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that such power is inherent even in the absence of statute¹⁹ support the desirability and propriety of denominating all new affirmative matter in the reply as an amendment to the complaint.

The proposed new rules limit the scope of the problem considerably since a reply is only allowed in response to a counterclaim denominated as such, or when ordered by the court.²⁰ Thus, unless the courts hold contrary to the apparent intention of the new rules, the number of instances when plaintiff may run afoul of North Carolina restrictions on the reply will be sharply reduced. Noting, however, that under the new rules, the *complaint* may contain claims which are alternative, inconsistent, or unrelated,²¹ the striking of the reply as not being defensive seems to find even less justification.

WILLIAM S. GEIMER

Taxation—Reintroduction of the Premium Payment Plan?

In Revenue Ruling 67-463¹ the Commissioner of Internal Revenue has taken the position that when a husband transfers all incidents of ownership of an insurance policy to his wife more than three years prior to his death, but continues to pay the premiums until his death, the premiums paid within the last three years are paid in contemplation of death and represent a transfer of an *interest* in the policy. The interest transferred is measured by the proportion the amount of premiums so paid bears to the total amount of premiums paid; therefore, the proportionate value of the insurance bought by these premiums is includible in his gross estate under section 2035.² Arguably, this ruling is a reintroduction of the old "premium payment" plan rejected by Congress in 1954.

In making this ruling, the Commissioner could have taken two

¹⁹ *Gilliam Furniture Inc. v. Bentwood Inc.*, 267 N.C. 119, 120, 147 S.E.2d 612, 613 (1966).

²⁰ PROPOSED N.C. RULES CIV. PROC. 7(a) (1967).

²¹ PROPOSED N.C. RULES CIV. PROC. 8(e) (1967).

¹ Rev. Rul. 67-463, 1967 INT. REV. BULL. No. 52, at 15.

² INT. REV. CODE of 1954, § 2035. For example, if A buys an insurance policy worth one hundred thousand dollars and pays eight thousand dollars in premiums over a four year period, with six thousand dollars being paid over the last three years prior to death, the Commissioner would include in his gross estate three-fourths of the value of the policy or seventy-five thousand dollars, and not the six thousand paid for the premiums.

other positions.³ He might have included the entire proceeds of the policy in decedent's estate on the theory that the payment of the last premium kept alive the right to receive the proceeds upon death. Or he could have included in the taxable estate only the amount of the premium payments actually made by the decedent within the three year period. However, the Commissioner chose the third alternative, ruling that "unlike the unrestricted gift of money, a premium payment is a gift of insurance protection, a *transfer of an interest in the policy*."⁴ The Revenue Ruling's position is contrary to that in *Lamade v. Brownell*.⁵ The two fact situations seem indistinguishable. The court in *Lamade* holds that where the insured has absolutely assigned the policy to his wife, having never exercised any incidents of ownership in the policy, the proceeds are not includible in his gross estate even though the insured *had paid premiums on it for the two years immediately prior to his death*. The court said that "the payment of premiums on said policy by the decedent for the two years immediately prior to his death was by way of gift."⁶

The Internal Revenue Code of 1954 changed the then existing law and provided in Section 2042⁷ that the sole test for determining whether proceeds, not payable to the executor, are includable in the decedent's estate is whether the decedent retained any of the incidents of ownership in the policy at his death.⁸ The congressional intent was to place life insurance on a par with other property, which may be given away free from estate tax if not made in contemplation of death or in violation of the other inter vivos transfer sections. It was felt by the majority of members of the House Ways and Means Committee that to discriminate against life insurance was unjustified, in that it should be the nature of the dis-

³ Moses, *Irrevocable Life Insurance Trusts Can Be Attractive Estate Planning Tool*, 18 J. TAXATION 206, 211 (1963).

⁴ Rev. Rul. 67-463, 1967 INT. REV. BULL. No. 52, at 15.

⁵ 245 F. Supp. 691 (M.D. Pa. 1965). Cited with approval in *United States v. Rhode Island Trust Co.*, 355 F.2d 7, 12 n.4 (1st Cir. 1966).

⁶ 245 F. Supp. at 697.

⁷ INT. REV. CODE OF 1954, § 2042.

