounts (IRAs) or in employer sponsored plans like 401(k)s, often make up a substantial portion of a taxpayer's wealth. But administering them after death is a process fraught with potential pitfalls. The rules surrounding retirement accounts are extremely complex, so making even a minor misstep in handling these assets may have huge consequences. Following are some areas where these mistakes frequently occur.

***Beneficiary Designations***

One key feature of retirement accounts is the right to designate a beneficiary who will inherit the account when you die. This seemingly small decision can have far-reaching consequences, including how long the tax-deferral benefits of the retirement account will last for your heirs.

Assets passing by beneficiary designation are not subject to probate, and are therefore not subject to the provisions of your will (or revocable trust), so it is vital to coordinate your retirement plan beneficiaries with your broader estate plan. For example, a will may create trusts to manage assets passing to your young children, but children named as beneficiaries of your IRA will receive those assets with no controls.

If no beneficiary is named, your estate usually inherits the plan by default. From an asset-protection standpoint, this subjects your retirement plan to the creditors of your estate. From a tax-planning point of view, it will substantially accelerate the income taxation of the retirement assets, since all assets must generally be withdrawn from the account within five years after you die.

Beneficiary designations should be reviewed regularly, and updated to reflect your current circumstances because they cannot be changed once you die. For example, consider a man who names his spouse as the beneficiary of his retirement plan, later gets divorced and remarries, but dies without ever changing the beneficiary designation. Much to the shock of the new spouse, his retirement account still passes to his first spouse.

***Required Minimum Distributions***

During lifetime, plan participants are generally required to take required minimum distributions (RMDs) from their plan each year once they reach age 70½.  RMDs are computed from the fair market value of the account at the end of the prior year and a life-expectancy factor published by the Internal Revenue Service. Failure to withdraw the RMD can result in tax penalties equal to 50 percent of the required distribution.

After age 70½, a final RMD is required for the year of the participant's death. Distributions taken by the account owner before count toward the RMD, but any shortfall must be withdrawn by the beneficiary. Especially for people who die later in the year, it can be easy for this important step to be forgotten.

Beneficiaries are required to take RMDs beginning in the year following the year the decedent dies. The labyrinth of rules governing computation of beneficiary RMDs may require the services of a professional tax advisor, especially where there are multiple beneficiaries or the designated beneficiary is a trust.

***Post-death Account Administration***

Retirement assets passing to the spouse of the person who died can be rolled into the spouse's own IRA, affording that spouse greater flexibility than any other beneficiary. Any other beneficiary can roll over the account into an "inherited IRA," but it can never be combined with any other IRAs. Checking the wrong box on the new account form for the beneficiary can mean the surviving spouse loses much of this flexibility.

It's also important to note that only direct rollovers from a retirement plan to inherited IRA are valid. Once funds have been distributed to a beneficiary, there is no way to put them back into a retirement account, and the entire amount will be taxed to the recipient as ordinary income in the year it is received.

The IRS has recently approved rollovers from a single retirement plan into multiple IRAs. For plans holding both pre-tax and after-tax contributions, this allows after-tax contributions to be converted to a Roth IRA with no tax consequences, and pre-tax contributions to be directed to a traditional IRA.

While the rules that govern passing retirement assets to heirs are complex, and may be difficult to navigate, many of the worst pitfalls can be avoided by simple actions once you are aware of them. It's vital to coordinate between retirement plan provisions and your overall estate plan to ensure your wishes are met.

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