Six Important Estate Planning Considerations – Part 4: Beneficiary Designations[1]

May 16, 2018 by Steve Hartnett

Beneficiary designations are a powerful tool in estate planning. They are a simple way to direct that specific assets go where desired. However, they must be used with care and coordinated with the overall estate plan to meet the client's objectives.

Life insurance and retirement accounts, such as IRAs, have beneficiary designations which determine to whom the assets go at death. Bank, brokerage, and other financial accounts may also have such beneficiary designations. Additionally, in many states, real estate may also have a transfer on death designation which works like a beneficiary designation to transfer the asset at the death of the current owner.

In other words, these accounts go automatically to the designated individuals, regardless of what the Will or Trust provide. In other words, it's a very blunt instrument. This is often confusing to clients.

Let's look at an example which illustrates one common problem with beneficiary designations. Mary has a Will prepared by an excellent attorney. Mary's Will provides for everything to go to her two children, John and Sally. Mary has $2 million in assets. She believes $1 million will go to each of her children, as her Will provides. Her children just turned 18.

Mary's assets include a brokerage account which she opened 25 years ago, before she had children. That account designates her sister, Peg, as the beneficiary. Mary also has a home which has a transfer on death designation to her mother.

Mary dies in an accident. Her brokerage account goes to her sister, Peg, due to the beneficiary designation. Mary's home goes to her mother due to the transfer on death designation. In other words, Mary's children are left with no mother, no home, and no money. Maybe Mary's mother and sister would give the assets to Mary's children, or maybe they wouldn't. They'd be under no legal obligation to do so.

Another common problem with beneficiary designations (and other specific designations) is that the assets could change in value. Let's say, in the example above, John had been the beneficiary of the brokerage account and Sally had been the transfer on death beneficiary of the home. Mary's intent would have been realized had the assets been comparable in value at her death. However, assets fluctuate in value. Let's say Mary had invested in the next Amazon or Apple and the brokerage account increased from $1 million to $10 million. Meanwhile, her home increased in value only a little to $1.2 million. Thus, at Mary's death in this scenario, John would receive the $10 million brokerage account and Sally would receive the $1.2 million house. Mary certainly never intended John to receive more than nine times the inheritance Sally would receive. This unintendedly lopsided bequest would sow the seeds of bitterness in the relationship between John and Sally.

The beneficiary designations avoided probate, but they introduced other problems. A better way would have been to have Mary's assets owned by her revocable trust without beneficiary designations. This would have avoided probate and provided incapacity planning, which the beneficiary designations did not. Further, the trust could have left the assets proportionately to the two children, rather than subject their future inheritances to the roulette wheel of chance. Finally, the trust could have added layers of protection for John and Sally to provide divorce protection, asset protection, or estate tax protection.

Beneficiary designations can be a simple solution in the right situation. However, often a revocable trust can provide a solution which is better at achieving the client's goals.

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[1] https://www.aaepa.com/2018/05/6-important-estate-planning-considerations-part-4-beneficiary-designations/#:~:text=Beneficiary%20designations%20are%20a%20powerful,specific%20assets%20go%20where%20desired.&text=Life%20insurance%20and%20retirement%20accounts,the%20assets%20go%20at%20death.