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## THE ROLE OF LIFE INSURANCE IN ESTATE PLANNING †

HAROLD G. WREN \*

**L**IFE insurance plays an uncommonly significant role in every estate plan. In smaller estates, it may make up the largest single asset, and almost invariably, the most liquid. In larger estates, life insurance is used to accomplish specific planning objectives not otherwise attainable. This article has as its objective a review of the uses of life insurance in typical estate plans.

In planning the life insurance program of the client, one should adhere to the following basic procedure:

1. Analyze his present insurance position.
2. Determine and suggest alternatives to rationalize his insurance program.
3. Analyze his object and the extent to which different plans may be used to accomplish them.
4. Determine the net cost of the plans considered.
5. Present an overall optimum plan, based on a balancing of insurance costs with the satisfaction of the client's objectives.

### ANALYZING THE CLIENT'S PRESENT POSITION

The estate planner begins his study by preparing a schedule of the client's life insurance policies. The schedule shows the type of policy, the premium, the proceeds, the

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beneficiary, etc. At this point, a host of questions should be answered in connection with the client's policies:

1. What are the face amounts?
2. What are the kinds of policies, *e.g.*, ordinary life, term, endowment, etc.?
3. Are the funds available for premiums being expended to the best advantage?
4. Are the companies satisfactory?
5. Should the ownership of the policies be changed?
6. Does the disposition qualify for the marital deduction if separate property is involved?
7. Will any life insurance be paid to a minor so as to require a guardianship? If so, what arrangements have been made to designate the guardian?
8. Does any portion of the insurance fall within the "transfer for value" rule?<sup>1</sup>
9. Is any life insurance subject to debt? If so, to whom is the debt owed? Will the estate plan be distorted if the debt is paid out of other assets?
10. Is any of the insurance payable to the estate of the insured, so as to make it subject to creditors' claims? Conversely, should consideration be given to making the insurance payable to the insured's estate to promote flexibility within the estate?
11. What arrangements have been made to insure that premiums will continue to be paid?
12. Will non-payment of premiums result in cancellation, a paid-up term policy, or some other optional settlement?
13. Are there any double indemnity or similar features?
14. Is there a waiver of premiums in the event of disability? Must it be claimed to be available?

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<sup>1</sup> INT. REV. CODE OF 1954, § 101(a)(2). Such a transfer for value may occur inadvertently, *e.g.*, where the insured transfers a policy (perhaps to his wholly owned corporation) on which he has borrowed money to pay premiums, and the transferee assumes the liability of the insured on the policy.

These are only some of the questions that must be answered to determine the effectiveness of the client's present insurance program.

#### RATIONALIZING THE CLIENT'S INSURANCE PROGRAM

After the planner has had an opportunity to study the client's present program, he turns to a consideration of all those things necessary to improve the insurance picture. Rarely will the client's insurance house be completely in order. He may be underinsured; he may have purchased the wrong types of policies; he may have designated the wrong beneficiaries; or he may not have integrated his insurance program into the other aspects of his over-all estate plan.

After tentatively deciding on the steps necessary to improve the client's program, the planner arranges for an interview, at which time he introduces the client to various insurance alternatives, pointing out the advantages and disadvantages of each. To be successful at this interview, the planner must have three areas of knowledge at his fingertips: (A) the kinds of policies; (B) the methods of payment; and (C) the tax advantages of each.

#### THE KINDS OF POLICIES

##### *Ordinary Life Insurance*

Not infrequently, the client will say that he would rather buy term insurance and use the difference between the cost of term and ordinary life for investment purposes. What are the insured's chances of making more by this method than by the purchase of whole life insurance?

The fact is that his chances are quite remote. This is because the interest component of ordinary life insurance is taxed neither to the insured when it is earned nor to the beneficiary when it is paid. Consider the following, quoted from *Fortune*:

The chart at the left [omitted] shows the cumulative cost of two \$10,000 policies to an individual who is thirty-five when they are

first taken out. On the whole-life policy he pays a total of \$4,758 in premiums, but this cost can be reduced by \$1,410 if he lets his dividends accumulate, leaving a net cost of \$3,348. On the term policy, the net premium cost is \$1,146—a difference of \$2,203, or about \$111 a year. The chart at right [omitted] shows that the individual who pays the extra premium will have \$3,898 (in cash surrender value) at the end of twenty years, and there is virtually no tax on this. To accumulate the same amount by investing \$111 a year during that period, he would have to earn 5.1 per cent on his money, and any such earnings would be fully taxed either as dividends or as capital gains. Even if he could count on earning an average of 8 per cent, all in the form of capital gains, he would be only a little better off than with whole life. An 8 per cent return on \$111 a year would give him \$5,600 after twenty years, but for anyone in the 50 per cent (or higher) tax bracket the capital gains tax would reduce this amount to \$4,760.<sup>2</sup>

Ordinary life insurance has the additional advantage that once the policy has been issued, it is never again necessary for the insured to take a physical examination. On retirement, if the insured finds that he has acquired enough assets so that the death-risk provided by the policy is no longer required, he may cash in the policy, or convert it to some other type of insurance, such as an annuity, or take a paid-up policy which requires no further premium payments.

### *Term Insurance*

Term insurance is pure death-risk insurance, and the term insurance contract will do this particular job better than any other type of insurance contract—provided the insured dies while the policy is in force. One difficulty with term insurance is that many such policies must be renewed after a term of years at a higher premium. Some policies require a new physical examination before renewal. This is, of course, a real danger. While each of us thinks of himself as one who will continue to stay in good health, any thoughtful person will concede that it is very easy to become uninsurable.

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<sup>2</sup> *The Case Against the Case for Term Insurance*, *Fortune*, Sept. 1963, p. 230.

Term insurance may serve a very useful function for some purposes. One of these is mortgage insurance, which takes the form of "decreasing term." In contrast with the usual term, where the amount of the proceeds remains level while the premiums are periodically stepped up, in mortgage insurance, the premium remains level, and the amount of the proceeds is stepped down over the term of the insurance. The term coincides with the duration of the mortgage, and the proceeds coincide with the balance due on the mortgage as of the date of the death of the insured.

Mortgage insurance makes particularly good sense for the typical breadwinner who buys his home by means of making payments which pay the interest due on the loan and also reduce the balance due on the principal of the mortgage. In the event of the insured's death, his widow receives a home that is fully paid for.

The principle of decreasing proceeds may also be used in conjunction with whole life insurance. Let us hypothesize a young executive, aged 42, who presently earns \$20,000 a year. His wife is age 38, and he has three children, ages 15, 14 and 8. The family owns its own home in typical Upper Middle Class Suburbia. For \$1,000 per year, our executive can obtain instant coverage of \$92,000 from a good life insurance company. This figure will gradually decline over the next 15 years, to a permanent coverage of \$23,000. By this time, the children will be on their own, and other assets in his estate will have increased in value to offset the decline in life insurance proceeds. The important thing is that his family will have obtained protection against his untimely death. Without such protection, it would be extremely difficult for his family to continue to live in the style to which they are accustomed.

