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Life Insurance and the Federal Estate Tax

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LIFE INSURANCE AND THE FEDERAL ESTATE TAX

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I. INTRODUCTION

Life insurance has been for many years one of the major tools of the estate planner.[1] As such, its uses and the tax consequences thereof are familiar to everyone with a basic knowledge of tax law. None the less, a reconsideration is in order.

The last decade has seen a number of forces at work to change the picture. The long recognized position of life insurance as a social institution has been further strengthened by the emphasis placed upon it by the armed forces.[2] This fact, together with the impact of continuing advertising campaigns[3] and a general high level of prosperity, has resulted in a phenomenal increase in the amount of life insurance in force.[4] At the same time, income tax rates and policies of both federal and state governments, in spite of recent federal reductions, tend to limit the size of estates which can be accumulated in a lifetime by the more traditional business or investment methods.[5] As a consequence, it may be predicted than an ever increasing percentage of the assets of the average decedent will be composed of life insurance proceeds. Finally, and perhaps even more important than the shifting economic background in indicating the timeliness of a reconsideration of insurance problems, two fundamental changes in the estate tax law within the past

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[1] No doubt true in some small measure since life insurance began to be written in considerable volume about 1870, MACLEAN, LIFE INSURANCE 592 (5th ed. 1939). Full consideration of life insurance as an integral part of the estate plan came concurrently with an increased interest in the art of estate planning during the decade from 1920 to 1930. In particular, attention was drawn to insurance by the almost simultaneous publication of a number of treatises dealing with the point at length, including: MADDEN, WILLS, TRUSTS AND ESTATES (1927); SCULLY, INSURANCE TRUSTS (1927); SHATTUCK, THE LIVING INSURANCE TRUST (1928); STEPHENSON, THE LIVING TRUST (1926).

[2] AMERICAN COLLEGE OF LIFE UNDERWRITERS, SIGNIFICANT DEVELOPMENTS OF THE WAR PERIOD IN LIFE INSURANCE 8 (1945).

[3] THE SPECTATOR, INSURANCE YEARBOOK—LIFE INSURANCE 160a (1946) reports that total insurance in force with legal reserve life companies as of Dec. 31, 1945 came to $155,722,777,547 as compared with $100,730,415,016 on Dec. 31, 1935. To the amount currently in force must be added approximately $38,000,000,000 of National Service Life Insurance according to INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 54 (1946).

[4] Johnson, *A New Era in the Public Understanding of Life Insurance,* LIFE INSURANCE TRENDS AND PROBLEMS 228 (1943).

[5] MAGILL, THE IMPACT OF FEDERAL TAXES 109 (1943).

ten years have affected the tax consequences of various insurance plans.[6]

In this discussion, the emphasis will obviously be placed upon the estate tax aspects of life insurance. It should be pointed out initially that this is merely the phase of life insurance selected for attention today. In the final analysis, taxation is only one of many considerations which the attorney must consider in planning the estate and the part life insurance will play therein. The needs of the family and the dictates of the specific situation are paramount in life insurance as elsewhere and tax saving becomes merely something to be accomplished whenever and wherever possible without too great a distortion of the basic plan.[7]

In developing the tax factors surrounding life insurance, there are three major types of situations to consider, corresponding to the three principal uses of life insurance in estate planning. In the first place, there are policies which provide for designated beneficiaries in lieu of or in addition to specific legacies.[8] Secondly, there are policies payable to the executor and designed to place the estate in a liquid position to meet immediate obligations after the death of the insured.[9] Finally, there are policies designed to fund the purchase from the estate of the decedent's interest in a business.[10] Each of these should now be considered in some detail.

II. Life Insurance Payable to Specific Beneficiaries

The treatment for estate tax purposes of insurance payable to specific beneficiaries demonstrates graphically that neither tax statutes nor the court and administrative interpretations thereof are stable items. True, prior to 1942 there had been only one major change in the statutory provisions on this point,[11] but the interpretation of the statute had constantly shifted, resulting in worse confusion than undue legislative tampering could ever have created.[12] Hence, there developed a demand for a complete overhauling of the life insurance provisions of the statute.[13] This demand was met in the course of the general revision of many sections of the Internal Revenue Code in 1942.

[6] Revenue Act of 1942, §404, 56 Stat. 944 (1942) amending Int. Rev. Code §811 (g); Revenue Act of 1948, §361, as amended by Pub. L. No. 869, 80th Cong., 2d Sess. (July 1, 1948), adding Int. Rev. Code §812 (e) (1) (G).

[7] See Shattuck, An Estate Planners Handbook 337 (1948).

[8] See Trachtman, Estate Planning 10-16 (Practising Law Institute Pamphlet, Current Problems in Federal Taxation Series, 1945).

