COORDINATING BENEFICIARY DESIGNATIONS– HAS YOUR WORLD CHANGED IN THE LAST FIVE YEARS?

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Table of Contents

I. Introduction G-1

II. Transfers to Beneficiaries Via Contract or Agreement G-1
- A. Interests Passing to Beneficiaries Via Beneficiary Designation G-1
- B. Interests Passing to Beneficiary as Joint Tenant with Rights of Survivorship (JTWROS) G-2
  1. Presumption of no survivorship G-2
  2. Survivorship is available by written agreement only G-2
  3. Does not apply to Community Property G-2
  4. Community Property with Right of Survivorship G-2
     - a. Formation G-2
     - b. Application G-2
     - c. Revocation G-2
  5. JTWROS and the Probate Process G-2

III. Considerations Related to Beneficiary Designations G-3
- A. Transfers to Minor Children and Incapacitated Persons G-3
  1. Amount Less than $10,000 . . . . G-3
  2. Amount Less than $100,000 . . . . G-3
  3. Formation of §867 Management Trust G-3
  4. Appointment of Guardian of Estate G-3
- B. Transfers to Indebted Beneficiaries and Wealthy Beneficiaries G-4
  1. New Development with Regard to Qualified Plans G-4
  2. Use of Disclaimers G-4
     - a. Persons Who May Disclaim G-4
     - b. Effective Date of Disclaimer G-4
     - c. Effect of Disclaimer G-4
     - d. Form and Filing of Disclaimer G-4
  3. Disclaimers Used to Defeat Creditor Claims G-5
  4. Limitations of Disclaimer G-5
- C. Transfers to Those Receiving Government Benefits G-5
- D. Apportionment of Estate Tax and other Liabilities of the Estate G-5
  1. Equitable Apportionment G-5
  2. Collecting the Estate Tax G-5
- E. Potential Misuse of Community Property G-5
  1. Sole Management Community Property (Special Community Property) G-6
  2. Protection of Third Parties G-6
  3. Fraud Against the Community G-6
- F. Unintended Distribution Resulting from Death of Beneficiary G-6
  1. Shortcomings of Beneficiary Designation Forms G-6
  2. Customizing Beneficiary Designations G-7

III. Special Rules Relating to IRAs and Qualified Plans G-7
A. Required Minimum Distributions ("RMD") G-7
B. Required Beginning Date ("RBD") G-8
1. RBD for IRA G-8
2. RBD for Qualified Plan G-8
C. Designated Beneficiary ("DB") G-8
1. Trusts as Designated Beneficiaries G-8
2. No Designated Beneficiary G-8
D. What is the RMD Period if Death Occurs Prior to RBD? G-8
E. What is the RMD Period if Death Occurs After the RBD? G-9
F. Inherited Qualified Plan/IRA G-9
G. What if the spouse is the DB? G-9
1. Spouse continues decedent's QP or IRA as the beneficiary G-9
2. Spouse Elects to treat the IRA as their own G-9
3. Spouse Elects Spousal Rollover G-9
H. Community Property and Qualified Plans G-9
1. Facts G-10
2. Procedural History G-10
a. Filings G-10
b. District Court G-10
c. Fifth Circuit G-10
d. The Supreme Court G-10
3. Analysis G-10
a. Sons not Participants or Beneficiaries G-10
b. Sons did not Claim to Have Valid QDRO G-11
4. Holding G-11

IV. Recommendations Related to Beneficiary Designations, Pay on Death and Third Party Accounts G-11
A. Name Spouse as Primary Beneficiary of Qualified Plans G-11
1. Benefits G-11
2. Drawbacks G-11
3. Use of Disclaimer to Optimally Fund Bypass Trust G-11
B. Name Trust as Beneficiary G-12
1. Non-Tax Related Benefits G-12
2. Tax Related Benefits G-12
C. Clearly Address Contingencies within the Beneficiary Designation G-12
D. Avoid Naming the Estate as a Beneficiary G-12
1. Estate as Beneficiary of Qualified Plan G-12
2. Estate as Beneficiary of Life Insurance and Annuity Proceeds G-13

V. Addressing Problematic Beneficiary Designations G-13
A. Ex-Spouse Named as Beneficiary G-13

1. Case Law G-13
a. Facts G-13
i. Provisions of the Plan G-13
ii. William Kennedy's Divorce G-13
iii. William Kennedy's Retirement G-14
b. Procedural History G-14
i. District Court G-14
ii. Fifth Circuit G-14
c. Analysis G-14
d. Holding G-14
2. Texas Family Code G-14
a. Pre-Decree Designation of Ex-Spouse as Beneficiary of Life Insurance or Financial Plans G-15
b. Notifying the Plan Administrator or Insurance Company of Invalid Designation G-15
B. Beneficiary Named as "Trustee" in the Absence of a Trust G-15
1. Example G-15
2. Applicable Law G-15
C. Beneficiary Designation Not Congruent with Applicable Divorce Decree G-16

VI. Conclusion G-16

I. Introduction

When my clients come to see me about an estate plan, most of the initial meeting is focused on determining who will receive and who will be in charge of their assets in the event of their death. Usually, a will or revocable trust is recommended as the centerpiece of the estate plan and it is drafted with an eye toward tax efficiency, ease of administration, and protecting the assets and beneficiaries. A great deal of time and talent is used to draft an estate plan which is congruent with the goals of the client. After the estate plan is signed, the client receives a letter from me setting out how their beneficiary designations should be styled. We call it "homework" and stress to them the importance of completing their homework. We offer to help them fill out the forms. We sometimes call or write to them to check on their progress. We offer to keep copies of the designations in our file. We do not charge them if they call us years later and have forgotten how to style the designation. Despite our best efforts, however, some clients don't do their homework and bad things happen. Very bad things happen when the homework is not complete and the client is wealthy or has a complicated family life.

II. Transfers to Beneficiaries Via Contract or Agreement

Non-probate transfers to beneficiaries spring from contract and usually are governed by a beneficiary designation, pay on death designation, or account agreement where the account owners agree that the survivor of them is entitled to the account.

