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OVERUSE OF BENEFICIARY DESIGNATIONS: HOW THEY CAN DERAIL A CLIENT'S ESTATE PLAN

Authors: Mary Margaret Colleary, Helen C. Heintz and Marissa A. O'Loughlin

If you have any questions about this Advisory, please contact:

MICHAEL T. CLEAR
203.363.7675
mclear@wiggin.com

ROBERT W. BENJAMIN
212.551.2602
rbenjamin@wiggin.com

DANIEL L. DANIELS
203.363.7665
ddaniels@wiggin.com

SETH E. ELLIS
561.910.7510
sellis@wiggin.com

HELEN C. HEINTZ
203.363.7607
hheintz@wiggin.com

DAVID W. KESNER
203.498.4406
dkesner@wiggin.com

LEONARD LEADER
203.363.7602
lleader@wiggin.com

VANESSA L. MACZKO
203.363.7667
vmaczko@wiggin.com

ERIN D. NICHOLLS
203.498.4319
enicholls@wiggin.com

"I notice that your account does not have a beneficiary listed, would you like to list one now? Listing a beneficiary can avoid the expense and delay of probate."

This is a question more and more of our clients are being asked (and encouraged to prepare) by representatives at financial institutions. However, for many of our clients – who have a comprehensive estate plan – naming a beneficiary on non-retirement accounts can, unbeknownst to the client, result in the unintended consequence of derailing the entire estate plan.

RETIREMENT ACCOUNTS AND LIFE INSURANCE POLICIES

Typically, retirement accounts and life insurance policies pass to beneficiaries as a result of the beneficiary designation forms completed when a retirement account is opened or an insurance policy is obtained. During the estate planning process, these beneficiary designations are reviewed to ensure that the beneficiaries are correct and that the distribution of these assets conforms with the client's intended estate plan. The beneficiary designations on these types of accounts are often carefully tailored to allow the assets to pass through to trusts created under the client's estate planning documents, affording a variety of benefits through this advanced estate planning technique. The beneficiary designations on these types of accounts also allow the assets to avoid probate after death.

TRANSFER ON DEATH AND PAYABLE ON DEATH DESIGNATIONS

Separate and apart from the beneficiary designations on retirement accounts and life insurance policies, a Transfer on Death (TOD) or Payable on Death (POD) designation can be set up for a checking, savings, certificate of deposit, U.S. savings bond or investment account. It is simple in concept and practice: upon the death of the account holder (i.e., the client) the funds pass directly to the named beneficiary. As a result, however, the assets do not pass under the client's estate planning documents, thereby possibly defeating the intended tax planning and distribution scheme provided for in these documents.

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CAROLYN A. REERS
203.363.7668
creers@wiggin.com

MATTHEW E. SMITH
203.363.7639
msmith@wiggin.com

WILLIAM M. BROMLEY
561.910.7530
wbromley@wiggin.com

GEORGE R. FREUND
561.910.7500
gfreund@wiggin.com

KATERYNA BAKHNAK
212.551.2855
kbakhnak@wiggin.com

JOSEPH BENDEL
561.910.7544
jbendel@wiggin.com

MARY MARGARET COLLEARY
212.551.2637
mcolleary@wiggin.com

RUTH FORTUNE
203.363.7658
rfortune@wiggin.com

ASHTON C. MALKIN
561.910.7500
amalkin@wiggin.com

MARISSA A. O'LOUGHLIN
203.363.7674
moloughlin@wiggin.com

KAITLYN A. PACELLI
203.363.7635
kpacelli@wiggin.com

ANDREW S. PHILBIN
203.363.7606
aphilbin@wiggin.com

MI-HAE K. RUSSO
212.551.2619
mrusso@wiggin.com

UNINTENDED CONSEQUENCES

Unfortunately, when it comes to non-retirement accounts, the effect of naming beneficiaries is usually not adequately explained to the client, and the financial representatives asking the question generally focus only on probate avoidance. Since many clients believe avoiding probate at all costs is a good thing, they will readily designate beneficiaries to any type of account for that reason alone, not understanding the potential repercussions. Estate planning professionals need to be aware of the increasing prevalence of this practice and advise clients accordingly.

Below are several possible unintended consequences of designating beneficiaries on all accounts.

1. **Loss of tax savings strategies.** Assets passing directly to beneficiaries do not pass under the client's estate planning documents. If the client's plan utilizes funding formulas to optimize tax savings by way of a credit shelter trust, marital trust or generation-skipping trust, the assets are not available to fund such trusts and tax planning strategies may not be utilized to their full potential, resulting in an inefficient use of the client's applicable exemptions and the potential loss of significant tax savings.

   Example: Naming your spouse as a beneficiary on every account may sound like an effective plan. Although doing so will utilize the unlimited marital deduction, it fails to allocate your generation skipping transfer (GST) tax exemption to a trust for the benefit of your spouse and descendants. Proper allocation of your GST tax exemption to a trust for the benefit of your spouse and descendants would not only accomplish the goal of supporting your spouse during his or her lifetime but also ultimately benefit your descendants. Overusing beneficiary designations can derail this goal.

2. **Unintentional beneficiary exclusion.** If all or a significant portion of assets pass directly to beneficiaries, there may be insufficient assets to satisfy bequests to individuals and fund trusts under the client's estate planning documents. Additionally, you may have named the people in your life at a time when you have not yet completed your family, thereby unintentionally excluding people you would otherwise want to treat equally.

   Example: Let's say you are married with one minor child. If you name your spouse as the primary beneficiary on every account, then name your child as secondary beneficiary, you risk unintentionally excluding any potential additional children you may have in the future. Proper estate planning outside of beneficiary designations can eliminate that risk by providing for all of your descendants, present and future.

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3. **Loss of creditor protection / asset management.** Many estate plans utilize trusts to protect assets against creditor claims of a beneficiary or to provide asset management for a beneficiary. If the assets pass directly to the beneficiary, any ability to provide creditor protection for the beneficiary and control asset management will be lost.

   Example: If you leave your assets outright to your adult children by beneficiary designation, you may inadvertently expose those funds to your adult children's creditors, including divorcing spouses or litigious parties related to their occupation (i.e., a patient suing your adult child who is a medical doctor).

4. **Estate administration issues.** If a significant portion of the client's assets pass directly to beneficiaries, the administration of the estate, including payment of taxes, debts and expenses, may be complicated by a lack of funds under the control of the fiduciary. If estate tax is due, the beneficiary of an account will be liable for paying the proportionate share of any such tax.

   Example: Let's say you have three children and four accounts. You use beneficiary designation riders to leave each child one account and you leave the fourth without a designated beneficiary. The account without a beneficiary will be included in your estate, which your Executor will collect, use to pay your debts, funeral and administrative expenses, and subsequently distribute the balance in accordance with your Will. If there is an insufficient amount in the estate account to pay estate tax, your Executor will have to collect money from each child to satisfy the tax due. Properly aligning your beneficiary designations with your estate plan will provide the most efficient tax planning that will keep such administrative headaches from burdening your children.

The use of beneficiary designations should be carefully coordinated with the rest of the client's estate plan. If you have any questions, or if you would like to discuss these issues in depth, please contact your **Wiggin and Dana attorney**.

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