Unintended Beneficiaries of Retirement Accounts, or: "My IRA is Going Where!?"

By J. Sabrina Go & Grayson Chester, attorneys with Rehberg Law Group, PLLC

Throughout your life, you were probably told time and again to save for retirement. Many of you followed this advice. You took advantage of methods blessed by state and federal governments with preferential, qualified tax treatment. You contributed to a 401k plan (if available), or you put money in a Traditional or Roth IRA. If there are any leftover savings in these accounts when you pass, you are able to direct where they should go by way of a beneficiary designation. Like with most areas of estate planning, it is important to keep your beneficiary designations up to date with current goals as well as current laws.[1] A failure to update a beneficiary designation can result in disastrous unintended consequences, including unintended beneficiaries. In the wake of the recently-passed Setting Every Community Up for Retirement Enhancement ("SECURE") Act, it is now more important than ever to make sure that your qualified retirement accounts benefit the people and causes you want—and to prevent unintended beneficiaries from ever profiting off of your success.

There are several ways in which you, as the retirement account owner, could have unintended beneficiaries on your retirement accounts that will be discussed in detail below: (1) You and your spouse have a prenuptial or postnuptial agreement that could conflict with the IRA contract; (2) You did not name a properly-designated contingent beneficiary on your retirement account; (3) You did not name a successor beneficiary to an inherited retirement account; (4) You may be creating a direct line for a creditor to access your beneficiary's pocket; (5) You named a minor as a beneficiary; or (6) You do not review or update your beneficiary designation.

How can a prenuptial or postnuptial agreement create unintended beneficiaries?

IRAs are normally governed under agreements which, among many other things, specify what should happen if you fail to name beneficiaries or if your named beneficiaries predecease you. But what happens if you and your spouse have a prenuptial or postnuptial agreement which denies the surviving spouse a right to claim a beneficial interest your retirement assets? This glaringly dangerous question was answered in the Ohio Supreme Court case *Kinkle v. Kinkle*, 699 NE2d 41 (1998). In this case, Mr. and Mrs. Kinkle executed a prenuptial agreement which specifically denied Mrs. Kinkle benefits from

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[1] Assets with a beneficiary designation, including retirement accounts, are not usually controlled by your estate planning documents, whether you have a Will or a Revocable Living Trust. Instead, the asset will transfer according to beneficiary designated in the retirement contract. This aspect of beneficiary designated assets reflects the importance of who and how beneficiaries are named.

Mr. Kinkle's IRA with Fidelity. Mr. Kinkle passed away without ever naming a beneficiary on his Fidelity IRA. Therefore, the contract governing the IRA at Fidelity determined the beneficiaries. In this case, the default beneficiary under the Fidelity IRA contract was the surviving spouse and, if none, the estate of the decedent. Consequently, Fidelity took the position that Mrs. Kinkle, the surviving spouse, was the beneficiary. Mr. Kinkle's children claimed the IRA beneficiary was Mr. Kinkle's estate because of the existence of the prenuptial agreement. The Ohio Supreme Court ruled in favor of Mr. Kinkle's children holding that the prenuptial agreement served to take the spouse out of the picture with regard to the IRA contract, thereby making the beneficiary the decedent's estate. Although not every state court has an answer to this issue yet, the point is clear: You do not want to be the test case on a question like this one. This case might have been decided differently had the decedent affirmatively named his spouse as his beneficiary, only underscoring the dangers of relying on an IRA contract's default beneficiaries.

How can an improperly-designated contingent beneficiary create unintended beneficiaries?

Most IRAs allow you to name not just a primary beneficiary, but also a contingent beneficiary. In most cases, you can even name a class of people, for example: "My children." And in many cases still, you are afforded the opportunity to provide some clarity about what should happen in the event one or more of the members of that class are not surviving. For example, if you name your three children equally as your beneficiaries and one predeceases you, where should his or her share go? Should it pass to the deceased child's own children (per stirpes) or should it pass to your other two children (per capita)?[2] It is important to affirmatively answer this question for yourself, otherwise you might end up unintentionally cutting out some family members at the expense of others.

How can a person who inherits a qualified account create unintended beneficiaries?

Even with successful beneficiary designation planning, it is still possible to create unintended beneficiaries at some point after your death, particularly if you are naming a non-spouse as the beneficiary. Once you have passed away and your IRA begins providing for the benefit of your intended non-spouse recipient, that beneficiary now has a critically time-sensitive task of his or her own: He or she must name his or her own successor beneficiaries as soon as possible to avoid the IRA contract from causing unintended beneficiaries. It could easily take a few months to complete the paperwork, and a beneficiary dying before this process can be completed could have devastating unintended effects.

[2] Some financial institutions today still do not let you choose between "per capita" and "per stirpes" and often force the class to be governed by the "per capita" rules. This shortcoming can be overcome, but only with thoughtful and careful planning.

To illustrate the importance of naming a successor beneficiary with all possible haste, imagine the following scenario. You have an IRA and you named your adult married child as the beneficiary of this IRA. You pass away and your child claims the IRA. An inherited IRA account was properly created and your child began the process of naming a sibling as the successor beneficiary to the IRA. Your child dies soon after completing some of the paperwork but before the beneficiary designation could be made. Who is the beneficiary of that IRA now? Since the paperwork has not been completed and processed, a new set of contractual default rules would apply, which vary across IRA contracts. Some IRA contracts name the surviving spouse as the primary beneficiary, and others name the decedent's estate as the primary beneficiary. In this example, there is a chance that your child's spouse is now the beneficiary of your IRA. You may be fine with that outcome, but what if your in-law was in the process of divorcing your child? Would you still be happy if the in-law were the default beneficiary? These hypotheticals illustrate the importance of naming a successor beneficiary as soon as possible after a death because there is no guarantee that the current IRA beneficiary would survive the time it takes for the successor beneficiary paperwork to be processed.

