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Avoid the Top 10 Mistakes Made With Beneficiary Designations

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The manner in which your assets are held will determine whether or not each asset will go through probate upon your death. Any asset titled in your name alone, with no designated beneficiary, will go through probate. Further, any asset designating your estate as the named beneficiary will also go through probate. Assets titled in the following manner will not go through probate upon your death.

Joint Tenancy

If you hold an asset in joint tenancy, then upon your death, title to that asset will pass outside of probate to the surviving owner(s). The advantage of this is to avoid probate and make a direct beneficiary distribution as to that particular asset.

However, the designation is limited to that asset only. Other disadvantages include inadvertent gifting of the joint tenant interest, possible guardianship for minors, misuse by irresponsible beneficiaries, loss of benefits to special needs beneficiaries, exposure to creditors of the other joint tenant(s), and loss to the estate of needed funds. (See mistakes numbered 4, 5, 6, 7, 9 and 10 below.) Also, the asset is still susceptible to adult guardianship jurisdiction if you become incompetent, and this is another form of probate (sometimes called “living probate”).

Important note regarding cost basis: When you gift an asset to a beneficiary during your lifetime (i.e., naming a beneficiary as a joint tenant or co-owner), the beneficiary inherits your original cost basis as to the interest gifted. Conversely, were your beneficiary to inherit the asset *upon your death,* the entire asset would receive a “step-up” in cost basis on your date of death, resulting in a possible reduction or elimination of the capital gains tax upon subsequent sale of the asset. Therefore, use caution when implementing joint tenancy as a gifting or probate avoidance strategy with a large or highly appreciated asset unless you have first consulted with an estate planning attorney and a CPA (certified public accountant).

Payable on Death (POD)

If you have designated a “POD” beneficiary on your bank account, then the account will be paid on your death directly to the named beneficiary(ies). As with joint tenancy, the advantage of POD is to avoid probate and make a direct beneficiary distribution as to that particular asset.
Again, the designation is limited to that asset only. Other disadvantages include possible guardianship for minors, misuse by irresponsible beneficiaries, loss of benefits to special needs beneficiaries, and loss to the estate of needed funds. (See mistakes numbered 3, 4, 5, 6, 7 and 10 below.)

Again, the asset is still susceptible to living probate if you become incompetent.

Transfer on Death (TOD)

If you have designated a "TOD" beneficiary on your investment account or real estate property, then that asset will be transferred on your death directly to the named beneficiary(ies).
If an account is involved, then the same advantages and disadvantages apply to TOD as to the POD designations described in the preceding paragraph. The asset is susceptible to living probate and to mistakes numbered 3, 4, 5, 6, 7 and 10.

However, if the TOD designation is placed against real estate, additional disadvantages are presented: First, if you have a lone beneficiary, he or she could die before you thus eliminating a non-probate beneficiary, redirecting your estate back to a distant heir or resulting in a death probate. Second, if you have multiple beneficiaries, you have essentially created for them all of the problems inherent in leaderless group action—the golden apple of discord tossed into the middle of a crowded room. See mistake number 8.

Beneficiary Designations

If you have named a direct beneficiary on your life insurance policy or retirement account, then that asset will pass directly to the named beneficiary(ies) on your death.
Here, the same advantages and disadvantages apply as to the non–real estate TOD and POD designations discussed previously. The asset is susceptible to living probate and to mistakes numbered 4, 5, 6, 7 and 10. However, we also find that people routinely forget to name a beneficiary on insurance or retirement accounts, fail to designate a contingent beneficiary, and fail to update after marriage, divorce, birth or death. (See mistakes numbered 1, 2 and 3.)

Furthermore, people often seem perfectly willing to have huge sums of insurance proceeds or retirement funds distributed to their beneficiaries without any structural protections or attention to alternative tax-deferral mechanisms. They simply write a name on a form. This will not achieve protection against predators, creditors or potential ex-spouses of the beneficiary. Similarly, it will not preserve an inherited IRA from seizure in bankruptcy court nor encourage the beneficiary to maintain tax-deferral on the retirement account.

Living Trust

Any asset titled in the name of your living trust will not go through probate. The only documentation your successor trustee will need at the time of your death will be your death certificate and your certificate of trust. The asset will ultimately pass to your beneficiaries privately and according to the terms of your living trust. Moreover, living probate (adult guardianship) over your assets is avoided.

