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Sharon L.R. Miller

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# "Incidents of Ownership" as Applied to a Right Held by a Decedent to Select an Optional Mode of Settlement

*Sharon L.R. Miller**

*This Article examines the definition of "incident of ownership" as that term is used in Internal Revenue Code section 2042(2). That Code section provides for the inclusion of life insurance proceeds in the gross estate of a decedent to the extent the decedent possessed in them "any of the incidents of ownership" at the time of his death. After focusing on the bases for the various tests courts have relied upon, and after analyzing two conflicting Courts of Appeals cases, the author concludes that such tests are not efficacious. Rather, the plain meaning of the statute, buttressed by explanatory Committee reports, offers the clearest source of law in the area. Unfortunately, in certain circumstances, such as where the decedent held the right to select an optional mode of settlement, the plain meaning of the statute may call for an unjust result; insurance policy proceeds over which a decedent had virtually no control will nevertheless be included in his gross estate. Avoidance of the unfairness of section 2042(2) can only be accomplished by congressional amendment. Until then, the conflated tests traditionally relied upon by courts should not be used to mask the clear meaning of section 2042(2).*

## INTRODUCTION

PROCEEDS FROM life insurance policies on the life of the decedent are included in the gross estate if "the decedent possessed at his death any of the *incidents of ownership*, exercisable either alone or in conjunction with any other person."[1] Courts have had difficulty interpreting the term "incidents of ownership" since Congress failed to define the term when it incorporated it into the Internal Revenue Code (the Code) in 1942.

This Article reviews the historical background of Code section 2042(2) and the struggle which courts have experienced in their

* Member of the Ohio Bar. B.S., Kent State University (1974); J.D., Ohio Northern University (1979); LL.M., University of Florida (1982).

1. I.R.C. § 2042(2) (1976) (emphasis added). Section 2042(1) also requires inclusion, without regard to "incidents of ownership," to the extent such proceeds are receivable by the executor.

endeavor to define "incidents of ownership," including the factors emphasized by courts in reaching their conclusions. With this background in mind, the Article then focuses on whether a power held by a decedent to elect an optional mode of settlement under a life insurance policy is an "incident of ownership" within the meaning of section 2042(2) such that proceeds from the policy are includable in the decedent's gross estate.

The United States Courts of Appeals for the Third and Fifth Circuits have taken opposing positions on this issue in two very similar cases.[2] Both cases involved the same employer and the same master group insurance policy. In each case, the beneficiaries and the priority among them were irrevocably fixed. The only power held by the decedent was to select an optional mode of settlement which would spread payments to the beneficiary over a longer period of time. In *Estate of Lumpkin v. Commissioner*,[3] the Fifth Circuit concluded that such a power was an "incident of ownership" and the value of the proceeds were includable in the decedent's gross estate. In *Estate of Connelly v. United States*,[4] the Third Circuit reached the opposite result.

In light of the history of section 2042(2) and the various factors courts have used to interpret "incidents of ownership," this Article concludes that the Fifth Circuit reached the correct result in *Lumpkin*, but for the wrong reasons. If on the date of death, a decedent possessed a right to select an optional mode of settlement, then the proceeds of the insurance policy should be includable in his gross estate. The language of section 2042(2) mandates this result since it requires inclusion if the decedent possessed "*any* of the incidents of ownership." This language suggests that even a fractional interest held by the decedent is includable.

It is the thesis of this Article that the clear statutory language provides the only basis for proper interpretation of the term "incidents of ownership." While courts have long applied various tests and factors in attempts to form a workable definition of the term, these have largely proved to be unsatisfactory, with Congress' own wording in section 2042(2) remaining the only clear source of law in this area.

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2. Estate of Connelly v. United States, 551 F.2d 545 (3d Cir. 1977); Estate of Lumpkin v. Commissioner, 474 F.2d 1092 (5th Cir. 1973). The Eighth Circuit has joined the Third Circuit in holding that the right to economic benefits of a policy is necessary for inclusion in the gross estate. Hunter v. United States, 624 F.2d 833 (8th Cir. 1980).

3. 474 F.2d 1092 (5th Cir. 1973).

4. 551 F.2d 545 (3d Cir. 1977).

## I. HISTORICAL BACKGROUND OF THE APPLICATION OF THE TRANSFER TAX TO LIFE INSURANCE PROCEEDS

The Revenue Act of 1916[5] imposed a federal estate tax on the privilege of transferring property at death. This tax was often avoided by an inter vivos transfer of property, in which the transferor retained a substantial interest in the property and continued to use and enjoy it until his death.[6] Although the transferee had legal title to such property, he did not assume its benefits until the transferor died and all rights to the property vested in the transferee. For example, an individual could avoid the estate tax if he transferred property to a trust and retained a life estate.[7] The transferor continued to have full use of the property until his death, yet had the benefit of a testamentary transfer since, upon death, the property would pass to a remainderman selected by the transferor. This method and others became popular substitutes for testamentary dispositions. As a result, Congress, to carry out its intent to tax property transferred at death, enacted additional provisions which provided for taxation of these substitutes for testamentary dispositions.[8]

In 1929, in *Chase National Bank v. United States*,[9] the Supreme Court considered the purpose of the transfer tax as applied to life insurance proceeds. The plaintiffs argued that the transfer tax did not apply since the proceeds were transferred to them from the insurance company, not from the decedent. The Court determined that the meaning of transfer could not be so restricted and thus included "the transfer of property procured through expenditures by the decedent with the purpose, effected at his death, of having it pass to another."[10]

In *Chase*, the Court introduced the term "incidents of ownership" as a test to determine the estate tax consequences of life insurance proceeds, stating:

> A power in the decedent to surrender and cancel the policies, to pledge them as security for loans and the power to dispose of them and their proceeds for his own benefit during his life which subjects them to the control of a bankruptcy court for the benefit of his creditors, and which may, under local law appli-

5. Ch. 463, §§ 200–12, 39 Stat. 756, 777–780.

6. *See, e.g.*, Comment, *Estate Taxation of Life Insurance Policies Held by the Insured as Trustee*, 32 MD. L. REV. 305, 313 (1972).