It is important to understand that although the decedent has less control over their beneficiary's behavior in this regard than they might wish, an IRA owner concerned about a negligent beneficiary should consider their options, including an IRA Trust, to help structure an effective solution to these and many other important questions. In any case, all IRA owners are strongly encouraged to discuss with their intended beneficiaries the immediate steps they must take as soon as possible after the IRA owner's death.

How can a creditor be an unintended beneficiary?

Qualified retirement accounts are special assets because they are normally protected to a large degree from both bankruptcy and creditors. As such, maintaining this protection can be a critically important goal in formulating a proper estate plan around an IRA. In the wake of the US Supreme Court's ruling in *Clark v. Rameker*, 134 S. Ct. 2242 (2014), we now know that inherited IRAs are no longer considered exempt from bankruptcy creditors. This is a huge blow for many because they presumed that their IRA, in the hands of their intended beneficiary, would hold the same bankruptcy and creditor protection that they do. In many cases, directing an IRA to a child with creditor issues is simply setting up a direct funnel into that creditor's wallet. If having creditor protection is a concern, an IRA Trust, as part of an estate plan, should be considered because an IRA Trust can offer creditor protection over inherited IRAs.

How can naming a minor as a beneficiary create unintended beneficiaries?

Naming a minor as a beneficiary for any asset is often a bad idea, but it can be especially so in the context of a qualified account. This is because a minor lacks the legal capacity to make most types of decisions for themselves, including deciding the right way to benefit from the IRA. When a minor is the beneficiary of an IRA, the custodial institution may require that the payment be made to a guardian to protect the minor beneficiaries' assets. This is both an expensive and time-consuming process. Additionally, there are compliance rules (and corresponding penalties) regarding the decedent's untouched RMD in the year of death. A minor beneficiary does not have the capacity to comply with the oftentimes very strict IRS rules. The inability to observe the mandatory withdrawal time frame can result in severe financial consequences as a result. In both of the above scenarios, the unintended beneficiary is the IRS, who pockets the penalty or needless taxes incurred on account of poor planning.

Another set of unintended beneficiaries when dealing with a minor child (or grandchild) beneficiary is that the individual does not have the capacity to name his or her own beneficiaries, as previously discussed. If that minor child (or grandchild) dies without having the ability to add a beneficiary to the asset, the IRA contract will govern. If the contract states that the beneficiary is the estate, this might very well have just caused an otherwise unnecessary probate.

How can reviewing beneficiary designations help prevent unintended beneficiaries?

For many people, the best way to prevent unintended beneficiaries of their qualified accounts is to review and update their beneficiary designations. A CPA, financial advisor, or estate planning attorney can help ensure that your beneficiary designations reflect your current goal and wishes, and that they are not creating a future problem for you and your family. In some cases, all you need to do is to update the beneficiary designation form. Older IRA beneficiary designation forms would oftentimes not allow you to create anything more than extremely basic contingency plans. For example, your primary beneficiary might be your spouse, but perhaps the only choice of contingent beneficiary you were given when you last reviewed your designations was either "surviving children" or "estate." You likely picked the one that best matched what you wanted then. Nowadays, however, these beneficiary designation provisions are more expansive and can better accommodate your wishes. Now, when updating your beneficiary designation, you have many more choices as to who can be your primary and contingent beneficiaries, such as your deceased child's children (your (adult) grandchildren), an IRA Trust, a Trust for a Disabled Beneficiary or a Chronically Ill Beneficiary, etc. By taking time now to review and update your beneficiaries, you can avoid creating an unintended beneficiary problem simply because you never got around to reviewing what you thought you wanted 30 years ago.

It cannot be emphasized enough the importance of having the correct beneficiary designation on your qualified retirement accounts. Unintended beneficiaries are just one of the many reasons that should prompt your periodic review of your own broader estate plan. When executing or reviewing your estate plan, it is prudent to take a holistic approach. Look at how your assets are distributed and make sure that those distributions match or complement the distributions of your beneficiary designated accounts. It is important to work with your CPA, your financial advisor, and your estate planning attorney—your trusted advisors who are here and available to help you achieve your goals and desires.

This article focuses on IRA owners with non-spousal beneficiaries. It does not cover the in-depth for spousal beneficiaries, which are beyond the scope of this article.

Rehberg Law Group is a boutique law firm in Washington State that focuses exclusively on estate planning and estate & trust administration. We have been providing estate planning services for Washington State's Puget Sound region since 1968.

J. Sabrina Go is a partner at Rehberg Law Group, PLLC and is licensed to practice law in Washington and Minnesota. She is also the editor of the firm's monthly newsletters. Sabrina has a B.A. degree in Political Science from University of British Columbia and a Juris Doctorate degree from University of St. Thomas School of Law in Minneapolis, Minnesota. She is a member of the East King County Estate Planning Council.

Grayson Chester is an attorney at Rehberg Law Group, PLLC and is licensed to practice law in Washington. He attended New College of Florida, graduating with a double major in History and International Studies and a Juris Doctor degree from the University of Washington School of Law.

You can reach Sabrina at sgo@rehberglaw.com and Grayson at gchester@rehberglaw.com, or by calling Rehberg Group at 206-246.8772.