There are a number of issues to be resolved when a couple divorces. Paramount among them is property ownership after the divorce, including the ownership of the couple’s life insurance policies. The parties must decide who will be the owners and beneficiaries of their life insurance policies. In addition, the divorce settlement or a divorce court judgment may require the “providing” spouse to maintain a life insurance policy to cover his or her alimony and/or child support obligations to the “recipient” spouse. To complicate matters, divorce laws vary by state. This article will address the major issues a divorcing couple (and their attorneys) must consider with regard to life insurance.

Changing Beneficiaries

Most married individuals name their spouse as the primary beneficiary of their life insurance policies. In some states, a beneficiary designation naming a spouse is automatically revoked upon divorce. In such cases, the death proceeds will pass to the contingent beneficiary. If state law does not automatically invalidate the beneficiary designation upon divorce, an ex-spouse will remain as beneficiary until replaced under a newly executed designation. Therefore, beneficiary designations should be changed as soon as it appears that a divorce may be imminent, and no later than when the divorce is final.

Employer-provided life insurance. Changing the beneficiary designation is necessary even if the insured lives in a state whose law automatically revokes the designation of an ex-spouse upon divorce. Employer-sponsored life insurance plans (as well as employer sponsored retirement plans) are specifically governed by a body of federal law known as the Employee Retirement Income Security Act of 1974 (ERISA), specifically intended to govern such benefits. In Egelhoff v Egelhoff the United States Supreme Court ruled that ERISA “trumped” state law and therefore life insurance benefits had to be paid to the named beneficiary (the ex-spouse) despite a Washington state law that required automatic revocation of the ex-spouse as beneficiary. Thus, beneficiary designations for employer-sponsored life insurance should be changed when marital problems arise and certainly no later than the date the divorce is finalized.

A life insurance policy owned by an ILIT. What happens if a life insurance policy is owned by an irrevocable life insurance trust (“ILIT”) for the benefit of an ex-spouse and children? Such trusts cannot be amended or revoked for estate tax reasons. However, if properly drafted, the ILIT will contain a clause that solves the problem by requiring distributions from the trust as if the ex-spouse had predeceased the grantor.

If the ILIT does not contain such a provision, there are several options to correct the problem:

♦ As part of the divorce settlement, the grantor’s spouse can agree to disclaim or renounce his or her rights in the ILIT.
♦ The grantor could request a court to amend the trust agreement to remove his or her ex-spouse as a beneficiary.
♦ The grantor can create a new ILIT and have it purchase the policy from the old ILIT for its cash surrender value (thereby leaving just the sales proceeds in the old ILIT).
♦ If the grantor is still insurable, the grantor could purchase a new policy (owned by a new ILIT) and have the trustee of the old ILIT surrender the old policy (leaving just the cash surrender value in the old ILIT).
Naming New Beneficiaries

While it is important that beneficiary designations be reviewed when a couple divorces, it is equally important to carefully consider who the new beneficiaries will be. For example, the insured should not name his or her minor children as beneficiaries. This is a common mistake and can complicate matters since an ex-spouse (as the natural guardian of the minor children) may end up controlling the death proceeds. Instead, the insured should set up an ILIT to be the owner and beneficiary of the life insurance policy so that a trustee of the insured’s choosing will have control.

Using an ILIT will provide three additional advantages:

♦ If the insured dies three or more years after transferring the policy to the ILIT, the death proceeds will not be subject to federal estate taxes.

♦ The insured gets to name a trustee to manage and distribute the death proceeds for his or her children, thereby eliminating the possibility that an ex-spouse may have some say in how the proceeds are to be invested and distributed.

♦ Because the trustee holds legal title to the assets, and not the children, the ILIT can protect the children from their inability, their disability, their creditors and their predators, including their divorced spouses.

Policy Ownership

The owner of a life insurance policy has all rights over the policy, such as the right to change the beneficiaries, the right to borrow against the cash values, and the right to surrender the policy. Thus, the divorce settlement must address policy ownership, particularly where one spouse owns a policy on the other spouse’s life. Usually, the divorce judgment or property settlement agreement will require the insured spouse to become the owner of all policies insuring his or her life. But, of course, the parties can always agree otherwise.

