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Beneficiary Designations for Traditional IRAs and Retirement Plans

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O'Keefe Investment Management

October 06, 2010

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What is it?

If you have a traditional IRA or participate in an employer-sponsored retirement plan such as a 401(k) plan, you are generally required to complete a beneficiary designation form with the IRA custodian or plan administrator. As you may know, the beneficiary or beneficiaries you name (you can generally name more than one) will receive the remaining funds in your IRA or plan account after you die. What you may not realize is that your choice of beneficiary may have implications in other important areas, including:

- The size of the annual required minimum distributions (RMDs) that you must take from the IRA or plan during your lifetime
- The rate at which the funds must be distributed from the IRA or plan after your death
- The combined federal estate tax liability of you and your spouse (assuming you are married and expect estate tax to be an issue for one or both of you)

Because of these and other issues, choosing beneficiaries for your IRA or plan is often a significant financial decision. This is particularly true if your financial situation is complicated, and if your retirement accounts make up a substantial portion of your total assets. It is in your best interest to select proper beneficiaries with the help of a tax advisor and/or other qualified professionals. Your financial and personal circumstances will likely evolve over time, and you are often free to add or remove beneficiaries whenever you want (though certain restrictions may apply, as discussed below). You should periodically review your beneficiary choices to make sure they are still the right choices.

> **Tip:** Employer-sponsored retirement plans include qualified stock bonus, pension, or profit-sharing plans. A 401(k) plan is a type of employer-sponsored retirement plan. If you are unsure if you participate in an employer-sponsored retirement plan, ask your employer. This discussion also applies to you if you are a schoolteacher or an employee of a tax-exempt organization or state or municipal government and participate in an eligible Section 457 plan or a Section 403(b) plan.
>
> **Caution:** This discussion does not apply to Roth IRAs. Roth IRAs have their own special beneficiary designation considerations.

The law may limit your choices

You are often free to name any beneficiaries you choose for your IRA or plan, but there are exceptions. If you are married and want to name a primary beneficiary other than your spouse, there may be restrictions on your ability to do so. No matter which state you live in, federal law may require that your surviving spouse be the primary beneficiary of your interest in some employer-sponsored retirement plans (such as 401(k) plans), unless your spouse signs a timely, effective written waiver allowing you to name a different primary beneficiary. You should consult your plan administrator for further details.

IRAs are not subject to this federal law, although your state may impose its own requirements. For example, if you live in one of the community property states, your spouse may have legal rights in your IRA regardless of whether he or she is named as the primary beneficiary. In addition, if your roles are reversed (your spouse is the IRA owner or plan participant, and you the primary beneficiary) and you die first, state law may prevent your surviving spouse from changing the beneficiary designation after your death (unless you grant your spouse the power to make these changes in a will or other document). You should consult an estate planning attorney for details regarding these and other state issues.

Your choice of beneficiary usually will not affect required minimum distributions during your lifetime

Under federal law, you must begin taking annual RMDs from your traditional IRA and most employer-sponsored retirement plans (including 401(k)s, 403(b)s, 457(b)s, SEPs, and SIMPLE plans) by April 1 of the calendar year following the calendar year in which you reach age 70½ (your "required beginning date"). With employer-sponsored retirement plans, you can delay your first distribution from your current employer's plan until April 1 of the calendar year following the calendar year in which you retire if (1) you retire after age 70½, (2) you are still participating in the employer's plan, and (3) you own five percent or less of the employer.

Your choice of beneficiary will not have an impact on the calculation of RMDs during your lifetime in most cases. An exception exists if your spouse is your sole designated beneficiary for the entire distribution year, and he or she is more than 10 years younger than you. Also, your choice of beneficiary can impact the tax deferral and other consequences for your beneficiaries.

> **Caution:** The calculation of RMDs is complex, as are the related tax and estate planning issues. Consult a tax professional.

> **Caution:** The Worker, Retiree, and Employer Recovery Act of 2008 waives required minimum distributions for the 2009 calendar year.

Your choice of beneficiary will affect required distributions after your death

After your death, your IRA or plan beneficiary (or beneficiaries) will generally have to receive the inherited retirement funds at some point. Distributions from an inherited IRA or retirement plan are referred to as required post-death distributions. With some exceptions, these distributions must begin by the end of the year following the year of your death.

> **Caution:** The Worker, Retiree, and Employer Recovery Act of 2008 waives required minimum distributions for the 2009 calendar year.

For federal income tax purposes, post-death distributions are treated the same as distributions you take during your lifetime. (State income tax may also apply.) The portion of a distribution that represents pretax or tax deductible contributions and investment earnings will be subject to tax, while the portion that represents after-tax contributions will not be. Your beneficiary's income tax bracket will determine how heavily the funds are taxed after your death. This may be something to consider when choosing your beneficiaries.