[9] *Id.* at 18.

[10] *Id.* at 72.

[11] Revenue Act of 1918, §402 (f), 40 Stat. 1098 (1918). The estate tax, as originally passed in 1916, contained no provisions specifically taxing life insurance. While the general provisions were broad enough to clearly tax life insurance payable to the estate, there was some doubt as to the status of insurance payable to specific beneficiaries. The 1918 change was intended to settle this doubt. See 1 Paul, Federal Estate and Gift Taxation §10.02 (1942).

[12] 1 Paul, Federal Estate and Gift Taxation §10.15 (1942).

[13] *Id.* at §10.29.

As a result of the amendments of 1942,[14] the entire proceeds of life insurance payable to specific beneficiaries are included in the decedent's gross estate: (a) if the decedent possessed at his death any of the incidents of ownership with respect to such insurance, or (b) if the decedent paid all of the premiums either directly or indirectly.[15] If the decedent possesses no incidents of ownership at death and has paid only a part of the premiums, the statute provides that only that part of the proceeds shall be included in his gross estate which bears the same proportion to total proceeds as the premiums paid by decedent bears to total premiums.[16] The regulations expand the allocation formula and provide that if the decedent possessed no incidents of ownership after January 10, 1941, the premiums paid by him before that date may be excluded from payments chargeable to him.[17]

At the present time, there are serious efforts underway further to amend the statute. During the past session of Congress, the House of Representatives passed a general revenue revision bill.[18] The Congress adjourned, however, prior to Senate action. Section 203 of the bill as passed by the House provides for a drastic change in the life insurance section. It would eliminate the payment of premiums test entirely and would tax life insurance proceeds as a part of the estate of the insured only if insured died possessed of incidents of ownership in the policy. Whether the next Congress will pass a bill containing a similar section is problematical. The loss of revenue is estimated at approximately $100,000,000 per year.[19] On the other hand, there is definite sentiment in favor of the bill.[20] Certainly passage would give an additional incentive for the purchase of large life insurance policies and would revive some of the tax saving possibilities of irrevocable insurance trusts. However, this discussion must in large part be confined to the law as it now is, not as it may be.

It is obvious that the present statutory provisions are sufficiently comprehensive to reach all normal life insurance arrangements. In fact, a majority of present policies, upon which the insured pays the premiums and possesses the power to change beneficiaries and to obtain the cash surrender value of the policy, are taxable under either of the alternate tests. It is plain that specialized planning and handling are necessary to exclude insurance proceeds from the gross estate. Furthermore, that in many smaller estates no special plan will prove feasible

[14] Revenue Act of 1942, §404, 56 STAT. 944 (1942).
[15] INT. REV. CODE §811 (g) (2).
[16] *Ibid.*
[17] U. S. Treas. Reg. 105, §81.27 (1943).
[18] H.R. 6712, 80th Cong., 2d Sess. (passed June 19, 1948).
[19] H.R. REP. No. 2087, 80th Cong., 2d Sess. (1948).
[20] The American Bar Association, see 71 A.B.A. REP. 133 (1946) and Committee Report of Section on Taxation, ABA, 47 (1948); The Special Tax Study Committee, see Report to Committee on Ways and Means H.R. 4041 (1947).

and the problem is pargely one of recognition of the effect of insurance on the tax total and of provision for the payment of taxes which result.

Since the demise of the irrevocable insurance trust as a tax saving measure in most situations,[21] only one absolutely safe method remains whereby insurance proceeds payable by reason of death will not be included in the gross estate of the decedent.[22] If a spouse, child or other party secures the policy, paying all of the premiums from funds derived from sources other than the insured and taking care not to vest any incident of ownership in the insured, then the policy proceeds will be tax free. This type of arrangement has definite limitations and in all but its most simple form raises questions which should be considered carefully before deciding upon its use.

The first point is a question of insurance law. A life insurance policy to be valid must be taken out by one with an insurable interest in the life of the insured.[23] Unquestionably a spouse has such an interest in this state.[24] The North Carolina courts have not passed upon whether a child or lineal descendant has the requisite interest, but the majority view permits such persons to insure the parent[25] and presumably North Carolina would follow these precedents. In the situation, then, in which spouse or person with insurable interest is to pay the premiums and hold the incidents of ownership it is wise for such person actually to take out the policy. However, more distant relatives and friends do not have an insurable interest.[26] In such cases, it will be necessary for the insured, who always has an insurable interest in his own life,[27] to take out the policy and then assign it, the assignee furnishing the first premium. While this course always involves the possibility of an attack on the issuance of the policy as invalid because of illusory insurable interest,[28] it is a chance which is unavoidable if all proceeds are to be removed from the estate.

