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General Problems of Life Insurance in Estate Planning

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Comments

General Problems of Life Insurance in Estate Planning

Because life insurance is one of the basic estate planning tools, and because the modern estate planner must also be a tax adviser, it is important that those general practitioners who plan estates have an understanding of the "transfer tax" treatment of life insurance. This paper is intended to acquaint the reader with the treatment afforded life insurance by the Federal Estate Tax; it does not represent an attempt to probe deeply into any of the various facets of that subject. If the reader, be he advocate or estate planner, is given a better understanding of the nature of some of the problems in this area, this paper will have served its intended purpose.

Basically the estate tax treatment of life insurance under the 1954 Internal Revenue Code is affected by section 2042. [1] This sec-

[1] Int. Rev. Code of 1954, § 2042. The value of the gross estate shall include the value of all property—

(1) RECEIVABLE BY THE EXECUTOR.—To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.

(2) 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, exercisable either alone or in conjunction with any other person. For purposes of the preceding sentence, the term "incidents 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 percent 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 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 the 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.

tion is one of the fourteen sections[2] which describe the Gross Estate, from which the allowable exemptions and deductions are subtracted to determine the value of a decendent's Taxable Estate. Thus, section 2042 describes the conditions under which the proceeds of insurance of the life of the decedent will be included in his gross estate just as the other sections describe the inclusion of other kinds of property.[3] Furthermore, as may be inferred, these sections are inter-related and proceeds of life insurance which are not includible under section 2042 may be includible under some other section. But, before examining this inter-relation, let us subject section 2042 to closer scrutiny.

I. THE APPLICATION OF SECTION 2042

At the outset we should note that the 2042 treatment of life insurance is significantly different than that afforded life insurance under the 1939 Code, and that this change affects only the gross estates of those persons dying on or after August 17, 1954. Under Section 811 (g) of the 1939 Code, life insurance proceeds were taxable (a) if the proceeds were receivable by the insured's estate, (b) if the insured paid any of the premiums or, (c) if the insured exercised any of the incidents of ownership either alone or in conjunction with another person. To the dismay of the Treasury Department,[4] section 2042 of the 1954 Code eliminated the premium payment test. However, "to place life insurance in an analogous position to other property,"[5] Congress provided that a reversionary interest which exceeded five percent of the value of the policy would be considered an incident of ownership. Thus, under section 2042 of the 1954 Code, life insurance proceeds are included in the insured's gross estate if (a) the proceeds are receivable by the insured's executor, (b) the insured possessed any of the incidents of ownership exercisable either alone or in conjunction with any

[2] Int. Rev. Code 1954, §§2031-2044.

[3] For the general effect of those other sections, see Proposed Regs., § 20.2031-1 (1956). On October 22, 1956, the Internal Revenue Service announced the Estate Tax Regulations proposed under the 1954 Code. 1956 Int. Rev. Bull., No. 43, at 5.

[4] Waldo, Life Insurance and Annuities under the 1954 Revenue Code, 1955 U. Ill. L. Forum 380, 397.

[5] H. R., No. 1337, 83d Cong., 2d Sess., 316 (1954); accepted in full Senate Committee of Finance, S. Rep. 1662, 83d Cong., 2d Sess., 124 (1954).

other person, or (c) the insured possessed a reversionary interest which exceeded five percent of the value of the policy.[6]

A. Preliminary Problems

To understand section 2042, it is necessary to know what is meant by the term insurance. Section 20.2042-1 of the proposed regulations states that the term insurance refers to life insurance of every description, including death benefits paid by fraternal societies operating under the lodge system. Thus, any contract, transaction, or other arrangement which relieves the insured of the risk of premature death will fall within the Code's definition of insurance. It is noteworthy that the Commissioner has also ruled that the statutory exemption from taxation afforded the proceeds of life insurance issued by the Veterans Administration does not apply to an "excise imposed upon the transfer of property brought about by the death of the insured."[7]

It also is necessary to know when proceeds are receivable by or for the benefit of the estate. Generally, this test will be met if the insured's estate will receive any economic benefit from the proceeds whether by the terms of the policy or not.[8]

Both of these problems are more intricate than first meets the eye, and they have been given this small space only because a shortage of time dictates a limitation of this discussion.

