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PLANNING A LIFE INSURANCE ESTATE FOR FEDERAL TAX PURPOSES

LEON L. RICE, JR.*

Recent developments in the field of Federal taxation mean that life insurance, like other abundant sources of revenue, must suffer ever-increasing depletions in the form of higher estate, gift and income taxes.¹ The beneficiary's potential share of the taxable insurance dollar has already been reduced by sharp increases in the general rates of taxation.² Still greater increases, abetted by the probable lowering of exemptions and exclusions, are in the offing.³ Equally foreboding has been the tightening of interpretation of existing statutes by the Treasury Department, the Board of Tax Appeals, and the courts.

This trend brings into sharp focus the necessity for acute tax-consciousness in planning life insurance estates. Studied consideration of legitimate tax savings in the fields of estate, gift and income taxes may enable taxpayers to minimize the ill effects of the trend. Such consideration should be given not only to prospective insurance programs, but also to programs already existent. The latter may no longer be adequate in the light of changed statutory constructions.

Any realistic plan will take into account the growing tendency of the courts to look with disfavor upon tax devices which are not in fact what they appear to be in form. Lack of good faith usually spells lack of effectiveness in transactions undertaken with something more than a weather eye on tax results. Moreover, taxpayers have no assurance that the applicable statutes will remain the same when the taxable event occurs.

With the foregoing factors in mind, it is the purpose of this article to survey some of the salient features of the existing Federal law relating to estate, gift and income taxes on life insurance, and to suggest ways deemed legitimate and effective to reduce these taxes.

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¹ An eminent tax authority has noted the tax potentialities of U. S. life insurance. Paul, *Life Insurance and the Federal Estate Tax* (1939) 52 HARV. L. REV. 1037.

² Compare particularly the following sections of the Revenue Act of 1941 with the corresponding provisions of prior revenue acts: §101 (income tax on individuals); §401 (estate tax); §402 (gift tax, effective only in 1942).

³ The Treasury Department proposed that the \$40,000 estate tax insurance exemption and the \$40,000 specific gift tax exemption each be reduced to \$25,000, but this proposal was not adopted in the 1941 Act.

ESTATE TAXES

1. *Proceeds payable to or for the benefit of the estate of the insured.*⁴

Life insurance proceeds payable to the estate of the insured are includible in their entirety in his gross estate, without benefit of the \$40,000 exemption, irrespective of who applied for the policy or paid the premiums.⁵ This suggests, of course, that wherever feasible someone other than the insured's estate should be made the beneficiary. It has been held, however, that if, under the law of the jurisdiction of the insured's domicile the proceeds payable to the estate pass directly to the widow and other relatives, and do not constitute assets of the estate subject to charges against it, they are not includible, except in so far as they exceed the statutory exemption.⁶

Even though the policy proceeds are not payable directly to the executors or administrators of the insured, they will be held to be entirely taxable if they inure to the benefit of his estate.⁷ The Treasury Regulations provide that the proceeds are considered to be so payable if the beneficiary is *legally obligated* to use them to pay taxes and other

⁴ It is assumed in this subdivision of the article, in any case where the proceeds of the policy, or a part thereof, are receivable by a beneficiary other than the insured's estate, that the insured paid the premiums, directly or indirectly. The effect of the payment of premiums by someone other than the insured in such a case is discussed in the next succeeding subdivision, *infra* pp. 29-33.

⁵ U. S. Treas. Reg. 80, Art. 26 as amended by T. D. 5032, 1941 Int. Rev. Bull. No. 3, at 13; Helen Kingsley Bromley, 16 B. T. A. 1322 (1929). The applicable statute is I. R. C. §811(g), which has remained unchanged since its first enactment as §402(f) of the Revenue Act of 1918. It reads as follows:

"The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States—

* * * *

"(g) Proceeds of Life Insurance.—To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over \$40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life."

As Professor Lowndes has aptly observed, the phrase "taken out by the decedent upon his own life" is meaningless where the estate of the insured is the beneficiary, since the effect of the regulations is that any insurance payable to the estate is "taken out" by the insured. Lowndes, *Tax Avoidance and the Federal Estate Tax* (1940) 7 LAW & CONTEMP. PROB. 309, 323, n. 72. But query whether the policy was "taken out" by the insured within its proper statutory meaning where he neither applied for it nor paid any premium thereon. *Lang v. Comm.*, 304 U. S. 264, 82 L. ed. 1331, 58 S. Ct. 880 (1938).

⁶ *Julia S. Lucky*, 2 B. T. A. 1268 (1925); *Comm. v. Jones*, 62 F. (2d) 496 (C. C. A. 6th, 1932); *Webster v. Comm.*, 120 F. (2d) 514 (C. C. A. 5th, 1941); *cf.* *The First National Bank of Memphis (Estate of Proutt)*, 41 B. T. A. 1299 (1940), taxpayer's appeal pending C. C. A. 6th, in which a contrary result was reached where the policy proceeds were specifically bequeathed in the insured's will, and the beneficiaries did not receive the same amounts they would have received by intestacy.

⁷ *Marmaduke B. Morton*, 23 B. T. A. 236 (1931), *acq.* X-2 CUM. BULL. 49.

charges enforceable against the estate.⁸ Hence, it would appear that if the use of the proceeds in such a manner is purely discretionary with the recipient (*e.g.*, a trustee), the \$40,000 exemption should attach.⁹ The Board of Tax Appeals has held that, even where there is a binding obligation so to use the proceeds, only the amount actually used for that purpose is payable for the benefit of the estate;¹⁰ hence, the remainder, if it goes to beneficiaries other than the estate, enjoys the benefit of the exemption. It has been suggested that the exemption can be preserved by making policies payable to beneficiaries other than the estate, with the understanding that the proceeds are to be devoted to purchasing assets of the estate at their fair market value, thus providing ready cash to liquidate the liabilities of the decedent.¹¹

Another instance where the proceeds are held to be receivable for the estate's benefit is where the policy has been procured by the decedent upon his life as collateral for a loan or other accommodation. Here the amount of the debt plus interest accrued to the date of death will be deductible in determining the net taxable estate of the insured.¹² It would seem, however, that only the proceeds in excess of the \$40,000 exemption would be taxable, if the creditor or the insurance company were obligated to pay the excess above the debt to some beneficiary other than the estate of the insured.¹³

2. *Proceeds payable to beneficiaries other than the estate of the insured.*

Although the statutory provision requiring the inclusion of the proceeds of policies (in excess of \$40,000) payable to beneficiaries other than the estate of the insured has not been modified since its enactment as part of the Revenue Act of 1918, it has been the chief bone of contention between the Government and taxpayers, and the subject of radical changes in construction upon the part of all concerned. The greatest vacillation has been indicated by the regulations of the Depart-

⁸ U. S. Treas. Reg. 80, Art. 26.

⁹ *Old Colony Trust Co.*, 39 B. T. A. 871 (1939), *acq.* 1939-2 CUM. BULL. 27. (*Caveat*: In this case none of the proceeds were used to pay debts.) The fact that debts are paid by a beneficiary in his discretion would not seem to affect the deductibility of such debts in arriving at the net estate of the insured. *Helvering v. O'Donnell*, 94 F. (2d) 852 (C. C. A. 2d, 1938).

¹⁰ *Mathilde B. Hooper*, 41 B. T. A. 114 (1940), *nonacq.* 1940-1 CUM. BULL. 7; *Estate of Waldo Rohnert*, 40 B. T. A. 1319 (1939); *Silas B. Mason*, 43 B. T. A. 818 (1941), *nonacq.* 1941 Int. Rev. Bull. No. 20 at 2.

¹¹ *Paul*, *supra* note 1, at 1058. The use of insurance to pay death taxes is to be recommended, particularly in the case of sizeable estates. For a discussion of this subject, see MONTGOMERY, *FEDERAL TAXES ON ESTATES, TRUSTS AND GIFTS* (1938-39) 446-454. This is true even where the insurance is to form the bulk of the taxable estate. 3 *Prentice-Hall* 1941 *Fed. Tax Serv.* ¶23,300.

¹² U. S. Treas. Reg. 80, Art. 26. A slightly different rule as to interest applies where the estate is valued a year after death. U. S. Treas. Reg. 80, Art. 36.

¹³ *Cf.* cases cited in note 10 *supra*.

ment itself.¹⁴ For example, the phrase "taken out by the decedent upon his own life", according to the regulations issued under the 1918 Act, meant that the decedent paid the premiums, directly or indirectly, whether or not he made the application.¹⁵ Regulations 68, issued under the Act of 1924, provided for an apportionment of the proceeds where a portion of the premiums was paid by the insured, and a portion by the beneficiary.¹⁶ On August 6, 1930, as a result of the decision in the case of *Chase National Bank v. United States*,¹⁷ the Department adopted the view that insurance payable to beneficiaries other than the insured's estate was not taxable to the estate unless the insured possessed at the date of his death some "legal incident of ownership" in the policy.¹⁸ Except for a few aberrations, such as that exhibited by the Court of Claims in its first decision in the celebrated *Bailey* case,¹⁹ the regulations incorporating the incidents of ownership test were generally followed by the Board of Tax Appeals and the lower Federal courts.²⁰

So it was that, at least in the decade from 1930 to 1940, a taxpayer could die in the fairly certain assurance that insurance on his life payable to a third party beneficiary would not be taxable to his estate unless

¹⁴ For a more complete review of the vacillation, see Paul, *supra* note 1 at 1060-1062; Lowndes, *loc. cit. supra* note 5.

