

Myths Surrounding Life Insurance Policies, Individual Retirement Accounts, and 401(k)s

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1. My will controls who receives these assets when I pass: Many people assume their Will may control who will receive proceeds from their life insurance policy and who will receive the money in their 401(k) and IRA. Actually, the person named as a beneficiary remains the beneficiary regardless of what your Will states and regardless of your marital status. Your beneficiary forms act as a contract outside of your Will, meaning if you have not changed your beneficiary designation forms, whomever you last named as a beneficiary receives these assets. When you re-do your Will, always update the beneficiary designation forms for these non-probate assets.

2. When I get a divorce, my ex-spouse is automatically prevented from receiving proceeds from my life insurance policy, IRA and 401(k): Don't fall for this trap! Divorce does not alter your beneficiary designations for these assets. Only changing your beneficiary designation can change who receives these assets. Whether you have been divorced for one week or 10 years, if your beneficiary designation for any of these items states your ex-spouse is your beneficiary, your ex-spouse receives the proceeds from that asset.

3. Life insurance proceeds pass outside of my estate and are not subject to estate taxes when I die: Right and wrong. Any insurance policies in which you have an "incident of ownership" are included as part of your taxable estate. This includes policies you can borrow against, assign or cancel, or for which you can revoke an assignment, or can name or change the beneficiary. The proceeds from your life insurance do pass outside of your will as a non-probate asset unless you

have named your estate as your beneficiary or your named beneficiary has predeceased you and the proceeds default to your estate. A non-probate asset simply means that your beneficiary does not have to wait for the probate of your estate to be completed to receive the proceeds. The fact life insurance proceeds pass outside of your estate only means it is a non-probate asset, and the Court does not assess probate fees based on this asset. The proceeds from the policy are included in the value of your gross estate and, if the total value of your gross estate reaches the threshold of a taxable estate, your estate pays taxes on the total amount, which will include the value of the life insurance proceeds.

The beneficiary may or may not owe estate taxes depending on how your will specifies the source of payment for estate taxes and debts. If you have no will then the recipient will pay a pro-rata share of the estate taxes. A taxable estate in the year 2007 is an estate worth \$2 million dollars.

4. I outwitted the system: My wife purchased a policy on my life and I purchased a policy on her life: Oops! Now you cannot change your mind as to who will benefit from the policy on your life. If you and your spouse divorce, there is no way to make sure your children or new spouse receive the benefits of the proceeds of your policy. Your ex-spouse owns the policy on your life and can change the beneficiary, cash out the policy and take the cash value, or even cancel the policy.

5. There is no way to provide life insurance proceeds to a beneficiary without paying estate taxes: You can pass life insurance proceeds without paying estate taxes if you create an irrevocable trust while you are alive, and make your irrevocable trust the owner and beneficiary of your life insurance policy. Since you no longer have any ownership of the policy, the amount of the proceeds of your policy are not considered part of your estate and do not add to the value of

your estate. Typically, you would make an annual gift of the premiums to the trust. The premiums you give to the trust may be subject to the gift tax rules but, depending on the value of your estate, this may be the right move! The IRS places other restrictions on such plans, so make sure you talk to an estate planning attorney before attempting to create an irrevocable trust that owns life insurance.

6. IRAs and 401(k)s pass outside of my estate, and are not subject to estate taxes when I die:

Right and wrong again. As in number three, these are non-probate assets but they are taxed as part of your estate if your estate reaches the value of a taxable estate. What's more, the beneficiary receiving the 401(k) or IRA account may be subject to paying estate taxes and income taxes on the asset if income taxes were deferred during the decedent's lifetime. If your spouse receives your IRA or 401(k) they will receive preferential tax treatment and may roll the account over and stretch out the distributions, paying no estate taxes and reducing lump sum payment of income taxes. Your spouse will have to roll the 401(k) into an IRA at this time.

If the person receiving the 401(k) or IRA account is not your spouse, they pay income taxes on the distributions they receive as this money has not yet been taxed to the Decedent. A 401(k) and an IRA allow a person to save money pre-taxes but, when a new person receives the account, the money must be taxed upon distribution of the asset. There are now favorable options for non-spousal beneficiaries and you should seek the advice of a professional investment advisor to take advantage of these new stretch IRAs available to beneficiaries.

7. I have minor children and have named my children's guardian as the beneficiary of life insurance to take care of my children: Make sure you have not named minor children or their guardian as the beneficiaries of any of these assets! Minors lack the legal capacity to own property, which means they cannot receive these items until they reach eighteen (18) years of age.

The Court will require the appointment of a conservator, not just a guardian, to hold these assets for the benefit of your minor child. If you merely name the Guardian outright as the beneficiary there will be no legal obligation to use the funds for the benefit of your children. A better alternative is creating a Trust for the benefit of the minor children and naming the Trust as the beneficiary of these assets. Talk to your estate planning attorney about options that exist if you have minor children.