### *Limited Pay Policies*

Limited pay insurance is a form of life insurance wherein the client pays premiums for a number of years, after which the policy is said to be "paid-up." Typically, limited pay policies are written for 5, 10, 15 or 20 years, and are paid up at age 65. The advantage is that premiums have to be

paid for a limited time only. At the end of the specified time, no further premiums are due, and the insurance continues in force. To accomplish this, the insurance company merely accelerates the premiums. Ordinary life is really a limited pay contract, but it is not paid up until age 100. Premiums for limited pay insurance are higher than for ordinary life for the same amount of coverage, and the cash values and paid-up values accumulate faster.

Why are these policies issued? Simply because many people wish to look forward to the time when no further premiums will become due, and they are willing to pay an extra amount to achieve this objective. These policies are ideal for people who have high earning power for a relatively short period of time, such as athletes and entertainers. There may also be some minor tax advantages, which we shall consider later.<sup>3</sup> Sometimes when the planner makes an analysis of the insurance arrangements of the typical family man, he may find some limited pay policies included in the insured's program by virtue of previous planning. The planner may recommend a rearrangement of the client's over-all insurance program to better accomplish his estate objectives which may have changed since the estate plan was last reviewed.

### *Endowment Policies*

Endowment policies resemble limited pay policies in that there is a fixed period in which premiums are paid. But where a limited pay policy pays nothing to the insured when he reaches the end of the limited pay period, the endowment policy matures and the insured begins to receive payment under the terms of the contract.

Both limited pay and endowment policies are forms of life insurance, *i.e.*, they provide a measure of protection against the risk of death, and a method of accumulating savings. The difference between the two policies lies in the fact that upon maturity of the endowment policy, the pro-

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<sup>3</sup> *E.g.*, the limited pay policy may serve as a counter to the Commissioner's contention that payment of the last three years of premiums on a policy in which the decedent has given up all incidents of ownership constitutes a gift in contemplation of death.

ceeds are paid to the insured, while in the limited pay policy, the proceeds are not paid until the insured's death.

### *Annuity Contracts*

An annuity may be described as the opposite of life insurance. In the case of life insurance, the insured pays a small amount in the form of insurance premiums over a period of years. On death, the insurance company pays a large amount to his estate or beneficiary. In the case of the annuity, the annuitant pays a large amount (*e.g.*, single premium annuity) to the insurance company at the outset, and the company returns it in periodic installments. Arrangements can be made for the repayment period to be deferred until a later date (*e.g.*, upon retirement), if this is desired. Today, most annuities do not involve a large premium payment at one time. Rather, the annuitant contributes to the cost of the annuity by paying for it over a period of time. Where the annuity has a death benefit, should the annuitant fail to live to maturity, the annuity acquires much the same appearance as an endowment contract.

An annuity guarantees a certain return to the annuitant for life, and relieves him of the burden of investment management. It also enjoys substantial tax advantages. The principal disadvantages are: (1) the principal is consumed, leaving nothing for one's descendants; and (2) the fixed payments received by the annuitant are subject to erosion of the purchasing power of the dollar through inflation.

Some attempt has been made in recent years to provide protection against inflation through the variable annuity. Under such a program, the annuitant buys an annuity over a period of years. Upon maturity (*e.g.*, age 65), the annuitant is paid in units of purchasing power, rather than fixed dollars. If, at the time of maturity, there is a period of deflation, the annuitant would receive fewer dollars, but would be able to buy proportionately more with those he did receive.

### METHODS OF PAYMENT

There are four basic ways in which an insurance company may discharge its obligation under the policy upon its



maturity. One of these, the optional modes of settlement, may in itself, be divided into four parts, two of which are very similar.

#### *Payment Directly to the Beneficiary in a Lump Sum*

The proceeds may be paid directly in one sum to the beneficiary named in the contract. This is possibly the most popular method, and in many instances, it may be the best method for a particular plan. But there are at least two disadvantages. First, the proceeds may be dissipated and not used to protect the spouse and family of the insured as he intended. In all probability, the dissipation would occur because the surviving wife and children do not have the proper training and experience for handling, managing, and investing a large sum of capital. The fact is that only eighteen per cent of the beneficiaries of life insurance policies paid in a lump sum had any funds on hand after two years. This is somewhat sobering when it is noted that proceeds from life insurance policies are being paid to beneficiaries by insurance companies at an annual rate of approximately three billion dollars.

If payment directly to the beneficiary is to be used, it is important that the planner analyze how the beneficiary will use it. For example, it has not been uncommon for a testator to designate his wife as the beneficiary of a policy with the thought that she might use some of the proceeds to pay taxes, expenses of the estate, or even his creditors. Such a plan would make little sense, as anyone who has handled the administration of an estate can testify. Once the wife receives the liquid funds directly from the insurance company, she may not want to use them for such purposes, regardless of how advantageous this might be for the whole estate.

#### *Payment to the Estate of the Insured*

As indicated above, the principal advantage of this method of payment is that the executor of the estate is provided with liquid funds which may then be used for the

payment of claims and taxes. Should the planner decide on this method of payment, he should do so, keeping in mind that the insurance proceeds will be subject to the claims of creditors and includible in the gross estate for tax purposes.

#### *Payment to the Trustee of a Life Insurance Trust*

In recent years, to obtain the greatest flexibility in the handling of the insurance proceeds without the disadvantages of having the proceeds payable to the estate, the life insurance trust has become quite popular. The trust will normally have been established during the lifetime of the insured, and it may be revocable or irrevocable. By using the trust arrangement, the planner assures maximum flexibility in the estate plan, and still avoids the expense of having the proceeds treated as part of the probate estate, as well as their subjection to the claims of creditors.

#### *Optional Modes of Settlement*

The optional modes of settlement make up the fourth and last method whereby insurance proceeds may be paid by an insurance company. While the optional modes may be useful in some estate plans, particularly where the estate is not too large, their inherent inflexibility has caused them to lose much of their popularity in recent years as estate plans have become more complex. There are four basic types of settlement options in general use; two of these four are quite similar.

##### *a. The interest option*

The insured may elect to have the sum payable held by the company at interest at a stipulated rate. Under this arrangement, the interest earned by the insurance proceeds is paid at regular intervals to the beneficiary named by the insured. This process continues throughout the lifetime of the beneficiary. There is often a minimum guarantee with respect to the interest, and while the guarantee usually is lower than the interest actually earned and paid to the beneficiary, it is nevertheless a valuable benefit. Upon the

death of the beneficiary, the principal is paid to a successor payee, named by the insured. The insured may also give the primary beneficiary the unlimited right to withdraw all or a portion of the principal during the beneficiary's lifetime.

As can be seen, the interest option resembles the life estate with a remainder. As such, it has limited utility. Moreover, even where the widow is given the power to invade principal, there is some risk that the arrangement may fail to qualify for the marital deduction for estate tax purposes.