A second and frequent problem arises from the fact that a spouse, particularly the wife, may have no funds derived by inheritance or her

[21] Probably effected by T.D. 5032 (January 10, 1941), 1941 CUM. BULL. 427. See Rice, *Planning a Life Insurance Estate*, 20 N.C.L. REV. 34 (1941). Definitely covered by INT. REV. CODE §811 (g) (2) and U. S. Treas. Reg. 105, §81.27. PAUL, FEDERAL ESTATE AND GIFT TAXATION 363 (1946 Supplement).

[22] SHATTUCK, AN ESTATE PLANNERS HANDBOOK 263 (1948).

[23] 2 APPLEMAN, INSURANCE LAW AND PRACTICE 77 (1941).

[24] Taylor, *The Law of Insurable Interest in North Carolina*, 24 N.C.L. REV. 258 (1946).

[25] VANCE, LAW OF INSURANCE 156 (2d ed. 1930).

[26] For example, nephew does not have insurable interest in life of uncle, Wharton v. Home Security Life Ins. Co., 206 N.C. 254, 173 S.E. 328 (1934); half-sisters do not have insurable interest in the lives of each other, Crump v. Southern Dixie Life Ins. Co., 204 N.C. 439, 168 S.E. 514 (1933). *But cf.* Webb v. Ins. Co., 216 N.C. 10, 3 S.E. 2d 428 (1939) holding that brothers do have an insurable interest.

[27] 2 APPLEMAN, *op. cit. supra* note 23, at 81.

[28] 3 P-H WILLS, ESTATES AND TRUSTS SERV. ¶6009 (1941).

own labors. When, if ever, may she purchase insurance upon her husband's life with funds he has given her, without having the proceeds included in his estate on the grounds that he indirectly paid the premiums? The Regulations state that the phrase "paid indirectly by the decedent" is to be given "broad scope."[29] As examples of such indirect payment, they cite use of funds given to spouse for purpose of paying premiums, payment of premiums by a funded insurance trust established by decedent, or payment by a corporation which is the alter ego of the decedent.[30] In placing this broad interpretation upon the statute, the Treasury is substantiated by the committee reports[31] on this phase of the Revenue Act of 1942. These reports indicate that this provision of the Act was intended to prevent tax avoidance and should be construed accordingly. Consequently any use of funds derived from the decedent is definitely open to attack.

In spite of these considerations, it is submitted that under some circumstances the spouse may use funds which originated with the decedent, although as yet there is very little in the way of precedent. In one of the few cases, *Estate of Cain*,[32] a case arising under the statute as it read prior to 1942 but involving the definition of the words "indirect premium payment" which were then contained in the regulations, the BTA refused to find that premiums paid by the wife were attributable to the deceased husband merely because he had given the property to her from which she made the payments. In considering the result in this case it should be noted that the gift was made some years before the income therefrom was first used for premium payments. In the absence of an extensive body of controlling precedent, it is suggested that the following factual criteria may be used to determine whether premium payments are indirectly attributable to the decedent, when made by the spouse from funds originally derived from decedent by gift. If the original gift was outright and unlimited as to use, if it was not closely related in time to the taking out or assignment of the insurance policies involved, if the gift was not of the exact amount needed to carry the policies—then it may be predicted that the decision will be that decedent did not indirectly pay the premiums through the medium of the gift.[34] If the spouse does possess some assets other than the gift property, one may be even more confident of such a decision. On

[29] U. S. Treas. Reg. 105, §81.27 (1943).
[30] *Ibid.*
[31] H.R. Rep. No. 2333, 77th Cong., 2d Sess. 162 (1942), reprinted 1942 Cum. Bull. 490; Sen. Rep. No. 1631, 77th Cong., 2d Sess. 235 (1942), reprinted 1942 Cum. Bull. 677.
[32] 43 B.T.A. 1133 (1941); *cf.* Booth, 3 T.C. 605 (1944). *But cf.* L. B. Foster 8 T.C. 205 (1947).
[33] Estate of Dundore, BTA Memo, Jan. 16, 1942. P-H Mem. BTA Serv. ¶42, 028; *cf.* Rogan v. Ferry, 154 F. 2d 974 (C.C.A. 9th 1946).
[34] Trachtman, *op. cit. supra* note 8, at 13.

the other hand, any closer connection between property derived from the spouse and the insurance will probably result in inclusion of insurance proceeds in the estate. As indicated above, in the final analysis, the issue of indirect premium payments by the decedent is a question of fact to be determined largely on a case to case basis[35] and to be won or lost in the Tax Court, for the general rejoicing over the death of the Dobson rule should not raise any undue hope over the prospect of extensive review or decisions of fact.