7. This transfer is now subject to estate tax pursuant to I.R.C. § 2036 (Supp. V 1981).

8. *See id.* §§ 2037–38, 2041 (1976).

9. 278 U.S. 327 (1929).

10. *Id.* at 337.

> cable to the parties here, subject them in part to the payment of his debts, is by no means the least substantial of the legal incidents of ownership, and its termination at his death so as to free the beneficiaries of the policy from the possibility of its exercise would seem to be no less a transfer within the reach of the taxing power than a transfer effected in other ways through death.[11]

Shortly after the *Chase* decision, a Treasury Department regulation required that the insured possess "incidents of ownership" in the policy in order for the proceeds to be included in his gross estate.[12] In 1934, a new regulation offered the alternative tests of "payment of premiums"[13] and "incidents of ownership" to determine the inclusion of life insurance proceeds in a decedent's gross estate.[14] These tests applied until "payment of premiums" became the exclusive test in 1941.[15] A year later, the Revenue Act of 1942[16] reinstated the alternative tests, which remained the standard until 1954, when "incidents of ownership" became the sole test, with respect to section 2042(2), for the inclusion of life insurance proceeds in the gross estate of the insured.[17]

## II. Interpretation of the "Incidents Of Ownership" Test

In their struggle to define the term "incidents of ownership," courts have emphasized four factors: (1) the ability of an insured to exercise the power or right for his own economic benefit, (2) the interrelationship between section 2042 and related code provisions, (3) the degree of control possessed by the decedent over the insurance proceeds, and (4) whether the power or right held by the decedent is a substitute for a testamentary disposition. These fac-

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11. *Id.* at 335 (citations omitted).

12. Treas. Reg. § 70 (1929); *see also* Comment, *Incidents of Ownership Tests for Inclusion of Life Insurance Proceeds in Decedents' Gross Estates*, 54 MARQ. L. REV. 370, 373 (1971).

13. The payment of premiums test was initially created in Treas. Reg. § 37 (1919) to determine whether a policy had been taken out by the decedent upon his own life. Under the Revenue Act of 1918, ch. 18, § 402(f), 40 Stat. 1057, 1098 (1919), this was one of three instances requiring inclusion of the proceeds in the gross estate. Comment, *supra* note 12, at 372.

14. Treas. Reg. § 80 (1934); Comment, *supra* note 12, at 373.

15. Treas. Reg. § 80, T.D. 5032, 1941-1 C.B. 427.

16. Ch. 619, § 404, 56 Stat. 798, 944 (amending I.R.C. § 811(g) (1939)).

17. Act of Aug. 16, 1954, Pub. L. No. 83-591, § 2042(2), 68A Stat. 3, 387. For a complete discussion of the history of the inclusion of life insurance proceeds in decedents' gross estates, see generally 2 J. MERTENS, THE LAW OF FEDERAL GIFT AND ESTATE TAXATION § 17 (1959); Comment, *supra* note 12.

tors are described separately below, although one should keep in mind that the courts often use a combination of these factors to reach a particular result.

## A. *Economic Benefit*

Some courts have concluded that if the insured decedent could not have exercised a power or right vis-a-vis insurance proceeds for his own economic benefit, the interest held by him cannot be considered an "incident of ownership" within the meaning of section 2042(2).[18] These courts have based their decisions partly on an interpretation of Treasury regulation section 20.2042-1(c)(2).[19]

This interpretation, however, fails to recognize accurately the role anticipated by Congress for the concept of economic benefit. While Congress did not define the term "incidents of ownership" when it adopted those words into the Code in 1942, the accompanying Senate and House Committee reports shed light on the term, indicating the proper nexus between incidents of ownership and economic benefit:

> There is no specific enumeration of incidents of ownership, the possession of which at death forms the basis for inclusion of insurance proceeds in the gross estate, as it is impossible to include an exhaustive list. Examples of such incidents are the right of the insured or his estate to the economic benefits of the insurance, the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign it, the power to revoke an assignment, the power to pledge the policy for a loan, or the power to obtain from the insurer a loan against the surrender value of the policy.[20]

Ostensibly similar language to that of the Committee reports appears in the Treasury regulation relied on by the courts:

> For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking the term has reference to the right of the insured or his estate to the economic benefits of the policy.[21]

After this general reference to economic benefit, the regulation

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18. *E.g.*, Estate of Connelly v. United States, 551 F.2d 545 (3d Cir. 1977); Estate of Skifter v. Commissioner, 468 F.2d 699 (2d Cir. 1972); Hunter v. United States, 474 F. Supp. 763 (W.D. Mo. 1979), *aff'd*, 624 F.2d 833 (8th Cir. 1980).

19. Treas. Reg. § 20.2042-1(c)(2) (1958); *see generally infra* notes 21-23 and accompanying text.

20. S. Rep. No. 1631, 77th Cong., 2d Sess. 235 (1942); H.R. Rep. No. 2333, 77th Cong., 2d Sess. 163 (1942).

21. Treas. Reg. § 20.2042-1(c)(2) (1958).

sets forth examples virtually identical to those described in the above Committee reports. The distinction, noted by some courts and commentators,[22] is that the Committee reports list the right to the economic benefits of a policy as an *example* of an "incident of ownership," whereas the regulation provides generally that the term refers to the economic benefits of the policy and then lists examples.[23]

While the Committee reports[24] indicate a congressional intent to define "incidents of ownership" broadly enough to encompass any power to affect the beneficial interest and enjoyment of the proceeds, regardless of whether the decedent could have personally benefited through exercise of the power,[25] courts have sought to interpret these words in terms of the degree of economic benefit held.

Some courts have focused on the issue of whether, if the decedent held powers vis-a-vis life insurance proceeds solely in a fiduciary capacity with no ability to exercise those powers for his own economic benefit, the value of the proceeds nevertheless should be included in his gross estate.