B. The Incidents of Ownership Rule

The first test of when proceeds payable to beneficiaries other than the decendent's estate are includible in the gross estate is imposed by the incidents of ownership rule: If the insured possessed any of the incidents of ownership of the policy, exercisable either alone or in conjunction with another person, the proceeds will be included in his gross estate even though they were not receivable for the benefit of the estate.

The Treasury Department invented this rule in 1930, and fluctuated between it and the payment of premiums test (or com-

[6] Although the Code treats the five percent reversionary interest as an incident of ownership, the author considers it more helpful to consider it as a third test.

[7] Rev. Rul. 55-622, 1955-2, Cum. Bull. 385.

[8] See: Proposed Regs. § 20.2042-1(b) (1956); U.S. Treas. Reg. 105 § 81.25; Hofferbert v. Comm'r, 46 B.T.A. 1101 (1942). But see Flye v. Comm'r, 39 B.T.A. 871 (1939).

binations of both) until ". . . Exasperated by the Treasury's indecisiveness, Congress finally stepped onto the merry-go-round in 1942 and legislated a return once more to a combination of both criteria."[9] Since its 1930 inception, the incidents of ownership test has been used for all but six years.[10]

Because the incidents of ownership rule has existed as a test for so long, it has become a well defined portion of Estate Tax Law. As one would expect, the term is not confined to ownership in the technical legal sense; instead, it includes the right of the insured or his estate to the economic benefits of the policy.[11]

The courts agree with the Commissioner that the right to change the primary[12] or contingent[13] beneficiaries either alone or with the consent of another person[14] are incidents of ownership.[15] Furthermore, the insured will be deemed to have an incident of ownership where the right to change the beneficiary is reserved to a corporation of which he is the sole stockholder.[16] Similarly, the insured has the incidents of ownership where the proceeds are payable to a trust and the insured has the right to change the beneficiary of that trust.[17] A more extreme case on the same issue is *Comm'r v. Estate of Karagheusian*,[18] decided on May 7, 1956. In that case W took out a life insurance policy on her husband, the decedent. The next year W transferred the policy to a trust which she had the power to alter or revoke in whole or in part with the

9 Yohlin, Life Insurance Planning Under the New Revenue Code, 33 Taxes 450, 451 (1955).

10 1934-37 and 1941-42. See Winkelman, Taxation of Life Insurance under the Revenue Act of 1954, 28 So. Calif. L. Rev. 348,349 (1955).

11 U.S. Treas. Reg., 105, § 81.27. Proposed Regs., § 20.2042-1 (c) (2) (1956).

12 Estate of Frank H. Knipp, 25 T.C.——, (October 31, 1955). ¶ 25.24 P-H T.C. Rep. Dec. (1955).

13 Broderick v. Keefe, 112 F.2d 293,296 (1st Cir. 1940).

14 Bank of New York v. United States, 115 F. Supp. 375, 385 (S.D.N.Y. 1953); Goldstein's Estate v. United States, 129 Ct. Cl. 264, 122 F. Supp. 677 (1954), *cert. denied,* 348 U.S. 942 (1954).

15 And this may extend to the retention of the power to change the amounts receivable by various beneficiaries. See Josephine P. Hendrick, P-H 1947 T.C. Mem. Dec. ¶ 47,235, where the power to vary trust income between members of a group was held to be an attribute of ownership under Income Tax Law.

