FEDERAL ESTATE TAXATION OF LIFE INSURANCE: YOU CAN'T TAKE IT WITH YOU AND IT'S OFTEN HARD TO LEAVE IT BEHIND

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The science of divesting yourself of something you don't actually have becomes more than a metaphysical exercise when it involves removing life insurance on your own life from the reach of the Federal Estate Tax. Several factors are causing this Federal Estate Tax problem to become a more frequently occurring one. Among these are the greater use of life insurance,[1] the fact that the dollar amount of the exemption has remained unchanged,[2] and an ever broadening interpretation of the guidelines for inclusion of life insurance proceeds on the life of the insured decedent.

This Article attempts to define the guidelines which have been drawn by the Federal Tax Regulations, court decisions, Revenue Rulings, and other government promulgations[3] in interpreting the content and scope of section 2042[4] of the Internal Revenue Code of 1954.[5] A discussion of section 2042 involves several other sections of the Code which will also be covered as they pertain to the proceeds of life insurance. Several specific problem areas such as the assignment of employee group life insurance, policies owned by the closely held corporation, insurance owned in connection with partnership agreements, and the use of insurance trusts will be covered.

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1 STATISTICAL ABSTRACT OF THE UNITED STATES. The total amount of life insurance in force in the United States has increased from $372,332 million in 1955 to $1,402,758 million in 1970. This means that there was approximately 3.45 times as much insurance in force in 1970 as in 1955, the year following the enactment of the Internal Revenue Code of 1954. Only $111,699 million of this amount should be attributed to inflation during this period. Since the average amount of life insurance on each insured individual approximately doubled during this same period, this means that both a greater number of persons were availing themselves of life insurance and those that were did so with larger amounts.

2 INT. REV. CODE of 1954, § 2052. The exemption per estate has always been $60,000 under the provisions of the 1954 Code, while personal income has increased from $1881 to $3676 per capita during the period 1955 to 1969 (the last year accurate figures are available).

3 Although a complete definition to include a discussion of the significance of each of these authorities is too lengthy to attempt here, in brief, the Regulations are written by the Commissioner of Internal Revenue, under authorization of Congress, as a means of putting into effect the will of Congress as expressed by statute.

4 "Proceeds of Life Insurance".

5 All references to the Code in this article will pertain to the Internal Revenue Code of 1954 unless otherwise specified.

I. An Analysis of Life Insurance on the Life of The Decedent—Authority for Inclusion

The primary Code section[6] which is the authority for including life insurance proceeds from policies owned by the decedent in his gross estate for Federal Estate Tax purposes is brief. It sets out two conditions for inclusion; proceeds which the decedent would have owned and controlled had he somehow survived,[7] and the proceeds of those policies on his life in which the decedent possessed at his death a power called an "incident of ownership."[8] The section contains a further elaboration almost in the form of a caveat which reminds the taxpayer that an incident of ownership includes a reversionary interest followed by an explanation of a reversionary interest using section 2037 language.

The corresponding Regulation sections[9] clarify the legislative intent somewhat by adding the information that death benefits paid by societies operating under the lodge system are part of the "life insurance of every description" referred to,[10] and further explaining that the proceeds of life insurance are to be treated no differently than any other asset if circumstances would dictate their inclusion.[11] The transfer in contemplation of death is used for an example, but

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[6] Int. Rev. Code of 1954, § 2042 states: Proceeds of Life Insurance

The value of the gross estate shall include the value of all property—

(I) Receivable by the executor—To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.

(II) Receivable by other beneficiaries—To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, excercisable either alone or in conjunction with any other person. For purposes of the preceding sentence, the term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 per cent of the value of the policy immediately before the death of the decedent. As used in this paragraph, the term "reversionary interest" includes a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him. The value of a reversionary interest at any time shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, pursuant to regulations prescribed by the Secretary or his delegate. In determining the value of a possibility that the policy or proceeds thereof may be subject to a power of disposition by the decedent, such possibility shall be valued as if it were a possibility that such policy or proceeds may return to the decedent or his estate.

[7] Int. Rev. Code of 1954, § 2042(1). Inasmuch as the executor stands in the shoes of the decedent for the handling of his affairs during the administration of the estate, it could be considered that the decedent himself is the actual recipient of these proceeds of life insurance on his own life.

[8] *Id.* § 2042(2). Even though the decedent's representative (the executor) possesses no control over the proceeds of life insurance on the life of the decedent passing directly to beneficiaries other than the estate itself, these sums are still included in the gross estate if the decedent himself possessed such powers immediately before he died, transferred them in contemplation of death, or had more than a 5% possibility that he would regain such a power immediately before his death. See Treas. Reg. § 20.2042-1(c) (1958).

[9] 26 C.F.R. 20.2042-1 (1971).

[10] 26 C.F.R. 20.2042-1(a)(1) (1971).

[11] 26 C.F.R. 20.2042-1(a)(2) (1971).

the language used clearly indicates that this is not the only Code section of which the taxpayer should be aware in his treatment of life insurance.[12]

The fact that the executor or the estate itself is not named as the beneficiary under the terms of the policy is immaterial when considering whether the estate is the actual benefactor, directly or indirectly, of the proceeds under the first of the two broad areas of this section authorizing inclusion. In describing the scope of the second test for inclusion in the decedent's gross estate, the incidents of ownership test, the regulations set forth, "the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.," as examples of strings which would pull the proceeds into the decedent's gross estate.[13] Almost, as an afterthought, it appears, the drafters felt that the "substance over form" test should not be forgotten when they stated, "Similarly, the term includes a power to change the beneficiary reserved to a corporation of which the decedent is the sole stockholder."[14] This tightly drawn admonition has been enlarged upon by case law as we shall see later.