A. Interests Passing to Beneficiaries Via Beneficiary Designation

§ 450 of the Texas Probate Code (TPC) limits the power of a will to govern certain assets in the taxable estate of a decedent. Generally a will does not govern the disposition of assets which pass to beneficiaries via contract. For example, life insurance, qualified plans, and annuities almost always pass to beneficiaries via beneficiary designation. Sometimes, banking and brokerage institutions enter into deposit agreements with their customers which provide that the assets being held with such banking or brokerage institution be payable at death to a beneficiary or pass to another person having rights of survivorship with regard to such assets. The provisions of TPC § 450 are set out below:

PROVISIONS FOR PAYMENT OR TRANSFER AT DEATH.

(a) Any of the following provisions in an insurance policy, contract of employment, bond, mortgage, promissory note, deposit agreement, employees' trust, retirement account, deferred compensation arrangement, custodial agreement, pension plan, trust agreement, conveyance of real or personal property, securities, accounts with financial institutions as defined in Part 1 of this chapter, mutual fund account, or any other written instrument effective as a contract, gift, conveyance, or trust is deemed to be non-testamentary, and this code does not invalidate the instrument or any provision:

(1) that money or other benefits theretofore due to, controlled, or owned by a decedent shall be paid after his death to a person designated by the decedent in either the instrument or a separate writing, including a will, executed at the same time as the instrument or subsequently;

(2) that any money due or to become due under the instrument shall cease to be payable in event of the death of the promisee or the promissor before payment or demand; or

(3) that any property which is the subject of the instrument shall pass to a person designated by the decedent in either the instrument or a separate writing, including a will, executed at the same time as the instrument or subsequently.

B. Interests Passing to Beneficiary as Joint Tenant with Rights of Survivorship (JTWROS)

If property is held with a right of survivorship, when one of the joint tenants dies or sells their interest, the property simply passes to the remaining joint tenant(s). For example, suppose that John, Paul, George, and Ringo own a yellow submarine as joint tenants with right of survivorship. When John dies, the submarine is then owned by Paul, George, and Ringo, and so on.

1. Presumption of no survivorship

The first sentence of §46(a) of the TPC makes clear that "if two or more persons hold an interest in property jointly, and one joint owner dies before severance, the interest of the decedent in the joint estate ***shall not*** survive to the remaining joint owner or owners but shall pass by will or intestacy from the decedent as if the decedent's interest had been severed." (Emphasis added)

2. Survivorship is available by written agreement only

The second sentence of §46(a) of the TPC states that if the joint owners want to create a right of survivorship then they may do so by agreeing in writing "that the interest of any joint owner who dies shall survive to the surviving joint owner or owners, but no such agreement shall be inferred from the mere fact that the property is held in joint ownership." According to the code, a right of survivorship is created between parties in a joint account if the following language is substantially followed. "On the death of one party to a joint account, all sums in the account on the date of death vest in and belong to the surviving party as his or her separate property and estate."

3. Does not apply to Community Property

§46(b) of the TPC makes clear that subsection (a) does not apply to agreements between spouses and their community property. These agreements are governed by chapter IX of the Texas Probate Code.

4. Community Property with Right of Survivorship

"Spouses may agree in writing that all or part of their community property becomes the property of the surviving spouse on the death of a spouse." Tex. Const. Art. 16, § 15. This is commonly called a "community property survivorship agreement."

a. Formation

According to TPC §452, the agreement must be in writing and signed by both spouses and must contain one of the following phrases:

i. "With right of survivorship"
ii. "Will become the property of the survivor"
iii. "Will vest in and belong to the surviving spouse" or
iv. "Shall pass to the surviving spouse"

b. Application

The agreement can apply to specific or general assets.

c. Revocation

If the agreement creating a right of survivorship provides a method of revocation then that method must be followed. If there is no method of revocation, then the agreement may be revoked by a writing signed by both spouses or a writing signed by one and delivered to the other. TPC §455.

5. JTWROS and the Probate Process

Property that is held in JTWROS by the decedent and another person(s) passes directly to the other person(s) and does not go through the probate process.

III. Considerations Related to Beneficiary Designations

The client should exercise special care in the preparation of beneficiary designation forms if the client has minor children, a beneficiary is indebted or wealthy, a beneficiary is receiving governmental benefits, the client expects estate taxes to be due, or the client is naming a person other than his spouse as beneficiary.

A. Transfers to Minor Children and Incapacitated Persons

Minor children and incapacitated persons should never be named as outright beneficiaries of assets. Minor children and incapacitated persons are unable to enter into contracts; and as a consequence, they are unable to maintain bank and brokerage accounts. When a minor child or incapacitated person receives assets, if the value of such assets exceeds the amount allowed to be deposited in the registry of the court, the courts will either appoint a guardian for such child or incapacitated person's estate or form an 867 Management Trust. As an aside, in the event such child or incapacitated has no guardian appointed for his or her estate and receives assets as a result of a judgment, the court may establish a trust for such person pursuant to Section 142 of the Texas Trust Code.

1. Amount Less than $10,000

According to Section 141.007 of the Texas Property Code, when the amount payable to a minor beneficiary is not in excess of $10,000, then such amount may be payable to an adult in the absence of specific authorization if:

a. the legal representative or trustee considers the transfer to be in the best interest of the minor; and
b. the transfer is not prohibited by or inconsistent with provisions of the applicable will, trust agreement, or other governing instrument.

2. Amount Less than $100,000

When a minor is entitled to receive an amount which is $100,000 or less, Section 887 of the TPC authorizes the debtor of such minor child or incapacitated person to deposit such amount into the registry of the court in the county where such minor child or incapacitated person resides. Until the child attains the age of majority or until the incapacitated person's rights are restored, the money will remain in the hands of the county clerk as custodian. It can be invested and earn income. It will be available to the person or parent of the child or incapacitated person having custody of such child or incapacitated person so long as such person or parent posts bond for the amount withdrawn.

3. Formation of §867 Management Trust

When a minor child or incapacitated person is entitled to assets outright as a result of a beneficiary designation, pay on death provision, testamentary bequest, or as a joint tenant with rights of survivorship, a §867 Management Trust is often formed as an alternative to the creation or maintenance of a guardianship. Until recently, the courts were unable to appoint individual trustees except in unusual circumstances. With recent legislative changes, individuals may be named as trustees if the courts determine it is in the best interest of the minor child or incapacitated person to name an individual trustee; and if the amount at stake is in excess of $150,000, a showing must be made that after diligence, the applicant for the creation of the trust has been unable to find a financial institution willing to serve as trustee.