In *Estate of Fruehauf v. Commissioner*,[26] the Sixth Circuit rejected a per se rule that the capacity in which powers were held is insignificant. The court held that the decedent possessed "incidents of ownership" since he could have exercised power for his own economic benefit, but recognized that "mere possesion by a decedent of any powers in the nature of incidents of ownership in

22. *See, e.g.*, Estate of Connelly v. United States, 551 F.2d at 545 n.7; Comment, *supra* note 6, at 310 n.23; Note, *"Incidents of Ownership" in Group Term Life Insurance, A Phrase Searching for Definition*, 52 N.C.L. REV. 671, 678 (1974); *see also* Estate of Skifter v. Commissioner, 468 F.2d 699, 702 (2d Cir. 1972).

23. One commentator reads the regulation to say that the insured *must* have a right to the economic benefits of the policy; the subsequent list merely contains examples of rights or powers which could be exercised for the economic benefit of the insured. Note, *supra* note 22, at 678. The author suggests this possible interpretation but also notes that it is difficult to determine what significance is attached to the difference in wording. *Cf.* Comment, *supra* note 6, at 310 n.23, (suggesting that a conclusion that the language change has significance is difficult to reach from what may have been an unintentional change).

An alternative reading of the regulation may be that the words "[g]enerally speaking" indicate that non-economic interests are not necessarily excluded. In Estate of Skifter v. Commissioner, 56 T.C. 1190 (1971), *aff'd*, 468 F.2d 699 (2d Cir. 1972), however, the Tax Court and Second Circuit in effect rejected this interpretation of the regulation, concluding that section 2042 only applies to beneficial interests, except for the special provision in Treas. Reg. 20.2042-1(c)(4) (1958). 468 F.2d at 702-03; *see also infra* text accompanying notes 37-43.

24. S. REP. No. 1631 and H.R. REP. No. 2333, *supra* note 20.

25. Comment, *supra* note 6, at 310 n.23.

26. 427 F.2d 80 (6th Cir. 1970).

a fiduciary capacity [will not] invariably [require] inclusion of the proceeds . . . in his gross estate."[27] The decedent, although a co-trustee of his wife's estate, which included several insurance policies on the decedent's life, had also been the beneficiary of the trust income for life.[28] As co-trustee, decedent had the power to surrender the insurance policies for their cash value and thus to increase the income producing capacity of the trust.[29]

Two years later, the Second Circuit also considered the fiduciary capacity in which the decedent held certain powers. In *Estate of Skifter v. Commissioner*,[30] the decedent had assigned nine policies on his life to his wife, who had predeceased him. Her will provided that her residuary estate, which included the nine policies, was to be placed in trust for the benefit of their daughter. The wife had appointed decedent as trustee with absolute discretion to pay over all or any part of the principal as well as other broad management powers.[31] The court concluded that the decedent did not possess "incidents of ownership" at death, since he had been the transferee of a fiduciary power which he could not exercise for his own economic benefit.[32]

To reach their respective conclusions in *Skifter*, the Second Circuit and the Tax Court[33] had to reconcile Treasury regulation sections 20.2042-1(c)(2) and 20.2042-1(c)(4).[34] According to section 20.2042-1(c)(2), the term "incidents of ownership" refers to the insured's right to the economic benefits of the policy.[35] Yet section 20.2042-1(c)(4) provides:

> A decedent is considered to have an "incident of ownership" in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, *even though the decedent has no beneficial interest in the trust*.[36]

There are three ways the courts in *Skifter* could have recon-

27. *Id.* at 85.
28. *Id.* at 84.
29. *Id.* at 86; *see also* Note, *supra* note 22, at 677, which further discusses the *Fruehauf* decision.
30. 468 F.2d 699 (2d Cir. 1972).
31. *Id.* at 701.
32. *Id.* at 704.
33. 56 T.C. 1190 (1971).
34. *See* Comment, *supra* note 6, at 308.
35. *See supra* notes 21-23 and accompanying text.
36. Treas. Reg. § 20.2042-1(c)(4) (1958) (emphasis added).

ciled the two provisions:[37] (1) read the introductory phrase "generally speaking"[38] in section 20.2042-1(c)(2) not to exclude non-economic interests, (2) limit section 20.2042-1(c)(4) to the case of a *transfer* in trust in which the decedent *retains* some power over the trust, or (3) read section 20.2042-1(c)(4), since it is the only section which speaks of policies "held in trust," to deal exclusively with such a situation. Under the second alternative, a non-beneficial power causes inclusion of insurance proceeds in the gross estate "only if retained by the decedent, and not where such power is conferred upon him by the independent actions of another person."[39] Under the third alternative, there would be no conflict between the two sections at all, and *Skifter* would be governed by section 20.2042-1(c)(4).[40]

In effect, both courts rejected the first alternative. The Tax Court maintained that if section 20.2042-1(c)(2) alone applied, a trustee's naked power, regardless of how substantial, would not be an "incident of ownership" if the power could not be exercised for his own or his estate's economic benefit.[41] Both courts essentially adopted the second alternative and concluded that Congress intended to give life insurance proceeds similar treatment to that given property under related code provisions. Since related provisions require the power to be retained pursuant to a transfer, the courts interpreted section 20.2042-1(c)(4) also to require retention.[42] Thus, since the powers possessed by the decedent in *Skifter* were not retained powers, and since such powers could not have been exercised for his own economic benefit, the courts concluded that the decedent did not possess "incidents of ownership" within the meaning of section 2042(2).[43] The courts did not consider the third alternative.

### B. *Section 2042 and Related Code Provisions*

To determine the meaning of the term "incidents of ownership," section 2042 has been compared to related sections of the

37. Comment, *supra* note 6, at 309; Note, *supra* note 22, at 680 n.44.

38. Treas. Reg. § 20.2042-1(c)(2) (1958) provides in part: "Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy."

39. Comment, *supra* note 6, at 309.

40. *Id.* at 309 n.19.

41. 56 T.C. 1190, 1198 (1971), *aff'd*, 468 F.2d 699 (2d Cir. 1972).

42. 468 F.2d at 703-05; 56 T.C. at 1199.

43. 468 F.2d at 703-04; 56 T.C. at 1197, 1199. *But cf.* Comment, *supra* note 6, at 310 (arguing that this conclusion is unsupportable).