¹⁵ U. S. Treas. Reg. 37 (1921 ed.), Arts. 32, 34, 35.

¹⁶ U. S. Treas. Reg. 68, Arts. 25, 27, 28.

¹⁷ 278 U. S. 327, 73 L. ed. 405, 49 S. Ct. 126 (1929). It was held in this case that policies payable to beneficiaries, other than the insured's estate, were taxable to the estate of the insured, because the insured had reserved the power to change beneficiaries, and the lapse of this power at death constituted a testamentary transfer.

¹⁸ U. S. Treas. Reg. 70 (1929 ed.), as amended by T. D. 4296, IX-2 Cum. BULL. 427 (1930). Legal incidents of ownership included, according to the regulations, the right of the insured or his estate to the economic benefits of the policy, the power to change the beneficiary, to surrender or cancel the policy, to assign it, to revoke an assignment, to pledge it for a loan, or to obtain a loan from the insurer against the cash surrender value of the policy, etc. U. S. Treas. Reg. 80, Art. 25, prior to amendment by T. D. 5032. Article 25, as amended by T. D. 5032, now provides in addition to the foregoing: "The insured possessed a legal incident of ownership if his death is necessary to terminate his interest in the insurance, as, for example, if the proceeds would become payable to his estate, or payable as he might direct, should the beneficiary predecease him."

¹⁹ *Bailey v. United States*, 27 F. Supp. 617 (Ct. Cls. 1939). It was held that insurance could be taxed to the insured's estate, despite an irrevocable assignment made by him prior to his death. A subsequent decision in the same case held the insurance not taxable when it was shown that the beneficiary paid the premiums after the assignment. *Bailey v. United States*, 30 F. Supp. 184 (Ct. Cls. 1939). Finally, it was held that the insurance was taxable to the estate because of a reversionary interest, on the authority of *Helvering v. Hallock*, 309 U. S. 106, 84 L. ed. 604, 60 S. Ct. 444 (1940). *Bailey v. United States*, 31 F. Supp. 778 (Ct. Cls. 1940), *cert. dismissed on stipulation*, 311 U. S. 721 (1940).

²⁰ Note (1940) 24 MINN. L. REV. 963, 973. Cases following and applying the payment of premiums test as then embodied in the applicable regulations include *Helvering v. Reybaine*, 83 F. (2d) 215 (C. C. A. 2d, 1936), *Lang v. Comm.*, 304 U. S. 264, 77 L. ed. 1066, 53 S. Ct. 534 (1938), and *Walker v. United States*, 83 F. (2d) 103 (C. C. A. 8th, 1936). The *Lang* case probably provided final impetus for T. D. 5032. See the concluding sentence of the opinion at page 270.

he retained some element of control over the insurance or its proceeds.²¹ On January 10, 1941, however, Treasury Decision 5032,²² amending Articles 25, 26 and 27 of Regulations 80 (1937 ed.), undermined this assurance. Briefly, the effect of the amendment is to make the payment of the premiums by the insured, directly or indirectly, the test of whether policy proceeds payable to beneficiaries other than his estate must be included in his gross estate. In the case of an insured dying after January 10, 1941, without having possessed any of the legal incidents of ownership after that date, such proceeds, in so far as they exceed the \$40,000 exemption, must be included in his gross estate in the ratio that the premiums paid by him, directly or indirectly after that date, bear to the entire cost of the policy. It is immaterial whether the policy was issued before, on, or after January 10. However, as an apparent concession to the taxpayer in view of the former Departmental attitude, any premiums paid by the decedent, directly or indirectly, on or before January 10 shall be disregarded (and that part of the insurance proceeds attributable to such payment shall be excluded from his gross estate), if the decedent possessed none of the legal incidents of ownership after that date. In the case of an insured who possessed legal incidents of ownership after January 10, 1941, the proceeds (subject to the \$40,000 exemption) must be included in the gross estate at least in the ratio that premiums paid by him, *before* or after that date, bear to the total cost of the policy; and, as subsequently pointed out, this factor may have even greater significance.

Let us take a simple illustration: In 1930, Mr. A took out an ordinary life insurance policy on his life in the face amount of \$100,000, payable to his wife. Prior to January 10, 1941, he paid annual premiums in the total sum of \$37,500. Although he retained all legal incidents of ownership in the policy until January 9, 1941, on that date he irrevocably assigned all rights in the policy to his wife, the beneficiary. After January 10, 1941, he paid additional premiums in the total sum of \$37,500 until his death in 1950. Since he did not have any of the legal incidents of ownership *after* January 10, we disregard the premiums paid *prior* to that date and *exclude* from his gross estate that part of the insurance proceeds attributable to the payment of these premiums. However, we take into account the premiums paid by him after January 10, whether or not he had legal incidents of ownership. Under these facts, and under Treasury Decision 5032, one-half of the policy proceeds, less the \$40,000 exemption, *i.e.*, \$10,000, would be taxable to the estate of the

²¹ This assurance might stem to a large degree from the thought that the Department, following its regulations, would not attempt to tax the proceeds without the retention of incidents of ownership. See unpublished ruling dated December 22, 1934, in 353 C. C. H. Fed. Tax Serv., ¶6057.

²² *Supra* note 5.

insured. If, instead of assigning the policy prior to January 10, he had retained incidents of ownership until after that date, all of the proceeds in excess of the exemption, *i.e.*, \$60,000, would have been taxable to his estate; and if, in the above example, the wife or someone else had paid a part of the premiums, whether before, on, or after January 10, 1941, the amount of the proceeds attributable to such premium payments would not be includible in the decedent's gross estate.

In case an insured died on or prior to January 10, 1941, whether or not proceeds would be includible in his gross estate would depend upon whether he possessed any legal incident of ownership at the time of his death. The new regulations would indicate that if he possessed such incidents, the proceeds would be includible only in the ratio that the insured paid the premiums, directly or indirectly.

While it appears that under the regulations as amended the *absence* of incidents of ownership in the insured is of significance only with respect to premiums paid by him on or before January 10, 1941, taxpayers who wish to exclude insurance from their taxable estate should beware of the possibility that the retention of incidents of ownership may still be sufficient to require inclusion, even though no premiums are paid by the insured, directly or indirectly. Such a possibility is forecast by a provision of amended Article 25 of Regulations 80 to the effect that if proceeds are not taxable under the specific language of the statute relating to life insurance, they may be taxable under some of the general estate tax provisions. That is, the Department could assert that, despite the nonpayment of premiums by the insured, his estate is nevertheless taxable with respect to the proceeds if, at the time of his death, he possessed any of the legal incidents of ownership, because he had an "interest in property" at the date of his death,²³ or because he made a transfer in contemplation of or intended to take effect in possession or enjoyment at or after his death.²⁴ In this regard,

²³ I. R. C. §811(a). Perhaps only the cash surrender value at the death of the insured would be includible on this theory. The Commissioner contended in the case of *Helvering v. Safe Deposit and Trust Co. of Baltimore*, 121 F. (2d) 307 (C. C. A. 4th, 1941), *cert. granted* Oct. 27, 1941, that a power of appointment plus certain other interests in trust property (where the power was not validly exercised), although not taxable under section 302(f) of the 1926 Act because of the non-exercise of the power constituted an "interest in property" within the meaning of section 302(a). The court held to the contrary.

²⁴ I. R. C. §811(c). *Cf.*, *Estate of Mary H. Hughes*, 44 B. T. A. No. 184 (1941) and editorial comment in 3 *Alexander* 1941 *Fed. Tax Serv.*, ¶1801.123. Strangely enough, an unpublished ruling issued by Deputy Commissioner Bliss, under date of February 14, 1941, 4 *Prentice-Hall* 1941 *Fed. Tax Serv.*, ¶66,180, states that if the insured paid none of the premiums none of the proceeds would be includible in his gross estate, even though he had incidents of ownership at his death. It may be questioned whether this ruling (which probably was not reviewed by the Chief Counsel of the Bureau) will remain unchanged as the Department's attitude develops in the administration of the amended regulations. See, as to the negligible authoritative value of such rulings, *Helvering v. New York Trust Co.*, 292 U. S. 455, 78 L. ed. 1361, 54 S. Ct. 806 (1934).

it is to be noted that the amended regulations now include as an incident of ownership a reversionary interest in the policy or its proceeds.²⁵ In a recent case,²⁶ decided before the amendment of the regulations, it was held that a possibility of reverter, which would have resulted in the payment of the proceeds to the insured's estate had the beneficiary predeceased him, alone justified the inclusion of the proceeds in his gross estate. The court reasoned, relying on the *Bailey* and *Hallock* cases, that the death of the insured prior to that of the beneficiary terminated all rights of his estate to receive payment under the policy and fixed them unalterably in the beneficiary, requiring the inclusion of the proceeds in his gross estate under section 302(g) of the 1926 Act. While the applicability of this decision may be seriously questionable under the new regulations promulgated under the insurance section of the statute, taxpayers should not only avoid all payment of premiums, directly or indirectly, but also remove any chance that they or their estates will have any control over the policy or any reversionary interest therein.²⁷ The latter can be taken care of by giving to the beneficiary a testamentary power of appointment with respect to the proceeds (which should expressly negative the power to appoint to the insured, or his estate, or to anyone directed by him), or by setting up a series of contingent beneficiaries, the last one of which might be a charitable, religious, or educational organization so as to prevent a reversion in case of the death of all primary and contingent beneficiaries who are natural persons.