II. A Definition of Life Insurance—Case Law Says What The Statute Implies

Perhaps the Commissioner of Internal Revenue[15] attributed the same intuitiveness to taxpayers that Associate Justice Stewart seemed to possess when the Supreme Court was seeking a working definition for pornography. Justice Stewart said, "I know it when I see it."[16]

In any event, the phrase in the Regulations, "The term insurance refers to life insurance of every description,"[17] has served as a skeleton upon which case law and Revenue Rulings have fastened the definitive flesh necessary to apply this portion of the estate tax law. Beginning with the ordinary life insurance policy as a given, the definition has been held to include term insurance,[18] accident insurance,[19] double indemnity policies,[20] endowment policies which are not completely paid up,[21] group policies,[22] National Service Life Insurance,[23]

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[12] 26 C.F.R. 20.2042-1(a)(2) (1971) states: ". . . be includible under some other section of part III of subchapter A of chapter 11. . . ."

[13] 26 C.F.R. 20.2042-1(c)(2) (1971).

[14] 26 C.F.R. 20.2042-1(c)(2) (1971).

[15] All future references to the Commissioner in this article will pertain to the Commissioner of Internal Revenue.

[16] Jacobellis v. Ohio, 378 U.S. 184, 197 (1964).

[17] 26 C.F.R. 20.2042-1(a)(1) (1971)

[18] Rev. Rul. 68-334, 1968-1 Cum. Bull. 397.

[19] Ackerman v. Commissioner, 15 B.T.A. 635 (1929)

[20] Rev. Rul. 61-123, 1961-2 Cum. Bull. 151; Commissioner v. Noel, 380 U.S. 678 (1965).

[21] Altschuler v. United States, 169 F. Supp. 456 (W.D. Mo. 1958); In re Estate of Michael Collino, 25 T.C. 1026 (1956). Rev. Rul. 68-334, 1968 Cum. Bull. 397.

[22] Rev. Rul. 68-334, 1968-1 Cum. Bull. 397; In re Estate of Ballinger, 23 B.T.A. 1312 (1931).

[23] United States Trust Co. v. Helvering, 307 U.S. 57 (1939); Rev. Rul. 55-622, 1955-2 Cum. Bull. 385; Deputy Commissioner's Letter, November 11, 1944.

and some types of contractual employment benefits.[24]

The latter two examples were particularly interesting determinations. The act creating National Service Life Insurance stated that this "insurance shall be exempt from all taxation."[25] However, the Court in *United States Trust Company v. Commissioner*[26] concluded that there was no indication of legislative intent to give government life insurance a status for estate tax purposes different from tax exempt bonds and other securities which had previously been held to be includible in the gross estate of the decedent. It was also pointed out that the estate tax is not a tax on the property itself, but rather it is an excise on the privilege of transmitting property by a decedent upon his death, the amount of tax being determined by the value of the property thus transferred.[27]

The private contractual death benefit in *Commissioner v. Treganowan*[28] required the purchaser of a seat on the New York Stock Exchange to pay $15 into a fund upon his admittance to the Exchange. Thereafter, upon the death of any member, another $15 per member was assessed with the family of the deceased member receiving this indemnification. The government successfully argued that such amounts were includible in the decedent's gross estate for Federal Estate Tax purposes by likening the proceeds to those of a group term policy. The court agreed that such a parallel existed, since the arrangement had no cash value to the member while he lived, and despite the fact that scheduled payments by the members were not required.[29] In the extreme example of a member dying after making the initial contribution and before any subsequent payments, the court likened this to a paid up single premium policy. The fact that an individual member could transfer the benefits of such an agreement by selling his seat on the Exchange gave him that degree of control necessary to constitute an incident of ownership.

In all of the foregoing examples there were the common elements of "risk-shifting" and "risk distribution"; the United States Supreme Court in *Helvering v. LeGrierse*[30] found these elements to be missing and therefore held that none of the proceeds from the annuity and insurance policies were actually "insurance" when the two contractual agreements are considered together. The lack of risk appeared to be the common thread running through the decisions in which the Court has determined that the proceeds were not insurance for Fed-

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[24] Commissioner v. Treganowan, 183 F.2d 288 (2d Cir. 1950); In re Estate of Moyer, 32 T.C. 515 (1959); Rev. Rul. 65-222, 1965-2 CUM. BULL. 374.

[25] WORLD WAR VETERANS ACT § 22 (1924).

[26] *Supra*, note 23.

[27] Chase National Bank v. United States, 278 U.S. 327 (1929); New York Trust Co. v. Eisner, 256 U.S. 345 (1921); Knowlton v. Moore, 178 U.S. 41 (1899).

[28] *Supra*, note 24.

[29] In re Estate of Clarence L. Moyer, 32 T.C. 515 (1959). The court found that the "other consideration" used in Section 811(G)(2), Internal Revenue Code of 1939, encompassed the non-regular payments to a gratuity fund which in turn made the stock exchange's death benefits includible in the gross estate as insurance.

[30] Helvering v. LeGierse, 312 U.S. 531 (1941). This case involved an eighty-year old man who was required to purchase an annuity to enable him to purchase a life insurance policy.

eral Estate Tax purposes. These cases have included combination annuity and life insurance policies,[31] wrongful death liability policies,[32] premium refunds when suicide voided the policy,[33] and some employee death benefits.[34] It is interesting to note that in the situation where life insurance is a portion of an employer's qualified employees' benefit plan, that portion of the proceeds attributable to employer contributions is excluded from the participating decedent's gross estate under section 2039(c) while any benefits attributable to voluntary employee contributions are includible under section 2042.[35]

In none of the foregoing situations where it has been determined that the proceeds or other monies belonging to the estate are not insurance and therefore not includible under section 2042 should it be assumed that this property is excluded from the gross estate altogether. The fowler's net of section 2033 then becomes the taxing authority and the taxpayer seeking an exclusion which might be applicable must look to other Code sections.[36]

Proceeds of insurance on the life of the decedent paid directly to his estate or the executor of his estate cause few, if any, problems. The fact that this asset arose through the medium of insurance is immaterial. The proceeds are just as certainly includible as if the total amount was cash in the decedent's pocket when he expired. Even local law does not recognize a distinction when the asset in the estate is from this source.[37]

A related area which might cause some confusion concerns those cases in which the decedent had been receiving the proceeds from insurance on the life of another during the decedent's lifetime,[38] or the decedent's estate is such a recipient.[39] Taxpayers faced with such a situation should note that section

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31 Fidelity-Philadelphia Trust Co. v. Smith, 356 U.S. 274 (1958); In re Estate of Montgomery, 56 T.C. 489 (1971), Rev. Rul. 65-69, 1965-1 CUM. BULL. 440.