16 U.S. Treas. Reg. 105, § 81.27; Proposed Regs., § 20.2042-1 (c) (2) (1956).

17 Laird v. Comm'r, 29 B.T.A. 196 (1933), modified on another point, 85 F.2d 598 (3rd Cir. 1936).

18 4A P-H (1956) Fed. Tax Serv. ¶ 140.267 (2d Cir. 1956).

consent of her husband and her daughter or their survivor. The Second Circuit, reversing the Tax Court[19] held that the insured had an incident of ownership exercisable in conjunction with another person.[20]

The courts also agree with the Commissioner that the power to surrender or cancel[21] and to pledge or assign[22] are incidents of ownership. In addition, the courts have considered such factors as the right to receive distributions in case of disability as incidents of ownership.[23] The fact that the insured does not have possession of the policy does not affect his retention of incidents of ownership;[24] nor is it necessary that he receive the cash surrender value upon cancellation.[25]

Thus, the phrase incidents of ownership as used in its tax law sense in section 2042 encompasses *all* of the benefits that an insured may derive from life insurance.[26] And, if an insured is to escape the incidents of ownership test he must not possess any of the benefits of the policies on his life. That it is unimportant that he does not intend to possess any of the incidents of ownership seems to have been decided by the Tax Court in *Collino's Estate*[27] in February 1956. To put the *Collino* case in its proper perspective,

[19] 23 T.C. 806 (1955).

[20] "The decedent acting with his wife and daughter had the power at any time until his death to determine the ultimate distribution of the insurance proceeds. This power was an incident of ownership. . . . To hold otherwise would be to sanction tax avoidance by means of insubstantial alterations in the form of ownership." Supra, note 18.

[21] Chase National Bank v. United States, 278 U.S. 327 (1928). This case also determined the constitutionality of the incidents test. The following sentence is often quoted from page 235: ". . . [T]o free the beneficiaries of the policy from the possibility its (i.e., the powers to surrender) exercise would seem to be no less a transfer within the reach of the taxing power than a transfer effected in other ways through death."

[22] Caldwell v. Jordan, 119 F. Supp. 66 (N.D. Ala. 1953).

[23] Old Point National Bank v. Comm'r, 39 B.T.A. 343,354 (1939).

[24] Fried v. Granger, 105 F. Supp. 564 (W.D. Pa. 1952), *aff'd per curiam* 202 F.2d 150, (3rd Cir. 1953).

[25] Estate of Selznick v. Comm'r, 15 T.C. 716 (1950), *aff'd per curiam* 195 F.2d 735 (9th Cir. 1952), where the cash surrender value would have been added to a trust, the income of which was payable to the insured for life.

[26] The possible exception is the peace of mind that comes with knowing that loved ones are "provided for," if that peace of mind is not destroyed by the fear of the Sheriff of Nottingham armed with the mighty incidents of the ownership concept.

[27] Estate of Collino, P-H T.C. Rep. Dec. ¶ 25.115 (1956).

it is necessary to first look at *Estate of Doerken v. Comm'r*[28] which was decided by the same court in 1942. The *Doerken* case held that where a closely held two-family corporation took out the policy, paid the premiums, carried the policy as an asset on its books, retained custody of the policy, and received the entire proceeds, those proceeds were not includible in the insured's gross estate even though all of the incidents of ownership were reserved to the insured by the terms of the policy. The court concluded that the insured was merely the nominal holders of the rights for the benefit of the corporation. Similarly, in 1950, the Court of Claims held[29] that proceeds were not includible where the intent of the parties was for a son who applied for the policy, kept custody of the policy, and paid all of the premiums to have the incidents of ownership on the ground that the parties' intent controlled over the terms of the policy. In that case an insurance agent testified that he inserted the word "insured" in the blank reserving the incidents of ownership without instruction in order to clinch the sale. Both of these cases looked "through the form of the policies to their substance." In the *Collino* case, a mother had applied for insurance on the life of her son; had paid all of the premiums, had retained possession of the policy, was the beneficiary, and received all of the proceeds. Yet, this court held that she had failed to establish the intent that the son should not have the incidents of ownership which were reserved to him as the "insured" by the terms of the policies.

