Twelve Life Insurance Mistakes
They Aren't "Cheaper By the Dozen"

Eleanor Roosevelt once said, "Learn from the mistakes of others. You can't live long enough to make them all yourself." The point is that a wise person learns from the mistakes of those who came before him while endeavoring to avoid them himself.

Life insurance is one of the most important purchases that you will ever make. The problem is that there is always the potential of making serious and costly mistakes. Others have already made all twelve of the mistakes that we are going to discuss but, with some education and awareness, you need not repeat them.

Mistake Number One: Lack of Education

Lack of education, whether it is on the part of your advisor or yourself, has led to many mistakes, including each of the other eleven that follow.

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

Mistake Number Two: Three People on a Policy - The "Unholy Trinity"

The beneficiary of a properly structured life insurance policy will generally receive the death proceeds income[1] and gift tax-free. However, where the so-called "unholy trinity" exists, policy proceeds are subject to gift taxation.

The "unholy trinity" exists when three different parties are designated as the owner, the insured, and the beneficiary of a life insurance policy. 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 "Unholy Trinity"

Mistake Number Three is similar to the prior mistake; however, in this situation, a business is the owner. This form of "unholy trinity" 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.

Mistake Number Four: Failure to Name a Successor Owner

When we think of the assets that we own, we generally think of stocks, bonds, and real estate. All too often, we fail to think of an insurance policy as an asset. This can lead to Mistake Number Four.

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

[1] Under IRC § 101(a).

a successor owner. If the policy owner did not name a successor owner, the policy will be subject to probate. Probate can cause the policy to be subject 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—where 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

Mistake Number Five 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 term insurance 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 Mistake Number Seven.

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 prior to policy issue.

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 policy owner sold the policy and received money equal to the debt deemed forgiven. If the amount of loan exceeds basis at the time of the transfer, a portion of the death proceeds will be subject to income tax.

On the other hand, if the loan is less than the policy owner's basis,[2] 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 policy owner basis at the time of transfer.

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 policy owner 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 policy owner should use funds independent of the policy to pay off the loan on the old policy prior to the exchange.

Mistake Number Ten: Pledging a Modified Endowment Contract

Because life insurance enjoys a number of tax benefits, Congress enacted 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 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 policy owner'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 a ten percent penalty tax. This result cannot be avoided by pledging the policy as security for a loan.

The solution is to pledge other assets.

[2, 3] Generally basis is equal to the amount of premiums paid.

Mistake Number Eleven: Taking Policy Withdrawals within the First Fifteen Years

Two characteristics of life insurance allow it to serve as an efficient retirement income supplement. The first is that cash value build-up is not subject to income tax. The second is that 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, anytime there is a cash distribution from a policy that results in a reduction of the death benefit within the policy's first fifteen 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 sixteen before taking a withdrawal or structure the distribution as a loan.

Mistake Number Twelve: Failure to Do Policy Reviews

At Mistake Number Nine, change was discussed as 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 there is a change of circumstances or an occurrence that would warrant an immediate review.

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 competent advisors is important and should not be overlooked.

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