Because You Asked

Advanced Markets

Life insurance beneficiary designations

When designating a beneficiary of a life insurance policy, the policy owner should consider a multitude of factors, such as the owner's planning objectives, the beneficiary's individual circumstances, creditor protection laws, and any estate, gift, and income tax implications that may arise from the designation (or lack thereof). This BYA is intended to address some of the intricacies that may arise when selecting a beneficiary of a life insurance policy.

Please refer to the attached **Appendix** for sample wording to consider when making a beneficiary designation. Policy owners should discuss their beneficiary designations with their tax and legal counsel.

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INSURANCE PRODUCTS		
Not FDIC Insured	Not Bank Guaranteed	May Lose Value
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1. When completing a beneficiary designation form, what kind of identifiable information will be required?

The beneficiary designation form(s) will generally require that identifiable information about the designated beneficiary be provided, such as:

- The beneficiary's full legal name
- Birthdate
- Taxpayer ID number
- Relationship to the insured

The specific information required on a *Beneficiary Designation Form* may differ slightly from carrier to carrier and policy owners must be mindful that they are following the rules applicable to their specific insurance carrier. Designations that fall outside of a particular company's rules may be rejected and sent to the policy owner for revision.

Properly identifying a beneficiary is essential. If the beneficiary cannot be determined, or if there are any ambiguities regarding the identity of a beneficiary, a court may have to determine who will receive the death benefit, which may or may not reflect the owner's original intent and delay the payment of proceeds.

2. Is the owner of a policy free to change the beneficiary at any time?

Generally, a policy owner is free to change beneficiary designations any time a policy is inforce without the consent of the original beneficiary. An exception arises when a beneficiary is designated as "irrevocable." In this situation, the irrevocable beneficiary and the policy owner generally must both consent to the change in writing.

3. Can a policy owner change the beneficiary of the policy via his or her last will and testament?

A life insurance policy is a contract, and the terms of the life insurance contract will most likely supersede the terms of a last will and testament. If a will and a life insurance policy designate different beneficiaries to receive insurance proceeds, it should be assumed that the proceeds will be paid to the beneficiary designated on the policy. This is likely to be true even if the will was executed after the policy issue date.

4. How often should beneficiary designations be reviewed?

All too often, life insurance contracts are put in force and largely forgotten. Life insurance policies should be treated like any other asset and should be reviewed frequently. As a guideline, the owner should review his or her beneficiary designations every three years, or sooner if there are changes in circumstance, such as a death, birth, marriage, or divorce.

5. How should a beneficiary designation that names multiple beneficiaries be addressed?

If there are multiple beneficiaries, each beneficiary must be identified and a specific percentage payable to each beneficiary should be explicitly defined. If a policy owner wants the beneficiaries to share equally in the proceeds, generally no percentage needs to be stated, only the names of the beneficiaries need to be provided. See **Appendix** for more information.

If a beneficiary predeceases the insured, the surviving beneficiaries in the same class (e.g., primary beneficiaries) will usually inherit the deceased beneficiary's interest in the death benefit, unless otherwise stated.

Example
Addie and Ben are each 50% primary beneficiaries of a policy. If Addie predeceases Ben, Ben would receive 100% of the death benefit and Addie's children would not receive anything.

The policy owner can also designate that the proceeds be divided "per stirpes" (in some jurisdictions, the term "by right of representation" is used) or "per capita" as a means to address predeceased beneficiaries when children or other lineal descendants will be named.

6. What is the difference between *per stirpes* and *per capita*?

Per stirpes and per capita refer to methods of distribution that consider how an estate (or an asset) is divided among a class of beneficiaries, particularly when members of the class have predeceased the decedent.

Under a "per stirpes" method of distribution, the asset in question is divided into equal shares based upon the number of living individuals and deceased individuals with living descendants, in the closest generation to the decedent. For example, assume decedent (D) leaves her estate in equal shares to "her living issue, per stirpes." At the time of D's death, she has two living children – A & B – and two children who have predeceased – C & E. C has two living children - C1 & C2, but E predeceased without any offspring. Because the children's generation is the closest generation to D, the per stirpes method divides D's estate into 3 equal shares for A, B, and C. A and B each receive 1/3rd of the estate and C's two living children – C1 and C2 – will share C's remaining 1/3rd interest – effectively providing C1 and C2 with a 1/6th interest. No share will be provided for E.

