

# BENEFICIARY DESIGNATIONS 101

## Everything you need to know about beneficiary designations

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### Are beneficiary designations important?

Beneficiary designations are one of the most important aspects of your estate plan. Your beneficiary designation determines who will own that asset upon your death.

### Does my Will override my beneficiary designation?

No, actually the opposite is true! A beneficiary designation overrides your Will. Many people complete a Will and forget about their beneficiary designations. This is a huge mistake. Your Will has no effect upon assets with a beneficiary designation. Many people have the majority of their wealth in assets with a beneficiary designation (such as life insurance or retirement plans), which means their Will will not control those assets when they die.

### What is a beneficiary designation?

A beneficiary designation is the process by which you name a person or entity (*i.e.*, trust, partnership, corporation, LLC, etc.) to receive an asset upon your death. A beneficiary designation functions similar to a Will but only applies to the particular asset for which it is made.

With respect to life insurance and accounts with financial institutions, the beneficiary designation is an agreement between you and the company, whereby the company agrees to transfer ownership of the remaining assets at your death (or the insurance proceeds) to whomever you have named on your beneficiary designation form. As this is a private agreement, each company has its own rules for how the beneficiary designation process works.

For example, you may have a brokerage account at a bank and have named your spouse as the beneficiary. This is actually a contract between you and the bank in which the bank has

agreed to transfer any remaining assets in the brokerage account at your death to whomever is named on your beneficiary designation form at the time of your death.

### What assets may have a beneficiary designation?

The most common assets that allow you to name a beneficiary are life insurance contracts, retirement plans (IRA, 401(k), etc.), and financial accounts (*i.e.*, checking, savings, brokerage, money market, etc.), but beneficiary designations may also be used with many other assets (such as stock/bond certificates, personal property, automobiles, rights under a contract, promissory notes, etc.). As described above, a beneficiary designation is simply an agreement between you and the company holding the assets in the account. Some companies allow you to name a beneficiary for certain accounts and not others; it is completely up to the company, and every company is different.

You may also execute a beneficiary deed for real estate. A beneficiary deed provides that upon your death, ownership of the real estate described on the deed will automatically pass to the person named as grantee on the deed. Until you die, the beneficiary deed has no effect (the named beneficiary has no legal right to the property during your lifetime). A beneficiary deed must be executed and recorded with the county recorder of deeds while you are alive.

### Is a beneficiary designation different from a POD or TOD?

No, these are just different names for the same thing. Different companies use different names. A pay on death (POD), or transfer on death (TOD), provision provides that upon your death ownership will be vested in the person named.



2000 Equitable Building ♦ 10 S. Broadway ♦ St. Louis, Missouri ♦ 63102  
12 Wolf Creek Drive ♦ Belleville (Swansea), Illinois ♦ 62226

Trusts & Estates Practice Group

314-241-9090



### Does a beneficiary designation avoid probate?

Yes, a beneficiary designation avoids the expense and time-consuming probate process if the named beneficiary survives you, unless you have named your “estate” as the beneficiary. Probate is only necessary for property still owned in your name after your death. If you have a beneficiary designation, then the property will automatically be owned by your beneficiary the moment after your death.

### What is the difference between a primary and a contingent beneficiary?

The primary beneficiary will receive the assets upon your death (if the primary beneficiary survives you). If you have named a trust or a company (partnership, corporation, LLC, PC, etc.) as your primary beneficiary, it will receive the assets if it is still in legal existence at the moment of your death.

If the primary beneficiary is not alive (or in existence) at the time of your death, then the contingent beneficiary will receive the assets.

### What if I do not complete a beneficiary designation form?

For financial accounts and life insurance, each company should have its own default beneficiary. Often, the default is your probate “estate”, which means the assets will eventually (after the probate process) be distributed according to the terms of your Will. For most retirement plans (other than IRAs), the default beneficiary will be your spouse if living, otherwise your estate.

For assets not held in an account, the default beneficiary will almost always be your estate, which means the assets will be subject to probate and will pass according to the terms of your Will.

