The ten most common life insurance mistakes and how to avoid them

Stephan R. Leimberg

WHITE PAPER

OVERVIEW

Life insurance may be one of the most important purchases individuals will ever make for themselves or their businesses. Yet sometimes they make significant blunders that could impact their financial outcomes. Some of these mistakes could lead to tax exposure, suitability issues, insufficient financial protection, or the loss of estate assets.

Learn about the top ten errors people make when buying life insurance policies. Discover how you can help to ensure that your clients avoid them and secure the financial protection they need.

This entire commentary is devoted to common mistakes involving personal and business life insurance. The mistakes are those made over and over — in fact, countless times over the years — and continue to be made.

Each of these life insurance mistakes has two things in common: First, each has potentially serious consequences in terms of both expense and aggravation. Second, each can easily be avoided or, if found in time, can be corrected quickly and inexpensively. There is a relatively simple solution to each of these ten common mistakes.

Who cares if these ten mistakes are not found and fixed? Certainly not the IRS. It profits from the mistakes of omission or commission made by others. The parties who care most about these mistakes are those that must make do with less or must do without.

The irony about all these errors is that they do not involve complex tax or other laws, and — perhaps for that very reason — are seldom discussed in law school, estate planning council, or CPA courses. Yet for a professional advisor to ignore or overlook them may be as poor or malpractice as to draft a will improperly, fail to suggest a marital/nonmarital trust, or neglect to file a tax return on time. And most of these mistakes can be spotted easily — even if you are not a professional advisor.

Insurance products issued by:
The Lincoln National Life Insurance Company
Lincoln Life & Annuity Company of New York

For agent or broker use only. Not for use with the public.

Mistake 1

The insured's estate is named as beficiary.

The problems

First, naming an estate as beneficiary of life insurance dooms the insurance proceeds (in many states) to needless state inheritance taxes or to a higher state death tax rate than if the proceeds were payable to a named beneficiary. Aside from relatively small amounts in unusual situations, life insurance should generally not be payable to the insured's estate.

Are there situations in which a relatively small amount of insurance proceeds should be paid to the insured's executor? Probably. Particularly in states where there is no inheritance tax on life insurance proceeds, where the client's estate is mainly illiquid, and in cases where the insured's estate is almost certain to be well below the federal estate tax exclusion, sufficient insurance to pay known and reasonably anticipated debts and estate expenses may be appropriate. But in most cases, the suggestions below will result in a much more efficient and effective use of life insurance.

Second, this mistake also makes it certain that creditors have full access to the life insurance proceeds even though most state laws provide full or significant exemption from the claims of creditors for life insurance proceeds payable to named beneficiaries such as a spouse, children, parent or sibling.

Third, by naming the insured's estate as beneficiary, it is almost guaranteed that the precious dollars intended to go to a loved one will be subjected to the expense and potential aggravation and delay of probate, and the fees of those who base their charges on the size of the probate estate. If the estate is named recipient of life insurance, it is also subject to claims under state laws by surviving spouses. This may not be the result the insured intended.

The solution

Be sure the beneficiary designations of all life insurance, group life insurance, pension-owned, and individually owned policies are up-to-date; and name the persons or organizations or entities intended to receive the insurance proceeds. Cut out the taxman and others who should not be recipients.

Mistake 2

Failure to name at least two "backup" beneficiaries.

The problem

If the named beneficiary dies before the insured (even if only minutes before) and no change was made in the beneficiary designation, the proceeds will be paid to the insured's estate. This needlessly subjects the insurance proceeds to all the problems of Mistake 1, just as if the insured's estate was named as beneficiary.

The solution

Employ "The Rule of Two." Two backups should be named for every person named in a life insurance policy as a beneficiary. The Rule of Two is a good practice for all dispositive documents and contracts. For instance, be sure your clients have provided two backup beneficiaries and two backup guardians in wills, trusts, pension or profit sharing plans, IRAs, HR-10s, and 401(k)s. Be sure your clients have also provided two backup executors and/or trustees in case those named for some reason fail to qualify or cease to act. Your client should name more than two backups — if the beneficiary is a "special needs" person who is physically, mentally or emotionally challenged — and consider naming one or more charities as ultimate beneficiaries in case the personal beneficiaries named predecease your client.

