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Taxation -- Marital Deduction -- Life Insurance Proceeds and the Terminable Interest Rule

Robert M. Huttar

CONCLUSION

These recent decisions contrast two schools of interpretation of the *International Shoe* doctrine: On the one hand are the state legislatures, seeking maximum jurisdiction in the interests of local residents by defining "minimum contacts" in such terms as "any contract made in this State,"[80] or the repeated solicitation of business in this State by mail or otherwise,[81] or the distribution of goods with the "reasonable expectation" that they will be used in this state and are so used,[82] or "tortious conduct" in this state,[83] provided the suit against the foreign corporation arises out of such "contacts."[84] On the other hand are the courts, refusing to accept these definitions when it is thought they will "offend traditional notions of fair play and substantial justice,"[85] yet accepting them when they are thought not to so offend.

It has been observed that by granting to the judiciary the power to determine what is "fair play" or "substantial justice" sets up the courts as policy-making bodies.[86] There is no argument here. The question is, what *is* the policy? And what is it to be tomorrow? From what has gone before, these observations seem justified: (1) Since *International Shoe,* the trend is clearly toward broader state jurisdiction; (2) however, there is a marked tendency to require physical presence of the agents of the corporation in the state before subjecting it to suit therein; and (3) the forum's inconvenience to the parties is sometimes deemed a factor but is of dubious pertinence; (4) although in the desire to secure a fair trial the doctrine of *forum non conveniens* may be seemingly incorrectly applied. It may be expected that, in the future, the "presence" and "convenience" factors will decline in importance, resulting in even broader state jurisdiction, with the *forum non conveniens* doctrine available as a safeguard against injustice to the foreign corporation.

FREDERICK A. BABSON, JR.

Taxation—Marital Deduction—Life Insurance Proceeds and the Terminable Interest Rule

In the Internal Revenue Act of 1948[1] Congress repealed the 1942 community property amendments,[2] and added the now familiar marital

[80] N. C. GEN. STAT. § 55-38.1(a)(1) (Supp. 1955).
[81] *Id.,* subdivision (2).
[82] *Id.,* subdivsion (3).
[83] *Id.,* subdivision (4).
[84] *Id.,* subsection (a).
[85] International Shoe Co. v. State of Washington, 326 U. S. at 316.
[86] Note, 20 TUL. L. REV. 437, 439 (1946). Justice Black, dissenting in the *International Shoe* case, 326 U. S. at 323, stated: "I think it a judicial deprivation to condition its exercise [state jurisdiction] upon this Court's notion of 'fair play,' however appealing that term may be."

[1] INT. REV. ACT OF 1948, 62 STAT. 110 (1948).
[2] INT. REV. CODE OF 1939, Sec. 811, as amended 62 STAT. 116 (1948).

deduction provision[3] to the Federal Estate Tax.

After setting out the marital deduction, the provision states that under certain circumstances, where the interest in property passing from the decedent to the surviving spouse might terminate or fail, the interest will not qualify for the deduction.[4] This portion of the section has come to be known as the "Terminable Interest Rule."

Broadly, the terminable interest rule excepts from marital deduction any asset included in decedent's gross estate which may, by any event, ultimately pass from the decedent to any person other than the surviving spouse for less than a full consideration in money or monies worth, and be possessed and enjoyed by such person after the surviving spouse.[5] For example, a terminable interest involving life insurance: decedent's life insurance proceeds are to be held by the insurer and are to be paid to the surviving spouse over a ten year period, with the added provision that if the surviving spouse should die within ten years, all remaining installments should be paid to decedent's children. In this case if the surviving spouse were to die within ten years, the interest in the property, which originally passed to decedent's surviving spouse, would terminate and pass to, and be enjoyed by, decedent's children for less than a full consideration. The fact that the surviving spouse may have a life expectancy of more than ten years will not prevent the interest from being terminable. It is enough that the interest *may* terminate and pass to someone else.

It is also important to note that to come within the rule, the interest must pass *from the decedent* to someone other than the surviving spouse. If the insurance proceeds were given to the surviving spouse as a lump sum settlement, and the surviving spouse later made a gift of the proceeds to other persons, the terminable interest rule would not apply since the proceeds would pass, not from the decedent to such other person, but from the surviving spouse.

The recently published proposed estate tax regulations for the Internal Revenue Code of 1954[6] have clarified a recent change in the application of the terminable interest rule to life insurance payments

[3] INT. REV. CODE OF 1939, Sec. 812 (e)added by 62 STAT. 117 (1948), amended 62 STAT. 1214 (1948).