32 Rev. Rul. 68-88, 1968-1 CUM. BULL. 397. In this situation the decedent's estate had received payment under the noninsured motorist provision of the decedent's own automobile insurance policy. Since under local law (Virginia), wrongful death benefits are not a part of the decedent's estate and hence not taxable for Federal Estate Tax purposes, neither was the payment in lieu thereof; Rev. Rul. 57-54, 1957-1 CUM. BULL. 298. This involved payment in voluntary settlement of a liability claim against the insurance carrier of an airplane. Since under local law the amount recovered in a suit for wrongful death would have been excluded from the gross estate, such amount received in settlement of the claim with the insurance company was also excludible.

33 Chew's Estate v. Commissioner, 148 F.2d 76 (5th Cir. 1945)

34 Rev. Rul. 67-371, 1967-2 CUM. BULL. 329. Here there was insurance which was used to pay benefits under a qualified non-contributory profit-sharing plan to the decedent's beneficiaries. The rationale of taxing the premiums as income to the decedent during his lifetime precluded the proceeds from being included in his gross estate. Section 2039(c) provided protection for the proceeds against, "any other provisions of law at variance therewith."

35 Rev. Rul. 70-211, 1970-1 CUM. BULL. 190.

36 *See, e.g.*, INT. REV. CODE of 1954, § 2039 (b) and (c) and § 2040 at it provides for contribution exclusion.

37 IOWA CODE ANN. § 450.2, 450.4; CAL. CODE ANN. § 13722; New York, Consolidated Law Service, Tax Law Section 954. The New York estate tax law uses section 2042 of the Internal Revenue Code of 1954 with some slight modification.

38 In re Estate of John J. Tuohy, Jr., 14 T.C. 245 (1950); In re Estate of Mable Morton, 12 T.C. 380 (1949); Second Nat'l Bank v. Dallman, 54 T.C. 1 USTC para. 10,935.

39 In re Estate of Roger M. Chown, 51 T.C. 140 (1968); Rundle v. Welch, 184 F. Supp. 777 (S.D. Ohio 1960).

2042 applies only to proceeds of policies on the life of the decedent and should not look to this portion of the Code to answer their questions regarding includibility.

III. Economic Benefit—The First Part of The Two-Pronged Test For Includibility

Situations where the proceeds of life insurance on the life of the decedent were payable for the benefit of his estate have provided considerable grist for the litigation mill. As previously stated, neither the executor nor the estate has to be the named beneficiary under the terms of the policy in order for either to be considered as having received the economic benefits of the proceeds. A landmark case in this area, *Pritchard v. United States*,[40] involved the absolute assignment of the proceeds of an insurance policy on his life by the decedent to his creditor. Although the decedent's wife was the owner of the policy and the decedent possessed no incidents of ownership in it, the court held that the proceeds were includible in the decedent's gross estate. The court reasoned that absent the insurance proceeds, the lender would have had a legally enforceable claim against the state for the amount of the proceeds. Therefore there was a benefit accruing which made the proceeds includible. While the fact pattern in this case, which fell squarely under the authority of Regulation section 20.2042-1(b)(1), made the proceeds a "washout" in the gross estate since the debt secured was larger than the proceeds, it did not answer the question of whether the entire proceeds would have been includible if the situation had been a smaller debt than the amount of the proceeds. This issue has not been decided.

The case of *Logan v. Commissioner*[41] is illustrative of an indirect benefit accruing to the estate. Here a trust was the beneficiary of the insurance policies, but the trust was made liable for debts and charges of the estate. The court had little trouble in determining that the proceeds were includible. However, there is an indication that by giving the trustee the power, but not the duty to pay debts and charges of the estate, the proceeds of life insurance on the decedent's life would be kept out of the gross estate.[42] The reasoning here is that these proceeds were not received by the executor. To make an even stronger case for excludibility, the person wishing to use this method should make certain the executor and the trustee are two separate entities.

IV. Incidents of Ownership—The Second Prong of The Commissioner's Test Instrument

A. *Full, Direct Ownership*

If the "economic benefit" portion of section 2042 has created a rivulet of estate tax litigation, the "incidents of ownership" fraction has caused a com-

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[40] 255 F. Supp. 552 (N.D. Tex. 1966); affirmed, 397 F.2d 60 (1968).
[41] 23 B.T.A. 236 (1931).
[42] In re Estate of Charles Wade, 47 B.T.A. 21 (1942). The court cited the law

parative raging torrent for the judiciary. This is understandable when you consider that sections 2035 through 2038[43] and section 2041[44] are all intertwined in this phrase of section 2042.[45] Additionally, the very nature of insurance with its contractual obligations of the parties, the options and powers available to the insured, combined with the various possibilities of ownership make the possible factual situations almost infinite in number.

The Commissioner has enumerated several specific examples of incidents of ownership which would cause inclusion.[46] Court decisions have sustained the Commissioner on the power to change the beneficiary,[47] to surrender or cancel the policy,[48] to assign the policy,[49] to revoke an assignment,[50] to pledge the policy for a loan,[51] or to obtain a loan from the insurer against the surrender value of the policy.[52]

B. *Indirect and Partial Ownership*

That favorite tool of many estate planners, the irrevocable trust, has probably created more litigation in this area of indirect possession of incidents of ownership than any other single vehicle. Without attempting to distinguish between the retained powers via section 2036[53] and section 2038[54], (it would appear that a revision of the 1954 Code would do well to combine these two closely related legislative promulgations) the following illustrates some of the situations which have called for inclusion of the insurance proceeds in the decedent's gross estate.

In *Harry R. Fruehauf v. Commissioner*,[55] the decedent had broad powers as trustee to deal with policies on his life placed in the trust by his pre-deceased wife. The decedent's wife had owned all incidents in these policies while alive. However, these broad trustee powers, coupled with the fact the decedent was the income beneficiary of the trust, led the court to hold the proceeds includible in the decedent's gross estate. In another insurance trust case,[56] the

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of Trusts which makes the exercise of a power discretionary, except to the extent to which it is required by the terms of the trust or by principles of law applicable to the duties of trustees. It should also be noted that no actual payment of charges had been made against the estate by the trustees. *See also*, In re Estate of Mathilde B. Hooper, 41 B.T.A. 114 (1940).

