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Life Insurance Premiums Paid in Contemplation-of-Death: A Return to Uncertainty

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I. INTRODUCTION

Generally, estate planners are a cautious and conservative group that tend to utilize well-established estate planning devices which offer little or no exposure to challenge by the Internal Revenue Service (IRS). Perhaps no aspect of estate planning has been the subject of as many recent controversial tax rulings, court decisions and legal commentaries as has life insurance. One of the most significant areas of current concern has been the payment of life insurance premiums by an insured after he has transferred all the incidents of ownership in the policy. This area possesses such a large amount of uncertainty that many estate planners now avoid transfers of life insurance policies in their estate plans for their clients.

Section 2035(a) of the Internal Revenue Code (Code) provides that there be included in a decedent's gross estate, the value of any interest in property transferred by him within three years of his date of death and in contemplation thereof (except in the case of a bona fide sale for an adequate and full consideration in cash or other property).[1] The contemplation-of-death inquiry is limited in that any "interest" transferred by a decedent more than three years prior to his death is conclusively presumed not to be a contemplation-of-death transfer. Where an interest is transferred within three years of death a contemplation-of-death assertion by the IRS creates a rebuttable presumption which places the burden of proof on the personal representatives of the decedent's estate. However the fact patterns in life insurance transfers have greatly strengthened the Commissioner's presumption.[2]

Even though each branch of the federal government, numerous commentators and other authorities have attempted to establish

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1. INT. REV. CODE OF 1954, § 2035.

2. *See* Quiggle, *Recent Developments in Contemplation of Death*, N.Y.U. 25TH INST. ON FED. TAX. 1047 (1967) [hereinafter cited as Quiggle]. *See also* H.R. REP. NO. 1337, 83d Cong., 2d Sess. B14-15 (1954).

guidelines to classify a true contemplation-of-death transfer, the final analysis requires an examination of the marshalled facts on a case by case basis. The scope of this article will not encompass the courts' examination of the pertinent factors in all contemplation-of-death decisions; the focus instead will be limited to one type of "interest"—life insurance—and to the characterization of premium payments by a decedent within three years of his death as a "transfer."

II. CONTEMPLATION-OF-DEATH IN LIFE INSURANCE

Although the Internal Revenue Service has achieved only limited success in contemplation-of-death cases,[3] it has achieved a substantial victory percentage in contemplation-of-death cases involving gifts of insurance policies.[4] Code section 2035 does not refer to the general expectation of death entertained by all persons, nor does it cover only those cases involving an apprehension that death is imminent or near.[5] The current test involves both the donor's motive in making the gift and his thought of death as a controlling factor in establishing this motive. Since the dominant purpose of the statute is to reach substitutes for testamentary dispositions, a transfer for the purpose of avoiding death taxes or as a substitute testamentary disposition tends to be a transfer prompted by the requisite thought of death.[6]

The death-related qualities of life insurance have prompted the IRS to consider any gifts of life insurance by a donor within three years of his death as being in contemplation-of-death.[7] While the judiciary traditionally has not sustained the IRS' overreaching position, recent decisions demonstrate the greater burden of persuasion placed upon the legal representatives of a decedent's estate for life insurance gifts versus gifts of other types of property.[8]

Life insurance is an asset that may have little or no value during life but obtains substantial value on death. Because an individual must wait until death to realize its value, life insurance's real economic significance is integrally related to, and dependent upon, the insured's death. The promotion of life insurance is often related to giving the insured's family increased asset liquidity or to enable the family to receive funds to compensate for the loss of the insured's earning capacity on his death. These factors make proof of life motives in life insurance transfers very difficult.

While taxpayers have recognized some success in contemplation-of-death cases involving life insurance transfers, the large number of

3. Quiggle, *supra* note 2.

4. See the cases discussed in Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945).

5. United States v. Wells, 283 U.S. 102 (1931).

6. *See* Estate of Morris R. Silverman, 61 T.C. No. 37 (Dec. 6, 1973).

7. Berall, *Use of Life Insurance in Estate Planning—Recent Developments*, N.Y.U. 31ST INST. ON FED. TAX. 1053, 1079 (1973) [hereinafter cited as Berall].

8. *See, e.g.*, First Nat'l Bank v. United States, 423 F.2d 1286 (5th Cir. 1970); Kahn v. United States, 349 F. Supp. 806 (N.D. Ga. 1972). *See* Shelnut, *Estate Taxation of Insurance Policies Transferred in Contemplation of Death*, 46 FLA. B.J. 674 (1972).

IRS victories have resulted largely from the lack of documentation of life motives in such gifts.