In *Collino* the court distinguished the *Metropolitan* case on its facts, placing great weight on the fact that the agent in *Metropolitan* had acted in his own best interest and without instruction from the insured or her son. It is submitted that the agent's action should make no difference as the parties in both cases failed to give any instructions to the insurance company or its agent. Thus, the only difference between these cases is that the agent testified as to the intent of the parties in the *Metropolitan* case while in the *Collino* case the taxpayer had to rely on overt manifestations of intent and did not have the aid of a repentant insurance agent.

Admitting that the *Metropolitan* case is the stronger on its facts, what more could the taxpayer have done in *Collino* to establish that as between the insured and his mother, it was intended

[28] 46 B.T.A. 809 (1942).

[29] National Metropolitan Bank v. United States, 87 F. Supp. 773 (Ct. Cl. 1950).

that she was the owner of the policies?[30] Does this mean that the Tax Court will not allow the taxpayer to show the intent of the parties without the aid of direct evidence?

Furthermore, it is submitted that the only material difference between *Estate of Doerken v. Comm'r* and the *Collino* case is the result. In *Doerken,* a closely held corporation did everything a corporation would normally do in dealing with a policy it owned; in *Collino,* the insured's mother did everything a mother would normally do in dealing with an insurance policy she owned.

Why did these cases reach opposite results? Because they were actually different on their facts or because the Tax Court has decided to prevent life insurance from becoming a haven for tax avoidance? In the *Metropolitan* case, the court indicated quite strongly[31] that if a trust instead of life insurance had been involved the result would have been different because ". . . Trusts are frequently established for the primary purpose of either avoiding or reducing taxes . . . [and] . . . the courts have also been inclined to construe them strictly . . ." The court also said:

> *Insurance policies are on a different footing.* Through the history of their development they have contained so many boilerplate provisions and fine-print stipulations that the courts through the years have been inclined to liberally construe them in such a way as to apply the natural interpretation which the party taking out the policies had made and his understanding of the purposes for which the policies were taken out.[32] (emphasis supplied)

It is submitted that the footing of life insurance has begun to crumble and that the Tax Court will soon help the Internal Revenue Service recoup any loss in revenue that would otherwise have been caused by the elimination of the premium payment test.[33] The very least we can say is that the incidents of ownership rule seems strong enough to prevent any flagrant tax avoidance.

C. The Reversionary Interest Rule

Section 2042 created a new test for including the proceeds of

[30] The fact that the insurance policies were not before the court in *Collino* seems inconsequential as the facts found by the Tax Court include the terms of the policies necessary to either result.

[31] 87 F. Supp. at 776.

[32] Ibid.

[33] See H.R. 1337, supra, note 5, at 3, which predicted a revenue loss of $25 million in fiscal year 1955 due to the elimination of the premium payment test.

life insurance in the insured's gross estate: If the insured possessed a reversionary interest (whether arising by the express terms of the policy, or by other instrument, or by operation of law) which exceeded five percent of the value of the policy immediately before his death, the proceeds will be included in his gross estate.

Much of the speculation and argument[34] about the meaning of this new test has been settled by the estate tax regulations which have been proposed for adoption under the 1954 Code. Section 20.2042-1 (c) (3) of these regulations provides that the term reversionary interest does not include the possibility that the insured might inherit a policy or its proceeds from another person. Note, however, that where a policy would return to the insured upon the prior death of the assignee a reversionary interest would arise, even though the value of that reversionary interest would not exceed five percent of the value of the policy if the beneficiary had the power to defeat the reversion as by surrendering the policy for its cash value.[35]

Section 20.2042-1 of the proposed regulations provides by cross reference to section 20.2037-1 (c) (3) and (4) that the reversionary interests of life insurance shall be valued, insofar as possible, in the same manner as reversionary interests in other property. Section 20.2037-1 (c) (3) provides that the reversionary interest will be valued in accordance with recognized valuation principles: Where actuarial principles can be applied this is to be done in accordance with the rules of section 20.2031-7 (d).[36] Where the interest is not subject to valuation by actuarial principles that interest will be valued at its fair market value as described in section 20.2031-1 (b). According to that section, ". . . The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or