43 INT. REV. CODE of 1954, § 2035, 2036, 2037, 2038.

44 INT. REV. CODE of 1954, § 2041.

45 INT. REV. CODE of 1954, § 2042 (2) and 26 C.F.R. 20.2042-1(c) (1971).

46 26 C.F.R. 20.2042-1(c)(2) (1971).

47 Chase Nat'l Bank v. Commissioner, 278 U.S. 327 (1929); Nance v. United States, 430 F.2d 662 (9th Cir. 1970); Farwell III v. United States, 243 F.2d 373 (7th Cir. 1957); In re Estate of Goldstein, 122 F. Supp. 677 (Ct. Cl. 1954), cert. denied 348 U.S. 942 (1955).

48 In re Estate of Myron Selenick, 15 T.C. 716 (1950).

49 Chase Nat'l Bank v. United States, 278 U.S. 327 (1929); Allentown National Bank, 37 B.T.A. 750 (1938); Caldwell v. Jordan, 119 F. Supp. 66 (N.D. Ala. 1950).

50 In re Estate of Arnold Resch, 20 T.C. 171 (1953).

51 In re Estate of B.S. McCoy, Sr., 20 T.C.M. 224 (1961).

52 St. Louis Union Trust Co. v. United States, 262 F. Supp. 27 (E.D. Mo. 1966).

53 INT. REV. CODE of 1954, § 2036 "Transfers With Retained Life Estate".

54 INT. REV. CODE of 1954, § 2038 "Revocable Transfers".

55 427 F.2d 80 (6th Cir. 1970); *cf.* In re Estate of Skifter, 56 T.C. 1190 (1971).

56 Karagheusian's Estate v. Commissioner, 233 F.2d 197 (2d Cir. 1956).

requirement that the insured and his daughter must give their written consent to alter the trust, caused insurance proceeds of policies owned by the insured decedent's wife to be included in the decedent's gross estate. The court in this case reasoned that this was merely a change in the form of control which would not preclude the decedent from determining the ultimate distribution of the insurance proceeds. Although it is considered an elementary principle since the decision in *Seward Estate v. Commissioner*[57] that the insurance policies themselves must be changed to reflect the proper ownership by the trustees in contrast to merely assigning them to the trust itself,[58] later cases have indicated that any power, other than strictly administrative ones delineated by ascertainable standards, would cause their inclusion.[59]

Historically the fact that a corporation is a separate entity capable of limiting the liability of its owners for practically all other purposes has not carried over into the area of Federal Estate Tax when the corporation is the owner of a life insurance policy on the life of a stockholder. While the court in a 1942 case[60] in which the corporation purchased the insurance policy, paid the premiums, was the beneficiary, and had all other incidents of ownership, held that the proceeds should be excluded from the decedent-stockholder's estate, it did so on the narrow interpretation of section 302 of the Internal Revenue Act of 1926 which required the policies to be "taken out by the decedent on his own life." The Commissioner envisioned the possibility of a one-man corporation being used to "own" all the incidents of ownership of an insurance policy on the life of its sole shareholder and in his Regulations to the 1954 Code unequivocally stated that reservation of a power to change the beneficiary in the corporation would be considered an incident of ownership, where the decedent was the sole stockholder.[61]

Using Regulations Section 20.2042-1(c)(2) as a guideline, the courts have uniformly held that the insurance proceeds of corporation owned policies are includible directly in the sole stockholder's gross estate despite the fact the corporate entity did not always possess all the incidents of ownership.[62] Since he was the sole stockholder, a decedent would have had only a slight chance of not having the full value of the proceeds reflected in the value of his gross estate in any instance where the proceeds were payable to the corporation; the

[57] 164 F.2d 434 (4th Cir. 1947).

[58] In re Estate of Sidney F. Bartlett, 54 T.C. 1590 (1970), in which the decedent had assigned policies to the corporate trustee but had not filed a copy of the trust agreement with the insurer.

[59] Carlton v. Commissioner, 298 F.2d 415 (2d Cir. 1962). Here is an example of a portion of the insurance being purchased through premiums paid by a funded trust after January 1, 1941 held to be includible in the decedent's gross estate because of powers the decedent had over the trust.

[60] In re Estate of Edward Doerken, 46 B.T.A. 809 (1942).

[61] 26 C.F.R. 20.2042-1(c)(2) (1971). "Similarly, the term [incidents of ownership] includes a power to change the beneficiary reserved to a corporation of which the decedent is sole stockholder".

[62] Piggott v. Commissioner, 340 F.2d 829 (6th Cir. 1965); Kearns v. Commissioner, 399 F.2d 226 (Ct. Cl. 1968); Hall v. Wheeler, 174 F. Supp. 418 (S.D. Me. 1959).

real problems arose in those cases where the decedent-stockholder held a majority, but less than 100 percent interest in the corporation.[63] In response to just such a situation where the decedent owned 75 percent of the outstanding stock, Revenue Ruling 71-463[64] was published. Here it was stated that the insurance proceeds were includible in the decedent's gross estate pursuant to section 2042 of the Code and furthermore, the insurance should not be reflected in the decedent's 75 percent interest in the corporation for inclusion under other Code sections. Immediately one can see that this solution prevented double taxation of the proceeds but at the same time it precluded the beneficiaries from obtaining the proper date of death basis for this stock while at the same time the estate had to pay tax on the 25 percent of the proceeds it didn't receive. Shortly thereafter Revenue Ruling 72-167[65] withdrawing Revenue Ruling 71-463 because Section 20.2042-1 of the Estate Tax Regulations was being reconsidered.[66]

The first indication of the Commissioner's thinking in this area[67] was his Proposed Amendments of Regulations filed with the Federal Register on August 24, 1972.[68] Replacing the terse statement regarding corporation owned life insurance[69] was a more detailed statement regarding the treatment of such proceeds. Briefly stated, this proposed change excludes the proceeds of insurance policies on the life of the *sole or controlling* stockholder-decedent to the extent they are payable to or for the benefit of the corporation. However, if any part of these proceeds are not payable to or for the benefit of the corporation (which in turn means that the stock valuation would not be affected by this portion of the proceeds), the incidents of ownership held by the corporation will be attributed to the decedent and included directly in his gross estate accordingly. Consequently a proposed amendment to Regulations section 20.2031-2(f)(2)[70] cautions those valuing the stock of corporations where selling prices or bid and asked prices are unavailable to consider such proceeds in making their determinations. It would appear that the proposed solution is the most equitable available and in all probability will be the one used in the final form of these amendments to the Regulations.

