NORTH CAROLINA LAW REVIEW

Volume 49 | Number 3 Article 9

4-1-1971

Federal Estate Taxation -- Life Insurance Trusts

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Agriculture. The great gaps in current education programs need to be filled by increased funding if the licensing proposals are to be meaningful.

> The issue of persistent pesticides is not whether the chemical revolution in the control of pests has proven useful . . . . [O]ur miracle innovations must be made to serve the ends of civilization . . . . Certainly no goal surpasses in importance the need to prevent man from harming, abusing or destroying himself and his environment.[61]

ELIZABETH LYNNE POU

Federal Estate Taxation—Life Insurance Trusts

Life insurance is often purchased by a wife on the life of her husband for the benefit of herself or her children. Should the wife predecease her insured husband, she may provide that he act either as executor of her estate or as trustee of a testamentary trust containing the insurance policies on his life and her other investment assets. Upon the insured husband's subsequent death, the Commissioner may contend that the proceeds of the insurance policies are to be included in the husband's gross estate due to the fact that at the time of his death the husband possessed incidents of ownership in the insurance policies, albeit in only a fiduciary capacity. The Court of Appeals for the Sixth Circuit dealt with such a problem in *Fruehauf v. Commissioner*,[1] in which fiduciary powers held by the insured over life insurance policies were deemed sufficient "incidents of ownership" to compel inclusion in the insured's gross estate under section 2042 of the Internal Revenue Code of 1954,[2] although he had neither owned nor made an inter vivos transfer of the policies.

Vera Fruehauf purchased six life insurance policies on the life of her husband, Harry, designated herself sole beneficiary of each policy, and paid all premiums due prior to her death. Under Vera's will, Harry was named both coexecutor of her estate and cotrustee of a trust to be formed

[61] *Persistent Pesticides* at 611.

[1] 427 F.2d 80 (6th Cir. 1970).

[2] INT. REV. CODE of 1954, § 2042, provides in part:

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

. . . .

(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.

from her residuary estate. The will provided that "[t]o the extent possible, all life insurance policies owned by me on the life of others . . . shall be assigned to the . . . trust."[3] The net income of the trust was to be paid to Harry for life with remainder to Vera's issue *per stirpes.*

The executors and trustees were given broad powers under Vera's will,[4] including the right to surrender the insurance policies for their cash surrender value. Harry died approximately fourteen months after Vera, leaving the administration of Vera's estate incomplete. Consequently, there had been no distribution to the trust provided for in Vera's will, nor had Harry been appointed trustee by the probate court. Therefore, the assets of Vera's estate, including the insurance policies, were distributed outright to the Fruehauf's sole surviving son pursuant to Vera's will.

The executors of Harry's estate did not include the proceeds of the insurance policies in his gross estate when they filed his federal estate tax return. The Commissioner asserted a deficiency on the theory that since Harry, at the time of his death, *possessed* "incidents of ownership" in the policies as cotrustee and as coexecutor of Vera's estate, the proceeds of the policies should be included in his gross estate under section 2042. The Commissioner did not attempt to include in Harry's gross estate any of the other assets that were to comprise the corpus of the testamentary trust.

Section 2042 includes in the gross estate the proceeds of all life insurance policies on a decedent's life to the extent that "the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person."[5] Subject to one exception,[6] the Code offers no definition of the term "incidents of ownership." The Regulations, however, provide some guidance:

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[3] Estate of Harry R. Fruehauf, 50 T.C. 915, 917 (1968).

[4] Vera's will provided in part:

> *Tenth:* My Executors and my trustees may retain for such periods as they determine advisable any insurance policies owned by me at my death on the life of any other person, and pay the premiums on such policies whenever they become due out of income and/or principal as they shall see fit, and cause themselves to be designated as the beneficiaries thereof, or they may, at any time, sell and assign any of such policies to the person whose life is insured for the cash surrender value thereof, or they may surrender any of such policies for their cash surrender value, or they may, at any time, convert any of such policies into paid up policies in whatever amounts may be provided by the terms of such policies. With respect to any policies retained by them, they may arrange for the automatic application of dividends in reduction of premium payments and they may borrow on any of such policies, make premium payments from the funds so derived, and repay such loans.