*b. Payments of a fixed amount*

There are two methods by which the insurance company will ordinarily make payments of fixed amounts. Under one method, the "fixed amount" option, the company pays the proceeds at regular intervals in payments of a fixed amount (e.g., \$100 per month) until the proceeds are exhausted. Under the second method, the "fixed period" option, the company pays out the proceeds over a fixed period in equal payments. In either case, the beneficiary may live beyond the period over which the payments are made.

*c. Life income*

If the life income option is selected, the insurance company will pay the proceeds to the named beneficiary in terms of a stated and regular amount for his life. This makes possible a guaranteed income for the life of the beneficiary. Some contracts provide that the proceeds shall be paid during the joint lives of more than one beneficiary, and then to the survivor. Here again, where the widow is the primary beneficiary, there may be some risk of failing to qualify for the marital deduction.

*d. The tax advantages*

To complete the rationalization of the client's insurance program, the planner must consider the tax advantages of various choices which the client may have made or will make with respect to various plans which already may be in effect or which the planner will recommend. Since the planner

incorporates these advantages into his preferred solution of the client's problems, we shall consider them in conjunction with typical client objectives, and how the planner may achieve them at minimum tax cost.

#### TESTING VARIOUS PLANS TO ACHIEVE THE CLIENT'S OBJECTIVES

Having analyzed the client's present insurance position, and having rationalized his insurance program, the planner next offers to the client various plans based upon the insured's objectives. Since taxes are critical in determining the optimum estate plan, we turn to a consideration of tax consequences as they affect typical estate planning alternatives.

#### USE OF LIFE INSURANCE TO CONTROL THE FEDERAL ESTATE TAX

One of the principal uses of life insurance in many estate plans is to provide liquid funds for the payment of the federal estate tax and other claims against the estate. One approach is to calculate the liquidity needed and, assuming that the client is insurable, to procure additional insurance to cover the tax obligation, remembering that the additional insurance will be included in the client's gross estate upon his death.

Apart from the difficulty of calculating the amount of insurance necessary, such a plan is hardly the better part of wisdom, since careful planning makes it possible to exclude the insurance from the gross estate.

But note that we said *careful* planning. More than one estate plan has floundered where the planner did not think through all the tax consequences.

#### *Proceeds Receivable by the Executor*

Section 2042(1) of the Internal Revenue Code of 1954 provides that "the value of the gross estate shall include the value of all property . . . to the extent of the amount receiv-

able by the executor as insurance under policies on the life of the decedent. . . .”

The critical language in this statute is the phrase “receivable by the executor.” Basically, this means that if the proceeds would be included in the decedent’s *probate* estate, they will also be included in his gross estate for estate tax purposes.<sup>4</sup> So far as this *part* of the statute is concerned, it is immaterial who owns the policy.

Assume, for example, that a life insurance man is about to close a very large policy, but the client objects that the proceeds will be included in his gross estate for federal estate tax purposes. He tells the client not to worry since he can exclude the proceeds by transferring the policy to his wife, and directing in his will that the wife use the proceeds to meet taxes, administration expenses, and claims against the estate.

*Does this sound like a good estate plan?*

It may *sound* like one, but actually, it is quite unwise. The Regulations provide:

It makes no difference whether or not the estate is specifically named as the beneficiary under the terms of the policy. Thus, if under the terms of an insurance policy the proceeds are receivable by another beneficiary but are subject to an obligation, *legally binding upon the other beneficiary*, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full (to the extent of the beneficiary’s obligation) of such taxes, debts, or other charges is includible in the gross estate.<sup>5</sup>

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<sup>4</sup> Whether insurance is “receivable by the executor” is dependent upon local law. *Commissioner v. Jones*, 62 F.2d 496 (6th Cir. 1932). Thus, where local law requires that insurance proceeds be paid to next-of-kin free of creditors’ claims, proceeds are not includible as insurance receivable by the estate. *Estate of Proutt v. Commissioner*, 125 F.2d 591 (6th Cir. 1942) (executor required to hold proceeds in trust for wife and daughter; held not receivable by the estate); *Estate of Webster v. Commissioner*, 120 F.2d 514 (5th Cir. 1941) (insurance not receivable by executor even though decedent made policies payable to executor; insurance passed under Florida law directly to next-of-kin or named beneficiary and not under residuary clause of decedent’s will); *Estate of Benjamin F. McGrew*, 46 B.T.A. 623 (1942), *nonacq.*, *aff’d on other grounds*, 135 F.2d 158 (6th Cir. 1943); *Julia S. Lucky*, 2 B.T.A. 1268 (1925) (decedent specifically provided that insurance should not pass under will).

<sup>5</sup> Treas. Reg. § 20.2042-1(b)(1) (1966). (Emphasis added.)

The wife might argue that she was not "legally bound" to make these payments to the estate, but a wiser approach would have been not to have used the proceeds of the policy in this fashion in the first place.

As early as 1922, the Commissioner ruled that where life insurance was taken out "to provide funds to meet the estate tax and other taxes or charges which are enforceable against the estate," the proceeds would be includible in the decedent's gross estate.<sup>6</sup> Since that time, the cases have distinguished situations where the beneficiary *must*,<sup>7</sup> from those where he *may*,<sup>8</sup> use the proceeds for the payment of taxes or other claims against the estate.

Sometimes, an estate planner will fall into this error in connection with business insurance. For example, in one case, the decedent and his associate entered into a contract whereby upon the death of one, the survivor would purchase the other's stock in a certain corporation. They further provided that the proceeds of a \$200,000 policy owned by the corporation on the life of each, *payable to his estate*, should be applied to the purchase price to be paid by the survivor for such stock. The court held that the insurance

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<sup>6</sup> Letter by Deputy Commissioner of Internal Revenue, Dec. 28, 1922.

<sup>7</sup> Mathilde B. Hooper, 41 B.T.A. 114 (1940), *acq. and nonacq.* (amount payable to trustee of inter vivos trust required to be used to liquidate estate obligations held a part of decedent's gross estate); Pacific Nat'l Bank, 40 B.T.A. 128 (1939) (proceeds payable to inter vivos trustee includible to extent of expenses of last illness and burial where decedent directed that such expenses should be paid out of such proceeds); Estate of Waldo Rohnert, 40 B.T.A. 1319 (1939) (decedent directed trustee of inter vivos trust to pay all estate taxes but failed to state that insurance payable to such trustee should not be used for this purpose; held, amount of estate taxes includible in decedent's gross estate); Marmaduke B. Morton, 23 B.T.A. 236 (1931), *acq.* (where insurance proceeds payable to trustee were subject to payment of charges against estate, such proceeds were includible in gross estate).