Frequently, the estate planner is faced with a situation in which one spouse, normally the husband, owns and pays the premiums upon existing policies which comprise all of the insurance it is deemed wise for the estate to carry. To what extent can a transfer to wife, child or other person, who will thereafter pay premiums from independent funds and possess the incidents of ownership, reduce the amount of proceeds to be included in the decedent's estate or eliminate this unpleasant prospect entirely? If, as normally will be the case, the transfer is a gift, it seems clear under the present statute that a part of the proceeds of the policy will be allocated to the estate of the insured by use of the formula previously discussed. Although this action merely reduces rather than eliminates this item from the estate, it is a tax saving possibility not to be overlooked. In estimating savings, however, the effect of the gift tax must be considered.

In the event that insured now holds the incidents of ownership in a policy which had become paid up prior to January 10, 1941, it would seem arguable in all logic from the principles previously discussed that an intervivos transfer of these incidents of ownership would prevent the policy proceeds from being included in his estate. Such, however, is not the case. Treasury Regulations 105, §81.27 indicates that the premiums paid before January 10, 1941 are excluded only when decedent has held no incidents of ownership since that date. The Treasury has corroborated this interpretation.[36] Thus, in selecting policies for transfer, if a choice is available, it is advantageous to pick relatively young policies on which gift tax is low, if applicable at all and on which the donee will pay a considerable part of the premiums, there being absolutely no estate tax advantage in transferring a paid up policy, even though paid up prior to January 10, 1941.

A more difficult problem is presented in those situations where the insured now possesses the incidents of ownership but premiums have been paid by someone else. What effect on the inclusion of the proceeds in the taxable estate does transfer of this policy have? In so far as the statute is concerned, it is plain that no part of the proceeds should be

[35] See PAUL, FEDERAL ESTATE AND GIFT TAXATION §10.36 (1946 Supp.).
[36] Letter dated April 4, 1946 signed D. S. Bliss, Deputy Commissioner reprinted 3 P-H 1948 FED. TAX. SERV. ¶23, 841.4.

included, if transfer is made prior to death. However, Treasury Regulation 105, §81.25 warns that this gift may be held a transfer in contemplation of death and be taxed as such.[37] That this is no idle threat has been demonstrated in a number of cases, arising chiefly out of transfers made during that period prior to January 10, 1941, when taxability of proceeds was determined solely by possession of the incidents of ownership.[38] Consequently, the lesson taught by these cases is of value not only in planning prospective transfers, but also in reviewing transactions already completed for their effect upon the tax liability of the estate. So also, the transfer of currently active policies may be the next target of this approach.

The treasury attack on these transfers as being made in contemplation of death has moved forward on the broad ground that all life insurance is testamentary in nature and looks to death as its reason for existence.[39] This ground is reinforced when the insurance is transferred to a trust which, being irrevocable, guarantees non-cancellation of the policies and ultimate payment to the beneficiaries.[40] A similar result has been held to follow when the transfer is part of an overall estate plan, looking to the avoidance or reduction of estate taxes.[41] These grounds comprehend a good proportion of insurance transfers and present a gloomy picture for the estate planner who would reduce the weight of the estate tax or thought that he had done so by a transfer a decade ago. However, it is not impossible to show that an insurance transfer was made for reasons other than death. Thus, a transfer of policies to a wife pursuant to a separation agreement[42] and a transfer to protect policies from creditors[43] have been held not motivated by death. Perhaps a transfer made at a time not contemporaneous with other estate planning can hold out some hope for similar treatment, if it is not to a trust and if it vests in the transferee substantial present rights.

A further problem in these cases is the amount of the proceeds to be included in the taxable estate in the event the transfer is found to have been made in contemplation of death. If the policy was paid up at the time of transfer, the entire proceeds are taxable.[44] A similar

[37] Pursuant to INT. REV. CODE §811 (c)..

[38] These cases collected and thoroughly analyzed by Guterman, *Transfers of Life Insurance and the Federal Estate Tax*, 48 COL. L. REV. 37 (1948); and by Cohn, *1947 Tax Decisions and Proposed Legislation Affecting Life Insurance*, 2 J. AM. SOC. C.L.U. 191 (1948).

[39] Estate of Sloan v. Commissioner, 5 P-H 1948 FED. TAX SERV. ¶72, 507 (C.C.A. 2d, June 1, 1948).

[40] First Trust & Dep. Co. v. Shaughnessy, 134 F. 2d 940 (C.C.A. 2d 1943), *cert. denied* 320 U. S. 744 (1943).

[41] Vanderlip v. Commissioner, 155 F. 2d 152 (C.C.A. 2d 1946), *cert. denied,* 329 U. S. 728 (1946); Satuloff v. Miller, P-H 1947 MEMO TC ¶47, 312 (1947).

