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5 ways to screw up your life insurance

By Lynnette Khalfani-Cox

If you've had the good sense to buy life insurance, you're probably reasonably conscientious about planning for your financial future.

But even the most thoughtful among us can make boneheaded blunders when dealing with insurance companies.

Here are five ways to screw up your life insurance -- and some tips to avoid these costly mistakes.

1. Neglecting to tell your beneficiaries that you even have life insurance

For various reasons, many people who buy life insurance don't tell their relatives -- or even the executor they've chosen -- that they have an insurance policy. Some individuals want to avoid financial questions or prevent family squabbles over the topic.

Others choose not to discuss their coverage because they want the freedom to discretely change beneficiaries. And some people simply forget to bring up this important subject with loved ones.

"But somebody has to know, because if you die, and nobody knows about the life insurance, who is going to contact the insurance company and have a claim processed?" asks W. Stuart Woodbury Jr., president of the Stuart Woodbury Insurance Agency Inc. in Liberty, Mo.

For family members trying to track down a loved one's life insurance, "it's like a needle in a haystack," Woodbury says.

That's because life insurance companies operate in a fragmented market and "there isn't a national database to hunt down insurance policies," says Glenn Daily, a fee-only life insurance consultant (which means he takes no commissions) in New York.

When Daly gets calls from people who suspect that relatives had life insurance, he refers the callers to the MIB Group, which offers a policy locator service. However, the service only tracks applications submitted in the last 14 years. If your relative applied for life insurance 20 years ago, MIB won’t know about it.

The Social Security Administration keeps an updated database of the deceased called the Death Master File, which includes names, birth dates, Social Security numbers and last known addresses.

Life insurance companies that check the Death Master File against their own list of customers can find out when benefits are due and to whom. But insurers generally don’t bother to do so. Here’s more on why life insurance companies don’t care if you’re dead.

A quick fix for anyone reluctant to divulge life insurance policy information to relatives is to tell a lawyer, accountant or financial adviser about the policy. Alternatively, "make a copy of the face sheet of the insurance policy, which includes your name, policy number and the contact information for the insurance company," Woodbury suggests. "Then put it in a sealed envelope and give it to the person who will make financial decisions at your death."

2. Buying life insurance to benefit multiple people but naming only one beneficiary

Attorney and estate planning expert Andy Mayoras in Troy, Mich., says some people

buy life insurance with the intention that several heirs will split the proceeds. But policyholders -- especially parents -- often make the mistake of naming just one beneficiary under the misguided assumption that the named beneficiary will properly divide the insurance money.

The named beneficiary might be the oldest child, the one deemed most fiscally "responsible" or perhaps the child closest to the parent. Conversely, parents sometimes opt not to name certain adult children as beneficiaries because the child has credit problems or a shaky marriage that may end in divorce. Whatever the case, if just one person is named as beneficiary and the intent is for the money to be divided among multiple parties, you’re asking for trouble.

"Don't assume that whoever you name is going to do the right thing and share," says Mayoras, co-founder and director of The Center for Probate Litigation, a division of Barron, Rosenberg, Mayoras & Mayoras, P.C. in Michigan. "That's a common mistake and the source of a lot of legal disputes over life insurance."

The solution: Name multiple beneficiaries and spell out the percentage each person should receive. Alternatively, "put the life insurance in a trust, naming the trustee as the beneficiary. Then specify in the trust who gets what part of the life insurance and why," Mayoras recommends.

3. Forgetting to update crucial personal information

Policyholders frequently forget to update beneficiaries after a major life change, such as a marriage or divorce. Consider this: Even if you split up with a former husband or wife and remarry, if you haven't changed your beneficiary and you die, your ex-spouse is entitled to all your life insurance proceeds.

Other policyholders forget to tell their life insurance company that they have moved or changed banks. So suddenly, insurance bills aren't being received or monthly electronic bank drafts for insurance premiums aren't being processed.

"That happens all the time," says Woodbury. "It's one reason why every year we contact every client to go over a checklist of items to make sure everything is correct, like named beneficiaries, banking information and even our clients' addresses."

"It's hard to pay an insurance bill if you don't get it," Woodbury notes. Nonetheless, if missed bills result in a lapsed policy, people who have to re-qualify to buy life insurance may risk paying higher life insurance rates.

4. Repeatedly dipping into the cash value of your life insurance

Just like some people constantly take loans from their 401(k) plans, some people are habitual "borrowers" from their permanent life insurance policies, creating two potential problems.

First, regardless of your life insurance rates or the total premiums you've paid, any loans against the policy that remain outstanding when you die will reduce the death benefit paid to your beneficiaries.

Additionally, "the biggest caution is to be aware that if you're depleting your cash value and it's not considered a loan, it's going to be a taxable event," says Jean Dorrell, president of Senior Financial Security in Summerfield, Fla.

Non-loan insurance distributions will be taxed at your ordinary income tax rate. Ouch!

5. Dying with a large, underutilized cash value

When you buy life insurance that is permanent, your rates are higher than term life rates because permanent life insurance builds up cash value. But some experts think it's a waste of money to die with a large cash value that hasn't been liquidated or leveraged properly.

"You want to try to die with as little cash value as possible" in a permanent life insurance policy, says Dorrell. "Otherwise, [the cash value] just goes to the insurance company, and your beneficiaries simply get the death benefit."

Dorrell's advice: Older policyholders should call their life insurance companies and ask for a higher policy face value in exchange for the cash value.

"MetLife, Prudential, New York Life and Northwestern [Mutual] are among the companies that almost always will increase your death benefit with your cash value," says Dorrell. "They won't tell you about it upfront. But if you call and ask, they will generally do it for you."