Code. In a 1976 Revenue Ruling, the Commissioner of Internal Revenue noted:

> At the time of the enactment of section 2042 of the Code, the Senate Finance Committee strongly inferred that Congress intended section 2042 to parallel the statutory scheme governing the interests and powers that will cause other types of property to be included in a decedent's estate under other Code sections, particularly sections 2036 and 2038.[44]

The Second Circuit, also relying primarily on statements made by the Senate Finance Committee, concluded in *Skifter* that Congress intended section 2042 to parallel other estate tax provisions.[45] When Congress replaced section 811(g) with section 2042 in 1954, it eliminated the premium payments test.[46] The Committee, in explaining the change, stated, "[n]o other property is subject to estate tax where the decedent initially purchased it and then long before his death gave away all rights to the property and to discriminate against life insurance in this regard is not justified."[47] The Second Circuit thus inferred that Congress intended section 2042 roughly to parallel sections 2036, 2037, 2038, and 2041.

Furthermore, the court noted that section 2042(2) specifically provides that the term "incidents of ownership" includes reversionary interests and treats such interests in a manner which closely parallels section 2037's treatment of reversionary interests.[48] The Committee explained the provision as follows: "To place life-insurance [sic] policies in an analogous position to other property, . . . it is necessary to make the 5-percent [sic] reversionary interest rule, applicable to other property, also applicable to life insurance."[49] Finally, the court found additional support for its conclusion that section 2042 deserved the treatment given analogous Code sections in the similarity between the types of in-

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44. Rev. Rul. 76-261, 1976-2 C.B. 276, 277 (citing S. REP. No. 1622, 83d Cong., 2d Sess., 124 (1954)); *see also* Estate of Lumpkin v. Commissioner, 474 F.2d 1092 (5th Cir. 1973); Estate of Skifter v. Commissioner, 468 F.2d 699, 702 (2d Cir. 1972); *cf.* Rose v. United States, 511 F.2d 259, 265 (5th Cir. 1975) (agreeing that § 2042 roughly parallels other estate tax provisions but noting a statutory distinction in the use of the word "possessed" rather than "retained"). *See generally* Comment, *supra* note 6, at 311 n.25 (discussing the basis for the theory that Congress intended section 2042 to parallel other related estate tax provisions).

45. 468 F.2d at 702; *see supra* text accompanying note 42.

46. *See supra* notes 16-17 and accompanying text.

47. 468 F.2d at 702 (quoting S. REP. No. 1622, 83d Cong., 2d Sess., 124, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4757).

48. 468 F.2d at 702.

49. *Id.* (quoting S. REP. No. 1622, *supra* note 47, at 124).

terests that Congress deemed "incidents of ownership"[50] and the interests and powers described in sections 2036, 2037, 2038, and 2041.[51]

Although recognizing this roughly parallel treatment, other courts have emphasized the distinctive language of section 2042. Section 2042(2) speaks of "incidents of ownership" *possessed* by the decedent, whereas section 2036 applies to interests *retained* by the decedent in connection with an incomplete transfer. Section 2038, while not using the word "retained," has an effect similar to that of section 2036.[52] In *Rose v. United States*,[53] the Fifth Circuit saw this difference in statutory language as significant:

> Sections 2036, 2037, 2038, 2041, and 2042 may be consanguineous, but each has an individual personality with genetic variations. These provisions developed from a common design to tax testamentary harvests, and they reach common sorts of decedent controls. . . . Each section is not identical, however. Life insurance is a specie of its own, it occupies a special place in the tax field, and we cannot simply graft terms from one provision onto another.[54]

### C. *Degree of Control*

A third factor considered by courts in their attempts to define the scope of "incidents of ownership" is whether the decedent's degree of control over the insurance proceeds at the time of death evidences an "incident of ownership," so as to include the proceeds in the gross estate. In *United States v. Rhode Island Hospital Trust Company*,[55] the First Circuit stated that "[t]he very phrase 'incidents of ownership' connotes something partial, minor, or even fractional in its scope. It speaks more of possibility than of probability."[56] Indeed, section 2042(2) itself refers to "*any* of the

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50. *See supra* note 20 and accompanying text.

51. 468 F.2d at 702.

52. Rose v. United States, 511 F.2d 259, 264 (5th Cir. 1975); Estate of Lumpkin v. Commissioner, 474 F.2d 1092, 1097 (5th Cir. 1973); *see* Estate of Connelly v. United States, 551 F.2d 545, 551 n.21 (3d Cir. 1977); *see also* Comment, *supra* note 6, at 315 (concluding that by selecting the word "possessed," "Congress must have intended to broaden the scope of the insurance section."). *But cf.* Estate of Skifter v. Commissioner, 468 F.2d 699, 705 (2d Cir. 1972) (concluding that Treas. Reg. § 20.2042–1(c)(4) (1958) applies only when a power constituting an "incident of ownership" was *retained* by the decedent.)

53. 511 F.2d 259 (5th Cir. 1975).

54. *Id.* at 265.

55. 355 F.2d 7 (1st Cir. 1966).

56. *Id.* at 10; *see also* Schwager v. Commissioner, 64 T.C. 781 (1975) (interpreting *Rhode Island Hosp. Trust Co.*, and concluding that "the number of powers possessed [is

incidents of ownership."[57]

One could thus argue that if Congress had intended section 2042(2) to apply only to more substantial types of ownership interests, it would have used a term other than "incident," a word suggesting a minor type of ownership interest. Based on *Rhode Island Hospital Trust Company* and the plain language of section 2042(2), the degree of control would seem to be irrelevant. Nevertheless, in *Estate of Lumpkin v. Commissioner*,[58] more fully explained below, the Fifth Circuit determined that a particular power was an "incident of ownership" precisely because it viewed the decedent as possessing a substantial degree of control over the insurance proceeds.[59]

### D. *Substitutes for Testamentary Disposition*

A fourth factor considered by courts in determining whether a decedent was possessed of "incidents of ownership" is whether the decedent was using an insurance vehicle for the purpose of avoiding estate tax. The federal estate tax was originally imposed on the privilege of transferring property at death. Since this tax was often avoided by an inter vivos transfer in which the transferor retained a substantial interest in the property for life, Congress enacted additional provisions, including section 2042, to tax these substitutes for testamentary disposition.[60] The underlying inquiry for some courts, then, as to the applicability of section 2042 is whether the exercise of a power or right over insurance proceeds can be deemed a substitute for a testamentary disposition. Not all courts, however, have deemed this distinction significant.