Mistake 3

Failure to check insurance policies at least every three years.

The problem

An astounding number of policies are payable to ex-spouses or others whom the insureds would not have wanted to receive the proceeds. Children born after a policy was purchased are often inadvertently omitted. Sometimes the person named as beneficiary is long deceased. This occurs because it's easy to forget who was named as the beneficiary of life insurance purchased several years ago. And many policies haven't been checked — and beneficiaries verified — for 10 or 20 years. In some cases, existing policies have long been totally forgotten.

Forgoing a once-every-three-years checkup also makes it likely that your client may not have the best possible type of policy to meet present needs, that there are valuable options not exercised, or that the coverage is dangerously out-of-date and inadequate because of a change in circumstances or merely because inflation at 2% or 3% per year has eroded the purchasing power of the coverage. For example, insurance that was adequate ten years ago has, at an average annual inflation rate of 3%, lost 30% of its purchasing power. It's also likely that your client's family is living at a much higher standard than it did 10 years ago.

The solution

Write to the   of the insurance company. Have the insurance company confirm in writing: (1) that the policies are in-force, (2) who the current beneficiaries are, and (3) that waiver of premium (a contractual provision that assures a policy is kept in-force and continues coverage even if the insured can't pay the premiums because of disability) is effective. Check to see if the policy has a guaranteed insurability (insurance of insurability) provision. Often, the insured's health has deteriorated, and such a provision makes it possible to purchase insurance at standard rates regardless of health. Don't fail to take advantage of these very valuable provisions.

Check to see if the persons or charities named are the people or organizations wanted as beneficiaries. It is equally important to confirm that the policy proceeds are payable to the appropriate beneficiaries in the manner that best meets their needs, abilities and circumstances—and the client's goals. It's also unwise for clients to pay large amounts outright to minor children or to children of any age who are not mature enough to wisely handle that much money.

Mistake 4

The product does not match the problem (the wrong type of life insurance).

The problem

If the insured policyowner has purchased a short-term product that will or may run out when needed the most, one of the essential benefits of buying life insurance—peace of mind—has been lost. How can life insurance provide the mental comfort it is intended to offer if it may not work when it is needed the most?

The solution

Have a discussion with your client to see if the right type of life insurance for the insured's present needs, circumstances, and objectives is in-force. There are dozens of new types of policies that have become available in the last few years that were not possible or even considered in the past. Many of these contracts are significantly lower in outlay than those available in the past. These new types of policies may be more appropriate to the insured's (and beneficiaries') present needs and circumstances than the currently held coverage.

Be sure the insured (policyowner) never drops or converts a policy before demanding a written list of the disadvantages and downsides of replacing currently owned insurance. For instance, if an old policy is replaced with a new one, the new contract will be contestable by the insurer for the next two years. Value inside a new contract builds up more slowly than the value inside a policy that has been in-force for several years.

No one should lapse a policy because he or she feels wealthy with other assets—unless it is a certainty that the other property can be converted into immediate cash without a significant loss. Never allow a switch to a new policy merely because the one currently held is "old-fashioned." Some of the "old-fashioned" contracts allow borrowing at 5% or 6%, and are still paying dividends that equal or exceed premiums. (If more coverage is needed, a new separate policy is often in order.)

Ask questions and demand answers. If an interest rate is shown in one company's illustration, make sure it's reasonable (long-term); then make sure the same rate and other assumptions are used in all comparisons.

Mistake 5

The amount of personal coverage is inadequate for family financial security or estate planning goals.

The problem

The federal estate tax at this time is far from dead. State death taxes can be astoundingly (and for almost all clients surprisingly) high.