C. *No Incidents of Ownership (or Very Nearly So)*

That anonymous mortal who first penned, "The only two things in this

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63 Although it would depend on what factors were being given the most weight in valuing a closely held corporation, adding the value of the insurance proceeds would always increase the company's net worth which is one of the factors Regulations section 20.2031-2(f)(2) and Revenue Ruling 59-60, 1959-1 C.B. 241-2 admonishes an appraiser to consider.

64 Cum. Bul. 1971-2, 333,4.

65 I.R.B. 1972-15.

66 26 C.F.R. 20.2042-1 (1971).

67 26 C.F.R. Part 20, Estate Tax.

68 CCH ¶ 8380, No. 55, 8-31-72.

69 See footnote 61 *supra*.

70 See CCH ¶ 8380A, No. 55, 8-31-72.

world that are certain are death and taxes", quite obviously had never done any estate planning in which life insurance was involved. Even complete divestiture of the incidents of ownership of the property was not enough to remove it from the decedent's gross estate in *Commissioner v. Holmes.*[71] In that case, the settlor-decedent had retained the power to terminate the irrevocable trust he had funded and made distribution to the beneficiaries, all of whom had a vested interest in the trust assets from its inception. The Court coined a much quoted sentence in this area when it stated, "A donor who keeps so strong a hold over the actual and immediate enjoyment of what he puts beyond his own power to retake has not divested himself of that degree of control which Section 811(d)(2)[72] requires in order to avoid the tax."[73] The Supreme Court quoted this earlier decision and reached the same result in *Lober v. United States.*[74] Here the settlor could also pay all or any portion of the trust assets over to his minor children at any time. The only distinction from the *Holmes* case was in the disposition of each beneficiary's share if he should not live to receive his portion of the corpus. The Court felt this was not a distinguishable point.

The Regulations use the illustration of a trust in stating the use of sections 2036 and 2038 for including the proceeds of such a policy (and other property in the trust which may be affected) in the gross estate.[75] However, the court in *Estate of Mudge*[76] decided that a trust clause compelling the trustee to follow the settlor's instructions regarding management of the trust property did not cause inclusion of the insurance proceeds of policies comprising a portion of the trust assets. Somehow the court felt that the trustee's obligation was limited to investment advice and this did not include the insurance policies nor the "economic benefits" therefrom.[77] Taxpayers relying on this decision would appear to be crowding close to the line that separates the two worlds of includibility and non-includibility. Funded trusts apparently meet the standards for exclusion when *all* incidents of ownership in both the trust and the policies themselves are relinquished by the insured.[78] Even putting limitations on the powers of the trustees such as restricting the group from which the trustees may designate beneficiaries and not specifically vesting the trustees with any additional powers did not make the proceeds includible in a recent case[79] in which the insured retained no active incidents of ownership in the form of a veto power.

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71 326 U.S. 480 (1946).
72 INT. REV. CODE of 1939. This became Section 2038 of the Internal Revenue Code of 1954.
73 Commissioner v. Holmes, 326 U.S. 480, 487 (1946).
74 346 U.S. 335 (1953).
75 26 C.F.R. 20.2042-1(c)(4) (1971).
76 27 T.C. 188 (1956).
77 *Id.* at 193.
78 Bennett v. United States, 185 F. Supp. 577 (N.D. Ill. 1960).
79 In re Estate of Powel Crosley Jr., 47 T.C. 310 (1966).

Another area in which section 2038 plays a key role in determining includibility is with group life insurance. The common situation is that of an employer providing group life insurance for his employees while they are in his employ. In cases decided under section 811(g), Internal Revenue Code of 1939, the courts looked to the source of the premium payments in deciding whether or in what proportions the proceeds of such policies were includible.[80] After the decision in *Estate of Flye*[81], it seems clear that the same tests of economic benefit and incidents of ownership apply to the proceeds of group life insurance as to other types of insurance. The real problem then becomes that of inter vivos divestiture by the insured. Here two hurdles are placed in the taxpayer's way: specific wording of the master contract under which the individual policy was issued,[82] and state law.[83] The importance of the former was vividly illustrated in a recent case[84] in which the master policy allowed assignment, but the wording of the individual policy did not. The court held that the master policy controlled and allowed the proceeds to be excluded from the deceased employee's gross estate.[85]

For the taxpayer persistent enough to have traversed the labyrinth thus far, there is still a question of whether the ability of the insured to terminate his employment and concurrently his coverage under the group policy is a

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[80] Commercial Nat'l Bank v. Johnson, 54-1 U.S. Tas Cas. para. 10,945. Here the Court held the proceeds includible on the basis that the premiums were in the nature of additional compensation to the employee. In re Estate of H.N. Keene, B.T.A. Memo Dec. 42,341 (1942). In this case, $153.60 of the total premiums paid of $372.05 were the decedent's contribution; the portion of the proceeds includible was 153.60/372.05.

[81] 39 B.T.A. 871 (1939); *see also* Rev. Rul. 69-54, 1969-1 CUM. BULL. 221 and In re Estate of Lumpkin, 56 T.C. 815 (1971).

[82] Rev. Rul. 69-54, 1969-1 CUM. BULL. 221.