In *Estate of Connelly v. United States*,[61] discussed in detail below, the Third Circuit, partly because of its decision that a right to change the period over which insurance proceeds would be received was not a substitute for a testamentary transfer, held that the proceeds were not included in the decedent's gross estate.[62] Yet, in *Lumpkin*, the Fifth Circuit did not even consider whether the same right was such a substitute in finding that the insurance

not] the determining factor . . . [but rather] the existence of even a 'fractional' power and not the 'probability' of its existence . . . controls.") 64 T.C. at 791.

57. I.R.C. § 2042(2) (1976) (emphasis added).

58. 474 F.2d 1092 (5th Cir. 1973).

59. *Id.* at 1097; *see infra* notes 67–89 and accompanying text.

60. *See supra* notes 6–8 and accompanying text.

61. 551 F.2d 545 (3d Cir. 1977).

62. *See infra* notes 90–107 and accompanying text.

proceeds were included in the gross estate of the insured.[63]

## III. THE RIGHT TO SELECT AN OPTIONAL MODE OF SETTLEMENT AS AN INCIDENT OF OWNERSHIP

This section specifically considers whether a right to select an optional mode of settlement is an "incident of ownership" within the meaning of section 2042(2) by examining in detail the opposing positions taken by the Fifth and Third Circuits in *Estate of Lumpkin v. Commissioner*,[64] and *Estate of Connelly v. United States*.[65] This section also examines a 1981 Revenue Ruling of the Commissioner of Internal Revenue which nonacquiesced to the Third Circuit's holding in *Connelly*.[66]

### A. Estate of Lumpkin

In 1971, in *Estate of Lumpkin v. Commissioner*,[67] the Tax Court held that the right of an insured to select an optional mode of settlement was not an "incident of ownership" within the meaning of section 2042(2). There, the employer had provided Mr. Lumpkin, an employee, with a group term life insurance policy which irrevocably fixed the beneficiaries and divided them into three classes.[68] The insured could change neither the beneficiaries nor the priority among them. The insured's only right with respect to the policy was to select an optional mode of settlement which would spread payments over a longer period of time.[69] The

63. *See infra* notes 67–89 and accompanying text.

64. 474 F.2d 1092 (5th Cir. 1973).

65. 551 F.2d 545 (3d Cir. 1977).

66. *See infra* notes 108–11 and accompanying text.

67. 56 T.C. 815 (1971).

68. Estate of Lumpkin v. Commissioner, 474 F.2d 1092, 1093 (5th Cir. 1973). The classes were as follows: 1) spouse, 2) minor or permanently disabled children, and 3) parents. In addition to an immediate lump sum payment, a series of monthly payments were to be made in descending order to the three classes of beneficiaries. Thus, the payments were to go first to class one until exhaustion of benefits or death of class-one beneficiaries; if cessation of payments to class one were due to death, then payments would go to class-two beneficiaries until exhaustion of benefits or death; if cessation of payments to class two were due to death, then payments would go to class three until exhaustion of benefits. *Id.*

69. *Id.* at 1093–95. If the insured elected the optional mode of settlement with respect to the spouse, the amount of each regular monthly payment was reduced and the balance of the payments was withheld and accumulated in a fund, with interest, so that when the regular monthly payments ceased, the spouse would continue to receive additional payments from the fund until it was exhausted. If the spouse died before payments from the fund were exhausted, the balance accumulated in the fund was to be paid to the executors or administrators of the spouse's estate. If the spouse died before the regular payments were exhausted, only the regular payments, and not the accumulated fund, would then be paid to the second class of beneficiaries. In any case, the insured could not divest his

Tax Court concluded that this right was insufficient to include the policy in decedent's taxable estate.[70]

On appeal, the Fifth Circuit reversed the Tax Court's decision.[71] First, it noted that the examples of "incidents of ownership" enumerated in House and Senate committee reports[72] evidenced Congress' intent to tax the value of life insurance proceeds over which the insured possessed a substantial degree of control at death.[73] The court's view that Congress had enacted section 2042 with the intent to give life insurance proceeds roughly equivalent treatment to that accorded other property under related code sections,[74] where the decedent's degree of control was important, further supported such an inference. The court explained that "[u]nder [sections] 2036 (transfers with retained life estate), 2037 (transfers taking effect at death), 2038 (revocable transfers), and 2041 (powers of appointment) substantial control is often the touchstone by which the determination is made that inclusion is necessary."[75]

The Fifth Circuit then considered whether a right to select a settlement option gave its holder a substantial degree of control. It noted that the optional settlement provision gave the holder the right to vary the time and manner in which the proceeds could be paid to the beneficiaries.[76] The Tax Court, however, had relied on *Billings v. Commissioner*,[77] a 1937 Board of Tax Appeals opinion, which held that the right to determine when the proceeds of an insurance policy should be paid to a beneficiary was too limited

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spouse or any relative of the proceeds to which that person was entitled under the policy. *Id.* at 1093-94.

70. 56 T.C. at 823-24. The court noted that in Billings v. Commissioner, 35 B.T.A. 1147 (1937), the decedent had wider options regarding modes of settlement and yet the court there held that "[t]he mere right to say when the proceeds of the insurance policies should be paid to the beneficiary does not amount to a control of the proceeds." 56 T.C. at 824 (quoting *Billings*, 35 B.T.A. at 1152).

71. 474 F.2d 1092 (5th Cir. 1973).

72. S. REP. No. 1631, 77th Cong., 2d Sess. 235 (1942); H.R. REP. No. 2333, 77th Cong., 2d Sess. 163 (1942).

73. 474 F.2d at 1095.

