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5 mistakes to avoid when deciding who should be your beneficiary

By: Allen Wastler

This article will ...



Explain why updating beneficiaries should be a regular part of any **financial wellness routine**.

List the common problems that arise with **ex-spouses**, **children**, and **family communication**.

Discuss how a sudden cash inflow can have negative implications for a **beneficiary's circumstances** or your **full estate plan**.

Chances are you have a beneficiary. They are pretty common, from retirement accounts to trusts to wills. And they figure prominently in life insurance policies.

Simply put, a beneficiary is the person (or legal entity) that will receive the proceeds from a financial vehicle once the owner passes. So, they typically tend to get named every time an account is opened, or policy purchased.

But just as common are certain mistakes that get made around beneficiary designations. Here are five that financial professionals like to warn people about when they decide who should be their beneficiary.

1. Updates and divorce distraction

Updating beneficiaries should be a regular part of any financial wellness routine. But sometimes it gets forgotten. More often than not, that's what happens during the emotional strife of a divorce case.

*"Divorce is a big one," said Glen Golish, president of **G Wealth Strategies** in Boca Raton, Florida. "Many divorce cases involve negotiating a new life insurance policy, but not always. If there is an existing policy, you may not want to leave your ex-spouse as the beneficiary. There could be an accumulation of cash in the policy that you could use to supplement your retirement, or it may have an increasing death benefit that you want to keep. People should also check employer-provided policies. A lot of individuals forget that step."*

Some states have statutes that automatically terminate the beneficiary status of a former spouse after the marriage has been dissolved; other states do not. Make sure to review your life insurance designations after the divorce is final.

*"Leaving an ex-spouse as a beneficiary is the biggest mistake, I see people make," agreed Doug Collins, a financial planner at **Fortis Lux Financial** in New York City. "The common thing to update is an insurance policy, but also people need to remember that retirement accounts, such as an old 401(k) or IRA, will have a named beneficiary that should be reviewed."*

2. Is the beneficiary benefiting?

On the surface, leaving money to somebody would generally be considered a good thing. But there are cases when deciding on who should be your beneficiary where, financially, it may not be it good thing for them.

"Ignoring the financial impact on the beneficiary – that's a mistake," said Golish. "Let's take a hypothetical case involving three children – one is financially well off and the other two aren't. Splitting the estate equally among the three, which on the surface might seem fair, could have a negative impact for one beneficiary. The inheritance could potentially create more tax liability for the wealthier child, while the other two could have benefited by inheriting more money. The wealthier child may have valued something else – a family heirloom or other physical asset – more than a monetary payout. With foresight and planning, you can make allowances and preparations for those kinds of situations."

Similarly, leaving a sum of money by making them a direct beneficiary can also affect the kind of support someone can get from other areas. For example, designating a special-needs individual the recipient of a large benefit could disqualify them from receiving government support. Or, if someone is on Medicaid, they would have to exit the program until they spend down a significant inheritance or death benefit.

Financial professionals can often help lay out alternatives for evaluating how to help someone through a beneficiary designation without sacrificing the availability of government benefits or programs.

3. Estate planning and thresholds

Some estate financial planning situations are straightforward. For instance, a single-person beneficiary of a life insurance policy can receive the death benefit tax free. Or a retirement account can be turned directly over to a designated, surviving spouse.

But often, families and personal situations are a little more complicated. Or there is a desire to distribute assets differently. But a life insurance death benefit paid to an estate can trigger tax and probate issues, not to mention become attachable by creditors. Add in retirement accounts and other financial assets, and the financial implications can get more complicated still, particularly if the assets exceed the \$12.06 million exemption (2022) for federal estate taxes or any state tax thresholds.

“Someone might make a few well-meaning gifts – cash, real estate or other assets – and suddenly their assets moved from tax free to taxable estate,” observed Golish.

So, depending on individual circumstances, many people turn to a financial professional to help navigate some of the implications of naming beneficiaries one way versus another. And, through an ongoing relationship, a financial professional can help keep you apprised of federal and state changes that may affect financial plans.

4. Careful with kids

There is a temptation to name children as beneficiaries, especially for life insurance policies. After all, if you are gone, you want to make sure your progeny have the wherewithal to move on.

But here, too, are potentially negative consequences if not planned in a careful way. One basic issue is that while an 18- or 21-year-old (depending on the state) can inherit a benefit directly, they often don't know what to do with a sudden, large sum of money. And a younger child will require legal oversight. A trust situation may be a solution.

“Naming a minor as a contingent beneficiary can also create problems,” said Collins. *“My 3-year-old could not inherit my life insurance policy, so then it falls to the courts to make the decisions. That is why it is crucial to have a properly structured will that spells out who will take care of minor children, but also who will handle the finances in case both parents pass away. Usually in that case, the will should dictate that a trust will be set up for the benefit of the children until they are of age.”*

Not having a plan and assuming family will step in isn't a secure answer, financial professionals caution.

If you have a child with special needs, experts suggest that it is vital to have a special-needs trust. Mistakenly, people leave money to another family member with the understanding that they will care for the child. Unfortunately, that isn't always the case, and the beneficiary may use some or all the funds for the care of their own children.

5. Let the family know

Communication, more precisely lack of it, can also be a problem.

Not letting family or loved ones know that you are making them a beneficiary may prevent them from warning you about potential problems — like a tax bill — or about opportunities for a more meaningful legacy — like the preference for a family heirloom versus money.

Communication can also head off ugliness.

“I had a client with a substantial life insurance policy name his daughter as the beneficiary,” said Golish. “When the daughter passed a few years ago, my client changed the beneficiary of the policy to his son. When my client recently passed away, the husband of the deceased daughter was shocked to learn about the change. He assumed that he would be receiving the death benefit of the policy. Even though the changes were documented, he claimed that he didn’t know about the beneficiary change, so he was quite upset, and a family feud ensued.”



Allen Wastler is a former financial journalist with over 30-years of experience, including time at CNBC, CNN, and Knight-Ridder Newspapers.

Conclusion

These are just some of the basic, more common mistakes and challenges that can arise out of beneficiary designations. Obviously, there can be more, often depending on the complexity of individual circumstances.

And often what started out as a simple situation can change.

As time goes by and financial assets hopefully grow, the question of who is beneficiary to what, and how everything ties together, can become more and more complex. Financial professionals can help navigate such circumstances and provide guidance on how to avoid the pitfalls.

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