4. Appointment of Guardian of Estate

Chapter XIII of the TPC sets out the court's authority to appoint a guardian of the estate of a minor child or an incapacitated person. Sometimes it may be difficult or inadvisable to form a management trust pursuant to TPC §867. In such cases, a person or entity is appointed guardian of the estate of such minor child or incapacitated person. Generally speaking, the

establishment and maintenance of a guardianship of a person's estate is involved and expensive because it requires the appointment of an attorney ad litem, perhaps the appointment of a guardian ad litem, and annual accountings. Consequently, the formation of an §867 Management Trust as an alternative to the formation of a guardianship is commonly preferred.

B. Transfers to Indebted Beneficiaries and Wealthy Beneficiaries

Outright gifts and bequests to indebted beneficiaries can, in some cases, create unexpected transfers to the creditors of such beneficiaries. Outright gifts to wealthy beneficiaries can, in some cases, create an unexpected transfer to the federal government. Sometimes, disclaimers may be used to avoid such results.

1. New Development with Regard to Qualified Plans

In a recent Texas bankruptcy case, *In re Jarboe*, an inherited IRA in the hands of an individual beneficiary was not deemed an exempt asset for bankruptcy purposes. *In re Jarboe*, 2007 WL 987314 (Bkrtcy. S.D. Tex. 2007). In such case, a mother left her IRA to her son, outright. Several years later, the son filed bankruptcy and listed the IRA as exempt property. The bankruptcy trustee claimed that since the son did not fund the IRA himself, the policies which favored exemption did not apply. In addition, the IRA did not technically qualify as exempt property under §42.0021 of the Texas Property Code since the inherited IRA did not have the same restrictions as the original IRA. The bankruptcy court sided with the trustee.

2. Use of Disclaimers

Disclaimers are often the solution where a distribution of a bequest would simply pass through the indebted beneficiary and to the creditors of such beneficiary. Conversely, disclaimers may also be used by wealthy beneficiaries seeking to reduce their estate tax exposure. In certain situations, indebted beneficiaries and wealthy beneficiaries may disclaim assets that would otherwise pass to them as a beneficiary, enabling such assets to be distributed as if such disclaiming beneficiary had predeceased the testator (in the case of a bequest under a Will), policy owner (in the case of a beneficiary designation under a life insurance or annuity contract), or account holder (in the case of a transfer on death provision or JTWROS agreement). §37A of the TPC sets out the requirements for a valid disclaimer.

a. Persons Who May Disclaim

Any person, the guardian of an incapacitated person, the personal representative of a deceased person's estate, the guardian ad litem of an unborn or unascertained person, and an attorney in fact or agent appointed under a durable power of attorney authorizing such power to disclaim may execute a disclaimer. However, a guardian or personal representative in a dependent administration will likely require court approval before such disclaimer may be effective.

b. Effective Date of Disclaimer

A disclaimer is effective as of the Decedent's death and shall relate back for all purposes to the death of the decedent and is not subject to the claims of any creditor of the disclaimant.

c. Effect of Disclaimer

The property subject to the disclaimer shall pass as if the person disclaiming or on whose behalf a disclaimer is made had predeceased the decedent.

d. Form and Filing of Disclaimer

The disclaimer must be:

i. In writing;
ii. Acknowledged before notary;
iii. Filed within nine months of the decedent's date of death unless the disclaimant is a charitable

organization or governmental agency;

iv. Executed before the disclaimant has exercised dominion and control of such property; and

v. Irrevocable.

3. Disclaimers Used to Defeat Creditor Claims

The court in *Dyer v. Eckols* held that a disclaimer was effective as against the disclaimant's creditors, because the disclaimer related back to the date of the transferor's death for all purposes. *Dyer v. Eckols*, 808 S.W.2d 531 (Tex. App.–Houston [14th Dist.] 1991, writ dism'd). In 1993, TPC §37A was amended to codify this principle.

4. Limitations of Disclaimer

Disclaimers may not be used to defeat a federal tax lien. *Drye v. United States*, 120 S. Ct. 474 (1999).

C. Transfers to Those Receiving Government Benefits

When a beneficiary has qualified for or will likely qualify for Medicaid assistance, outright gifts or bequests often cause the unintended consequence of disqualifying such beneficiary for such governmental benefits. Unfortunately, a disclaimer by such beneficiary will not enable such beneficiary to maintain qualification. Under the Medicaid eligibility rules, the disclaiming beneficiary is deemed to have received such property and then immediately transferred such property. *See* Medicaid Eligibility Handbook §2353.52. *See also* 42 U.S.C. §1396p(e)(1).

D. Apportionment of Estate Tax and other Liabilities of the Estate

Assets passing via beneficiary designation are not necessarily under the authority of the person charged with filing the 706 Estate Tax Return and paying estate tax.

1. Equitable Apportionment

Texas Probate Code §322A allows for "equitable apportionment" for payment of taxes owned by an estate. Unless the will says otherwise, the representative must divide up the total taxes owed by the estate and charge each beneficiary their pro rata share. Each beneficiary's share is based upon the "same ratio as the taxable value of the beneficiary's interest bears to the total taxable value of all persons interested in the estate."[1] Therefore, interests that do not generate tax will not bear any portion of the tax burden.

2. Collecting the Estate Tax

Those assets that pass via beneficiary designation are not liable for estate taxes if the will has a clause that forces all taxes to be paid out of the residuary estate. However, absent such express provisions, assets passing outside of probate will be liable for estate taxes generated by such transfer. When the person charged with filing the 706 Estate Tax Return is not in control of such non-probate assets, it may be difficult to collect such estate taxes from the recipient. Section 322A of the TPC gives the personal representative of the estate the right to bring action, if necessary, to recover the tax from the beneficiaries of transfers taking place outside of probate. One author has surmised that the executor "may have an affirmative duty to pursue claims against persons who are not beneficiaries of the estate."[2]

E. Potential Misuse of Community Property

When a spouse names someone other than his or her spouse as the beneficiary of an account, insurance policy, or annuity contract which contains community property, the surviving spouse may argue that naming someone other than the surviving spouse constitutes fraud on the community estate.

