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10 Common Mistakes Made with Life Insurance Beneficiary Designations

We all know that having adequate life insurance coverage is an important part of any plan to protect our families from catastrophic events. As important as it is, it is also something that most of us do not want to think about or dwell on too much. As a result, prior decisions are rarely reviewed and mistakes remain undiscovered, particularly with beneficiary designations, until it is too late. That is why it is just as important to review all your life insurance policies and beneficiary designations on a regular basis. These reviews can help to find and correct mistakes or to make changes to your insurance program to adjust to life changes. Here are 10 of the more common mistakes made with life insurance beneficiary designations.

1 Failure to Review Beneficiary Designations on a Regular Basis. Life insurance policies are assets and just like your mutual funds, stocks, IRAs, retirement plans, and bank accounts, should be reviewed regularly and at least on an annual basis. Each year, any number of events could have happened in your life necessitating a change in your insurance coverage and beneficiary designations. Life changes include marriage, divorce, death, the birth or adoption of a child, receiving a significant windfall, having to care for a family member with special needs, a devastating sickness or injury, exposure to estate and inheritance taxes, and more. Any one of these events could be a reason to revise your life insurance beneficiary designations.

Divorce is one of the most common events where a review is necessary but often neglected. Most people believe that a divorce will automatically revoke an ex-spouse's rights to the life insurance. That sounds reasonable enough, but that might not be true in all states. Additionally, a divorce decree could mandate changes to your life insurance coverage to benefit your ex-spouse and children, so a review is necessary to determine if changes are needed.

2 Naming Your Estate as the Beneficiary of Your Life Insurance Policy. Many people believe that naming their estate as the beneficiary of an insurance policy is the simplest way to ensure that the proceeds are distributed in the manner that they choose. Unfortunately, that leads to several complications:

- The insurance proceeds cannot be distributed and used immediately by your surviving family members. The proceeds must first go through the estate probate or intestacy administration process, which could be very time consuming and costly. Distribution according to the probate or administration process may not be how you intended the insurance proceeds to be distributed.

- The proceeds are now part of the public court records so there is a loss of privacy.
- The proceeds may now be subject to the claims of creditors of the estate, whereas naming a specific individual as the beneficiary could have protected those proceeds from creditors depending upon state law.
- The proceeds may now be included in the decedent's estate and subject to potential estate and inheritance taxes, regardless of how the ownership of the policy was structured to avoid that result.

3 Naming a Minor Child as the Beneficiary of Your Life Insurance Policy. There is nothing to stop you from naming a minor child as a beneficiary, but that may not be the wisest thing to do because laws will prohibit the carrier from distributing the proceeds directly to a minor. Instead, a court proceeding will be required to name a guardian or conservator for the child to receive and manage the insurance proceeds until the child attains the age of majority. That court process can be time consuming and costly. Even at the age of majority, which is typically anywhere from 18 to 21 years of age in most states, how many of these young adults are ready to wisely manage and spend large sums of money from the insurance proceeds?

As an alternative, it may be beneficial to create a trust for the benefit of the minor child, naming the trust as the beneficiary of the life insurance. One of the main benefits of a trust is that it can remain in place for many years, even beyond the child's age of majority, and the insurance proceeds can be invested, managed and distributed as needed by a responsible trustee. The trust may also offer protection against potential creditors of the child. Trusts offer a lot of flexibility and protection but require an attorney to set up.

If the complexity of a trust isn't desired, life insurance proceeds can be left to a custodianship under your state's Uniform Transfers to Minors Act ("UTMA"). The custodian will receive the death benefit and can invest and manage the funds for the exclusive benefit of the minor child until the child reaches the age of majority.

4 Failure to Name a Contingent Beneficiary. You should always try to name a contingent beneficiary in the event the primary beneficiary predeceases. Indeed, you might want to name two contingent beneficiaries. This will ensure that the insurance proceeds go to whomever you intend.

Otherwise, if the primary beneficiary predeceases the insured and no contingent is named, the proceeds will be included in the estate and be subject to all of the issues mentioned before, including delays and expense.

5 Naming an Individual as the Beneficiary of a Business-Owned Policy. Often, a business may purchase life insurance on the life of a key employee to help protect the business from financial loss due to the death of that employee ("key person insurance"). Other reasons may be to fund a business succession plan, to help protect against a default on a bank loan, or to fund an executive benefit plan such as a non-qualified deferred compensation or retention bonus plan. In those cases, the business should also be named as the beneficiary.

Occasionally, the business may want some of the death benefit to go to a family member of the employee, so the business names the family member as a partial beneficiary of the insurance policy. That could be a mistake. As you may know, insurance proceeds are typically received income tax-free. However, naming an individual, such as the employee's spouse, would cause the insurance proceeds to be considered taxable income to the beneficiary either as ordinary income or as a dividend, depending upon the relationship of the insured to the business.

