How a Few Simple Measures Can Protect Your Legacy

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We probably all know that it's important to prepare an estate plan. Among the many benefits it provides is protection and peace of mind for you and your spouse, children and other loved ones. It can also help you fulfill charitable goals and leave behind the legacy you desire.

What may surprise some folks, however, is that one of the simplest and most effective ways to ensure your bequest wishes are carried out doesn't necessarily require drafting a formal legal document. Rather, it requires you to properly choose your "beneficiary designations."

So what are these designations, how do you update them and why are they so important?

Let's start with some background. Property is transferred to others at death in three primary ways. First is through the probate process directed by your last will and testament. If you have not created a will, assets will transfer based on the intestacy laws of the state you live in. Second, assets can transfer based on operation of law. This typically applies to assets transferred under a trust arrangement or based on how the asset was titled (e.g. joint tenants with right of survivorship). Finally, certain assets transfer based on who is listed as the direct beneficiaries. These assets include individual retirement accounts (IRAs), qualified retirement plan accounts (e.g. 401(k) plans), life insurance policies and annuities.

For the purposes of this article, let's look at IRAs and what happens to them when the holder is deceased.

IRAs often make up the largest liquid investment assets for households. They do not transfer at death based on what you have indicated in your will. Instead, IRAs transfer based on the beneficiaries you designated.

It is most common for an IRA to have an individual named as a primary beneficiary. If you are married, that individual will usually be your spouse. Surviving spouses can roll over their deceased spouse's IRA into their own and not necessarily be required to start taking required minimum distributions (RMDs) right away. If the beneficiary is someone other than a spouse, such as children or grandchildren, different rules apply for future RMDs.

Entities such as charities or trusts can also be named as beneficiaries. For income and estate tax planning, it is often desirable to name a tax-exempt public charity as beneficiary. It can also be practical to name a trust as a beneficiary for asset protection purposes and to have more control over what happens to your IRA after death. You would want to work closely with your advisor and estate planning attorney to ensure the trust is drafted in a way that avoids unintended tax consequences.

If you do not review these designations regularly, you should at least do so after substantial family and life events occur. This includes birth, death, marriage and divorce. There can be unintended consequences if you neglect to keep your designations up-to-date.

One of the most common mistakes is failing to update beneficiaries after a divorce. Remarrying and introducing step-children into the picture makes it even more important to regularly review your estate plan. State laws may bail you out if you fail to update a beneficiary, by revoking designations upon divorce. However, federal law could trump state statutes in certain situations. Nevertheless, why risk putting your family and loved ones through litigation when a few simple, proactive measures can be taken to avoid it?

Fortunately, the process to change designations is straightforward. Generally, you can request a beneficiary designation form from the custodian that holds your IRA. When you're making changes to this form, it's important to properly choose your "contingent" beneficiaries as well. This makes sure assets transfer properly if your primary beneficiary has passed away first. It is especially important to fill this section in when you do not have trusts established as a backup to your estate plan.

Finally, don't forget to update beneficiaries on non-IRA accounts where applicable, such as life insurance and annuity contracts.

Estate planning can be complex, but sometimes the simplest actions can make the most impact. By periodically reviewing and updating your beneficiary designations, you can ensure your family and loved ones benefit from the legacy you've built and preserved.

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