Costly Life Insurance Mistakes (Part 1)

GOODMAN VIOLATION

Also known as the Goodman Triangle, this violation 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. This is most commonly a problem where a policy on a parent's life is owned by one adult child and other children are named beneficiaries. *Reference: Goodman V Comm'r, 156 F 2d 218 (2d Cir. 1946)*

FAILING TO COMPLY WITH 101(J)

"Employer-owned contracts" issued after August 17, 2006, that fail to comply with requirements in IRC §101(j) result in a portion of the death benefit subject to income tax. In order to be compliant, employers must make sure that prior to issue, notice and consent requirements are met by all employees covered. Possible contracts affected include key person coverage, nonqualified deferred compensation, split dollar and buy-sell arrangements. The only way to fix the problem is to start over. *Reference: 26 U.S.C. § 101(j)*

BOOT TRANSACTIONS

These transactions occur when cash is taken or shifted, via withdrawal or internal withdrawal, to repay an existing loan - 12 months before or 12 months after a 1035 exchange if using the internal policy values. The amount of the withdrawal is considered 'Boot' compensation in addition to the like kind exchange, and will be taxed up to the extent there is gain inside the contract. *Reference: PLR 8905004; 26 U.S.C. § 72 and §1031(b)*

TRANSFER FOR VALUE

A transfer of a policy in exchange for value will result in a portion of the death benefit proceeds being subject to ordinary income tax, except where the transfer is to one of the five statutory exceptions. Transfer is broadly defined to include any transfer of a right to receive all, or any part, of a life insurance policy and can even include term insurance. *Reference: 26 U.S.C. § 101(a)(2)*

WITHDRAWAL IN THE FIRST 15 POLICY YEARS

For non-MECs issued after 1984, any time there is a distribution that is accompanied by a reduction in the death benefit in the first 15 years of a "cash-rich" policy, the policy must be tested to determine if it should be subject to tax. It's important to either use loans rather than withdrawals in the first 15 years or to defer withdrawals until after the 15th year. *Reference: 26 U.S.C. § 7702*

100 Cummings Center, Ste. 442P ■ Beverly, MA 01915 ■ 978-927-2008 ■ 888-927-2008 ■ www.thebishopcompanyllc.com