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White Paper

*New and Continuing Needs for
Life Insurance in Divorce*

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New and Continuing Needs for Life Insurance in Divorce

What is it?

You and your spouse have recently divorced or are planning to divorce. Either one of you may have life insurance policies in effect, and you probably have questions about your new and continuing needs for life insurance. You may be wondering if you still need to have life insurance coverage at all. More likely, you're wondering whether you will need additional insurance to protect your alimony or child support payments.

While married, you purchased life insurance as protection in case of the untimely death of yourself or your spouse. After a divorce, life insurance is still valuable protection for yourself and your family. Many of the concerns you shared while married will still apply after divorce. Almost as certainly, divorce will also create new concerns for you and your family.

Protecting your children

Insure the life of noncustodial parent

Much of the reason you purchased life insurance in the first place may have been to protect your children. The death of the parent responsible for child support payments could have a devastating impact on your children's financial future. The lost income could mean financial hardships for children who are dependent on the support for their basic needs and educational expenses. You will likely want to ensure that there is a sufficient amount of insurance on the life of the support-paying spouse to protect the children's financial future.

Change the beneficiary designation

Divorce may also create beneficiary designation issues. Your former spouse is often the beneficiary of your life insurance policy. Many people overlook the need to change the designation after a divorce--in fact, it should be one of the first things you do. Designating your child as the beneficiary is one option; designating your estate is another.

Caution: Designating the estate isn't as beneficial, however, because it could greatly increase the value of your estate and, thus, increase the potential estate tax exposure at the time of your death. As long as you live for three years after the designation, making your child beneficiary of an irrevocable life insurance trust can avoid these estate tax consequences. See Introduction to Estate Planning for more details.

Protecting your alimony/child-support payments

In general

If you are receiving alimony or child support payments, you should protect those payments by insuring the life of your former spouse. Support payments can be critical to your own well-being, as well as to your children's. There are some options.

Be named the beneficiary of your former spouse's policy

As part of the divorce settlement, the easiest option is to be named the beneficiary of any existing policies on your spouse's life. This will protect you in the event of your former spouse's untimely death.

Caution: Be aware that you will have no real control over the policy. The problem is that if your former spouse still owns the policy, anything can happen. He or she may take loans on the policy or fail to pay the premiums. There is more than one story in the big city of an unscrupulous spouse changing the beneficiary designation or taking a loan on the policy, leaving an unsuspecting former spouse with little or no protection.

Have existing life insurance policies transferred to you

Having the policy transferred or assigned to you can be a valuable alimony-protection tool. When you own the policy, you are protected from your former spouse taking loans or making any other changes to it. Another benefit of ownership is that the insurance company notifies you if the premium is not paid on time. Such a transfer should be part of the divorce agreement to avoid gift tax consequences.

You may also be able to have the divorce agreement require your former spouse to continue paying the premiums on the policy transferred to you. Depending on the cost of the premiums, this can be a big help. If there's some controversy over who will pay the premiums, think of it this way: If you pay them, you have the peace of mind to know that they are being paid in a timely fashion. Moreover, if your former spouse pays the premiums, they will likely be considered alimony and, therefore, taxable to you. More on tax considerations later.

Purchase additional insurance on your former spouse

As a slightly more difficult option, purchasing a policy on your former spouse can give you the protection you need along with much more control than if you are just the designated beneficiary. If it's too late to make any changes to the divorce or separation agreement, purchasing a separate insurance policy on the life of the former spouse may be your only option for protecting your alimony payments.

Caution: Buying life insurance can be an expensive proposition, especially if your former spouse is older or in poor health.

Caution: An unwilling ex-spouse may not go along with extensive physical examinations or underwriting that may be required to purchase a new policy. It's a good idea to make sure that the former spouse is willing to be insured before relying on this option.

Seek to have the alimony/child-support payments increased to cover the cost of additional insurance

It may be the most beneficial option for both of you to increase the alimony or child-support payments by the amount necessary to pay for a new policy. You and your spouse can agree to this as part of the divorce settlement. This option gives you total control over the policy while at the same time protecting your alimony/child support payments.