The validity of the regulations, as amended by Treasury Decision 5032, has yet to be finally tested in the courts. An argument which doubtless will be made is that the regulations making the reservation of incidents of ownership the test of taxability has been adopted by Congress.²⁸ The success of this argument is hardly to be expected, due

²⁵ See *supra* note 18.

²⁶ *Chase National Bank of City of New York v. United States*, 116 F. (2d) 625 (C. C. A. 2d, 1940); *cf.*, *Broderick v. Keefe*, 112 F. (2d) 293 (C. C. A. 1st, 1940), *dismissed* 311 U. S. 721 (1941).

²⁷ The case of *John E. Cain, Sr.*, 43 B. T. A. 1133 (1941), *acq.* 1941 Int. Rev. Bull. No. 23, at 1, indicates just how remote a possibility of reverter may require the inclusion of proceeds in the insured's estate. The policy provided that the income from the proceeds was to be paid to insured's wife for life; upon her death the proceeds were to be distributed to each of their surviving children and to the surviving children of each of their deceased children; and in the event the decedent outlived his wife and all of their children and grandchildren, the proceeds should revert to his estate. The insured paid only the first annual premium, and did not retain any incidents of ownership except the possibility of reverter. The wife paid the subsequent premiums. The Board held that the transfer was not complete until the death of the insured and that the proceeds were taxable under section 302(g) of the 1926 Act; only, however, in the ratio that the insured paid the premiums. In so holding it is significant that the Board relied upon T. D. 5032. But see as to remoteness of a possibility of reverter, *Estate of Mary H. Hughes*, 44 B. T. A. No. 184 (1941). The *Central Bank* case, *infra* note 95, supports the view that only the value of the reversionary interest is taxable at the death of the insured.

²⁸ *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U. S. 110, 83 L. ed. 536,

particularly to the lack of consistent administrative interpretation of the statute,²⁹ and to the fact that Congress has not considered the statute affirmatively since the incidents of ownership test was incorporated in the regulations. Other arguments may impinge upon the fact that, in the case of those possessing no legal incidents of ownership after January 10, 1941, different tests are applied with respect to premiums paid before that date and those paid thereafter;³⁰ that the regulations make it impossible, for estate tax purposes, completely to give away insurance where the insured paid premiums prior to January 10, and retained incidents of ownership after that date;³¹ that the Department treats the payment of premiums by an insured on a policy irrevocably assigned as taxable gifts;³² that Congress did not intend to tax an insured who merely paid the premiums on the policy or a part thereof;³³ and that it is unconstitutional to tax policy proceeds to an insured who retained no control over the policy.³⁴ Whether or not any of these arguments will be successful remains to be seen. The Board of Tax Appeals has already applied the amended regulations.³⁵ This, plus the implications of the *Lang* case³⁶ and the current tendency toward protection of the revenue,

59 S. Ct. 423 (1939); *Lang v. Comm.*, 304 U. S. 264, 77 L. ed. 1066, 53 S. Ct. 534 (1938). See generally Brown, *Regulations, Reenactment and the Revenue Acts* (1941) 54 HARV. L. REV. 377; Griswold, *A Summary of the Regulations Problem* (1941) 54 HARV. L. REV. 398; Feller, *Addendum to the Regulations Problem* (1941) 54 HARV. L. REV. 1311; Surrey, *The Scope and Effect of Treasury Regulations under the Income, Estate, and Gift Taxes* (1940) 88 U. OF PA. L. REV. 556.

²⁹ *Burnet v. Chicago Portrait Co.*, 285 U. S. 1, 76 L. ed. 587, 52 S. Ct. 275 (1932); Brown, *supra* note 28, at 389. It is to be remembered that the payment of premiums test is not new, and that the incidents of ownership criterion has been followed by the Department only since 1930. However, the court in *Broderick v. Keefe*, 112 F. (2d) 293 (C. C. A. 1st, 1940), thought that the incidents of ownership test had been adopted by Congress.

³⁰ To this it may be replied that the difference is based upon an effort to be fair to the taxpayer, and the change of test is largely prospective in operation.

³¹ This is one of the most unreasonable features of the amended regulations, for presumably taxpayers had no warning of the change and could not, prior to the issuance of T. D. 5032 on January 10, 1941, know that unless they divested themselves of policy control on or before that date at least a portion of the proceeds (attributable to the payment of premiums by them) could not be effectively excluded from their estates, except possibly by a cancellation of the insurance. Such a result, however, apparently does not worry the Bureau of Internal Revenue, as indicated by an unpublished ruling dated June 3, 1941, 3 Alexander 1941 Fed. Tax. Serv., ¶1801.215, in which this situation was compared with transfers in contemplation of death, transfers with reservations of life estates, and transfers which the decedent could modify only with the consent of the beneficiaries.

³² U. S. Treas. Reg. 79, Art. 2(6).

³³ *Lang v. Comm.*, 304 U. S. 264, 77 L. ed. 1066, 53 S. Ct. 534 (1938), cited *supra* note 20, contains the contrary implication.

³⁴ This would be based largely upon the decision of the Supreme Court in *Chase Nat. Bank v. United States*, 278 U. S. 327, 73 L. ed. 405, 49 S. Ct. 126 (1929).

³⁵ *John E. Cain, Sr.*, 43 B. T. A. 1133 (1941); *Silas B. Mason*, 43 B. T. A. 818 (1941).

³⁶ *Lang v. Comm.*, 304 U. S. 264, 77 L. ed. 1066, 53 S. Ct. 534 (1938), cited *supra* note 20.

would seem to predict that the regulations will withstand all attacks.³⁷ In all events, however, wise taxpayers should assume their validity in planning or replanning their insurance estates.

In the light of the new regulations, what are some of the ways in which estate taxes may be saved or avoided?

Where new insurance is to be taken out, and where the beneficiary has sufficient funds of his own to pay the premiums, it is advisable that the beneficiary apply for the policy (assuming he has an insurable interest) and pay all of the premiums, giving the insured no interest whatever in the policy. Manifestly, in such a case, none of the proceeds would be taxable to the estate of the insured.³⁸ If a husband and wife wish to insure their lives, each in favor of the other, it is preferable to have each take out insurance on the life of the other and pay the premiums out of his or her own money.³⁹

Probably the most common case will be where the beneficiary (*e.g.*, the wife of the insured) does not have sufficient funds to meet the premiums. Gifts of cash by the insured to the beneficiary with which the premium payments are made appear likely to be held indirect payments by the insured.⁴⁰ The likelihood will increase in relation to the intimacy of the gifts to the premium payments; if the beneficiary is free to use the funds as he sees fit; if the amount of the gifts and the time thereof bear no close relation to the amount and time of the premium payments; if the beneficiary already has an independent income sufficient to pay the premiums; and if it has been the custom of the insured to make such gifts in the past, regardless of insurance, there is a reasonable possibility that the gifts will be held not to be indirect payments of the donor. If a deficiency is asserted against the estate of the insured on account of allegedly indirect premium payments, the burden will be on the estate to prove the *bona fides* of the gifts.

The safest procedure, where the beneficiary does not have enough funds to pay the premiums, is to have the insured assign to the beneficiary absolutely, and without direction or reservation, property producing income sufficient for that purpose.⁴¹ The gift tax, and the

³⁷ Professor Lowndes thinks the premium-payment criterion a legitimate one. Lowndes, *supra* note 5, at 325.

³⁸ It could hardly be said that there was either any *inter vivos* or testamentary transfer by the insured in such a case. But conceivably Congress might impose in the future a tax upon the privilege of receiving insurance proceeds. Query whether such a tax could be retroactively applied to pre-existing policies.

³⁹ Such a reciprocal arrangement, particularly if the policies were identical or substantially so, could result in a holding that each insured paid premiums on his own life policy. Cf., Purdon Smith Whiteley, 42 B. T. A. 316 (1940); Lehman v. Comm., 109 F. (2d) 99 (C. C. A. 2d, 1940), *cert. denied* 310 U. S. 637, 84 L. ed. 1406, 60 S. Ct. 1080 (1941).

⁴⁰ 4 Prentice-Hall 1941 Fed. Tax Serv., ¶68,076.

⁴¹ This situation existed in the case of John E. Cain, Sr., 43 B. T. A. 1133 (1941), but the Board apparently attached no significance to it. The theory would

possibility of an estate tax because of a gift in contemplation of death, would have to be weighed in the balance of convenience.