III. CONTEMPLATION-OF-DEATH AND THE PAYMENT OF INSURANCE PREMIUMS

Recent developments in the contemplation-of-death gifts of life insurance controversy have been primarily concerned with the amount of insurance to be included in the decedent-insured's gross estate rather than with the determination of whether a contemplation of death transfer had been made. This situation involves a decedent paying, in contemplation-of-death, the premiums on a policy on his life, which he either never owned,[9] or, if he did, which he transferred more than three years prior to his death.[10] The question, in essence, is what portion of the proceeds, if any, would be drawn back into the decedent-insured's gross estate as a result of his contemplation-of-death premium payments. While the answer to this question may be dependent upon the type of policy transferred, there are generally four possible alternatives:

(1) Inclusion of the contemplation-of-death premiums in the decedent-insured's gross estate;
(2) Inclusion of the allocable portion of the proceeds attributable to the premium payments paid in contemplation-of-death;
(3) No inclusion for either the premium payments or the insurance proceeds; or
(4) Inclusion of the entire proceeds in the decedent-insured's gross estate.

IV. PREMIUM PAYMENTS—RETURN TO UNCERTAINTY

Prior to the enactment of the 1954 Code, life insurance proceeds were includable in a decedent-insured's gross estate where:[11]

(1) The decedent-insured's estate was the named beneficiary of the policy;
(2) The insured possessed certain incidents of ownership over the policy; or
(3) The insured, either directly or indirectly, paid the premiums on a policy on his life or the owner of the policy was the named beneficiary of said policy.

In drafting section 2042 of the 1954 Code, Congress specifically rejected the third situation as an "incident of ownership" for inclusion of the proceeds of a policy in the estate of the insured.[12] The scope of

9. Bel v. United States, 452 F.2d 683 (5th Cir. 1971).

10. Rev. Rul. 71-497, 1971-2 CUM. BULL. 329.

11. Int. Rev. Code of 1939, ch. 3, § 811(g), 53 Stat. 122, *as amended by* Act of Oct. 21, 1942, ch. 619, § 404, 56 Stat. 944.

12. *Hearings on the Subject of General Revenue Revision Before the House Committee on Ways and Means*, 83d Cong., 1st Sess. 1582 (1953).

this congressional action was restricted, however, to the operative predecessor of this Code section. The effect of the repeal of the "premium-payment" test on situations arising under section 2042 became clear; that Code section was only applicable to situations in which the insured possessed incidents of ownership or where the proceeds of a policy were payable to an insured's estate. While Congress eliminated the premium-payment test for Code section 2042, this legislative body did not specifically repeal this test for other estate tax provisions which could apply to a life insurance situation. It was, therefore, arguable that the premium-payment test was still "alive" for any other estate tax provisions, specifically section 2035.

Even though the IRS asserted the applicability of the premium-payment test in estate tax cases at its District and Appellate Conferee levels,[13] the government did not announce its official position until 1967.[14] This official position was predicated upon the view that life insurance premiums and proceeds were integrally and inextricably related. Revenue Ruling 67-463 dealt with two situations:

(1) An insured transferred a policy on his life more than three years prior to his death but continued to pay the premiums until his death; and
(2) The decedent-insured's wife was the original applicant for the policy, but the insured made all premium payments until his death.

In both situations, the IRS concluded that a section 2035 "transfer" of an "interest" in the policy had occurred. This interest was measured by the proportion that the amount of the premiums paid by the insured bore to the total amount of the premiums paid. Moreover, the Ruling stated that under section 2035 the application for the insurance policy by another had no effect on the inclusion of the proportionate part of the proceeds in the decedent-insured's gross estate.

The basis of the IRS' position was the United States Supreme Court's interpretation of the term "transfer" in *Chase National Bank v. United States*.[15] In that case, the Court concluded that the word "transfer" could not be interpreted in a restricted sense as referring

13. Berall, *supra* note 7, at 1081.

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

15. 278 U.S. 327 (1929). The Court stated:
Obviously, the word "transfer" in the statute, or the privilege which may constitutionally be taxed, cannot be taken in such a restricted sense as to refer only to the passing of particular items of property directly from the decedent to the transferee. It must, we think, at least include the transfer of property procured through expenditures by the decedent with the purpose, effected at his death, of having it pass to another. Sec. 402 (c) taxes transfers made in contemplation of death. It would not, we assume, be seriously argued that its provisions could be evaded by the purchase by a decedent from a third person of property, a savings bank book for example, and its delivery by the seller directly to the intended beneficiary on the purchaser's death, or that the measure of the tax would be the cost and not the value or proceeds at the time of death.
Id. at 337.

only to items passing directly from the decedent to the transferee.[16] The Supreme Court held that a "transfer" also included property procured through expenditures by the decedent with the purpose, effected at his death, of having it passed to another.[17]

Thus, a premium paid by the insured in contemplation of his death, would, in the Commissioner's view, result in the inclusion in the decedent-insured's gross estate of a proportionate part of the proceeds of the policy. This proportion would be determined by multiplying the proceeds by a fraction, the numerator of which would be the contemplation-of-death premiums and the denominator of which would be the total of all the premiums paid. The commentators immediately criticized the Ruling as ignoring the legislative history regarding the elimination of the premium-payment test from section 2042, disregarding the rights of the policy owner, overlooking the actuary reality of life insurance, failing to consider the application of the non-forfeiture values and not being supportable by the judicial decisions upon which the Ruling was based.[18]