### How do I name my beneficiary?

For life insurance or an account, you simply request the appropriate form from the company and fill in the required beneficiary information. For retirement plans, you should request the appropriate form from the plan administrator. For real estate, an attorney must prepare a beneficiary deed for your signature, which must then be recorded with the county recorder of deeds. For automobiles, you must fill out a new title with the department of motor vehicles that lists your beneficiary under the TOD section. For personal property without a title, an attorney can prepare a document that names your beneficiary.

### How do I know who is named as my beneficiary?

For financial accounts, IRAs, life insurance and securities (stocks, bonds, etc), you must contact the company where the account is held (*i.e.*, the life insurance company, bank or brokerage firm) and ask them to put in writing your primary and contingent beneficiaries.

For retirement plans (other than IRAs) you should contact the plan administrator. For real estate, you can contact the county recorder of deeds to ask for a copy of your beneficiary deed. For automobiles you must look at your title to see who is listed under the TOD section.

### How often may I change my beneficiary designation?

As often as you like. There are usually no restrictions on how often you can update your beneficiary. Similar to a Will, you could update it every day if you wanted to do so.

### How often should I change my beneficiary designation?

You should change your beneficiary designation any time you decide someone other than the current primary beneficiary should receive the assets at your death. Some common situations in which you should change your primary beneficiary are if you divorce, the account owner dies, the primary or contingent beneficiary dies, or if the beneficiary no longer needs the money.

### Should an attorney complete my beneficiary designation?

Before you file your beneficiary designation, you should always send it to your estate planning attorney to have it reviewed to ensure it is consistent with your overall estate plan.

### Should I have proof that my beneficiary designation was accepted?

Yes, you should always have a signed writing from the company that specifies your beneficiary designation has been accepted and is on file.

### Who should I name as the beneficiary of my nontax-deferred assets?

You should name whomever you want to have the assets at your death. If you have a revocable trust, then your trust should usually be the owner of all of your nontax-deferred assets (financial accounts, real estate, personal property, stocks, bonds, mutual funds, etc.). If your revocable trust is the owner, a beneficiary designation is not needed.

If you have a revocable trust, the primary beneficiary of your life insurance policies should be the revocable trust, unless you have an irrevocable life insurance trust.

If you do not have a revocable trust (which everyone should consider), then the primary beneficiary is typically your spouse, or if you are not married, then your children in equal shares, unless they are minors.

### Who should I name as the beneficiary of my tax-deferred accounts?

Some accounts are tax-deferred. This means you have not paid income taxes on the money in the account. The payment of income tax is deferred until you withdraw money from the account. The most common tax-deferred accounts, are 401(k)s, 403(b)s, IRAs, certain annuities, and certain other retirement plans. If you have a substantial amount in tax-deferred accounts, then you should discuss with your estate planning attorney who should be the beneficiary.

If you die with money in a tax-deferred account, then each year the beneficiary will include the amount withdrawn

from the account as income on his personal income tax return for that year. For example, assume you die in 2005 with \$1 million in your IRA, you have named your son as the primary beneficiary and your son survives you. If your son takes all of the money out of the IRA in 2005, then he will include this \$1 million in his gross income on his 1040 for 2005. All of this \$1 million (plus all of his other income earned during 2005) will be subject to income tax. If your son has an immediate need for the entire \$1 million and will spend all of it in 2005, then there are limited options. However, if your son only intends to spend a portion of the \$1 million in 2005, then he should only withdraw the amount he intends to spend, because only the amount withdrawn will be subject to income tax. The amount left in the account can continue to be invested and grow tax-deferred until withdrawn.

For example, if your son needs \$200,000 for the purchase of a home, but has no immediate need for the remaining \$800,000, then he may wish to only withdraw \$200,000 in 2005. If the IRA allows this, he will then only include the \$200,000 in his gross income and the remaining \$800,000 will stay in the account, growing income-tax free, invested as he desires, until he chooses to make another withdrawal.