A beneficiary who does not have money enough to purchase the insurance in its entirety might consider the plan of buying a single-premium policy on the life of another with borrowed money, using the policy as collateral for the loan. Even if the insured should have to make up the difference in the cost of the policy out of his own pocket (possibly paying a gift tax thereon), this would probably cause the inclusion in his gross estate of only a relatively small proportion of the proceeds. Whether or not the repayment of the loan by the beneficiary would be easier than the payment of annual premiums would depend upon the terms of the loan agreement, including the interest rate, time or times of payment, etc. During the pendency of the loan the beneficiary would be protected, and the death of the insured prior to the maturity of the loan would result in satisfying the debt out of the face value of the policy and the payment of the excess to the beneficiary without cash outlay by him.

An insured who has retained incidents of ownership after January 10, 1941, and who has paid policy premiums, is faced with the fact that, according to Treasury Decision 5032, he cannot keep up his insurance and have it wholly excluded from his gross estate.⁴² He can, however, relinquish the incidents of ownership to the beneficiary and have the latter pay the premiums, either out of funds which he already owns or out of the income from property donated to him by the insured. This will result in the exclusion of the proportion of the proceeds attributable to premium payments by the beneficiary from the insured's estate. Should it turn out that the proportion allocable to premiums paid by the insured is less than the statutory exemption, none of the insurance will be taxed to his estate. The surrender of an old policy and the taking out of a new one by the beneficiary is hardly to be recommended in the absence of special circumstances, because the consequent loss usually inherent in such surrenders and the increased cost of a new policy due to the advanced age of the insured would perhaps more than offset possible estate tax savings.⁴³

be that the income from the donated property is that of the donee. The donee would be subject to income tax upon such income, unless it is tax-free income. Also worthy of consideration is a gift of a partnership interest. See R. C. Bennett, B. T. A. Memo. Op., Sept. 2, 1941.

⁴² This is on the assumption that the proceeds attributable to premium payments by the insured will exceed the statutory exemption existing at the date of death. Taxpayers should keep in mind the possibility that the \$40,000 insurance exemption will be lowered or entirely eliminated before their death. It is, therefore, not entirely safe merely to assign policies above \$40,000 in face amount, with the thought that the insurance retained will be tax-free even though the insured pays the premiums.

⁴³ The taking out of a new policy would also depend upon the then insurability

The establishment of an irrevocable funded trust by the insured for the payment of premiums on policies on his life, a device used successfully in the past to escape estate taxes,⁴⁴ is of doubtful effectiveness in view of Treasury Decision 5032. An express provision of the Internal Revenue Code⁴⁵ makes the insured taxable on the income of such a trust used for such purpose. The Department will probably contend that, to the extent the trust income is used to pay insurance premiums, this constitutes an indirect payment by the insured.⁴⁶ Countenance is given to this view by the recent gift tax decision of the Board in the *Beck* case.⁴⁷ There the petitioner created an irrevocable funded insurance trust, transferring thereto certain securities and insurance policies on his life. During the petitioner's lifetime, net trust income was applicable to the payment of premiums on the assigned policies; additional income was payable to designated beneficiaries, with no possibility of reverter in the petitioner. The Board upheld the contention of the petitioner that he was liable for a gift tax only on the value of the securities and policies at the date of the transfer, less the capitalized value of the income necessary to pay premiums during his life. This was on the theory that petitioner had reserved to himself for life economic benefits, which prevented the imposition of a gift tax. If it be recalled that, for the purposes of the estate tax, the reservation of income for life makes the trust fund itself includible in the settlor's gross estate,⁴⁸ the disadvantages of a device of this kind become obvious.

If a funded insurance trust is to be employed to pay premiums, it

of the insured. Another plan which might be considered would be for the insured to exercise an option to take a paid-up policy. Since the insured will have paid the entire cost of such a policy, the entire proceeds in excess of the exemption would be taxable to his estate; but this would be a smaller amount than if the original policy were kept in force until maturity.

⁴⁴ *Helvering v. Reybaine*, 83 F. (2d) 215 (C. C. A. 2d, 1936). In this case, trustees were directed to use trust income to pay premiums, provided they thought the use of such income would not deprive the beneficiary of proper education and support. The court held that the payment of premiums by the beneficiaries under these circumstances could not be indirectly attributed to the insured. It thought the income tax treatment was not apropos to the estate tax question. The result might have been different had the trustees been required to use the income to pay premiums at all events. *But see* The First National Bank of Birmingham, 36 B. T. A. 651 (1937), *acq.* 1937-2 CUM. BULL. 24; *cf.*, *Comm. v. Prouty*, 115 F. (2d) 331 (C. C. A. 1st, 1940). See generally, Tye, *Federal Taxation of Insurance Reexamined*, 19 TAXES 387 (1941).

⁴⁵ I. R. C. §167 (a) (3). A leading case is *Burnet v. Wells*, 289 U. S. 670, 77 L. ed. 1439, 53 S. Ct. 761 (1933). See also *Rand v. Helvering*, 116 F. (2d) 929 (C. C. A. 8th, 1941), *cert. denied*, 85 L. ed. (Adv. Ops.) 1004 (1941).

⁴⁶ *But see Helvering v. Reybaine*, 83 F. (2d) 215 (C. C. A. 2d, 1936). It would seem that the same result would follow if the trust principal, or a part thereof, were to be used for the premium payments, pursuant to the insured's direction or authority.

⁴⁷ *Martin Beck*, 43 B. T. A. 147 (1941), *nonacq.* 1941 Int. Rev. Bull. No. 12, on appeal to C. C. A. 2d. The interrelation of the gift tax and the estate tax is in a doubtful state. See discussion, *infra*, pp. 41-43.

⁴⁸ I. R. C. §811(c).

should be set up by the beneficiary with his or her own property. A court may look to the realities of the situation, if the beneficiary sets up the trust with property donated by the insured, and the same results may follow as discussed in the paragraph just preceding.⁴⁹ Where the trust is created in the beneficiary's discretion and with his property, the proceeds will not be includible in the estate of the insured.⁵⁰ Whether or not the beneficiary will be taxed upon the income of the trust, is a question not entirely settled at present.⁵¹ If the beneficiary is held to be taxable on the income, he likewise runs the risk of having the trust fund taxed to his estate because of the reservation of a life interest.⁵²

In addition to funded insurance trusts for the payment of premiums, taxpayers should consider the plan of making insurance proceeds payable to a trustee as irrevocable beneficiary under the policy, to be distributed by the trustees in accordance with the terms of an *inter vivos* or testamentary trust agreement. In this way the statutory exemption will apply,⁵³ and if the insured does not pay any premiums, none of the proceeds will be includible in his estate. Moreover, there can be a flexibility in the distribution and administration of the proceeds not possible where payment is made directly by the insurer to designated beneficiaries. For example, spendthrift provisions can be inserted for the protection of the beneficiaries. The trustee may be directed to invest the proceeds and pay out the income to specified individuals.⁵⁴ In order to provide cash for the satisfaction of estate obligations, the trustee can be empowered to lend the proceeds to the insured's estate, or to purchase estate assets. In addition, by giving the primary beneficiary a life estate, with remainder over, estate taxes at the death of the beneficiary may be avoided.

Various ramifications of the problems incident to so-called "business insurance" will have to be clarified in view of Treasury Decision 5032. Assuming that the amendment to the regulations will stand, the decisive inquiry will be here, as elsewhere, "who paid the premiums?" Where an employer obtains and maintains insurance on the life of a valued officer or employee, and is the beneficiary for the purpose of being reimbursed for loss in case of the death of the insured, clearly the pro-

⁴⁹ Cf., *Whiteley v. Comm.*, 120 F. (2d) 782 (C. C. A. 3d, 1941), *cert. denied*, October 13, 1941.

⁵⁰ This stems from the fact that the insured neither pays premiums nor has incidents of ownership. A gift tax might be due, without benefit of the \$4,000 exclusion. I. R. C. §1003(b) (2).

⁵¹ *Frances S. Willson*, 44 B. T. A. No. 93 (1941) (holding the beneficiary not taxable on the trust income); *Comm. v. Morton*, 108 F. (2d) 1005 (C. C. A. 7th, 1940) (holding the beneficiary taxable on the trust income).

⁵² I. R. C. §811(c).

⁵³ *Boston Safe Deposit & Trust Co. v. Comm.*, 100 F. (2d) 266 (C. C. A. 1st, 1938); *Old Colony Trust Co.*, 39 B. T. A. 871 (1939); *Fidelity and Columbia Trust Co. v. Glenn*, Alexander 1941 Fed. Tax Serv., ¶20,856.