The "per capita" method of distribution differs slightly from the "per stirpes" method in that it divides the asset/estate into equal shares based upon the closest generational level where there is at least one living member of the generation. To understand this distinction, assume that all the children from the previous example – A, B, C and

E – predecease our decedent, D; A and C are the only children to leave offspring – A1, C1, and C2. Under the "per stirpes" method described above, the estate would be divided into two shares – ½ for A and ½ for C – with the result that A1 inherits ½ of the estate and C1 and C2 will split C's share – giving them each a ¼ interest. Counter that with the "per capita" approach, which divides the estate based upon the generational level closest to D with a living member. Because all members of the children's generation predeceased D, D's estate is divided into three equal shares for A1, C1 and C2, providing them each with a 1/3rd interest in the estate.

Although in many instances a per capita and per stirpes designation may lead to the same result, it is important to work with client's counsel to determine the appropriateness of either of these distribution methods, especially given that state or local law may define these terms differently that the explanation provided here.

7. Can I name a minor child as the beneficiary of a policy?

A minor child can be the beneficiary of a life insurance policy; however, if a minor is the beneficiary, the life insurance company will be prohibited from transferring any death benefit directly to the minor. Instead, a guardian or conservator (depending on state law) will need to be appointed to receive the proceeds, and he or she will handle the administration of the funds for the benefit of the minor until the child attains the age of majority (either 18 or 21, depending on the state).

Because guardian appointments can be expensive and burdensome, it may be preferable to consider creating a trust to benefit the minor child and naming the trust as the beneficiary of the life insurance. Having a trust as the beneficiary allows the client to choose a competent trustee to manage and invest the funds and will avoid the delays, expenses, and uncertainties associated with a court proceeding.

Alternatively, a Uniform Transfers to Minors' Act (UTMA) custodianship may be used. All 50 states and the District of Columbia have adopted the UTMA in some form. Under these laws, a "custodian" (often a parent or other relative) is designated as the beneficiary of a policy for the benefit of the minor child. Upon the death of the insured, the custodian will receive the death benefit and must administer and use those funds for the exclusive benefit of the minor child until the child reaches the age of majority, or later as allowed by state law.[1]

Please see the **Appendix** for sample language that may be appropriate to name a custodian on behalf of a minor child under UTMA law. If this type of designation is desired, please refer to the applicable UTMA/UGMA state statute and/or to legal counsel to ensure the appropriateness of this type of beneficiary designation.

8. Should a person with special needs be named as the beneficiary of a life insurance policy?

It is typically inadvisable to designate an individual with special needs as the beneficiary of a policy because the receipt of proceeds could make the individual ineligible for government assistance. If an individual, such as a special needs child or other relative, receives government assistance such as Supplemental Security Income, Medicaid, or funds from other government funded programs, life insurance proceeds received in an amount in excess of $2,000 will disqualify the beneficiary from such assistance programs.

Rather than designate an individual with special needs as the beneficiary of an insurance policy, clients should consider naming a special needs trust, established for the benefit of such individual, as the beneficiary. Life insurance proceeds received by a special needs trust can provide much needed funds to improve the life of a special needs individual without jeopardizing his or her eligibility for government programs. Furthermore, the trust structure will allow a trustee to manage the trust's assets without the need for a court-appointed guardian.[2]

9. Can an individual beneficiary disclaim his or her interest in life insurance proceeds?

Yes. A beneficiary may disclaim his or her interest in the policy. A disclaimer of benefits by a beneficiary will result in the proceeds being paid to whomever would have received the proceeds had the disclaiming beneficiary predeceased the insured. A disclaimer must meet both federal and state statutory requirements to be considered a qualified disclaimer effective for tax law purposes. If the disclaimer isn't "qualified," the property in question will be considered a personal asset of the beneficiary that was given as a taxable gift.