⁸ H.R. REP. No. 1337, 83d Cong., 2nd Sess. 90 (1954). The House Ways and Means Committee said: "The bill (sec 2042) would make a basic change by excluding life insurance proceeds from the taxable estate of the insured unless at his death he possesses 'incidents of ownership' of the policy. Where the insured gives away the beneficial interest in the policy, but pays the premiums, the death benefits would no longer be taxed in his estate." *Id.* at B 14.

position rather than the property which determines the testamentary character of the gift.⁹

Section 2042 of the Internal Revenue Code, is not, of course, the only section under which the proceeds of life insurance can be included in the gross estate. Section 2035¹⁰ treats a transfer of the incidents of ownership within three years of death as being in contemplation of death. However, the Revenue Ruling applies where all the incidents of ownership of the policy itself are transferred more than three years before death. The only question of this Revenue Ruling is whether the money used to pay the premiums, admittedly transferred in contemplation of death, represents more than the actual dollar amount of the premium.

The Commissioner cites several cases in support of his affirmative position. *Chase National Bank v. United States*¹¹ is cited for the proposition that a "transfer" means more than the passing of items of property *directly* from the decedent to the transferee, and includes the transfer of property procured through expenditures by the decedent which results in having it pass to another. The court in this refund case was concerned with plaintiff's argument that because the proceeds were payable from the insurance company to the beneficiary, rather than *directly* from the insured, there was nothing on which a transfer tax from the insured to the beneficiary could be imposed. The crux of the argument centers on the word *directly*. The court said that "the power to tax the privilege of transfer at death cannot be controlled by the mere choice . . . of the particular methods by which his purpose is effected, so long as he retains control over those benefits."¹² This case is distinguishable from the Revenue Ruling, because it involves a complete transfer of the policy in which the decedent has no control over the benefits already transferred. The only property under his control is the money used to pay the premiums.

⁹ *Id.* The minority position is also stated in the Reports "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." *Id.*

¹⁰ INT. REV. CODE of 1954, § 2035.

¹¹ 278 U.S. 327 (1929). *Lehman v. Commissioner*, 109 F.2d 99 (2d Cir. 1940), *cert. denied*, 310 U.S. 637 (1940), is cited for the same proposition.

¹² 278 U.S. at 338.

Liebman v. Hassett,¹³ according to many writers,¹⁴ constitutes valid authority for the Commissioner's position in the Revenue Ruling. The case involved an assignment of a policy by the decedent to his wife two years before his death, thus raising a presumption of a transfer "in contemplation of death." Since the assignee had paid the two premiums during the period between assignment and death, it was held that the face value of the policy less the pro rata amount of insurance purchased with the two premiums paid by the assignee was to be included in the gross estate. In anticipation of the position taken by the Commissioner in this Revenue Ruling two writers¹⁵ have already explored the differentiating factors between the *Liebman* situation and the rationale of the present ruling. The most distinguishable factor is that in *Liebman* the policy itself was transferred in contemplation of death. In the Revenue Ruling the policy and all incidents of ownership were transferred more than three years before death with only a premium payment being transferred in contemplation of death. Moreover, it is necessary to consider the word "transfer" as used in Section 2035, which includes in the gross estate "property [except real property situated outside of the United States] to the extent of any interest therein of which the decedent has at any time made a transfer . . . in contemplation of his death."¹⁶ The emphasis is on a transfer of property made during decedent's life, and what is included is the value of the property which was the *subject of the inter vivos transfer*. "Although the tax is to be measured by the value of the transferred property as of the date of the donor's death, this does not mean that, for the purpose of determining what

¹³ 148 F.2d 247 (1st Cir. 1945).

¹⁴ See W. WARREN & S. SURRY, FEDERAL ESTATE AND GIFT TAXATION 523 (1961 ed.); Mannheimer, Wheeler, Friedman, *Gifts of Life Insurance By the Insured*, N.Y.U. 13TH INST. ON FED. TAX. 260 (1954); Moses, *Irrevocable Life Insurance Trusts Can Be Attractive Estate Planning Tool*, 18 J. TAXATION 206, 211 (1963); J. AM. Soc'y C.L.U., Spring 1962, 117, 131.

¹⁵ Brown & Sherman, *Payment of Premiums as Transfers in Contemplation of Death*, 101 TRUSTS & ESTATES 790 (1962). The authors also point out that even if there had been no assignment the same portion of the proceeds would have been excluded. The case was decided under the Revenue Act of 1926, Sec. 302(g). This section made life insurance, payable to named beneficiaries, taxable to the extent that it was "taken out" by the decedent. Under T.D. 5032, 36 TREAS. DEC. INT. REV. 15 (1941), "taken out" meant the extent decedent paid the premiums.

