Watch Those Beneficiary Designations

We all want to live a long and productive life, with our retirement account landing at zero as we take our final breath. But of course it rarely works out that way. So when was the last time you reviewed and updated the beneficiary designations of your 401(k), 403(b), or IRA?

Did you know that *how* you designate a beneficiary—or your failure to do so—can dramatically affect the taxes owed and whether or not the account might keep growing after you're gone?

Over the years, you've been able to defer income taxes through account contributions and (hopefully) through growth of the investments. But at age 70 ½ or your death if earlier, Uncle Sam wants his pound of flesh…at least annually.

If you're married and have named your spouse as beneficiary, there's considerable flexibility. Your spouse can remain as beneficiary and follow the distribution rules or can treat the retirement account as his or her own.

If you've named a beneficiary who is not your spouse, then that person(s) will have the opportunity to stretch the annual required minimum distributions (RMDs) over their own life expectancy. Depending on the beneficiary's tax bracket and the size of the distributions, it may result in lower overall taxes spread over many years—plus the potential for continued tax-deferred account growth.

Note that the IRS differentiates between "beneficiary" and "designated beneficiary." An entity such as a charity or your estate can never be a designated beneficiary. Charities and estates have no life expectancy over which to stretch the required distributions. While ABC Charity can be named a "beneficiary," you must have a pulse to be considered a "designated beneficiary" and be eligible for the stretch option.

Unless there's a compelling reason to control account distributions from beyond the grave (spendthrift children or second marriage situations, for example), you generally will want to avoid naming a trust as beneficiary of your retirement account. There is no particular tax benefit to be gained by it and it simply creates an additional layer in the distribution process. Be sure to consult a qualified attorney if you are considering this option.

Failure to designate a beneficiary doesn't necessarily mean that your family won't eventually benefit from your retirement account. But it does mean the account must be distributed over a much shorter period, likely resulting in a bigger tax bite and curtailing any potential ongoing growth.

So be sure to review and update your beneficiary designations periodically—especially if you've had a change in marital status or previously designated beneficiaries have gone before you.

© 2009 Larry McClanahan, CASL®, CFP® -- All Rights Reserved. Larry is an independent, fee-based advisor in the Portland, Oregon area, and principal of SecondHalf Planning & Investment (www.secondhalf.us), a firm serving the unique financial needs of retirees and those actively preparing for retirement. He can be reached at 503.698.5680. Advisory services and securities through KMS Financial Services Inc., a registered investment advisor and broker-dealer, member FINRA/SIPC.