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[1] Johanson's Texas Probate Code Annotated §322A, commentary.

[2] *See* Stephanie E. Donoho, "Tax Apportionment," Advanced Drafting: Estate Planning and Probate Course, Chapter V, 1992.

1. Sole Management Community Property (Special Community Property)[3]

Each spouse has the sole management, control, and disposition of the community property that the spouse would have owned if single (sole management or special community property), including:

a. Personal earnings;
b. Revenue from separate property;
c. Recoveries from personal injuries; and
d. The increase and mutations of, and the revenue from, all property subject to the spouse's sole management, control, and disposition.

2. Protection of Third Parties

If property is held in one spouse's name alone it is presumed to be that spouse's sole management property. If the spouse (transferor) transfers this property to a third person (transferee), then the transferee can rely against anyone, including the other spouse, that the transferor had authority to transfer the property if:

a. The property is presumed to be sole management community property of the transferor spouse; and
b. The person (transferee) dealing with the spouse (transferor):
   i. is not a party to fraud on the other spouse or another person; and
   ii. does not have actual or constructive notice of the transferor spouse's lack of authority.[4]

3. Fraud Against the Community

Each spouse can dispose of their sole management/special community property that is held in their name without their spouse's consent as long as it is not "fraud against the community." Determining whether such transfer constitutes fraud requires examination of the following fact questions:

a. What is the size of the gift in relation to the total size of the community estate?
b. Are the remaining assets in the estate adequate to provide for the other spouse?
c. What is the relationship between the donor/transferor spouse and the donee/transferee?
d. Are there special circumstances that justify the gift?
e. Were the community funds used in reasonable proportion to the remaining estate?[5]

F. Unintended Distribution Resulting from Death of Beneficiary

The distribution provisions which apply in the event a beneficiary predeceases the account or contract owner vary depending upon the contract between the institution and the account or contract owner.

1. Shortcomings of Beneficiary Designation Forms

After reviewing several beneficiary designation forms, the following shortcomings were found to be common:

a. Form does not recommend that the account holder seek the advice of an attorney.
b. Form did not provide examples.

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[3]Texas Family Code §3.102(a)

[4]Texas Family Code §3.104

[5]*See Horlock v. Horlock*, 533 S.W.2d 52, (Tex. App. Houston [14th] 1975); *Givens v. The Gerrard Life Ins. Co.*, 480 S.W.2d 421 (Tex. App. Dallas 1972, writ ref'd nre).

c. Form did not address what happens if the primary beneficiary predeceases the account holder.
d. Form did not make naming a trust as a beneficiary easy.
e. Form did not warn the user about naming minors as beneficiaries.
f. Form did not state to whom the assets pass if no beneficiary is named.

The Appendix includes a chart setting out the contents of several sample beneficiary designation forms. The chart illustrates some common shortcomings of beneficiary designation forms.

2. Customizing Beneficiary Designations

If the beneficiary designation the client wishes to make is complex, consider drafting a customized beneficiary designation. Some financial institutions will allow you to submit a customized beneficiary designation. If you choose to prepare a customized beneficiary designation or when are advising clients on preparing beneficiary forms, consider the following suggestions:

a. Plan for all possible contingencies;
b. Anticipate the use of disclaimers in post mortem planning;
c. If a trust is being named as a beneficiary of a qualified plan or IRA, confirm that the trust is a qualified trust;
d. Confirm that the institution received and accepted the beneficiary designation; and
e. Retain or ask your client to retain a copy of the beneficiary designation.

III. Special Rules Relating to IRAs and Qualified Plans

The income tax consequences associated with the death of a participant vary widely depending upon the identity of the beneficiary.

A. Required Minimum Distributions ("RMD")[6]

A RMD is the amount of annual distribution that the account holder must withdraw from the Qualified Plan[7] ("QP") or IRA to avoid penalties. An IRA and a QP are generally subject to the same distribution rules.[8]

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[6]For an excellent discussion of RMD and Stretching, *see* Patrick B. Casey, *Required Minimum Distributions and Stretching, in Wealth Counsel® Estate Planning Strategies: Collective Wisdom Proven Techniques* (Leslie Daff & Randy Gardner eds., 2009).

[7]A Qualified Plan as defined in Treasury Regulation §1.409A-1(2) is: (I) Any plan described in section 401(a) and a trust exempt from tax under section 501(a) or that is described in section 402(d). (ii) Any annuity plan described in section 403(a). (iii) Any annuity contract described in section 403(b). (iv) Any simplified employee pension (within the meaning of section 408(k)). (v) Any simple retirement account (within the meaning of section 408(p)). (vi) Any plan under which an active participant makes deductible contributions to a trust described in section 501(c)(18). (vii) Any eligible deferred compensation plan (within the meaning of section 457(b)). (viii) Any plan described in section 415(m). (ix) Any plan described in Sec. 1022(i)(2) of the Employee Retirement Income Security Act of 1974, Public Law 93-406 (88 Stat. 829, 942) (Sept. 2, 1974) (ERISA).

[8]Treasury Regulation §1.408-8, A-1.

B. Required Beginning Date ("RBD")

The RBD is the date on which the account holder must begin taking withdrawals from the QP or IRA in order to avoid penalties.

1. RBD for IRA

For an IRA, generally, this is April 1 of the year after the account holder attains the age 70 ½.[9] Funds can be withdrawn as early as age 59 ½ but if withdrawn earlier they are subject to a 10% penalty on the amount withdrawn.

2. RBD for Qualified Plan

For a QP, generally, this is April 1 of the year following the later of:[10]

a. the calendar year in which the employee attains the age 70 ½; or
b. the calendar year in which the employee retires

C. Designated Beneficiary ("DB")[11]

A DB is an *individual* who is entitled to receive a portion of the QP or IRA upon the account owner's death or other specified event.[12]

1. Trusts as Designated Beneficiaries

Some trusts can be named as DB under the following rules:[13]

a. The trust is valid under state law, or would be but for the fact that there is no corpus.
b. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the participant.
c. The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the participant's benefits are identifiable within the meaning of A-1 of this [1.401(a)(9)-4] section from the trust instrument.
d. The documentation described in A-6 of this section [1.401(a)(9)-4] has been provided to a plan administrator.

