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Trusts and Estates

Completing the Estate Plan: Updating Beneficiary Designations

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For most folks, given that it is the last task on their "to do" lists, we find that the project of getting around to signing a will and implementing an estate plan (or even thinking about it) is met with moderate to extreme procrastination. When a set of estate planning documents is finally executed by clients, they typically experience a sense of relief and peace of mind. However, it's important to understand that the core estate planning documents alone (typically a will and/or revocable trust) cannot govern how all assets pass at death.

There are many assets which pass by operation of law (such as real estate in joint names) or by beneficiary designation form and not by will; and, under current law, a will cannot override how such assets pass. In this article, we will focus on beneficiary designations and the importance of properly coordinating those designations with the overall estate plan to provide for a cohesive, properly integrated estate plan. Not completing this final step of the process can lead to unintended and potentially problematic consequences.

Beneficiary designations for life insurance policies, annuity contracts, retirement plans and IRAs are sometimes referred to as "will substitutes." For these types of assets, beneficiary designations are required by contract. Often these assets constitute a large portion of the wealth transferred by an individual at death. There is no one size fits all approach to beneficiary designations. As part of the estate planning process, the lawyer who prepares an estate plan can guide the client to coordinate how these nonprobate assets pass, with the goal of ensuring that they pass to the right beneficiaries and in the right proportions. It is also important that when new assets are acquired, or when they are moved from one financial institution to another, that the new beneficiary designation forms are completed appropriately. Clients must be vigilant about this on their own since it is rare that they touch base with their estate planning lawyer each time new assets are acquired or transferred to new financial institutions (including job changes which typically lead to new qualified retirement plan benefits).

While sometimes individual beneficiaries are named directly in beneficiary designations, if the estate plan involves one or more trusts which are to be established under a will or revocable trust after the decedent's death, or if there is a special plan for contingent

beneficiaries, it is generally advisable for the beneficiary designations to identify the trusts (or simply name the trustees under a will or for a revocable trust) as the primary or contingent beneficiaries. This will keep the planning consistent by having all of the assets consolidated to flow through the overall dispositive scheme contained in the trust provisions. Also, if later there are any changes made to the terms of the trust by a codicil to the will or amendment to the revocable trust, generally no changes would need to be made to the beneficiary designations since the trusts (not the beneficiary designation itself) contains the operative dispositive provisions.

For retirement plans or IRAs, the spouse is often named as the primary beneficiary to take advantage of the rollover option (i.e., the spouse can rollover the account to his or her own IRA, which is treated the same way as an IRA that he or she funded personally for the purposes of the required minimum distribution (RMD) rules). With respect to 401(k) plans and other "qualified retirement plans" subject to the ERISA provisions of federal law, the surviving spouse has certain rights to plan benefits (even if a prenuptial agreement waiving those rights was signed), unless the spouse specifically waived such rights in writing in conjunction with the designation of a different beneficiary. By contrast, no such formal waiver is required in Pennsylvania for IRAs, annuities and life insurance beneficiary designations in order for those benefits to be effectively directed to a nonspouse beneficiary (subject to potential elective share rights of a surviving spouse under Pennsylvania law for up to a third of those assets).

In the event of divorce, it's important to take the steps to make sure to update beneficiary designations which designate a spouse. Although on their face, Pennsylvania statutes automatically revoke beneficiary designations in favor of former spouses upon divorce, ERISA provisions pre-empt state law with respect to qualified retirement plan benefits. Where the former spouse remains named by the participant as beneficiary on the beneficiary designation form for a qualified retirement plan benefit at the time of the participant's death, depending on the provisions of the ERISA plan, the plan administrator may be required to pay the death benefit to that divorced spouse.

Estate plans vary widely as to whether retirement benefits will be left outright to children (or grandchildren), in trust for them, in trust for the surviving spouse, or to one or more charities. Although it may seem like a logical choice to efficiently implement a particular estate plan, it is generally not advisable to name a client's estate as a beneficiary of an IRA or qualified retirement plan benefit in order to best preserve optimal income tax deferral benefits of such assets available for the beneficiaries under the minimum distribution rules. Naming a charity as beneficiary of a retirement plan may make sense in certain situations, but this should be carefully weighed against the value of the income tax deferral for beneficiaries of the estate who wish to maximize the stretch out (particularly in the case of Roth accounts).

For life insurance, it is generally not advisable to name an estate as beneficiary for creditor protection reasons and other reasons. Instead, generally naming the trustees (or specific trusts) under the Will or a revocable trust will serve the purpose of keeping the plan consistent. If a life insurance trust is established for estate tax saving purposes, that trust would be named as the beneficiary of the life insurance policy which is owned by the trust. Often we have come across individuals with an old insurance trust which was intended to be funded with one or more life insurance policies (for federal estate tax planning reasons), but the change of ownership and change of beneficiary forms were never implemented. Signing the basic estate planning documents is not enough.

In addition to beneficiary designations for retirement plans and life insurance, sometimes a client has designated a beneficiary on his or her regular bank and investment accounts or individual stock certificates or savings bonds. Such designations occur through payable on death (i.e., POD) titling or transfer on death (TOD) titling, which may involve special account forms for a securities account, or Totten trust titling (ITF for in trust for). Oftentimes, unintended and unpleasant issues arise in the estate administration process because of these designations, particularly in cases where a client doesn't realize (or forgets) that the account was titled in such way. If these accounts are not properly updated during the estate planning process, beneficiaries under the intended estate plan may end up being disinherited or bearing the burden of the inheritance and/or estate taxes imposed on such assets passing outside of the probate estate. Also, if the estate plan has trust structures for family members, a payable on death account which names individuals will disrupt the estate plan and cause inconsistencies.

While, in general, it makes sense to update beneficiary designation forms so that the beneficiaries named on those forms are consistent with the beneficiaries named under one's estate planning documents, there are times when it may be desirable to name different individuals or organizations for certain assets passing by beneficiary designation for various reasons. However, if this is the case, it is still important for the estate planning attorney to understand how such assets will pass so that the estate planning documents can properly take this into account. Particularly, the tax clause will need to address whether the estate/inheritance taxes on these assets passing outside of the will should be borne by the residuary beneficiaries or should otherwise be charged to the beneficiaries specifically named to receive such assets.

Updating beneficiary designations is not always an easy task, particularly when there are multiple policies, plans or accounts (often at multiple financial institutions) which require such designations. Unfortunately there is no universal form—every financial institution has its own beneficiary designation form with different questions or requirements for completion. The process of updating these forms can be tedious. In our experience, sometimes these forms are rejected by the financial institutions because the person (or computer) processing the forms doesn't understand trusts or the difference between trusts under wills, revocable trusts or irrevocable trusts. It can be a grueling process.

Having one universal form for all beneficiary designations would be ideal for consistency and ease, but that option does not exist in today's world. Going one step further, it would be ideal in most situations if a client could override all beneficiary forms by a statement in a will (to apply retroactively and prospectively). This would likely leave less room for error and provide for an overall consistent estate plan with greater ease than what is currently possible. •

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