[34] See, for example: Casner, The Internal Revenue Code of 1954: Estate Planning, 68 Harv. L. Rev. 222, 255 (1955); Mannheimer, Wheeler and Friedman, Gifts of Life Insurance by the Insured, N.Y.U. 13th Inst. on Fed. Tax 247, 250-253 (1955); Waldo, Life Insurance and Annuities Under the 1954 Revenue Code, 1955 U. Ill. L. Forum 380, 398.

[35] The effect of this provision of Proposed Regs. § 20.2042-1 is to make Int. Rev. Code of 1954, § 2042 more like § 2037 than is required by the wording of those sections. However, this treatment seems to be in line with the intention of Congress to make the treatment of life insurance analogous to that of other property. See, Mannheimer, Wheeler and Friedman, op. cit. supra, note 34, at 250-253.

[36] This paragraph explains the mechanics of determining the value of remainders of reversionary interests from the two tables which are part of the section.

to sell and both having reasonable knowledge of relevant facts." And, section 20.2042-1(c) (3) provides that any powers held by others which would affect the value of the reversionary interest must be specifically taken into consideration.

Section 20.2037-1(c) (4) of the proposed regulations purports to describe the method for determining whether the reversionary interest exceeds five percent of the value of the transferred property. The rule of this paragraph[37] is not very helpful when applied to life insurance where it may be important to know whether the replacement cost, the cash value, or some other value is to be used. Admittedly, this problem does not arise where the value of the reversionary interest can be determined by actuarial principles for the problem may then be stated in terms of whether the decedent had a one-in-twenty chance of reacquiring the policy, regardless of its value.[38] However, if a reversionary interest has a fair market value even though its value cannot be determined by actuarial principles, it will be necessary to know what the basis of valuation of the policy is in order to determine whether that fair market value exceeds five percent of the value of the policy.[39]

Like most innovations in the law, all of the effects of the reversionary interest rule will not be known until it has been put to the tests of practice.

II. THE APPLICATION OF OTHER SECTIONS

A. Section 2035: Transfers in Contemplation of Death

Even if the proceeds of life insurance are not includible in the decedent's gross estate under section 2042, they may be so included under another section of the Code.[40] Of primary importance in this regard is section 2035 which deals with transfers in contemplation of death. The value of all property transferred in contemplation of

[37] ". . . the value of the reversionary interest is compared with the value of the transferred property, including interests therein which are not dependent upon survivorship of the decedent. . . ." Proposed Reg. § 20-2037-1(c) (4)(1956).

[38] Waldo, op. cit. supra note 34, at 398.

[39] Waldo, ibid, is contra. Also, the "Report of the Life Insurance and Annuities Committee of the New York State Bar Association on H. R. 8300", as quoted by Mannheimer, Wheeler and Friedman, op cit. supra note 34 at 251, for the proposition that the concept of the "value of the policy" should be eliminated as it is unnecessary and ambiguous. Note, however, that both assume the reversionary interest can be valued by actuarial principles, and to the extent that this can be done, this writer is in accord.

[40] Proposed Regs. § 20.2042-1(a)(2)(1956).

death is included within the gross estate except the value of that property which was transferred for adequate and full consideration in money or money's worth. Furthermore, section 2035 establishes a rebuttable presumption that all transfers made within three years of death are made in contemplation of death.

