Are You (and Your Beneficiary Designations) up to Date?

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Sometimes the simple things in life—and life insurance—are the most important.

As financial planners, we typically focus on the most complex issues facing clients, such as determining the asset allocation, constructing the portfolio, calculating appropriate savings levels to meet retirement, educational and major purchase goals, and developing gifting and estate strategies to reduce or eliminate exposure to transfer taxes. Of course, these esoteric aspects of planning provide significant value for the client, but often the simplest actions and advice—such as making sure that beneficiary designations are up to date—are most important to a client.

How Property Is Transferred at Death

Property can be transferred to others at the client's death in three ways: through probate, by operation of law, or by contract. The probate process transfers all property that has not already been transferred to others by operation of law or by contract, and is governed either by the terms of the decedent's last will and testament, or, if the decedent left no will, by the intestacy law of the state of the decedent's domicile. Property transferred under a revocable or irrevocable trust arrangement and property transferred automatically to a survivor by asset titling (such as property held as joint tenants with right of survivorship or tenancy by the entirety) is said to pass by operation of law.

Many financial products permit a client to name a beneficiary to receive the residual value of the account at the client's death, which is a form of property transfer by contract. Examples of financial products that permit beneficiary designations include life insurance, annuity contracts, and retirement plans. In many instances, the value of life insurance, annuity contracts, and retirement plans represent a significant portion of a client's net worth.

Beneficiary designations provide an easy way for a client to transfer wealth, but also pose a danger to the unwary. If circumstances change but the client's beneficiary designation does not, property may be transferred to an unintended recipient. A common example might be divorce and remarriage. Many clients name their spouse as the beneficiary of their life insurance policy, but do not take action to change the beneficiary designation after a divorce occurs even though it is likely that the client would not want the former spouse to receive those benefits.

In an effort to protect individuals from the consequences of their own inaction, most states have adopted legislation that provides for automatic revocation of bequests made to a former spouse in a will that was made prior to the date of the client's divorce. Some states have taken this a step further by enacting legislation that automatically revokes beneficiary designations in favor of a former spouse that were made prior to the client's divorce.

The *Hillman v. Maretta* Case

The Supreme Court's unanimous 2013 ruling in the case of *Hillman v. Maretta* (133 S. Ct. 1943) makes it clear that those state laws will not always apply and emphasizes the importance of keeping beneficiary designations up to date. Warren Hillman, a resident of Virginia, was a federal employee and was covered by the Federal Employees Group Life Insurance (FEGLI) plan. In 1996, he designated his wife, Judy Maretta, as the beneficiary of his FEGLI life insurance. Two years later, Hillman and Maretta divorced, and in 2002 Mr. Hillman remarried. In 2008, Mr. Hillman was diagnosed with leukemia, and died shortly thereafter. His will left his estate to his then-current wife, Jacqueline Hillman, but Mr. Hillman had never changed the beneficiary designation on his FEGLI life insurance contract.

Mr. Hillman's widow (Jacqueline) claimed the FEGLI death benefit under Mr. Hillman's policy even though Judy Maretta was still listed as beneficiary. After her claim was denied, she filed a lawsuit seeking to direct the payment of the death benefit to her through Mr. Hillman's estate. Jacqueline Hillman argued that, under Virginia law, beneficiary designations for life insurance contracts are automatically revoked upon divorce, and since no successor beneficiary was named, the death benefit should be payable to Mr. Hillman's estate. Because Jacqueline was the beneficiary of Mr. Hillman's estate, she should be the recipient of the life insurance proceeds.

The Supreme Court found that Judy Maretta, not Jacqueline, was entitled to receive the FEGLI death benefit. According to the Court, the payment of the death benefit is governed by the beneficiary designation on file with the plan, as specified under federal law (the Federal Employee's Group Life Insurance Act of 1954). Because the Virginia law terminating the beneficiary designation was in conflict with federal law, and the supremacy clause of the U.S. Constitution says that federal law is the supreme law of the land, the Virginia statute was preempted. The end result is that Mr. Hillman's widow lost access to the FEGLI death benefit in favor of Mr. Hillman's former spouse. This consequence was probably not intended by Mr. Hillman, but was caused by his inaction in not keeping his beneficiary designations up to date.

The decision in the Hillman case has a broader reach than FEGLI. The Supreme Court made it clear that any time federal law permits beneficiary designations, state legislation revoking those beneficiary designations will not be effective due to the conflict with federal law. Consequently, the result in the Hillman case will likely be applied to other federal employee benefit plans and to retirement plans covered by ERISA.

Alternative Beneficiary Designation Options

Although planners and clients know that keeping beneficiary designations up to date is important, this task is not always at the forefront of their minds, especially when major life events occur. Some strategies can be employed that will help avoid the result in *Hillman v. Maretta*.

In some cases, it may be wise to consider naming a revocable, or living, trust as the beneficiary of life insurance proceeds. Many people use revocable living trusts to avoid the probate administration process (revocable trusts transfer property by operation of law outside of the probate process). The value of assets in a revocable trust is included in a taxpayer's gross estate for estate tax purposes. Likewise, if an individual owns a life insurance policy on his or her own life, or holds any incident of ownership in that policy, the death benefit will be included in the decedent's taxable estate, but will pass outside of probate. Naming a revocable trust as the beneficiary of life insurance owned by the insured, or over which the insured holds an incident of ownership, will not change the transfer tax results for the insured, but may provide additional assurance that the Hillman decision will not result in the policy death benefit being transferred to an unintended beneficiary.

If Mr. Hillman had named a revocable living trust as the beneficiary of his FEGLI life insurance proceeds, Judy Maretta would not have walked away with the insurance proceeds. Using the reasoning of the Supreme Court in the Hillman case, the beneficiary designation will stand, and there would be no need to change the beneficiary designation on Mr. Hillman's life insurance policy upon his divorce, because the beneficiary would have been Mr. Hillman's revocable trust.

In the facts of the Hillman case, Mr. Hillman apparently changed his will after his marriage to Jacqueline, naming her as the beneficiary of his estate. If Mr. Hillman had a revocable trust in place, he could likewise have amended the trust to transfer his property, including the life insurance death benefit, to Jacqueline. Ironically, under Virginia law, he would not have had to amend the trust for this to happen, because Virginia law terminates bequests made to a former spouse prior to the date of their divorce, so Judy Maretta's interest in Mr. Hillman's revocable trust (which is governed by state, not federal, law) would have been terminated. In his revocable trust, Mr. Hillman could have simply stated that his "spouse" is the beneficiary of the trust without directly naming his spouse, in which case the trust assets, including the FEGLI death benefit, would have been transferred to his spouse, Jacqueline, at the time of his death.

Although life insurance proceeds may be transferred in this manner, it would not be advisable to name a revocable trust as the beneficiary of qualified plan assets, as this would trigger a taxable distribution from the qualified plan to the trust. Had an individual beneficiary been named as the recipient of qualified plan assets, the beneficiary would have the option of stretching the distributions, and the tax liability, over the beneficiary's life expectancy.

A Final Note

The common mistake of naming the estate as the beneficiary is typically not the fault of the planner, who may have had nothing to do with the original policy purchase. Failure to review beneficiary designations is most definitely an error of omission by the planner. *Hillman v. Maretta* further emphasizes the point by showing that even state laws may not provide the protection they claim. Planners must regularly review beneficiary designations to ensure they are up to date, especially in the case of life events, such as birth, marriage, divorce, and death. As the Hillman case demonstrates, failure to do so, or failure to keep up with relevant court rulings, can yield unintended consequences. ■