College and graduate-school costs — and even private undergraduate school tuitions — can amount to hundreds of thousands of dollars. All too often, individuals never accurately figure the real (after-tax, after-inflation) costs of the living expenses of survivors. Who's going to pay for food, clothing, and shelter for the next X years? (Figure roughly that to raise a child through age 21, the average cost, excluding college expenses, is almost a quarter of a million dollars, about $70,000 for food alone). Will there be enough after taxes, the payoff of debts, and other expenses just to go on living? If no one checks, how will the client know?

Seldom do individuals consider how little after-tax, after-expenses income is produced by a money market account, a mutual fund, or stock portfolio (particularly one in trust, even with reasonable trustee's fees).

The solution

Perform a no-nonsense insurance analysis of what the proposed insured has and what the family will need if the insured dies — and what would be needed if the insured became disabled. A couple of hours with a competent life insurance advisor has often saved a family's financial way of life — or could have. Those who didn't make that investment have all too often done with less — or done without.

Over and above all the amounts necessary to keep a family at the standard of living the client feels is appropriate, consider having the client's spouse own and be beneficiary of life insurance equal to at least one year's gross income on the client's life. This is what I call a "Survivors' Shock Absorber" (SSA). Psychologically, this Survivors' Shock Absorber buys time for the surviving spouse and family to readjust. It is very comforting — and calming — for them to know that — financially at least — for one whole year, nothing has to change and no snap decisions are necessary regarding moving or making radical adjustments in lifestyle. This SSA cushion can make an incredible difference in terms of financial and psychological security.

Mistake 6

The policy proceeds are payable outright to minor children or grandchildren, or to handicapped or emotionally immature or financially irresponsible individuals.

The problem

Improper disposition of assets is one of the most frequent and serious of all estate planning errors. It occurs when the wrong asset goes to the wrong person at the wrong time in the wrong manner. Stated in another way, "Equal is not necessarily equitable." Perhaps children have different needs or different abilities to handle various sums of money. Should they all receive equal shares of your client's life insurance? Should they receive their shares outright?

Because minors are under a legal disability, state law, in many cases, will tie up those proceeds and make it expensive or time-consuming for them to use the money. No insurance company will knowingly pay large amounts outright to minor children. So a guardian or custodian will have to be appointed by a court at the expense of your client's children in order to dole out their money to them.

It is clearly imprudent to pay a lump sum of almost any amount to a spendthrift child — even if that child is legally an adult. It may be equally foolish to pay a large sum of insurance money to an individual with no financial management experience or to an emotionally immature individual of any age.

The solution

Often, the best solution is to set up a trust for the insured's spouse and children, and name the trust as the recipient of life insurance proceeds. A great deal of flexibility can be incorporated. Many legal restrictions imposed on outright distributions can be avoided. This is a much safer and surer way to provide financial security for those who can't or don't want to handle large sums of money or other assets.

A very cost-effective alternative where the amount involved is more modest (or for any reason a trust is impractical or not desired) is to have the insurer pay out policy proceeds under a "settlement option," which provides a steady and consistent small amount of cash monthly over a long period of time. This conversion of insurance proceeds into a long-term or even lifetime annuity is a vastly underused elegant solution to many dispositive problems.

Mistake 7

All the insurance is owned by the insured.

The problem

If the insured's estate (including the death benefit from life insurance and retirement plans) will never exceed the federal exclusion amount, federal estate taxes may not be a problem. But if the estate is likely to be greater than that amount over time, the ownership of insurance in the insured's own name may lead to needless federal estate tax inclusion, which usually results in unnecessary federal (and in some cases state) estate tax liability.

The solution

Ideally, to avoid federal estate tax on life insurance proceeds, a trust or a responsible adult beneficiary should purchase, own, and be recipient of insurance. If the insured never owns the policy or has any rights in it, it can't be included in the insured's estate (even if the insured gives the actual legal owner cash gifts, which are then voluntarily used to pay premiums).

Mistake 8

There's been no investigation to see if the insured's business or practice can provide insurance on a more cost- or tax-efficient basis.

