TAX GUY

Never forget to change your beneficiaries — 3 horror stories on how it can all go wrong

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Make this estate planning move right now

Regardless of your income or net worth, there's one estate planning move you should probably make right now: check the beneficiary designations.

With today's relatively generous $11.18 million federal estate tax exemption, estate planning is only a concern for the rich. Right? Wrong! In fact, regardless of your income or net worth, there's one estate planning move you should probably make right now: check the beneficiary designations for your life insurance policies, bank accounts, brokerage firm accounts, retirement accounts, and so forth. If you've not yet turned in the proper forms to designate beneficiaries, do it now. If your forms are out of date, refresh them.

The consequences of failing to take these simple steps can be dire. If you don't believe it, consider the following trifecta of real-life horror stories.

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Horror story No. 1

A 2012 Fifth Circuit Court of Appeals decision reversed an early District Court decision by finding that a pension plan administrator didn't abuse her discretion in determining that a deceased plan participant's stepsons weren't considered his "children" under the terms of the plan. Therefore, the deceased participant's siblings, rather than the stepsons, were entitled to inherit the plan benefits. Source: Herring v. Campbell, 5th Circuit 2012.

Factually, John Wayne Hunter died in October of 2005. He had retired from Marathon Oil Company, where he was a participant in the company pension plan. The plan allowed Hunter to designate a primary and secondary beneficiary. Hunter designated his wife as the primary beneficiary but failed to designate any secondary (contingent) beneficiary. After his wife died, he failed to designate a new primary beneficiary. Under the plan's terms, when a participant died without designating a valid beneficiary, the deceased participant's benefits were distributed in the following order of priority: (1) surviving spouse, (2) surviving children, (3) surviving parents, (4) surviving brothers and sisters (siblings), and finally (5) participant's estate.

After Hunter died, the plan administrator considered, and rejected, the possibility that Hunter's two stepsons might qualify as "children" who would therefore be entitled to all of Hunter's benefits. Instead, the plan administrator distributed the benefits, which totaled more than $300,000, to Hunter's six siblings.

The stepsons sued, claiming they should have inherited the benefits. Evidence presented in the resulting Texas District Court proceeding showed they had a close relationship with Hunter. His estate had been left to them, and Hunter referred to them as his "beloved sons" in his will. The stepsons claimed they were in fact Hunter's children because, by his actions, he had "equitably adopted" them.

The evidence seemed to indicate that Hunter probably did intend to leave his benefits to the stepsons, and the District Court took their side by concluding that the plan administrator had abused her discretion by failing to consider the stepsons' equitable adoption claim. However, the plan administrator wasn't ready to give up the fight. She appealed to the Fifth Circuit.

The Fifth Circuit found no error in the administrator's interpretation that the term "children" for purposes of the plan meant biological or legally adopted children as opposed to un-adopted stepchildren. As to the stepson's claim that they had been equitably adopted by Hunter, the Fifth Circuit found that nothing required the plan administrator to incorporate the theory of equitable adoption into the plan's definition of "children."

Therefore, the District Court's decision was reversed, and all of Hunter's pension benefits went to his six siblings.

Horror story No. 2

How would you feel if you died and your ex, who you intended to get nothing further after your recent divorce, was allowed to collect all your company pension benefits and the proceeds from your company-provided life insurance? Probably not very good if you wanted your son and daughter from an earlier marriage to get the money. Unfortunately, the dad in this case failed to change the beneficiary designations for his pension benefits and life insurance after the divorce, so his ex-wife remained the named beneficiary. Two months later, dad was killed in a car crash. The Supreme Court ruled that the beneficiary designations trumped state law that would have automatically disinherited the ex. So the ex got the money, and the kids got the bills for an expensive and unsuccessful legal fight. Source: Egelhoff v. Egelhoff, Supreme Court 2001.

Horror story No. 3

In yet another real-life case, an ex-wife collected $400,000 from her ex-husband's company savings and investment plan even though the ex-wife had specifically waived any interest in the plan under the divorce agreement. Believing the divorce agreement was the last word on the subject, the ex-husband failed to turn in the form required to officially change the plan beneficiary from his ex-wife to his daughter. He died seven years after the divorce. The plan document stipulated that beneficiaries could only be changed by submitting the form. The Supreme Court ruled that the hideously out-of-date beneficiary designation trumped the divorce agreement. So the ex-wife got the $400,000 and the daughter got stiffed. Source: Kennedy Estate v. Plan Administrator for the DuPont Saving and Investment Plan, Supreme Court 2008.

The moral

Of course, beloved stepchildren and divorces aren't the only scenarios where failing to turn in or update beneficiary designation forms can cause big problems for someone's intended heirs. You face the same basic issue if you've become disgusted with one of your offspring because he has decided to become a professional Frisbee golfer. Or you might want to leave more of your life insurance benefits to an adult child who just had triplets and a bit less to your childless heirs. Bottom line: when your circumstances change, your beneficiary designations may need to change too.

Warning: Don't depend on your will or living trust document to override outdated beneficiary designations. As a general rule, whoever is named on the most-recent beneficiary form will get the money automatically if you die — regardless of what your will or living trust papers might say.

Special advice if you're married

If you're married and have accounts set up with you and your spouse named as joint owners with right of survivorship, the surviving spouse will automatically take over sole ownership when the first spouse dies. If that's what you intend, great. Still, you may want to name some secondary beneficiaries to cover the possibility that your spouse dies before you do. Note that in the nine community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin), you will usually need your spouse's consent to make beneficiary changes because assets accumulated during your marriage are generally considered to be owned 50/50.

Turning in beneficiary forms can also help you avoid probate

Beyond just ensuring that your money goes where you want it to go, another advantage of designating individual beneficiaries is that it can help you avoid probate — because the money goes directly to the named beneficiaries by "operation of law." In contrast, if you name your estate as your beneficiary and then depend on your will to parcel out assets to your intended heirs, your estate must go through the potentially time-consuming and expensive process of court-supervised probate.

The last word

If you don't have any minor children, keeping your beneficiary designations up-to-date can sometimes eliminate the need for a will (if you do have kids, you need a will to designate a guardian for them). The key words here are up-to-date. So it's a really good idea to check your designations at least once a year or whenever significant life changes occur. For example, when grandchildren arrive, you may want to name them as secondary (contingent) beneficiaries if their parents (your adult children) pass away.

In any event, you can usually conduct a beneficiary checkup and make needed changes in just a few minutes. Even better, beneficiary forms can often be accessed and submitted online. But if you wait, it could be too late — as the unlucky folks in the aforementioned horror stories can attest.

Sidebar: Beneficiary to-do list

Life insurance policies, annuities, IRAs and other tax-favored retirement accounts, employer-sponsored benefit plans: Fill out and turn in beneficiary designation forms to establish or change beneficiaries.

Bank and brokerage firm accounts: Fill out and turn in transfer on death (TOD) or payable on death (POD) form to establish or change beneficiaries.

529 college saving accounts: Fill out and turn in beneficiary change form if you want to change the account beneficiary.

Name secondary beneficiaries: Naming a primary beneficiary isn't enough. Name one or more secondary (contingent) beneficiaries to inherit your money if the primary beneficiary dies before you do. Sadly, this is a common occurrence that must be taken into account.

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