<sup>8</sup> United States v. First Nat'l Bank & Trust Co., 133 F.2d 886 (8th Cir. 1943) (insurance payable to testamentary trustee held not receivable by the executor); Boston Safe Deposit & Trust Co. v. Commissioner, 100 F.2d 266 (1st Cir. 1938) (proceeds not includible although payable to trustee although decedent created a testamentary trust in which he named same trustee beneficiary of policy); Estate of Charles H. Wade, 47 B.T.A. 21 (1942), *acq.* (trustee had the *power* but not the *duty* to pay charges); Louis E. Flye, 39 B.T.A. 871 (1939), *acq. and nonacq.* (although trustee could use trust funds to pay debts and taxes, it was not obligated to do so).

proceeds which were paid to the decedent's estate were includible in his gross estate.<sup>9</sup>

Similarly, where insurance is used as a method of paying claims against the estate, the insurance will be includible, although it may be offset by a claim deductible for estate tax purposes.<sup>10</sup>

In short, if life insurance is to be excluded from the gross estate, the planner must make certain that the proceeds will neither be payable to the estate nor subject to the requirement that they be used to meet estate obligations.

### *Proceeds Payable to Other Beneficiaries*

If insurance proceeds are made payable to beneficiaries other than the estate, they will be included in the insured's gross estate only if he retained "incidents of ownership" over the policy. While the precise meaning of this term is still subject to development, it basically refers to economic control over the policy.

How this came to be the sole test for the inclusion of life insurance payable to other beneficiaries is a familiar story of estate tax history. Prior to 1942, the decedent's gross estate included the excess over \$40,000 of all life insurance proceeds receivable by all other beneficiaries as insurance under policies "taken out by the decedent" upon his own life. During this period, in determining whether a policy was "taken out by the decedent," the Regulations vacillated between saying that this was determined by whether the decedent held the incidents of ownership, had paid the premiums, or had done both.

Congress resolved the problem in 1942 by eliminating the exemption of \$40,000, along with the phrase "taken out

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<sup>9</sup> Estate of John T. H. Mitchell, 37 B.T.A. 1 (1938), *acq.*; see also Paul Legallet, 41 B.T.A. 294 (1940) (income tax case; cost basis to surviving partner of interest in partnership determined by considering insurance in estate of first partner to die).

<sup>10</sup> Estate of Max Reinhold, 13 P-H TAX CT. MEM. 302 (1944) (policies assigned as collateral on loan; debts allowed as deduction; policies includible in gross estate); Estate of Silas B. Mason, 43 B.T.A. 813 (1941), *nonacq.* (insurance payable to ex-wife to satisfy alimony claims includible since proceeds of policy were used to satisfy debt of decedent, but also deductible from value of gross estate).

by the decedent." At the same time, it provided that insurance proceeds payable to designated beneficiaries would be included in the decedent's gross estate if he either (1) had paid the premiums directly or indirectly, or (2) possessed at the time of his death any of the incidents of ownership exercisable either alone or in conjunction with any person. The 1942 law also provided that a reversionary interest in the insured was not an incident of ownership.

In 1954, Congress eliminated the "payment of premiums" test and provided that a reversionary interest should be considered an incident of ownership only if its value exceeded five per cent of the value of the policy immediately before the death of the decedent. At the time of the enactment, a minority of the House Ways and Means Committee said that the new law would "virtually do away with the estate taxation of life insurance."<sup>11</sup>

Life insurance today provides a convenient way of achieving liquidity in the hands of the decedent's heirs without increasing the estate tax burden. Whether this is done successfully or not depends upon the care exercised in establishing the particular estate plan.<sup>12</sup>

Careful planning requires that the life insurance policy be assigned to a new owner, that payment for the premiums be arranged, and that there be a clear arrangement for the use of the proceeds. In community property jurisdictions, there is the additional problem of whether the insurance transferred, or the proceeds at death, are to be treated as separate or community property.

*a. Transferring the incidents of ownership*

The Regulations state that incidents of ownership include "the power to change the beneficiary, to surrender or

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<sup>11</sup> H.R. REP. No. 1337, 83d Cong., 2d Sess. B15 (1954).

<sup>12</sup> As a matter of practice, all too often the client is not careful enough about completely removing himself from a position of economic control. He may, for example, seek a loan on the policy after he has purported to transfer it to his wife. Such an approach is most damaging, as the Internal Revenue Service is then able to proceed against the transfer either under the gift tax, the estate tax, or both—whichever will produce the greatest revenue in a given situation.



cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy. . . ." Similarly, the term includes a power to change the beneficiary reserved to a corporation of which the decedent is sole stockholder,<sup>13</sup> as well as such a power held by a trustee under a life insurance trust where the decedent is one of the trustees.<sup>14</sup>

That the concept of "incidents of ownership" is broad is illustrated by a leading case<sup>15</sup> in which the decedent had been a member of the New York Stock Exchange. The second circuit first ruled that the benefits paid out of the Exchange's gratuity fund were proceeds of life insurance.<sup>16</sup> It then held that the decedent had retained incidents of ownership with respect to this fund, since he could deprive his beneficiaries of their interest by selling his membership, the value of which was increased by the existence of the fund.

While the insured might attempt to dispose of individual incidents of ownership, the only way that he could be sure of divesting himself entirely would be to make a complete and irrevocable assignment of all rights in the policy. A recent case<sup>17</sup> from the United States Supreme Court indicates how one may be freed of the incidents of ownership. The decedent, Noel, was driven to the airport by his wife; he was to board an airplane for Venezuela. Just before taking off, he signed applications for two round-trip flight insurance policies aggregating \$125,000, naming his wife as beneficiary. The wife paid the premiums and Mr. Noel instructed the sales clerk to "give them to my wife. They are hers now, I no longer have anything to do with them." The plane crashed in the Atlantic, killing all on board, less than three hours after take-off.

In reversing the court of appeals, the Supreme Court held that the proceeds constituted life insurance. In so

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<sup>13</sup> Treas. Reg. § 20.2042-1(c)(2) (1966).

<sup>14</sup> Treas. Reg. § 20.2042-1(c)(4) (1966).

<sup>15</sup> *Commissioner v. Treganowan*, 183 F.2d 228 (2d Cir.), *cert. denied*, 340 U.S. 853 (1950).

<sup>16</sup> The court found that the fund employed a method for shifting the risk of death, the basic characteristic of life insurance.

<sup>17</sup> *Commissioner v. Estate of Noel*, 380 U.S. 678 (1965).

doing, it rejected the holding below that flight insurance is really accident insurance since it covers a risk "which is *evitable* and not likely to occur." Life insurance proceeds constituted a sum which the insurer "agrees to pay . . . upon the occurrence of an *inevitable* event."<sup>18</sup>

The Court then rejected three arguments of the taxpayer, all of which sought to show that the taxpayer had no incidents of ownership in the policy at the time of his death. The arguments were: (1) Mrs. Noel had purchased the policies and therefore owned them; (2) even if her husband had owned the policies, he had given them to her, thereby depriving himself of power to assign the policies or to change the beneficiary; and (3) assuming that he still had the power to assign the policies or change the beneficiary, this power was illusory since he could not have exercised it between the time of take-off and the crash of the plane. The Court's rejection of these points turned on the fact that the husband had not endorsed the policy to show any assignment or change of beneficiary. The result was that the husband had failed to make the alleged transfer of the policy.

