Why Your Estate Shouldn't Be Your IRA Beneficiary

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I have met several people who believe naming their estate as the beneficiary of their IRA is an erudite, sophisticated decision. When I ask why they did this they explain that naming their estate as their IRA's beneficiary provides creditor protection, ensures rapid administration and ensures distributions are fair and simple. Nothing could be further from the truth.

Operation of Law Is Not Probate or Administration

When we know who receives an account the moment we pass away we say that asset is transferred by the legal process known as operation of law. Retirement plans with completed beneficiary designation forms that name specific beneficiaries pass by operation of law when we die because "we know who gets the money" at the moment of our passing.

When we don't know who receives an asset automatically upon our death, the funds are transferred to our estate. Alternatively, we can specifically name our estate as an account's beneficiary. When our estate becomes our IRA's beneficiary we have to either administer to the person's will, a legal process known as probate or, if no will can be found, by a process known as estate administration.

You Have to Get the Court Involved

The benefit of probate is that your will can also name a beneficiary to receive your account; the benefit of administration is that your default family inheritors—think of them as your next of kin—are automatically predetermined to receive the account. However, when you fail to name appropriate beneficiaries to your retirement plans, thereby requiring the account to pass through probate or administration, you ruin several benefits otherwise built into your retirement plan. (For related reading, see: *Mistakes in Designating a Retirement Beneficiary*.)

Operation of law assets pass without any court oversight. The beneficiary merely sends in the account holder's death certificate and some paperwork to the financial company and is permitted to choose to either roll over the proceeds to an inherited IRA or cash out the account. Not so with probate or administration. Both require that the court be petitioned, meaning you may need to pay an attorney to help you fill in the court's paperwork and navigate through the court's processes and procedures.

Your Nearest Heirs Must Be Placed on Notice

People seem oblivious to the fact that probate and administration require your next of kin to consent to the legal proceeding. This means every disgruntled child, close disinherited family member or court-appointed attorney representing a minor beneficiary must sign paperwork agreeing with the contents of the will (even if you disinherited any beneficiaries in the will), or show up in court to either begin a will dispute or cause a grinding delay in the hopes of a future settlement. In addition, more distant beneficiaries under the will may have to receive mailed notice as well.

When you name "my estate" as your beneficiary, you are placing the onus of finishing the transfer on your executor or administration; when you name a specific beneficiary under your IRA you are placing the burden on an objecting party to try to stop the process (a process they might not figure out, since operation of law transfers are private, while probate and administration are public). (For related reading, see: *5 Surprising Hazards of Being an Executor*.)

You Have to Pay Probate/Administration Filing Fees

Probate and administration both require court filing fees. True, these fees pale in comparison to attorney fees, but unlike legal fees to lawyers court fees must be paid since you cannot opt out of using the court once your estate is the beneficiary of your retirement plan.

Your Estate Loses Creditor Protection

Your retirement plans are protected from almost every creditor. Your IRA is protected from civil lawsuits, professional malpractice, credit card companies, defaulted mortgages, state taxing authorities and more. The only entities that serve as "super creditors" against your IRA are the IRS, a divorcing spouse and possibly minor children owed a support obligation. (For related reading, see: *Which Retirement Funds Are Protected From Creditors?*)

This creditor protection ends once your estate receives your retirement assets. Your credit cards, medical bills, lenders, creditors, bank loans, Medicaid, state taxing authorities and underpaid ex-spouse are all waiting to place a lien against your estate, and now you have given them the funds to collect from that would otherwise be protected if you had instead named proper beneficiaries. And because probate and administration are public processes it is easy for these creditors to find out whether a proceeding has commenced.

Your Beneficiaries Lose the Ability to Stretch RMDs

No discussion about retirement plans is complete without mentioning the ability for your beneficiaries to "stretch" required minimum distributions based on their life expectancies. Yes, the concept of stretching IRA RMDs is a bit more complicated than that, but the idea is that younger beneficiaries can continue tax-deferred growth of the IRA for a prolonged period, allowing for further compound growth of their accounts.

The problem is that all of the beneficiaries on your IRA must have life expectancies in order for any of them to stretch their RMDs. When any charity, non-compliant trust or your estate is a beneficiary, even for as little as 1% of your retirement plan, all beneficiaries must distribute the entire IRA within five years. This can lead to beneficiaries paying high income tax rates on large inherited IRAs, since large account balances are typically being distributed in short periods of time to younger recipients during their peak earning years. So yes, if you name your estate as the IRA's beneficiary and leave your children everything in your will, your kids do receive the proceeds of the IRA, but they are potentially required to pay more taxes on those funds.

The Bottom Line

Don't name your estate as the beneficiary of your IRA. If you want to leave your IRA to a minor beneficiary, spendthrift recipients or disabled family members it is best to leave them to a trust created for that beneficiary. And when you don't know the answer to your retirement plan question, it is probably best not to go with the most fancy-sounding option.

(For more from this author, see: *Traditional or Roth IRA? One Has an Absolute Benefit*.)

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