IRAs without designated beneficiaries = a problem (or lawsuit) waiting to happen.

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Advisors can add value by checking beneficiary forms and avoiding time-consuming headaches (or worse) later on.

Every client with an IRA or other retirement account must have a designated beneficiary, or bad things can happen. Among them: stretch IRA being lost; children getting disinherited; or the wrong beneficiaries, like ex-spouses, receiving the funds and other unintended consequences.

A designated beneficiary is an individual who is named on the IRA beneficiary form, *not* in the will. A designated beneficiary can only be an individual: a person, not an entity like your estate.

If the same beneficiary inherits through the will, under the tax law, it is treated as if the estate were the beneficiary. And since the estate is not an individual and has no life expectancy, the inherited IRA must be paid out much sooner to beneficiaries, causing an increased tax bill and diminishing the value of the inherited IRA tax shelter, since it won't be able to last as long.

A non-person inheriting an IRA, such as an estate, a trust or a charity, cannot use a life expectancy to stretch post-death distributions, because these entities do not have a life expectancy. Only a designated beneficiary can use the stretch IRA to extend distributions over their life expectancy.

A big problem confronting those with significant retirement savings is that the money that they have accumulated is "qualified" money.

If there is no designated beneficiary, the beneficiary who does inherit (possibly through the estate) will have to take the IRA funds out much sooner after death. They will follow the distribution rules that apply when there is no designated beneficiary. Those rules depend on when the IRA owner dies.

If the IRA owner does not have a designated beneficiary and dies before his required beginning date, which is April 1st of the year following the year he turns 70 ½, then the entire inherited IRA must be withdrawn under the 5-year rule. The IRA balance must be emptied by the end of the 5th year after the year of death. That could cause a big tax in a short amount of time if the account is large enough.

It's even worse with a Roth IRA. If you die without a designated beneficiary on a Roth IRA, *the 5-year rule always applies* to beneficiaries who end up receiving the Roth IRA through the will or estate.

If death occurs after the age 70 ½ required beginning date and there is no designated beneficiary, then beneficiaries may do a bit better, but not much.

In that case, beneficiaries still cannot stretch distributions over their lifetimes because they were not named on the IRA beneficiary form.

They will be stuck taking distributions over the deceased IRA owner’s remaining life, had he lived. The longest payout possible would be only 15 years. That’s nothing compared to a 30-year old beneficiary being able to extend distributions over 50 years.

A Roth IRA has no lifetime distributions; so regardless of your age, when you die with a Roth IRA, you do so before the required beginning date; and beneficiaries will always be stuck with the 5-year rule if they are not designated beneficiaries.

Remember that these harsher rules only apply when a client dies without a designated beneficiary, like when an IRA is left to the estate. That should not happen.

If you neglect to name beneficiaries, beneficiaries may have a chance to upgrade their status to a designated beneficiary based on who the default beneficiaries are.

Financial institutions have default beneficiaries that kick in if there is no beneficiary named. They need to know who to pay without a long legal battle.

The default beneficiary for most financial institutions is the estate. If the estate becomes the beneficiary by default, then you won’t have a designated beneficiary and beneficiaries will be stuck with those less favorable distribution rules.

Some institutions though have defaults that say, if there is no beneficiary, then it first goes to your spouse, if no spouse, then to your children and if no children, then to your estate. So they have two lines of defense set up if no beneficiary is named.

In that case, say you named your wife as your IRA beneficiary, and wanted your son to be next in line but you neglected to name him as your contingent beneficiary. If your wife died, and you did not update your beneficiary form, and then you died, you would have no beneficiary and the default provision would kick in.

If the default was the kind that said that if you have no beneficiary, it’s first the spouse, then your children , then your estate, then in that case, since your spouse is already deceased and you have no contingent beneficiary, it will go to your son as the default beneficiary.

In that case, the son will be considered a designated beneficiary as if he were named originally on the beneficiary form.

But advisors should never plan hoping that the default beneficiary will bail the client out.

If the default in that example was the estate, the son might still inherit, but he won’t be a designated beneficiary, since the estate was the beneficiary by default.

The son might get the IRA but would have to follow the less favorable distribution rules that apply when you don’t have a designated beneficiary. Also, the IRA would end up going through probate because it first went to the estate.

In that example, the son should have been named as the contingent beneficiary on the beneficiary form. Then if the wife died, the son would automatically move up as primary beneficiary, without doing anything.

IRA beneficiary forms are easy to check and update, but still this is the number one oversight when it comes to retirement accounts. Advisors can add real value by taking the time to check beneficiary forms, and avoid time consuming headaches — or worse — later on.