*Noel* dramatizes the care that must be exercised in the assignment of a life insurance policy. While the cases, law, and regulations do not distinguish between an assignment of the policy and the irrevocable naming of a beneficiary, *Noel* indicates that the former course of action is wiser. The best procedure is to notify the insurance company of the assignment and change the beneficiary to conform to the assignee.

Often the client will desire to make his wife assignee with or without naming her as beneficiary. While such an assignment may be convenient, it involves inherent risks. The wife may pre-decease her husband, thereby causing the terminal reserve value of the policy to be added to her gross estate. Sometimes the policy will revert in whole or in part to the insured, by virtue of provisions in her will or because of intestacy. In a community property jurisdiction, such interspousal transfers not infrequently present difficult legal

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<sup>18</sup> 332 F.2d 950, 952 (3d Cir. 1964). (Emphasis added.)

questions as well as unexpected and undesirable results with regard to both taxes and who shall benefit from the policy.

Sometimes the client may suggest that his children be named assignees and beneficiaries of the policy. But if any of the children are minors, a guardianship for each minor will be necessary with the unnecessary complexity and expense inherent in such an arrangement.

In most cases the best solution is to establish an irrevocable life insurance trust. The policy is assigned to the trustee who is named beneficiary. On the death of the insured, the proceeds of the policy are paid to the trustee who holds them in accordance with the terms of the trust instrument. Drafting the terms of this instrument is a major (and difficult) undertaking for the estate planner. The dispositive provisions typically provide that in the event that the wife of the insured survives him, she shall be paid the income from the proceeds during her life, and at her death the principal shall be distributed among the children of the insured. The administrative provisions should include clauses allowing the trustee to sell or buy assets, as well as to lend or borrow money to or from the estate of the insured. Such provisions become extremely important on the death of the insured, when it is desired that the liquid assets created by the insurance proceeds be placed in the estate, and the non-liquid assets (*e.g.*, the business of the insured) be removed from the decedent's estate, and placed into what was formerly the life insurance trust.

#### *b. The life insurance trust*

Assuming that the best solution to the problem of determining the assignee-beneficiary of the policy is to use an irrevocable life insurance trust, certain questions remain: should the trust be funded or unfunded? If unfunded, how are premiums to be paid? Should the payment of premiums be coordinated with a gift program? If a gift program is to be used, how can the \$3,000 exclusion be protected?

*b (1). The funded life insurance trust*

A funded life insurance trust is one in which the grantor transfers property to a trustee with instructions to use the income from the trust property to purchase insurance on the life of the insured. If the insurance is to be purchased on the grantor's own life, the trust income is taxed to the grantor.<sup>19</sup> The result is that the funded insurance trust provides no income tax saving although the grantor is deprived of the use of the trust income. In a few instances, the funded insurance trust may be desirable where the insurance is to be purchased on the life of someone other than the grantor. A grandfather might establish such a trust and give the trustee discretion to purchase insurance on the life of a son or son-in-law who is the father of the settlor's grandchildren. If the father is young, such an investment by the trustee might constitute a profitable investment for the trust.<sup>20</sup> At the same time, the grandchildren are protected against the untimely death of their father.

A wife having separate property may establish an irrevocable funded life insurance trust in which she would provide that the trustee could purchase life insurance on the life of her husband. Again, such a trust is particularly useful in protecting the children of the grantor and the insured.

*b (2). The unfunded life insurance trust*

More common than the funded life insurance trust is the unfunded life insurance trust, whereby the grantor is insured. The grantor takes out the policy<sup>21</sup> and assigns it to a trustee who, as beneficiary, will receive the proceeds of the policy on the death of the insured. The grantor makes periodic gifts to the trust which the trustee uses to pay insurance premiums on his life. At the death of the grantor,

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<sup>19</sup> INT. REV. CODE OF 1954, § 677(a)(3).

<sup>20</sup> Care must be taken to make sure that the trust will not be deemed a "support" trust, with resulting income taxation of the trust income to the son or son-in-law.

<sup>21</sup> Alternatively, the policy may be applied for by one having an insurable interest in the insured, as in the case of the settlor who is the grandfather or wife of the insured.

the policy proceeds are paid to the trustee who holds them in accordance with the dispositive provisions of the trust.

The unfunded life insurance trust provides no income tax saving, but the grantor has use of the money on which income tax has been paid. The gift and estate taxes are usually avoided. Since the grantor has no incidents of ownership at his death,<sup>22</sup> there will be no estate tax. To the extent that the grantor takes advantage of his \$30,000 personal exemption (and that of his wife)<sup>23</sup> and the annual gift tax exclusions, he may avoid the gift tax. The annual exclusion may be lost as gifts of future interests,<sup>24</sup> but will be available if the grantor makes use of the special provisions of the Code which preserve the exclusion for a gift to a trust for the benefit of a minor.<sup>25</sup>

### b (3). *Eliminating the grantor's control*

The principal problem of all transfers in trust is, of course, the desire of the grantor to retain control. Here, we deal with those situations where the principal of a life insurance trust is included in his gross estate by virtue of his *possession* of incidents of ownership.<sup>26</sup>

Typical of the rights held by the grantor at death which have caused this result are: (1) the right to change the beneficiary;<sup>27</sup> (2) the right to revoke the assignment of the

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<sup>22</sup> INT. REV. CODE OF 1954, § 2042(2).

<sup>23</sup> INT. REV. CODE OF 1954, § 2521. If the transfer is of the grantor's separate property, the wife's consent to the use of her exemption is required.

<sup>24</sup> INT. REV. CODE OF 1954, § 2503(b).

<sup>25</sup> INT. REV. CODE OF 1954, § 2503(c). The wisest practice is to establish a separate trust for each minor child and carefully trace the language of § 2503(c) to insure that the gift will qualify as not being a gift of a future interest. By several nonacquiescences, the Commissioner has indicated his intention to require strict compliance with the statute. *Accord*, Carl E. Weller, 38 T.C. 790 (1962), *nonacqu.*, 1963-2 CUM. BULL. 6; Jacob Konner, 35 T.C. 727 (1961), *nonacqu.*, 1963-2 CUM. BULL. 6; Arlean I. Herr, 35 T.C. 732 (1961), *aff'd*, 303 F.2d 780 (3d Cir. 1962).

<sup>26</sup> The statute deals with possession, not retention, of incidents of ownership. INT. REV. CODE OF 1954, § 2042(2).

