



Leimberg's Think About It

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CRAFTING THE CORRECT BENEFICIARY DESIGNATION: AN OVERVIEW FOR THE FINANCIAL SERVICE PROFESSIONAL

INTRODUCTION

When clients approach their financial service professionals to implement a plan, they expect the parts to work together. Those of us who work in estate planning seek to do our best with lots of different objectives, managing

- Family issues
- Control issues
- Taxes

The sophisticated estate plan may involve the use of many estate-planning tools, such as revocable trusts. The revocable trust creates advantages for the client including avoidance of probate and efficient transfer of wealth to heirs.

The beneficiary designation, while not as obviously as sophisticated a tool as a revocable trust, is at least as important. Those of us in the financial services business most commonly see beneficiary designations for

- Life insurance
- Annuities
- Pensions and IRAs

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A specific beneficiary designation in contractual arrangements, such as life insurance, annuities, pensions, and IRAs, allows the property to pass directly to the beneficiary without the need for probate. Its effect generally supersedes anything that a will or trust might say.

At the death of the insured or account holder, the beneficiary simply produces the death certificate, and the beneficiary's interest in the benefit vests immediately and absolutely. That direct, absolute, and nearly immediate access is a powerful estate planning advantage. And, in most cases, the amounts paid directly to a beneficiary are not subject to the claims of creditors of the decedent.

Further, beneficiary designations can integrate tightly with the rest of a client's estate plan. For example, a young married couple might have wills that create a testamentary trust to protect their young child in the event both parents are gone. Both spouses might have life insurance policies that name the surviving spouse as the beneficiary. The temptation for both spouses might be to name their child as the secondary beneficiary.

That would be inconsistent with the rest of their estate plan.

Most clients in those circumstances would opt for having the life insurance death benefit paid to a testamentary trust at the second parent's death. In most jurisdictions, the contingent beneficiary designation can point to the testamentary trust. As with an individual beneficiary, funds would be available quickly, and the trustee of the testamentary trust could bypass the probate process.

This isn't the only example of how a proper beneficiary designation might integrate into a client's estate plan. Say a client has health or practical issues that prevent her from updating a will. Assume also that the will is twenty years old and she was newly married to her husband at the time. The will has provisions that largely exclude her husband from inheriting her estate, instead favoring the client's children from a prior relationship.

If we also assume that the client has a large IRA balance, and that the IRA also names the client's children its beneficiaries, the potential opportunity is clear. Perhaps the client might name her spouse as sole or partial beneficiary of the IRA to take better financial care of him. That possible solution is simpler than creating a new will and probably has the advantage of more favorable tax treatment of the client's IRA assets.

Estate planning attorneys have passed along the observation that most of the clients they see have made beneficiary designations for their life, annuity and IRA products, but have failed to make contingent choices. That's a missed opportunity. In general, the issuing company assumes that, in the absence of an active beneficiary designation, the estate of the insured (or account owner) is the next beneficiary.

What's wrong with that?

If the estate is the beneficiary, the access of the heirs to any money associated with the financial product is delayed because the money must go through probate. With probate, in some cases, the

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delay can be a year or more. Any asset forced through the probate process becomes part of the public record, so privacy is lost. Finally, and perhaps most importantly, in most jurisdictions, the money paid into probate becomes subject to the claims of creditors of the decedent's estate.

There are a number of other ways that a beneficiary designation can fail to perform as expected:

- The beneficiary designation is inconsistent with the requirements of state law, especially elective or spousal share rules.
- The beneficiary designation will not be honored because it fails to conform to other agreements.
- The client and his advisors have failed to consider tax or technical nuances associated with the particular beneficiary designation.
- The beneficiary language itself is inconsistent with the client's intent.

Potential Problems With Beneficiary Designations

Elective or Spousal Share Issues

Each state has its own rules regarding how much of the estate the deceased spouse must leave to the surviving spouse or other estate heirs. For example, in many states, if the deceased spouse's will does not leave enough probate assets to the surviving spouse, then the surviving spouse can “elect against the will” and become entitled to one-third of the probate assets.

To make matters more complex, the spousal share rules in some states do not apply to non-probate assets. That means that most beneficiary designations will go unchanged because “named beneficiary” assets, such as life insurance payable by contract, are not generally subject to probate.

However, in some states – for instance Florida – the amount of the spousal share is calculated based on the value of the “enhanced” estate, not just the probate estate. The enhanced estate is defined as sum of the assets that go through probate, one-half of jointly owned assets, and some “named beneficiary” assets that pass by contract, such as life insurance, annuities and IRAs.