74. *Id.* The court noted that such intent was recognized by the Second Circuit in Estate of Skifter v. Commissioner, 468 F.2d 699 (2d Cir. 1972).

75. 474 F.2d at 1095-96.

76. *Id.* at 1093-96. The court noted that the insured could make an election with respect to his spouse without the consent of anyone else. The optional settlement provision also entitled the insured to select other means of disbursement to other classes of beneficiaries upon obtaining the approval of his employer and the insurer.

77. 35 B.T.A. 1147 (1937).

and insignificant to amount to control over the proceeds.[78] To offset the impact of the *Billings* decision, the Commissioner relied on two more recent Supreme Court cases, *Lober v. United States*[79] *and United States v. O'Malley*,[80] involving the application of related code sections 2036 and 2038 to a power over the time and manner of enjoyment of trust assets.[81] In *Lober*, the decedent had established three irrevocable trusts for the benefit of each of his children, but retained the right to pay any or all of the trust assets to the children at any time. The Supreme Court, referring to the decedent's right to alter the time of enjoyment, stated: "[A] donor who keeps so strong a hold over the actual and immediate enjoyment of what he puts beyond his own power to retake has not divested himself of that degree of control which § 811(d)(2) requires in order to avoid the tax."[82] In *O'Malley*, the decedent had created five irrevocable trusts, and as one of three trustees, had the discretion to pay or accumulate the trust income. The Court held that the value of the trust property was included in the decedent's gross estate under the forerunner of section 2036,[83] since the decedent retained power over the time and manner of enjoyment "of sufficient substance to be deemed the power to 'designate' within the meaning of section 811(c)(1)(B)(ii)."[84] The Fifth Circuit concluded from these two cases that the right to alter the time and manner of enjoyment gave the holder a substantial degree of control for purposes of sections 2036 and 2038.[85]

The court then noted that the only significant distinction between sections 2036 and 2038 on the one hand and section 2042 on the other was in the manner in which the particular power was held.[86]

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78. *Id.* at 1152. The Commissioner's acquiescence in the *Billings* case, 1937-2 C.B. 3, remained outstanding at the time litigation commenced but was later withdrawn and substituted with a non-acquiescence, 1972-1 C.B. 3. The court cited Dixon v. United States, 381 U.S. 68 (1965), for the proposition that the Commissioner had plenary power to modify, amend, or revoke his acquiescences and to make retroactive suit changes. 474 F.2d at 1096 n.11.

79. 346 U.S. 335 (1953).

80. 383 U.S. 627 (1966).

81. 474 F.2d at 1096-97.

82. 346 U.S. at 337 (quoting Commissioner v. Holmes, 326 U.S. 480, 487 (1946)). Section 811(d)(2) was the forerunner to the present § 2038.

83. I.R.C. § 811(c)(1)(B)(ii) (1939).

84. 383 U.S. at 631.

85. 474 F.2d at 1097.

86. *Id. But cf.* Note, *supra* note 22, at 672 (suggesting that the *Lumpkin* court's conclusion and method of analysis seem logically inconsistent with other recent decisions which have focused on the meaning of the term).

Under sections 2036 and 2038, the decedent must have *retained* some control over property he initially transferred, whereas under section 2042, the decedent need only have *possessed* an "incident of ownership" on the date of death.[87] How the decedent came into possession is irrelevant.[88] Finding that this distinction did not affect the degree of power over property a decedent must hold to include its value in the gross estate, the court decided to treat section 2042 similarly, stating:

> In view of the Congressional intention to make estate tax treatment of life insurance roughly analogous to that bestowed upon other types of property, somewhat of an anomaly would be created if power over the time and manner of enjoyment was said to impart enough control to activate [sections] 2036 and 2038 yet not enough to make it an "incident of ownership" within the context of [section] 2042.[89]

### B. Estate of Connelly

In 1977, in *Estate of Connelly v. United States*,[90] the Third Circuit held that a right to select an optional mode of settlement was not an "incident of ownership" within the meaning of section 2042(2). *Connelly* involved the identical insurance policy at issue in *Lumpkin*, except that Mr. Connelly was a widower at the time of his death.[91] As a result, the policy required that the proceeds go to a class-two beneficiary,[92] and that the insured obtain the approval of his employer and the insurer before making an election.[93] As in *Lumpkin*, however, the decedent's sole power over the proceeds was to select a settlement option which would spread payments over a longer period of time.

The Third Circuit concluded that the *Lumpkin* decision did not reflect applicable law.[94] The court said that the Fifth Circuit's

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87. 474 F.2d at 1097.

88. *Id.*

89. *Id.*

90. 551 F.2d 545 (3d Cir. 1977).

91. *Id.* at 549. Messrs. Lumpkin and Connelly were both employees of the Humble Oil & Refining Co. and were covered by the same non-contributory group term life insurance policy issued by the Equitable Life Assurance Co. of the United States.

92. *See supra* note 68.

93. 551 F.2d at 546–47. An election with respect to a spouse, a class-one beneficiary, could be made by the insured without the consent of anyone else. *Id.* at 547 n.5.

94. *Id.* at 550. There were some minor factual distinctions between the two cases but the main issue with respect to each was whether an optional settlement provision which could be utilized to spread payments over a longer period of time was an "incident of ownership" within the meaning of section 2042(2). The factual distinctions noted were as follows: 1) In *Lumpkin*, the decedent was still employed at the time of death and thus could

reliance on *Lober* and *O'Malley* was misplaced since those cases dealt with different statutory provisions. The power to alter payments in both *Lober* and *O'Malley*, if exercised, actually could have changed the beneficiaries—a power that is clearly an "incident of ownership."[95] In *Lober*, the decedent could accelerate payments so as to cut off the remaindermen,[96] and in *O'Malley*, the decedent could accumulate the trust income, reducing payments to the income beneficiaries and increasing benefits to the remaindermen.[97] Mr. Connelly, however, could have changed neither the beneficiaries nor the amount they would receive. He could only have affected the time at which the proceeds would be received.

