Be Careful When Naming Beneficiaries

You might not have thought much about beneficiary designations — but they can play a big role in your estate planning.

When you purchase insurance policies and open investment accounts, such as your IRA, you'll be asked to name a beneficiary, and, in some cases, more than one. This might seem easy, especially if you have a spouse and children, but if you experience a major life event, such as a divorce or a death in the family, you may need to make some changes — because beneficiary designations carry a lot of weight under the law.

In fact, these designations can supersede the instructions you may have written in your will or living trust, so everyone in your family should know who is expected to get which assets. One significant benefit of having proper beneficiary designations in place is that they may enable beneficiaries to avoid the time-consuming — and possibly expensive — probate process.

The beneficiary issue can become complex because not everyone reacts the same way to events such as divorce — some people want their ex-spouses to still receive assets while others don't. Furthermore, not all the states have the same rules about how beneficiary designations are treated after a divorce. And some financial assets are treated differently than others.

Here's the big picture: If you've named your spouse as a beneficiary of an IRA, bank or brokerage account, insurance policy, will or trust, this beneficiary designation will automatically be revoked upon divorce in about half the states. So, if you still want your ex-spouse to get these assets, you will need to name them as a non-spouse beneficiary after the divorce. But if you've named your spouse as beneficiary for a 401(k) plan or pension, the designation will remain intact until and unless you change it, regardless of where you live.

However, in community property states, couples are generally required to split equally all assets they acquired during their marriage. When couples divorce, the community property laws require they split their assets 50/50, but only those assets they obtained while they lived in that state. If you were to stay in the same community property state throughout your marriage and divorce, the ownership issue is generally straightforward, but if you were to move to or from one of these states, it might change the joint ownership picture.

Thus far, we've only talked about beneficiary designation issues surrounding divorce. But if an ex-spouse — or any beneficiary — passes away, the assets will generally pass to a contingent beneficiary — which is why it's important that you name one at the same time you designate the primary beneficiary. Also, it may be appropriate to name a special needs trust as beneficiary for a family member who has special needs or becomes disabled. If this individual were to be the direct beneficiary, any assets passing directly into their hands could affect their eligibility for certain programs.

You may need to work with a legal professional to sort out beneficiary designation issues and the rules that apply in your state. But you may also want to do a beneficiary review with your financial advisor whenever you experience a major life event, such as a marriage, divorce or the addition of a new child. Your investments, retirement accounts and life insurance proceeds are valuable assets — and you want them to go where you intended.

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