Contemplation of death is defined by the proposed regulations as follows:

> The phrase "in contemplation of death" . . . does not have reference to that general expectation of death such as all persons entertain. On the other hand, its meaning is not restricted to an apprehension that death is imminent or near. A transfer "in contemplation of death" is a disposition of property prompted by the thought of death (although it need not be solely so prompted).[41]

The application of this definition has given rise to much litigation, and it will undoubtedly continue to do so as this is another area where the facts make the law in any particular case. Generally, the same tests which are applied to transfers of other property are applied to transfers of life insurance to determine whether the transfer was made in contemplation of death. However, the testamentary nature of life insurance makes the application of the general tests more difficult.[42] As the intricacies of this concept make it a subject unto itself, only the general picture will be set forth here. What is probably the most important single lesson in this area was put quite well by Judge Kern, who, after describing a man who was 94 years old when he died, said:

> This portrait may not be an accurate likeness of the real Oliver Johnson. It is possible that the verbal picture of Oliver created at the trial by the testimony of witnesses brought out by skillful guidance of petitioner's counsel emphasized certain of his features and left others in shadow to the extent that the Oliver Johnson of the verbal portrait has more resemblance to a synthesis of decendents whose transfers have been held in many reported cases to have been made not in contemplation of death than to the real Oliver Johnson who transferred real estate. . . . But the judicial process requires that we create our image of Oliver from the material in the record before us. We cannot be certain that our portrait of Oliver is a lifelike replica of the real Oliver but

[41] Proposed Regs. § 20.2035-1(c)(1956).

[42] I Polisher, Estate Planning and Estate Tax Saving 83 (1948). The testamentary nature of life insurance will be considered in determining the motive of the transferor. However, ". . . the testamentary nature . . . does not necessarily mean that the motive actuating the transfer is likewise testamentary in nature. . .." Cronin's Estate v. Comm'r, 164 F.2d 561,565 (6th Cir. 1947).

> we are confident that it accurately reflects the portrait of Oliver drawn by the evidence in the record. [43]

Thus, the advocate must take the time to learn *all* of the facts and circumstances surrounding any transfer made within three years of the decedent's death so that he may present them in the light most favorable to his client. On the other hand, the estate planner should emphasize all aspects of transfers that are associated with life and see that the evidence of these aspects is carefully preserved.

In addition, the estate planner may find it advantageous to have the transferee pay the premium for at least three years after the transfer. This will take advantage of the doctrine announced in *Liebmann v. Hassett*[44] which allows that portion of the proceeds attributable to the transferee's payment of premiums to be excluded from the gross estate. This doctrine is based on the theory that the value of the decedent's gross estate should not be increased by the transferee's enhancement of the value of the property.[45] Thus, if the transfer of the policy is determined to be in contemplation of death, the transferee's having paid the premiums will result in a tax saving.

This brings us to another problem presented by section 2035: Suppose that an insured died more than three years after he transferred a policy and that he continued to pay the premiums until his death. Suppose also that the advocate was unable to rebut the presumption that the premium payments during the last three years of decedent's life were made in contemplation of death. Is there to be included in the decendent's gross estate only the amount of the premiums paid, or such portion of the proceeds as the premiums paid within the three year period bears to the total premiums paid?

The consensus of the commentators appears to be that the pro rata amount of the proceeds will be included in the gross estate.[46] This result is reached by reasoning backwards from *Liebmann v. Hassett,* supra. Reduced to its simplest form this view is: Because the gross estate is credited with the proportional amount of the proceeds attributable to premiums paid by the transferee when the transfer of the policy is found to be in contemplation of

[43] Estate of Oliver Johnson v. Comm'r, 10 T.C. 680, 691 (1948).

[44] 148 F.2d 247,251 (1st Cir. 1945).

[45] U.S. Treas. Reg. 105, § 81.15; Proposed Regs. § 20.2035-1(e)(1956).

[46] Freyburger, Gifts of Life Insurance, 94 Trusts & Estates 476, 478 (1955), where he quotes Mannheimer, Wheeler and Friedman, 1955 Ins. L.J. 153, 159, for this same proposition.

death, the gross estate should include the amount of the proceeds which are attributable to premium payments which were made in contemplation of death.

