

Designating Beneficiaries

By Hyman G. Darling, Esq

FAST FACTS

- Receiving a death benefit from a loved one may push a person's estate to a taxable level.
- There are now options that allow for a non-spouse beneficiary to reduce his or her tax burden.
- Beneficiary designations are contractual, so an ex-spouse may receive the benefit if the ex-spouse's name is not removed as a beneficiary.

The beneficiaries and back-up beneficiaries named on retirement plans and life insurance policies must be carefully considered and properly designated. A single person without children, for example, may want siblings, nieces, and nephews to be the beneficiaries and not parents. Parents could be elderly and institutionalized, which would mean that any funds left to them would be used to cover long-term care.

A minor child of a single person, if named as a beneficiary, will receive the benefits at age 18. A guardian is appointed by the Probate Court to hold these funds for the benefit of the child. If there is no beneficiary designation, then the balance of the funds (e.g., by an insurance company) are payable to the estate and thus must pass through probate.

Potential Tax Consequences

It is very important to review the tax issues as they apply to beneficiary designations. Most life insurance is not income taxable; however, the death benefit is included in the estate for estate tax purposes. The following are issues that must be considered:

- It is possible that although a person does not currently have a taxable

federal estate (exemption of \$2,000,000 in 2008 and \$3,500,000 in 2009), the estate may cross that threshold when the death benefit of employer-owned insurance, group insurance, or accidental-death coverage is accepted.

- A term insurance policy should not be owned by the insured because this subjects the policy to estate taxes. It is preferable to have the policy owned by and payable to another person (e.g., family member, friend, or any revocable trust).
- It is very important to consider the beneficiary of IRAs, annuities, and other qualified retirement plans to be sure that the appropriate person, people, or charities are named. A married individual may receive a spouse's qualified retirement plan benefits tax free by rolling the funds over into an IRA.
- There is no estate tax or income tax due when one dies and leaves all assets to the living spouse. However, the income tax and potential estate tax when the surviving spouse dies are significant.
- A non-spouse now has certain options so that he or she does not have to pay taxes in a lump sum on the death of the contributor of the funds. The non-spouse beneficiary may take these funds over 5 years, take them in a lump sum distribution, or have them rolled over into a special IRA (decendent IRA), where they receive the funds over a lifetime. These distributions have to be made to Trustee to Trustee for the benefit of the beneficiary. A person may not elect to merely take the funds on their own, deposit them in an IRA for

themselves, and claim no income tax status.

- A beneficiary may wish to take what is known as a Stretch IRA. In this case, the beneficiary does not necessarily have to pay all of the income taxes in a lump sum, as he or she spreads the distribution over a lifetime. These beneficiaries are not only deferring their taxes but also protecting these assets in the event that they are sued because the assets are not available as a lump sum.
- In addition, when added to the recipient's own income, a lump sum receipt of these funds may push the recipient into a higher income tax bracket, since the receipt of the IRA

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About the Author



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include all areas of estate planning, probate, and elder law. Darling is a past President of the Hampden County Bar Association; he teaches elder law at Bay Path College and is an Adjunct Professor at Western New England College School of Law (the LLM program) where he teaches elder law. He is a frequent lecturer on various estate planning and elder law topics at both the local and national levels, and he hosts a popular estate planning blog at http://bwlaw.blogs.com/estate_planning_bits.

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would be at ordinary income tax rates. By taking the funds as an annuity over a lifetime, the recipient allows the funds to build tax deferred. Later in life, these funds may be construed as retirement benefits, which may permit the beneficiary to retire early, since they will constitute a steady stream of income guaranteed for a lifetime.

- Even when a person is married, it sometimes makes sense to consider leaving retirement funds to the children instead of the spouse for income and estate tax purposes. However, it is a requirement of federal law that the spouse signs off on the beneficiary form (i.e., a person may not exclude a spouse from being the beneficiary unless the spouse signs a written, notarized waiver). However, a person must consider income taxes, estate taxes, and the need for a spouse to survive on only his or her income.

The Big Picture

Beneficiary and back-up beneficiary designations should be reviewed often to ensure that they are properly completed. Upon a person's death, the beneficiary designation is payable under a contractual relationship, regardless of what the Will says, and therefore, the proceeds are payable to an ex-spouse, for example, in the case of a divorce, which is probably not what a person actually wants. Many beneficiary designation forms permit a portion to be paid to multiple beneficiaries rather than having all funds left to one particular beneficiary. Whether a specific beneficiary receives a dollar amount or a percentage of the proceeds, the form should be reviewed often and kept with all other important papers, such the Will, Health Care Proxy, Power of Attorney, and Trust, if applicable.