A beneficiary may look to disclaim for several reasons including:

- Preference that the proceeds go to someone else (e.g., sibling, child, etc.),
- A desire to avoid future taxation (e.g., gift or estate taxes), or
- Has creditor or other debt issues

If a beneficiary would like to disclaim a portion or all of his/her share of a life insurance policy, he/she will be required to file a Disclaimer Form with John Hancock.

10. Does divorce terminate a beneficiary-spouse's interest in the policy?

It depends. It is very common for the owner of a life insurance contract to name his or her spouse as the beneficiary of the policy. In the instance of divorce, it would seem intuitive that the beneficiary-spouse's rights would terminate, however, this is not always the case. About half the states have enacted laws where divorce immediately voids any beneficiary designations in favor of a former spouse unless there is a clear written contract between the spouses or a court order to the contrary.[3] In other jurisdictions, divorce does not automatically terminate a former spouse's right to receive death benefits. Note, the U.S. Supreme Court determined that a Minnesota revocation upon divorce statute enacted after a policy was issued naming an ex-spouse as beneficiary applied to deny her the death benefit proceeds.[4] Furthermore, federal law generally preempts state law in the case of life insurance and retirement benefits that fall under ERISA, as well as for federal employment benefits, such as federal group life insurance plans.[5] Therefore, it is essential that in the case of divorce, a policy owner review his or her beneficiary designations and make revisions as needed taking into account local law.

11. If a life insurance policy is owned in a qualified plan, who is an eligible beneficiary?

If a life insurance policy is owned in a qualified plan, John Hancock requires that the qualified plan be the beneficiary of the policy. An outside beneficiary may not be named.

12. Should the policy owner name a contingent beneficiary?

As a best practice, policy owners should follow the "rule of two," meaning that at least two back-up beneficiaries should always be named. If contingent beneficiaries are not named and the primary beneficiary predeceases the insured, the proceeds typically will be paid to the estate of the insured, which may not be ideal depending on the policy owner's preferences (see question 13 below). Note that when the owner of the policy is not the insured (i.e., a third-party owner) proceeds will usually be paid to the policy owner (or owner's estate) when there is no designated living beneficiary.

13. Should the insured's estate be named as the beneficiary of a life insurance policy?

In many cases, naming the insured's estate (or a testamentary trust) as the beneficiary of a life insurance policy may be perceived as the simplest way to provide needed estate liquidity and a lower cost method for the orderly distribution of the proceeds (as compared to creating a trust).

While naming the insured's estate as the beneficiary of a policy can have its advantages, there may be significant drawbacks, including:

- **Inclusion in the insured's estate –** the proceeds will be taxable in the insured's estate, regardless of whether the insured owned the policy or had any incidents of ownership at death. In some states, the proceeds may also be subject to state estate and/or inheritance taxes.
- **Probate delays and expense –** the insurance proceeds will be part of the probate estate, which may result in increased estate administration costs and undesirable delays in receiving the proceeds. Moreover, the insurance proceeds will also be part of the public record and the insured will lose the privacy afforded by naming individuals or other entities, such as a trust, as beneficiaries.
- **Creditor attachment –** while allowing an estate to receive insurance proceeds may result in needed liquidity, it could become problematic because the proceeds may now be attached by creditors of the insured.

14. What are the benefits of naming a revocable trust as the beneficiary of a life insurance policy? What information is required by John Hancock?

Naming the policy owner's revocable trust as the beneficiary of a life insurance policy has many distinct benefits, including the ability to amend or revoke the trust as family needs change and affording the owner the ability to control the final disposition of the proceeds via the dispositive provisions of the trust (which become irrevocable upon the owner's death).

However, naming a revocable trust as the beneficiary may not be a good idea if the owner has exposure to federal and/or state estate/inheritance taxes as the proceeds payable to the trust will be includible in the owner's estate.

