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Avoid a Big Tax Hit By Properly Naming Beneficiaries

Advisor Don Cloud addresses this issue with a couple looking to provide for daughters, including on with special needs.

By CHERYL WINOKUR MUNK

Don Cloud (center) with Germi Cloud (right) and Charlie Harriman (left.) The lead advisors are Cloud Financial Inc. of Huntsville, Alabama.

A married couple in their late 50s, with two adult daughters, sought help from financial adviser Don Cloud. They were retired, had a net worth of about $1.25 million and were concerned about the way they had structured the beneficiaries on their retirement accounts.

"Beneficiary structure can be one of the most critically overlooked facts when developing a comprehensive financial plan," says Mr. Cloud, president of Cloud Financial in Huntsville, Ala., which manages $140 million for 375 clients. Unfortunately, problems with beneficiary designations often aren't discovered until after an account holder dies, at which point it is too late to make changes, he adds.

Mr. Cloud found that indeed they hadn't properly set up the beneficiaries on their accounts: The husband had named his wife as the primary beneficiary on his 401(k), worth around $600,000, but he hadn't listed any contingent beneficiaries. The wife, meanwhile, had named no beneficiaries on her 403(b) account through the state of Alabama, which contained $40,000.

While surviving spouses usually inherit a retirement plan, if both of them were to die and no contingent beneficiaries were named, the money would go to the estate—at which point federal income taxes would seriously cut into the retirement funds. There could be a federal income-tax bill of at least $253,000, Mr. Cloud calculated.

The couple's daughters were both in their 20s. The older one was a pharmacist who earned around $100,000 a year, while the younger one had special needs and still lived at home. The parents incorrectly thought they didn't need to name contingent beneficiaries for their retirement accounts because they planned to set out in their will how they wanted the money to be divided.

Their idea was that all of their retirement assets should go to their older daughter, the pharmacist. They wanted her to be responsible for distributing 60% of the inherited retirement funds into a special-needs trust the parents had already established for their younger daughter.

Mr. Cloud explained to the couple that if they were to implement their plan, the money their pharmacist daughter inherited would be considered income and taxed before she distributed the requisite funds into her sister's trust. That would have pushed her up four tax brackets into the 39.6% marginal bracket, considerably higher than that of their special-needs child.

Instead, Mr. Cloud suggested, for simplicity and increased investment options, that the couple open up individual retirement accounts and transfer their respective 401(k) and 403(b) funds into the new accounts. Then he recommended that each spouse be named as the primary beneficiary of the other's account. On each IRA, the pharmacist and the special-needs trust were named contingent beneficiaries, to receive 40% and 60%, respectively.

Upon their parents' eventual deaths, the daughters will have the option to spread the IRA distributions over their life expectancy. In that way, they can continue growing the money tax-deferred, paying taxes only on their required minimum distributions.

The solution meant the daughters would save significantly on taxes, and thus have more money available to them. In the case of the younger daughter in particular, Mr. Cloud notes, "hundreds of thousands of dollars can make a world of difference to the financial security of someone who has special needs."

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