The judicial response to the IRS' position announced in the Revenue Ruling was immediate, hostile opposition. In *Gorman v. United States,*[19] the decedent arranged for a five-year renewable, convertible term policy to be issued to his wife. The policy was issued to the wife and was owned by her at all times. The decedent made the first premium payment and passed away nine months later. Relying on Revenue Ruling 67-463 and the Supreme Court's interpretation of "transfer,"[20] the Commissioner sought to include the policy's $50,000 proceeds in the decedent's gross estate. The court rejected this argument as being an administrative attempt to adopt the premium-payment test which had been eliminated by the enactment of the 1954 Code.[21] After determining that section 2035 was an asset transfer section, the court found that the only "specific asset" transferred was the value of the premiums. The amount included in the decedent's gross estate, therefore, was the amount equal to the premiums the decedent had paid on the policy.[22]

Shortly after this "defeat" in the *Gorman* case, the Commissioner lost a Tax Court case which paralleled situation (2) in Revenue Ruling

16. *Id.*

17. *Id.*

18. *See, e.g.,* Simmons, *Contemplation of Death Aspects of Life Insurance,* U. MIAMI INST. OF EST. PLAN. ¶68.110 (1968). While the IRS' position differed somewhat from the eliminated premium-payment test in that the Ruling analyzed what the insured's payment actually acquired, almost all the judicial decisions construing the Ruling have either criticized, distinguished or invalidated the Ruling as being an attempted resurrection of the premium-payment test. *See* Gorman v. United States, 288 F. Supp. 225 (E.D. Mich. 1968); Estate of Inez Coleman, 52 T.C. 921, 923 (1969).

19. 288 F. Supp. 225 (E.D. Mich 1968) [hereinafter referred to as *Gorman*].

20. *See* note 15 *supra* and accompanying text.

21. 288 F. Supp. at 230.

22. *Id.* at 234.

67-463. In the *Estate of Inez Coleman,*[23] the decedent-insured had her children apply for a life insurance policy within three years prior to her death. While the decedent never possessed or transferred any of the incidents of ownership, she paid all the premiums on the policy. The taxpayer and the government stipulated that approximately fifty percent of the premiums paid on the policy were in contemplation-of-death. The government attempted to include approximately one-half of the policy's proceeds in the decedent's gross estate. The taxpayer argued that only the premiums paid in contemplation-of-death should be included. The basis of the court's decision was its determination of what constituted the "transferred property interest." Legislative history, the court noted, revealed that the "payment of premiums [would] no longer [be] a factor in determining the taxability *under this section* of insurance proceeds."[24] The court concluded that the words "under this section" were limited to the application of section 2042 and not to any other Code provision—in this case, section 2035. In analyzing the "transfer" requirements of section 2035, the court looked to what the decedent had parted with as a result of her payment of the premiums in contemplation-of-death. The court determined that the decedent had no interest in the policy or its proceeds and, therefore, could not have made a constructive transfer of an interest in the policy. As in the *Gorman* decision, the only amount included in the decedent's estate was the value of the premiums paid in contemplation-of-death.[25]

While the *Coleman* court attempted to limit the repeal of the premium payment test to section 2042, its decision under section 2035 was clearly influenced by the repeal of said test. Prior to the court's analysis of certain elements of section 2035, the court discredited any attempt to allow the premium payment test to "rise phoenixlike" from its ashes.[26] Although a substantial and articulate dissent was registered by four judges,[27] the *Coleman* court reaffirmed the rationale of the *Gorman* decision by stating that the "frontiers of section 2035 should not be extended to include the proceeds of life insurance simply because a decedent paid the premiums."[28]

The Internal Revenue Service found short-lived success for its position in a Texas Federal District Court's decision. In *First National Bank v. United States,*[29] the decedent's two daughters applied for life insurance on the decedent's life in 1953, and the decedent paid all premiums on each policy until his death in 1961. Citing only Revenue Ruling 67-463 to justify its holding, the district court upheld the IRS'

23. 52 T.C. 921 (1969) [hereinafter referred to as *Coleman*].
24. *Id.* at 922 (emphasis added).
25. *Id.* at 924.
26. *Id.* at 923.
27. Judges Tietjens, Raum and Dawson each rendered a dissenting opinion with Judge Simpson agreeing to the reasoning in all three dissents. *Id.* at 926-28.
28. *Id.* at 924.
29. 69-1 U.S. Tax Cas. ¶12,574 (W.D. Tex. 1969).

inclusion of a proportionate portion of the insurance proceeds attributable to premium payments paid in contemplation-of-death.[30] The Court of Appeals for the Fifth Circuit, in reversing the district court's decision, struck down the government's attempt to equate a decedent paying premiums on a policy owned by another with a person who physically transfers the policy.[31] In addition, Revenue Ruling 67-463 was found to be invalid since it was not supportable by statute or judicial authority.[32]

