Beware the "Goodman Triangle" . . . Avoid It!

by Candice Faith, CLU, ChFC
Assistant Vice President, Marketing

You have heard of the Bermuda Triangle and the dangers there. You are aware of the potential problems inherent in an "Eternal Triangle." Now, you will discover a third risky triangle, the "Goodman Triangle."

Well-meaning Intentions.

A loving grandparent wants to see that her grandchildren are provided for if their father, her son, should die prematurely. She purchases a policy on her son and names the children as the beneficiaries. She may have even gone so far as to create a revocable trust on the children's behalf. You've heard it said that, "No good deed goes unpunished." In this case, it is true. If her son dies, the death benefit becomes a "completed gift" and our generous grandparent/policyowner may owe "gift taxes" on the death benefit received by her grandchildren.

A caring husband/father needs life insurance coverage, but doesn't want the death benefit to be included in his estate. He and his wife decide that by having the wife purchase the policy, this will avoid estate taxes on the death benefit. She becomes the policy owner and names their children as the beneficiaries. Again, a gift tax alert should be sounded.

Or, similar scenario, the adult child is the owner of the policy on a parent and the beneficiaries are the adult child/policyowner and all of the siblings. Sound the alert.

The "Goodman Triangle"

What do these three scenarios have in common that should bring on an alert? The insured is one person, the owner is a second person, and the beneficiary(ies) either is, or includes, a third person(s). This is the "Goodman Triangle;" three parties having an interest in one life insurance contract.

Goodman v. Commissioner, 156F2d 218 (2nd Cir. 1946)

In 1930, Mrs. Goodman, who owned several policies on her husband, transferred the policies to a Revocable Trust and named her three children and her sister-in-law the beneficiaries of the trust. When her husband died in 1939, the trust became an Irrevocable Trust and the policies became a "completed gift" to the beneficiaries of the trust. This triggered a gift tax. As the donor, Mrs. Goodman was responsible for paying the gift tax. Thus the "Goodman Triangle" was born.

Incomplete vs Completed

As long as Mrs. Goodman retained some control over the life insurance policies, the gift was "incomplete." She could have changed the beneficiary, therefore the gift was not "completed" until the trust became irrevocable at the death of the insured, her husband.

Knowing the difference between an "incomplete gift" and a "completed" gift is important to avoiding this tax trap. A gift is complete once the donor has relinquished the power to reclaim the benefit or to rename who will receive the benefit or to change the interests of the beneficiaries. If the insured dies, this "completes" the gift as the terms of the life insurance contract cannot be changed. Once the gift is "completed" the value of the gift is determined and the donor becomes responsible for any taxes due.

If you think the gift should actually be the premiums paid or the cash value of the policy, it is not. That ship sailed. The death benefit is the gift amount less any interest in the death benefit retained by the donor. Limiting the gift to the premiums paid or the cash value could have been arranged during the lifetime of the insured. A life insurance policy can be designed with a split dollar arrangement or an irrevocable trust may be the owner and beneficiary.

(Continued)

Avoid It!

When completing the life insurance application, gift tax, estate tax and income tax questions should be considered. When your client purchases life insurance, it is usually with an objective in mind. The client may be interested in keeping the death benefit out of his/her estate. This is a common objective. The agent may suggest that the spouse own the policy and be the beneficiary. This arrangement will not create a gift tax.

However, if the client wants his/her children to be the beneficiaries, the surviving spouse/policyowner will have gift taxes to pay. Remember, the parties to the policy should not exceed two. The insured or the beneficiary must be the policyowner to avoid gift tax complications. The remedy may be creating an Irrevocable Trust for the benefit of the children. The "trust" would then own and be the beneficiary of the life insurance policy.

Caution: If the policyowner is the beneficiary and there are other primary beneficiaries, there will be gift tax complications. Again, an irrevocable trust may be the solution. Applying for multiple life insurance policies may be an alternative as well. The client's objectives, personal situation and comfort level determine the final decision.

It can be corrected!

The Goodman Triangle is easy to spot and it can be corrected. With proper planning it can be avoided and you can still accomplish your client's objectives. When approaching new prospects, mentioning the Goodman Triangle may give rise to at least their considering allowing you to conduct a policy audit. The Goodman Triangle may get your foot in the door. Policy audits can open the door—please refer to "Policy Audits: Boring? Or Revealing", Form 0013051.

Every time you complete an application for a client, the Goodman Triangle should be one of the pitfalls you avoid. If you have questions about this topic or have a client situation you want to discuss, give me a call at 607-338-7375.

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INSURANCE COMPANY OF NEW YORK
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P.O. BOX 1625 • BINGHAMTON, NY 13902-1625
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