2. No Designated Beneficiary

If anyone other than an individual or appropriate trust (i.e., a charity) is named as the DB then the account will be treated as having no DB.[14] If there is no named DB then some plans will name the "estate" as default. This is the same as not having a DB.[15]

D. What is the RMD Period if Death Occurs <u>Prior</u> to RBD?[16]

The answer depends on whether a DB was named. If a DB was named, then RMD can be spread out over the life expectancy of the DB. This "stretches" the IRA. If there are multiple DBs, then the shortest life expectancy will be used in calculating the RMD. If a DB was not named, then RMD must be completed by December 31 of the fifth year after the owner's death. This is known as the "5 year rule."

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[9]Treasury Regulation § 1.408-8, A-3.

[10]IRC §401(a)(9)(C)(i).

[11]Treasury Regulation §1.401(a)(9) - 4.

[12]IRC §401(a)(9)(E).

[13]Treasury Regulation § 1.401(a)(9)-4, A-5(b).

[14]Treasury Regulation § 1.4019a)(9)-4, A-3.

[15]Id.

[16]Treasury Regulation §1.401(a)(9) -3.

E. What is the RMD Period if Death Occurs After the RBD?[17]

Again, the answer depends on whether a DB was named. If a DB was named, then RMD can be spread out over the longer of the account owner's or DB's life expectancy. If a DB was not named, RMD will have to be spread out over the theoretical life expectancy of the account owner for their age in the year they died.

F. Inherited Qualified Plan/IRA

If the person who now has an interest in the QP or IRA obtained that interest because the owner died, then it is an Inherited Plan or IRA. With regard to an Inherited Plan or IRA, there are two important facts to consider. First, the beneficiary designation form is the tool that allows the new owner to have an interest in the Plan or IRA. Second, the new owner should not just re-title the IRA or Plan in their own name; the IRS sees this as a full distribution. In order to avoid a full distribution of an IRA or Plan, the IRA or Plan ownership should be styled: "Jane Doe, deceased (1/1/2001), FBO John Doe, beneficiary."

G. What if the spouse is the DB?

Three primary options are available when the surviving spouse is named as the DB:

1. Spouse continues decedent's QP or IRA as the beneficiary

If the spouse is the named beneficiary of the deceased account owner's QP or IRA, the spouse may elect to receive the QP or IRA as the beneficiary. In this case, RMDs do not have to begin until Dec. 31 of the year following the calendar year in which the account owner died. If the surviving spouse is the "sole beneficiary" and the account owner dies *before* their RBD, then the spouse who elects to receive the IRA or QP as a beneficiary may defer RMDs until December 31 of the year following the year in which the account owner would have attained the age 70½.[18] Also under this scenario, the surviving spouse is not subject to the 10% penalty for withdrawal of funds from the IRA prior to age 59½. For this option to be exercised the IRA must remain in the name of the deceased spouse (IRA owner) and the surviving spouse should retitle the IRA or QP as follows: [deceased spouse,] deceased (1/1/2010), FBO [surviving spouse,] beneficiary."

2. Spouse Elects to treat the IRA as their own[19]

To exercise this option, the spouse must be the "sole beneficiary" of the inherited IRA or QP; if so, the surviving spouse can retitle the IRA or QP in their own name. This option can also be exercised by default in two ways. One, the surviving spouse fails to take RMD by the appropriate date. (The date is determined as if the spouse were a beneficiary.) Two, the surviving spouse contributes additional funds to the IRA or QP.

3. Spouse Elects Spousal Rollover[20]

To use this option, the surviving spouse rolls over the Inherited QP or IRA into their own QP or IRA. After a rollover, the surviving spouse can also treat the QP or IRA as their own as described in the previous example.

H. Community Property and Qualified Plans

Boggs v. Boggs, 520 U.S. 833 (1997), represents the seminal case governing a nonparticipating spouse's right to dispose of her community property interest in a qualified plan.

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[17]Treasury Regulation § 1.401(a)(9)-2.

[18]Treasury Regulation §1.401(a)(9)-3, A-3(b).

[19]Treasury Regulation §1.408-8, A-5.

[20]Treasury Regulation § 1.408-8, A-7.

1. Facts

Isaac Boggs worked for South Central Bell (Bell) in Louisiana for 36 years. During most of this time he was married to Dorothy (first wife) and together they had three sons. Dorothy passed away in 1979 and a short time later he married Sandra (second wife and surviving spouse) and remained married to her until his death in 1989. Through her will, Dorothy gave Isaac 1/3 of her estate and a usufruct (life estate) in the remaining 2/3, in which two of the three sons held the "naked ownership" (remainder of the life estate). Included in the remaining 2/3 was Dorothy's interest in Isaac's retirement earnings. During his tenure at Bell he participated in the Bell System Savings Plan for Salaried Employees which he later rolled into an IRA (IRA). Upon his retirement this account was worth approximately $152,000. Also upon retirement he received 96 shares of AT&T stock from the Bell South Employee Stock Ownership Plan (ESOP) and a monthly annuity of approximately $1800 from the Bell South Service Retirement Plan (annuity).

2. Procedural History

a. Filings

After Isaac's death, two of the sons filed an action for accounting requesting the court to award them an interest in, "the IRA; the ESOP shares of AT&T stock; the monthly annuity payments received by Isaac during his retirement; and Sandra's [second wife] survivor annuity payments, both received and payable." Id. at 837. Sandra responded by filing an action to declare that ERISA pre-empted community property laws and "succession laws to the extent they recognize the sons' claim to an interest in the disputed retirement benefits." Id.

b. District Court

The United States District Court for the Eastern District of Louisiana granted summary judgment to the sons. It held under Louisiana community property law, "Dorothy [first wife] had an ownership interest in her husband's pension plan benefits built up during their marriage." Id at 838. The court explained that the creation of this interest did not violate ERISA's anti alienation provision because "congress did not intend to alter traditional familial and support obligations." Id. The court reasoned there was no assignment or alienation "because Dorothy's rights in the benefits were acquired by operation of community property law and not from transfer from Isaac." Id.

c. Fifth Circuit

The Fifth Circuit affirmed stressing that "state law affects only what a plan participant may do with his or her benefits after they are received and not the relationship between the pension plan administrator and the plan beneficiary." Id. Like the District Court, the Court of Appeals held that the transfer from Dorothy to her sons was not a prohibited alienation or assignment because it was "two steps removed from the disbursement of benefits." Id.

d. The Supreme Court

The United States Supreme Court overturned the Court of Appeals holding that Dorothy's testamentary transfer of Isaac's pension plan benefits was a prohibited assignment or alienation. Therefore, the sons did not have a claim under ERISA to a share of Isaac's benefits.

