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Planning for the Future

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The Importance of Maintaining Current Beneficiary Designations

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Beneficiary designations are forms that are routinely completed for life insurance policies, retirement accounts and even some bank and investment accounts. The forms say who will receive the asset upon the asset owner's death. These designations are also sometimes called "pay on death" or "transfer on death" designations. When a beneficiary designation is in place, it generally controls the disposition of the asset it is associated with, regardless of what one's will says. As part of a periodic review of your estate plan, it is vitally important to review all of your beneficiary designations. This is particularly important when facing major life events such as divorce, the death of a beneficiary, birth of a child, or the marriage of a beneficiary to a less-than-desirable spouse.

Divorce or Separation

Some states, such as Virginia, provide by law that any beneficiary designation in favor of a former spouse is automatically revoked upon divorce. Those states in effect change the client's designation for them. Other states, however, such as Maryland, have no such rule, meaning that the former spouse may continue to be entitled to the asset unless the designation is changed. It is possible that the terms of a property settlement agreement may be sufficient to nullify a particular beneficiary designation, but it is always safer not to assume that is the case and to actually change the designation. In the case of some pension and 401(k) plan accounts, it is critical to assess whether a so-called "qualified domestic relations order" must be used to legally effectuate the division of the accounts, and if so, to make sure the order is properly drafted. Estate planning counsel can help a divorcing individual understand the impact of state law, federal retirement plan law and property settlement agreement contractual issues, but it is always best to affirmatively redo beneficiary designations to make sure the associated assets will go where you want them to go.

Separated but not-yet-divorced individuals face some additional considerations. Spouses often have automatic rights to share in assets under federal retirement laws or under state laws. For example, Virginia has what is known as an "augmented estate statute," which would give the spouse of a deceased person a right to a portion of the deceased person's assets, even if the deceased person removed the spouse as a designated beneficiary and cut

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the spouse out of his or her will. For separated people, it is important to make sure that any changes to beneficiary designations do not run afoul of these laws; otherwise your family might end up with a costly dispute after your death.

The Kennedy Case

The recent United States Supreme Court decision in *Kennedy, Executrix v. Plan Administrator of the DuPont Savings and Investment Plan* serves as a reminder of the need for retirement plan participants and IRA accountholders to review their beneficiary designations on a regular basis, particularly when involved in a divorce.

Mr. Kennedy had named his spouse as the sole beneficiary of his benefits under the DuPont Savings and Investment Plan. He and his wife later divorced, and as part of the divorce proceeding, his former spouse signed a waiver of all of his employee benefits. Unfortunately, the waiver was not made in the form of a "qualified domestic relations order," which is the documentation procedure for allocating retirement benefits in a divorce proceeding under the federal retirement plan law known as ERISA. Following the divorce, Mr. Kennedy failed to change his beneficiary designation. Soon thereafter, he died, and then his former spouse subsequently died. The plan administrator of the DuPont Savings Plan concluded that the beneficiary designation on file was the controlling document and paid the benefits to the estate of the former spouse. The executrix of Mr. Kennedy's estate sued to invalidate the beneficiary designation.

The Supreme Court, in a unanimous decision, ruled that the beneficiary designation was undisturbed by the waiver in the state court proceeding. Essentially, the court ruled that the plan administrator had the right to rely on the plan documents that were available to the participant to name a beneficiary. That document named his former spouse as the beneficiary. If Mr. Kennedy had only changed the beneficiary designation after the divorce, he could have prevented the quagmire that followed. Unfortunately, he failed to do so.

The Kennedy case applies to beneficiary designations in employee benefit plans that are covered by ERISA, such as a defined benefit plan, a 401(k) plan or a profit sharing plan. However, disputes over beneficiaries also arise in retirement vehicles such as IRAs and life insurance policies. Beneficiary designations for IRAs will continue to grow in importance as people retire and move their retirement funds into self-directed IRAs. While the IRA is not the same form of plan as an ERISA plan, nonetheless, in a dispute the courts may look to the need of the IRA custodian or IRA trustee to rely solely on the beneficiary designation that is in place at the time of death. Fortunately, today, the beneficiary designation for an IRA product is usually available on the IRA custodian's website, which makes it easy to change the beneficiary. Many mutual funds also permit the IRA accountholder to make the changes online.

Other Considerations

We recommend that you check these designations periodically to make sure that no life event has changed the intent of your distribution. Often beneficiary designations provide for a contingent beneficiary, which is essential if the primary beneficiary is deceased. If the primary beneficiary is deceased and a contingent beneficiary is not named, the IRA custody agreement will generally invoke a default mechanism that will distribute the funds to the IRA accountholder's estate. This is not desirable because the funds become subject to the decedent's creditors and many of the income tax advantages of the IRA will also be lost.

Beneficiary designations can also be very useful in planning to minimize the impact of estate taxes. Many estate plans provide for the creation of a trust benefitting the surviving spouse at the death of the first spouse to die that shelters assets from taxes when the surviving spouse dies, by keeping those

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assets out of the survivor's estate. In situations where the bulk of a decedent's wealth is in retirement plans and insurance policies — which typically name the surviving spouse as the designated beneficiary — it can be difficult to find assets with which to fund the estate tax-saving trust. However, if the trust is named as either primary or contingent beneficiary of the account, it is possible to direct the account to the trust instead of to the spouse. This technique is particularly useful for insurance policies, but can also be useful for other assets, such as retirement accounts, under the right circumstances. If you have any questions about the impact of your designations on your estate plan, or if we can be of any help in interpreting a plan document or beneficiary designation, please call us.

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