[42] Estate of Hurd, 9 T.C. 92 (1947).

[43] Estate of Ruthrauff, 9 T.C. 59 (1947).

[44] PAUL, FEDERAL ESTATE AND GIFT TAXATION §10.24 (Supp. 1946).

result follows if the decedent has continued to pay premiums after the transfer.[45] If, on the other hand, the beneficiary has paid the premiums after transfer, it has been held in one case, *Liebman v. Hassett*,[46] that only the proportion of the proceeds which the premiums paid by the decedent bear to the total should be included. This position would seem borne out by the regulations which provide that, if the transferee has made betterments, the enhanced value of the property is not included in valuing the gift in contemplation of death. The allocation formula in the insurance sections would seem to indicate a similar result. However, there has been some tendency in the Tax Court to ignore these factors and include the entire proceeds.[47] It is submitted that this view will not obtain and that *Liebman v. Hassett* represents the probable ultimate line of decision.

The final point to be considered in determining whether to remove insurance from an estate through the medium of ownership and premium payment by a spouse beneficiary is the possibility that said spouse may die first. If this does happen, the policy which is so owned and upon which premiums have been paid is obviously an asset of the beneficiary's estate to the extent of its current value.[48] If the purpose of the policy is to provide for the spouse beneficiary who has paid the premiums and holds the incidents of ownership, this result cannot be avoided and all that can be said is that it should be recognized. If, however, the desire is to provide for children through the medium of insurance on the husband, for example, carried by the wife, there is one tax saving possibility open. An irrevocable funded or unfunded insurance trust for the benefit of the children set up by the wife, she providing the necessary finances and the husband the life to be insured, will result in funds coming into the trust upon the husband's death without being taxable in his estate, and in the event the wife dies first, the policy value will not be included in her estate.[49] From the family viewpoint a funded trust is probably advisable as insuring the continuance of the policies in the event of the wife's death first.

Since this discussion is directed largely at tax saving, little mention has been made of the personal insurance trust except in the special circumstances just described. With the adoption of the premium payment test, such a trust lost its tax attractiveness under most possible arrangements.[50] However, it retains its other advantages and it goes

[45] Estate of Sloan v. Commissioner, 5 P-H 1948 FED. TAX SERV. ¶72, 507 (C.C.A 2d, June 1, 1948).

[46] 148 F. 2d 247 (C.C.A. 1st 1945).

[47] Estate of Cronin, 7 T.C. 1403 (1946), *revd. on another point*, 164 F. 2d 561 (C.C.A. 6th 1947).

[48] OPPENHEIM, THE FEDERAL ESTATE TAX 36 (Pamphlet, Practicing Law Institute Series, Fundamentals of Federal Taxation, 1946).

[49] TRACHTMAN, *op. cit. supra* note 8, at 19.

[50] See note 21 *supra*.

without saying that where an individual may collect a policy tax free, a trust normally can do so as well. Therefore, a consideration of life insurance in estate planning would not be complete if it were not pointed out that as a consequence of the insurance trust's features of management and flexibility, it may well be utilized in many instances where it accomplishes no tax economies.[51]

In summary, the only possible present means of preventing insurance proceeds payable to specific beneficiaries from becoming a part of the gross estate of the insured is to vest policy ownership in someone other than the insured and to secure premium payments from a similar outside source. In setting up such a plan, careful consideration should be given to the problems of insurable interest, if a new policy is secured; to the possibility that a gift in contemplation of death may result if existing policies are transferred; and to the fact that unless certain special arrangements seem desirable, the present value of the policy will be taxed to the person possessing the right thereto, if such person should predecease the insured. As a final caution, care must be taken to avoid any arrangement which involves indirect payment of the premiums by the insured or which does or may in the future vest any incidents of ownership in him.

III. Life Insurance Payable to Spouse and the Marital Deduction

In considering the tax aspects of the life insurance assets of an estate, the focus has so far been upon actions which might take the proceeds totally out of the gross estate of the decedent. In many cases this will not be possible or will be deemed unwise. In these cases, to secure the maximum tax savings it becomes necessary to analyze life insurance payable to the spouse to determine whether it will qualify for the marital deduction.[52]

The Revenue Act of 1948 contained rather specific provisions concerning the eligibility of life insurance for this deduction. These provisions were not entirely satisfactory and were amended July 1, 1948.[53] It is not necessary to discuss the original provisions since the amended act was made retroactive to January 1, 1948, to coincide with unchanged parts of the Revenue Act. The change, however, is worthy of mention because it renders a goodly part of the early discussions of the insurance clauses of the Revenue Act of 1948 inaccurate. Under the provisions of the statute as it now stands, life insurance payable outright to the surviving spouse qualifies for the marital deduction to the extent that

[51] Shattuck, An Estate Planners Handbook §7 (1948).