6 Violating the Three-Party Rule. The three-party rule (a/k/a "Goodman triangle" or "unholy trinity") stems from a 1946 federal court case which found that in situations where the owner of the policy, insured and beneficiary are three different people, then the policyowner is deemed to have made a gift of the insurance proceeds to the beneficiary. That "gift" may potentially be subject to gift taxes. In the business context, violating the three-party rule may result in the insurance proceeds being considered taxable income. This adverse result is easily prevented by ensuring that there are only two parties to an insurance contract. Most often, the policyowner and beneficiary would be the same (e.g., Husband is the owner and beneficiary of a policy on Wife), or the policyowner and insured would be the same (e.g., Wife is the owner and insured on the policy, and Husband is named as a beneficiary).

7 Naming a Person with Special Needs as a Beneficiary. One of the main goals of special needs planning is to ensure that the individual with special needs can qualify for various government assistance programs while still maintaining a high quality of life and having access to programs or comforts that government programs cannot or do not provide.

Unfortunately, it is not uncommon for well-intentioned family members to name such a person as a beneficiary of life insurance or some other financial instrument. Receipt of these benefits may disqualify the individual from the government assistance programs. Instead, a special needs trust should be established for that individual. A special needs trust is specifically designed to maintain eligibility for government programs while providing the individual with supplemental assistance for a better life. The beneficiary of the life insurance can be the trust. Indeed, often a special needs trust would purchase and be the beneficiary of a life insurance policy on the life of a parent.

8 **Failing to Properly Identify a Beneficiary.** It is not uncommon for family members to mistakenly use nicknames or abbreviated names instead of legal names when identifying individuals. Insurance companies, however, have an obligation to ensure that insurance proceeds are paid out correctly to the right beneficiaries. Without all of the right information, payment of the proceeds can be delayed and court proceedings may be required so that payment can be made. When filling out the beneficiary designation form, make sure that you use the beneficiary's full legal name. Include the beneficiary's birthdate, taxpayer ID number, sex, address of residence, and relationship to the insured for more accurate identification.

9 **Mistakes When Naming Multiple Beneficiaries.** When more than one beneficiary is named, there is often some confusion as to the proper convention for designating multiple beneficiaries. For example, if one beneficiary predeceases the insured, does the remaining beneficiary receive all of the proceeds or does the deceased beneficiary's heirs get that share? Typically, when one beneficiary predeceases the insured, the remaining beneficiary will receive all of the proceeds unless explicitly stated otherwise.

One method to explicitly state otherwise is to name a contingent beneficiary for a particular beneficiary, particularly when the primary and contingent beneficiaries are not lineal descendants.

For example: Bruce Brown is the policyowner and insured. Bruce names Joe Black and Nancy Gold as his primary beneficiaries. Without any other instructions, Joe and Nancy will receive the insurance proceeds equally, but if one of them predeceases Bruce, the other will receive all of the proceeds. That is not what Bruce wants. He wants Joe's and Nancy's respective spouses to receive the proceeds. In that case, he names Joe's wife, Sally Black, as contingent beneficiary if Joe Black predeceases Bruce, and Nancy's husband, Steven Gold, is named as contingent beneficiary if Nancy Gold predeceases Bruce.

10 **Improperly Using *Per Capita* and *Per Stirpes* in Beneficiary Designations.** The phrases *per capita* and *per stirpes* are often used in estate-planning documents such as a Last Will and Testament and in beneficiary designations on a life insurance policy. They are both Latin phrases and, as a result, are often used incorrectly. *Per capita* means "by head" and *per stirpes* means "by representation."

In the prior example, Bruce names Joe and Nancy as his primary beneficiaries, *per capita*. If Joe predeceases Bruce, then upon Bruce's death, all of the insurance proceeds will go to Nancy. However, if Bruce had named Joe and Nancy as his primary beneficiaries, *per stirpes*, then upon Bruce's death, Joe's share of the insurance proceeds will be distributed to Joe's descendants. Joe's descendants receive the proceeds as representatives of Joe.

What happens if Joe doesn't have any descendants? In that case, there are no lineal descendants to represent Joe, so Nancy will also be the beneficiary of Joe's share.

Conclusion

As you can see, there are many ways to make mistakes with life insurance beneficiary designations. This list is not all-inclusive. Consult with your Security Mutual life insurance advisor today to conduct a review of your life insurance policies and determine if the product choices, coverage amounts and beneficiary designations are in line with your current financial situation and your current goals and objectives to financially protect your family.

For more information, contact:

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