[4] INT. REV. CODE OF 1939, § 812 (e) (1), 62 STAT. 117 (1948), amended 62 STAT. 1214 (1948).

[5] *Id.* See also Estate of Reilly v. Comm., 239 F. 2d 707 (3rd Cir. 1957). To qualify for marital deduction the asset must pass to the surviving spouse. The terminable rule concerns cases where an interest in property passing to the surviving spouse may terminate and pass to someone other than the surviving spouse. The purpose of the rule is to prevent property, which is not taxed in decedent's estate, from passing to someone other than the surviving spouse. Under the terminable interest rule an asset is taxed in either decedent's estate, or in estate of surviving spouse provided it is not dissipated or given away by surviving spouse prior to her death.

[6] 21 Fed. Reg. 7850 (1956).

made to the surviving spouse. The following discussion will be limited to the application of the rule to such proceeds.[7]

Terminable Interest Rule Prior to 1954 Code

Section 812 (e) (1) of the Internal Revenue Code of 1939[8] sets out the "power of appointment" exception to the terminable interest rule. Subparagraph G is made applicable to only life insurance and annuity payments.[9] Although stated in the code section, the requirements that must be followed to bring payments within this exception are more clearly stated in the regulations,[10] as follows:

"1) The proceeds must be held by the insurer subject to an agreement either to pay the proceeds in installments, or to pay interest thereon, with all such amounts payable during the life of the surviving spouse payable only to her.

"2) Such installments or interest must be payable annually or more frequently, commencing not later than 13 months after the decedent's death.

"3) The surviving spouse must have the power, exercisable in favor of herself or her estate, *to appoint all amounts so held by the insurer.*

"4) Such power in the surviving spouse must be exercisable by such surviving spouse alone and (whether exercisable by will or during life) must be exercisable in all events.

"5) The amounts payable under such a contract must not be subject

[7] For a full discussion of the Terminable Interest Rule as applied to other interests passing from decedent to the surviving spouse, see Lowndes & Kramer, *Federal Estate and Gift Taxes* 386 (1956).

[8] Sec. 812 (e) (1) (G)—Life Insurance or Annuity Payments with Power of Appointment in the Surviving Spouse—In the case of an interest in property passing from the decedent consisting of proceeds under a life insurance, endowment, or annuity contract, if under the terms of the contract such proceeds are payable in installments, or are held by the insurer subject to an agreement to pay interest thereon (whether the proceeds upon termination of any interest payments are payable in a lump sum or in annual or more frequent installments), and such installments or interest payments are payable annually or at more frequent intervals commencing not later than thirteen months after decedent's death, and all amounts payable during the life of the surviving spouse are payable only to such spouse, and such spouse has the power to appoint all amounts payable under such contract (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, whether or not in each case the power is exercisable in favor of the others) with no power in any other person to appoint to any person other than the surviving spouse any part of the amounts payable under such contract.
(i) such proceeds shall, for purposes of subparagraph (A) be considered as passing to the surviving spouse, and
(ii) No part of such proceeds shall, for purposes of subparagraph (B) (i), be considered as passing to any person other than the surviving spouse.
This subparagraph shall be applicable only if, under the terms of the contract, such power in the surviving spouse to appoint, whether exercisable by will or during life, is exercisable by such spouse alone, and in all events."

[9] Other portions of § 812 (e) (1) apply the power of appointment exception to interest passing to the surviving spouse other than life insurance.

[10] 26 C. F. R. 81.47 (a) (d) (1) (Supp. 1956).

to a power of appointment in any person, to appoint any part thereof, to any person other than the surviving spouse." (Emphasis added.)

In applying these regulations to an insurance plan the particular requirement that would cause special difficulty is that which states that the power of appointment in the surviving spouse must extend to "all the amounts so held by the insurer." It would follow from this requirement that if the power of appointment in the surviving spouse extended to only a portion of the proceeds held by the insurer, and the remainder were to be paid out as a terminable interest, then none of the proceeds would qualify for marital deduction.

The question thus facing the estate planner was, how could the settlement of life insurance proceeds be arranged so that although all of the proceeds would not qualify for marital deduction, at least that portion which satisfied the five requirements would qualify.