[52] See Foosaner, The Federal Revenue Act of 1948—Its Application to Insurance and Estate Planning 18 (1948).

[53] Pub. L. No. 869, 80th Cong., 2d Sess. (1948).

it is included in the gross estate under the principles previously discussed.[54] The limitation becomes important, for example, when the decedent does not possess the incidents of ownership at death and a part or all of the premiums were paid by someone other than the insured.

Life insurance subject to settlement options will also qualify under certain circumstances. These options vary considerably in their details from company to company, but possess sufficient common basic features to allow generalized treatment.[55] In the first place, the policy may provide for selection of the option solely by the insured prior to his death, or it may provide for the beneficiary to elect between a lump sum payment or one of the options after the policy has matured. Even in the absence of regulations, it would seem probable that the policy proceeds qualify for the marital deduction, if the spouse has actually become entitled outright to the proceeds and has made other arrangements by her own selection of an option.[56]

When the insured selects a settlement option, however, and the spouse beneficiary is not entitled to determine whether or not the proceeds will be collected in one lump sum, careful analysis is essential to a determination of the availability of the marital deduction. The statute[57] provides that an interest in the proceeds under life insurance, endowment and annuity contracts qualifies if:

(1) Either interest or installment payments are made at least once each year;
(2) The first payment is to be made within thirteen months after the death of the decedent;
(3) Interest and installment payments may be made only to the spouse during her lifetime;
(4) The surviving spouse has a power exercisable by the spouse alone and in all events to appoint any unpaid proceeds either to such surviving spouse or to the surviving spouse's estate, whether or not she can also appoint to others.

If all of those requirements are met, any of the normal options may qualify for the deduction. Many existing policies, however, in which the insured has designated a settlement option, are deficient in one or more respects and must be amended if the estate is to have the benefit of the deduction. In this connection the only requirement which may cause difficulty is that which makes mandatory a power of appointment in the primary beneficiary.

[54] INT. REV. CODE §812 (e) (1) (G).
[55] TRACHTMAN, *op. cit. supra* note 8, at 22.
[56] Foosaner and Lore, *New Estate and Gift Taxes, How They Affect Life Insurance*, 26 TAXES 411 (1948). But see reaching a contrary conclusion Gemmill, *Estate Planning in the Light of the Revenue Act of 1948*, 26 TAXES 601 (1948).
[57] INT. REV. CODE §812 (e) (1) (G).

Many options, which provide for specific regular payments of principal or interest, operate in such fashion that a remainder is available after the death of the primary beneficiary. True, in the past, a provision that the beneficiary upon appropriate notice could take the cash remainder value and close out the policy has not been unheard of and this type clause seems to satisfy the requirement of a power of appointment. But normally one of the chief objects in selecting a fixed payment of fixed period option in contrast to a lump sum settlement is to prevent such action and most contracts have been so worded. Such a situation, as noted, results in an unpaid balance on death of the primary beneficiary and therefore the insured has named secondary beneficiaries. Under the contract forms in use by most companies, the primary beneficiary has been unable to take this action or alter the designation of secondary beneficiary from that previously made by the insured, the companies being wary of the legal technicalities involved in powers of appointment and their exercise.[58] Yet without this power, the policy proceeds will not qualify for the deduction. As a consequence, the charges of unrealistic and unworkable have been leveled at the life insurance sections of the new revenue law.[59] However, it is now apparent that most of the major companies, after a period of indecision, have determined to grant upon request a power which will qualify new policies.[60] They show a similar willingness to amend old policies, if the insured has retained the power to make changes. Generally speaking, they limit the grant to a power to appoint by the surviving spouse to self during life or to such surviving spouse's estate by notice filed before death. A majority probably still refuse to grant any testamentary power to the surviving spouse and do not permit the designation of takers other than the surviving spouse or such spouse's estate by anyone after the death of the insured.

Since life insurance policies can be arranged to qualify for the marital deduction in the above manner, at least one possibility is open to the estate planner whose client wishes to receive maximum benefit from the marital deduction and provide the largest possible annual income for his spouse, while placing as little as possible of the corpus of his estate under either her immediate or ultimate control. Such an estate can be arranged with the insurance payable to the spouse on an extended settlement option and with power in said spouse to appoint any part of the insurance which might remain on death to the estate

[58] McLucas, *Marital Deduction for Estate Taxes*, 86 TRUSTS AND ESTATES 512 (1948).

[59] 2 RABKIN AND JOHNSON, FEDERAL TAXATION 3619a.