It's easy to see how a beneficiary designation can be defeated. Say a Florida resident's only asset is an IRA. The resident names an adult child the beneficiary of an IRA, not the surviving spouse. The spouse can make a spousal election and claim 30% of the IRA proceeds.

Prudence dictates that the responsible planner will familiarize him/herself with the nuances of state elective or spousal share rules.

Failure to Conform to Other Agreements

When explicit agreements and beneficiary designations are inconsistent, courts may step in and overrule the effect of the designation. This can often happen in divorce situations.

For example, Carl Johnson named his wife at the time, Antoinette Seaman, as the beneficiary of his group term life insurance policy with his employer. When Johnson and Seaman divorced in 1976, their divorce settlement declared the couple's two minor children as beneficiaries until they reached the age of majority. The divorce decree also specified Antoinette would have no further interest in the policy.

Carl never changed the beneficiary designation of his policy. At the time of Johnson's death, the children were adults, and both Antoinette and Johnson's current wife claimed the proceeds of his policy.

The trial court held the divorce decree trumped the beneficiary designation filed with the plan. The Sixth Circuit agreed. According to both courts, the divorce decree effectively erased the beneficiary designation of the former spouse and replaced it with the children as beneficiaries. The designation of the children then expired once the children became adults, which left no beneficiary. Under the terms of the plan, the insurance benefits passed to the insured's estate by default. The terms of the divorce decree thus nullified the beneficiary designation on file with the plan. (*Seaman v. Johnson*, 6th Cir. 2004.)

A split dollar or collateral assignment agreement may also be inconsistent with the plain language of a beneficiary designation and cause the beneficiary designation to be ignored. It is best for the professional to check to make sure that, if a split-dollar, nonqualified deferred compensation, Death Benefit Only, or other such agreements exist, the beneficiary designation is consistent with the agreements.

Tax and Technical Nuances

We've outlined some general technical nuances in making beneficiary designations in the introduction to this article. Here are some particular considerations based on the type of underlying financial product with which we are dealing.

Life Insurance

One of the great things about life insurance is that the death benefit is usually income tax free. However, if the beneficiary designation is not done right, it can drastically change the tax result.

Ownership and Beneficiary Do Not Match

In general, if the insured owns a life insurance contract, he can name anyone he wants as the beneficiary of the contract--while still keeping the death proceeds income tax free.

If a third party owns the contract, the third party must name himself (or itself) the beneficiary of the policy. If there's a mismatch, it creates tax trouble.

For example, say that Ben's company owns a life insurance contract on Ben's life. The company names Ben's wife as the beneficiary of the policy's death benefit. At Ben's death, the death proceeds will be treated as a taxable distribution to Ben's wife. See *Golden v. Comm.*, 113 F.2d 590 (3rd Cir. 1940) and Revenue Ruling 61-134. The result could be treated either as compensation or, in some cases, as a dividend depending on the facts.

In a personal situation, say that Cathy owns a life policy on her husband Paul's life. Cathy decides that, in the event of Paul's death, she doesn't need the death proceeds. Cathy names their son, Brandon, as the beneficiary.

At Paul's death, Cathy will be considered to be making a taxable gift to Brandon. While that doesn't expose the death proceeds to income taxes, it does make them subject to gift taxes. See *Goodman v. Comm.*, 156 F.2d 218 (2d Cir. 1946). In some cases, the gift tax exposure might be a worse tax result than income tax inclusion.

The rule of thumb for the professional advisor is that if a third party owns a life contract, the same third party should be the beneficiary.

Section 101 (j)

The Pension Protection Act of 2006 created a new and very unpalatable general rule: life insurance death benefits on an employee's life payable to the business are income taxable.

The tax-free death benefit can be preserved if (1) proper notice and consent forms are obtained before the coverage is issued and (2) if the employee is:

- A director of the employer company
- A 5% or greater owner of the employer company at any time during the preceding year
- A recipient of more than \$95,000 in compensation from the employer in the preceding year if the preceding year is 2005 (\$100,000 if the preceding year is 2006 and \$105,000 if the preceding year is 2007, indexed for inflation)
- One of the five highest-paid officers of employer
- Among the highest paid 35% of all employees of employer

While in many cases it's possible to avoid the income taxes associated with Section 101(j) by having the proper forms signed and making sure IRS reporting takes place, the rules are still new and often overlooked or misunderstood. As noted above, under the language of Section 101(j), the notice and consent requirements must be fulfilled prior to the issuance of the policy. If the requirements are not met, the income-tax taint on the policy appears to be permanent and there are no rules that allow a post-issuance correction.

