

Your Insurance: Are You Making Any of These 14 Big Mistakes?

Life insurance is an extremely important part of your financial holdings. It represents big cash tomorrow (the death benefit) for cash paid today (the premiums). It also provides critical protection for your family and dependents.

To reinforce the importance of reviewing and updating your life insurance *today*, we have listed below the 14 biggest mistakes individuals and businesses make regarding life insurance. These mistakes and oversights can have a devastating impact on your heirs. But they're very easy to change or correct if identified in time. Review them carefully; simply circle the numbers that apply to your situation and discuss them with your advisers.

The 14 Deadly Mistakes

#1 — Making irrevocable transactions. Don't enter into irrevocable transactions without getting the advice of two experts. You don't want to give away something you or your spouse may need in the future. *The problem:* Once you transfer the ownership of a life insurance policy, you will need the new owner's approval to borrow from the policy, receive dividends, change ownership, or effect other important policy amendments.

#2 — Retaining rights. Avoid *incidents of ownership* where you retain certain rights over the policy, e.g., the right to change the beneficiary or borrow from the policy. Retaining incidents of ownership may lead the IRS to decide you have *constructive ownership*. In that case, the income from those properties is taxable income to you and the value of the assets is included in your taxable estate.

#3 — Terminating a policy. If you are considering cancelling, replacing, or terminating a life insurance policy or annuity contract, be aware that part or all of the surrender value paid to you, including prior borrowings on the cash value, can be taxable income. That's usually the case if the total of the cash

value, untaxed accumulated dividends, and loans exceed the total premiums paid over the life of the policy.

What to do: Request an “in-force illustration” from your insurance agent, which will show the current status of premium cost, dividends, and the annual increase in the policy’s cash value. Also included in the illustration will be projected premiums, dividends, and cash values. From this data, you will be able to make a more informed decision on whether to keep or cash in a life insurance policy. *Also important:* If you decide to “cash in,” replace, change ownership, or otherwise terminate or transfer a policy, get a letter from the insurance company in advance indicating the tax consequences.

#4 — Naming beneficiaries. Do you want to name *new* beneficiaries because the old beneficiaries have died or grown so wealthy that they have no need for the insurance proceeds? Perhaps your children named years ago in a policy have become self-sufficient and you’d prefer to provide for your grandchildren’s education. Or, you may have overlooked an individual child or grandchild born after the policy was taken out. Have you specified contingent and tertiary beneficiaries in case of a common disaster or the beneficiaries predeceasing you?

#5 — Changing ownership. Review the ownership of all policies — the insured, beneficiary, another person, insurance trust, or your business. *Reason:* You may wish to change the ownership for tax reasons. If the ownership is in your name, it will be included as part of your taxable estate and subject to estate taxes. In contrast, if your spouse, children, or an insurance trust owns the policy, there is no estate tax payable on the insurance proceeds on your death since you don’t own the policy.

Caution: The proceeds from life insurance policies are included in your personal estate if transferred within three years of death. It’s called the IRS’ *contemplation of death* rule. In addition, the IRS could label the transfer a taxable transaction. So check with your agent and accountant *before* transferring, selling, or gifting any life insurance policy to your family, business, or a trust, and follow the advice in #3 on the prior page if you plan to terminate a policy.

#6 — Switching life insurance. Before lapsing or surrendering a life insurance policy, make sure the new policy is in force and that any health problems have been fully disclosed. Otherwise, the new policy may be contested and you could find yourself without any coverage. This is particularly important when replacing older life insurance policies with new policies since any new policy can be contested for two years after issuance.

#7 — Keeping insurance in force. Is there an “automatic” use of the policy’s borrowing power or accumulated dividends to pay the premiums in case the owner of the policy forgets to make a payment? If not, you should amend the policy to include this provision. It protects against the policy lapsing if you unintentionally miss a premium. Without this provision, the policy will be reinstated *only* after you prove *insurability* during the period the premium wasn’t paid.

#8 — Reviewing insurance needs and taxes. Are you still carrying the same coverage you took out years ago even though your children are now grown, your assets have increased, and your spouse has substantial support provided in your will or trust? Based on your circumstances today, *who should be* the owners and beneficiaries of the policies? How much money can you save in income and potential estate taxes by *changing* the ownership? Have you considered the fact that new and existing estate tax reductions and options may have *dramatically* reduced your life insurance needs and/or changed the type of insurance protection you should have now?

#9 — Determining type of insurance. What types of policies do you have: term, permanent (whole life), group, universal? Have you considered *second-to-die* insurance on your and your spouse's life to provide for your children and estate taxes on the death of the second spouse? Or *first-to-die* insurance to fund a buy-sell agreement on the death of the first owner? Since the purposes of these policies are very targeted and specific, their cost can be substantially less than regular life policies on each person’s life.

#10 — Specifying settlement options. What are the settlement options that determine how and when the insurance proceeds are paid to your

beneficiaries? All cash today or installments paid out equally over five or 10 years? Do you want to change existing settlement options so that your heirs, especially younger children, don't collect all the money at once? Many taxpayers elect to pay out the proceeds to their heirs over 5 to 10 years, e.g., 10% to 20% a year, to encourage prudent spending. This is especially true if the amounts are large or the heirs young in age or impulsive in nature.

#11 — Using new or existing term insurance. Buying term life insurance is a wise move for many individuals. The premium can be much lower than permanent, variable, and universal policies and it can fill gaps in one's overall insurance protection. However, term insurance is *not* permanent insurance, so you have to be very careful on how long you keep term insurance before converting the policy. You also must periodically review *existing* term policies so you don't overlook important options which expire over time, e.g., your right to convert the term policy to permanent insurance.

Questions to ask: For how long is the term insurance convertible to permanent insurance — 5, 10, or 20 years? Is the life insurance effective to death or only to a certain age, e.g., 65? Are the premiums guaranteed against annual increases? Is continuation of insurance coverage or convertibility to permanent insurance contingent on a medical exam? *Note:* Be careful; some term insurance policies *do not guarantee* the premium rate when the policy is converted. To obtain the guaranteed rate, a medical examination may be needed. If the exam reveals health problems, the premium on the converted policy could be substantially above the premium specified in your term insurance policy.

What to do: Call your insurance agent and get answers to the questions posed above. Also consider converting your current term insurance coverage to permanent insurance which usually does not require a medical exam. *Reasons:* You don't want any term insurance nonrenewable or cancelled by the insurer when you need it most. You also don't want substantially higher premiums later if you decide to convert the term insurance to permanent insurance. As a general rule, if you know you will be converting a term policy to permanent insurance, do it as soon as possible. That way, part of the premium goes to the build-up in the policy's cash value.

#12 — Conforming to changes. What about new or past tax legislation? Are your will and trust documents up to date? Is your life insurance coordinated with these documents so there are no overlapping beneficiaries, heirs, or money distributions?

#13 — Complying with business laws. Were corporate minutes required and completed for those business insurance policies that require them, e.g., split-dollar and key-executive insurance, deferred compensation? Does any insurance have to meet IRS nondiscrimination tests or top-heavy rules? *Reasons:* You don't want the life insurance proceeds to be taxable income *and* you don't want the tax deductions disallowed because of noncompliance with the IRS and tax laws.

#14 — Selecting an insurer. Do not buy insurance or annuities from questionable insurance companies, brokers, or mutual funds. Check out their rating, investment performance for the last five and 10 years, and financial health before doing business with them.

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If you are unsure of the answers to any of the questions posed in this advisory, it's time to review your personal, family, and business insurance policies, coverage, premiums, ownership, and beneficiaries. That review should also include policies taken out on the lives of your spouse and children. □

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