John Hancock requires the following information when a revocable trust is named as the beneficiary of a life insurance policy:

1. Trustee's name
2. Full legal name of the trust
3. Date of the trust
4. The trust's tax identification number (or the grantor's social security number)

15. When is the use of an irrevocable life insurance trust advisable?

For some individuals, particularly those facing a possible estate tax, an irrevocable trust structure may be an attractive option. An ILIT is an irrevocable trust created to own life insurance. The ILIT is both the owner and the beneficiary of one or more life insurance policies, typically insuring the life of the grantor. If structured properly, the life insurance proceeds will not be subject to income tax or estate tax upon the death of the insured or the insured's spouse.[6]

The tax-free proceeds can provide needed liquidity for the payment of estate taxes, debts, and administration costs. Moreover, the irrevocable trust structure can have significant non-tax benefits as well, such as control "beyond the grave" over how and when trust proceeds will be distributed to beneficiaries, and creditor protection. Proceeds received by an ILIT are typically protected from creditors of the ILIT beneficiaries until the ILIT beneficiaries receive the trust proceeds.

For more information on how ILITs are structured, please refer to the BYA on Basics of Irrevocable Life Insurance Trusts (ILITs).

16. Can the policy owner, the insured, and the beneficiary all be different individuals?

Yes, but a "Goodman Triangle" may arise when a life insurance policy is owned by one person on another's life and a third person (who is not the owner's spouse) is named as the policy beneficiary. This scenario is problematic as it can cause unexpected gift tax liability.

Example

"A" owns a policy insuring his wife "B's" life, and names their child "C" as the beneficiary. Upon B's death, A is deemed to have made a gift of the policy proceeds to C when the proceeds are paid. A, as the person who made the gift, will be liable for any gift tax due to the extent the proceeds payable to the beneficiary exceed the federal gift tax exemption limits.[7]

Although not technically a "Goodman triangle," a tax issue can also present itself when a business owns a policy insuring the life of a shareholder/partner or employee and someone other than the company is named as the beneficiary.

17. Are there any special considerations when a business is the owner/beneficiary?

Yes. If an employer owns life insurance on an employee's life, §101(j) of the Internal Revenue Code ("IRC") must be complied with for the death benefit proceeds to be received income tax free. To comply with §101(j), generally two requirements must be satisfied: (1) Notice and Consent must be obtained before the policy is issued, and (2) the insured must fall into one of the statutorily defined coverage conditions or "exceptions." The employer must also file an informational filing, Form 8925, each year with its annual income tax return.

See our BYA on §101(j) Requirements for Employer-Owned Insurance for more information about this rule and its requirements.

18. Are there any special considerations when a foreign beneficiary is named?

Generally speaking, an owner may designate a non-U.S. citizen as the beneficiary of a life insurance policy, and proceeds will be received U.S. income tax free by the beneficiary. However, if the foreign beneficiary is a spouse of the insured, his/her estate will not be entitled to the unlimited estate tax marital deduction available to U.S. spouses. In such a case, naming a Qualified Domestic Trust (QDOT) to receive the property may be advisable. Please see our BYA on Non-Citizen Estate and Gift Tax Treatment for more information.

19. What is an "irrevocable" beneficiary designation?

By designating a beneficiary as 'Irrevocable' typically the owner cannot make future changes to the policy without the consent of the named irrevocable beneficiary. The changes that require the consent of the irrevocable beneficiary include: a change to the beneficiary, an assignment, or requesting a loan, a surrender, or a withdrawal.

Appendix

The following sample wording for beneficiary designations is provided as a reference only and assumes a John Hancock Application for Life Insurance or Beneficiary Designation form is being used. Clients must seek their own tax counsel to determine the appropriate wording based on the client's specific planning goals.

For John Hancock policies, unless otherwise specified, beneficiaries in the same beneficiary class (e.g., primary or secondary beneficiaries) will share equally in any death benefit payable to them. If proceeds are to be paid in unequal shares, express the shares as a percentage of the proceeds payable.