Most 401(k) and 403(b) accounts require your beneficiary to take a lump-sum distribution of the entire account balance at the time of your death. If your employer's retirement plan only allows a lump-sum distribution, then there are very limited options available to defer this tax after your death unless you name your spouse as the beneficiary. However, most IRAs allow your beneficiary to withdraw the money in the account according to the IRS minimum distribution rules. In addition, spouses may roll-over retirement plan assets into his/her own IRA to defer distributions and the income tax.

These minimum distribution rules require that a percentage of the account must be distributed (and therefore subject to income tax) each calendar year. If you name an individual (*i.e.*, not your estate or a trust) as the beneficiary of your IRA, then the IRS allows your beneficiary to withdraw only a portion of the account each year (determined according to a chart that reflects the account balance and the beneficiary's age). Of course, if your beneficiary wants to withdraw the entire account in one year to make a large purchase, then the entire amount withdrawn will be taxed.

If your beneficiary recognizes the benefits of withdrawing a small portion of the account each year, then your IRA provider will work with them to only distribute the minimum amount required. This is often called a “stretch IRA”.

If you intend to create a stretch IRA for multiple beneficiaries (as opposed to a single beneficiary), then you must include special language on your beneficiary designation form or you must create separate accounts for each beneficiary while you are alive. You can never create a stretch IRA if you name your estate as the beneficiary. In addition, only certain trusts can be named as the beneficiary if you intend to create a stretch IRA.

### Can I name a trust as the beneficiary of my 401(k) or IRA?

Yes, you can always name a trust as a beneficiary of any account, whether tax-deferred or otherwise. However, you may only create a stretch IRA (or stretch 401(k)) if the trust and beneficiary designation are structured properly.

If you would like to create a stretch IRA or 401(k), but you do not want to give the individual beneficiary(ies) the ability to withdraw all of the account upon your death (because the beneficiary is young or you do not trust them to withdraw a proper amount), then a specially designed trust may be appropriate as the beneficiary. A trust may also be appropriate as the primary beneficiary if retirement assets must be utilized to fund a credit-shelter (*i.e.*, bypass or family) trust. The trust can be created so a Trustee may decide how much to distribute to the beneficiary each year (or the trust can provide that the beneficiary may only receive the minimum amount required under law, unless the beneficiary needs more for an emergency). If you intend to create a stretch IRA, then you should discuss this with your estate planning attorney as special language will need to be

included in the trust agreement and on the beneficiary designation form.

### What other taxes apply to tax-deferred accounts?

Tax-deferred accounts are not only subject to income tax when distributed to the beneficiary, they are also subject to estate tax at the death of the owner. For the year 2004, the combined effect of the 48 percent estate tax, a top federal income tax rate of 35 percent and a Missouri state income tax rate of 6 percent can be debilitating.

For example, consider Mr. Smith who dies in 2004 owning a \$2 million IRA and the entire \$2 million is distributed to Mr. Smith’s son as the beneficiary in 2004. Assuming Mr. Smith has other assets in excess of his Applicable Exclusion Amount, then the IRA will generate an estate tax of \$960,000 and income taxes of \$820,000, leaving only \$220,000 for the beneficiary. However, with careful planning, the income tax liability can be deferred for many years in the future. This heavy tax burden makes tax-deferred accounts the best source for charitable bequests at death.

### What should I do to ensure my beneficiary designations are accurate, up to date, and consistent with my estate plan?

First you should contact each of your banks, brokerage firms, retirement plan administrators, and life insurance companies and ask them to provide you with a written document describing who is the primary and contingent beneficiary of each of your accounts and policies.

Next, you should discuss this information with your estate planning attorney to ensure your beneficiaries are appropriate given your circumstances and overall estate plan.

*For further information please contact :*

**Edward F. Reilly, William G. Jochens, Walter L. Wittenberg, Garrett C. Reuter,  
Joseph R. Lowery, MaryAnn G. Nessel, Laura L. Staley,  
Keith A. Herman, Jennifer A. Clump, Donald E. Weihl**

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