<sup>27</sup> *Farwell v. United States*, 243 F.2d 373 (7th Cir. 1957); *Estate of Rhodes v. Commissioner*, 174 F.2d 584 (3d Cir. 1949); *Estate of Seward v. Commissioner*, 164 F.2d 434 (4th Cir. 1947); *Helvering v. Estate of Reybire*, 83 F.2d 215 (2d Cir. 1936) (portion of insurance paid for by decedent includible under 1926 Revenue Act where decedent could change beneficiaries of policies after assignment to trust).

policy;<sup>28</sup> (3) the right to borrow on the policy;<sup>29</sup> (4) the right to the cash surrender value of the policy;<sup>30</sup> (5) the right to the income from the policy;<sup>31</sup> and (6) the right to cancel the policy and reinvest the cash surrender value in the grantor.<sup>32</sup>

In a few cases, the Tax Court has ruled that the right to replace an individual cotrustee,<sup>33</sup> the right to income from the trust in excess of the amount needed to pay premiums,<sup>34</sup> and the fact that the decedent received dividends and income on a few of the policies transferred in trust<sup>35</sup> did not constitute incidents of ownership. Such cases can hardly be used as a basis for planning. Even assuming that they are correct under section 2042, transfers in trust with such powers retained may still be subject to attack under section 2036 or 2038.

While most estate tax cases involving life insurance trusts have presented situations where the insured was grantor, in a few unusual situations, the insured has been held to possess an incident of ownership even though *he* did not establish the trust.

Such a case is *Estate of Karagheusian*.<sup>36</sup> There, the wife of the insured, took out the insurance on the life of her husband. All rights of ownership in the policy vested

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<sup>28</sup> Estate of Seward v. Commissioner, *supra* note 27.

<sup>29</sup> Estate of Rhodes v. Commissioner, *supra* note 27.

<sup>30</sup> *Ibid.*

<sup>31</sup> Estate of Selznick, 15 T.C. 716 (1950), *aff'd*, 195 F.2d 735 (9th Cir. 1952); Estate of Herbert G. Larsh, 8 CCH TAX CT. MEM. 799 (1949) (grantor retained right to income for life plus power to amend or revoke).

<sup>32</sup> Estate of Selznick, *supra* note 31.

<sup>33</sup> Estate of N. Carlton, 34 T.C. 988 (1960), *rev'd on other grounds*, 298 F.2d 415 (2d Cir. 1962) (any control decedent would have acquired had he appointed himself cotrustee would have been jointly with a corporate trustee and solely for the benefit of the trust). *But cf.* State Street Trust Co. v. United States, 263 F.2d 635 (1st Cir. 1959).

<sup>34</sup> Estate of N. Carlton, *supra* note 33 (there never was any excess income over the amount needed to pay premiums and the right to dividends on the policies had been assigned to the trustees).

<sup>35</sup> Estate of L. Richards, 20 T.C. 904 (1953), *aff'd per curiam*, 221 F.2d 808 (9th Cir. 1955) (no finding that decedent had retained the right to the income from the trust).

<sup>36</sup> Commissioner v. Estate of Karagheusian, 233 F.2d 197 (2d Cir. 1956), *reversing* 23 T.C. 806 (1955).

in her for life, then to their daughter, for life, and finally to insured, his executors, administrators or assigns.

The wife then executed a trust, retaining a power of revocation and a power of modification with respect to the trust exercisable only in conjunction with her daughter and husband, or the survivor. The husband died. The Tax Court ruled a *portion* of the insurance proceeds includible in the husband's gross estate on the theory that some of the premiums on the policy were paid in part out of income from property which he had contributed to the trust. Both the Commissioner and the taxpayer appealed to the second circuit. In that court, the entire proceeds were held includible, since the husband possessed an incident of ownership by reason of his wife's retention of the power to revoke or modify the trust with his consent. The court said:

The decedent, acting with his wife and daughter, had the power at any time until his death to determine the ultimate distribution of the insurance proceeds. This power was an incident of ownership within the meaning of Section 811(g)(2)(B). . . .<sup>37</sup>

*b (4). Transfers in contemplation of death*

In 1927, the Commissioner took the position that the proceeds of life insurance were not taxable under the provisions of the estate tax law with regard to transfers in contemplation of death, since the statute contained specific provisions governing the taxation of insurance.<sup>38</sup> In 1936, he revoked this earlier ruling, and took the position that the excess over \$40,000 would be includible in the decedent's gross estate if the insurance was assigned by way of a transfer in contemplation of death, or if it was intended to take effect in possession or enjoyment at or after death.<sup>39</sup> With the elimination of the \$40,000 exemption for life insurance proceeds in 1942, life insurance became subject to a

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<sup>37</sup> *Id.* at 200. The present statute is INT. REV. CODE OF 1954, § 2042(2).

<sup>38</sup> G.C.M. 1164, VI-1 CUM. BULL. 315 (1927).

<sup>39</sup> G.C.M. 16932, XV-2 CUM. BULL. 299 (1936).

possible transfer in contemplation of death like any other property.<sup>40</sup>

If the *policy* is transferred in contemplation of death, the entire proceeds are includible. But if the transfer is of the *premiums* or of *funds to pay premiums*, the amount includible is that portion of the proceeds allocable to those premiums transferred in contemplation of death.<sup>41</sup>

Planning for the insured's payment of the premiums thus becomes somewhat precarious. For example, suppose that the insured takes out a policy for four years prior to his death, assigns the policy to an unfunded life insurance trust, and then pays four annual premiums. The Commissioner has contended that three-fourths of the life insurance proceeds should be included in the decedent's gross estate. While such a case has not reached the courts, internal revenue agents throughout the country have advanced this position in auditing estate tax returns.

Fortunately, there is one case decided by the Tax Court which supports the taxpayer where the insured paid the premiums over a period of time as part of a planned program. In *Estate of Israel*,<sup>42</sup> the decedent paid premiums on life

<sup>40</sup> The test of whether the transfer was in contemplation of death or not is, of course, a factual issue. Cases holding that the transfer of life insurance was in contemplation of death include: *Estate of Garrett v. Commissioner*, 180 F.2d 955 (2d Cir. 1950); *Estate of Sloan v. Commissioner*, 168 F.2d 470 (2d Cir. 1948); *Estate of Slifka v. Johnson*, 161 F.2d 467 (2d Cir.), *cert. denied*, 332 U.S. 758 (1947); *Estate of Diamond v. Commissioner*, 159 F.2d 672 (2d Cir. 1947); *Estate of Davidson v. Commissioner*, 158 F.2d 239 (10th Cir. 1946); *Estate of Vanderlip v. Commissioner*, 155 F.2d 152 (2d Cir.), *cert. denied*, 329 U.S. 728 (1946); *First Trust & Deposit Co. v. Shaughnessy*, 134 F.2d 940 (2d Cir.), *cert. denied*, 320 U.S. 744 (1943); *Liebmann v. Hassett*, 50 F. Supp. 537 (D. Mass. 1943), *aff'd*, 148 F.2d 247 (1st Cir. 1945). Cases holding that the transfer of life insurance was not in contemplation of death include: *Estate of Aaron v. Commissioner*, 224 F.2d 314 (3d Cir. 1955); *Estate of Singer v. Shaughnessy*, 198 F.2d 178 (2d Cir. 1952); *Estate of Flick v. Commissioner*, 166 F.2d 733 (5th Cir. 1948); *Estate of Cronin v. Commissioner*, 164 F.2d 561 (6th Cir. 1947); *Estate of Cowles v. United States*, 152 F.2d 212 (2d Cir. 1945).

