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Heed importance of naming, updating IRA beneficiaries

Failing to name contingent beneficiaries, for example, can prove costly oversight

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President Lincoln spoke 272 words at Gettysburg. The Bible was written by more than 40 different authors over a span of 1500 years, using 774,746 words to summarize the history of early Christianity. IRS laws and regulations contain nearly 5.6 million words spanning 13,000 pages and costing taxpayers $13.7 billion—money used by the Internal Revenue Service and other government agencies to oversee and enforce these laws.


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The Gettysburg Address takes about 90 seconds to read, the Bible about 70 hours, and the tax code with all the changes, amendments, and reinterpretations—an entire lifetime.

With a tax code so massive, it's understandable when investors, who save all their lives for retirement, end up giving a good portion of their funds to Uncle Sam because of unknown or misinterpreted tax laws.

Most owners of individual retirement accounts know they need to name a primary beneficiary on the IRA beneficiary form—this is usually the spouse—but it's equally important to name a contingent beneficiary. For instance, in the unfortunate simultaneous deaths of both the IRA owner and the primary beneficiary, if no contingent beneficiary is named, the account might be required to be emptied within five years.

Instead of the account growing tax deferred over the life expectancy of a contingent beneficiary, the account could lose its ability to earn potentially hundreds of thousands of dollars. Even if your IRA account is transferred to your estate after the simultaneous deaths, the account still might be required to be emptied within five years. Naming a contingent beneficiary on your IRA beneficiary form normally trumps the will.

Here's an example. Say the value of an IRA is $250,000 at the time of the deaths of both the IRA owner and the primary beneficiary. If the account is required to be emptied within five years, the total amount withdrawn by the beneficiary named in the will is $304,360. That assumes that the account earns 8 percent annually, and the beneficiary withdraws 20 percent of the value of the account the first year and an additional 20 percent each year for the next four years.

Now, let's say a contingent beneficiary was named on the IRA beneficiary form, and only the required minimum distribution (RMD) is withdrawn each year. Assuming the contingent beneficiary is 47 years old when RMDs must begin, the remaining life expectancy of someone that age is 37 years, according to the IRS's single life expectancy table. This means that the contingent beneficiary can "stretch" his annual withdrawals over a 37-year period while the account continues to earn 8 percent annually. The total amount withdrawn in that case would be $1,481,863, a difference of $1,177,503 compared with the five-year scenario.

The contingent beneficiary may withdraw the entire amount any time after inheriting the account, but at least he or she now has the option to "stretch" the withdrawals. The longer a contingent beneficiary has to withdraw IRA money, the longer the account has a chance to grow to a substantial size because of the power of compounding.

As most of you probably know, an RMD is simply the minimum amount that must be withdrawn from an IRA account each year, and IRA owners normally are required to begin taking a certain amount

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from their accounts the year after they turn 70 1/2 years old. If they fail to take this amount, or fail to take enough, the IRS can slap a tax of 50 percent on the shortfall. Ouch!

Is your IRA beneficiary form updated? Let's say you have gone through a divorce and remarried, and your desire is to leave everything to your new spouse. Did you forget to name your new spouse as the primary beneficiary on your IRA beneficiary form? If your ex-spouse is still the primary beneficiary, and you die, guess what? Your ex-spouse gets the money. Remember, the IRA beneficiary form normally trumps the will.

Let's look at another scenario. You were married, but now are widowed. You've named your two children and one grandchild as the primary beneficiaries, each to receive a third of the account. Their ages are 40, 35, and 5 respectively. You are 68 years old, living on other sources of income, and don't need to tap your IRA funds. Unfortunately, you die one year later.

There are at least two ways for your beneficiaries to handle the inherited IRA. One way is to keep a single inherited IRA. If this is the case, the RMD is calculated using the age of the oldest beneficiary and when withdrawn, is divided equally among the three beneficiaries.

Since the additional life expectancy of someone 40 years old is 43.6 years, according to the IRS table, the account can compound for another 44 years while the heir withdraws the RMD each year.

Usually, a more favorable way to handle this is to split the IRA account into three separate inherited IRAs, one for each beneficiary. Splitting the account into separate accounts allows each beneficiary to use his or her own life expectancy to calculate RMD. Again, the 40-year-old has an additional life expectancy of 43.6 years, the 35-year-old has a further life expectancy of 48.5 years, and the 5-year-old has an additional life expectancy of 77.7 years.

Clearly, splitting the account would be a great benefit to the 5-year-old since the account would compound an additional 34.1 years. As stated above, the longer the account has time to compound, the larger the account will grow and the greater the amount of money that can be withdrawn over the life of the account.

Roth IRAs are an additional way to save for retirement. Unlike traditional IRAs which are tax-deferred, contributions to a Roth are made with after-tax money. Roth IRAs grow tax free, and no tax is owned when the money is withdrawn (providing certain criteria are met) and they aren't bound by the RMD rules—unless the particular Roth IRA is an inherited one. If you own an inherited Roth IRA, you're subject to the same RMD rules as with a traditional IRA, meaning that failing to take the RMD, or not withdrawing enough, could trigger that previously mentioned 50 percent tax on the shortfall.

There are many possible mistakes that can be made when it comes to retirement accounts; when one is made, it could be irrevocable and expensive. Contact your financial adviser. Don't be like one of those investors who saved all their lives only to lose a good portion to Uncle Sam.

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