3. Analysis

The Court's reasoning is two fold: First, the sons were neither "participants" nor "beneficiaries." Id. at 848. Second, the court explains that nonparticipant spouses or dependents have beneficiary status only in certain circumstances.

a. Sons not Participants or Beneficiaries

A "participant" is an "employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit." Id. A "beneficiary" is a "person designated by a

participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder." Id.

b. Sons did not Claim to Have Valid QDRO

Nonparticipant spouses or dependents have beneficiary status when the beneficiaries have a QDRO which creates an "alternate payees right to, or assigns to an alternate payee the right to, a portion of the benefits payable with respect to a participant plan." Id. Under ERISA, when a beneficiary has a QDRO they are "exempt from the anti-alienation provision, § 1056(d)(3)(A), and ERISA's general preemption clause, § 1144(b)(7)." Id. at 846. The sons did not argue that they had a valid QDRO.

4. Holding

Therefore, the court held that ERISA preempts a state law allowing a nonparticipant spouse to transfer by testamentary instrument an interest in undistributed pension plan benefits.

IV. Recommendations Related to Beneficiary Designations, Pay on Death and Third Party Accounts

A. Name Spouse as Primary Beneficiary of Qualified Plans

When a participant is married, it is almost always the case that all or part of the assets held in a qualified plan represent community property. The surviving spouse should be named as primary beneficiary of at least the portion of the qualified plan that represents the surviving spouse's community property interest in such plan. There are income tax benefits to naming the surviving spouse as the outright beneficiary of qualified plan assets.

1. Benefits

First, the surviving spouse has the option of the spousal rollover. This option enables a spouse who is younger than the participant spouse to extend the applicable life expectancy for purposes of calculating the minimum required distributions. Second, if the surviving spouse elects a spousal rollover, she can name the couple's children (or trusts created for their benefit) as beneficiaries to take upon her death. When the children ultimately inherit the IRA, their minimum required distributions will be based upon their life expectancy, or in the event a qualified trust is the beneficiary, the minimum required distributions will be based upon the life expectancy of the eldest beneficiary.[21]

2. Drawbacks

First, if a married couple has a taxable estate and much of the estate is comprised of assets in qualified plans, naming the surviving spouse as the primary beneficiary of such qualified plans might prevent the bypass trust from being optimally funded. Second, if the married couple has a blended family, naming the surviving spouse as the outright beneficiary enables the surviving spouse to control the disposition of the qualified plan.

3. Use of Disclaimer to Optimally Fund Bypass Trust

In an environment of uncertainty with regard to the future of estate tax laws and uncertainty regarding economic forecasts, flexible planning with an eye toward the future use of disclaimers has gained popularity. However, in order to enjoy flexible planning opportunities using disclaimers, thought should be given to the appropriate style of contingent beneficiaries of qualified plans. If the surviving spouse is named as the primary beneficiary and a bypass trust is named as alternate beneficiary of a qualified plan, the surviving spouse may disclaim an amount necessary to optimally fund a bypass trust, thereby

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[21] *See* Lewis D. Wall, III, "Beneficiary Designation for Retirement Plans," Presented to the 8th Annual Estate Planning, Guardianship and Elder Law Conference, August 10, 2006.

balancing the income tax benefits associated with a spousal rollover and the estate tax benefits associated with an optimally funded bypass trust.

B. Name Trust as Beneficiary

Understandably, the simplicity of naming individuals as outright beneficiaries of qualified plans, annuities, and life insurance policies is attractive. However, important non-tax related benefits to naming a trust as a beneficiary should be considered.

1. Non-Tax Related Benefits

First, in a blended family situation, often the participant or account owner has a greater need to control the disposition of the assets subject to the beneficiary designation upon the surviving spouse's death. Naming a trust as a beneficiary may help insure that the assets subject to the trust ultimately filter down to the beneficiaries selected by the account owner or participant after his spouse's death. Second, in the case where minor, incapacitated, or irresponsible beneficiaries stand to inherit assets pursuant to a beneficiary designation, naming a trust will enable the trust assets to be managed by a person or institution selected by the account owner or participant. Third, naming a trust as the beneficiary will protect the trust assets from the creditor claims of and perhaps even failed marriages of the beneficiaries. Finally, naming a trust as the beneficiary will enable a special needs beneficiary to enjoy trust assets without the threat of becoming ineligible for government related benefits.

2. Tax Related Benefits

When life insurance proceeds or qualified plans represent a significant amount of value in a married couple's estate, naming a bypass or credit shelter trust as the beneficiary of such assets enables the bypass trust to be optimally funded, thereby reducing the estate tax exposure associated with the surviving spouse's estate. Also, if the surviving spouse is not a citizen of the United States and she stands to inherit assets having a greater value than the exemption amount from her spouse, assets having a value in excess of the exemption amount should be placed into a Qualified Domestic Trust (QDOT).

C. Clearly Address Contingencies within the Beneficiary Designation

If a client desires to name individuals as the beneficiaries of qualified plans, life insurance, or annuities, careful examination of the beneficiary designation is important. In the event such client survives the named beneficiary, most beneficiary forms provide for an alternate beneficiary. Most ambiguities relating to beneficiary designations arise when multiple beneficiaries are named and one or more of such named beneficiaries predeceases the client. Do the children of such deceased named beneficiary take such beneficiary's share? Do the remaining named beneficiaries who survived the client take such deceased beneficiary's share? Does such deceased beneficiary's share pass to the client's estate? To avoid this potential ambiguity, be sure the beneficiary designation form (or the client's designation) addresses this and other contingencies.