If a beneficiary dies before the insured, his or her share will be allocated equally among any surviving beneficiaries in the same class, unless stated otherwise. In other words, if division per stirpes or per capita is not specified, proceeds typically will be divided among the surviving beneficiaries equally with no proceeds payable to the issue of a deceased beneficiary. If there is no remaining beneficiary in the same class, the proceeds are payable to the contingent beneficiaries (i.e., secondary beneficiaries). If no contingent beneficiary is named or alive at the time the proceeds are payable, the proceeds will be paid to the insured's estate.

Proceeds payable to	Sample wording	Note
Insured's estate	Estate of the Life Insured	
First to spouse then to children	**Primary:** Mary J. Doe, wife of the insured **Secondary:** John Doe, James Doe, and Ann Smith, children	If spouse predeceases the insured, the proceeds will be payable to the surviving children in equal shares.
Testamentary Trust	The trustee of the trust created in the instrument admitted to probate as my Last Will and Testament; provided, however, should my Last Will and Testament contain no Trust or not be admitted to probate or should I die intestate, then to my estate.	
Multiple beneficiaries in equal amounts	**Primary:** To my children, Jane Doe and John Doe **Secondary:** To my issue, per stirpes	Proceeds paid in equal amounts (e.g. 50/50) to Jane and John. If one of the children has predeceased the insured, the surviving child will receive 100% of the death benefit. If both children predecease the insured, the death benefit will be paid to insured's issue living at the time of death, per stirpes.
Multiple beneficiaries in unequal amounts	75% to Jane Doe, daughter, and 25% to John Doe, son.	Always use percentages when allocating proceeds unequally among the beneficiaries. A contingent beneficiary will not take until all members of the primary class are deceased. E.g., if Jane Doe predeceases John Doe, John Doe will receive 100% and Jane's heirs will not receive anything.

Proceeds payable to	Sample wording	Note
Children	To Jane Doe, daughter, John Doe, son, David Doe, son, equally or to the survivors among them, per stirpes.	As a practical matter, children should be specifically named to avoid any confusion. Designating children as a general "class" of beneficiaries may be a better practice than naming specific children if the intention is to have all children as beneficiaries. For example, if specific children are named and another child is born after the policy is issued, the after-born child could be inadvertently omitted as a beneficiary.
Minor children	John Doe, James Doe, and Ann Smith, my children. Any payment due to a beneficiary during minority shall instead be paid to Dan Smith, guardian, for the benefit of such beneficiary.	
Minor children, payable to UTMA account	John Doe, James Doe, and Ann Smith, my children. Any payment due to a beneficiary during minority shall be paid to Dan Smith, custodian, for the benefit of such minor beneficiary under the [name state] Uniform Transfers to Minors Act.	Please refer to the applicable State's UTMA law to confirm proper wording.

1. The age of majority varies by state (generally age 18 or 21) and, under some state laws, the donor can designate the custodian to hold the assets even past the age of majority. The grantor of an UGMA/UTMA account should refer to the applicable statutes in their state and/or legal counsel for more information on state-specific law.

2. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds.

3. See, e.g., 20 Pa.C.S. § 6111.2; and Va. Code § 20-111.1.

4. See, Sveen et al. v. Melin, 584 U.S. , Slip Opinion No. 16-1432, June 11, 2018.

5. See Egelhoff v. Egelhoff, 532 U.S. 141 (2001) (holding that the WA state statute had a "connection with" ERISA plans and therefore ERISA superseded state law); Hillman v.

Maretta, 133 S. Ct. 1943, 186 L. Ed. 2d 43, 2013 U.S. LEXIS 4167 (holding that federal law pre-empted the VA state statute which revoked an ex-spouse's beneficiary interest in a Federal Employees' Group Life Insurance policy).

6. Whether the proceeds of a life insurance contract are included in the gross estate of the insured depends upon whether, at the time of death (or within the three-year period prior to death) the insured held any "incidents of ownership" with respect to the policy. IRC §§2042 and 2035(d)(2).

7. Goodman v. Commissioner, 156 F.2d 218 (2nd Cir. 1946).

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