427 F.2d at 82.

[5] INT. REV. CODE of 1954, § 2042.

[6] INT. REV. CODE of 1954, § 2042, does provide that "the term 'incidents of

> For the purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus it includes 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. . . .[7]

Harry's estate argued that the power Harry possessed over the policies did not constitute "incidents of ownership" within the meaning of section 2042 since these powers were held solely in a fiduciary capacity, and Harry at no time had owned or transferred the policies in an individual capacity. The Commissioner felt that both of these contentions were incorrect, and "[t]he issue was thus narrowed . . . to the question of whether the powers over the policies which decedent . . . held constitute 'incidents of ownership' in view of the fact that he held these powers in a fiduciary capacity only."[8] Both the Tax Court and the court of appeals answered in the affirmative, but for different reasons.

The Tax Court majority, relying heavily on cases arising under section 2038[9] (revocable transfers), reasoned that

> [t]here is no doubt at all but that sections 2038 and 2042 are parts of a tax pattern to make includable in the gross estate property over which the decedent held various powers affecting beneficial enjoyment. Since case law makes immaterial for purposes of section 2038 the capacity in which the powers are held, it is not logical to make capacity a significant factor as far as section 2042 is concerned.[10]

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ownership' includes a reversionary interest . . . if the value of such reversionary interest exceeded 5 per cent of the value of the policy immediately before the death of the decedent."

[7] Treas. Reg. § 20.2042-1(c)(2) (1958).

[8] 427 F.2d at 83.

[9] INT. REV. CODE of 1954, § 2038, provides in part:

(a) . . . The value of the gross estate shall include the value of all property—

(1) . . . To the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death.

[10] Estate of Harry R. Fruehauf, 50 T.C. 915, 926 (1968).

The Tax Court held that "the fact the powers over the policies were held in a fiduciary capacity is no bar to their constituting incidents of ownership under section 2042."[11] The concurring judges, however, intimated that they would not go so far as to hold that "any power in the nature of an incident of ownership exercisable by an insured decedent in his fiduciary capacity causes the proceeds of the policy to be included in his gross estate."[12] They felt that the holding should be limited to its facts. That is, Harry's power as trustee enabled him to surrender the policies for their cash surrender value, which could be added to the trust corpus, thereby increasing the income producing capacity of the trust to Harry's advantage as income beneficiary.

The court of appeals disagreed with the Tax Court's approach in two respects: (1) the Tax Court's failure to recognize the different considerations underlying sections 2038 and 2042; and (2) its failure to recognize the fundamental nature of the fiduciary relationship. In discussing the first point the court of appeals declared:

> We must disagree with the Tax Court's broad *per se* rule. We believe there is a distinction between the issues arising under § 2038 where the decedent, as *transferor* of certain property, possesses at his death the power, even though in a fiduciary capacity, to revoke or change the transfer, and the issues in a case arising under § 2042 where the decedent is the *transferee,* in a fiduciary capacity, of powers constituting incidents of ownership in the insurance policies on his life. Where a decedent holds the requisite powers over policies on his life solely because he is a *transferee,* in a fiduciary capacity, of those powers, with no beneficial interest therein, such arrangement can hardly be construed as a substitute for testamentary disposition on decedent's part.[13]

As to the second point, the court criticized the Tax Court for not following previous Tax Court decisions. In *Estate of Newcomb Carlton,*[14] in which the decedent transferred twenty-one insurance policies along with certain securities to a trust, the Tax Court had held that the decedent's powers over insurance policies did *not* constitute incidents of ownership. Although the decedent retained the right to appoint a cotrustee (including himself), as well as the right to the trust income in excess of the amount needed to pay the premiums on the policies, the Tax Court concluded that

[11] *Id.*
[12] *Id.*
[13] 427 F.2d at 84 (emphasis added).
[14] 34 T.C. 988 (1960), *rev'd on other grounds,* 298 F.2d 415 (2d Cir. 1962).