D. Avoid Naming the Estate as a Beneficiary

When no beneficiary of a qualified plan, life insurance policy, or annuity is named the most common default beneficiary is the participant or policy owner's estate. Such a default is unfortunate as it can cause an unfavorable income tax result when applied to qualified plans and such a default can cause life insurance and annuity proceeds to be exposed to the creditor claims of the decedent's estate when such assets would have been exempt assets in the hands of individual beneficiaries.

1. Estate as Beneficiary of Qualified Plan

Naming the estate as the beneficiary of a qualified plan can spell disaster, especially when the qualified plan is large. Unfortunately, when a

qualified plan is payable to the estate of a decedent, the income tax liability is accelerated in that, depending upon whether the participant died before or after his required beginning date, the assets of the qualified plan must be distributed within five years following the death of the participant or the assets of the qualified plan must be distributed to the beneficiaries with required minimum distributions based upon the deceased participant's remaining, theoretical life expectancy.

2. Estate as Beneficiary of Life Insurance and Annuity Proceeds

In the hands of an individual beneficiary, life insurance policy proceeds and annuities are usually exempt property according to Article 21.22 of the Texas Insurance Code.[22] The only exception to this rule is if the policy holder attempted to defraud creditors at the time the beneficiary designation was made. So, if a client names the estate as the beneficiary of a life insurance or an annuity contract or fails to name a beneficiary and the estate becomes the default beneficiary, such assets are paid to the estate and subject to the creditor claims of such estate.

V. Addressing Problematic Beneficiary Designations

Complications relating to beneficiary designations are common. Some of the most common problems involve an ex-spouse being named as a beneficiary, a person or entity named as trustee without a corresponding trust agreement, and beneficiary designations made contrary to stipulations in a divorce decree.

A. Ex-Spouse Named as Beneficiary

1. Case Law

In *Kennedy v. Plan Administrator for DuPont Savings and Investment Plan,* Slip opinion Decided Jan. 26, 2009,

a. Facts

William Kennedy worked for the DuPont de Nemours & Company (DuPont) and participated in their Savings and Investment Plan (SIP), which was an ERISA "employee pension benefit plan." *Kennedy v. DuPont Savings and Investment Plan,* 497 F.3d 426, 427 (5th Cir. 2007). He had both the power to designate any beneficiary or beneficiaries to receive the funds upon his death and to revoke or replace those designations.

i. Provisions of the Plan

The application provided the terms of the plan and required that "all authorizations, designations and requests concerning the Plan to be made by employees in the manner prescribed by the plan administrator." The Plan provided that upon the employees death any benefits would be paid to the designated beneficiary listed on the appropriate forms filled out by the employee. However, if there was no surviving spouse or no beneficiary designation in effect, then distribution would be made as directed by the estate's executor or administrator. The Plan also provided that a designated beneficiary could disclaim their benefits by submitting a "qualified disclaimer as defined under the Tax Code." Slip Opinion at 2. If such disclaimer was put into effect the benefits would then pass to any contingent beneficiary named on the beneficiary designation form filled out by the employee.

ii. William Kennedy's Divorce

In 1971, William married Liv Kennedy (Liv) and named her as the designated beneficiary of his SIP in 1974. He did not name a contingent beneficiary to receive the benefits of the SIP if she disclaimed her interest. *Kennedy v. DuPont Savings and Investment Plan,* at 427. William and Liv remained married for 23 years until their divorce in 1994. Contained in the divorce decree was a

[22] *See Parker Square State Bank v. Huttash,* 484 S.W.2d 429 (Tex. Civ. App.– Ft. Worth 1972*, writ ref'd).*

provision in which Liv agreed to be divested of all of her "right, title, and interest" and claim in and to all sums of money from any if William's retirement, pension, or similar plans.

iii. William Kennedy's Retirement

William retired from DuPont in 1998 and died in 2001 without naming a new beneficiary for the SIP. He did however name his daughter, Kari Kennedy, as the new beneficiary of another DuPont sponsored ERISA plan.

b. Procedural History

Upon William's death in 2001, Kari, as executor of William's estate, petitioned the court to require DuPont to distribute the funds from the SIP to his estate as per the Plan. Instead, DuPont paid the $400,000 balance in the SIP to Liv, relying on the beneficiary designation form. The Estate then sued DuPont arguing the divorce decree was a waiver of Liv's benefits and therefore DuPont had violated ERISA by following the beneficiary designation forms.

i. District Court

The District Court agreed and granted summary judgment to the estate, ordering DuPont to pay the benefits to the estate. On appeal, the Fifth Circuit reversed holding that Liv's waiver in the divorce decree was "an assignment or alienation of her interest in the SIP benefits to the Estate, and so could not be honored." *Kennedy v. DuPont Savings and Investment Plan,* at 429.

ii. Fifth Circuit

The fifth circuit relied heavily on the QDRO provision found in ERISA which states that the anti-alienation provision does not apply when a valid QDRO is given to the court. The court held that the divorce decree was not a QDRO and therefore they could not honor Liv's waiver in it. They further saw the waiver as an "assignment" or "alienation" which is not allowed under ERISA's terms. § 1056(d)(1).

c. Analysis

The Supreme Court goes back to the foundation of ERISA and notes that "every employee benefit plan is to be established and maintained pursuant to a written instrument and specify the basis on which payments are to be made to and from the plan." 29 U.S.C. §1102(a)(1), (b)(4). The plan administrator then must follow the rules in the written instrument which govern the plan; they do not have to look to other documents to determine where funds are to be paid. The reason for this is so there is "simple administration" and ensures that beneficiaries get their distributions quickly. Slip Opinion 15.

d. Holding

Therefore, relying on the terms of the plan, the Court held the administrator "did exactly what §1104(a)(1)(D) required: 'the documents control and those name [Liv].'" Slip Opinion at 18 (Citing *McMillan v. Parrott*, 913 F. 2d 310, 312 (6th Cir. 1990)). Under ERISA, a plan administrator must manage "in accordance with the documents and instruments governing them." §1104(a)(1)(D). The plan provided a method for William to change the beneficiary of the SIP plan, but he did not follow it. The plan also provided a way for Liv to disclaim her interest in the SIP account, but she did not follow it. Ultimately, "Liv's waiver was not rendered a nullity by the terms of §1056, the plan administrator properly distributed the SIP benefits to Liv in accordance with the plan documents." Slip Opinion at 19.