Thus reduced, the reasoning appears to be wrong. First of all, it should be noted that the conclusion is not a logical necessity of the *Liebmann* pro rata rule because that rule deals with transfers of *policies* made in contemplation of death, while the transfers in the hypothetical are payments of *premiums* made in contemplation of death. Secondly, the *Liebmann* rule was based on a policy against charging the estate with enhancement of value caused by the transferee, and that policy has no application here. Thirdly, "it does not follow that merely because a donor pays an obligation of the donee and prevents a policy from lapsing, or a mortgage from being in default, or a leasehold from being forfeited, that he has made a gift of the proportionate part of the property."[47]

Arguments against the inclusion of any part of the proceeds can also be drawn by analogy to other parts of the law; e.g., the insured's estate is depleted only in the amount of the premium;[48] the increase in value was more like income than appreciation in value;[49] and,· the majority of states will only let the creditors of insolvent insured's reach the premiums.[50] It may also be argued that to include the proportional amount of the proceeds is to resurrect the premium payment test, contrary to the intent of Congress.[51]

On the other hand, Warren and Surrey suggest that even more than the proportional amount of the proceeds of the policy may be includible where the insured paid most of the premiums but only one of them in contemplation of death:

> . . .The argument would run as follows: in paying a premium within three years of his death the decedent insured kept alive the right to collect the entire proceeds of the policy at his death, and to the extent that the proceeds are attributable to premiums that he paid they should be included in his gross estate. Since this argument does not conflict with the premium payment test or with the policy reasons motivating the enactment of the provision that is now 2035 (b), it might succeed. [52]

47 Ibid.

48 Cf. E.T. 19, 1946-2 Cum. Bull. 166.

49 Cf. Harvey v. United States, 185 F.2d 463 (7th Cir. 1950).

50 Cf. 24 Am. Jur., Fraudulent Conveyances, § 90, 240 (1939).

51 Yohlin, op. cit. supra note 9, 456.

52 Warren and Surrey, Federal Estate and Gift Taxation, Cases and Materials 530 (1956 ed.).

Because the proposed regulations shed no light on this problem area, we may assume that it will be before the courts in the not-too-distant future. This assumption will probably be valid even though the entire issue may be avoided if the insured makes cash gifts and lets someone else pay the premiums.

B. Section 2036: Transfers with Retained Life Estates

In certain situations the Commissioner also is able to argue that the proceeds of life insurance are includible in the gross estate under section 2036—transfers with retained life estates. The argument arises from insurance companies' issuing single premium life policies to persons who are otherwise uninsurable if those persons relieve the company of the risk by the simultaneous purchase of an annuity.[53] Where the risk element was so eliminated, the Supreme Court held that the policy and the annuity were inseparable and that the insurance part of the combination was not insurance within the meaning of the Federal Estate Tax.[54] Using that decision as a lever, the Commissioner then argued that since the insurance and the annuity were inseparable, a transfer of the policy was just another transfer with a retained life estate and was, therefore, includible in the decedents gross estate under section 2036. This argument prevailed in the second[55] and sixth[56] circuits as well as in the tax court.[57] However, the seventh circuit refused to follow.[58] In specifically refusing to follow the other circuits, this court distinguished *Le Gierse* and held that the two contracts were in fact separable, that the annuity was neither based nor dependent upon the policy, and that the proceeds of the policy

[53] The remainder of the annuity at the time of decedent's death is payable to the company and used to pay the proceeds of the policy. In 1952, no less than 14 U.S. insurance companies issued this combination, and during September 1952, Prudential Life Insurance Company of America had 1,694 of these contracts in force providing insurance of almost thirty-one and one quarter million dollars. Note, 62 Yale L. J. 822 (1953).

[54] Helvering v. Le Gierse, 312 U.S. 531 (1941), the taxpayer arguing that it was insurance in an effort to take advantage of the then existing $40,000 exemption.

[55] Burr v. Comm'r, 156 F.2d 871 (2d Cir. 1946).