Caution: Remember that the alimony payments you receive are considered taxable income to you and are deductible by your former spouse. Notice the tax consequences in the following example.

Example(s): As part of their divorce agreement, John's former spouse, Mary, is required to pay \$500 per month in child support to John for their daughter, Abby (whom John has custody of) until she reaches age 18. Abby is 8 years old. The parties agree in the divorce settlement that the \$500 includes the cost of a 10-year term life insurance policy on Mary's life. Results: (1) The child support payments are protected until Abby reaches age 18, when they are to end normally, (2) Mary is happy because term life insurance is inexpensive, and (3) John is happy that the additional child support payments are not taxable to him as income.

Protecting yourself as the noncustodial parent

Insure the life of the custodial parent

Insuring the life of the custodial parent can protect you and the well-being of your children. If the custodial parent dies, you're the one who will have to take custody of the children. Financially, this could be a very difficult situation. All of the costs of raising the children will now fall on you as the only parent. From basic needs to higher education, these costs can be extensive. A policy on your former spouse's life can prove invaluable in meeting these costs.

Options if you have remarried

Qualified terminable interest property (QTIP) trust

If you have remarried, a QTIP trust can be a great method for supporting your new spouse, protecting children of a prior marriage, and deferring estate taxes. Upon your death, a QTIP trust holds assets for the benefit of your current spouse for his or her life and then pays the remaining funds to a third person (typically your children) designated by you. Since the transfer is between spouses, gift taxes are avoided

because the amounts used to fund the QTIP trust fall within the unlimited marital deduction. The QTIP trust also defers possible estate tax on the trust amount until the death of the surviving spouse.

Caution: The potential downside of the QTIP trust is that the children (or whomever you designate) will not be able to make use of the assets until the death of your spouse.

What are the tax considerations?

The gift tax applies to transfers and purchases of insurance policies

As part of the divorce settlement, you may decide to transfer your existing life insurance policy or purchase a new policy for your spouse or children.

Caution: Transfer of an existing cash value policy to your ex-spouse or your children may entail a substantial federal gift tax.

Tip: If the policy is transferred to your former spouse prior to--or as part of--the divorce, gift taxes are avoided because the transfer is between spouses. A little pre-divorce planning can go a long way.

Can the payment of insurance premiums be considered alimony?

The payment of insurance premiums can be considered alimony under certain circumstances. Payments that are considered alimony are deductible by the payor (the person making the payments) and includable as taxable income to the payee (the person receiving the payments). So, if the premium payments are considered alimony, the payor spouse gets a tax benefit.

Generally, premiums paid by the payor spouse for life insurance on the payor's life made under the terms of the divorce or separation instrument will qualify as alimony to the extent that the payee spouse is the owner of the policy. For the payment of premiums to be considered alimony, the beneficiary spouse must be made the owner and the irrevocable beneficiary of the policy. There cannot be any contingencies. For example, an agreement to pay insurance premiums until the payee spouse remarries or dies is a contingent one and, therefore, not tax-deductible as alimony.

Tip: If you can plan it ahead of time, it is better for the payor to agree to increase the amount of cash alimony paid by the amount necessary for the payee spouse to secure insurance on the payor's life and pay the premiums. This will be deductible as alimony by the payor and can be limited to contingent circumstances, such as remarriage or death. This solution serves both spouses' interests by creating a tax deduction for the payor and giving the payee complete control over the insurance policy.

Example(s): Spouse A agrees to an alimony payment of \$500 per month until Spouse B dies or remarries. Spouse B agrees to purchase insurance on the life of A with the money paid in alimony. Consequences: Spouse A receives a \$6,000 (\$500 X 12) income-tax deduction for

alimony payments. Spouse B gets \$6,000 additional income for income-tax purposes but also gets a substitute for the lost alimony if Spouse A dies.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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