Because of the great risk associated with these new rules, we recommend that 101(j) procedures be followed in every case where there is any chance an employer – no matter the legal form of the entity or how large or small the business – might be thought to benefit from a life policy, either directly as a beneficiary or indirectly.

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This includes the following situations that involve life insurance, although the list is by no means comprehensive:

- Buy-sell funding
- Key man insurance
- Informal financing of deferred compensation
- Split dollar
- VEBA or other welfare benefit plans

Nonqualified Annuities

The main beneficiary issues that arise with annuities are related to taxes.

At the annuitant's or policyowner's death, a nonqualified annuity contract usually pays its value as a death benefit to the beneficiary. Any amount received in excess of what the policyowner paid is taxable as ordinary income to the beneficiary.

Beneficiaries may have some choices with regard to the timing of the payments from an annuity contract and, thus, with the timing of the tax result.

A surviving spouse named as beneficiary generally has the right to continue the deferred annuity as if it is her own after the death of the spousal policyowner. The spouse can choose to defer distributions and the income tax result associated with them until her death. That tax deferral can be a very powerful device.

However, if a marital trust is named beneficiary instead of the surviving spouse directly, the ability to continue the annuity on a tax-deferred basis until the spouse's death is probably lost. If tax-deferred continuation by a surviving spouse is desired, it is simplest to name the spouse as the direct beneficiary.

A nonspousal beneficiary must take distributions from a nonqualified annuity 1) at least as rapidly as under the method of distribution in effect at the owner's death or 2) completely within five years of the owner's death.

The IRS offers favorable distribution and taxation rules if the beneficiary is an individual. If the named beneficiary annuitizes the annuity over his lifetime within a year of the owner's death, he'll be considered to be in compliance with the distribution rules. This annuitization has some income-tax appeal, as it allows the beneficiary to stretch the income-tax result over his/her lifetime.

However, the policyowner may want to control how the beneficiary can access the annuity. For example, the policy owner may want annuity funds directed to a testamentary trust for the benefit of his children in the event of his death.

Based on current rules, it appears that directing nonqualified annuity proceeds to a trust will require that the annuity be completely distributed and taxed within five years of the policy owner's death.

IRAs and Pensions

Pensions, Nonspouse Beneficiary, and ERISA

Pension plans and IRAs are similar in their rules with regard to beneficiary designations, and most of the observations that follow apply to both. However, ERISA (The Employee Retirement and Income Security Act) imposes some special rules for pensions. ERISA requires that, if a participant is married, the spouse must be the beneficiary of a pension plan – unless the spouse has consented (in writing) otherwise. With a 401(k) account, for example, if no spousal consent has been filed with the employer, the spouse is the beneficiary. Absent a specific spousal consent, a beneficiary form that purports to name someone other than the spouse will be ignored.

ERISA spousal consent rules do not apply to IRAs, so no consent form is needed to name children as beneficiaries.

Pension and IRA Issues

For the purpose of the rest of this discussion, we will limit our consideration to IRAs. However, the analysis that applies to IRAs also generally applies to pension plan balances, such as those associated with 401(k) plans.

As with nonqualified deferred annuities, the surviving spouse, if named direct beneficiary, has the option to continue an IRA as if it were her own. However, naming a trust as the beneficiary may eliminate the continuation option.

Marital trusts are often used where 1) the spouse may need management help over assets or 2) the planning spouse wants to exercise control over the spouse's access to the trust funds; often this is a second marriage situation.

It is the IRS's policy to allow a trust to elect spousal continuation only if the trust gives the spouse broad powers to control the IRA and if the trust gives her the ability to act alone to withdraw IRA money.

While the asset management trust described above may be drafted with broad powers for the spouse, the marital trust used to exercise control probably will not. The planner and the client will need to make a choice about whether the tax result or the distribution objective is the more important planning factor.

A nonspousal beneficiary must take distributions from an IRA 1) under the life expectancy rule or 2) completely within five years of the owner's death.

In general, if the beneficiary is a named individual and the beneficiary makes regular RMD (Required Minimum Distribution)-like distributions from the IRA over his lifetime, the beneficiary is considered to have complied with the life expectancy rule. This RMD-like approach, sometimes referred to as the “Stretch IRA,” has some income-tax appeal since it allows the beneficiary to stretch the income tax liability over his lifetime.

However, the account owner may want to control how the beneficiary can access the IRA. For example, the account owner may want IRA funds directed to a testamentary trust for the benefit of his children in the event of his death.

If the beneficiary is not a named individual, the Stretch IRA option is lost, and the entire IRA must be distributed within five years of the account owner’s death and is taxed as income.

