



Beneficiary Designations

This is a summary of issues and general discussion about beneficiary designations. It is not intended to cover all possible scenarios, and clients are encouraged to coordinate with the administrator/custodian of their accounts to be sure the designations will produce the desired results. If a client has sophisticated tax planning or a complicated estate plan, they should involve their attorney, tax advisor, and financial planner to ensure the designations are congruent with other aspects of the estate plan.

The goal when making beneficiary designations is to state **clearly** (1) who gets the account, (2) how much they get, and (3) to establish contingent beneficiaries.

Keep it simple. Choose the simplest approach to meet your needs.

1. Never put "estate" as a beneficiary. Many beneficiary designation forms list "estate" as an option, and it's tempting to use since it does not require making any tough decisions about who gets your account. However, if "estate" is your beneficiary, an asset that would otherwise not pass through the probate court for distribution is now subject to the probate process. Think of it this way, beneficiaries are people (except in limited circumstances), not things. "Estate" is a thing, and the account administrator has no way of knowing who the beneficiaries of your estate are when you die, which means the probate court has to determine that.

2. Always use names, not just relationships or classifications. Remember the goal is to be clear; state the designation as "James Bond, my husband" rather than only "my husband." Similarly, if there is more than one beneficiary, state the names of the recipients and their relationship/classification. For example, "Winken, sister; Blinken, sister; Nod, brother" rather than "to my siblings" or "to my brothers and sisters." Often the beneficiary form is structured so that the name and relationship is required; if so, follow the directions when completing the form.

3. If there is more than one beneficiary, be sure the amount each is to receive is clear: "Winken, sister, 30%; Blinken, sister, 30%; Nod, brother, 40%." Watch for 1/3s 1/6ths and any other amounts that do not divide equally – it's better for the owner to divide these amounts than the financial institution. Also if everyone is to get the same amount, use the term "equal shares" or designate equal percentages. The verb "share" on its own does not mean "to share equally," instead it means "to all get some."

4. Be sure the amounts each beneficiary is to receive can be determined upon your death. Avoid using numeric amounts since those could change upon the date of death. If the account value is \$10,000 today and the designation says "\$4,000 to Winken, my sister and \$6,000 to Blinken, my sister," but the account value is \$20,000 at death, who gets the additional \$10,000? Don't assume the account administrator or the court will necessarily conclude you wanted the additional \$10,000 shared on the same basis as the first \$10,000.

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5. Be sure to differentiate between beneficiaries who share on the same level, and primary, secondary, etc., beneficiaries. Many designation forms will have a space for the primary, secondary, and tertiary (or "contingent") beneficiaries. If you have three persons you wish to be primary beneficiaries and each is to receive a third, you don't want to list them as primary, secondary, and tertiary beneficiaries because then the person listed as primary beneficiary would receive all the proceeds (if they survive you) and the other two would get none. Instead, you need to list all three persons as primary beneficiaries and indicate the amount each receives, or use "in equal shares" if they are to receive equal amounts. If the shares are not equal, I recommend stating the amount in percentages – just be sure all the percentages add up to 100 – no more, no less.

6. Charity beneficiaries. If the beneficiary is a charity, be sure it is clearly identified: "AIDS Services of Austin" as opposed to "charity." Charities can be named as beneficiaries without causing the problems "estate" or "trust" beneficiaries can cause because IRS rules make an exception for charities.

7. IRAs. Individual retirement accounts (IRAs) present some additional issues to consider because of IRS rules controlling when withdrawals must be made. It may be tempting to get creative when making these designations, but, if you stick to the simple rules, you have a better chance of accomplishing your goals. If your estate is really complicated, involved your advisors to make sure the designations work the way you intend.

8. Special issues for IRAs

a) Is the beneficiary spouse a US citizen? Non-citizen spouses do not get favorable estate tax benefits and must take all distributions immediately (use a QDOT "Qualified Domestic Trust" to avoid).

b) Spouse's consent required if someone other than spouse is the beneficiary.

c) Designated beneficiary rules. Many IRS rules govern IRAs. Benefits must be paid according to the age of the "Designated Beneficiary" or "DB." The DB rules are very important when there are multiple beneficiaries because the oldest beneficiary becomes the DB and their life is used to determine the timing of distributions.

d) "Young spouse"/"old spouse." There are some exceptions to when the beneficiary spouse must take the benefits if they are substantially older or younger (10 years) than the participant spouse.

9. Best designations for IRAs

a) Married. If you're married, designate your spouse as the sole beneficiary. In addition to promoting marital harmony, this is the easiest and simplest for all parties to deal with. Why? It qualifies for the estate tax marital deduction, it does not raise gift tax issues, the spouse qualifies as the sole designated beneficiary, and upon death the beneficiary spouse has lots of flexibility with the account. She can roll over the account into her name (an option only spouses have), assume the deceased spouse's IRA, take distributions as beneficiary, or disclaim the benefits. The only time disclaimer makes sense is if the contingent beneficiary of the IRA is

the trustee of a trust solely for the benefit of the beneficiary spouse—the reason to disclaim would be because the trust could obtain more favorable tax treatment than the spouse – and either way the spouse gets all of the benefits.

b) Single with children. Designate your adult children as outright (not via trust or otherwise) beneficiaries. The oldest child is the default DB, so if you don't want all kids to receive their distributions on that child's timetable, create separate IRA accounts for each child, or segregate the assets before death. Be sure you know what your IRA custodian will allow—don't make assumptions on how things will be handled.

c) Single without children. Designate to individuals, keeping in mind the DB concerns mentioned above.

d) Charities as beneficiaries. If charities are beneficiaries, make sure the designation does not go through the will or a living trust. If there are people and charity beneficiaries, set up separate accounts or segregate the assets so people are not penalized by the immediate distribution rules that may apply to charities.

10. Trusts as beneficiary. Consider whether there are really advantages to making a trust the beneficiary of your IRA or retirement plan. Simple is better, all other things being equal.

a) Non- tax reasons to name a trust beneficiary of a plan. There are some compelling non-tax reasons to name a trust the beneficiary of an IRA: to control the ultimate disposition of asset, capable management of the asset, to protect distributions from creditors, to preserve the separate property character (if it was separate property to begin with), and to plan for multiple beneficiaries.

b) Tax reasons to name a trust beneficiary of plan. Tax reasons to use a trust as beneficiary are: to fund a bypass or QDOT trust, generation skipping planning, and charitable giving in conjunction with benefits to persons.

c) Four requirements must exist for a trust to be a beneficiary of a retirement plan. (1) there must be a valid trust in place (2) the trust must be irrevocable upon the death of the participant in the plan (3) all beneficiaries of the trust must be identified, and (4) the administrator of the retirement plan must receive all necessary documents by 10/31 of the year following death.

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