V. REVENUE RULING 71-497—A CHANGE IN THE IRS POSITION

Confronted with universal judicial rejection of its position, the IRS reconsidered and revoked Revenue Ruling 67-463. Revenue Ruling 71-497[33] announced that the IRS would now follow the *First National Bank* decision and would no longer apply the principles of Revenue Ruling 67-463 in the following situations:

Policy Purchased Prior to Three-Year Period. In one factual situation of Revenue Ruling 71-497, four years prior to his death, a decedent purchased and transferred to his wife all incidents of ownership of both a whole life and a five-year term policy on his life. The decedent-insured continued to pay the premiums on both policies. Following the *First National Bank* rationale, The IRS ruled that no part of the proceeds were includable in the decedent's gross estate. The only amount taxed was the value of the premiums paid by decedent during the three-year contemplation-of-death period.

Policy Purchased Within Three-Year Period. Situation two involved a one-year term, accidental death policy purchased nine months prior to the insured's accidental death. While his children were the owners and beneficiaries of the policy, the decedent paid all the premiums. The IRS held that this was a transfer of the policy to decedent's children which would cause the entire amount of the proceeds to be included in the decedent's gross estate. After discussing the

30. *Id.*

31. First Nat'l Bank v. United States, 423 F.2d 1286 (5th Cir. 1970) [hereinafter referred to as *First National Bank*].

> We cannot agree that any bundle of rights was transferred. As already pointed out, the right to collect the proceeds of the policies had existed from the inception of the policies. The daughters could have paid the premiums themselves; they were under no duty to allow someone else to pay them.

Id. at 1288.

32. It should be noted that the Fifth Circuit's opinion struck down the Revenue Ruling by finding that the Supreme Court's opinion in the *Chase* case was inapplicable to insurance proceeds in contemplation-of-death controversies. The court noted that the *Chase* case should be limited to the classification of the federal estate tax as a "direct tax" on insurance proceeds. The interesting aspect of this limitation on the *Chase* rationale is striking in light of the Fifth Circuit's reliance on this Supreme Court case two years later in Bel v. United States, 452 F.2d 683 (5th Cir. 1971).

33. 1971-2 CUM. BULL. 329. *See* Eliasberg, *Contemplation of Death and Estate Taxation of Life Insurance,* 111 TRUSTS & ESTATES 690 (1972); Rhodes, *Contemplation of Death—The Problem of Life Insurance Premiums,* 24 TAX LAW 589 (1971).

Supreme Court's holding concerning indirect transfers and the application of section 2035, the Internal Revenue Service supported the rationale for the inclusion for the entire proceeds generated by the accidental death policy as follows:

> Thus, in *Situation 2,* the economic benefit that the decedent did in substance transfer to his children by the purchase of the insurance policy was not the use of the cash amount of the premium payment, but the right to the insurance coverage for the one-year period of the contract. This coverage matured into the proceeds of the policy at his death. Accordingly, it is held that the value of the insurance in this situation is includible in his gross estate under Section 2035 of the Code. See Section 2042-1(a)(2) of the regulations.[34]

In essence, Revenue Ruling 71-497 extensively modified the position announced in Revenue Ruling 67-463. The new Revenue Ruling, however, did not concern itself with those situations in which the policy transfer took place less than three years before the decedent-insured's death or in situations where the premium-paying insured, non-owner died within three years of the purchase of the policy by another.

VI. *The Bel Case*–A SUBSTANTIAL IRS VICTORY

In an apparent, cogent appeal to the Court of Appeals for the Fifth Circuit to reverse a 1970 taxpayer victory in the federal district court, Revenue Ruling 71-497, focused upon the inclusion of the entire proceeds of a one-year accidental policy in a decedent-insured's estate if the decedent had paid the premiums. This situation delineated in the Revenue Ruling encompassed the exact fact situation found in *Bel v. United States.*[35] In *Bel,* the decedent-insured purchased a renewable $250,000 accidental death policy. While the decedent executed the original insurance application and paid all the premiums, the policies from their inception were owned solely by the decedent's three children. Since the policies had to be renewed annually by the decedent, he was forced to make a premium payment in contemplation of his death.

The federal district court held for the taxpayer by looking to the legislative history of section 2042 and to the prior judicial decisions refusing to extend the premium payment test to a section 2035 situation.[36] Furthermore, the lower court reiterated the Tax Court's reasoning in the *Coleman* decision and held that the only amount that

34. Rev. Rul. 71-497, 1971-2 CUM. BULL. 330.

35. 452 F.2d 683 (5th Cir. 1971) [hereinafter referred to as *Bel*]. For excellent analyses of the *Bel* decision, *see* Rosenberg, *Section 2035—Premium Payments Made in Contemplation of Death,* 51 TAXES 468 (1973); Walker, *Contemplation-of-Death in Payment of Life Insurance Premiums: Where Do We Now Stand?,* 39 J. TAX. 348 (1973).