The IRS has issued regulations and letter rulings over the past few years on how trusts may be used in conjunction with Stretch IRA planning. Beneficiaries of a trust may be treated as designated beneficiaries and qualify for stretch treatment if four requirements are met:

1. The trust is valid under state law
2. The trust is irrevocable or becomes irrevocable upon the death of the grantor
3. The beneficiaries of the trust are readily identifiable from the trust itself
4. A list of beneficiaries or a copy of the trust is provided to the IRA by October 31 of the year following the date of the grantor’s death.

These types of trusts are referred to as “look-through” trusts. The oldest beneficiary of such trusts is considered to be the “designated beneficiary” for Stretch IRA purposes.

If the beneficiaries are widely separated in age, using the oldest as the measuring life for Stretch IRA purposes may not give the optimal result. It may make sense to plan on the front end to

- Divide the IRA into multiple accounts, and
- Direct each of the accounts into separate look-through trusts for each one of the beneficiaries in order to maximize the control and tax aspects of the IRA planning.

Sample Beneficiary Designations

Please note: The beneficiary designations that follow are designed to provide suggested language for common beneficiary situations. The particular company with which you are placing the financial product may have its own preferred language for such situations. Likewise, the client’s attorney may also have favored language for the client’s situation. Make sure that you seek and incorporate the input of your company and the appropriate professional advisors before implementing a beneficiary designation on behalf of a specific client.

If the Beneficiary is:	Sample Beneficiary designation:
An individual	My spouse, Karen Smith.
A lifetime trust – either revocable or irrevocable	Great American Bank and Trust or its successor in trust, as Trustee of the Smith Family Trust Number One dated May 1, 2008.
A testamentary trust created in a will	The trustee of the testamentary trust created in Section 5.4 of my Last Will and Testament.
Only those in the named group who are surviving at the time	In equal shares to those of my children, John Smith, Ann Smith and Barbara Smith, who survive me.
All living children, including after-born, to be shared equally	In equal shares to my children, John Smith, Ann Smith and Barbara Smith, and all others who are adopted during or born of the marriage of me and Karen Smith. All said beneficiaries who survive me shall share in equal shares.
Unequal distribution to the beneficiaries with survivors to share in proportion	One twenty-five percent (25%) share to my son, John Smith, one twenty-five percent (25%) share to my daughter, Ann Smith, and one fifty percent (50%) share to my daughter, Barbara Smith. If one or more of these beneficiaries shall predecease me, the survivors shall share in the same proportions.
Equal proportions to the members of the class, or to their children if predeceased	In equal shares to my children, John Smith, Ann Smith and Barbara Smith, per stirpes.
Unequal distribution to the beneficiaries with their children to take if predeceased	One twenty-five percent (25%) share to my son, John Smith, one twenty-five percent (25%) share to my daughter, Ann Smith, and one fifty percent (50%) share to my daughter, Barbara Smith. If one or more of these beneficiaries shall predecease me, the amount designated shall be distributed per stirpes to the predeceased beneficiary's living issue, if any, otherwise surviving beneficiary(s) shall share in the same proportions.
A life policy subject to a collateral assignment in favor of a lender	Karen Smith, subject to the interest of Great American Bank and Trust, as it may appear in our Collateral Assignment Agreement dated May 1, 2008.

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If the Beneficiary is:	Sample Beneficiary designation:
A life policy or account subject to the provisions of marital settlement or support agreement	In equal shares to my children John Smith, Ann Smith and Barbara Smith, per stirpes, subject to the interest of my ex-spouse Karen Smith, as it may appear in our Marital Settlement Agreement dated May 1, 2008.
A life policy subject to a collateral assignment split dollar agreement	Karen Smith subject to the interest of ABC Corporation, as it may appear in our Split Dollar Agreement dated May 1, 2008.
A life policy subject to an endorsement split dollar agreement	ABC Corporation, subject to the interest of Karen Smith, as it may appear in our Split Dollar Agreement dated May 1, 2008.

Conclusion

Estate planning is a tricky business. The financial service professional must juggle competing factors – tax, administrative, legal, family and practical – in developing specific recommendations for a particular client.

While life insurance planners do not and should not draft legal documents, they generally are often the professionals upon whom clients rely to “take a look at” and review beneficiary designations.

In many cases, life insurance, pensions, IRAs and annuities are among the largest assets within the client’s estate. Planners must thoroughly understand how the beneficiary designations for those assets integrate within the entire estate plan to make sure that the client’s overall estate planning objectives are met.

This training material has been prepared to assist our licensed financial professionals. It is designed to provide general information in regard to the subject matter covered. It should be used with the understanding that Prudential is not rendering legal, accounting or tax advice. Such services should be provided by the client’s own advisors.

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