[83] All of the following states permit or authorize the assignment of the rights, benefits, and/or incidents of ownership by the policyholder-employee under a group life insurance policy: 20 ARIZ. REV. STAT. ANN. § 20-1122 (1969); ARK. STAT. § 54-3528 (1969); CAL. GEN. LAWS ANN. Ch. 644 CAL. INS. CODE § 10209.3 (Deering 1955); S.B. 48, Laws 1971; COLO. REV. STAT. § 72-6-7 (1971); PA 205, Laws 1971; CONN. GEN. STAT. REV. § 38-153(a) (1971); Ch. 70-10, Laws 1970; FLA. STAT. § 627.0420 (1965); Ch. 19, Laws 1969; GA. INS. CODE § 56-2707 (1969); Ch. 277, Laws 1955 HAWAII REV. STAT. § 431-436 (1955); Ch. 50, Laws 1970; IDAHO CODE § 41-2025 (1970); P.A. 76-1443, Laws 1969; ILL. REV. STAT. Ch. 73 § 857.1 (1969); Ch. 327, Laws 1969; IND. STAT. ANNOT. § 39-4223(a) (1969); S.B. 386, Laws [Iowa 1971]; Chs. 234 and 239, Laws 1969; KAN. STAT. ANNOT. § 40-433a, 40-439 (1969); KY. REV. STAT. Ch. 304, subtitle 14, Sec. 25 (1971); 22 LA. REV. STAT. § 642 (1966); 24-A ME. REV. STAT. § 2420 (1969); MD. ANN. CODE Art. 48A, § 436 B (1969); MASS. GEN. LAWS Ch. 175, § 134 C (1932); MICH. COMP. LAWS § 500.4439 (1969); Chapter 393, Laws [Mississippi 1971]; S.B. 125. Laws [Missouri 1971]; NEB. REV. STAT. § 44-1619 (1969); NEV. REV. STAT. § 690.175 (1969); N.J. REV. STAT. § 17.34 - 32.3 (1969); N.M. STAT. ANN. § 58-8-35 (1969); Ch. 843, Laws [New York 1969]; N.C. GEN. STAT. § 58.211.3 (1969); S.B. 2155, Laws [North Dakota 1971]; OHIO REV. CODE § 3917.07 (1967); House Bill 1296 (approved 6-30-71, effective 9-9-71) [Oregon]; Chapter 210, Laws [Rhode Island 1970]; S.C., Code § 37-307.1; H.B. 726, Laws [South Dakota 1971]; TENN. CODE ANN. § 56-1144; TEX. REV. STAT. art. 3.50, § 2; UTAH CODE ANN. § 31-23-18; VT. STAT. ANN. T.T. 8 Ch. 103 § 3713; VA. CODE ANN. § 38, 1-424, 38.1-442; W. VA. CODE ANN. § 33-14-28 (1966); WIS. STAT. § 201.065 (1966).

[84] In re Estate of Max J. Gorby, 53 T.C. 80 (1969).

[85] *See* In re Estate of Sidney F. Bartlett, 54 T.C. 1590 (1970). Here the master contract did not permit assignments but one was attempted.

"power" sufficient to cause includibility.[86] To overcome this barrier to divestiture, the taxpayer must look to Revenue Ruling 69-54,[87] the terms of the policy,[88] and state law.[89] In those cases where the employee cannot completely divest himself of a policy because of not being able to assign the conversion privilege, it would appear that an irrevocable waiver of the right to convert would accomplish the same objective. While at first blush it might seem that this would be too high a price to pay to exclude the proceeds from his estate since the taxpayer may have become uninsurable during the period the group policy was in effect, he has just as certainly "lost" this conversion privilege when he makes an irrevocable assignment of the privilege to a third party. The only feature which the assignment has over the waiver is the fact that the insured might be able to exert some influence over the person to whom it had been assigned to effectuate the conversion. If the beneficiary were the same as the person holding the power of conversion, it would be in the beneficiary's self-interest to do so.

With continued mechanization and computerization reducing the number of employees required in the work force but demanding greater skills and proficiencies at the lower levels and more outstanding talents at the upper levels of management to coordinate the overall program, it is not unlikely that employers will be offering greater fringe benefits, to attract the types of individuals

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[86] Although there is no indication Congress intended that the employee's right to terminate his employment should be an incident of ownership in property sufficient to cause inclusion, termination of employment without conversion privilege for the insured could void all other rights in the policy whosoever owned them.

[87] *Supra* note 81. The IRS requires the conversion privilege along with the other incidents of ownership, to be assigned inter vivos to remove the proceeds of the group insurance policy from the insured-employee's gross estate.

[88] As was noted in regard to the assignability of the other rights and benefits of a group policy, the master contract must permit conversion upon termination of employment before the IRS would recognize a complete assignment as sufficient to exclude the proceeds from the insured's gross estate. Otherwise, the employee-insured might be considered to have a power to revoke sufficient to include the proceeds per section 2038 (but see footnote 86 for recent holdings).

[89] The states which provide for the right to convert, either by separate statute or as part of a statutory required standard policy provision, are as follows: ARIZ. REV. STAT. ANN. § 20-1266 (1956); ARK. STAT. § 66-3516 (1947); CAL. GEN. LAWS ANN. § 10209(b) (Deering 1969); COLO. REV. STAT. ANN. § 72-6-2 (10) (1963); D.C. CODE § 35-710 (8); FLA. STAT. § 627.0415 (1963); HAWAII CODE § 181-578, 181-580; IDAHO CODE § 41-2018; ILL. REV. STAT. § 73-843(d) (1965); IND. ANN. STAT. § 39-4222(8); IOWA CODE § 509.2(8) (1962); KY. REV. STAT. § 304.856 (1969); LA. REV. STAT. Tit. 22 § 17C (H) (1950); ME. REV. STAT. ANN. tit. 24 § 1752 (H) (1964); MD. ANN. CODE Art. 48A, § 434 (1957); MASS. GEN. LAWS § 175-134 (1932); MICH. COMP. LAWS § 12435 (1948); MINN. STAT. § 61.38(2)(g) (1965); MONT. CODE ANN. § 40-3918 (1969); NEB. REV. STAT. § 44-1607(8) (1969); NEV. REV. STAT. § 690.160(8) (1969); N.H. REV. STAT. ANN. § 408.16(8) (1955); N.J. REV. STAT. T.T. 17 § 34-32(10) (1937); N.M. STAT. ANN. § 58-8-30 (1953); N.Y. LAWS ANN. STAT. 7 § 161(e) (McKinney 1964); N.C. GEN. STAT. § 58-211(8) (1969); OHIO GEN. CODE ANN. § 9426-2(5) (Page 1964); OKLA. STAT. § 46-4103(8) (1961); ORE. REV. STAT. § 739-625(2)(h) (1969); PA. STAT. Tit. 40 § 532.6(8) (Purdon); S.C. CODE § 37-307(9) (1962); TENN. CODE ANN. § 56.1141(1) (1969); TEX. STAT. ANN. Art. 3, Ch. 50 § 29 (Vernon 1966); UTAH CODE ANN. § 31-23-15 (1953); VT. STAT. ANN. Tit. 8 § 3822(8) (1966); VA. CODE § 38.1-428.1 (1966); WASH. REV. CODE § 48-24-180 (1966); W. VA. CODE § 3472(112) (1961); WIS. STAT. § 206.61(8) (1961).