[56] Conway v. Glenn, 193 F.2d 965 (6th Cir. 1952).

[57] Estate of Reynolds v. Comm'r, 45 B.T.A. 44 (1941).

[58] Bohnen v. Harrison, 199 F.2d 492 (7th Cir. 1952), decided 2-1 with Judge Duffy dissenting.

were not includible in the gross estate merely because of the annuity. The Supreme Court granted certiorari[59] but divided equally[60] and would not allow a rehearing.[61] Thus, the issue is still undecided. The new regulations state that ". . . [A] contract under which the death benefit could never exceed the total premium paid, plus interest, contains no element of insurance,"[62] but they are otherwise silent on this problem. The most recent case in this area is *Fidelity-Philadelphia Trust Co. v. Smith*,[63] which was decided by a district court[64] in the third circuit on June 27, 1956. In holding that the proceeds of the policy which had been transferred were not includible in the gross estate, Judge Kraft relied heavily on the reasoning of the seventh circuit in *Bohnen*.

C. Section 2037: Transfers Effective at Death

It should be noted that a third alternative to holding that the proceeds are either includible or not includible is to hold that they are partially includible under section 2037—transfers taking effect at death.[65] This view divides the value of the proceeds into (a) the amount of the cash value just before decedent's death, and (b) the difference between the cash value just before death and its face value; excluding the cash value on the theory that its transfer was complete and could have been realized at any time before death, and including the remainder on the theory that it could be obtained only by surviving the decedent. However, this argument overlooks the fact that section 2037 will not apply unless a reversionary interest is found, and that the retention of income alone does not constitute such a reversionary interest. Thus, if no other reverter is found, this argument will fail.[66]

59 345 U.S. 903 (1953).

60 345 U.S. 946 (1953).

61 345 U.S. 978 (1953).

62 Proposed Regs. § 20.2039-1(d). See also: § 20.2042-1(a)(2).

63 142 F. Supp. 561 (E.D. Pa. 1956).

64 Ibid.

65 Note, 62 Yale L.J. 822,830 (1953), suggests this argument under Int. Rev. Code of 1939, § 811(c) (B).

66 Note that neither § 2037 nor § 2038 of the Int. Rev. Code of 1954 will normally be applied to life insurance policies as similar provisions are contained in § 2042.

III. SUMMARY

By way of summary, let us look at the problems that are presented by the 1954 Code's treatment of life insurance: First, the term insurance is used in its broadest sense. Second, if the decedent's estate will receive any benefit from the insurance, the proceeds must be included in the gross estate. Third, the proceeds will be included in the gross estate even though they are payable to other beneficiaries if at the time of his death the decedent had any of the incidents of ownership which, as we have seen, include any economic benefit whether the insured intended to have that benefit or not. And, fourth, the proceeds will be included in the decedent's gross estate if he retains a reverter which exceeds five percent of the value of the policy. Even if the estate planner is able to take insurance out of the reach of section 2042, his plan may still fall short of the desired tax savings under the sections of the Code dealing with contemplation of death, retained life estate, or transfers taking effect at death.

Thus, when the estate planner is deciding whether to suggest the transfer of life insurance for the purpose of an estate tax saving, he must first determine that on his particular set of facts, it will be possible to escape all of these tests.

In addition, the estate planner must try to predict the effect any possible change in the Code's treatment of life insurance would have upon his particular transfer. This question may be characterized in many different ways[67] but the basic question always remains the same: To what extent should life insurance be taxed? The answer depends upon such factors as who benefits when insurance is not taxed; should they be allowed so to benefit, or should the benefit be spread across the board by a reduction in the rate of taxation; does the difference have a beneficial effect on the nation's economy, etc. These factors lie in the complex area of social economics. They are left to the estate planner and his imagination.

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[67] A partial collection is found in the American Law Institute Proceedings (32d Annual Meeting) p. 101-20 which appears in Warren and Surrey, op. cit. supra, note 52, at p. 513ff.