The regulations gave a solution to this question by a provision which stated in effect that if the insured, by the contract, directed that the proceeds be paid into separate funds to be held by the insurer and if the above requirements were satisfied as to all amounts held in any one of these separate funds, then the portion of the proceeds in that fund would qualify for marital deduction.[11] This separation of the insurance proceeds by direction in the contract appeared to be the only way the proceeds would be divided into separate interests, for marital deduction purposes.

The case of *Estate of Reilly v. Commissioner of Internal Revenue*,[12] though not involving the power of appointment provision, presented an interesting aspect of this problem. There the decedent's life insurance was planned so that the surviving spouse would receive a life annuity, with payments guaranteed for ten years. The policy further provided that if the surviving spouse died within ten years, all remaining payments would be made to decedent's children. The beneficiaries were denied the right to alienate, commute, assign, or anticipate payments.[13] The insurer, by actuarial computation had determined that of the $58,000 insurance proceeds, $28,000 would be necessary to pay the annuity for the ten year period, and $30,000 to pay the life annuity to the wife after the ten years. The tax payer conceded that the $28,000 necessary to pay the installments over the ten year period was a terminable interest,[14] but argued that since annuity payments to the surviving

[11] 26 C. F. R. 81.47 (a) (d) (2) (Supp. 1956).

[12] 239 F. 2d 797 (3rd Cir. 1957). Tax Court decision appears in 25 T. C. 366 (1955).

[13] If the surviving spouse were given such powers it might be argued that they were tantamount to a power of appointment.

[14] This portion was a terminable interest since the surviving spouse might die within ten years and then an interest in the property would pass to someone other

spouse after the ten year period was not a terminable interest,[15] the portion of the insurance proceeds necessary for those payments should qualify for marital deduction. The commissioner argued that "property" as used in the code referred to the entire property and that none of the insurance proceeds should qualify for marital deduction. The court, in adopting the taxpayer's theory that the insurance proceeds could be divided into separate property interests, stated, "The fact that each single property had its genesis in the same piece of paper is of no consequence taxwise."[16] As support for its holding the court cites the regulation providing for the separation of the proceeds into two funds.[17] Apparently, the court felt that although the decedent did not specifically direct payment into separate funds, he inadvertently accomplished the same result by choosing a settlement option as he did.[18]

Thus, prior to the Internal Revenue Code of 1954, if a division of insurance proceeds was desired for marital deduction purposes, the decedent could either direct that proceeds be divided into separate funds or hope that the court would hold that the settlement options selected accomplished the same result.

Terminable Interest Under the 1954 Internal Revenue Code

When the power of appointment provision applicable to life insurance proceeds in the Internal Revenue Code of 1954[19] is compared to its counterpart under the 1939 Code[20] the change in government policy in the area becomes quite apparent.

Section 812 (e) (1) (G) of the 1939 Code, in setting out the requirements for marital deduction states, "and such spouse has the power *to appoint all amounts payable under such contract*" (Emphasis added). Section 2056 (b) (6) of the Internal Revenue Code of 1954 is almost

than the surviving spouse, here the decedent's children, for less than an adequate consideration, and be possessed and enjoyed by them.

[15] As for payments after the ten year period, upon the death of the surviving spouse all payments ceased and no interest passed to anyone else.

[16] 239 F. 2d 797, 800. (3rd Cir. 1957.)

[17] 26 C. F. R. 81.47 (a) (d) (2) (Supp. 1956).

[18] In Shedds Estate v. Commissioner, 237 F. 2d 345 (9th Cir. 1956) involving property held in trust for the decedent's surviving spouse, the surviving spouse's interest in the trust entitled her to two-thirds of the income for life, and gave her power of appointment over one-half of the corpus. Though the question was not discussed, the Court refused to allow the corpus to be split into separate property interests, but gave full effect to subsection F of § 812 (e) (1) of the 1939 Code, which requires that the surviving spouse must have power of appointment over the *entire* corpus before marital deduction will be permitted. The Court said, "It is well settled that statutory exemption from taxes of this kind should be strictly construed against the taxpayer, and are held applicable only to subject matter or beneficiaries clearly within their terms." *Ibid.* at 357. Apparently this view was not adopted by the Court in the Reilly case.

[19] INT. REV. CODE OF 1954, § 2056 (b) (6).

