Choosing Beneficiaries for Your Retirement Accounts

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Who you choose as a beneficiary of your retirement accounts, and how you designate each beneficiary, can have a significant impact on your family. Properly designating beneficiaries as part of your retirement planning process can help you contribute to the financial well-being of your heirs, giving them more options for how they receive the money and when those assets are taxed.

BY THE NUMBERS

- A missed required minimum distribution* may be subject to a penalty tax.**
- Consider meeting with your financial advisor or investment professional at least once a year to ensure that your retirement investments, beneficiaries and overall financial plan meet your needs.

*Under the "Setting Every Community Up for Retirement Enhancement Act" of 2019, as revised in 2022 ("the SECURE Act 2.0"), the required beginning date of RMDs was raised from age 72 to 73 for any person who attains age 72 after December 31, 2022. There is no change to RMDs for people who turned age 72 prior to January 1, 2023.

**In 2023, the SECURE Act 2.0. reduced the IRS penalty for taking out less than your full RMD from 50% of the underpayment to 25% (10% if corrected in a timely manner). You should consult your investment professional or tax advisor about your specific situation.

Different accounts have different rules

Many people saving for retirement have their assets in a mix of tax-advantaged retirement accounts, such as 401(k)s, 403(b)s and IRAs. While these accounts have many similar features, there are important distinctions.

One of the most critical differences involves spousal beneficiary rights. In a 401(k) plan,[1] your spouse is considered your beneficiary unless they sign a waiver. This can get complicated if your spouse at the time of your death was not your spouse when you named your beneficiaries — you may not think of asking them if they are willing to sign a waiver after you are married. The beneficiary rules for IRAs are governed by state law or by the IRA document. Some states protect a spouse's right to be a beneficiary while others do not.

Why is this important? Let's look at an example. Suppose that after his divorce, a man names his children as beneficiaries on his IRA and his 401(k) accounts but neglects to change the beneficiary on his Roth IRA (leaving it as his ex-wife). A couple of years later, he remarries and then dies a short time later. His current wife receives the proceeds of his 401(k) because she did not sign a waiver. The assets in his IRA go to his children and his ex-wife is entitled to his Roth IRA unless state law or the IRA document says differently. But this may not be what the man intended. A situation such as this shows why it is important to conduct a full beneficiary review after any major life change such as a marriage, a divorce or the birth of a child.

[1] This applies to most qualified retirement plans of private US companies that are subject to ERISA.

KEY POINTS

- What your beneficiaries do with your retirement account assets can be as important as what you do with the assets. You may want to include them in your planning.
- Beneficiaries of all types of retirement accounts are subject to required distribution rules. It is important to understand these rules.
- Your legal and tax advisors can help you designate beneficiaries for a retirement account so that your decision fits with your own financial and estate plan.

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Types of beneficiaries

Your primary beneficiaries are the people first in line to inherit an account. If they are alive when the account holder dies, these beneficiaries may choose to accept the account or disclaim it. If the beneficiaries decide to disclaim or decline the benefit, they cannot choose who will receive it instead.

In a situation such as this, the account goes to the person who would have received it if the disclaiming beneficiary had predeceased the account holder.[2]

You may also name *contingent beneficiaries*, and this is generally a good idea. Your contingent beneficiaries will inherit your retirement account if the primary beneficiary predeceases you or disclaims the benefit. For married couples with children, it is common to name your spouse as the primary beneficiary and your children as the contingent beneficiaries.

In order to name someone other than your spouse as the beneficiary on an ERISA qualified retirement plan such as a 401(k), your spouse would need to sign a waiver.

Designated beneficiary

A person or qualifying trust identified on your beneficiary form is considered a *designated beneficiary*. Designated beneficiaries must fully deplete the retirement account they have inherited by the end of the year that includes the tenth anniversary of the account holders death.[3] Some beneficiaries are able to wait until the tenth year to take all the money out and some are required to take distributions each year during the ten year period. The beneficiary's investment professional or tax advisor can help them make an educated decision.

An estate, a charity and some trusts are considered a non-designated beneficiary. Non-designated beneficiaries must fully deplete the account they have inherited by the end of the year that includes the fifth anniversary of the account holders death.

Eligible designated beneficiaries

Disabled beneficiaries, chronically ill beneficiaries, the retirement account owner's minor children, spouse and people not more than 10 years younger than the owner are eligible designated beneficiaries and have different options. An eligible designated beneficiary can use their life expectancy to calculate their annual required distribution. The owner's minor children may use their life expectancy until they reach the age of majority and then switch to the ten year rule.

[2] A valid disclaimer must be made in accordance with state law within nine months of the account owner's death.

[3] If an IRA owner passed away before 1/1/20, different rules apply. Please consult a tax or investment professional for details.

Your beneficiaries' options

Your beneficiaries have a choice about what to do with an inherited retirement account, and their decision will have important tax implications. Because of this, you may want to suggest that beneficiaries talk with a legal or tax advisor before deciding on a course of action.

Any beneficiary may choose to take a full distribution of the account, if permitted under the plan, although there may be tax consequences. Distributions from traditional IRAs and qualified plans are generally taxable, so taking a complete distribution in a single tax year can create a substantial tax liability. Generally, distributions from a Roth IRA that is at least five years old are tax-free.

Any beneficiary may choose to reregister an IRA as an inherited IRA or roll a lump sum distribution from a qualified retirement account into an inherited IRA. Depending on the type of IRA, who the beneficiary is and what required minimum distribution rules may apply, this option can spread the inherited account's income tax liability over a longer period of time or, in the case of tax-free Roth distributions, potentially result in more after-tax income than taking a lump sum withdrawal. You and your beneficiaries should consult your financial advisor or investment professional about the rules specific to your account.

A spousal beneficiary has the option of treating an inherited IRA as his or her own. Spouses can also roll an inherited retirement account such as a 401(k) into their own IRA. In both instances, all regular IRA distribution rules apply once the transactions are complete. The spouse's option to treat the decedent's IRA as their own, does not need to be elected immediately, so the spouse could choose to re-register the account at a later time.

Keep in mind that there are advantages and disadvantages to an IRA rollover, depending on the investment options, services, fees and expenses, withdrawal options, required minimum distributions, tax treatment and your unique financial needs and retirement goals. Your financial advisor or investment professional can assist in determining if a rollover is appropriate for you.

A spousal beneficiary can leave the IRA as an inherited IRA and does not have to take required minimum distributions (RMDs) until the decedent would have turned age 73.

As you can see, beneficiary choices about how to deal with an inherited retirement account have important tax implications. Heirs should always consult their legal or tax advisor before making any decisions.

Conclusion

Determining the beneficiaries of your retirement assets is a crucial part of any estate plan. Check with your legal and tax advisors about the beneficiary options that are right for your estate planning needs.

Contact your financial advisor or investment professional for more information or visit mfs.com.

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