The Importance of Beneficiary Designations

Some types of assets allow the owner of the asset to name a “beneficiary.” If the original owner later dies, ownership of the asset passes automatically to the named beneficiary. Because beneficiary designations are easy to use, they can be a key estate planning tool. However, significant negative tax, financial, and even personal problems can arise if the “wrong” individual or entity is named as the beneficiary.

Common Named Beneficiaries

A number of individuals, entities, or organizations are commonly named as a designated beneficiary:

- **Spouse:** A married individual’s spouse is perhaps the most common beneficiary designation. Assets passing to a surviving spouse generally escape federal estate tax because of the unlimited marital deduction.[1]
- **Children:** Children, as adults or minors,[2] are often named as beneficiaries. Step-children or other children adopted informally generally need to be specifically identified.
- **Other family members:** Brothers and sisters, aunts and uncles, and nieces and nephews are frequently encountered beneficiaries.
- **Estate:** In some situations, the asset owner will name his or her estate as the beneficiary.
- **Trust:** As a part of a more complex estate plan, a trust may be named as a beneficiary. The trust must exist at the time of death for the beneficiary designation to be valid.
- **Charity:** A charity may be a designated beneficiary, which can reduce the owner’s taxable estate.
- **Corporation or partnership:** Buy-sell agreements, key man insurance, stock redemption, split-dollar arrangements, and salary continuation plans are all valid business reasons why a corporation or partnership may be named as a beneficiary.

[1] The discussion here concerns federal income and estate tax law. State or local law may vary.

[2] In many states, 18 is the “age of majority” when an individual is considered, for legal purposes, to be an “adult.” In some states the age of majority is 21.

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General Considerations in Making Beneficiary Designations

There are a number of general issues to consider when using beneficiary designations:

- **Keep beneficiary designations current:** Divorce, the birth of a child, the death of a beneficiary, or any number of other life changes can result in the need to update a beneficiary designation. Lack of planning can result in an ex-spouse receiving retirement benefits intended to provide for others or for assets to inadvertently be paid to the estate when a named beneficiary has predeceased the owner.
- **Your estate or executor as the beneficiary:** In these situations, the transferred assets must generally go through a costly and time-consuming court-supervised process known as "probate." During probate the proceeds can be subject to the claims of creditors. In some situations there may be valid estate planning reasons for naming the estate as a beneficiary.
- **A minor as beneficiary:** In most states, a minor generally cannot legally enter into contracts or own property. If a minor is named as the beneficiary of an asset, the end result is frequently an expensive court-appointed guardianship with court supervision of the use of these funds. Once reaching his or her majority, the individual then takes control of the assets.
- **Per Capita vs. Per Stirpes:** A beneficiary designation form will generally use one of these two terms to specify how an asset will be distributed if a named beneficiary predeceases the asset owner. In a "Per Capita" distribution, generally, each survivor (a living beneficiary or a deceased beneficiary's heirs) receives an equal share. In a "Per Stirpes" distribution, generally, a deceased beneficiary's heirs divide his or her share into equal portions. Many states have modified these rules.
- **Spousal rights:** In some states, a surviving spouse may have the right to claim a portion of a decedent's estate, including part of assets that can be transferred by a beneficiary designation. In Community Property[1] states, a surviving spouse may have rights that need to be considered.

[1] The Community Property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. In Alaska, spouses may opt-in to a community property arrangement.

- **Common disaster:** What provision has been made for a situation in which both the asset owner and a designated beneficiary (think of spouses who travel together) die in a common disaster? This contingency is frequently addressed in an individual's will.
- **Impact on the beneficiary:** Consider how receiving an asset will impact the beneficiary's life:
  - Is the beneficiary capable of using the inheritance as the donor might wish, or will it be wasted? Is the beneficiary capable of managing the inheritance?
  - Are there income tax considerations? Assets such as deferred annuities, or retirement plans such as IRAs or 401(k) plans, have varying distribution requirements, depending on who inherits the assets. Will one beneficiary pay less income tax than another?
  - Does the intended beneficiary need the money?
  - Are there other ways, such as via a will or trust, to transfer assets to the intended beneficiary that might ultimately benefit the beneficiary more than an outright gift?
- **Conflict with other estate planning documents:** In some cases, an individual will leave contradictory instructions with regard to how his or her assets should be distributed. For example, a will may indicate that an individual's retirement plan assets are to pass to a child, while the beneficiary designation form for the retirement plan shows that the ex-wife is to receive the funds. As a general rule, the instructions contained in the beneficiary designation form will trump those contained in a will or trust.

Seek Professional Guidance

While beneficiary designations are easy to use, they should be considered to be only one part of an overall, coordinated estate plan. The guidance of experienced, trained estate, income tax, and other financial professionals is strongly recommended.