[60] For full discussion of present company position see Thore, *The Revenue Act of 1948*, EASTERN UNDERWRITER 13 (Sept. 10, 1948) (Reprint of an address delivered at the annual meeting of the American Bar Association, Seattle, Wash., Sept. 1948).

of such spouse. By thus using so much of the insurance as is needed to equal one half of the adjusted gross estate, supplementing it, if necessary, by property in trust subject to a power of appointment which meets the test of section 812 (e) (i) (F), maximum advantage can be taken of the marital deduction. At the same time the remainder of the estate can be handled as successive interests in a trust, thus avoiding a second estate tax on the death of the spouse holding the first beneficial interest. There are many obvious variations on this general pattern, using the insurance which would probably be expended in any event, to secure the marital deduction and allowing the conservation of the remainder of the estate.[61]

Whether or not any such plan as mentioned in the preceding paragraph is desirable, one point is plain as a result of the insurance features of the Revenue Act of 1948. Every existing policy and every new policy in which a spouse is named as beneficiary must be carefully reviewed and checked against the statute for eligibility for the marital deduction. Failure to do so and to take corrective action where indicated may result in a much heavier tax on an estate made up largely of insurance policies payable to the spouse under rigid option settlements.

IV. Insurance Payable to the Estate

The second major use of insurance in estate planning is to provide the executor with ready funds to meet the immediate obligations with which he is faced, such as taxes, debts of the decedent and other expenses of administration.[62] The need for such funds varies with the nature of the assets expected to comprise the estate, a point to be fully developed by another speaker. Pertinent here is the fact that one of the most common methods of meeting this situation is a policy carried by the decedent in an amount estimated to be sufficient and payable to his estate. Also on occasion, where he is doubtful as to beneficiaries he wishes to designate, an insured will carry policies payable to his estate in excess of any possible expenses in order to make available funds for specific legacies or to add to the residual legacy. The tax consequences of all such policies are plain. The statute[63] squarely provides that the proceeds of policies payable to the estate are included therein for tax purposes, regardless of policy ownership or source of premium payments.

The course of the estate planner who would hold taxes to a minimum is plain. It is merely pointing out the obvious to say that any policies which are wholly or partially tax free as a consequence of premium payment history and location of the incidents of ownership should al-

[61] *Id.* at 15.
[62] Roubik, *Estate Liquidity*, 2 J. Am. Soc. C. L. U. 154 (1948).
[63] Int. Rev. Code §811 (g) (1).

ways remain payable to specific beneficiaries and the newer policies, which are probably taxable in any event under current criteria, be made payable to the estate to fund its expected expenses. Only one possibility exists for the providing of these funds through insurance without including policy proceeds in the gross estate. If it can be assured that the beneficiary of a tax free policy will loan without interest sufficient funds to the executor to carry him through initial expenses, the tax increasing policy payable to the estate may be eliminated. In the event that the beneficiary is a trust, it will, of course, be necessary to write the authorization for such loans into the trust instrument.[64]

In considering the meeting of executor's needs for cash in the manner just discussed, there is always the possibility of non-cooperation between the executor on the one hand and the beneficiary or trustee. If insurance must supply liquidity, the advantage which lies in having a definite cash sum unequivocally available may well outweigh efforts to reduce taxation through the somewhat doubtful expedient of loans, and thus indicate inclusion in the overall estate plan of a policy payable to the executor in spite of the fact that it is fully taxable.[65] However, the total amount of tax and other liabilities which it is feasable to fund by direct insurance is strictly limited by the tax increasing effect of such policies,

V. Insurance to Provide Means for Purchase of Business

The third principal usage of life insurance is founded upon the necessity of protecting the estate's interest in receiving full value for the business of the decedent. Hurried liquidation of a business which has been operated by the deceased as a sole proprietorship, a partnership, or major stockholder in a closed corporation, will inevitably result in a heavy loss. Even at best, a careful and slow liquidation or a forced sale as a going concern will rarely yield the full intrinsic worth of the deceased's interest.[66]

True enough, one method of meeting this problem is not to liquidate at all, but to establish a trust to take over and operate the business. Originally, this was considered an arrangement suitable only where a son or other family member would assume control on maturity and it was desired to preserve the business for him. However, specialists in the trust field have recently predicted an increasing use of this device to preserve the business as a whole for the family in general, because

[64] Roubik, *supra* note 60, at 158.

[65] But note that the mathematics of estate taxation and planning place a definite limit on the size of such policy. It is not feasible to fund the estate tax liability of a large estate in this fashion. See the discussion by MONTGOMERY, 1946-1947 FEDERAL TAXES—ESTATES, TRUSTS AND GIFTS 27 (1946).

