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Retirement plan death benefits

Tax-qualified retirement plans are primarily designed to help employees accumulate funds to support them in retirement. If an employee dies while participating in a plan, his or her plan benefits are generally payable to a designated beneficiary. Like retirement benefits, these death benefits also receive favorable tax treatment.

THE BENEFICIARY

Under federal law, a plan participant's spouse is the default beneficiary. A participant may designate the spouse or other persons as plan beneficiaries, and retirement plans have forms available to make this designation.

The beneficiary designation may split the benefit (for example, among living children equally). A participant may also designate contingent beneficiaries. A common designation states that the spouse is the primary beneficiary, and if the spouse dies before the participant, the participant's children are equal beneficiaries. In this case the children are "contingent," or secondary beneficiaries.

If the participant designates someone other than his or her spouse as a beneficiary, the spouse must consent to this in writing, with the spouse's signature witnessed by a notary or other plan representative.

Changing beneficiaries

A participant may change beneficiaries at any time by completing and submitting a new beneficiary designation form to the Plan Administrator (typically the company that sponsors the plan). Most plans will recognize only the most recent beneficiary designation on file. The participant should keep a copy of the most recent designation with his or her will.

Marital status and beneficiaries

Participants should submit a new designation whenever their marital status changes. Most participants do not want their ex-spouse as a beneficiary, but this can happen if participants do not keep these up to date! Also, prenuptial agreements are not beneficiary designations, nor do they qualify as a valid spousal consent to designate a non-spouse beneficiary. Only a spouse can consent to the non-spouse beneficiary. By definition, a prenuptial agreement is between persons who are not yet married.

If a participant fails to name a beneficiary, the plan document will govern. The spouse will be the primary beneficiary. If there is no surviving spouse, most plans will then name surviving children as equal beneficiaries. If there are no surviving children, often the benefits will be paid to the deceased participant's estate.

Death benefit payment

Once the plan beneficiary is determined, he or she should make a claim to the Plan Administrator for payment of the death benefit.

If the benefits are paid directly to the beneficiary, they are generally taxed to the beneficiary as ordinary income. There is no additional tax penalty for taking these funds, even if the beneficiary is under age 59 1/2.

Income tax options

If the beneficiary does not want to receive the distribution as taxable income, there are tax-deferred rollovers available. Some or all of the distribution may be rolled over. If rolled over, only the amount that is ***not*** rolled over is immediately taxable. Different types of beneficiaries have different rollover options:

- A spouse may roll over some or all of the death benefit to his or her personal Individual Retirement Account (IRA) without any immediate income tax or penalties. Subsequent distributions from the IRA are subject to normal IRA distribution rules and are taxable when paid (including pre-age 59 ½ penalties, if applicable). Distributions from the IRA do not have to start until the beneficiary reaches age 72.

- A non-spouse may roll over some or all of the death benefit to an inherited IRA account, and distributions must be made from this account in accordance with inherited IRA rules.

Amount of death benefit *prior* to the participant's retirement

If a participant dies prior to retirement, the amount of the pre-retirement death benefit payable from the plan is defined in the plan document. For most 401(k) and profit sharing plans, it is the participant's account balance. If it is not fully vested, the vested portion is the death benefit, the non-vested portion is forfeited back to the plan.

For defined benefit pension plans, the pre-retirement death benefit is the current value of the accrued retirement benefit or the "Qualified Pre-Retirement Survivor Annuity." The plan's benefit statements will often include the current death benefit amount as well as the vesting percentage. Generally, the beneficiary can choose between an annuity paid over their lifetime, or a lump sum payment, but this is governed by the terms of the plan.

Amount of death benefit *after* the participant's retirement

In most 401(k) and profit sharing plans, the death benefit after the participant's retirement is the remaining account balance in the plan, and it is fully vested, since it's past the participant's retirement date.

In smaller company defined benefit plans, if the participant has not yet started retirement distributions from the plan, the post-retirement death benefit is the current value of the accrued retirement benefit and it is fully vested.

In larger company defined benefit plans or government plans, the retirement benefit is typically paid as a monthly benefit for life. Upon retirement, a participant is given a choice of electing a "single life" monthly benefit, or a "joint life" monthly benefit payable for the lifetimes of the participant and spouse. The joint life benefit is often less than the single benefit since it may be paid for a longer period of time, depending on how long the participant and spouse live. If the participant elects a single life benefit, there is NO death benefit payable. The monthly benefit stops after the participant dies. If the joint life benefit is elected, then the monthly benefit continues until the spouse dies. This continued benefit may be between 50% to 100% of the participant's benefit, depending on the election made by the participant upon retirement.

Conclusion

Retirement plan death benefits can provide a valuable source of funds for the beneficiaries of deceased participants. For many participants, the benefit payment and taxation will be straightforward. However, for participants with complex tax situations and multiple beneficiaries, it is often necessary for beneficiaries to obtain professional legal and accounting advice before taking payment of the benefit.

The most difficult situations arise where there is no clear beneficiary designation, or there are multiple persons claiming to be the beneficiary. All plan participants should ensure they have designated their beneficiaries and communicated this to their beneficiaries. Retain copies of the current beneficiary designation and destroy all prior designations.