¹⁶ INT. REV. CODE OF 1954, § 2035.

property was transferred, the gifts should be regarded as having been made as of the date of death."¹⁷ It is arguable therefore that if the decedent owns no part of the policy (having transferred all incidents of ownership to the assignee more than three years before death) the value of the gift should be determined by what property is still under his control, i.e. the money used to pay the premiums. Reinforcing this argument is the expressed wish of Congress to eliminate the payment of premium plan in section 2042 of the 1954 Code,¹⁸ and the fact that *Liebman* is a 1943 decision. Whether *Liebman* should be considered good authority in a contemplation of death case, even if it were on "all fours," is questionable in view of the 1954 changes in section 2042. It seems reasonable to assume that Congress intended to eliminate the payment of premium test altogether, considering the expressed purpose of the Committee to treat insurance like any other property. If decedent transfers income producing property, the taxability of the income depends on whether the transferor completely divested himself of all interests in the property, and if he did, the income is not taxable to him.¹⁹ Similarly, the increased value of the policy should not be taxed to him because he has completely transferred all incidents of ownership.

The recent case of *Scott v. Commissioner*²⁰ is cited by the Commissioner as holding that upon the husband's death, the proportionate part of the proceeds of the policy attributable to his payment of the premiums is includible in his gross estate. The facts show that decedent and his wife owned the policies as community property under California law. The wife predeceased her husband and bequeathed to her sons her one-half community interest in policies on his life. After her death, the husband paid premiums on the policies, and the court held that the proportionate part represented by his payment of premiums was includible in his estate.²¹

¹⁷ *McGhee v. Commissioner*, 260 F.2d 818, 820 (5th Cir. 1958).

¹⁸ H.R. REP. No. 1337, 83d CONG. 2d SESS. 90 (1954).

¹⁹ See Treas. Reg. § 20.2035-1(e) (1964); Jacob Gidwitz, 14 T.C. 1263 (1950) *aff'd*, 196 F.2d 813 (7th Cir. 1952); James E. Frizzel, 9 T.C. 979 (1947), *aff'd on reconsideration*, 11 T.C. 576 (1948), *aff'd* 177 F.2d 739 (5th Cir. 1949).

²⁰ 374 F.2d 154 (9th Cir. 1967).

²¹ The regulations since 1949 have stated that in determining whether or not a decedent possessed any incidents of ownership in a policy, regard must be given to the effect of the state or applicable law upon the terms of the policy. Thus, California property law must be consulted to determine whether incidents of ownership are possessed in an insurance policy purchased with community funds. See R. PAUL, SELECTED STUDIES IN FEDERAL

California cases clearly hold that such insurance contracts may be separate property, community property, or mixed, depending upon the source of the premium payments.²² Thus, to the extent of determining whether a policy is community property the premium payment test is preserved. This is quite different from the Revenue Ruling in that the question is not the determination of a community property interest, but whether the transfer involved more than the actual money given in contemplation of death.

The issue facing the Commissioner involved the basic determination of exactly what property interest the payment of a premium represented. As stated by the Supreme Court, the estate tax "extends to the creation, exercise, acquisition, or relinquishment of any power or legal privilege which is incident to the ownership of property."²³ Basic to a transfer is the transmission from one to another of an interest in property. The interest must be capable of existing and must be one which is in fact transferred.²⁴ If the interest exists, then a determination of some value on the interest should be possible. To find the fair market value of a property interest at the decedent's death the test is to put oneself in the position of a potential purchaser of the interest at that time.²⁵ It is submitted that a purchaser would give little for the "interest" decedent had in the policy for the three years prior to death. He had transferred all incidents of ownership and therefore had no control over the property which was in the hands of the recipient.²⁶

It is hoped that the reasoning of the *Lamade* case, combined with the expressed intent of Congress, will be followed when Revenue Ruling 67-463 is litigated. To find for the Commissioner would be a reintroduction of the payment of premium test, at least in spirit. This test was abandoned by Congress in 1954 and should not be reestablished by judicial interpretation of section 2035. If the result advocated by the Revenue Ruling is desirable, then section 2035 or section 2042 should be amended by Congress to reflect such a desire.

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TAXATION 1-33 (2d ser. 1938). See also *Lang v. Commissioner*, 304 U.S. 264 (1938).

²² *Travelers Ins. Co. v. Fancher*, 219 Cal. 351, 26 P.2d 482 (1933); *Gettman v. Los Angeles*, 87 Cal. App. 2d 862, 197 P.2d 817 (Dist. Ct. 1948).

²³ *Fernandez v. Wiener*, 326 U.S. 340, 352 (1945).

²⁴ *Eleanor A. Bradford*, 34 T.C. 1059, 1064 (1960).

²⁵ *United States v. Land*, 303 F.2d 170 (5th Cir. 1962).

²⁶ *But see Walter v. United States*, 341 F.2d 182 (6th Cir. 1965).