

# Choosing a Life Insurance Beneficiary

## The ‘Natural’ Choice Is Not Always Best

The blank on the life insurance application form simply reads “Beneficiary: \_\_\_\_\_.” Not a lot of room for what may be the single most important decision regarding your estate plan. Who should receive the insurance policy proceeds? The automatic response is: “My spouse, if living, otherwise, my then-living children.” But this arrangement is often inadvisable for several reasons, and the alternatives demand consideration.

### *Spouse*

You may not want your spouse to receive substantial life insurance proceeds outright for several reasons:

1. The proceeds become subject to the claims of your spouse’s current and future creditors.
2. The proceeds may become subject to rights and claims of your spouse’s next spouse, or the next spouse may use influence to deprive your spouse — or eventually your children — of the proceeds.

3. If the proceeds are paid directly to your spouse, they cannot fund a credit shelter trust to take advantage of the current \$675,000 applicable exclusion amount. An overfunded marital deduction often ultimately results in higher estate tax.
4. Children and other relatives may ask your spouse for gifts or loans or may offer bad investment advice.

### *Children*

Naming your children or surviving children as beneficiaries is a lottery approach. You could be excluding a grandchild through a deceased child. Better to designate your then-living issue or descendants *per stirpes* or by representation so that children of a deceased child will take the deceased child’s share. Also, many of the problems noted above for a spouse who receives substantial insurance proceeds outright also apply to outright payment of proceeds to children and grandchildren. Whether your children have the

maturity to handle money may also be an issue.

### ***Estate***

Designating your estate as beneficiary will have the benefit of bringing all your assets together for effective credit shelter tax planning and for the use of spendthrift trusts. But here are a few reasons why your estate should not be named:

- The proceeds will become part of your probate estate and may be subject to creditors' claims (though some state laws protect the proceeds from creditors).
- The proceeds will increase the size of the probate estate and may result in higher executor fees and attorney fees — especially when the fees are based in part on the size of the probate estate.
- The proceeds may not qualify for the inheritance tax exemption provided by some states for insurance payable to a named beneficiary. In such states, a higher tax may be owed.
- The proceeds may increase your federal and state taxes and perhaps state death tax as well.

### ***Testamentary Trust***

Naming a testamentary trust as beneficiary of an insurance policy may be appropriate, but the law in some states is not clear as to whether this approach will exclude the proceeds from your estate. Where permitted, it will facilitate use of credit shelter trust planning and spendthrift trusts. Of course, your will should specifically designate the trust or trusts to which the proceeds should be allocated, but this predesignation will reduce funding flexibility.

### ***Revocable Trust***

Where the insurance proceeds are substantial (and you have determined not to try to remove the insurance from your estate for estate tax purposes), you may name a revocable *inter vivos* (lifetime) trust as the beneficiary under the policy. The trust must exist before the designation is made and specify that the insurance proceeds cannot be used for certain estate obligations, such as creditor claims. Coordinate the trust with a pour-over will. This permits use of credit shelter trust planning and spendthrift trusts for your spouse and children.

## ***Creditor***

At times insurance is needed to secure a creditor, perhaps in connection with a business-related loan or a large mortgage. Although better ways to handle this situation may exist, often the creditor is named directly as policy beneficiary. Then you must specify clearly that the creditor is a beneficiary only to the extent of its interest (the debt obligation) and designate an additional beneficiary for any excess proceeds (or for all proceeds if the debt has been discharged).

## ***Noncitizen Spouse***

Special concerns arise if your spouse is not a U.S. citizen. Insurance proceeds paid to a noncitizen spouse will not qualify for the estate tax marital deduction. A good solution is to designate as the beneficiary an *inter*

*vivos* revocable trust or a testamentary trust under which a special qualified domestic trust (QDOT) is created to hold assets for the noncitizen spouse. A QDOT can qualify for the estate tax marital deduction. Alternatively, if you want your spouse to receive the proceeds outright, you may make a lifetime gift of the policy to the spouse and make him or her the owner. You are allowed to make annual gifts up to \$103,000 per year to a noncitizen spouse. Your spouse would name himself or herself as the beneficiary of the policy.

## ***Choose a Beneficiary Carefully***

The designation of the beneficiary of your life insurance requires much more than passing consideration. Don't just accept a suggested format that may accompany a policy application. Discuss your objectives and concerns with your professional advisors before you make this important decision.