> [a]ny control that decedent would have acquired over the insurance policies had he appointed himself cotrustee would have been control over the policies jointly with the corporate trustee as trustee only and *such control would be solely for the benefit of the trust. Such control as trustee would not constitute incidents of ownership in the insurance policies in decedent except in his capacity as trustee for the benefit of the trust.*[15]

Similarly, the Tax Court clearly recognized the principle that fiduciary powers do not necessarily constitute incidents of ownership within the meaning of section 2042 in *Estate of Bert L. Fuchs*:[16]

> Assuming, *arguendo*, that the insured . . . possessed the naked power to change beneficiaries or make an assignment, we cannot say . . . that the insured herein should be treated in any way differently than a common trustee. Each insured herein was under no less of a legal duty to respect the terms of the partners' agreement than a common trustee legally obligated to respect the terms of a trust indenture. Decedent merely had the same type of power over the . . . policies as a trustee's power to affect trust proceeds. We do not believe that this type of naked power alone is sufficient to bring the insurance proceeds within decedent's gross estate.[17]

Based upon these two decisions, the court of appeals rejected the sweeping rule espoused by the Tax Court in *Fruehauf* by refusing to hold that "mere possession by a decedent of any powers in the nature of incidents of ownership in a fiduciary capacity invariably requires the inclusion of the proceeds of the policies on the decedent's life in his gross estate."[18] Nevertheless, the court felt that since Harry could exercise his fiduciary powers in such a manner as to benefit himself as the income beneficiary of Vera's trust, these powers, notwithstanding the fiduciary capacity in which they were held, did constitute sufficient "incidents of ownership" within the meaning of section 2042.[19]

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[15] *Id.* at 996 (emphasis added).

[16] 47 T.C. 199 (1966). This case involved a partnership purchase agreement that prohibited decedent-owner from exercising his rights under the life insurance policy to change the beneficiary or to surrender the policy for its cash surrender value.

[17] *Id.* at 204.

[18] 427 F.2d at 85.

[19] Whereas the concurring judges in the Tax Court only emphasized Harry's power as cotrustee of Vera's testamentary trust, the court of appeals felt that either power alone (*i.e.*, cotrustee *or* coexecutor) would be sufficient to demand inclusion, reasoning that

> [u]nder the provisions of . . . decedent's wife's will, decedent was authorized, both as executor and as trustee, to surrender the policies on his life

One may criticize the *Fruehauf* opinion for its failure to examine the position of life insurance in the overall estate tax scheme. Since *Fruehauf* is the first case to hold that a decedent possesses "incidents of ownership" by virtue of his fiduciary power in life insurance policies, which he neither owned nor transferred inter vivos, one might well expect the court to set forth a detailed analysis of its reasoning. However, the court not only failed to set forth the rationale of its holding, but it also failed to take proper account of *Estate of Newcomb Carlton*,[20] which held for the taxpayer on the precise issue raised in *Fruehauf*. Although *Fruehauf* arguably overrules *Carlton* while purporting to rely upon it, it is actually a stronger case for the taxpayer than *Carlton* since the decedent in *Carlton* at one time owned the policies outright and subsequently made an inter vivos transfer to a trust, reserving the right to the net income in excess of that needed to pay the premiums and the right to appoint himself as cotrustee. Had he exercised his right to appoint himself trustee he, like Harry, could have surrendered the policies for their cash surrender value, thereby increasing the income producing ability of the trust which would inure to his benefit in exactly the same manner that prompted the court in *Fruehauf* to hold against the taxpayer. Moreover, in *Fruehauf* the fiduciary powers that the decedent possessed were not *retained* by him in connection with a lifetime transfer, as was the case in *Carlton*, but rather were *conferred* upon him by his wife's will.