The court also noted the Fifth Circuit's conclusion that Congress intended to give life insurance proceeds estate tax treatment roughly equivalent to that found in sections such as 2036, 2037 and 2038.[98] The Third Circuit opined, however, that under the Fifth Circuit's construction, section 2042 is the only section which imposes an estate tax on property in which the decedent has no beneficial interest. Most related sections require the decedent to have made an incomplete transfer of the property, presuming that the decedent initially had a beneficial interest in the property transferred.[99] The court in *Connelly* reasoned that if Congress intended roughly equivalent estate tax treatment, Congress must have intended to equate "incidents of ownership" with the right to economic benefits of the policy.[100] In addition, the court noted that regulation section 20.2042-1(c)(2) defined "incidents of ownership" as "the right of the insured or his estate to the economic benefits of the policy."[101] Finding that Mr. Connelly had no such rights, the court quoted *Billings v. Commissioner*[102] for the propo-

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have canceled the policy by quitting his job; 2) since Mr. Lumpkin was survived by his wife, under the terms of the policy, he could have exercised a settlement option unilaterally; and 3) Mr. Lumpkin had the right to assign his power to exercise the option, whereas under New Jersey law, Mr. Connelly did not have that right. *Id.* at 549.

95. *See* Treas. Reg. § 20.2042-1(c)(2) (1958).

96. 551 F.2d at 532. Although the court concluded that the exercise of a power to accelerate the remainder would cut off the remaindermen, that would not have been the case in *Lober*, since each trust named the same person as income beneficiary and remainderman. 346 U.S. at 336.

97. 551 F.2d at 552.

98. *Id.* at 551.

99. *Id.* at 551, n.21; *see also* Note, *supra* note 22, at 683.

100. 551 F.2d at 551. The court cited several cases, including Estate of Skifter v. Commissioner, 468 F.2d 699 (2d Cir. 1972), which explicitly made such an equation.

101. Treas. Reg. § 20.2042-1(c)(2) (1958).

102. 35 B.T.A. 1147 (1937).

sition that "[t]he mere right to say when the proceeds of the insurance policies should be paid to the beneficiary does not amount to a control of the proceeds. They irrevocably belonged to the beneficiary from the date the policies were taken out."[103] The court noted that *Billings* controlled the instant case notwithstanding that the Commissioner of Internal Revenue had withdrawn the Service's acquiescence.[104]

The Third Circuit also considered whether the right to select a settlement option was a substitute for a testamentary disposition.[105] It noted that "[t]he federal estate tax is imposed on the privilege of transferring property at death coupled with 'taxes upon other types of transfers that have some of the aspects of a testamentary transfer and would otherwise be resorted to in order to escape a tax limited to strictly testamentary transfers.'"[106] Since Mr. Connelly did not purchase the insurance policy, but acquired it by virtue of his employment, the court concluded that the right to exercise the settlement option was not a substitute for a testamentary disposition.[107]

### C. *Revenue Ruling 81-128*

In Revenue Ruling 81-128,[108] the Commissioner declared the Service's nonacquiescence to *Connelly* after concluding that the right to elect settlement options was an "incident of ownership" within the meaning of section 2042. The ruling was based on section 20.2042-1(c)(4) of the Treasury regulations[109] and the Supreme Court decisions in *Lober* and *O'Malley*.[110] The Commissioner also noted that the Tax Court had departed from its position in *Billings*.[111] Hence, in all future cases, except those arising in the Third Circuit, the Commissioner will take the position that an insured's right to select an optional mode of settlement is

103. 551 F.2d at 548 (quoting Billings v. Commissioner, 35 B.T.A. at 1152).

104. *Id. See* 1972-1 C.B.3 (withdrawal of service's acquiescence to *Billings*).

105. 551 F.2d at 551.

106. *Id.* (quoting Lowndes, *An Introduction to the Federal Estate and Gift Taxes*, 44 N.C.L. Rev. 1, 4 (1965)).

107. 551 F.2d at 551.

108. 1981-1 C.B. 469.

109. *See supra* text accompanying note 36.

110. This conclusion served as the basis for the withdrawal of the Commissioner's acquiescence in Billings v. Commissioner, 35 B.T.A. 1147 (1937). 1972-1 C.B. 3.

111. In Schwager v. Commissioner, 64 T.C. 781, 791 (1975), the Tax Court noted that since a power to elect a settlement option gave the holder a substantial degree of control, it also must be considered an "incident of ownership."

an "incident of ownership" such that the proceeds are subject to inclusion in the decedent's gross estate under section 2042.

## IV. REASSESSING "INCIDENTS OF OWNERSHIP": A CRITIQUE OF THE EXISTING TESTS

As this Article has demonstrated, courts have used several tests to define "incidents of ownership."[112] Furthermore, the Third and Fifth Circuits have reached conflicting results after applying these tests, in varying degrees, to the right of an insured to select an optional mode of settlement.[113] That these courts reached opposite conclusions based on almost identical facts belies the usefulness of these factors as analytical tools to interpret "incidents of ownership" in section 2042(2).

As an indicator of the possession of "incidents of ownership," the economic benefits test is at best irrelevant, and at worst, misleading. Since section 2042(2) applies to "any of the incidents of ownership," and since noneconomic interests are not otherwise specifically excluded, the fact that the insured cannot utilize a settlement option for his own economic benefit should not have decisive impact on whether the right is considered an "incident of ownership" within the meaning of section 2042(2).[114]

The worth of asking whether a particular right to control the receipt of insurance proceeds is a substitute for a testamentary disposition so that it may be deemed an "incident of ownership" is more difficult to judge. Since section 2042 was one of the sections that Congress enacted with the intent to tax substitutes for testamentary dispositions,[115] this test, of the four, seems to be the most pertinent inquiry.

In *Connelly*, since the insured's employer provided the policy, and the insured himself had not purchased it, the court decided that the right to exercise the settlement option was not a substitute for a testamentary disposition.[116] Because of the very narrow scope of the right, it is difficult to conclude otherwise. Regardless of whether the right was exercised, each eligible beneficiary still

112. *See supra* notes 18-63 and accompanying text.

113. *See supra* notes 67–107 and accompanying text.