⁵⁴ Perhaps more income can be produced in this way than if the proceeds were left with the insurance company to draw interest.

ceeds are not includible in the estate of the insured.⁵⁵ On the other hand, if the beneficiary of such a policy is one of the natural objects of the insured's bounty, or a person named by him as beneficiary, it seems that the premium payments made by the employer can be indirectly attributed to the insured on the theory that they are additional compensation to him.⁵⁶ This is particularly true where the insured is in control of the employer. Thus, in the case of *George Matthew Adams*,⁵⁷ the Board held that premium payments made by a corporation on policies issued on the life of its president and principal stockholder, where the corporation was not named beneficiary, were taxable income to the insured. If the policy, however, is a true group insurance contract, there are decisions as authority for the proposition that the proceeds are not taxable to the insured's estate, even though the employer paid the premium's and the employee named the beneficiary.⁵⁸ Support is given to this view by the income tax regulations, to the effect that premiums paid by an employer on policies of group insurance on the lives of employees, the beneficiaries of which are designated by the employees, are not taxable income to the employees.⁵⁹ However, in the case of *First National Bank and Trust Co. of Minneapolis*,⁶⁰ the Board found that the proceeds of an alleged "group" policy, maintained by the Mayo Clinic upon one of its directors and stockholders, and payable to the wife of the insured, were taxable to the insured's estate. In so doing, the Board adverted to the fact that there is no estate tax regulation on the subject of group insurance comparable to that with respect to the income tax. But the holding was premised mainly upon the fact that the premiums had been paid indirectly by the insured within the meaning of the applicable regulations,⁶¹ and upon the fact that the policy was not a "group" policy within the meaning of prior decisions. Whether the Clinic was a corporation or a partnership was thought to be of little significance by the Board. If it were a corporation, the opinion points out, the directors could not legally give away the corporate property; hence, the premiums must have been additional compensation to the insured. If it were a partnership, the argument that the insured paid

⁵⁵ The employer would not be allowed to deduct the premiums for income tax purposes. I. R. C., §24(a) (4).

⁵⁶ *Comm. v. Bonwit*, 87 F. (2d) 764 (C. C. A. 2d, 1937), *cert. denied* 302 U. S. 694, 82 L. ed. 536, 58 S. Ct. 13 (1937); *M. W. Dobrzensky*, 34 B. T. A. 305 (1936); *cf.*, *Brown v. Comm.*, 95 F. (2d) 184 (C. C. A. 6th, 1938), *cert. denied* 305 U. S. 644, 83 L. ed. 416, 59 S. Ct. 147 (1938). *Contra*: *Wilson v. Crooks*, 52 F. (2d) 692 (D. C. W. D. Mo. 1931).

⁵⁷ 18 B. T. A. 381 (1929).

⁵⁸ *Bessie M. Ballinger*, 23 B. T. A. 1312 (1931), *nonacq.* XI-1 CUM. BULL. 8 (1932); *M. W. Dobrzensky*, 34 B. T. A. 305 (1936); *Old Colony Trust Co.*, 39 B. T. A. 871 (1939).

⁵⁹ U. S. Treas. Reg. 103, Sec. 19.22(a)-3.

⁶⁰ 39 B. T. A. 134 (1939).

⁶¹ U. S. Treas. Reg. 80 (1934 ed.), Art. 25.

the premiums was thought to be stronger, because of the direct interest of the partners in the firm property and profits. This case cannot be taken as categorically overruling previous decisions to the effect that the proceeds of group policies are exempt from estate taxes (for such prior decisions were distinguished), but it does go a considerable way in taking away the effectiveness of such decisions, and indicates how closely so-called group policies will be scrutinized to determine their real nature.⁶²

The purchase of life insurance by a partnership or small, closely-held corporation to acquire the business interest of a deceased partner or employee may present definite advantages. Let us assume that a corporation obtains and pays the premiums on a policy on the life of an officer who is also a stockholder, and that the payment of the premiums will be attributed to the insured (*e.g.*, as additional compensation or as a dividend). It follows, under Treasury Decision 5032, that, if the proceeds are made payable to beneficiaries other than the estate of the insured, they will be includible in the insured's gross estate in so far as they exceed \$40,000. Now, if the proceeds are paid to the objects of the insured's bounty pursuant to an agreement that they shall be received in lieu of the insured's interest in the business, there is authority that such interest is excluded from the insured's gross estate for estate tax purposes and that the insurance proceeds, with the benefit of the \$40,000 exemption, are included in the estate.⁶³ The advantage to the corporation is that ready money is available to buy the interest of the insured in the business, and the advantage to the insured's estate is that it gets the benefit of the \$40,000 exemption. If it is not possible, because of charter provisions or the local law, for the corporation to purchase its own stock, stockholders may purchase insurance on the lives of other stockholders,⁶⁴ or the proceeds may be made payable to a trustee to purchase the interests of deceased stockholders.⁶⁵ If, in any of the

⁶² In the *Adams* case, 18 B. T. A. 381 (1929), discussed in the text, the Board threw light upon the distinction between group and individual policies in the following language: "Counsel for the respondent argues that ordinarily group insurance is taken out without the consent and without the knowledge in most cases of the employee, who is not consulted, and who does not make application for the insurance, and who is told about the matter after the thing has been accomplished. . . ." Lack of knowledge on the part of the insured goes more to the question of motivation than to the question of additional compensation. It may be seriously questioned whether, for estate tax purposes, there is any real distinction between the two types of policies. The Board admitted in the *First National Bank* case, 39 B. T. A. 134 (1939), that in the *Ballinger* case, 23 B. T. A. 1312 (1931), which perhaps was the first case holding group insurance proceeds exempt from estate tax, it applied the words "taken out by the insured" literally.

⁶³ *M. W. Dobrzensky*, 34 B. T. A. 305 (1936); *Estate of John T. H. Mitchell*, 37 B. T. A. 1 (1938); see MONTGOMERY, *op. cit. supra* note 11, at 219.

⁶⁴ *Estate of John T. H. Mitchell*, 37 B. T. A. 1 (1938). An insurable interest would be necessary.

⁶⁵ *Wilson v. Crooks*, 52 F. (2d) 692 (D. C. W. D. Mo. 1931).

above cases, it should be decided that the premium payments are not to be attributed to the insured, it could follow that both the business interest and the insurance proceeds will be excluded from the estate of the insured.⁶⁶ It is not believed that the doctrine will be pushed to that extent.⁶⁷

Insurance may, of course, be similarly employed by a partnership to purchase the interest of a deceased partner. Where the premiums are paid by the firm, they will in all probability be attributed to the insured partner, at least to the extent of his interest in the firm.⁶⁸ A variation which may be suggested is where one partner obtains a policy on the life of the other, pays the premiums and makes himself the beneficiary. Upon the death of the insured, none of the proceeds will be includible in his estate, but the partnership interest will be includible in its entirety. If this is done as a mutual arrangement, each partner taking out insurance on the life of the other, the payment of the premiums may possibly be attributed to the respective insureds.⁶⁹ Another variation is where a partner takes out insurance on his own life and makes it payable to his estate, with an agreement with his associate that the proceeds shall be credited to the purchase price to be paid by the survivor for the insured's interest in the business. Here the proceeds would be includible in their entirety in the estate of the insured, but the partnership interest would not be includible except to the extent it exceeds the proceeds.⁷⁰

A popular method of obtaining the \$40,000 exemption in the case of uninsurable persons has been eliminated by the Supreme Court in the *Le Gierse* and *Keller* cases.⁷¹ This method involved the purchase of a paid-up annuity and a paid-up insurance contract without medical examination. It was first held that where the two contracts were not separate, the transaction was an investment rather than "insurance" within the statutory meaning.⁷² Then was evolved the plan of separating the contracts, which was successful to some degree,⁷³ until the Supreme Court had its say a few months ago. The effect of these decisions is that such contracts, even though written separately, involve no insurance risk on the part of the insurance company, and are not

⁶⁶ *Ibid.*

⁶⁷ See Paul, *supra* note 1, at 1071.

⁶⁸ M. W. Dobrzensky, 34 B. T. A. 305 (1936). In *Sampson v. United States*, 1 F. Supp. 95 (D. C. Mass. 1932), where the premiums were paid by a partnership composed of two members, the Commissioner contended that one-half of the premiums were paid by the insured indirectly, the beneficiary being the surviving partner. This contention was upheld by the court.

⁶⁹ See cases cited *supra* note 39.

⁷⁰ Cf. *Estate of John T. H. Mitchell*, 37 B. T. A. 1 (1938).

⁷¹ *Helvering v. Le Gierse*, 312 U. S. 531, 61 S. Ct. 646 (1941); *Keller v. Comm.*, 312 U. S. 543, 61 S. Ct. 651 (1941). See also *Tyler v. Helvering*, 312 U. S. 657, 61 S. Ct. 729 (1941).

⁷² *Old Colony Trust Co. v. Comm.*, 102 F. (2d) 380 (C. C. A. 1st, 1939).

⁷³ *Comm. v. Le Gierse*, 110 F. (2d) 734 (C. C. A. 3d, 1940), *aff'd* 39 B. T. A. 1134, *rev'd*, *Helvering v. Le Gierse*, 312 U. S. 531, 61 Sup. Ct. 729 (1941).

insurance within the statutory intentment.⁷⁴ This result stemmed largely from the fact that the aggregate amount paid for the two contracts exceeded the face amount of the "insurance" policy. Where the face amount of the policy is substantially in excess of the consideration paid, a different result might conceivably entail, because of the risk assumed by the insurer.

