John Hancock INSURANCE

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# The "Goodman Triangle"

Life insurance contracts are somewhat unique in that there are three distinct parties that may be associated with a policy: the policy owner, the insured, and the beneficiary. When these parties are all different an unexpected gift tax liability may result. This three-party scenario is commonly referred to as a "Goodman Triangle" after the 1946 Tax Court case, *Goodman v. Commissioner,* 156 F.2d 218 (2nd Cir., 1946).

## *Goodman v. Commissioner*

**FACTS:** Mrs. Goodman transferred five existing policies insuring her husband's life to a REVOCABLE life insurance trust in 1930. Beneficiaries of the trust were her three children and her sister-in-law. In 1939, her husband died and the trust became irrevocable.

**FINDING:** The Court held that at the time that the trust became irrevocable, Mrs. Goodman had made a gift to the trust beneficiaries equal to the value of the trust, which included all of the death benefits from the policies insuring her husband.

**SIGNIFICANCE:** The Goodman Triangle can cause unexpected gift tax liability in any situation where a life insurance policy is owned by one person on another's life and names a third person (who is not the owner's spouse) as the policy beneficiary. Although the *Goodman* case involved a revocable trust, most Goodman Triangle situations result when there is personal ownership as opposed to trust ownership. Consider the following example:

> ***Example:*** Terri wants to insure her life for $3M. She recognizes that life insurance will create a source of liquid assets that will allow her family to pay estate taxes after her death. Her oldest son, Nathan, is named as owner of a $3M life insurance policy on Terri's life. Beneficiaries of the policy are Nathan and his two siblings — Zachariah and Alexander. Terri doesn't see the need for paying the expenses of creating an irrevocable life insurance trust (ILIT), since Nathan can hold the policy for the benefit of himself and his brothers. Upon Terri's death, the $3M death benefit will be paid in equal shares to Nathan, Zachariah, and Alexander. But, to Nathan's surprise, as owner of the life insurance policy, he will be deemed to have made taxable gift of $2M to his brothers when the death benefit is paid.

To avoid the Goodman Triangle tax trap, most clients will use an irrevocable life insurance trust (ILIT) to own the policy. Although there are expenses associated with the creation of an ILIT, the use of an ILIT in the above example would have helped keep the death benefits out of Terri's estate and avoided the gifting issues when death proceeds are paid out. Use of an ILIT would also help to provide creditor protection and afford Terri more control over how the proceeds are distributed to the beneficiaries.

### PLANNING NOTE

It should also be noted that a three-party scenario also can be problematic in an employer/business scenario where a business owns the policy on the life of an employee or shareholder and names an outside entity or individual as the beneficiary. Although not technically a Goodman Triangle as it is not related to gift taxes, this type of arrangement can cause income taxation of the death benefit received by the third-party beneficiary. To avoid income taxation, typically the employee or shareholder must pay or recognize an economic benefit each year associated with the death benefit receivable. See Split Dollar Regulations at Treas. Reg. 1.61-22

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