Here, we can provide structural protections for our clients' beneficiaries in relation to the designations they have made on insurance, retirement, brokerage or deposit accounts, and even with respect to real estate. We can also provide alternative tax-deferral mechanisms on qualified accounts. This level of planning is not available by merely completing a simple beneficiary designation form alone.

The primary disadvantage of a living trust is that the legal fees involved with creating a comprehensive living trust–based estate plan are more expensive than those involved with creating a will-based estate plan. However, in most situations, this cost is far less than the legal fees and other costs associated with a potential death probate or living probate. Further, if you desire court

involvement and oversight with regard to the management and distribution of your assets upon your death or incompetency, then a living trust may not be suitable for you.

Top 10 Mistakes

Although avoiding probate sounds great and is often a good idea, it should not always be the primary objective when creating ownership arrangements and designating beneficiaries.

Thus, after many years of witnessing the disastrous consequences of poor estate planning, here are our top 10 mistakes made with beneficiary designations and ownership arrangements.

1. Not Naming a Beneficiary

By not naming a beneficiary on your life insurance policy or retirement account, you have most likely guaranteed that the asset will go through probate upon your death. Further, for a retirement account, this could create some avoidable tax consequences. The company holding your asset may have contract provisions designating default beneficiaries that could be completely inconsistent with your estate planning goals. Even if your estate is your beneficiary, you should complete a beneficiary designation form.

2. Not Designating Contingent Beneficiaries

Often, an account holder will designate a primary beneficiary when an account is initially established but will fail to designate any contingent beneficiaries. If your primary beneficiary (your spouse, for example) predeceases you, or if you die together or before you have had an opportunity to designate a new beneficiary, then the same consequences will result as if you had not named a beneficiary at all.

3. Failing to Keep Beneficiary Designations Up-to-Date

First and foremost, if you get divorced, it is *essential* that you immediately review and update all beneficiary designations! If your ex-spouse is still named as your beneficiary upon your death, then the company holding your asset will most likely distribute the asset directly to your ex-spouse—even if you are remarried to someone else.
Further, if your primary beneficiary predeceases you, then it is essential to review and update your beneficiary designations at that time to ensure your beneficiaries remain consistent with your estate planning goals.

4. Naming Minors as Direct Beneficiaries

Many parents establish testamentary trusts within their wills designating an age at which their children may have control over their assets and naming a trustee (who may or may not be the same person named as the child’s guardian) to manage those assets until each child has reached the designated age. Most often, the assets are available in the meantime at the trustee’s discretion for the child’s health, education, maintenance or support.

However, regardless of the provisions contained in your will, if you name a minor child as the direct beneficiary of your life insurance policy, the proceeds will most likely be paid out to your child outright as soon as he or she reaches the age of 18. Considering that the average inheritance is spent in about 18 months, providing an 18-year-old with immediate access to a large sum of money is probably not in his or her best interest. Generally, if you have minor children and no living trust, it is better to name your estate as your beneficiary and allow the proceeds to go through the probate process in order to ensure they are distributed to the testamentary trusts established for your children according to the terms of your will.

5. Naming Special Needs Individuals as Direct Beneficiaries

If you name a “special needs” individual (i.e., a person who is receiving a governmental benefit such as Supplemental Security Income (SSI) or medical assistance based on a disability) as a direct beneficiary, you could unintentionally disqualify that individual from receiving his or her valuable governmental benefits. The individual must then “spend down” the inheritance and, after virtually all the money has been spent, go through the application process again. This “spend down” effectively defeats the purpose of naming a beneficiary!
If you wish to leave an inheritance for a loved one who is receiving this type of assistance, it is much better to create a “special needs trust,” also known as a “supplemental needs trust,” within your will or living trust to hold the inheritance for the benefit of that individual for his or her lifetime without jeopardizing his or her benefits.

6. Naming Financially Irresponsible Beneficiaries

Many of us have loved ones who have repeatedly demonstrated that they will never be financially responsible. Clearly, naming this type of individual as a direct beneficiary may serve only to contribute to a gambling or drug addiction, or result in assets being claimed by creditors in a bankruptcy or income tax proceeding.

Often, it is better to create a lifetime “spendthrift trust” to hold the inheritance for the benefit of that individual for his or her lifetime while protecting the assets from creditors.