GIFT TAXES

Any plan to minimize Federal estate taxes on insurance is likely to involve Federal gift tax liability, for the gift tax is designed to be complementary to the estate tax. An insured who donates money or property to be used for the payment of premiums, who himself pays premiums on policies owned by someone else, who irrevocably assigns a policy, who irrevocably designates a beneficiary, must take the gift tax into consideration. If the choice must be between a gift tax and an estate tax, normally the decision will go in favor of the former, for the rates are lower.⁷⁵ Moreover, taxpayers have been given a rare "break" by the Revenue Act of 1941, in that the substantially increased gift tax rates, as contrasted with the new estate tax rates, will only apply to gifts made on or after January 1, 1942.⁷⁶ A word to the wise should hardly be necessary.

The present gift tax law dates from June 6, 1932.⁷⁷ A donor is allowed an annual exemption, denominated an "exclusion", of \$4,000 for gifts made to each donee within the year, unless the donee be a trust or the gift be of a future interest, in which cases no exclusion is permitted.⁷⁸ He is also allowed a cumulative specific exemption of \$40,000, which may be taken in one year or in any number of years at the option of the donor, but which, once used, is gone forever.⁷⁹ The \$40,000 exemption relates to gifts made after the date of enactment of the gift tax law; it need not be used unless and until the annual exclusion is exceeded. This means that a donor who has not made any

⁷⁴ For a discussion of the meaning of "insurance" as used in the statute, see Comment (1940) 38 MICH. L. REV. 526.

⁷⁵ The gift tax rates are three-fourths of the estate tax rates. Revenue Act of 1941, §402, amending I. R. C., §1001. But the tax figures lower than the comparison of rates would indicate. This stems primarily from the fact that the estate taxes must be paid out of the estate which is taxed, whereas the amount of the tax is not included in the sum subject to gift taxes. See MONTGOMERY, *op. cit. supra* note 11, at 424. Also, the property donated will be removed from the top estate tax bracket and placed in the lower gift tax bracket. It must be remembered, however, that the gift tax law contains no specific insurance exemption such as that found in the estate tax law.

⁷⁶ Revenue Act of 1941, §402 (b).

⁷⁷ The date of enactment of the Revenue Act of 1932, 47 Stat. 169-289. The first Federal gift tax was passed in 1924, repealed in 1926.

⁷⁸ I. R. C., §1003(b) (2). Prior to the year 1939, the exclusion was \$5,000, except in the case of gifts of future interests. I. R. C., §1003(b) (1).

⁷⁹ I. R. C., §1004. The 1935 Act reduced the specific exemption from \$50,000 to the present figure. Revenue Act of 1935, §301(b), 49 Stat. 1014 *et seq.*

taxable gifts since 1932 could give away \$44,000 (or a greater amount if more than one donee is involved) in 1941 without paying any gift tax; or he could, until the law is changed, make annual gifts of \$4,000 each to as many individuals as he desires without encroaching upon his \$40,000 exemption. Once the exemption and the exclusions are exceeded, and a gift tax has been paid for any year, gifts made in future years will be taxed more heavily, because the tax operates in snowball fashion.⁸⁰

The gift tax law itself contains no specific reference to life insurance. The regulations, however, provide that an assignment of a life insurance policy, or the designation of a beneficiary thereof without the retention of a power of revocation (as, for example, the right to surrender or cancel the policy, the right to obtain a loan against the policy or its surrender value, or the right to change the beneficiary or assignee, if by the exercise of such latter right the proceeds of the policy might be made payable to the insured, his estate, or otherwise for his benefit), constitutes a taxable gift, even though the right of the assignee or beneficiary to receive the proceeds is conditioned upon his surviving the insured.⁸¹ Should an insured transfer an insurance policy without consideration (or for an inadequate consideration),⁸² reserving the power to change the beneficiary, but expressly providing that he should not have the right to make the proceeds payable to him, his estate, or otherwise for his benefit, the regulations imply that this would be a completed taxable gift. The reserved power might also require the inclusion of the proceeds in the insured's gross estate for estate tax purposes, at least to the extent that they would be attributable to premiums paid by the insured.⁸³ The validity of the regulations, as applied to the hypothetical case given, is open to serious question in view of the *Sanford* case,⁸⁴ holding that a transfer in trust is not complete for gift tax purposes until the relinquishment of a reserved power to modify the trust, although such power would not permit modification for the benefit of the transferor.⁸⁵ Moreover, the provision of the regulations to the

⁸⁰ Net taxable gifts made since June 6, 1932, are taken into consideration in making computations for later years. U. S. Treas. Reg. 79, Art. 5, as amended by T. D. 4996, 1940-2 Cum. Bull. 295.

⁸¹ U. S. Treas. Reg. 79, Art. 2(5), as amended by T. D. 5041, 1941 Int. Rev. Bull. No. 10, at 13; *Blaffer v. Comm.*, 103 F. (2d) 489 (C. C. A. 5th, 1939), *cert. denied*, 308 U. S. 559, 84 L. ed. 469, 60 S. Ct. 91 (1939).

⁸² Transfers for less than an adequate consideration may be considered gifts to the extent that the value of the property transferred exceeds the consideration. U. S. Treas. Reg. 79, Art. 8.

⁸³ I. R. C., §§802(c), 802(d); *cf.*, John E. Cain, Sr., 43 B. T. A. 1133 (1941); Doris Bond Sherman, 41 B. T. A. 898 (1940), *nonacq.*, 1941-1 Cum. Bull. 8. And see discussion in text, *supra*, pp. 29-30.

⁸⁴ *Estate of Sanford v. Comm.*, 308 U. S. 39, 84 L. ed. 20, 60 S. Ct. 51 (1939). See also the companion case of *Rasquin v. Humphreys*, 308 U. S. 54, 84 L. ed. 77, 60 S. Ct. 60 (1939).

⁸⁵ This has been suggested by Professor Brandis, who also points out the lack

effect that a gift may be taxable, despite the fact that the right of the assignee or beneficiary to receive the proceeds is conditioned upon his surviving the insured, likewise presents a chance of the imposition of both gift and estate taxes, in view of the *Hallock* case.

The foregoing regulations lead into some of the deepest waters of current Federal taxation—namely, questions incident to the correlation of gift and estate taxes.⁸⁶ Leaving aside gifts in contemplation of death,⁸⁷ is a lifetime transfer which may be subject to estate tax also subject to gift tax? Does the imposition of an estate tax preclude the imposition of a gift tax, and vice versa? If a transfer is subject to both taxes, what is the value subject to each? These are questions with respect to which the Commissioner of Internal Revenue and the Board of Tax Appeals are largely at odds.

Lack of space forbids a complete discussion of the questions posed in the preceding paragraph, but let us take just a few examples to indicate the discrepancies. Following the *Sanford* decision, the Department amended its regulations regarding the question of when, and to what extent, gifts are complete.⁸⁸ They now recognize that a gift may be wholly incomplete, partially complete and partially incomplete, or complete, depending upon the extent to which the donor has relinquished his dominion and control over the donated property, or any interest therein. The apparent intentment is that, to the extent of any interest in property which the donor has placed beyond his power of disposition and recall, the gift is taxable. The Board is willing to go along to a certain degree. If, for example, the donor irrevocably gives away a life estate in property, but retains a power of disposition over the remainder, or retains a reversion, it will hold that there is a gift of the life estate.⁸⁹ But the Commissioner and the Board do not always agree as to what constitutes a power of revocation sufficient to prevent imposition of the gift tax.⁹⁰ Nor do they agree in all cases as to the

of consistency between this provision and the provisions of Regulations 79, Art. 3, as amended following the *Sanford* decision. Brandis, *State Gift Taxes—Their Relation to Death Taxes* (1941) 26 IOWA L. REV. 479, at 505.

⁸⁶ It has been suggested that the gift and estate tax laws be integrated. Altman, *Integration of the Estate and Gift Taxes* (1940) 7 LAW AND CONTEMP. PROB. 331. See also discussion in Brandis, *supra* note 85, at 491, *et seq.*; Warren, *Correlation of Gift and Estate Taxes* (1941) 55 HARV. L. REV. 1.

⁸⁷ The Supreme Court has cited this as an example of a transfer subject to both types of taxes. *Estate of Sanford v. Comm.*, 308 U. S. 39, 84 L. ed. 20, 60 S. Ct. 51 (1939).

⁸⁸ U. S. Treas. Reg. 79, Art. 3, amended by T. D. 5010, 1940-2 CUM. BULL. 293.

⁸⁹ William T. Walker, 40 B. T. A. 762 (1939), *appeal dismissed on Govt.'s motion*, *Helvering v. Walker*, 111 F. (2d) 646 (C. C. A. 6th, 1940); Emery May Holden Norweb, 41 B. T. A. 179 (1940), *acq.* 1940-1 CUM. BULL. 3.