Although the court sharply criticized the Tax Court for not distinguishing the basic nature of the fiduciary relationship, it apparently felt that if the trustee had a personal stake in the trust (*e.g.*, as income beneficiary) then this somehow changed the "fundamental nature of the fiduciary duty." No support for this position can be found in the Code or case law. In fact, *Carlton* stands in stark conflict with this view. Arguably, it should be of no significance whether or not the fiduciary has a personal stake in the trust. For one thing, he is still subject to control by a state court for abuse of discretion. This position was apparently adopted in *Old Colony Trust Co. v. United States*,[21] in which the first circuit seemingly

for their cash value. If this had been done the policies would have been transformed from non-income producing assets designed to benefit primarily the ultimate beneficiary of the trust into income producing assets (since it must be assumed that such proceeds would not remain idle), which would benefit decedent when he assumed his capacity as trustee and income beneficiary of the trust.

Id. at 86.

[20] 34 T.C. 988 (1960).

[21] 423 F.2d 601 (1st Cir. 1970).

rejected its earlier holding in *State Street Trust Co. v. United States*,[22] and implied that since even broad fiduciary powers are within the reach of equity courts, they do not constitute the requisite powers over the trust property that demand inclusion in a decedent's gross estate.[23]

A major deficiency in the court's opinion is its failure to deal with the estate's argument that under the Commissioner's view, insurance is treated more harshly than other assets,[24] thus being contrary to Congress' express intent to treat life insurance like other property.[25] While the full

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[22] 263 F.2d 635 (1st Cir. 1959). In *State Street*, a case arising under section 2036, the court accepted the Commissioner's strict view that certain broad fiduciary powers can constitute a power to shift beneficiary enjoyment of a trust interest between life tenants and remaindermen and that these powers may be beyond the reach of a court of equity. However, it must be pointed out that in this case the fiduciary powers were retained by, not conferred upon, the decedent.

[23] Even before *Old Colony Trust* state courts had generally agreed with a Massachusetts court's criticism of *State Street* in a case holding that a trustee's broad power to shift enjoyment is subject to control by a court of equity, and such power, regardless of how broad, can only be exercised in accordance with proper fiduciary standards. Boston Safe Deposit & Trust Co. v. Stone, 348 Mass. 345, 203 N.E.2d 547 (1965). The court considered *State Street* and said that "[e]ven broadly expressed administrative and management powers . . . 'are limited by standards which the Massachusetts court of equity could and would apply to supervise effectively * * * [proper trust] administration.' We disagree with any suggestion to the contrary . . . in the majority opinion in that case. . . ." *Id.* at 351 n.8, 203 N.E.2d at 552 n.8. *See also*, United States v. Powell, 307 F.2d 821 (10th Cir. 1962); Estate of Ralph Budd, 49 T.C. 468 (1968); Estate of Marvin L. Pardee, 49 T.C. 140 (1967). Even the Commissioner, prior to *Fruehauf*, seemed to be backing away from his strict position regarding fiduciary powers. *Cf.* Rev. Rul. 69-56, 1969-1 CUM. BULL. 224.

[24] The estate's brief stated:

> Thus in 1954 Congress took great care to be sure that the same reversionary interest rule that applies to transfers made by a decedent that take effect at his death (section 2037) applied also to insurance so as "[t]o place life insurance policies in an analogous position to other property * * *." This illustrates the degree of thought that Congress gave to a redefinition of "incidents of ownership" in 1954; yet it did nothing to indicate that it intended to create a broader rule for the inclusion of life insurance proceeds than for other assets. *Nevertheless, that is precisely the result that the Tax Court reached in this case, for its holding includes the life insurance proceeds in Harry's estate but not the other assets in the same trust!*

Brief for Petitioner-Appellant at 19-20.