36. Bel v. United States, 310 F. Supp. 1189 (W.D. La. 1970).

could be included in the decedent's gross estate was the value of the premium paid in contemplation-of-death.[37]

The Fifth Circuit rejected the lower court's reasoning by properly noting that the lower court misapplied the legislative history concerning section 2042.[38] In addition, the court found the *Bel* factual situation different from the *Coleman* case in that *Coleman* involved a transfer of a policy more than three years prior to a decedent's death. In *Bel,* however, the court found that the

> Premium paid by the decedent less than one year prior to his death engendered the entire right, title, and interest, which the decedent's children had in the accidental death policy. Essentially, every stick in the bundle of rights constituting the policy and its proceeds had its genesis within three years of the decedent's death.[39]

The court then took an expansive view of the word "transfer." The court held that the scope of the judicial inquiry should not focus upon what the decedent "parted with" or "diverted from his estate" as a result of his purchase of the accidental death policy in contemplation-of-death. Although *Coleman* and the lower court decision in *Bel* adopted this "diversion" principle, the Fifth Circuit chose to analyze the Supreme Court's interpretation of "transfer" in the *Chase* case. Moreover, the restrictive interpretation of "transfer" given by the *Gorman* court was criticized as an impermissible subversion of the underlying purpose of section 2035.[40]

Both the *Bel* decision and Revenue Ruling 71-497 (situation no. 2), by including in a decedent's gross estate the proceeds purchased from premiums paid in contemplation-of-death, appear to be limited to policies taken out within three years of a decedent's death. The interesting aspects of the Revenue Ruling and the *Bel* case are: (1) the rejection of the "diversion" principle espoused in the *Gorman* case; (2) the reintroduction of the expansive interpretation of "transfer"; and (3) the assertion that sections 2042 and 2035 are not to be read *in pari materia.*

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37. *Id.* at 1194-95.

38. 452 F.2d at 690. The court noted that the application of the legislative history for section 2042 to section 2035 was similar to applying a provision concerning lemons to another provision dealing with oranges. The court asserted that sections 2042 and 2035 "came into being at different times," were aimed at diverse "respective targets" and had "no philosophic confluence to twin them." *Id.* at 690.

39. *Id.* at 690.

40. *Id.* at 690-91. Although Judges Dyer and Coleman composed two of the three judges deciding both the *First National Bank* and the *Bel* case, there are numerous differences in the principles espoused. The *Bel* court distinguished its 1970 decision by delineating the fact that in that case the insurance policy had been procured more than three years prior to the decedent's death. In *Bel,* the policy was acquired one year prior to the insured's death. The *Bel* court, however, did reverse its earlier construction of the meaning of the *Chase* decision which it had announced in its *First National Bank* case.

VII. JUDICIAL RESPONSE TO *Bel*

Armed with a significant victory in the *Bel* decision, the Commissioner, in *Kahn v. United States*,[41] argued that the purchase and transfer of an accidental death policy within three years of death automatically constituted a transfer in contemplation-of-death within the meaning of the estate tax provisions. The rationale for this assertion was based upon the nature of accidental death policies in that these policies provide no benefits until death, have no cash surrender value, usually cannot be utilized for borrowing purposes, and therefore, should be classified as "testamentary dispositions." The federal district court, however, refused to accept this view and held that the contemplation-of-death presumption was rebutted by the taxpayer through the affirmative presentation of "life" motives supporting the transfer of the property.[42]

In *Kahn,* the president of a corporation, on the advice of his insurance agent, purchased group insurance for his corporate employees with the corporation paying for all premiums on the policies. Among the employees who obtained such insurance coverage were the son and daughter-in-law of the president of the corporation. This couple, on their insurance applications, designated the respective spouse as the owner-beneficiary of the respective group policies. Approximately one year later while the policies were still in effect, the son and daughter-in-law perished in a fire.

The *Kahn* court found that there had been a "transfer" since the husband had a vested interest and owned his certificate of insurance prior to designating his wife as owner-beneficiary, and that the wife had a similar interest in her certificate prior to her reciprocal designation. While the court's reasoning seems logical, there is other language in the opinion which is disturbing. The court held that, while neither party had procured the certificates nor had they made any premium payments, each had given consideration for the certificates—the husband through his continuing employment with the corporation and the wife as the spouse of an eligible employee. This "continuing employment" theory is contrary to the Internal Revenue Service's position that the power to cancel an insurance policy by termination of employment is not an incident of ownership over the policy for purposes of inclusion in a decedent's gross estate.[43] Thus, the *Kahn* opinion was too broad for purposes of determining ownership of a policy prior to its transfer.[44]

The impact of the *Bel* decision was soon illustrated in cases decided by two courts of appeal. In *Detroit Bank & Trust Co. v.*

41. 349 F. Supp. 806 (N.D. Ga. 1972).

42. *Id.*

43. Rev. Rul. 72-307, 1972-1 CUM. BULL. 307.

44. It should be noted that the opinion analyzed the life motive of the decedents in their respective transfers along with their total lack of estate planning to hold that the transfers were not in contemplation of death.

