Common Mistakes Made on Beneficiary Designations

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1. Naming the estate as the beneficiary of a life insurance policy. It's a mistake because of a couple of major reasons. First, the proceeds are now subject to probate or intestate administration which can take a long time to complete. This may delay access and use of the proceeds by the surviving family members. Second, it will subject the proceeds to federal and state estate taxes regardless of how policy ownership was structured. Third, any creditor protection that may have covered life insurance proceeds under state law may be lost. Fourth, the distribution of the proceeds is now subject to the terms of the decedent's Will or intestacy proceedings, which may or may not be what the decedent intended with the insurance proceeds. Naming an individual, for a personally owned policy, or the trust, for a trust-owned policy, is the appropriate method.

2. Failure to name a contingent beneficiary. Every financial product that allows for beneficiary designations should have primary and secondary beneficiaries, and perhaps even tertiary beneficiaries. This helps to ensure that the asset goes to the individual whom the decedent intended, even if the primary beneficiary has predeceased. Otherwise, the asset will be included in the estate and similar to #1 above, that means the necessity of having the asset go through probate or intestate administration and the resulting delay in access and use of the asset and unnecessary legal and administrative fees. When a beneficiary designation is allowed, there should be primary and secondary (or contingent) beneficiaries named.

3. Naming a minor child as a beneficiary to a life insurance policy. It's a mistake because an insurance carrier will not pay the benefits to a minor. As a result, that may lead to court proceedings to designate a custodian, conservator or trustee for the minor's benefit to receive the proceeds. That delays access and use of the proceeds and causes unnecessary legal and administrative expenses. If the minor is intended to be the beneficiary of the policy, then a trust or at the very least, an account subject to that state's Uniform Transfers to Minors Act, should be named as beneficiary.

4. Failure to remove an ex-spouse as beneficiary after a divorce. Too often, we see ex-spouses still listed as beneficiaries of life insurance, IRAs, qualified plans and other financial accounts even though that clearly was not the intent. Depending upon the type of product and the state in which the individuals reside in, but particularly with a qualified retirement plan, a divorce may not automatically remove the ex-spouse as a beneficiary. Beneficiary designations should immediately be changed upon a divorce.

5. Failing to regularly review beneficiary designations for any financial product. Similar to the divorce situation, too often, we see people that have already predeceased the policy or account owner, or family members who have been estranged, still named as beneficiaries. The obvious result of that is that proceeds and account balances may go to unintended beneficiaries, or result in unnecessary legal and administrative expenses, as well as delay in access and use. Beneficiary designations should be reviewed on a regular basis and certainly after a significant life event.

6. Violating the three-party rule (a/k/a "unholy trinity") on a life insurance policy. When you have the owner, insured and beneficiary of a life insurance policy as three different individuals, there may be adverse gift tax consequences. For example, it is not uncommon to have a husband who buys a policy on his wife, but names his child as a beneficiary. The law states that the husband is deemed to have made a taxable gift to the child in this scenario. While this might not be as big of an issue these days for the average person given that we currently have a $5.34MM federal gift tax exemption for 2014 ($5.43MM for 2015), it can be a big issue for high net worth individuals or those who live in states that have a separate estate and gift tax system. With life insurance, there should never be more than two parties to an insurance contract.

7. Failure to account for "special needs" children. Increasingly, we see well intentioned family members designate others who may have special needs, as beneficiaries of life insurance or other financial products (e.g., a grandparent wishing to leave an account or insurance proceeds to a grandchild). Often, it is because of ignorance of the laws or ignorance about the planning that the parents of a special needs child may have already undertaken. However, those good intentions may now disqualify the special needs child from various benefits and governmental assistance. In situations involving special needs planning, careful attention to the details matter. The proper course is to determine first, what the parents of the child have already planned, and possibly using the assets to fund Special Needs Trusts.

8. Naming an individual as the beneficiary of a business owned life insurance policy. In the business setting, businesses may purchase life insurance on the life of owners or key employees, and may allow the insured to designate a family member as a beneficiary of some or all of the proceeds. These business owned policies are typically used to fund business continuation arrangements or executive benefits. The reasons for doing so are typically out of good will, expediency, cost savings or simply ignorance of the law. Unfortunately, instead of receiving the insurance proceeds income tax-free, the proceeds may be considered taxable income to the beneficiary either as ordinary income or as a dividend, depending upon who the insured is and the relationship of the beneficiary to the insured. For business owners, the situation may also result in what is known as a "transfer-for-value" which also results in the insurance proceeds being taxable. The beneficiary of a business owned policy should always be the business.

9. Naming improperly drafted trusts as beneficiaries of IRAs. One of the benefits of naming individuals as beneficiaries of IRAs and qualified retirement plans is to allow for the continued tax-deferred growth of the assets in those accounts (a/k/a "Stretch IRAs") over the beneficiary's life expectancy. However, many higher net worth individuals would like to leave their retirement assets to a trust, rather than distributing the assets directly to a beneficiary because the trust can help to manage and protect the assets. However, the rules are very detailed and complicated, such that failure to comply or violating the rules, may result in the loss of that "stretch." Individuals who desire to name a trust as a beneficiary of their retirement accounts should consult with an experienced attorney to get the trust properly drafted to meet all of the applicable rules.

10. Failure to coordinate all accounts that allow for beneficiary designations with the overall estate plan. This is one of the biggest mistakes that people make. They don't spend enough time thinking through their overall estate plan. People forget that when they designate beneficiaries to their financial products and accounts, the beneficiary designation automatically controls who gets the asset. The Will is over-ridden by the designation. This may result in unintended consequences such as adverse tax consequences, failure to leave the estate in the manner intended (e.g., children don't get an even share although that was intended), or worse, inadvertently leaving out a family member from an inheritance. Beneficiary designations should be carefully reviewed with the estate planning attorney and financial advisor.

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