[20] INT. REV. CODE OF 1939, § 812 (e) (1) (G). See footnote 8 for the complete section.

identical to the comparable section of the 1939 Code except that the 1954 Code section states, "and all amounts, *or a specific portion of all such amounts,* payable during the life of the surviving spouse are payable only to her, and such surviving spouse has power to appoint all amounts, *or such specific portions,* payable under such contract" (Emphasis added).[21]

Thus, under the 1954 Code, if the power of appointment requirements are satisfied as to only a portion of the insurance proceeds, that portion will qualify for marital deduction even though the remainder of the proceeds may be paid out as a terminable interest. The estate planner can now apply the power of appointment provision without any fear that if any part of of the insurance proceeds are paid out as a terminable interest, it will cause the entire proceeds to be disqualified for marital deduction purposes.

Under the 1954 Code, if interest on the entire proceeds of decedent's insurance were to be paid to the surviving spouse during his or her life time and the proceeds were to be paid to decedent's children at the death of the surviving spouse, if the wife were given a power to appoint only one-third of the proceeds, then only that one third would qualify for marital deduction. Conversely, if the wife had power of appointment over the entire proceeds, but received interest on only one third, still only one third would qualify.[22]

Now that the government has clearly adopted a policy of allowing proceeds to be divided into separate properties where the power of appointment provision is used, the question remains, will that policy be adopted in situations such as the Reilly case presented, where the power of appointment provision is not applied. It would seem that since the policy has been adopted, it would be applied in all cases, whether or not the power of appointment provision is involved.

Summary

In dealing with the particular area of marital deduction, the estate planner must make certain that, as to the portion of the life insurance proceeds which he expects to qualify for marital deduction, *all* of the requirements are met.

[21] In the Proposed Estate Tax Regulations, under the Internal Revenue Code of 1954, published in 21 Fed. Reg. 7901 (1956) the clause, "or such specific portions of such proceeds" is included in all appropriate places. With this clause added, the five requirements of a valid power of appointment, as set out earlier in the note, are the same under the 1954 Code proposed regulations as under the regulations for the 1939 Code. A similar addition was also made in § 2056 (b) (5) of the 1954 Code relating to life estates with power of appointment in the surviving spouse.

[22] In the second example, as to the two-thirds of the proceeds on which the wife did not receive interest, the requirement that proceeds must be held subject to an agreement to pay interest (or installments) thereon to surviving spouse during her life time, would not have been met.

Special notice should be taken to the following:

1) Payments of either interest or installments *must be made* during the life of the surviving spouse, and only to the surviving spouse. Here special care should be taken in making certain that interest, or even dividends, could not be received by anyone other than the surviving spouse.

2) Payments must be made at least annually, and commence within thirteen months of decedent's death. An annuity for the surviving spouse that would commence two years from decedent's death would fail to qualify if interest were not paid in the interim.

3) The power of appointment in the surviving spouse can be exercisable only in favor of the surviving spouse or her estate.

4) Only the surviving spouse may exercise the power of appointment, and it *must be exercisable* in all events. If the policy provided that the surviving spouse would lose the power of appointment, for example, if she remarried, this condition would not be satisfied.[23]

It would pay the estate planner to compare payments made under each settlement option employed, with the requirements set out in the regulations, with particular attention toward all contingencies that might occur under each option. In this way the planner would be assured that the proceeds which he expects to qualify would, in the final analysis, be subject to marital deduction.

ROBERT M. HUTTAR.

Torts—Distinction Between Intentional and Negligent Conduct Under Tort Claims Act

Governmental immunity from civil suit is an historical characteristic of Anglo-American jurisprudence. The principle developed in England on the premise that "the king can do no wrong."[1] While it may be said that immunity is still the basic rule and liability the exception, the modern trend is to allow limited avenues of enforceable liability against the government.[2] In allowing itself to be sued for any wrongful act of its employees and permitting liability "to the same extent as a private individual,"[3] the Federal Government, with a few exceptions,[4] has

[23] The only exception to this rule is that an interest passing to surviving spouse will not be considered terminable because of a common disaster clause provided 1) the clause does not exceed six months, and 2) the termination of wife's interest by a common disaster does not, in fact, occur. Sec. 21 Fed. Reg. 7894 (1956).

[1] See Hans v. Louisiana, 134 U. S. 1, 33 Law. Ed. 842 (1889).

[2] Leflar and Kantrowitz, *Tort Liability of the States*, 29 N. Y. U. L. REV. 1363 (1954).

[3] 28 U. S. C. § 2674 (1952).

[4] 28 U. S. C. § 2680 (1952).