[25] Congress' reasons for the 1954 changes in the taxation of life insurance is set forth in the following Senate Report:

> The proceeds of life insurance on a decedent are subjected to tax in his estate under present law if the policy is payable to the executor, if the decedent paid the premiums on the policy (in this case includable in proportion to the amount paid), or if the decedent possessed any elements of ownership in the policy at date of death.
>
> No other property is subject to estate tax where the decedent initially purchased it and then long before his death gave away all rights to the

extent of congressional intent in this respect remains uncertain, the estate's argument should have been answered rather than completely ignored. At first glance it does seem unfair to include the total amount of the insurance proceeds in Harry's gross estate since he neither owned the policies outright nor had he transferred them during his life. In fact, Harry did not enjoy any of the tangible benefits of ownership during his lifetime other than the right, derived solely from Vera's will, to become income beneficiary of a trust comprised partially of the insurance policies as well as other assets. The fact that none of the other assets that were to be included in Vera's testamentary trust were included in Harry's gross estate, although his fiduciary powers over these noninsurance assets were just as broad as those over the insurance policies, does show that life insurance, for the first time since the 1954 Code, is being treated more harshly than other assets.

The obvious discrimination that one discerns in *Fruehauf* can be further illustrated by two hypotheticals: First, if Harry in his capacity as coexecutor immediately surrendered the policies for their cash surrender value, no inclusion would result because at his death he would not have *possessed* any incidents of ownership in the policies, but only incidents of ownership as cotrustee in noninsurance assets. However, since the property existed in the form of life insurance at the time of his death, inclusion was required. Second, suppose that instead of life insurance, the asset had been nonincome producing real property, and Harry had the power to sell and reinvest in some type of income producing asset. Here, even though the exercise of this power would benefit him as income beneficiary, there would be no inclusion[26] because the power that Harry possessed

> property and to discriminate against life insurance in this respect is not justified.
>
> The House and your committee's bill retains the present rule including life-insurance proceeds in the decedent's estate if the policy is owned by him or payable to his executor, but the premium test has been removed. To place life-insurance policies in an analogous position to other property, however, it is necessary to make the 5-percent reversionary interest rule, applicable to other property, also applicable to life insurance.

S. REP. No. 1622, 83d Cong., 2d Sess., found in 3 *U.S. Code Congressional and Administrative News* 4757 (1954).

[26] Since the fiduciary powers Harry held over Vera's testamentary trust were conferred rather than retained, no other type of asset would be included in Harry's gross estate under any of the gross estate sections for the simple reason that the estate tax is a transfer tax which requires a transfer before taxation is appropriate. C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES § 1.1 (2d ed. 1962) [hereinafter cited as LOWNDES & KRAMER]. The estate tax extends to those transactions in which the decedent previously

would not be retained by him in connection with a lifetime transfer, but rather would be considered as conferred upon him by Vera's will. Although the authorities differ as to whether life insurance should be treated on a par with other types of property,[27] Congress has indicated that it should be so treated. As such, the dictum in *Gorman v. United States*[28] becomes particularly instructive: since Congress intended life insurance to be treated like other property a "court [should] not legislate, nor shall the Service, in an area specifically reserved to Congress."[29]

Fruehauf portrays only one of the many estate tax pitfalls awaiting the unwary estate planner faced with life insurance. Primarily, these problems arise because at no time during the history of the estate tax has Congress, the Treasury, or the courts set forth a workable definition of "incidents of ownershp." Congress should meet this challenge and carefully define the scope of "incidents of ownership" as well as the position of life insurance in the overall scheme of estate taxation.[30] Until this can be done, however, estate planners should avoid placing the surviving spouse