they desire. These factors, combined with the fierce competition among insurers in the field of group insurance, point towards larger and possibly more attractive types of insurance, such as those which offer some type of accumulation plan rather than strictly being term. All of this points towards a greater use of divestiture as a means of reducing the employee's gross estate. Alert taxpayers and counselors who assist them would do well to keep abreast of the developments in this area of the estate tax law.

While it would seem that the "reversionary interest" type of incident of ownership would cause few if any problems concerning includibility this is not the case. Indeed, even the special attention devoted to this section 2037 type of ownership in the Code[90] and Regulations[91] would tend to belie the contention that any appreciable amount of controversy would arise in this area. The results have been otherwise. *In re Estate of Hall*[92] was the vehicle which opened what may prove to be a Pandora's Box regarding reversionary interest valuations. In the *Hall* case the decedent's interest was 9.413% based on the Commissioner's actuarial tables, while experts valued the decedent's interest at 2.61% due to her failing health. The court decided in favor of the taxpayer, reciting that the Code itself states that the value of the reversionary interest shall be determined by "usual methods of valuation . . . *including* the use of . . . mortality and actuarial principles,"[93] which were instructive as to methods to be employed but were not limited to use of the tables. Later cases have followed the rationale in *Hall*, but at least one case has been decided contra on the basis that Congress had enacted section 2037 as a *de minimus* provision which would be emasculated if the tables weren't followed in valuing reversionary interests.[94]

Thus we have another uncertainty thrust into this portion of the insurance section which is already somewhat mystifying by the use of the phrase "if the value of the reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy." It is assumed that the drafters meant "if the likelihood of reversion exceeded 5 percent, or 1 chance in 20", but that isn't what the Code and Regulation sections state. If, immediately before his death, the decedent had only one chance in twenty of obtaining the benefits or control of a policy, he would have to look long and hard to find a buyer willing to pay him 5 percent of the value of the policy for it (especially if the potential buyer had no reason to believe death was near at hand for the seller). Throughout the Code, "value" is taken as "fair market value" and this is further defined, the price at which it would change hands between a willing buyer and a willing seller, both having reasonable knowledge

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90 INT. REV. CODE of 1954 § 2042(2).
91 26 C.F.R. 20.2042-187(3) (1971).
92 353 F.2d 500 (7th Cir. 1965).
93 Int. Rev. Code of 1954 § 2037(b).
94 In re Estate of Dwight B. Roy Jr., 54 T.C .1317 (1970).

of the revelant facts.[95] It would appear that the language regarding reversionary interests both here, and in section 2037, could be made much clearer when the code is revised.

The transfer by the decedent of all the incidents of ownership in a life insurance policy on his own life within three years of death creates a very strong presumption that it was accomplished in contemplation of death and hence is includible in his estate.[96] This is primarily due to the nature of the asset;[97] most policies ordinarily do not reach their full value until death, and some such as ordinary term life insurance and accident insurance have no value until death. The presumption still remains rebuttable, however, and a plausible living motive offers the taxpayer caught in such a dilemma his best chance of excluding this asset.[98]

Transfer of a policy outside the three year period prior to death with the decedent-insured continuing to pay the premiums presents a somewhat different problem. The Commissioner's previously announced position of including that proportion of the proceeds from such a policy that the premiums paid within the three years bears to the total premiums paid,[99] has now been changed,[100] following several adverse court decisions.[101] These adverse deci-

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[95] 26 C.F.R. 20.2031-1(b) (1971).

[96] Int. Rev. Code of 1954, Sec. 2035 makes the value of all transfers, except those where adequate and full consideration in money or money's worth is received, includible in the gross estate if the transfers were made during the last 3 years of the decedent's life. The presumption that the transfer was in contemplation of death is rebuttable, however.

[97] When the 1954 Act was being considered, there was a split over how the proceeds of insurance should be treated. The minority position, as it appeared in House Report #1337, 83rd Congress, 2d Session, B 14, B15 (1954), was in part as follows:
"It is sought to justify this change (deletion of the premium payment test for includibility of insurance proceeds), merely putting life insurance on a par with other property which may be given away free from estate tax if the gift is not made "in contemplation of death". But life insurance is not like other property. It is inherently testamentary in nature. It is designed, in effect, to serve as a will regardless of its investment features. Where the insured has paid the premiums on life insurance for the purpose of adding to what he leaves behind at his death for his beneficiaries, the insurance proceeds should certainly be included in his taxable estate."

[98] Hull v. Commissioner, 325 F.2d 367 (3rd Cir. 1963) (to make the children-assignees secure); Parish v. Commissioner, 187 F.2d 390 (7th Cir. 1951) (to make the children-assignees independent); In re Verne C. Hunt, 14 T.C. 1182 (1950) (to make the policy secure from creditors).

[99] Rev. Rul. 67-463, 1967-2 CUM. BULL. 327. This ruling appears to have been a vestigium of the 1939 Code, Section 811(g) as amended by the Revenue Act of 1942, which made that portion of the proceeds which the decedent had purchased by paying premiums prior to the transfer of a policy includible in his gross estate on a premium paid before to premiums paid after transfer ratio.

[100] Rev. Rul. 71-497, I.R.B. 1971-45, 16. The only asset includible in the decedent's gross estate where a policy has been transferred prior to three years before his death is the value of the premiums paid during the three years preceding death. Revenue Ruling 67-463 was thereby revoked.