[66] Laikin, *Death, Taxes and Your Business*, 85 TRUSTS AND ESTATES 372 (1947).

of the relatively large income it normally produces as compared to the traditional trust portfolio securities.[67]

But even with increasing use of the trust to operate a business, there will be many instances where circumstances dictate a sale upon the owner's death and a sale at its fair market value as a going concern. The prospective purchaser may be a family member, a key employee, a surviving partner or shareholder. The important and difficult problem is the necessity that such person have adequate funds.[68] In many instances insurance alone will provide these. A second problem is the desirability of assuring the use of such funds for the purpose intended. Hence, the frequent interposition of the trust device, with an impartial trustee holding the policies and named as beneficiary to collect and apply proceeds in the agreed manner.[69] Whether or not a trust is used, the arrangement must be reduced to a carefully drafted written agreement.[70]

There are two principal types of situations.[71] In one, a single individual, in effect, "owns" the business, regardless of the form in which he has organized it and it is necessary to provide for his death by selecting a successor and providing funds for purchase. In the second situation, there are two partners or stockholders holding equal or nearly equal interest and it is necessary to arrange the plan so that either who survives may purchase the interest of the other.

In the first type situation, to avoid any possibility of taxation of the life insurance proceeds to the decedent, the successor should take out the policy and pay the premiums. In the absence of the use of a trust device, the successor will name himself as beneficiary and will hold the policy as owner. However, the agreement between the parties should limit his right to borrow on the policy or redeem it for its cash surrender value and should provide definitely many other details such as valuation of the property for the transfer. Alternately a trustee can hold the policy and be named as beneficiary, with the trust instrument prescribing methods of carrying out the transfer and valuing the business interest. As previously indicated, the latter seems preferable.

Where there are two partners or two major shareholders, the object is to provide either with funds to purchase the interest of the other, with it immaterial which dies first as far as the success of the plan is concerned. This is best done by having each partner or major share-

[67] SHATTUCK, AN ESTATE PLANNERS HANDBOOK §8 (1948).

[68] LAIKIN, *op. cit. supra* note 66, at 374.

[69] TRACHTMAN, *op. cit. supra* note 8, at 72.

[70] See Forster, *Legal, Tax and Practical Problems Under Partnership Purchase and Sale Agreements Coupled with Life Insurance*, 19 SO. CAL. L. REV. 31 (1945); Lacovara, *Business Insurance Trusts*, 43 COL. L. REV. 328 (1943).

[71] For a full discussion of all variations see series of articles by Laikin, *Death, Taxes and Your Business*, 85 TRUSTS AND ESTATES 374, 459, 517 (1947), 86 TRUSTS AND ESTATES 13, 145 (1948).

holder insure the life of the other, taking out the policy and paying the premiums. Again the agreement should be specific, containing the agreement to buy and sell, the method by which the decedent's interest is to be valued, the agreement of each to insure the other and maintain the insurance by payment of premiums, and frequently providing a trust to carry out the agreement.

Undoubtedly one great temptation when a partnership or corporation is involved is to vary the above plan by having the business pay the premiums and own the policies. This relieves the individual of expense and is an attractive solution at first glance. It becomes even more attractive when there are several partners or shareholders and cross insurance becomes complex. Consequently many plans have been set up on this basis. However, this plan has certain dangerous potentialities. The Treasury and the courts may well hold that the decedent has indirectly paid the premiums and so include the insurance proceeds as an asset of the estate as well as the business interest which they purchase. As yet this possibility has not been directly tested, but the implications of *Legallet v. Commissioner*[72] definitely indicate the risk involved in this arrangement.

To be definitely avoided is any agreement whereby the sole proprietor or each partner or shareholder pays for insurance on his own life with the survivor or business named as beneficiary. Under the present law, policy proceeds would be included in the estate of the deceased since he paid the premiums.[73]

In summary, then, business insurance is a most valuable device for the estate planner, but it must be handled properly or it will prove a two-edged sword.

VI. CONCLUSION

By way of conclusion, it perhaps is best to end the discussion on the same note it began. Insurance is the pivotal asset in probably the majority of the smaller estates being planned today in North Carolina. Both its intrinsic nature and its tax consequences present complex problems which call for careful study and skillful handling. In this analysis, emphasis has been on the tax aspects of the problem. But these, while important, cannot be allowed to obscure the ultimate objective of an estate properly designed to meet the specific individual situation. The insurance phase of the plan must contribute to the best overall result, with the tax impact as a result of such insurance held to a minimum consistent with this basic objective.

[72] 41 B.T.A. 294 (1940). For extended comment on these implications see SHATTUCK, AN ESTATE PLANNERS HANDBOOK §39B (1948).
[73] INT. REV. CODE §811 (g) (2).