Beneficiary Designations: What You Need to Consider

By David Wentz and Bill Stapp

When meeting with clients, one of the things I always stress is the importance of beneficiary designation for retirement plans and life insurance policies. In the event of your death, the money accumulated in your 401(k) plan and life insurance is distributed based on the beneficiaries you name for each respective plan. There is sometimes confusion among investors related to the operation of testamentary documents, such as a will. To be clear, beneficiaries selected on financial contracts supersede wishes left in a will.

In most cases, you can select anyone you want to be a beneficiary. However, 401(k) beneficiary designation is unique. As a participant in a 401(k), married people are required by law to designate a spouse as the primary 401(k) beneficiary. In the event you want someone else to be your primary beneficiary, your spouse must sign a waiver. Once that waiver is signed, you are free to designate anyone or any organization you wish. It is always important to designate contingent beneficiaries, in the event that something were to happen to your primary beneficiary. Even if you are single, it is still important for you to name beneficiaries to your retirement plan. There are multiple ways to do this, including naming them as alternates on the original document, or as primary on an amended form. Why is this important? If your heirs are not listed specifically, the plan administrator will not transfer the assets automatically. Consequently, the proceeds from your 401(k) would pass to your estate, and would thus be subject to additional regulations that may not be ideal for your heirs.

An additional important aspect of a 401(k) plan as related to beneficiary designation is the way money is to be distributed. Generally speaking, the money can be paid out in a variety of ways that include a lump sum payment, or paid out over many years dependent on your beneficiary’s life expectancy. In some cases, there may be additional restrictions to consider. For example, some plans might specify the way in which the proceeds are to be distributed. Plan restrictions can have implications for tax purposes, so in the event you have questions, contact your plan administrator.

When you leave your 401(k) to your heirs, there are certain tax considerations that can affect them. Your 401(k) can potentially be the subject of federal estate tax if your estate’s value is greater than the lifetime federal gift tax and estate tax exclusion amount. The federal estate tax can be applied to both traditional and Roth plans. However, beneficiaries of a traditional 401(k) plan are far more likely to be impacted by federal and state income taxes. The reason is that retirement accounts traditionally defer taxes on contributions and earnings in the account. Eventually you or your designated beneficiaries will pay taxes on that money upon withdrawing your contributions and earnings (excluding after-tax contributions).

You should also consider age and tax bracket when electing beneficiaries. In the event that your spouse is financially sound and does not need the 401(k) contributions, leaving the money to your younger heirs is a great option, as younger people tend to benefit the most from an extended distribution compared to older people. Another benefit to leaving your retirement income to heirs with lower incomes is that they are in lower tax brackets.

As with many 401(k) plans, life insurance contracts (in most cases) also allow you to select anyone as your secondary beneficiary. You can also select multiple secondary and contingent beneficiaries through a per stirpes designation, which allows your assets to be divided equally among your children and adopted children. However, this does not include stepchildren.

Additionally, there are two other kinds of life insurance beneficiaries that are important to keep in mind: irrevocable and revocable. An irrevocable beneficiary is one whose stake in your contract cannot be changed without his or her consent. This can sometimes become an issue with divorced couples. For example, Jim and Pam were married for 10 years before getting divorced. Jim then gets married to Angela, and wants her to be the primary beneficiary of his life insurance contract. In order for this to happen, Jim will need to get the consent (signature) of Pam. If Jim isn’t able to get Pam’s consent, then Pam, not Angela, will be the beneficiary of Jim’s death benefit. The opposite of an irrevocable beneficiary is a revocable beneficiary. With a revocable beneficiary, you retain the ability to change who will receive the death benefit from your policy or terminate the policy without the consent of the beneficiary.

If you ever have a question regarding your financial landscape, or would like find out how you can participate in The Bar Retirement Plan, contact Bill Stapp or David Wentz with Tax Favored Benefits at (913) 648-5526. We work at your convenience to help you achieve your goals.

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ABOUT THE AUTHORS:

David and Bill have each focused on helping clients in the 401(k) market for more than 20 years. David joined TFB after completing law school in 1992; Bill joined TFB in 1996 and practiced law for approximately five years. David and Bill are proud to raise their families in the KC metro, just as they were raised.