⁹⁰ See Doris Bond Sherman, 41 B. T. A. 898 (1940) (gift not complete where transferor retained right to add other children who might be born); Meta Biddle Robinette, 44 B. T. A. No. 112 (1941), *nonacq.* 1941 Int. Rev. Bull. No. 34

extent of the completeness of the gift.⁹¹ The Board seems to be adhering to the rule that property which may be includible in the donor's gross estate (excepting, of course, gifts in contemplation of death) is not subject to gift tax.⁹² The application of this rule is most clearly illustrated by its decisions regarding gifts with the reservation of possibilities of reverter. Inasmuch as the donated property may be subject to estate tax under the *Hallock* decision, opines the Board, it is not subject to gift tax.⁹³ The Commissioner, contrariwise, contends that the gift is complete and subject to tax, except as to the value of the reverter, if any.⁹⁴ When it comes to the estate tax on such a transfer, however, we find that the Government is trying to eat its cake and have it too, for it recently argued that the entire value of the donated property is nevertheless includible in the donor's gross estate at death.⁹⁵ The Court of Claims decided, contrary to the above contention, that only the value of the reverter was taxable under the estate tax. This it did upon the finding that the parties involved in the *Hallock* case recomputed the deficiency only upon the basis of the reverter value.⁹⁶ If this decision is ultimately held to be good law, the Board, to be consistent, would presumably have to agree that a gift subject to a possibility of reverter is complete except as to the value of the reverter.

The existent doubts and differences of opinion regarding the gift tax and its relation to the estate tax make it advisable for donors of insurance policies, where there are gifts subject to contingent reversion-

⁹¹ See the *Martin Beck* case, 43 B. T. A. 147 (1941), discussed in text, *supra*, p. 34; see also cases cited *infra* note 93.

⁹² Emily Trevor, 40 B. T. A. 1241 (1939), *acq.* 1940-1 CUM. BULL. 4.

⁹³ Marrs McLean, 41 B. T. A. 1266 (1940), *nonacq.* 1940-2 CUM. BULL. 13. In its original decision in this case (the decision cited), the Board suggested that there might have been completed gifts of something less than a fee, but held that the necessary facts were not in the record. However, in a later memorandum opinion, upon the Commissioner's motion for reconsideration, this possibility was rejected as being contrary to the law. Alexander 1940 Fed. Tax Serv., ¶1801.389. Again, in the case of Morris Michel, 43 B. T. A. 1036 (1941), *nonacq.* 1941 Int. Rev. Bull. No. 20, on appeal to C. C. A. 7th, the Board found that the record was not proper for holding anything less than the entire interest to be subject to gift tax. See also Carl J. Schmidlapp, 43 B. T. A. 829 (1941), *nonacq.* 1941 Int. Rev. Bull. No. 19 (completed gift of joint life estate, not subject to be defeated by reverter). For a case holding that a life interest in income is subject to gift tax where the corpus was subject to a possibility of reverter, see *Smith v. Shaughnessy*, Alexander 1941 Fed. Tax Serv., ¶20,887 (D. C. N. D. N. Y., July 14, 1941).

⁹⁴ See cases cited *supra* note 93. In an informal ruling the Commissioner held that a gift of an insurance policy, subject to a possibility of reverter, was complete except as to the value of the reverter, which was admitted to be very small. Prentice-Hall 1941 Fed. Tax Serv., ¶24,650-E, 24,651.

⁹⁵ This contention was made in the case of Central National Bank of Cleveland v. United States, Alexander 1941 Fed. Tax Serv., ¶20,947 (Ct. Cls., October 6, 1941).

⁹⁶ See in further support of this view, Everett, *Valuation of a "Possibility of Reverter" under the Hallock Case* (1940) 18 TAXES 611.

ary interests or with "strings" attached, to file protective refund claims if gift taxes are paid.

The effect of Treasury Decision 5032 upon gifts of insurance policies will depend to a large degree upon the answer to questions incident to the correlation of estate and gift taxes. If an insured has paid premiums upon a policy and has retained incidents of ownership after January 10, 1941, he cannot effectively give away for estate tax purposes that portion of the policy proceeds attributable to such premium payments. If the gift tax and the estate tax are to be mutually exclusive, it might be argued to be a fair rule that the value of the donated policy for gift tax purposes should not include premiums paid by the insured prior to the transfer of the policy, or at least prior to January 10, 1941, for this value will enter into the computation of the proceeds to be included in the insured's estate. On the other hand, since the gift tax is measured by the value of the policy at the time of the gift, and since the portion of the proceeds attributable to premium payments by the insured cannot be determined until his death, such a rule is probably so indefinite as to be unworkable. It is hardly to be expected that the mutual exclusion rule will be extended so far. Logical extension of the argument advanced above would also result in the rule that premiums paid by the insured on an irrevocably assigned policy are not taxable gifts.

Taxpayers who wish to control the incidence of the gift tax may find it possible to do so by retaining certain powers of control over a donated policy or its proceeds. In this way, the imposition of a gift tax may be postponed until the release of the powers.⁹⁷ Ordinarily, however, the rising trend of the gift tax rates and the chance of an estate tax, would dictate an immediate, complete taxable gift. It may be possible, also, to stagger gift taxes on donated insurance; as, for example, by irrevocably giving away a life interest, and in a later year relinquishing a reserved power over the remainder.

It should be noted in passing that the regulations provide that, if an insured makes an irrevocable gift of a policy, and thereafter pays the premiums, each premium payment is a gift.⁹⁸ Conversely, where the insured retains the incidents of ownership in the policy, and the beneficiary pays the premiums, it may be held that the latter is making taxable gifts of the premiums to the "owner" of the policy.

Assuming an irrevocable taxable gift of an insurance policy, the

⁹⁷ *Burnet v. Guggenheim*, 288 U. S. 280, 77 L. ed. 748, 53 S. Ct. 369 (1933); *Amelia Solomon*, 43 B. T. A. 234 (1941), *nonacq.* 1941 Int. Rev. Bull. No. 11, at 1, on appeal to C. C. A. 3d.

⁹⁸ U. S. Treas. Reg. 79, Art. 2(6). In *Comm. v. Boeing, Alexander* 1941 Fed. Tax Serv. ¶20,973 (C. C. A. 9th, 1941), it was held that premium payments on assigned policies were gifts of future interests; hence, no annual exclusions were allowed.

question will arise as to the value of the policy for gift tax purposes. A large number of cases held that the value was the cash surrender value of the donated policy.⁹⁹ Early in 1941, however, the Supreme Court upheld the contention of the Government that the measure of value of a single premium policy is the cost of purchasing a similar contract on the date of the gift.¹⁰⁰ The rule is the same whether the policy was purchased and simultaneously given away, or whether considerable time elapsed between the date of the purchase and the date of the gift. The Board has applied the rule to annual premium policies,¹⁰¹ which appears to be reasonable in view of the language of the Supreme Court decisions referred to.

INCOME TAXES

The Internal Revenue Code provides that life insurance proceeds paid by reason of the death of the insured are exempt from income taxes, but that if such proceeds are held by the insurer under an agreement to pay interest thereon, the interest payments must be included in gross income.¹⁰² The Treasury Department construes this to mean that where the proceeds are directed, either by the insured or the beneficiary, to be paid over in installments rather than in a lump sum the only part of the proceeds which is exempt from income taxes is the part which would have been payable immediately upon the death of the insured had not installment payments been elected.¹⁰³ The "interest element" of the installments, says the Department, must be included in gross income. Where such installment payments were made *pursuant to a contract between the insured and the insurance company*, leaving the beneficiary no option, the Board of Tax Appeals and at least two Circuit Courts of Appeal have held that none of the installments need be included in the beneficiary's income, despite the fact that they include interest on the proceeds.¹⁰⁴ Two District Courts recently adopted the contrary view, holding the interest element to be taxable.¹⁰⁵

⁹⁹ Ernest A. Cronin, 37 B. T. A. 914 (1938). See cases collected in Alexander 1941 Fed. Tax Serv., ¶6041-A.03.

¹⁰⁰ Guggenheim v. Rasquin, 312 U. S. 254, 85 L. ed. 432, 61 S. Ct. 507 (1941); Powers v. Comm., 312 U. S. 259, 85 L. ed. 435, 61 S. Ct. 509 (1941); United States v. Ryerson, 312 U. S. 260, 85 L. ed. 434, 61 S. Ct. 656 (1941). See U. S. Treas. Reg. 79, Art. 19(9), for Treasury's method of computing the value.

¹⁰¹ Margaret R. Phipps, 43 B. T. A. 790 (1941).

¹⁰² I. R. C., §22(b) (1).

¹⁰³ U. S. Treas. Reg. 103, ¶19.22(b) (1)-1; G. C. M. 13796, (1934) XIII-2 CUM. BULL. 41.

¹⁰⁴ Comm. v. Winslow, 113 F. (2d) 418 (C. C. A. 1st, 1940), *aff'g*. 39 B. T. A. 373 (1939); Comm. v. Bartlett, 113 F. (2d) 766 (C. C. A. 2d, 1940); Comm. v. Buck, 120 F. (2d) 775 (C. C. A. 2d, 1941); Winifred Wheeler McIntyre, 45 B. T. A. No. 14 (Sept. 12, 1941) (commuted value of installment payments, held exempt).