[101] Gorman v. United States, 288 F. Supp. 225 (E.D. Mich. 1968); In re Estate of Inez G. Coleman, 52 T.C. 921 (1969); In re Chapin's Estate, 29 T.C.M. 11 (1970); Ritter v. United States. All of these decisions held that no part of the proceeds of the insurance policies were includible in the gross estates, only the amount of the actual premiums themselves were includible.

sions plus a reversal of the only decision in the government's favor on appeal,[102] made the Commissioner's position untenable. It was made abundantly clear, however, by means of *Situation 2* in Rev. Rul. 71-497 that the Commissioner's position remains unchanged in regard to policies transferred within three years of the date of death.

Sale of a policy for less than full and adequate consideration, determined to have been made in contemplation of death, required the difference between the sale price and the proceeds to be included in the gross estate in *In re Estate of J.S. Pritchard.*[103] Future cases may determine a different basis for valuing a policy at the time of transfer which will in turn change the entire contemplation of death result or at least radically change the dollar amount to be included in the gross estate of the decedent. An example of this might be the transfer of a "right" to obtain additional insurance on the life of the decedent without evidence of insurability. Exercise of such a right by a donee or purchaser could prove quite remunerative, especially if the decedent had a terminal disease or condition at the time he parted with the right. This problem, which could prove very interesting, would be mostly one of valuation rather than inclusion however, and won't be pursued further here.

V. Conclusion

A law professor once told our Evidence class, "It's an inept trial lawyer who cannot get hearsay evidence into the record despite the Hearsay Rule." Perhaps this best describes the government Estate Tax attorney who cannot include the proceeds of a life insurance policy on the decedent's life in his gross estate for Federal Estate Tax purposes. Congress has indeed put many arrows in the Commissioner's quiver in the form of sections 2033, 2035 to 2038, 2041 and 2043, in addition to the basic life insurance section, 2042, of the Code. The Commissioner has added barbs in the form of Revenue Rulings and Regulations to make these missiles stick and hold once they have been fired. In some instances, the courts have blunted the Commissioner's tools, such as the holdings regarding contemplation of death premium payments and reversionary interests which are not measured strictly by the actuarial tables, but by and large, the courts have sustained the government's positions in the life insurance cases. Some of the areas where the courts have held in favor

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102 First Nat'l Bank, 423 F.2d 1286 (1968): Where premiums are paid from community funds during the last three years of the decedent's life, the portion of the proceeds that are includible in the gross estate is equal to the amount of premiums paid during the last three years divided by the total premiums paid times the total proceeds times one-half (community funds used to pay premiums). The basis for inclusion was Revenue Ruling 67-463. This decision was later reversed on appeal, 423 F.2d 1286 (5th Cir. 1970).

103 4 T.C. 204 (1944).

of the taxpayer have involved other contracts which were binding on the proceeds of life insurance policies owned by the decedent,[104] the question of termination of employment as a power to revoke,[105] the "actual" ownership of a policy maintained in compliance with a divorce settlement,[106] and cases in which there had been a mistake in the policies which did not represent the true intent of the insured at any time.[107] The reformation power has been used sparingly, as a perusal of the cases in which the taxpayer relied on "intent facts" to overcome "policy facts" will indicate.[108]

The law in the insurance area of estate taxation is as dynamic as that in any field of tax law. Problems of determining includibility persist, with only the specific issues changing. Where once the issues were primarily the determination of what actually constituted insurance and what qualified as an incident of ownership, these yielded to the problems of insurance trusts and impossibility of exercise of incidents of ownership, only to be replaced in the judicial spotlight by cases involving theoretical control through a corporate entity and inclusion of the proceeds of life insurance policies on which the decedent had paid the premiums in contemplation of death. It is not unlikely that future attention will center upon such issues as the standards for valuing reversionary interests in determining includibility, the includibility of insurance obtained in contemplation of death through the exercise of "rights" by third parties, and new criteria for determining the includibility of various and unique types of group life insurance policies. While the exact issues yet to be argued remain in doubt, one thing is certain, issues will continue to arise and will continue to be argued on the battleground of section 2042. For to the list

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104 In re Estate of Bert L. Fuchs, 47 T.C. 199 (1966); In re Estate of Infante, 29 T.C.M. 903 (1970); Morton v. United States, 322 F. Supp. 1139 (S.D. W. Va. 1971).

105 *Supra* note 68. The power to terminate employment was not sufficient revocation power to cause inclusion. In re Estate of Whitworth, 22 T.C.M. 177 (1963). The inclusion decision should not turn on the decedent's ability to terminate insurance by terminating employment.

106 In re Estate of Chester H. Bowers, 23 T.C. 911 (1955). The court found that the only actual rights which the decedent had in the policies were reversionary and these were less than 5%.

107 National Metropolitan Bank v. United States, 87 F. Supp. 773 (Ct. Cl. 1950). There the insurance agent had intentionally entered the wrong name of owner of policy. Lamade's Estate v. Brownwell, 245 F. Supp. 691 (M.D. Pa. 1965). There the court found the policy language reserving the right to change the beneficiary in the insured was not controlling where the intent of all parties was to effect a complete assignment of all interest in the policy to a third party.

108 Commissioner v. Noel's Estate, 380 U.S. 678 (1965) (physical impossibility to exercise incidents of ownership was not sufficient to bar inclusion in the decedent's estate); *see also* Rev. Rul. 61-123, 1961-2 Cum. Bull. 151 based on Noel facts, proceeds includible; Piggott v. Commissioner, 340 F.2d (6th Cir. 1965) (Physical custody by another is not a sufficient bar to exercise of powers by decedent as to cause exclusion from his estate); Kearns v. Commissioner, 399 F.2d 226 (Ct. Cl. 1968) (Intent facts "showing corporation to be owner of policy were not strong enough to overcome 'policy facts' that gave decedent incidents of ownership in policy"); United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7 (1st Cir. 1966) (policy facts have heavy predominance over intent facts where the policy itself does not reflect instructions of the parties).

of certainties of death and taxes may be added a third—"the taxpayer's continual struggle to minimize the latter upon the occurrence of the former."