LIFE ADVANCED MARKETS ESSENTIAL CONCEPTS

Understanding the tax trap of the Goodman Triangle

Whether life insurance is used by a business as part of a succession plan or by an individual to protect his or her family, most life insurance transactions focus primarily on the insured and who should receive the policy's death benefits. But thinking about the relationships between the policy owner, the insured, and the beneficiary is critical, especially when the owner, insured, and beneficiary are all different individuals or entities. Such situations may often lead to unintended gift-tax consequences.

The 1946 Tax Court case of *Goodman v. Commissioner* is a good example. The three-party situation described in the case is often referred to as the *Goodman Triangle* and the court's ruling as the *Goodman Rule*.

WHAT THE CASE WAS ABOUT

Mrs. Goodman owned several life insurance policies on her husband. In 1930, she transferred each of those policies to the trustees of a revocable trust, but as the donor, Mrs. Goodman failed to give up control of the trust. The beneficiaries of the trust were her three children, along with her husband's sister.

Following her husband's death in 1946, the trust became irrevocable, and the life insurance policies were deemed a completed, taxable gift at that time to the beneficiaries.

WHY THE CASE IS IMPORTANT

The outcome of the *Goodman* case highlights the importance of carefully considering who should be the owner, insured, and beneficiary of a life insurance policy to avoid potentially unintended – and sometimes adverse – gift-tax consequences.

A HYPOTHETICAL CASE STUDY THAT ILLUSTRATES THE RULE

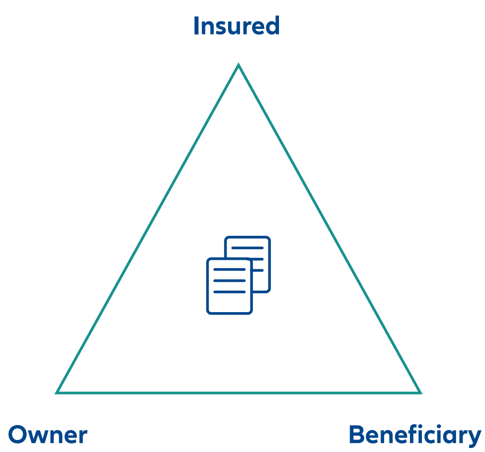
Andrew and Bob are equal co-owners of a successful business worth $20 million. They just signed a cross-purchase, buy-sell agreement. So if either Andrew or Bob dies while owning the business, the agreement requires the estate to transfer the deceased owner's interest to the surviving owner.

Andrew and Bob each agree to purchase a $10 million life insurance policy on the other. Now, if either dies while owning the business, their family will receive the life insurance death benefit as payment for the deceased owner's interest. Andrew and Bob each designate the spouse of the insured as beneficiary on each policy, believing that this arrangement will expedite future transfers.

Andrew dies a year later. Andrew's wife receives $10 million in life insurance proceeds. Bob is surprised to learn that, as the surviving business owner and owner of the policy on Andrew's life, he is deemed to have made a $10 million gift to Andrew's spouse as beneficiary.

A better, and more common, approach would have been to have each policy owner designate themselves as beneficiary. That way, once the policy owner received the death benefits, they could simply apply the proceeds to the purchase of the business from the deceased owner's estate.

GOODMAN RULE



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