In addition, different types of beneficiaries will have different post-death options and be subject to different payout periods. The payout period is important because the longer the funds can remain in the IRA or plan, the more time they have to benefit from tax-deferred growth. Also, a longer payout period spreads out the income tax liability on the funds over more years. In most cases, an individual designated as a beneficiary can take post-death distributions over his or her remaining life expectancy. The younger the individual, the longer the payout period. A surviving spouse can generally use this method, but often has other options as well (such as the ability to roll over the inherited funds to the spouse's own IRA or plan). Special post-death rules apply if you name a trust, a charity, or your estate as beneficiary.

> **Caution:** Nonspouse beneficiaries cannot roll over inherited funds to their own IRA or plan. However, the Pension Protection Act of 2006 lets a nonspouse beneficiary make a direct rollover of certain death benefits from an employer-sponsored retirement plan to an inherited IRA (traditional or Roth), effective for distributions received after 2006. However, employer plans aren't required to offer this rollover option to nonspouse beneficiaries until 2010.

Be aware that your beneficiaries will be subject to a federal penalty tax if required post-death distributions are not taken, or not taken in a timely manner. The penalty tax is equal to 50 percent of the undistributed required amount for a given year. This is the same penalty tax that applies when lifetime RMDs (see above) are not taken by the applicable deadline.

Finally, the important point is that who or what you name as your beneficiary is crucial because it will ultimately determine how the funds are paid out after you die, and what portion is lost to taxes. Estate taxes may also be a factor to consider if you expect the value of your estate and/or your spouse's estate to exceed the federal applicable exclusion amount ($3.5 million for 2009, $2 million for 2008).

> **Caution:** In the case of a retirement plan account, the plan may be able to specify the post-death distribution options available to your beneficiaries. Those options may or may not be identical to the allowable options set forth in the IRS distribution rules. You should consult your plan administrator for details, as this could have an impact on your choice of beneficiaries.

Other considerations when choosing beneficiaries

Income and estate taxes are very important considerations when choosing IRA and plan beneficiaries, but they are not the only factors that should enter into your decision. Never forget that, ultimately, you are deciding who will receive your IRA or retirement plan benefits after you die. Think carefully about who you want to provide for, and about how this decision fits into your overall estate plan. Consider the value of your IRA or retirement plan in relation to the value of all of your other assets. Designating the beneficiary of a $20,000 IRA that makes up five percent of your total assets is very different from designating the beneficiary of an $800,000 retirement plan that makes up 80 percent of your total assets. In the first situation, your decision impacts only a small portion of your total estate. In the second situation, your retirement plan is the bulk of your estate.

Designated beneficiaries vs. named beneficiaries

Designated beneficiaries get preferential income tax treatment after your death. Being a "designated" beneficiary is not necessarily the same as being named as a beneficiary on a beneficiary designation form. IRAs and retirement plan accounts may have beneficiaries, but no designated beneficiaries. Designated beneficiaries are individuals (human beings) who are named as beneficiaries, do not share the IRA or plan account with nonindividuals, and are named in a timely manner. Charities and/or your estate can be named as beneficiaries, but they are not designated beneficiaries. A trust named as a beneficiary is not a designated beneficiary either, although the underlying beneficiaries of the trust can be designated beneficiaries under certain conditions.

The distinction between a designated beneficiary and a named beneficiary is important because designated beneficiaries generally have more flexible post-death distribution options, often resulting in more favorable income tax treatment. For example, only a designated beneficiary can use the life expectancy payout method for post-death distributions.

What happens if you have named both an individual and a non-individual (for example, a charity) as beneficiaries of your IRA or plan? Is the individual beneficiary allowed to use the life expectancy method to distribute his or her share? The answer is maybe. It depends on whether certain rules are followed. If you have left your IRA or plan to the beneficiaries in fractional amounts (as opposed to dollar amounts), the account may be divided into separate accounts up until December 31 of the calendar year following the year of your death. Then, the individual beneficiary can use his or her own life expectancy for his or her separate account. Or, the benefits due to the non-individual beneficiary can simply be paid out before September 30 of the calendar year following the year of your death. If the non-individual beneficiary has been fully paid off by the date indicated above, it is no longer considered a beneficiary for distribution purposes. (This approach can be used whether the non-individual beneficiary's share is expressed as a fractional amount or a dollar amount, but the separate accounts rules generally won't apply to pecuniary (specific dollar amount) bequests.)

> **Caution:** If separate accounts are not established by December 31 of the year following the year of your death, or benefits are not paid to the non-individual before September 30 of the year following the year of your death, then your entire account will generally be treated as if there were no designated beneficiary.

> **Caution:** The rules regarding separate accounts are complex. Consult a tax professional.

Primary and secondary beneficiaries

When it comes to beneficiary designation forms, your goal should be to avoid gaps. If you do not have a named beneficiary who survives you, your estate may end up as the "default" beneficiary of your IRA or plan. That typically produces the worst possible result in terms of estate and income taxes and other issues.

