The Overlooked Beneficiary Designation

Chances are, when you buy life insurance, you put a lot of thought into it. How much coverage do you need? Are you covering the potential loss of income due to premature death, or will you use the proceeds to pay estate taxes or provide an inheritance? What kind of coverage do you want?

But many people who shop for life insurance spend almost no time considering how to fill out one of the most important parts of their policy: the part of the form where you name the beneficiary.

Why is this so important? Let's say you name your estate as the beneficiary, and then decide who will receive your assets, from your estate, in your will. (You have a will, right?) This approach exposes your life insurance proceeds to state estate taxes, and also to federal estate taxes. As it stands now, the first $5.25 million of estate assets are exempted from federal taxes, so if you die tomorrow with less than that in your name, you may not have to worry about paying a chunk of your death proceeds to Uncle Sam (rather than your loved ones). But do you want to bet that the exemption will still be that high when you pass away? And do you want to bet that you won't someday be worth that much or more, when your life insurance face amount is eventually included in total?

Meanwhile, state estate tax thresholds can start as low as $675,000, and most are in the $1 million range. Those taxes will likely take a bite out of the money received by your beneficiaries.

It's more tax-efficient to put your spouse's name on the beneficiary form. But if you do, you want to make sure you name one or more secondary beneficiaries. Why? If you and your spouse die at the same time, and no secondary beneficiaries are listed, then the life insurance proceeds go right back into your estate. Even if you predecease, if your spouse dies without naming a proper beneficiary, what's left of your life insurance payment could be subject to estate taxes.

Couldn't you name your children as beneficiaries? This could work from an estate tax perspective if you're willing to give up ownership of the policy. But then you leave your spouse without those assets that he or she may need to live on. And a bigger problem is naming one child as the beneficiary and asking him/her to divide the money among the others. Why? When your daughter receives the life insurance proceeds, it arrives tax-free. But when she pays a third of the money to her two brothers, those become taxable gifts, from her to them. Once again, you've invited Uncle Sam to the table.

Professional advisors often recommend another beneficiary: an irrevocable life insurance trust. This requires you to assign the ownership of the policy to the trust, and gift the amount of the insurance premiums to the beneficiaries of that trust, with the proviso that they use that money to buy the policy and keep it current. You won't have any control over the policy or the premiums, but this makes sure that your life insurance won't be included in your taxable estate. And if the trust is drawn up properly, it could mean that this money will be available not just to your spouse, and then your kids, but also your grandkids and their kids, all without having to pay estate taxes.

This sounds like a complicated strategy, but in fact it can give each generation control of the assets to take out for their own use or leave in to compound tax-free indefinitely. Meanwhile, though, the most important question is: if you have a life insurance policy currently, do you know who your beneficiaries are?