The problem

If the insured owns, controls, or has a voice in the decision-making process of a closely or publicly held business, those business dollars may be much more tax and cash flow cost-effective than after-tax, out-of-pocket personal dollars to provide for the financial security of the insured's family. In a nutshell, it is probably costing more than necessary if the insured pays for life insurance entirely with after-tax personal dollars.

The solution

Consider how to maximize business-sponsored life insurance benefits. Prepare a breakdown for the client of the advantages and disadvantages of DBO (death benefit only) a/k/a salary continuation plans, nonqualified deferred compensation, Section 162 plans, group term life insurance, group term carve-outs, and split-dollar life insurance. If any of these terms are unfamiliar to the insured, it's a good sign that the planning team needs to revisit what such plans can do for the client and his/her family.

Mistake 9

The parties forgot that term insurance (including group term coverage) will self-terminate at some point and/or become prohibitively expensive to carry.

The problem

Both individuals and business buyers tend to confuse the words "low outlay" with "inexpensive." Low outlay is a measurable relationship of the premium dollars required to carry one policy with the number of dollars to purchase another policy. Term insurance will almost always require a lower outlay than permanent life insurance coverage of any type. "Inexpensive" is a term that demands we measure what our dollars have accomplished, e.g., the relative cost efficiency of meeting a given goal.

The solution

Both the client and his/her advisors should be asking: What life insurance policy will accomplish the client's expressed objectives with the least outlay? If the policy never accomplishes the client's objective(s), it is the most expensive—no matter how low the outlay.

Short-term products (such as term insurance) should be used when the duration of the need is definitely short-term. Long-term products—some type of permanent coverage—should be employed when the need is long-term or indefinite. A combination of term and whole life is appropriate if the parties are not sure how long the need will last—or if the client's cash flow is inadequate to meet the need totally with a form of permanent coverage. In other words, be sure you've matched the product to the problem.

If term insurance is appropriate to solve the problem, consider long-term locked-in-price term contracts, but be sure the client can convert to a viable permanent contract at a reasonable price.

Permanent coverage is appropriate if the client is highly successful—for business and estate liquidity needs. Permanent coverage is even more necessary if the insured is not financially successful, because it may be the only way to support the lifestyle of those he or she loves and is responsible for.

Permanent coverage is best to hedge the risk of misjudging the length of the duration of the need. For instance, many individuals thought the cost of their lifestyle would drop at retirement, while many others never anticipated the need to provide financial support for parents (and even adult children and their children) after they (the insureds) retired. Certainly, permanent coverage is indicated where there are physically or emotionally or mentally handicapped children who are likely to survive their parents.

Mistake 10

Insurance has been purchased or treated as though it were a commodity.

The problem

All life insurance—even from the same company—is not equal. More properly stated: The wise and informed advice of a competent and careful professional insurance specialist can make an amazing difference.

For instance, a mistake in setting up life insurance can cost tens of thousands of dollars. Transfer life insurance to the wrong party in the wrong manner, and the income tax-free status of the death proceeds is lost. Instead of being income tax-free, the death benefit is taxable.

The solution

How life insurance is arranged, the quality of advice and the peace of mind gained when it is properly coordinated to most efficiently and effectively accomplish objectives, and the relationship of trust built with a professional life insurance advisor are invaluable. For example, by setting up life insurance through an irrevocable life insurance trust rather than owning it outright, it's possible to save a significant percentage of the death benefit from confiscatory death taxes.

A smart consumer will search out a competent, compassionate advisor who "gets things done," who—after listening to the consumer and asking many insightful questions—puts the client's priorities and best interests first.

Wise advisors will be willing to pay the price of establishing a relationship rather than looking for a quick sale. And true professional life insurance advisors keep up-to-date—and keep their clients informed when new cases or rulings are released or when the tax laws change, and make sure they are up-to-date on the legitimate and ethical tax-saving mechanisms available under the tax law.

Life insurance contracts and companies, like advisors, are not all alike. The apparent lowest price or the highest possible return are not always the hallmark of the right policy. The economic history of the recent past proves the danger of shopping for the lowest priced policy. Records show that many insurance companies that didn't have the lowest premiums or offer to pay the highest dividends are the companies that were (and continue to be) the most financially sound and fiscally responsible. There is a difference in the quality of insurance companies that stand behind the policy.

