ADVANCED PLANNING

Life Insurance

Twelve Life Insurance Mistakes to Avoid

When it comes to choosing a life insurance policy, there is the potential to make serious and costly mistakes. Here are twelve mistakes to avoid when you are considering purchasing a policy.

Life insurance is one of the most important purchases that you will ever make.

Mistake Number One
LACK OF EDUCATION

Lack of education, whether your financial professional's or your own, can lead to many mistakes, including the subsequent eleven mistakes below.

Life insurance is not a one-size-fits-all commodity. You need a high degree of comfort with the insurance company, the financial professional, and the products being considered before purchasing anything. Spend the time to do the research first, and you can avoid headaches later.

Mistake Number Two
THE "TRIANGLE"—THREE PEOPLE ON A POLICY

The beneficiary of a properly structured life insurance policy will generally receive the death proceeds income[1] and gift tax-free. However, policy proceeds are subject to gift taxation when three different parties are designated as the owner, the insured, and the beneficiary of a life insurance policy. This is called the "Triangle," named for a famous 1946 federal court decision.[2] This court decision held that, where a "Triangle" exists at the death of the insured, the owner of the policy (not the insured) will be deemed to have made a taxable gift of the entire death proceeds to the beneficiary. Should the insured person die under those circumstances, the policy proceeds are considered to be a gift from the owner to the beneficiary.

The solution is very simple: either the insured and owner should be the same individual, or the owner and beneficiary should be identical.

Mistake Number Three
THE BUSINESS "TRIANGLE"

Similar to the mistake above, but, in this situation, a business is the owner. This form of the "Triangle" frequently occurs with business owners when they name themselves as the insured, use the business to own the policy, and name a spouse, children, or another business owner as the policy beneficiary.

The negative tax consequences of the transaction are changed if the business owns the policy. In this situation, the death proceeds paid to the beneficiaries are subject to income tax instead of gift tax.

Like the previous mistake, the solution lies in properly structuring the policy ownership and beneficiary designation.

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[1] Under IRC § 101(a).

[2] Triangle v. Commissioner, 156 F.2d 218 (2d Cir. 1946).

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Mistake Number Four
FAILURE TO NAME A SUCCESSOR OWNER

Think of the assets you own. Chances are you thought of stocks, bonds, and real estate. But what about life insurance? All too often, people fail to think of a life insurance policy as an asset.

If the owner and insured on a life insurance policy are two different people and the owner dies first, the policy ownership has to pass to a successor owner. If the policyowner did not name a successor owner, the policy will be subject to probate. Probate can cause the policy to be subject to creditors' claims and unnecessary costs. It can also cause ownership of the policy to pass to an unintended owner or to be divided among multiple owners.

The solution is quite simple: if the insured and owner are different individuals, either name at least one successor owner or have an entity such as a trust own the policy.

Mistake Number Five
ESTATE AS BENEFICIARY

This occurs when the estate is named or becomes the beneficiary of an insurance policy. The estate may become the beneficiary unintentionally. For example, if only one beneficiary is named but he or she predeceases the insured, then, by default, the estate becomes the beneficiary.

If the insured's estate is the beneficiary, the policy proceeds may needlessly be subject to probate, creditor claims, and estate or inheritance taxes.

The solution is to name both primary and secondary beneficiaries.

Mistake Number Six
POLICY SUBJECT TO ESTATE TAX

If an individual is the owner of his or her policy, all of the death proceeds are included in his or her estate. For most individuals, this will not be a problem; however, if the individual has a large estate, this may trigger unnecessary estate taxation. Typically, when an individual discovers that ownership of a policy creates an estate tax problem, he or she transfers ownership to another individual or to a trust. That sounds like a quick and easy solution, but it could be Mistake Number Six.

The Internal Revenue Code contains a rule that provides that if an insured owns a policy on his or her life and gives the policy to another person, trust, or entity and then dies within three years of the transfer, the policy proceeds will be included in the estate of the insured and subject to estate taxation.

While there are a number of complex ways to structure a transfer to avoid the three-year estate inclusion, one simple solution is to purchase a separate insurance policy for the three-year period during which the policy would be subject to estate tax.

Mistake Number Seven
FAILURE TO MEET NOTICE AND CONSENT REQUIREMENTS ON AN EMPLOYER-OWNED CONTRACT

It's not unusual for a business to purchase insurance on the life of a key employee or owner. In general, death proceeds on employer-owned contracts issued after August 17, 2006, are subject to income tax. At first glance, you might wonder why any business would purchase life insurance.

Fortunately, where specific employee notice and consent requirements are met and certain exceptions apply, a business can continue to receive death proceeds income tax-free. The notice and consent requirements must be met before policy issue. Failing to meet the notice and consent requirements is the mistake.

If the specific notice and consent requirements are not met before policy issue, the only corrective option appears to be reissuing the contract, subject to full underwriting. Consequently, it is important that action be taken before the policy is issued.