Your primary beneficiary is your first choice to receive your retirement assets after you die. You can name more than one person or entity as your primary beneficiary (see below--Having multiple beneficiaries). If your primary beneficiary does not survive you or decides to decline the inherited funds (the tax term for this is a "disclaimer"), then your secondary beneficiaries (also called "contingent" beneficiaries) receive the assets. Typically, the beneficiary designation form that you complete will have separate sections for the different levels of beneficiaries.

Having multiple beneficiaries

You may generally name more than one primary beneficiary to share in the IRA or retirement plan proceeds. You just need to specify (on the beneficiary designation form) the portion of the funds that you want each beneficiary to receive. This can be expressed as fractional amounts (i.e., percentages) or as fixed dollar amounts. Fractional or percentage amounts usually make more sense, since the dollar value of the account usually fluctuates with the underlying investments and the separate account rules (discussed below) generally won't apply to pecuniary (specific dollar amount) bequests. The account does not have to be divided equally among multiple beneficiaries. For example, you can leave 60 percent to one of your primary beneficiaries, and 20 percent each to your other two primary beneficiaries.

In addition, you can designate multiple beneficiaries by name or by a grouping. For example, you might want to name your spouse as your primary beneficiary and your children as the secondary beneficiaries. You can do this by providing the full name of each person, or by listing them simply as "my spouse who survives me" and "my children who survive me."

In some cases, you may want to designate a different beneficiary for each of your retirement accounts (assuming you have more than one), or divide an account into separate subaccounts (with a separate beneficiary for each subaccount). This could potentially allow each beneficiary to use his or her own life expectancy to calculate required post-death distributions, providing greater income tax deferral for your beneficiaries in many cases. If you do this, however, you should try to plan withdrawals from the different accounts accordingly. Taking most of your distributions from one IRA or plan account could leave the beneficiary of that account with less money than you had intended.

If you have more than one beneficiary you want to provide for, the advantage of having one retirement account (or as few as possible) with multiple primary beneficiaries is reduced paperwork and record keeping. Account consolidation may also save you money in annual fees and other expenses. The drawback is that this may limit post-death options. For example, say your children are all named as primary beneficiaries of your one IRA, and they want to use the life expectancy method for post-death distributions. The calculation would generally have to be based on the age of the oldest child, subjecting the other children to a shorter payout period than they could otherwise have.

This outcome can be avoided, however, if separate accounts are established for the children at some point. An IRA or plan account with multiple designated beneficiaries can generally be split into separate accounts at any time up until December 31 of the year following the year of your death (but note that designated beneficiaries are determined by September 30). Each account and its beneficiary might then be treated separately for purposes of determining required post-death distributions.

Caution: The rules regarding "separate accounts" are complicated. Consult a tax professional.

When do you have to choose your beneficiaries?

In the past, you typically had to choose a beneficiary for your IRA or retirement plan by your required beginning

date for lifetime RMDs. Your choice was then "locked in" (at least for certain purposes) on the earlier of that date or the date of your death. The final IRS regulations issued in 2002 extend the deadline for finalizing your beneficiary choices for purposes of post-death distributions until September 30 of the year following your death. This gives you greater flexibility because you are now free to change beneficiaries any time during your life. Changes made after your required beginning date usually will not affect the distributions you are taking (since your choice of beneficiary, unless it is a more than 10 years younger spouse, now has no bearing on the calculation of your RMDs during your lifetime).

The final regulation distribution rules also create significant opportunities for post-death planning. Since your IRA or plan beneficiaries are not finalized until September 30 of the year following your death, a beneficiary could either disclaim (refuse to accept) or cash out (withdraw) his or her share of the inherited funds by this deadline. That beneficiary would then be removed from the list of designated beneficiaries. Only those beneficiaries remaining as of the September 30 deadline would be considered when determining required post-death distributions from the account.

> **Caution:** Although the date for finalizing beneficiaries for distribution purposes is September 30 of the year following your death, an IRA or plan account can be split into separate accounts up until December 31 of that same year. Again, consult a tax professional regarding the rules for separate accounts.

Paying death taxes on IRA and plan benefits

Consult your estate planner as to the source to pay any death taxes due on your IRA and retirement plan benefits. Depending on the death tax payment clause in your will and/or trust and state law, it could be that other assets are used to pay death taxes, or it might be that the benefits will be diminished by the payment of death taxes. An important part of completing your beneficiary designations is making sure that the source of payment of death taxes does not conflict with your overall estate plan.

Your options when choosing your beneficiaries

The terms of your IRA or retirement plan may govern your beneficiary designations. As discussed, many qualified retirement plans require you to designate your spouse as beneficiary or, alternatively, that you have your spouse sign a consent and waiver. Some states (particularly community property states) may require similar spousal consent for IRAs.

Assuming you have a choice, you should carefully consider your options and seek qualified professional advice. The designation of a beneficiary can involve income taxes, estate tax, and other important non-tax issues. Often it will make sense to name your spouse as beneficiary of your IRA or retirement plan benefits. In other cases, it may make sense to name a child, grandchild, or other individual, a trust, a charity, or in rare cases, your estate, as beneficiary. Make sure you understand the advantages and disadvantages of each particular beneficiary choice.

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