TOP 7 MISTAKES PEOPLE MAKE WITH BENEFICIARY DESIGNATIONS

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Take a look at these top 7 mistakes people often make with beneficiary designations. Being aware of these common mistakes could help you, and your beneficiaries, avoid complications.

MISTAKE #1

Not updating your beneficiary forms

The beneficiary designation form takes precedence over the will, trust, or any other legal document. If you do not pay attention to detail, and update your beneficiary forms after life events such as marriage, death of a loved one, or even divorce, you may be in for a rude awakening.

To illustrate, a man was left without a dime even though his wife's pension was valued at almost a million dollars. Bruce, age 61, and his wife Anne were married for almost 20 years when Anne passed suddenly from a heart attack. Bruce had no doubt her school pension would go to him since on the teacher's monthly pension statement it indicated no named beneficiary.

Because he was Anne's closest beneficiary, he knew he would receive those funds. But, the state found a form filled out 27 years prior, indicating the named beneficiaries were Anne's mother, uncle, and sister. Her mother and uncle were dead, so the funds went to her sister, Jane McLaughlin. Even though Bruce appealed the ruling, the court stated that, "Anne's intention of making her husband the beneficiary could not be assumed," and that "the paperwork on file was clear."

Bruce will not get a dime of his wife's retirement. Make sure you update your beneficiary forms, or your money may not go to the proper person.

MISTAKE #2

Naming your revocable trust or your estate beneficiary for IRAs and other retirement accounts

Carefully consider your options when naming your primary beneficiary as either your estate or a revocable trust for any retirement accounts.

Take Lorraine for example. Lorraine was a thrifty saver. She would contribute the maximum percentage allowed to her employer's retirement plan and would match each year what percentage her employer would match into her 401(k) retirement account. On top of this, her husband, Rick, opened and contributed another $400 per month, before tax dollars, to his traditional IRA as a supplement to their retirement.

Rick passed away at the age of 75, and Lorraine obtained control of his assets as his spouse. Here's the kicker: Lorraine, now widowed, decided to name her primary beneficiary as her revocable trust. After accumulating over $1,000,000 in retirement assets between both Lorraine and Rick's Traditional IRAs, she did not realize the tax implications that would occur from listing the revocable trust as the primary beneficiary.

MAKE SURE YOU UPDATE YOUR BENEFICIARY FORMS, OR YOUR MONEY MAY NOT GO TO THE PROPER PERSON

Consequently, Lorraine's daughters are required to withdraw the assets within five years. This resulted in a higher federal tax (between 30-40%) and state income tax bracket (up to 15%) and the inability to continue tax deferrals for Lorraine's heirs. This mistake will cost her daughters a lofty tax bill close to $400,000 over a five-year period. At the time, Lorraine thought naming her revocable trust as the beneficiary would ultimately save her two daughters from going through probate and the expense. If she had named the two daughters as primary beneficiaries, this would have allowed each daughter to continue tax deferral by stretching the payments over their life expectancy, dramatically lowering their taxes.

MISTAKE #3

Not titling life insurance properly will create a taxable gift

When it comes to life insurance, there are three people every client should consider when structuring and signing a life insurance application: the policy owner, the insured, and the beneficiary. The last thing you want to do is create a taxable gift to your beneficiaries, as you will see with Judy and Larry.

Larry was a VP, who contributed the maximum amount of $18,000 to his 401(k). His financial professional suggested that Larry should only contribute what his employer would match to his 401(k), 5%. With the remaining after-tax dollars, his professional recommended Larry purchase cash value life insurance to protect his legacy and grow his cash values as an additional investment for retirement. This gave Larry the option to take tax-free withdrawals*, along with continued tax deferrals. Larry followed through with suggestions and signed the application.

Two years into the policy, Larry realized there were tax consequences with the way he structured his original policy. Normally, life insurance proceeds are tax-free. However, this was not the case for Larry and Judy. When Larry opened his life insurance policy, he had his wife, Judy, own the life insurance policy because she handled all of the bills. Larry wanted to leave his life insurance policy to his daughter Karen (from his previous marriage), who he had listed as the primary beneficiary. Little did he know this would create a taxable gift liability for his wife if Larry were to pass away.

This could have been avoided by having Larry own the life insurance policy and remain as the insured. This can become more complex if you reside in a community property state. Please consult with your financial advisor to conduct a policy review to make sure your life insurance is structured properly.

MISTAKE #4

Not including a contingent secondary beneficiary

You do not want a deceased person as your beneficiary designation. If your primary beneficiary dies and you do not have a contingent beneficiary, this will create problems for you. You can name a contingent or secondary beneficiary, so take advantage of this. If you are predeceased by your primary beneficiary, naming a contingent one allows them to receive your insurance or investments.

MISTAKE #5

Naming minor children as beneficiaries

Roman and Maria were married, and both died in a tragic auto accident. Thankfully their 13-year-old Nick was staying with his grandparents, but unfortunately, Nick was named as the contingent beneficiary.

Since the insurance company can't pay out death benefits to a minor, a petition for guardianship would need to be filed with the probate court, with no guaranty the court will appoint a guardian of Roman and Maria's choosing. Roman and Maria could have instead created a

*Income-tax-free distributions are achieved by withdrawing the cost basis (premiums paid), then using policy loans. Loans and withdrawals may generate an income tax liability, reduce available cash value, and reduce the death benefit, or cause the policy to lapse. This assumes the policy qualifies as life insurance and is not a modified endowment contract.

trust for the benefit of their minor child. Doing so would have given them the ability to put restrictions on how funds are distributed.

MISTAKE #6

Naming a child over a spouse as a beneficiary

For your IRAs, listing your primary beneficiaries as your children over your spouse or partner could cause problems. Obviously, there are situations where this could apply, but in most cases, this is not a plan you will want to consider for married couples, especially when there is a large age gap.

For example: take Lisa, who is in her late-fifties and Richard, who is in his late sixties. Rich has a $1,000,000 IRA and is living quite comfortably, while Lisa is still working and receiving income. Lisa loves her job and does not see herself retiring until 65. She has accumulated a nice little nest egg for retirement and is projected to have over $2,000,000 in retirement assets by the age of 65. Both Lisa and Rich spoke with their financial professional and decided to purchase a small $200,000 annuity held within Rich's traditional IRA and earmark these specific assets to be split between their children. Rather than titling the beneficiary to Lisa, the couple decided to give the annuity to their two boys, Jake and Josh, who are in their late twenties and early thirties.

Rich passed away, leaving the annuity to his children. Although the children's' inherited IRAs are not subject to the 10% penalty, Jake and Josh are required to take minimum distributions based on each of their life expectancies. This limited their ability to let the assets compound and continue as tax deferrals. Also, the IRA custodian or trustee will have to report these RMDs as "death distributions" on their IRS 1099-R. Failure to take RMDs will result in an excise penalty tax of 50% on the amount which should have been distributed.

In this case, Lisa and Rich could have named their two kids as contingent beneficiaries and Lisa as the primary beneficiary. The assets would then continue to compound and grow tax-deferred. Lisa would not need to take required minimum tax distributions until 70½. Once Lisa passed away, Jake and Josh could stretch these payments over their life expectancy and continue tax deferral.

MISTAKE #7

Being afraid to include a charity as a beneficiary

If you want to make a difference in the world, you can designate a non-profit organization as your beneficiary. By doing this, the organization will get 100% of the funds, and the IRS will not take any of the money going to the non-profit organization. Be sure to notify the non-profit organization of your intentions so they can tell you how to set it up properly.

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