United States,[45] the decedent entered into an irrevocable trust agreement with the bank as trustee. The decedent transferred $9,600 to the trust in order to acquire $100,000 of life insurance payable to the decedent's children on his death. The trust agreement provided that the decedent was to continue to make contributions to the trust for the payment of life insurance premiums, and the trustee was to expend said funds only for this specific purpose. Although decedent was in apparent good health when he established the trust, he died approximately six months later.

Relying on the *Gorman* rationale, the federal district court granted the decedent's estate a summary judgment and held that only the $9,600 previously transferred to the trust was includable as a transfer in contemplation-of-death under section 2035.[46] The government appealed and both parties stipulated that the funds transferred by the decedent to the trust were paid in contemplation-of-death. The decedent's estate sought to affirm the lower court's decision on the basis that decedent never owned the insurance policy and, therefore, could not have transferred it. The government argued that the trustee was, in essence, the decedent's agent for the purpose of purchasing the life insurance.

The Court of Appeals for the Sixth Circuit analyzed the dominant purpose of section 2035 in reaching substitutes for testamentary dispositions in order to evade estate taxes and held that the trustee, by acting as the agent for the decedent in purchasing life insurance, was utilizing a trust device that was a substitute for testamentary disposition.[47] After the court analyzed the *Bel* opinion and the Supreme Court interpretation of "transfer" outlined in the *Chase* case, it suggested that Congress intended to include in the gross estate of a decedent any gifts of insurance made in contemplation-of-death to be valued in terms of the transfer of the proceeds at death rather than at the purchase or premium cost.[48]

One week after the *Detroit Bank* decision, a federal district court, in *First National Bank of Oregon v. United States,*[49] followed the *Bel* rationale by holding that a life insurance contract, which was applied for and owned by the insured's wife, was transferred in contemplation-of-death because all of the premium payments were paid by the insured. Since the policy was procured by the wife within three years of her husband's death, the court found that "[t]he purchase of

45. 467 F.2d 964 (6th Cir. 1972) [hereinafter referred to as *Detroit Bank*].

46. Detroit Bank & Trust Co. v. United States, 338 F. Supp. 971 (E.D. Mich. 1971).

47. 467 F.2d at 969. The taxpayer did not seriously dispute the government's argument that the taxpayer adopted this method of estate planning to decrease federal estate taxes. The court was influenced from this "evasion of the estate tax" by a substitute testamentary device.

48. *Id.* On remand, the district court found life motives in setting up the irrevocable trust and, therefore, reversed the court of appeals' inclusion of the proceeds in the decedent's estate. Detroit Bank & Trust Co. v. United States, 369 F. Supp. 672 (E.D. Mich. 1974).

49. 352 F. Supp. 1157 (D. Ore. 1972) [hereinafter referred to as *Bank of Oregon*].

two policies by the decedent in his wife's name cannot be distinguished from the procurement of the policies in his own name and immediately transferring all ownership rights to his wife."[50] While this statement may be supportable under the facts in this specific case, its validity as a general statement of law is highly questionable. The decedent's estate based its argument upon the invalidity of this statement of the lower court by asserting that a "transfer" by the decedent was impossible since he neither procured nor owned the policies.

The Court of Appeals for the Ninth Circuit upheld the lower court decision by stating that "where a policy is both procured at the behest of the decedent within the statutory period and where all the premiums are paid by the deceased in contemplation-of-death, the gift must necessarily be one of the property interest in the policy."[51] The court established an "agency-type" basis for including the life insurance proceeds under section 2035. By emphasizing the relevance of the life insurance being "procured at the behest of the decedent," the court indicated that funds directly or indirectly provided by the decedent-insured with specific instructions to purchase life insurance from said funds would require inclusion of the life insurance proceeds in the decedent's estate.[52] Thus, the often-used method of having a husband make a gift to his wife or children of sufficient funds to purchase life insurance on his life would fail under the *Bank of Oregon* rationale. While the result in this case could have been avoided if the decedent's spouse had paid the premiums with her own independent funds, the consequences of the case are more difficult where the wife or children have no sources of independent income. It has been suggested that an unconditional gift of money in an amount different from the premium obligation with no requirement for the purchase of a life insurance policy on the insured's life could avoid the problems encountered in the *Detroit Bank* and *Bank of Oregon* decisions.[53] Future cases analyzing this alternative will determine its success as an estate planning tool.

In a 1973 decision, the Court of Appeals for the Fifth Circuit, in reversing a lower court decision, decided a gift in contemplation-of-death life insurance situation that may be even more troubling than the consequences of the *Bel* decision. In *Berman v. United States*,[54]

50. *Id.* at 1158.

51. First Nat'l Bank of Ore. v. United States, 488 F.2d 575, 577 (9th Cir. 1973).

52. *Id.* at 577.