owned and transferred property during his lifetime but *retained* some interest, power, or right over the property. The estate taxation of such transactions is justified on the basis that they are mere substitutes for testamentary dispositions of property. The sole exception to these general statements is the specific section of the Code that deals with the situation in which a decedent possessed powers that were conferred upon him by another person—section 2041. Arguably, this section is not applicable to the *Fruehauf* facts. Section 2041 taxes general powers of appointment and thus permits inclusion in the gross estate of property never owned nor transferred by the decedent. In effect, this section represents congressional recogniton of general powers of appointment as *substantial* incidents of ownership since the holder of the power can freely dispose of property that he does not own according to his own desires. Since the language of section 2042 seems, on its face, to be more analogous to the language of section 2041 dealing with *conferred* powers (*i.e.*, section 2042 does not expressly require that the decedent own or transfer the policy, but only that he possess at his death any of the incidents of ownership), the Commissioner has interpreted section 2042 literally, and has taken the position that if the decedent dies with any of the requisite incidents of ownership over the policies, then the entire face value is to be included in his gross estate regardless of whether he possessed these incidents of ownership as a "string" *retained* by him as a result of an incomplete transfer, or simply as a result of having them *conferred* upon him in a fiduciary capacity.

[27] Many writers disagree with Congress' position that life insurance should be treated like any other type property. *E.g.*, LOWNDES & KRAMER § 13.4; Groll, *Some Federal Tax Aspects of Life Insurance*, 15 DE PAUL L. REV. 48 (1965). However, Congress' position has been supported by others. *E.g.*, Swihart, *Federal Taxation of Life Insurance Wealth*, 37 IND. L.J. 167 (1962).

[28] 288 F. Supp. 225 (E.D. Mich. 1968).

[29] *Id.* at 230.

[30] This has been suggested previously in Note, *Taxation—Federal Estate Tax—Cotrusteeship Sufficient Incidents of Ownership To Require Inclusion of Corpus in Cotrustee's Gross Estate Where Possibility of Economic Benefit Exists*, 22 VAND. L. REV. 711 (1969).

in a position whereby he has any powers over insurance polices on his life capable of being exercised for his own benefit. Thus, in order to avoid the *Fruehauf* tax trap the estate planner must provide for two trusts—one containing only the insurance policies, over which the surviving spouse should have no powers in the nature of "incidents of ownership;"[81] the other containing noninsurance assets, over which the surviving spouse may safely act as trustee. Additionally, *Fruehauf* indicates that should the surviving spouse act as executor, he must be expressly prohibited from exercising any powers in the nature of "incidents of ownership" over insurance policies on his life owned by his spouse, if these policies are to ultimately become a part of a *Fruehauf* trust. Until this area is resolved, this is the only safe course of estate planning to take when faced with life insurance trusts.

THOMAS R. CRAWFORD

Federal Estate Taxation—Revenue Ruling 67-463 Has Been Dealt A Grave Injustice

As the smoke clears from the aftermath of the decision of *First National Bank (of Midland) v. United States*,[1] we find that the Commissioner of the Internal Revenue Service has once again met defeat. The score now stands: taxpayers, three, the Commissioner and Revenue Ruling 67-463, zero.[2] Completely realizing the possible adverse consequences to taxpayers and estate tax planners, it will be shown, nevertheless, that the Commissioner has been dealt a grave injustice.

Several years ago the Commissioner decided to review the estate tax consequences of gifts of life insurance in situations where the deceased-insured paid part of the premiums in contemplation of death, but had given away all incidents of ownership in the policy more than three years prior to death.[3] To determine the amount to be included in the decedent's gross estate the Commissioner issued Revenue Ruling 67-463:

[81] In fact, the surviving spouse should never be designated as trustee over the insurance trust since many states have provisions providing that a trustee has certain broad powers, such as the power to sell, even though not specifically granted by the trust instrument.

[1] 423 F.2d 1286 (5th Cir. 1970).

[2] Rev. Rul. 67-463, 1967-2 CUM. BULL. 327.

[3] For example, decedent took out a fifty thousand dollar face amount policy on his life six years before death. He paid all six thousand dollars of the premiums (one thousand dollars annually), with one-half (three thousand dollars) of the