<sup>41</sup> *Liebmann v. Hassett*, 148 F.2d 247 (1st Cir. 1945); *Estate of Vanderlip*, 3 T.C. 358, *aff'd*, 155 F.2d 152 (2d Cir.), *cert. denied*, 329 U.S. 728 (1946) (entire proceeds includible where decedent paid all premiums after transfer of policy). Under present law, only those premiums paid during the last three years of decedent's life could be considered in contemplation of death.

<sup>42</sup> 44 P-H TAX Ct. MEM. 1423 (1944).



insurance policies held in trust by making gifts to the trust over a period of time for that purpose. The Tax Court held that since the premiums were paid pursuant to a well established custom of the decedent in making such gifts with the intention of preserving the principal of the trust, they were not paid in contemplation of death.

Sometimes a transfer will be made in contemplation of death and the assignor will receive back from the transferee a consideration. In such event, the amount includible in the gross estate is the value of the proceeds less the consideration received back by the transferor.<sup>43</sup> Such transfers should, of course, be avoided because of the income tax rule which causes the transferee to realize gain on the death of the insured to the extent that the proceeds exceed the consideration which he has paid.<sup>44</sup>

The planner should make every effort to avoid transfers in contemplation of death. A planned program extending over a period of years commencing sometime prior to the three-year presumptive period should rebut the presumption of "in contemplation of death" with regard to payments made during the last three years of life. Limited pay policies may be used with the thought that the insurance may be paid up prior to the three-year presumptive period. Transfers for value should be avoided as they may well result in adverse income tax consequences to the transferee with little estate tax relief for the transferor.

*b (5). The problems of community property*

Up to this point, we have assumed that we are dealing with life insurance in a common-law state, or with separate property in a community property jurisdiction. When we turn to the problems of community property, an additional set of rules comes into play.<sup>45</sup> If the insured transfers an

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<sup>43</sup> Estate of Pritchard, 4 T.C. 204 (1944).

<sup>44</sup> INT. REV. CODE OF 1954, § 101(a)(2).

<sup>45</sup> If any portion of the proceeds is to be treated as the insured's separate property, a similar tax result can be obtained but only if the proceeds are qualified for the marital deduction. INT. REV. CODE OF 1954, § 2056(a), (b)(6).

asset of the community to his spouse, he changes the community property into the separate property of the transferee. In jurisdictions such as Arizona, California and Idaho, where dual ownership is recognized, either spouse may make this conversion. However, in Texas, where the husband is the manager of the community, he may convert community property into separate property of the wife, but the wife has no power to convert her interest in the community into her husband's separate property.

Normally transfers of policies to the spouse should be avoided. The better approach is to assign the policy to an unfunded irrevocable life insurance trust, and to transfer the funds to the trust to meet premium payments.

If the insured fails to make a complete transfer, or if he makes the transfer in contemplation of death or with some interest retained, some value will be included in his gross estate. If the transfer is of community property, the amount includible is measured by the insured's one-half of the community property.

The characterization of life insurance as community or separate property is complicated because: (1) the law has used different theories for different community property states; (2) there may be a difference in the transferor's marital status between the time a policy is taken out and the time of payment of premiums; and (3) there are differences depending upon whether the transfer is of the policy, the proceeds, or the funds to pay premiums.

The amount includible in the insured's gross estate is based on the proceeds of the policy, but only if the insured is the first to die. If his spouse should predecease him, the value of her community interest in the life insurance policy (one-half of the interpolated terminal reserve value as of the date of her husband's death) is includible.<sup>46</sup> If the proceeds are payable to someone other than the wife, on the death of the insured, the wife surviving, the wife is deemed

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<sup>46</sup> Rev. Rul. 48, 1953-1 CUM. BULL. 392.

to have made a gift of her one-half community interest in the *proceeds* to the beneficiary of the policy.<sup>47</sup>

Except for the period from 1942 to 1948, when estate taxation of community property was based on a federal statute,<sup>48</sup> the estate taxation of life insurance proceeds in community property jurisdictions has been governed by local law.<sup>49</sup> Differences in local law have caused the courts to use different approaches. In Washington and California, proceeds are said to be community or separate property in proportion to the amount of community or separate funds used to pay premiums. Where the husband, as the insured, took out insurance on his own life prior to marriage, paid one premium out of separate funds, married, and paid all later premiums out of community funds, the Supreme Court held that the amount includible in the husband's gross estate was the total proceeds reduced by one-half of the portion of the proceeds allocable to the premiums paid after marriage.<sup>50</sup>

In Louisiana and Texas, the proceeds are community or separate, depending upon the "inception of title" doctrine, *i.e.*, the characterization of the policy at the time it was taken out. By this approach, it is immaterial who pays the premiums for purposes of distinguishing separate from community property.

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<sup>47</sup> *Ibid.*

<sup>48</sup> INT. REV. CODE of 1939, §811(g)(4), added by Rev. Act of 1942, repealed by Rev. Act of 1948. Held constitutional, insofar as the section requires inclusion of entire proceeds of insurance paid out of community where insured retained incidents of ownership and surviving spouse could not show that any of the funds were originally hers, in *Fernandez v. Wiener*, 326 U.S. 340 (1945).

<sup>49</sup> *Lang v. Commissioner*, 304 U.S. 264 (1938), holding that Bank of America Nat'l Trust & Savings Assoc. v. Commissioner, 90 F.2d 981 (9th Cir. 1937) was wrongly decided. The latter case held that provisions of local law had no significance in determining taxability of proceeds. See also *Estate of Louisa Morris Carroll*, 29 B.T.A. 11 (1933) (Louisiana community property law held controlling).

<sup>50</sup> See *Lang v. Commissioner*, *supra* note 49, at 267. The California law prior to July 29, 1927, was much the same as the community property law of New Mexico today. The wife had no interest in the community property to her husband's death. If she died first, nothing passed at her death. Effective July 29, 1927, the California legislature gave the wife a vested interest in the community. The Board of Tax Appeals held that the nature of insurance proceeds was determined by whether premiums were paid out of pre-1927 or post-1927 community property. *Estate of George W. Fuhr*, 42 P-H B.T.A. MEM. DEC. 410 (1942); *Estate of Daniel G. Arbutnot*,

In a 1953 ruling,<sup>51</sup> the Commissioner illustrated the operation of the Louisiana and Texas rule:

The ruling posed five hypothetical situations, in each of which it was assumed that the beneficiary of the policy was: (1) anyone other than the surviving spouse or the estate of the insured; (2) the surviving spouse; and (3) the insured's estate. In all five situations the insured husband retained the incidents of ownership. The five hypothetical situations were as follows:

1. Husband takes out the policy while married; all premiums are paid out of community funds;

2. Husband takes out the policy while married; all premiums are paid from his separate funds;

3. Husband takes out the policy while married; all premiums are paid out of wife's separate funds;

4. Husband takes out the policy while single; pays one premium before marriage; wife pays the balance of the premiums out of her separate funds after marriage;

5. Husband takes out the policy while single; pays one premium before marriage; pays the balance of the premiums out of community funds after marriage.