53. The Treasury Department proposed a rule that would treat an insured-decedent as "constructively" paying the premiums on a policy if he had made cash gifts or loans to the owner-beneficiary sufficient to pay the premiums during the three years preceding his death. 3 UNITED STATES TREAS. DEPT. TAX REFORM STUDIES AND PROPOSALS 375 (Comm. Print 1969). *But see* Estate of William C. Chapin, 29 CCH TAX CT. MEM. 11 (1970), where the Tax Court held for the taxpayer in a situation where a wife, on her husband's advice, applied for a policy on her husband's life. He paid the first premium and she paid the second premium by "borrowing-out" on the policy. The husband died soon thereafter and the court included only the premiums in his estate even though it found a contemplation-of-death transfer. *Id.* at 16.

54. 487 F.2d 70 (5th Cir. 1973) [hereinafter referred to as *Berman*].

the insured-decedent obtained an airline life insurance policy at the airport and immediately assigned the policy to his son before boarding the airplane. The airplane crashed and the government included the airline insurance proceeds in the decedent's gross estate. The district court found that the transfer was not in contemplation-of-death by finding that insured (1) was in good health; (2) had no pressing problems; (3) had made similar flights in the past; (4) had purchased the smallest policy available (which represented only a nominal part of his net worth); and (5) would presumably not have boarded the plane if he had in fact contemplated death.[55]

In its reversal, the court of appeals distinguished "contemplation-of-death" from "expectation of death." In essence, the court found that even though the decedent may not have expected to die, the evidence was insufficient to prove that he had not contemplated death.[56] The court reasoned that the burden was on the estate to prove that the decedent's assignment of the life insurance policy was primarily motivated by the expectation of continued life. The *Berman* reasoning arguably converts the "rebuttable presumption" of section 2035 into a conclusive presumption when the property transferred is term life insurance of a limited duration. The court's rationale places life insurance in a distinct category of gifts since it is so intertwined with the effects of death. The solution of a *Berman*-type situation would be to have the beneficiary of a flight insurance policy procure and pay for this type of insurance on the insured's life; however, in this fast-paced, jet-aged world, such a solution is often impractical.

VIII. THE PRESENT STATUS OF THE LAW

The recent decisions by the various courts of appeals and Revenue Ruling 71-497 must be viewed together in order to properly plan a life insurance transfer. The following situations seem to provide an overall analysis of this area of law:

(1) Revenue Ruling 71-497 indicates that if a non-insured owner is the owner of a policy for more than three years before the insured's death, irrespective of the manner in which the owner acquired the policy, the amount includable as a gift in contemplation-of-death is limited to the premiums paid by the insured within three years of his death. While this position is both correct and equitable, it lends little aid to an estate planner since the insured must live at least three years after the non-insured owner acquires the policy.

(2) If the insured applies for a policy on his life and transfers the policy within three years of his death, the entire proceeds will be included in the insured's gross estate.

(3) Where the insured applies for the policy but the policy is issued to another individual—*i.e.*, the insured's spouse—the Revenue Ruling

55. Berman v. United States, 367 F. Supp. 622 (S.D. Miss. 1973).
56. 487 F.2d 70 (5th Cir. 1973).

and the court decisions indicate that the policy's proceeds will be includable in the insured's gross estate if he has continued to make all premium payments. The basis of this holding is the active influence and control that the insured possesses in the acquisition of the policy and his continuing participation in keeping the policy in effect.

(4) If a relative applies for a policy on the life of the insured without the influence of the insured in acquiring the policy, and the insured agrees to make all premium payments, there may be sufficient distinctions from this situation to exclude the proceeds from the decedent's gross estate.[57] The problems involved in this factual pattern center on the role the insured plays in the administrative events required in the acquisition of a life insurance policy. Often, an insured must undergo a medical examination or must satisfy numerous requirements of the life insurance company before a policy will be issued on his life. This participation may be sufficient to engender the includability of life insurance proceeds via the *Bel* and *Bank of Oregon* doctrines.

(5) The problems involved in the renewal of an annual policy present an extremely difficult and still unresolved dilemma to the estate planner. The classification of the renewed policy is the key to the inclusion or exclusion of the life insurance proceeds from the decedent's gross estate. Thus, where the insured has transferred an annual, renewable policy at least three years prior to his death, the classification of the renewed policy as a continuation of the old policy should include only the premium payments made by the insured during the three year contemplation-of-death period.[58] If, however, the renewed policy is substantially different from the original policy so that it is classified as a new policy, the premium payments by the insured would presumably procure a new policy and would cause the inclusion of the policy's proceeds.

(6) The assignment of flight insurance policies will probably be included in the decedent's gross estate in an estate tax audit where the decedent applied for and/or paid the premiums on such a policy and another individual owned the policy at the time the insured perished in the plane crash. The *Berman* decision indicates that the estate will have a very difficult burden of persuasion to rebut the contemplation-of-death presumption. Although it is somewhat impractical, the main solution to this problem would be to have the beneficiary accompany the insured to the airport so that the beneficiary can acquire and pay for the airline insurance policy.