7. Naming Direct Beneficiaries on All Assets Other than Real Estate

As probate attorneys, we have witnessed this troublesome scenario on numerous occasions. If you own real estate titled solely in your name (or titled as a tenant in common) upon your death, the real estate interest will need to go through the probate process before it can pass to your beneficiaries—*even if you have a will in place.*
It is not unusual for the death probate process to take a year or longer. In the meantime, before your real estate can be sold or distributed, your estate is responsible for paying maintenance expenses including, but not limited to, real estate taxes, insurance, utilities, maintenance and general upkeep of the property. Your estate is also responsible for your final debts and expenses, including your funeral bill, court costs and attorney’s fees.

If you have insufficient cash available within your estate, then your children or other beneficiaries will need to find a way to pay these costs. However, they are under no legal obligation to pay these costs from life insurance proceeds, cash received through POD designations, etc.

Therefore, if you own real estate that will go through probate upon your death, it is generally advisable to also allow your cash accounts and/or life insurance proceeds to go through probate as well in order to eliminate situations such as the one described above.

8. Naming Multiple Beneficiaries on a Transfer on Death Deed

Some states allow a special type of deed known as “transfer on death deed” or “Lady Bird deed.” Through this type of deed, you can designate a beneficiary or beneficiaries who will inherit your real estate outside of probate upon your death.

If you have only one child who is a responsible adult, and who is not a special needs individual, then this strategy may work well. However, if you have multiple beneficiaries, then a transfer on death deed is most likely not a good option. If multiple individuals own a single piece of real estate, they all must agree on the realtor and the sale price, and until the property is sold all owners should contribute equally to the maintenance of the property as described in mistake number 7.

For obvious reasons, this arrangement can create more trouble and family disputes than might have occurred had the property gone through an organized probate proceeding and remained in the control of a single designated personal representative.

9. Naming a Child as a Co-Owner of a Deposit or Investment Account

In his or her later years, a parent will sometimes add a trusted adult child as the co-owner of his or her bank account(s). The purpose of this arrangement is usually to allow the child to assist the parent in managing his or her finances, signing checks, etc. Generally, the intent is not for this child to inherit the entire balance of the account upon the parent’s death to the exclusion of the other children.

There are numerous potential issues with this arrangement, some of which are outlined below.

- Gifting: When you add your child (or anyone else) as the co-owner of your asset, you have just legally gifted them half the value of the asset. Currently, you can gift up to $14,000 per year per beneficiary without incurring any gift tax consequences. If the value you have “gifted” is greater than this amount, then you are legally required to file a gift tax return and incur any gift tax consequences associated with the transfer.
- Creditor Issues: Once your child (or anyone else) becomes the co-owner of your account, half of your account will then become subject to the claims of that person’s creditors. Therefore, if the co-owner gets sued or files for bankruptcy, then half of your account could end up in the hands of his or her creditors. Your account could even become an issue within your child’s divorce proceeding!
- Final Expenses: Even if your intent is for the money in your account to be used to pay your funeral expenses after your death, the child you have named as a co-owner of your account is under no legal obligation to use this money for its intended purpose. He or she could simply walk away with the account balance, leaving the other assets in your estate to pay for these expenses, resulting in a “windfall” for that child.

By employing other estate planning techniques, you can better accomplish your estate planning objectives without putting your account at risk. For example, you can create a durable power of attorney naming your trusted child as the agent to manage your account during your lifetime. You can then either add a POD designation to the account, or allow the account to go through probate upon your death with the rest of your probate estate. As a final alternative, you could create a living trust and title the account in the name of your living trust.

10. Naming One Child as the Sole Beneficiary of a Life Insurance Policy or Deposit Account

A parent with multiple adult children will sometimes designate one child as the sole beneficiary of a life insurance policy or deposit account, with the intent that this child will use the proceeds to pay for funeral and other final expenses and then distribute the remaining balance equally among his or her siblings.

However, similar to the co-owner situation referenced above, the child you have named as your beneficiary is under no legal obligation to use this money for its intended purpose and could simply walk away with the account balance. Further, your child may be unable to distribute the account balance to his or her siblings without incurring his or her own gift tax consequences.

Conclusion

Regardless of your particular estate planning objectives, it is important that all of the pieces to your estate planning puzzle fit together.

Your beneficiary designations are an important piece to this puzzle, and they are the most effective means to ensure that your assets are passed on in the manner you choose.