

# The Perils of IRA Beneficiary Designations: When Even a Judge Can't Save You

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One of the benefits of an Individual Retirement Account (IRA) is that its favorable tax treatment can continue upon the owner's death, to the advantage of the named beneficiaries. Generally speaking, non-spouse beneficiaries have two options: liquidating the account within five years of the original owner's death, or taking distributions over their life own expectancy. In both instances, the beneficiary recognizes regular income upon distribution. The benefit of the second option (known as the stretch option) is that the payment of taxes is deferred- often over decades if the beneficiary is one or more generations below the original owner, leaving the funds sheltered from tax while they grow in the IRA for as long as possible. In accounts with a substantial balance, the difference in the tax bill to the beneficiary can be enormous.

In addition to other administrative rules, to retain the benefit of the stretch option, there must be a named beneficiary with an ascertainable life expectancy. Accordingly, having the proper IRA beneficiary designation is critical to retaining the benefit of the stretch option. The problem is that beneficiary designation paperwork is often out of date and may not reflect current circumstances following a death, divorce or disinheritance. Furthermore, incorrectly completed beneficiary designations may result in the account being payable to the estate of the owner or another individual. In that event, the stretch option is lost forever, even in the event of an inadvertent mistake.

With the prevalence of trusts in estate planning, extra caution must be taken when completing beneficiary designations. With exceedingly careful drafting, certain trusts can be the beneficiary of an IRA and retain the stretch out option, based on the life expectancy of the trust beneficiaries. However, one cannot and should not assume that any trust will qualify as the type of "look through" trust recognized by the IRS for these purposes.

Of course during the life of the original account owner, the beneficiary designation can be changed at any time, but upon their death, whatever designation was in place (or lack thereof) will control. But what about in the event of an honest mistake or oversight by the account owner, can the beneficiary designation be changed retroactively to reflect the owner's wishes and preserve the intended tax benefits? This month, in *Private Letter Ruling 201628004* the IRS declined to recognize effect of a state court judge's order that reformed and modified an erroneous beneficiary designation.

In that ruling an account owner owned two IRAs, the beneficiaries of which were trusts that qualified as "look though" trusts to preserve the stretch out option. When the account owner moved the IRAs to a different broker, the new paperwork was done incorrectly with the result that his estate was the beneficiary of the accounts. Bear in mind that the owner had presumably established these specifically qualifying trusts to be the beneficiaries of the IRA accounts.

Upon the owner's death, the trustees went to court seeking a judicial order to change the designations back to the trusts. The trustees proved their case and the court ordered that the beneficiary designations retroactively be changed to the trusts. When the trustees sought the IRS' blessing to calculate the IRA

payouts based on the life expectancy of the now "official" beneficiaries (the trust beneficiaries), the IRS disregarded the state court's reformation as effective for tax purposes. The result was that the IRAs were taxed as payable to the owner's estate, the tax benefit was lost, and the owner's estate plan was thwarted.

The lesson here is that ensuring that proper beneficiary designations are correctly completed, accurately reflect the account owner's wishes and compliment their estate plan is critical. If you have not checked your beneficiary designations since you opened that account, now is the time to do so.

Please feel free to contact the attorney in our office with whom you typically work or any of the members of our Estate Planning and Wealth Preservation Practice Group if you have any questions about your beneficiary designations or your estate plan.