¹⁰⁵ Allis v. LaBudde, Alexander 1941 Fed. Tax Serv., ¶20,922 (D. C. E. D. Wis., July 17, 1941); Kaufman v. United States, Alexander 1941 Fed. Tax Serv., ¶20,923 (D. C. E. D. Va., Sept. 3, 1941).

The present majority view is supported by decisions holding that, in this situation, the insurance company cannot have any deduction for interest paid.¹⁰⁶ Certainly, if the view of the two District Courts is ultimately upheld, consistency should require that the insurance company be allowed a deduction. It would seem to be clear that, in a case where the entire proceeds are left with the insurance company and only interest or "dividends" are paid to the beneficiary, whether pursuant to agreement between the insured and the company or the beneficiary and the company, such interest or dividends are taxable income.¹⁰⁷

At least until the present majority view is upset by the Supreme Court, or by statutory amendment, insurance taxpayers should take the cue and have the insurance contract itself provide that the proceeds are payable in installments, either over a fixed number of years or for the life of the beneficiary. In this way, income taxes may be saved, which is not possible where the installment election is that of the recipient.

Amounts received by an insured as a return of premiums under a life insurance contract, such as the so-called "dividends" of mutual insurance companies, which may be credited against current premiums, are not subject to income tax.¹⁰⁸

If the proceeds of a policy are paid by reason of the death of the insured to one who acquired the policy for a valuable consideration, the excess of the proceeds over the consideration and any premiums subsequently paid by the purchaser is taxable income.¹⁰⁹ In a case where the insured assigned a policy to his wife for an amount equal to the surrender value of the policy, which was then reassigned by the wife to her daughter without valuable consideration, but with the right to revoke the assignment, the Board held that the portion of the proceeds which exceeded the consideration and subsequent premiums paid by the wife was taxable income to the daughter.¹¹⁰ However, where a policy taken out and maintained by a corporation upon the life of one of its

¹⁰⁶ *Comm. v. Pan-American Life Ins. Co.*, 111 F. (2d) 366 (C. C. A. 5th, 1940), *aff'd.* on other issue, 311 U. S. 272 (1940); *Jefferson Standard Life Insurance Co.*, 44 B. T. A. No. 54 (1941); *Equitable Life Assurance Society of the U. S.*, 44 B. T. A. No. 53 (1941).

¹⁰⁷ *United States v. Heilbroner*, 22 F. Supp. 368 (D. C. S. D. N. Y. 1938), *aff'd.* 100 F. (2d) 379 (C. C. A. 2d, 1938); U. S. Treas. Reg. 103, §19.22(b) (1)-1(b); I. T. 3202, 1938-2 CUM. BULL. 138. The Bureau has ruled informally that where an insured receives dividends on a paid-up policy, they need not be included in income until they exceed the premiums paid. The same is true with respect to dividends applied to purchase paid-up insurance. Interest on dividends left with the company is taxable. Ruling dated December 13, 1940, Alexander 1940 Fed. Tax Serv., ¶1801.499.

¹⁰⁸ U. S. Treas. Reg. 103, §19.23(a)-13.

¹⁰⁹ I. R. C., §22(b) (2).

¹¹⁰ *Alcy Sivyver Hacker*, 36 B. T. A. 659 (1937). Possibly the result of this decision can be avoided by the insured's borrowing the cash surrender value from the company before making the assignment, then transferring the policy subject to the loan.

officers was assigned to the insured for its cash surrender value, the officer making his wife the beneficiary and paying subsequent premiums, the Bureau ruled that none of the proceeds was subject to the tax.¹¹¹ The fact that the assignment for a consideration was to the *insured*, was considered to distinguish the case from the Board decision mentioned. It has been held that the transfer of an insurance policy on the life of an officer of a corporation to a successor corporation in a tax-free reorganization constitutes a transfer for a valuable consideration, and any gain thereon to the successor is taxable.¹¹² This decision is very questionable in view of the fact that such a transaction is recognized as being a tax-free exchange under other provisions of the income tax law.¹¹³ The result of the decision, however, may perhaps be avoided by transferring the policy to the insured, who can in turn designate the reorganized corporation as the beneficiary.

In general, if a life insurance or endowment policy matures during the insured's lifetime, or such a policy is surrendered by the insured, the excess of the amount received over the premiums or consideration paid is taxable gain.¹¹⁴ Annuities are taxed annually at the rate of 3 per cent of the consideration paid therefor, until the consideration is fully returned, after which time amounts received are entirely taxable.¹¹⁵ Substantial income tax savings will usually result if election is made to receive the proceeds of an endowment contract in installments instead of a lump sum. In this way, the installments will probably be taxed as annuities, and the entire gain will not be taxed in one year, as in the case of a lump sum settlement.¹¹⁶

CONCLUSION

Taxpayers and their attorneys who study the statutes and decisions as they relate to the Federal taxation of life insurance are in danger of failing to see the forest for looking at the trees. In its ultimate

¹¹¹ I. T. 3212, 1938-2 CUM. BULL. 65; see further *Durr Drug Co. v. United States*, 99 F. (2d) 757 (C. C. A. 5th, 1938), in which a corporation was held not to be a transferee for a valuable consideration where a debtor made it the beneficiary of a policy on his life to secure the loan, and the corporation paid the premiums.

¹¹² *King Plow Co. v. Comm.*, 110 F. (2d) 649 (C. C. A. 5th, 1940).

¹¹³ I. R. C., §112(b).

¹¹⁴ I. R. C., §22(b) (2). The rule is the same where the proceeds are received by a donee of the insured. I. T. 2634 (1932) XI-2 CUM. BULL. 63. The rule may be different, however, if the policy was taken out prior to March 1, 1913. *Prentice-Hall 1941 Fed. Tax Serv.*, ¶8224; *Lucas v. Alexander*, 279 U. S. 573, 73 L. ed. 851, 49 S. Ct. 426 (1929).

¹¹⁵ *Ibid.*

¹¹⁶ G. C. M. 21666, 1940-1 CUM. BULL. 116. This is true even though the policy gives the insured the option of taking the cash surrender value, provided he does not exercise this option. G. C. M. 22519, 1941 Int. Rev. Bull. No. 4, at 6. See further *Prentice-Hall 1941 Fed. Tax Serv.*, ¶3044; and I. T. 2380, (1927) VI-2 CUM. BULL. 32 (so-called "annuity" taxed as interest).

analysis, planning a life insurance estate for Federal tax purposes means endeavoring to preserve as much of the insurance dollar from the depletions of such taxes as is reasonably possible. In so doing, it is necessary to take the broad view. If too much attention is directed to one phase of the question or one type of tax, another phase or another type of tax may crop up unexpectedly and defeat the purpose in mind. It is for this reason that this article has been concerned with estate, gift, and income taxes as they affect life insurance. Let the taxpayer consider all three in making his plans.

The big news under the Federal estate tax is Treasury Decision 5032, which, as we know, makes the payment of the premiums by the insured, directly or *indirectly*, the measuring rod for determining how much of the proceeds are to be taxed to the estate of the insured at his death. There has been, and there will be, a rush to make the necessary arrangements to have the premiums paid by the beneficiary, or someone other than the insured. Where the insured is the source of the payment, intimately or remotely, the battle will be fought out between the Government and the taxpayers over the meaning of the word "indirectly." This assumes that Treasury Decision 5032 will be held to be valid, an assumption which may not be justified in so far as the Decision retroactively affects the payment of premiums prior to its issuance on January 10, 1941. The effect of the retention of "incidents of ownership" by the insured (including a "possibility of reverter") is uncertain. This very uncertainty makes it advisable for the insured to retain none of the incidents. The use of the trust device still is pregnant with tax saving possibilities, but if the trust is to pay premiums, it should be created by someone other than the insured.

Because of the doubts incident to the question of the relation between gift and estate taxes, taxpayers are at a loss as to the gift tax effects of donating insurance policies, particularly if less than the entire interest of the insured is transferred. Watchful waiting should be the policy, with the filing of protective refund claims in all except clear cases. At least it is now certain that the gift tax value of an irrevocably-donated policy is its replacement cost, not its cash surrender value.

The specific statutory exemption of life insurance proceeds paid by reason of the death of the insured provides the answer to many problems which might otherwise arise under the income tax. Perhaps the most important of the currently litigated questions is whether any part of installments paid to a beneficiary over a series of years pursuant to the insured's direction represents interest income. Two recent decisions have somewhat blemished an otherwise clear tax-saving picture, but not so greatly as to remove all hopes.

Finally, taxpayers should not forget to take into account the tax laws of their own states affecting life insurance.¹¹⁷ While many of them will probably follow the Federal lead, there will doubtless be significant variations which will justify respectful study.

¹¹⁷ For instance, the North Carolina inheritance tax statute relating to insurance provides in part: "The proceeds of all life insurance policies payable at or after the death of the insured, *when the premiums have been paid by the insured,* and whether payable to the estate of the insured or to a beneficiary or beneficiaries named in the policy, shall be taxable . . ." (Italics added). N. C. CODE ANN. (Michie, 1939) §7880 (11). See further, Nutting, *Life Insurance Proceeds in State Inheritance and Estate Taxation* (1941) 26 IOWA L. REV. 579.