Three-Party Life Insurance: Unholy Trinity Taxation

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

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

This situation is also known as the "Goodman Trap," named for a famous 1946 Federal Court decision.[1] This court decision held that, where an "unholy trinity" 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 policy owner 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 policy owner's right to change the beneficiary, thereby completing the gift, and it matures the policy.

The "unholy trinity" problem is often overlooked. You should watch for situations in which an individual other than the insured or beneficiary owns the policy. Several examples will illustrate the problem.

One common situation is created where 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.

The problem also occurs when 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.

Another variation to the three-party policy structure occurs when 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.

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

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

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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.

The "unholy trinity" can be avoided. One solution is for the insured to 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. Another solution is to 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 "unholy trinity" might seem like a logical solution, care must be taken that other adverse tax consequences are not the result. The change of ownership could in 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.

In Summary. Always be suspicious where there are "three on a policy." Unless adjustments are made, the arrangement will result in a taxable gift to the beneficiaries by the policy owner at the death of the insured. 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 policy owner will owe gift tax and have no death benefit available to pay it, forcing the payment from other assets.

Clearly, to avoid any potential tax traps, the client's tax and legal advisors should carefully review the initial selection of policy ownership and beneficiary designations as well as any subsequent changes