PERSONAL STRATEGIES

Three-Party Life Insurance: The "Goodman Trap"

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FREQUENTLY ASKED QUESTIONS

Will there be adverse tax consequences to a policyowner where three different parties are designated as the owner, the insured, and the beneficiary of a life insurance policy?

Yes. Care must be exercised in structuring life insurance ownership and beneficiary arrangements to avoid the "Goodman Trap." The "Goodman Trap" structure exists when three different parties are designated as the owner, the insured, and the beneficiary of a life insurance policy.

The "Goodman Trap" is named for a famous 1946 federal court decision.[1] This court decision held that, where a "Goodman Trap" exists at the death of the insured, the owner of the policy (not the insured) will be deemed to have made a taxable gift of the entire death proceeds to the beneficiary.

The rationale for this result is this: There is no completed gift until the death of the insured since the policyowner maintains control over the policy, including the right to revoke or change the beneficiary. However, the insured's death has a dual effect: it instantaneously terminates the policyowner's right to change the beneficiary, thereby completing the gift; and it matures the policy.

When there are three on a policy, unless adjustments are made, the arrangement will result in a taxable gift to the beneficiaries by the policyowner when the insured dies:

- If the gift is **greater than the annual exclusion**, the owner will be forced to use his or her gift tax applicable exclusion amount.
- If the gift also **exceeds the available applicable exclusion amount**, the policyowner will owe gift tax and have no death benefit available to pay it, forcing the payment from other assets.

The "Goodman Trap" is often overlooked but can occur in situations like those that follow.

WITHIN A FAMILY

- **Situation A**: A spouse owns a policy on the life of the other spouse and the children are the beneficiaries. At the insured spouse's death, the surviving spouse will be considered to have made a taxable gift of the death proceeds to the children.
- **Situation B**: One child is the owner of a life insurance policy insuring a parent, and multiple children are beneficiaries. At the death of the insured parent, the child owning the policy will be deemed to have made gifts to the other beneficiaries equal to their individual shares of the policy proceeds.

Community property states present special problems. In those states, each spouse is considered to own 50% of all community property assets. This includes life insurance policies, even if just one spouse is listed as owner on the application and policy. If children are listed as beneficiaries on a policy where one spouse is the insured/applicant and owner, the nonowner spouse has still made a taxable gift to the children when the insured spouse dies.

- For example, assume that the husband is the owner of a policy insuring him for $1,000,000 and that his wife and three children are each listed as beneficiaries of 25% of the death benefit. At the husband's death, each child receives $250,000. If premiums were paid from community property funds, the wife will have made a taxable gift of one half of that amount ($125,000) to each child.

[1]Goodman v. Commissioner, 156 F.2d 218 (2d Cir. 1946).

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WITHIN A BUSINESS

- **Situation**: A business is the owner of a policy insuring an employee or shareholder and the employee's spouse is the beneficiary. In this situation, the death of the insured could cause the death proceeds to be taxed to the beneficiary as compensation or as a dividend.

POTENTIAL SOLUTIONS

- **Have the insured be the sole owner of the policy**. Of course, this solution will cause the death proceeds to be included in the insured's gross estate.
- **Have the policy beneficiary(ies) be the owner(s)**. In community property states, where one spouse is the owner/applicant/insured and the children are listed as beneficiaries, premiums should be paid from the owner spouse's separate assets.

While changing policy ownership to avoid the tax consequences of the "Goodman Trap" might seem like a logical solution, care must be taken that other adverse tax consequences are not the result. The change of ownership could itself be a taxable gift or, in some cases, could constitute a transfer-for-value, subjecting all or a portion of the death benefit to income tax.

To avoid any potential tax traps, your tax and legal advisors should carefully review the initial selection of policy ownership and beneficiary designations, as well as any subsequent changes.