2. Texas Family Code

Whether a beneficiary designation in favor of an ex-spouse will be held valid depends upon when the designation was made and in what capacity the ex-spouse is named as beneficiary.

a. Pre-Decree Designation of Ex-Spouse as Beneficiary of Life Insurance or Financial Plans[23]

If a decree of divorce or annulment is rendered *after* an insured or account owner has designated his spouse as beneficiary under a life insurance policy or financial plan, a provision in the policy or beneficiary designation in favor of the insured or account owner's former spouse is *not* effective unless:

i. The decree designates the insured's former spouse as the beneficiary
ii. The insured redesignates the former spouse as the beneficiary after rendition of the decree; or
iii. The former spouse is designated to receive the proceeds in trust for, on behalf of, or for the benefit of a child or a dependent of either former spouse.

b. Notifying the Plan Administrator or Insurance Company of Invalid Designation

According to Sections 9.301(c) and 9.302(c) of the Texas Family Code, an insurer who pays the proceeds of a life insurance policy issued by the insurer or the plan administrator who delivers account assets to the beneficiary under an invalid designation is liable for payment of the proceeds or delivery of the account assets to the person or estate rightfully entitled to such proceeds or assets only if:

i. before payment of the proceeds to the designated beneficiary, the insurer or plan administrator receives written notice at the home office of the insurer or plan administrator from an interested person that the designation is not effective; and
ii. the insurer or plan administrator has not interpleaded the proceeds into the registry of a court of competent jurisdiction in accordance with the Texas Rules of Civil Procedure.

B. Beneficiary Named as "Trustee" in the Absence of a Trust

Considering all of the benefits to naming a trust as the beneficiary of assets passing via beneficiary designation, it's no wonder that folks are eager to name a trustee, so eager in fact that they sometimes forget the trust agreement.

1. Example

Suppose an employee names his children as beneficiaries and his spouse as trustee on a beneficiary designation form for his 401(k) plan. However, there is no reference to a trust in any other document. Where will the funds be distributed upon his death?

2. Applicable Law

According to the Texas Trust Code, "a trust is created only if the settlor manifests an intention to create a trust."[24] "A trust can be created by the property owner's inter vivos transfer of his property to another person as a trustee for third persons."[25] Furthermore, there are no particular forms or words that are necessary to create a trust, if there is "reasonable certainty as to a putative trust's property, object and beneficiaries."[26] In our situation, because the settlor manifested his intent to create a trust (use of the term "trustee"), the trust's property is ascertainable (proceeds from the 401(k)), and the beneficiaries are known

[23] Texas Family Code §9.301 and Texas Family Code §9.302.

[24] Texas Trust Code §112.002.

[25] Id. At §112.001.

[26] *See Fred Rizk Const. Co v. Cousins Mortg. & Equity Invenstments*, 627 S.W.2d 753, 757 (Tex. App. Houston [1st Dist.] 1981, writ ref'd (n.r.e.)).

(children), a trust will be created for the benefit of the children and the spouse will serve as trustee.[27] Therefore, merely naming a trustee and a beneficiary is sufficient. However, if the employee simply named his spouse as "trustee" but did not name his children as beneficiaries, the trust would fail as an express trust because there are no ascertainable beneficiaries; beneficiaries can not be identified by parol evidence. A resulting trust will be created and the spouse will then hold the benefits for the heirs of the employee.

C. Beneficiary Designation Not Congruent with Applicable Divorce Decree

Suppose a divorce decree orders the husband to name his ex-spouse as the beneficiary on a life insurance policy or a retirement account as trustee for his children. He complies with the decree for a time, but upon meeting his future spouse, he changes the beneficiary on his accounts from his ex-spouse to his future spouse. What effect does the divorce decree have on this subsequent change? According to the Texas Family Code a *pre*-decree designation of an ex-spouse as beneficiary of life insurance or retirement benefits is not effective unless certain criteria are met.[28] Here, there is a *post*-decree change in the beneficiary. It is likely that this post-decree designation will be seen as a breach of contract and not given full effect. It is well settled in Texas case law that "an agreed divorce decree is a contract subject to the usual rules on contract interpretation."[29] Therefore, upon motion by the ex-spouse a court will likely find the post-decree change of beneficiary void and order the funds to be paid to the ex-spouse as ordered in the decree.

VI. Conclusion

After clients sign their estate planning document, we breath a collective sigh of relief and congratulate each other on a job well done. However, when the client has qualified plans, IRA, life insurance, or annuities, the estate plan is not complete until the beneficiary designations are dovetailed with the estate plan.

[27] *See Tomlinson v. Tomlinson*, 960 S.W.2d 337 (Tex. App. - Corpus Christi 1997, no pet.).

[28] Texas Family Code §§ 9.301, 9.302.

[29] *Chapmon v. Abbot*, 251 S.W.3d 612, 616 (Tex. App. [1st Dist.] 2007 no pet.) *(Citing Broesche v. Jacobson*, 218 S.W.3d 267, 271 (Tex. App. -Houston [14th] 2007, pet. denied)). *See also McGoodwin v. McGoodwin*, 671 S.W.2d 880, 882 (Tex. 1984).

Appendix A

Summary of Contents of Sample Beneficiary Designation Forms*

Name of Institution	Form Advises User to Consult Attorney	Form Provides Examples	Form Addresses Distribution in Event Primary Beneficiary Predeceases User	Form Makes Naming a Trust Easy (through examples or instructions)	Form Warns User About Naming Minors as Beneficiaries	Form Allows For Spouse Consent if Spouse Not Named as Beneficiary	Form Designates Where Funds Will go if no Beneficiary is Named
AMS		✓		✓		✓	✓
Enron		✓	✓	✓		✓	
EPIC Life Ins.			✓				✓
Fort Dearborn Life Ins.	✓		✓	✓	✓	✓	
MetLife			✓	✓			✓
John Hancock	✓		✓	✓		✓	✓
Oklahoma State and Employee Ins.			✓	✓	✓		
OSGLI - Veterans Benefits			✓	✓			✓
Provident			✓				
The Standard					✓		
TIAA Cref		✓	✓			✓	✓

*The forms reviewed to prepare this table were chosen at random and may not be the forms currently in use by such institution.