Smart insurance buyers will judge an insurance company's quality—at least partially—by examining the type of person who serves as the company's advisor. Smart buyers will ask for references and talk to other people who have dealt with the advisor. They will demand to know if the advisor is (or is studying to become) a CLU (Chartered Life Underwriter), ChFC (Chartered Financial Consultant), CFP® (Certified Financial Planner), or has an MSFS (Masters in Financial Services).

And the potential clients will ask the advisor: (1) when he/she last took a continuing education course in insurance, income taxation, or estate planning, and (2) if the advisor subscribes to a service or newsletter that keeps him continually up-to-date and exposes him to new tools and techniques.

Conclusion

Life insurance may be one of the most important purchases an individual (and/or his or her business) will ever make. As is the case with any important purchase, it pays dividends to avoid the pitfalls into which a buyer can so easily fall. These common mistakes can be avoided by following the simple checklist that accompanies this commentary.

Checklist for avoiding mistakes

1. An insured's estate should not typically be named the beneficiary of insurance.
2. At least two backup beneficiaries should be named.
3. At least every three years, a written confirmation of the status of policies and beneficiaries should be requested from the insurer's Home Office.
4. The insurance product should match the problem. Be sure the insured has the right policy for his/her/its needs.
5. Above all, check to be sure there's enough life insurance to provide food, clothing and shelter, and to pay off debts so that those the insured loves can continue in their present lifestyle.
6. Don't name minors as outright beneficiaries. Consider a trust or settlement option.
7. Consider a transfer of life insurance to others to save federal estate taxes.
8. Clients should check to see if their business or practice can provide their family with insurance on a more cost-effective basis.
9. Remember that term insurance by definition runs out and contractually becomes more expensive as a client grows older.
10. Clients shouldn't buy life insurance as though it were a commodity. The knowledge of their advisor and the integrity of the insurer and their commitment to service can make a major difference as to how cost-effective life insurance will be.

About the author

Stephan R. Leimberg is an attorney and CEO of Leimberg Information Services, Inc. (http://www.leimbergservices.com), a provider of commentary on recent cases, rulings, and legislation to legal, accounting, and financial service professionals; CEO of Leimberg and LeClair, Inc., (http://www.leimberg.com) an estate and financial planning software company in Bryn Mawr, Pennsylvania; and president of Leimberg Associates, Inc., a software and publishing company.

His email address is steve@leimbergservices.com. This article was originally published in the August 2004 issue of *Estate Planning* (vol. 31, no. 8).

Reprinted with permission.

For more information about protecting wealth with life insurance, contact your Lincoln representative.

[First Name] [MI] [Last Name]
[Des 1], [Des 2], [Des 3]
[Title]
[Company Name]
[Phone Number] [Ext. XXXXX]
[Email]

[Disclaimer 1]

[Company Name] is not an affiliate of Lincoln Financial Group.

Not a deposit
Not FDIC-insured
Not insured by any federal government agency
Not guaranteed by any bank or savings association
May go down in value

©2015 Lincoln National Corporation

LincolnFinancial.com

LCN-1227841-061615
POD 8/15 **Z01 _VDP**
Order code: LIF-PR-WPR001

Lincoln Financial Group® affiliates, their distributors, and their respective employees, representatives and/or insurance agents do not provide tax, accounting or legal advice. Please consult an independent advisor as to any tax, accounting or legal statements made herein.

Lincoln Financial Group is the marketing name for Lincoln National Corporation and its affiliates, including broker-dealer/distributor Lincoln Financial Distributors, Inc., Radnor, PA, and insurance company affiliates The Lincoln National Life Insurance Company, Fort Wayne, IN, and Lincoln Life & Annuity Company of New York, Syracuse, NY. Affiliates are separately responsible for their own financial and contractual obligations.

For agent or broker use only. Not for use with the public.

XXXXXXXXXXXXXXXXXXXX