

Understanding Beneficiary Designations

Ten things everyone should know

Most of us think of our estate plan as our will or living trust. However, in many cases, your will or trust will not control the disposition of life insurance, annuities, IRAs, retirement plans, and many types of employee benefit plans. Instead, your beneficiary designations control who will receive those assets. Here are ten important considerations to keep in mind when making, reviewing, or changing your beneficiary designations.

- 1. Don't forget to name beneficiaries.** Naming a beneficiary keeps you in control: at death, assets in the account are transferred to the person(s) you designate. What happens if you do not specify who the beneficiary(ies) will be?
 - In some cases, the governing agreement may provide for “default” beneficiaries. (By way of example, the Wells Fargo Advisors IRA Custodial Agreement provides that if no beneficiary is named, the account will pass first to the owner’s spouse, or if there is no spouse, to the owner’s surviving children, and then to the estate.) A provision of this type is usually helpful, but it is possible that the default beneficiaries may not be who you intended.
 - If the governing agreement does not include default provisions (or if it does, but there are no persons in those categories), then the account typically becomes part of the probate estate. In some cases, this can result in delayed distributions, additional administrative costs, and unfavorable income tax treatment.
- 2. Name both primary and contingent beneficiaries.** It’s a good practice to name a “back up” or contingent beneficiary in case the primary beneficiary predeceases you. Again, being specific can help you avoid unintended or unwelcome results.
- 3. Update for life events.** Review your beneficiary designations regularly and update them as needed, based on major life events such as a birth, death, marriage, or divorce. Failure to update designations can result in a transfer of assets to unintended beneficiaries — or leave out someone you might have wanted to include.
- 4. Read the instructions.** Beneficiary designation forms are not all alike. Forms and governing agreements may vary considerably between financial institutions, and for different types of assets or accounts. Don’t just quickly fill in names — be sure to read the beneficiary designation form carefully.
- 5. Coordinate with your will and trust.** Whenever you change your will or trust, be sure to talk with your attorney about your beneficiary designations. Precisely because your beneficiary designations operate independently of your will or trust, it is important to understand how all the different parts of your estate plan work as a whole.

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Examples of assets that typically pass according to a beneficiary designation:

Individual Retirement Accounts (IRAs)

Retirement plans

- 401(k), 403(b), and 457 plans
- SEP and SIMPLE IRAs
- Pension plans
- Employee stock ownership plans (ESOPs)

Life insurance

Annuities

Other employee benefit plans

- Group term life insurance
- Stock options
- Restricted stock
- Phantom stock or stock appreciation rights (SARs)
- Employee stock purchase plans (ESPPs)
- Nonqualified deferred compensation (NQDC) plans

Transfer-on-death (TOD) accounts

6. Understand potential consequences of naming individual beneficiaries for particular assets. Consider the example of someone who established three equal accounts and named a different child as beneficiary of each. Over the years, some accounts grew more than others, so some beneficiaries got more and others less — which may not be what was originally intended.

7. Avoid naming your estate as beneficiary. In most cases, this produces less-than optimal results because it causes nonprobate assets to become subject to probate. And for IRAs and qualified retirement plans, there may be unfavorable income-tax consequences. An estate is not a person and does not qualify as a “designated beneficiary.” And so, in most cases, taxable distributions must be made over a shorter time frame than would apply if an individual (or qualifying “look-through” trust) had been named as beneficiary. An exception: If an IRA or qualified plan owner names the estate as beneficiary and dies after the Required Beginning Date (age 72), distributions would be made based on the deceased owner’s remaining life expectancy. This life-expectancy payout could actually be longer than the 10-year limit that applies to distributions to most non-spouse individuals.

8. Use caution when naming a trust as beneficiary. Consult your attorney or CPA before naming a trust as beneficiary for IRAs, qualified retirement plans or annuities. In many cases, the governing document (the plan document or annuity contract) or tax law (the RMD rules) may require accelerated taxable distributions when a trust is beneficiary. There are situations where it makes sense to name a trust — for example, if your beneficiaries are minor children, in second-marriage situations, or if you want to control access to funds — but be sure you understand the tax consequences in advance.

It is particularly important to review existing trust planning around IRAs and qualified plans after the enactment of the SECURE Act, which changed the required distribution rules for defined contribution plans and IRAs. Even if your trust documents were designed with the intention to allow life-expectancy payouts, they may not work as expected because new rules apply for deaths occurring after December 31, 2019. Assets may be distributed to the trust beneficiary much sooner than desired. Accelerated distributions could increase income tax consequences to the trust or its beneficiary. In short, trusts drafted before the SECURE Act may be problematic now, and your beneficiary designation strategy should be revisited with your attorney to make sure your estate plan is structured appropriately under current rules.

9. Be aware of tax consequences and planning opportunities. Many different types of assets can be transferred by a beneficiary designation. It’s helpful to work with an experienced tax advisor, who can help provide planning ideas that fit your particular situation. Here are some examples of beneficiary designation “fine tuning”:

- Martha is a successful corporate executive. She has named a charity as beneficiary of a life insurance policy that she owns. She also has in-the-money nonqualified stock options, and has named her children as beneficiaries under the plan. Both assets are roughly the same value. Martha’s CPA pointed

Coordinate your plan

Beneficiary designations can have a big effect on whether your estate plan works as intended. It's helpful to have up-to-date information available about all of your beneficiary designations so you will be better prepared when you meet with your attorney and CPA to review your estate plan.

out that some simple changes in beneficiary planning could lead to a more attractive tax result. She suggested that perhaps it would work better to name the children to receive the income tax free insurance benefit, and leave the (normally taxable) nonqualified options to a tax-exempt charity.

- Jorge, a widower, is retired. He has a qualified retirement plan from his former employer, which is his largest asset. Jorge has made it a habit to only take Required Minimum Distributions (RMDs) from the plan; he hopes to pass these amounts on to his daughter Lourdes, who is named as beneficiary. Jorge explained to his estate planning attorney that one of his goals is to give Lourdes, after his death, the opportunity to “stretch out” distributions and continue tax deferral to the greatest extent possible. His attorney pointed out that under the SECURE Act of 2019, Lourdes would no longer be able to use a life-expectancy payout, but would have 10 years after Jorge’s death to fully distribute the plan assets. He also noted that, while employer plans routinely offer extended distribution options for former employees and their spouses, they often require non-spouse beneficiaries to use a more rapid distribution method. However, the employer-sponsored plan must allow a non-spouse beneficiary to directly transfer the inherited plan assets to an inherited IRA. Jorge’s attorney advised him to check the specific terms of his plan to see what distribution options would be available to non-spouse beneficiaries. If the plan terms would permit similar distribution options, Lourdes might want to keep the funds with the employer’s plan; but if the plan terms require more accelerated distributions for a non-spouse beneficiary, Lourdes might want to consider transferring the assets to an inherited IRA after her father’s death.

- 10. Use disclaimers when necessary — but be careful.** Sometimes a beneficiary may want to decline assets that he or she would otherwise receive. This might be motivated by estate planning considerations, income taxes, estate equalization or re-distribution, or seeking a way to “repair” an unintended result that would otherwise occur. In some cases, it is possible to achieve a different asset distribution or “fix” beneficiary designation mistakes by using a disclaimer — a legal document that lets the named beneficiary irrevocably refuse the asset. It’s important to understand that the disclaiming beneficiary cannot direct where the asset will go. Instead, when a beneficiary disclaims an asset, it passes to whomever is next in line on the beneficiary form, or if there are no other named beneficiaries, to the contract defaults. Disclaimers involve complex legal and tax issues and require careful consultation with your attorney and CPA.

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