(7) One element that has caused great consternation to estate planners has been the "tracing" effect of these judicial opinions. The courts have analyzed the "control beam" or "bundle of rights" that the

57. *Compare* Estate of Inez Coleman, 52 T.C. 921 (1969), *with* Bel v. United States, 452 F.2d 683 (5th Cir. 1971).

58. *But see* Bel v. United States, 452 F.2d 683 (5th Cir. 1971).

decedent-insured possessed over a policy which he did not own. The consequences of this language have caused many estate planners to forego the gifting of premium payment funds from the insured to the owner of the policy. These estate planners feel that the Internal Revenue Service's assertion that the owner was merely an "agent" for the insured will be upheld in the event a court battle develops. While this concern is justifiable for conditional gifts or for gifts of funds in amounts exactly equal to the premium obligation, it is difficult to assume that the Service will automatically be successful in its argument against this planning tool. If the insured makes an unconditional gift of funds or property whose value is different from the premium obligation, the exposure to inclusion of the policy proceeds is greatly decreased.[59] Of course, the unconditional nature of the gift may depend upon the facts and circumstances of each case; a mutual understanding among the donor and donee to use the gift to pay insurance premiums may necessitate inclusion of the proceeds. Proper counseling by the estate planner, in addition to his explanation of the consequences of improper handling of insurance matters, should greatly strengthen the taxpayer's chances of success.

IX. Additional Planning Devices and Recommendations

Where it is desirable to keep life insurance proceeds out of the insured's gross estate, the beneficiary should be the owner-applicant, should pay all premiums with independent funds and should not be influenced by the insured in the procurement of the policy. If the owner-applicant has no substantial independent assets, the owner-applicant can proceed in the manner outlined earlier in this article or should seek to receive income-producing assets from the insured. The problems involved, however, in these methods are often unavoidable; the owner-applicant will not have sufficient independent funds or the insured does not have an income-producing asset that can be transferred to the owner-applicant. While an estate planner will attempt to

59. There are sophisticated variations to these gifts which may withstand an IRS challenge. The insured, prior to transferring a policy he owns, can irrevocably deposit three years of premiums with the insurance company. Thereafter, he will make an annual deposit of an additional year's premium. Each premium payment after the first three premiums would be paid with funds given away at least three years earlier. Upon the insured's death, the only amount included in his estate would arguably be the cash or deposit with the insurance company; this amount would have been transferred within three years of the insured's death but would not have purchased any insurance protection. The taxpayer's argument would be based upon a first-in, first-out approach (FIFO); the government, of course, could argue for a last-in, first-out approach (LIFO) to invoke a transfer within the three year period. Another weakness of this alternative is the possible exposure to a section 2035 problem of the insured dying within the three year period subsequent to the initial deposit. Instead of having the insured make the initial deposit for the three years' premiums, the beneficiary could deposit this amount with the insurance company, and the insured could make the subsequent annual payments. In this latter situation, the insured has made no payment which would purchase insurance within three years after the transfer of the policy. This method is, however, also susceptible to a LIFO argument. *See also* Abbin, *Significant Recent Developments Concerning Estate Planning (pt. 1)*, 5 TAX ADVISOR 68 (1974).

structure his client's insurance affairs so that his estate plans are susceptible to the minimum amount of risk if challenged by the Internal Revenue Service, the numerous uncertainties in this area of law require legislative action.

If Congress decides to effectuate its announced goal of revising the estate and gift tax code provisions, some definite guidelines should be established for the treatment of life insurance in the contemplation-of-death area. Specifically, congressional revision of the tax laws should provide that:

(1) The only amount included in a decedent's gross estate in a situation where another individual is the owner-applicant of the policy and the insured-decedent pays the premiums during the three-year period would be the amount of insurance premiums paid during the contemplation-of-death period.

In essence, this provision would eliminate the premium-payment test as an "incident of ownership" for purposes of a transfer under section 2035.

(2) There should be no distinction established for annual, renewable policies where the renewed policy is similar in form to the original policy. The effect of such a provision would allow an insured to transfer an annual, renewable policy at least three years prior to his death, but continue to keep the policy in effect by making the premium payments.

Under this proposed revision, only the premiums paid by the insured will be includable in his gross estate.

(3) Where the insured transfers a life insurance policy, which was owned and applied for by the insured, within the three years prior to his death, the normal contemplation-of-death factors should be analyzed without any additional burdens caused by the nature of the asset.

The recent court decisions evince a changing attitude within the judiciary regarding transfers of insurance policies in contemplation-of-death. The continued application of the premium-payment test along with the examination of the insured's control over the premium payments as an "incident of ownership" capable of effecting a transfer under section 2035 have been broadened to the extent that they now encompass areas never before challenged by the Internal Revenue Service. In light of the fact that a Supreme Court pronouncement will probably be limited to a specific factual issue, congressional action is imperative. Congress must now act to treat life insurance in a manner similar to any other asset for purposes of gifts in contemplation-of-death.