Avoid beneficiary designation errors

Help ensure that those your client wants to inherit the account assets are the ones who actually do

By Craig Brimhall

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If you ever have spent time helping clients or their heirs work through an estate plan that was botched due to im-proper beneficiary designations on individual retirement accounts and qualified plans, you know how costly these mistakes can be.

Here are six mistakes that can be avoided with proactive planning:

Not naming a beneficiary. Ensure that your clients have listed beneficiary designations on all their retirement accounts. Failing to do so can turn a non-probate asset into one that has to go through the painstaking probate process. If the estate becomes the beneficiary, the ability to use “stretch” payouts based on a beneficiary's life expectancy can be lost because estates have no life expectancy. This means that the ability to retain tax-advantaged status for the assets is lost and the probate process can't be avoided.

Not listing contingent beneficiaries or contemplating disclaimers. Spouses are typically primary beneficiaries. But when a spouse dies prior to the account owner and no contingent beneficiaries are listed, it is comparable to having no beneficiary designation. If both spouses die at the same time, funds go into probate, a process most people want to avoid. Naming contingent beneficiaries lets the primary beneficiary execute a qualified disclaimer so some assets can pass to “next in line” beneficiaries.

Lacking specifics in beneficiary designations. Your clients may list children as beneficiaries, but including specific names may be more appropriate. Many states won't include or recognize stepchildren when the word “children” is used. Another risk of being vague is that a long-lost child may enter the picture and try to claim a piece of the remaining assets. Remember that a qualified legal professional should be consulted, as these circumstances can become complex. Be aware that listing specific names makes it even more critical that beneficiary designations are updated when major life events requiring that names be added or subtracted occur.

Failing to keep designations up-to-date. Clients may need to update their beneficiary designations every few years due to life changes. Perhaps certain beneficiaries have died or their relationship with the account owner has changed. This is particularly applicable when a client gets divorced or remarried. If an ex-spouse inadvertently remains as the designated beneficiary of an account, he or she may have the upper hand if the case winds up in court. Also keep in mind the requirement from the Employee Retirement Income Security Act of 1974 regarding qualified plans that a spouse can't be disinherited without his or her consent. If children from a first marriage are beneficiaries of a plan but the client's new spouse never signed the required consent form, the assets automatically go to the new spouse upon the client's death.

Failing to keep beneficiary designation forms on file. Clients should keep copies of updated beneficiary designation forms on file. The records of an acquired custodial company can easily be lost or destroyed when a new firm assumes ownership. Without a verifiable form to prove beneficiary status, the default provision of the plan applies, which typically may be phrased as “spouse first, if living; if not, then the estate.”

Not considering the financial or emotional readiness of beneficiaries. The money that designated beneficiaries receive from IRAs or qualified plans is unrestricted in most cases. Clients can't control who gets what amount of money or when, or limit how money is used, unless advance restrictions are put in place. One restriction is naming a trust as beneficiary and drafting terms that stipulate when individuals receive their share of the accounts. Trusts are often used when beneficiaries can't manage their finances or lack self-control, or in complex family situations.

Trusts are especially useful for clients who have children from a previous marriage. For example, if all assets flow to a second spouse as the primary beneficiary, that spouse could “disinherit” the account owner's own children even if they are contingent beneficiaries.

Once the account owner dies, the surviving spouse can stipulate his or her own beneficiaries, leaving out the deceased spouse's desired beneficiaries. A trust allows the account owner to be more specific about who ultimately will receive the money and under what terms.

A properly constructed trust even allows stretch payouts, but they are based on the life expectancy of the oldest beneficiary.

Reviewing designated beneficiaries is a business opportunity. You may identify orphaned workplace savings accounts or IRAs that are ripe for rollover business.

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