114. *See supra* notes 18–25 and accompanying text. The clear language of the Senate and House Committee Reports indicates that Congress meant economic benefit to be merely an example of rather than the basis for an "incident of ownership." *See supra* note 20 and accompanying text & text accompanying note 23.

115. *See supra* notes 6–8 and accompanying text.

116. *See supra* notes 105–07 and accompanying text.

received the same amount. The only impact of its exercise was to spread out payments over a longer period of time. If the beneficiary died before the payments were exhausted, the beneficiary's estate would receive the difference between the amount the beneficiary actually had received and the amount which would have been paid had the option not been elected.[117]

If, then, the right to select an optional settlement mode is not a substitute for a testamentary dispositon, can section 2042 still apply to the proceeds of the policy? Notwithstanding *Connelly*, the answer would seem to be yes. Although the overall congressional intent with respect to section 2042 and related provisions such as sections 2036, 2037, 2038, and 2041 was to tax substitutes for testamentary disposition, one must consider the specific language of section 2042, which provides something more. That language speaks of "any of the incidents of ownership" over the insurance proceeds.[118] A decision that the right to select a settlement option is not a substitute for testamentary disposition, therefore, does not preclude the application of section 2042(2) if the right is otherwise an "incident of ownership."

As for the viability of the "degree of control" and "related code sections" tests, the Fifth Circuit's conclusion in *Lumpkin* that a right to elect a settlement option was an "incident of ownership" pursuant to section 2042(2) is instructive. The court reached the correct result under the statute, but its rationale is puzzling and hard to accept.

The court noted that section 2042 and the related code provisions were part of a congressional scheme to tax the value of property transferred at death, whether by will, intestacy, or by lapse of substantial control at death.[119] By analogizing the insured's rights to those applicable to related provisions, it concluded that a right to elect a settlement option gave the decedent a substantial degree of control.[120]

117. 551 F.2d at 547.

118. I.R.C. § 2042(2) (1976).

119. 474 F.2d at 1097.

120. *Id. Cf.* Rose v. United States, 511 F.2d 259 (5th Cir. 1975) (indicating that I.R.C. § 2036 is not analogous to § 2042(2) because the former speaks of interests *retained* by the decedent and the latter speaks of "incidents of ownership" *possessed* by the decedent); *see supra* notes 52-54 and accompanying text. The use of the word "possessed" in 2042(2) suggests that any "incident of ownership" the decedent held on the date of death should be included in the gross estate no matter how the decedent acquired such right or power and regardless of the capacity in which it was held. *Contra* Estate of Skifter v. Commissioner, 468 F.2d 699, 704 (2d Cir. 1972); *see supra* notes 26-43 and accompanying text.

Even if the degree of control were relevant for purposes of section 2042(2), the court's conclusion that the right gave the decedent a substantial degree of control is puzzling. The court itself recognized that the right to select an optional settlement mode was very limited and quoted *United States v. Rhode Island Hospital Trust Company*[121] for the proposition that " '[i]ncidents of ownership' connotes something partial, minor, or even fractional in scope."[122] Yet the court decided that the right was substantial since the nature of the power—to affect the time and manner of enjoyment—was considered to be a substantial degree of control under sections 2036 and 2038.

To conclude that the decedent had a substantial degree of control, the Fifth Circuit erred by placing too much reliance on treatment accorded property under related sections.[123] The court should have looked beyond the *nature* of the power and examined the *extent* of the power itself. The powers which caused inclusion of property in the decedent's gross estate under sections 2036 and 2038 were the power to accelerate payments and the power to accumulate income. These powers, if exercised, actually could have changed the beneficiaries or the amounts they received.[124] A right to elect a settlement option, if exercised, could have done neither. The holder of such a right could only affect the time at which the proceeds would be received.[125] Since the consequences of an exercise of a right to elect a settlement option were not parallel to the consequences of an exercise of a power to accelerate payments or a power to accumulate income, reliance on treatment accorded property under sections 2036 and 2038 was not justified. The Fifth Circuit could have reached the same result with less confusion if it had concluded that the degree of control was irrelevant based on the language of section 2042(2), "any of the incidents of ownership," and the First Circuit's interpretation of that language in *Rhode Island Hospital Trust Company*.[126]

In short, the tests devised to interpret section 2042(2) are less than helpful in deciding whether the right to select an optional settlement mode is an "incident of ownership." Because of the minimal degree of power associated with an "incident" of owner-

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121. 355 F.2d 7 (1st Cir. 1966).

122. *Id.* at 10.

123. *See supra* notes 74–89 and accompanying text.

124. *See, e.g., supra* notes 95–97 and accompanying text.

125. *See supra* text accompanying note 69.

126. 335 F.2d at 10.

ship, the control and economic benefit tests are irrelevant. The inquiry into substitutes for testamentary disposition does not alone determine inclusion of insurance proceeds in the gross estate of a decedent. Finally, the similarity between section 2042(2) and other code sections is helpful only to the extent that the rights involved, if exercised, have similar consequences.

## V. CONCLUSION

The purpose of this Article has not been to suggest a novel test to interpret "incidents of ownership" in section 2042(2). Nor has it been to attempt to weave together the existing tests into a rational approach that will satisfy both the Commissioner of Internal Revenue and the courts. Rather, this Article has attempted to point out that the existing tests to determine whether an insured possesses "incidents of ownership" in the proceeds of an insurance policy are unsatisfactory.

In particular, the tests have proved to be of little help in deciding whether a right to select an optional settlement mode is such an "incident of ownership." The right itself is of minor importance, merely allowing the insured to decide, within certain parameters, when (not whether) unalterable beneficiaries are to receive the proceeds of the policy. Yet the Fifth Circuit in *Lumpkin* reached the statutorily correct but unsatisfactory conclusion that the optional settlement right was an "incident of ownership." Rather than relying on its errant reasoning, however, the court could have reached its conclusion merely by noting that the plain language of section 2042(2) mandated inclusion. The outcome of *Lumpkin* seems harsh considering the de minimis nature of the right, but such an outcome is required under the present statutory scheme. Congress must change the language of the statute if it desires a different result.