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Mistake Number Eight
GIFT OF A POLICY SUBJECT TO A LOAN

The gift of a policy with an outstanding loan is a common occurrence. In fact, individuals often borrow from a policy before transferring it in order to reduce its value for gift tax purposes. But, as with any technique, too much of a good thing can lead to an undesired tax result.

The transfer of a policy subject to a loan, even by gift, is treated as if the policyowner sold the policy and received money equal to the debt deemed forgiven. If the amount of loan exceeds basis[3] at the time of the transfer, or if the transfer is considered for valuable consideration ("bargain sale"), a portion of the death proceeds will be subject to income tax.

On the other hand, if the loan is less than the policyowner's basis,[3] the death proceeds will generally be received income tax-free by the beneficiaries. Consequently, the solution is to make sure the loan amount does not exceed policyowner basis at the time of transfer and the gift of a policy in this scenario is not considered a transfer of a policy for value.

Mistake Number Nine
EXCHANGING A POLICY SUBJECT TO A LOAN

Very little in life is static. For a number of reasons, there may be a need to exchange an existing life insurance policy for a new one. Congress recognized that changes do occur and addressed the need by permitting the exchange of one policy for another without any income tax implications at the time of the exchange as long as the requirements contained in Section 1035 of the Internal Revenue Code are met.

One of the requirements is that no money or property other than "like-kind" can be received at the time the policy is exchanged. And if it is, income will be recognized to the extent of that other property. Like the prior mistake, when an existing policy has a loan against it, if the new policy does not carry over the old loan, the policyowner is treated as if money is received, and any gain in the contract will be recognized up to the amount of the loan.

One solution is to arrange for the new policy to be subject to the existing policy loan. In circumstances where that cannot be done, the policyowner should use funds independent of the policy to pay off the loan on the old policy before the exchange.

Mistake Number Ten
PLEDGING A MODIFIED ENDOWMENT CONTRACT (MEC)

Because life insurance enjoys a number of tax benefits, there are limits on how much premium can be put into a life insurance policy. One of the limits imposed is contained in the Modified Endowment Contract (MEC) rules. Premiums that exceed these limits will cause the policy to be classified as a MEC, causing a loss of some of its income tax benefits.

One of the lost benefits involves the treatment of loans and withdrawals of policy cash surrender values. The general rule is that as long as a life insurance policy is in force, withdrawals that do not exceed the policyowner's basis[3] may be taken from the policy's cash values income tax-free.

Further, loans of any amount permitted by the insurance carrier can be taken income tax-free. However, if a policy is classified as a MEC, loans and withdrawals are subject to income tax to the extent of gain in the policy. In addition, there may be an additional 10% tax. This result cannot be avoided by pledging the policy as security for a loan.

The solution is to pledge other assets.

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[3] Generally basis is equal to the amount of premiums paid.

Mistake Number Eleven
TAKING POLICY WITHDRAWALS WITHIN THE FIRST 15 YEARS

Two characteristics of life insurance allow it to serve as an efficient retirement income supplement:

- Cash value build-up is not subject to income tax.
- Cash values can be withdrawn (to the extent of basis) or borrowed, free of income taxation.

It is important to understand that withdrawing or borrowing cash values may cause a decrease in the policy's death benefit.

To prevent abuses of the tax-favored treatment of life insurance, Congress enacted provisions in the Internal Revenue Code sometimes referred to as the "cash-rich rules." In general, the rules affect policies with large premiums relative to the death benefits that are issued or exchanged after 1984.

According to the cash-rich rules, any time there is a cash distribution from a policy that results in a reduction of the death benefit within the policy's first 15 years, there is the possibility that some portion of the distribution will be subject to income tax.

There are many ways to avoid the adverse income tax consequences of a "cash-rich" policy. One simple solution is to either wait until year 16 before taking a withdrawal, or structure the distribution as a loan.

Mistake Number Twelve
FAILURE TO DO POLICY REVIEWS[4]

Change is a reason for considering the exchange of an existing insurance policy. Not all change requires a new policy, but it is an important reason for reviewing existing policies.

Generally speaking, it is a good idea to review policies every three years, as well as whenever circumstances change or an event occurs that would warrant an immediate review.

Life insurance is an integral part of a package of personal and financial protection that requires care and attention. Be sure to engage the help of a trusted financial professional who can provide guidance and education as you make your choice.

You should carefully consider the risks and benefits before taking action, including your current need for coverage, current health status and insurability, fees and charges associated with terminating an existing contract, and future liquidity needs.

CONCLUSION

No one would argue that a listing of twelve mistakes is inclusive of all of the errors that could be made with life insurance. It is hoped that an awareness of these limited issues has highlighted the fact that protecting one's family and business by means of life insurance is very serious and should be done with considerable thought as to the details. Insurance is an integral part of a package of personal and financial protection that requires care in its implementation. The role of a competent team of financial professionals is important and should not be overlooked.

[4] When conducting an insurance policy review and presenting options that include replacing an existing insurance contract, it is important to discuss the risks and benefits. Client should carefully consider the risks and benefits before taking action, including their current need for coverage, their current health status and insurability, fees and charges associated with terminating an existing contract, and future liquidity needs.

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