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Life Insurance and Divorce

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What effect does divorce have on life insurance?

Like most of your financial planning objectives, your life insurance needs are related to the circumstances of your life. As your life goes through changes, your life insurance often needs to change with it.

No life change may be of more consequence than a divorce. In addition to the financial and emotional difficulties that often accompany divorce, there are special concerns about your life insurance. Generally, one spouse is the beneficiary of the other's insurance, and vice versa. So you have to think about whether to change your beneficiary and whom your new one will be. You also have to consider whether a new designation will have tax consequences. One thing is certain: A divorce will have an effect on your life insurance needs, and your policy must be updated to reflect them. Not all life insurance policies are just for death protection. You may have cash value policies such as whole life, universal life, variable universal life, or variable life that you've used to save for your children's college education or as a supplement to retirement. Divorce may not directly affect the savings side of your life insurance. Keep in mind, however, that the cash value of any savings may be considered part of the marital assets.

New and continuing needs for life insurance

In general

Early planning is essential for evaluating your new and continuing needs for life insurance . Your planning should begin long before the divorce is final. If you have children, protecting them will be one of your first concerns.

If you don't have children, protecting alimony payments that you are receiving may be on the top of your list. Life insurance could prove to be a beneficial protection. Your needs will differ depending on your post-divorce point of view. The parent who is responsible for the children (custodial parent) has different concerns than the parent who is not (the noncustodial parent). If you are a custodial parent, you should make sure that the life of the noncustodial parent is insured. You don't want to be in a position where the child support payments suddenly end because of the death of the parent responsible for paying them. The same thing applies to alimony payments. Life insurance can protect you and your children in case of the other parent's untimely death. If you are the noncustodial parent, you should insure the life of your custodial counterpart. If the other parent were to die, you would most likely gain custody of the children. This will increase your expenses dramatically, especially when multiple children are involved. Life insurance coverage can be used to help you protect your children's future.

Protecting yourself as the former spouse who has no insurance

Purchase a new policy on the life of your former spouse

Going out and purchasing a life insurance policy on your former spouse is the easiest way to protect yourself. You may not be able to afford it, however, or the other spouse may not be willing to go through the necessary physical examination and blood tests. The insurance company also has to agree that there is an insurable interest between former spouses.

Have existing policies transferred to you

If your former spouse has an existing policy on his or her life, it can be transferred to you as the policyowner and beneficiary for the protection of your alimony/child support payments. This can be planned as part of the divorce agreement. It's also a good option when you can't obtain new insurance on your former spouse.

Tip: *Including this in a divorce agreement is generally a good idea with respect to gift tax planning. Generally, if a husband and a wife enter into an agreement covering their property rights and divorce occurs within a specified period, all transfers of property under the agreement are considered made for full consideration and, therefore, are not subject to gift tax.*

Have alimony/child support payments increased to cover the cost of additional insurance

If you receive alimony payments, you can seek an increase in the amount of alimony paid by your former spouse by the amount necessary to insure his or her life. The insurance likely cannot be issued unless your former spouse agrees to be insured.

Caution: *The downside is that when you receive alimony payments, they are included as taxable income to you and can end if you remarry or die.*

If you receive child support payments, you can similarly seek to have them increased to cover the cost of life insurance. From the custodial parent's point of view, it's better to have the payments categorized as child support because they are not included as income to the custodial parent. The decision as to whether the payments are alimony or child support has to be worked out between you and your former spouse. This can, and should, be planned for in the divorce agreement.

Protecting your children as the parent who has insurance

Have the insurance proceeds paid to your child

Using the proceeds of your life insurance policy to protect your children is an obvious and practical planning choice. What's not so obvious is how to use your existing policy in a way that is most beneficial to you and your child.

Purchase a policy on your life for the custodial parent

If you are the noncustodial parent, a second option is to purchase a new policy on your life for the custodial parent. This way you can keep any policies you currently have and protect your children's future at the same time.

Tip: *The benefit of this choice is that the policy can be given to your spouse free from gift tax if given either before or as part of the divorce agreement.*

Tip: *If the policy is entirely in your former spouse's name and you have no incidents of ownership with respect to the policy (i.e., you don't retain any control of the policy in the event of contingencies, such as death or remarriage), you can pay the premiums on the policy and the premiums will likely be considered alimony and deductible for income tax purposes. The court decides many of these alimony/child support issues.*

Caution: *If you purchase a new policy for your former spouse, you won't be able to control who is designated beneficiary. Other options may provide you with more control.*

Beneficiary designation issues

In general

If you have a policy that designates your former spouse as beneficiary, the first thing you will probably want to do is change the designation. Before you do, there are beneficiary designation issues to consider.

Generally, the divorce itself will not remove your former spouse as the beneficiary, so you need to take action if you wish to change the beneficiary. If a court has ordered you to maintain an existing policy in favor of your former spouse, you cannot change it. Changing the beneficiary is usually as easy as calling up the insurer and requesting the appropriate paperwork. Occasionally, a physical endorsement will also be required.

Who to designate as beneficiary

You can generally designate any person or entity to be the beneficiary of your life insurance proceeds. The choice, however, typically boils down to either designating your estate or your children.

Caution: *Designating your estate as beneficiary may tie up the insurance proceeds in probate and may cause the insurance to be subject to estate taxes.*

If you have children, it's a good idea for you to designate them as your beneficiaries. This may not be as simple as it seems, however. There are many different ways to go about it, and each has various benefits and drawbacks. Four options are illustrated in the following table:

Children As Beneficiaries of Life Insurance--The Options

	Option	Benefits	Drawbacks
1.	Name your child beneficiary of your existing life insurance	• Easy to create • Inexpensive	• Proceeds are includable in your gross estate at death • Problematic for younger (minor) children • No control over how the proceeds are used
2.	Purchase an insurance policy on your life in your child's name	• Inexpensive and easy • Takes the proceeds of the insurance out of your gross estate • You can gift money to the child to pay the premiums (tax free up to the annual gift tax exclusion amount)	• Possible gift tax repercussions (depending on the cash value of the policy) • Minor children may not be able to own the policy • No control over how the proceeds are used
3.	Set up a trust to receive the insurance proceeds for the benefit of your child	• Great if you have young children • Greater control over how the proceeds are used • Easier to plan for multiple children	• Proceeds are includable in your gross estate at death • Involves cost to create (legal fees) and to maintain (trustee costs); means less money for your children
4.	Set up an irrevocable trust to purchase life insurance on your life for the benefit of your child	• Great if you have young children • Greater control over how the proceeds are used • Easier to plan for multiple children • Takes the proceeds of the insurance out of your gross estate, assuming that you retain no incidents of ownership • You can gift money to the trust to pay the premiums (tax free up to the annual gift tax exclusion amount and beneficiary has Crummey power)	• Possible gift tax repercussions (depending on the cash value of the policy) • Even more expensive to create (legal fees) and to maintain (trustee costs), because it's in existence longer than option 3

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