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# When Your Client's Life Changes Be Sure Their Life Insurance Beneficiary Designations Keep Up, But Avoid The Tax Traps Along The Way

***Situation:*** One of the most important decisions the owner of a life insurance policy makes is deciding who to name as the beneficiary. On the surface, a beneficiary designation may seem simple and straightforward, but they have the potential to be complex. Unfortunately, many people do not put much thought into the identification of a beneficiary when setting up their life insurance policies, even though some of the most common errors are made with respect to the naming of beneficiaries. While this error can cause unnecessary taxes, the most serious result of this mistake is that the death benefit proceeds may pass to unintended individuals.

Beneficiary designations should be considered carefully and reviewed regularly. Consequently, when performing a policy review, in addition to reviewing the performance and market competitiveness of the policy. You should also review errors in beneficiary designations. This *Counselor's Corner* includes a discussion of three situations that may arise in life insurance policy designations that create tax problems. In addition, we have attached a checklist to help you in your review of beneficiary designations as well as a guide on drafting life insurance beneficiary designations.

***Solution:*** There are several tax considerations that can arise when establishing or changing a beneficiary designation. The following are three of the most commonly occurring situations and suggestions for correction:

**Making a Taxable Gift by Having Three Different Parties on a Policy: The "Goodman Rule."**

The most common error I see is where the policy owner unknowingly makes a large taxable gift of the death benefit because of poor beneficiary planning. This can occur when the policy owner, insured, and a named beneficiary are all different people or entities. For example, this unintended tax can occur when a parent is an insured, the spouse is owner, and children are beneficiaries. In this situation, at the death of the parent, the spouse/policy owner will be deemed to have made a taxable gift to the children. This result can be avoided by making sure the policy owner is either the insured or the beneficiary.

The same type of error can occur in the business situation, but with a different tax result. I see a policy structured where the business is the policy owner, the insured is an employee/business owner, and the spouse/family are beneficiary(s). In this situation, at the death of the insured, the death proceeds received by the spouse/family are to be considered income-taxable compensation or a business distribution.

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[1] *Bisco, J., Gradisher, S., Wang, J., "Life Insurance Beneficiaries – Per Capita vs Per Stirpes: Is It Really That Clear?" Journal of Insurance Regulation. July 2023*



* Not in the practice of law

**Having a Policy Death Benefit Become Taxable Income by Violating the Transfer-for-Value/ Reportable Policy Sale Rules.** When an insured dies, policy death proceeds are generally received by the beneficiaries income tax-free under IRC §101. However, this income tax exclusion can be lost if prior to the insured's death the policy owner transferred an interest in the policy to someone else and received valuable consideration in exchange. Many financial advisors are aware that the sale of a policy and change of ownership pursuant to a life settlement causes the proceeds to be subject to income tax. Likewise, many advisors are aware that a change of policy ownership from a corporation to a co-shareholder pursuant to the funding of a cross-purchase buy-sell agreement also triggers the rules' application. Unfortunately, many advisors are not aware that a change in beneficiary designations can also cause the proceeds to be subject to income tax. Fortunately, there are several exceptions to the rule. For example, a transfer to:

1. The insured, or a partner of the insured;
2. A partnership in which the insured is a partner;
3. A corporation in which the insured is an officer or shareholder
4. A transfer where the cost basis of the policy carries over from the transferor to the transferee

Because the consequences for violating this rule do not apply until the insured's death, it may be possible to "cure" the violation while the insured is alive by retransferring the policy to one of the recognized exceptions.

**Causing the Death Benefit to Become Taxable by Violating the Employer-Owned Life Insurance (Section 101(j)) Rule.** For policies issued after August 17, 2006, where the business is the owner and beneficiary and the insured is an employee at the time of policy issue, the death benefit is taxed as ordinary income to the extent the amounts paid under the contract exceed premiums and other amounts paid by the employer. However, death proceeds are not taxed under this provision where the following two conditions are met:

- Employer satisfies certain notice and consent requirements prior to policy issue and
- certain safe harbor exceptions apply.

Unfortunately, the notice and consent disclosure requirements are often missed at policy issue because they are not an insurance company requirement and many companies do not provide forms as part of the application process. Like the transfer-for-value rule, since this rule does not apply until the insured's death, it may be possible to "cure" the oversight while the insured is alive by executing a notice and consent prior to issue of a "new" policy. Of course, this means the insured must be able to qualify for new insurance coverage.

**In Summary.** Of all the errors that occur with life insurance beneficiary designations, the one that occurs with the greatest frequency is the failure to regularly review beneficiary designations. Unfortunately, after the purchase of a policy, many people put the whole thing out of mind. The policy is locked up, along with other "important papers," and not looked at again until the time to file a death claim. To the great surprise of many, an ex-spouse or deceased individual may be the beneficiary. The solution to this problem is easy. . . make sure you regularly help your clients review their beneficiary designations. Changing a beneficiary designation is very simple, but before you proceed with the change, you need to make sure you will not create an unintended tax problem in the process.





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