When the parties agree that one spouse will continue to own a policy on his or her ex-spouse’s life after the divorce, the issue of “insurable interest” arises. Every state has an insurable interest rule that, if not met, negates the policy. Generally, that rule exists (as a matter of public policy) to prevent someone from profiting when the death of someone else would not cause him or her any financial loss. Clearly, the insurable interest rule is not violated when a spouse purchases a policy on his or her spouse’s life. But what if the owner of the policy and the insured are no longer married? Arguably, the insurable interest might cease following the dissolution of the marriage. Most state laws, however, provide that while there must be an insurable interest at the time the insurance is purchased, it need not continue until death. Therefore, where an individual continues to own a policy on an ex-spouse, the policy will be unaffected by the fact that the original insurable interest no longer exists.

Transferring a Policy

If, in connection with a divorce settlement after July 18, 1994, one spouse transfers an existing life insurance policy on his or her life to an ex-spouse, the transferor spouse recognizes no gain. Instead, the recipient spouse will have a cost basis in the policy equal to the net premiums paid by the transferor spouse. In addition, the death proceeds will be income tax free. Normally, when a policy is transferred for value, a portion of the death proceeds are subject to income taxation. However, there is an exception to this “transfer-for-value” rule under these circumstances.

Maintaining Life Insurance to Secure Alimony or Child Support Payments

It is very common for the divorce decree or property settlement agreement to require that the providing spouse maintain a life insurance policy on his or her life during the period that alimony and child support payments are being made. Such a provision presents a number of issues that both spouses and their attorneys must address:

♦ **What type of insurance should be used?**

The shorter the obligation, the more likely term insurance will be advisable. Conversely, the longer the time frame, the more likely some form of permanent insurance should be used. For example, when lifetime alimony payments are required, permanent insurance will usually be preferred.
How can the recipient spouse be assured that the life insurance policy remains in force? Theoretically, the ideal policy would be one that is fully paid, but it is unlikely that this would be financially viable or agreed to by the parties. The next best option would be to require annual premium payments. Annual payments simplify the recipient spouse’s monitoring burdens. Another option would be for the premiums to be automatically deducted from the providing spouse’s checking account. In either case, the recipient spouse should automatically be given written notification by the carrier when the premium is not paid. If the carrier does not offer such a service, then at a minimum the recipient spouse should be able to call the carrier to verify that the premium has been paid.

What are the income tax consequences to the parties? For divorce decrees entered into after 1984, if the recipient spouse is the owner of the policy, the premiums paid by the providing spouse are deductible as alimony payments and taxable (as ordinary income) to the recipient spouse. Moreover, the death proceeds will be received by the recipient spouse income tax free. If, however, the providing spouse owns the policy, then the premium payments are not deductible to the providing spouse and are not taxable to the recipient spouse. But the installment payments of the death proceeds would be taxable to the recipient spouse.

What are the estate tax consequences to the providing spouse? If the providing spouse owns the policy, the insurance proceeds will be taxed in his or her estate. However, the IRS’s position is that where a divorced spouse is required by the terms of a divorce decree to maintain insurance on his or her life payable to an ex-spouse (or to a child), an offsetting deduction is allowed the deceased spouse’s estate.

Summary

As we see, there are a number of issues — both tax and non-tax-related — concerning life insurance incident to a divorce. The insurance decisions one makes (or does not make) can wind up costing more than ever imagined. Therefore, if you are considering a divorce, you should consult not only with a divorce attorney, but also with a life insurance professional or financial planner to make sure you are adequately protected.

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Julius H. Giarmarco, attorney, is a partner in Giarmarco, Mullins & Horton, P.C. located in Troy, Michigan. Mr. Giarmarco specializes in estate and business planning for owners of closely held businesses, professionals and individuals with large estates. He has written several articles on estate planning and has also lectured extensively on estate and business planning at national and local institutes sponsored by professional organizations and companies providing financial services and products. This brochure is designed to provide accurate (at the time of printing) and authoritative information with regard to the subject matter covered. This brochure is based on the laws applicable to common law states, and not necessarily the laws of community property states. It must not be used as the basis for legal or tax advice. In specific cases, the parties involved must always seek out and rely on the counsel of their own attorneys. Thus, responsibility for modifying and guiding any party’s action with respect to legal and tax matters is placed where it belongs — with his or her own legal counsel.

This article contains information to help you understand estate planning issues, including how life insurance can be used to help meet clients’ needs. Although it refers to legal and tax considerations, it is not meant to provide advice in this regard. Legal and tax advice should come from an attorney and a tax advisor such as an accountant. These advisors can determine how any product or planning technique presented may benefit a particular situation and how best to utilize such product or technique.