In the fourth and fifth hypotheticals, the Commissioner adopted the "inception of title" doctrine, holding that since the policy was taken out while the insured was single, the proceeds were his separate property and includible in his gross estate, without regard to who paid the premiums.<sup>52</sup>

In the first hypothetical, the proceeds were community property under the "inception of title" rule. Accordingly, only one-half of the proceeds were includible in the gross

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42 P-H B.T.A. MEM. DEC. 919 (1942); Estate of Albert Scheuer, 40 P-H B.T.A. MEM. DEC. 248 (1940); E. C. McCoy, 39 B.T.A. 822 (1939), *acq.*; Estate of Victor Eisner, 39 P-H B.T.A. MEM. DEC. 824 (1939).

<sup>51</sup> Rev. Rul. 232, 1953-2 CUM. BULL. 268.

<sup>52</sup> The ruling is somewhat unclear as to the basis for the Commissioner's ruling in the fifth hypothetical. In the fourth hypothetical, the "inception of title" doctrine is clearly controlling. In the fifth situation, however, the Commissioner first stated that the insured "possessed incidents of ownership" and then ruled: "The policy here is regarded under applicable Louisiana Law as a separate asset of the insured."

estate of the husband, regardless of the identity of the beneficiary. In the case where the beneficiary was someone other than the surviving spouse, the wife was deemed to have made a taxable gift of one-half of the proceeds at her husband's death.

In the second hypothetical, where the husband paid all the premiums out of his separate funds, the Commissioner abandoned the "inception of title" doctrine, and held that the insurance policy was the separate property of the husband in this circumstance under applicable Louisiana law. Accordingly, the *entire* amount of the proceeds was includible.

In the third hypothetical, where the wife paid the premiums out of her separate funds, but where the husband retained the incidents of ownership, the Commissioner reached the anomalous result that the *entire* proceeds were includible in the husband's gross estate by virtue of his retention of the incidents of ownership.

Throughout this 1953 ruling, the Commissioner took the position that might conceivably provide the greatest revenue, except where the law was clearly to the contrary. If there was any doubt, the proceeds were said to be includible, whether the reason given was the possession of incidents of ownership, the payment of premiums, or the fact that the proceeds constituted the insured's separate property.

While payment of premiums is no longer a test for inclusion in the gross estate, it is significant as a test for determining whether the proceeds are separate or community property. Even under the "inception of title" theory, where the husband paid the premiums out of his separate funds, the proceeds were held to be his separate property *for this reason*. The problem arises, of course, through the failure to distinguish the tests for includibility of life insurance under the tax law from the tests for determining whether the policy, proceeds, or premiums constituted separate or community property.

Much of the confusion in the cases is attributable to the fact that prior to 1954, the "payment of premiums test" was significant for both purposes.

Fortunately, the courts have not been as rigorous in the application of the tests as the Commissioner in his 1953 ruling. Where the insured is married at the time he takes out the policy, and all the premiums are paid from community funds, the courts agree that only one-half of the proceeds are includible.<sup>53</sup> Difficulties arise only where the insurance is taken out while the insured is single and premiums are paid during marriage.

Despite the occasional reference to "inception of title" in rulings having an orientation to Louisiana<sup>54</sup> or Texas,<sup>55</sup> the courts have consistently held that the source for the payment of premiums is ultimately determinative of whether proceeds are to be treated as community or separate property.<sup>56</sup>

The question remains whether the taxpayer or the Commissioner has the burden of proving that the premiums are paid from separate or community funds. Since the determination of whether property is properly classified as community or separate property is a question of local law, the fifth circuit has taken the view that, in the absence of evidence to the contrary, payments of premiums by a married person will be considered to be out of community,

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<sup>53</sup> DeLappe v. Commissioner, 113 F.2d 48 (5th Cir. 1940) (Louisiana); Estate of S. Moody, 42 B.T.A. 987 (1940) (Texas); Townsend v. Thomas, 42-1 U.S. Tax Cas. ¶ 10,155 (D. Tex. 1942).

<sup>54</sup> Rev. Rul. 232, 1953-2 CUM. BULL. 268.

<sup>55</sup> Rev. Rul. 54-272, 1954-2 CUM. BULL. 298 (H takes out policy before marriage and pays one premium out of separate funds; H then marries and pays all other premiums out of community funds. *Held*: Since the character of the policy is determined at the time it is taken out, the policy constitutes H's separate property and the entire proceeds are includible where H retains incidents of ownership).

<sup>56</sup> Stapf v. United States, 189 F. Supp. 830 (W.D. Tex. 1960), *aff'd in part and rev'd in part on other issues*, 309 F.2d 592 (5th Cir. 1962), *rev'd as to other issues*, 375 U.S. 118 (1963) (premiums paid on policies issued prior to marriage from separate funds before marriage and from Texas community funds after marriage; *held*: "that part of the total insurance monies, measured by the same proportion as the sum of the premiums paid from the decedent's separate estate, plus one-half of the premiums paid from the community estate, bears to the total amount of all premiums paid is includible in decedent's gross estate"); Estate of O. Levy, 42 B.T.A. 991 (1940) (policies purchased subsequent to H's marriage includible at one-half their value; policies purchased prior to marriage includible to extent of premiums paid from H's separate funds or his share of the Louisiana community property); Estate of S. Moody, 42 B.T.A. 987 (1940) (proceeds of policies less one-half of proportion of total proceeds which premiums satisfied with Texas community funds bore to total premiums held includible).

rather than separate funds.<sup>57</sup> Often this will be to the taxpayer's advantage if the question is whether all or only one-half of the proceeds are includible in the decedent's gross estate. In the case, however, where the husband has transferred a policy to his wife, thereby making it her separate property, it would be wise to make sure that the premiums are clearly paid out of the wife's separate funds, to avoid the possible argument that upon the husband's death the proceeds constituted "community property" where the premiums were paid out of community funds.

From the standpoint of planning, the estate planner should remember the following:

1. *Avoid assignments of policies by a husband directly to his wife.* While a large amount of insurance is sold on the theory that the insured can place the title to the policy in his wife, good planning calls for avoidance of this method completely. In the first place, the insured not infrequently fails to completely transfer the policy. He may fail to make complete delivery of the policy; he may continue to pay premiums out of community funds; or he may subsequently try to use the policy for his own purposes, *e.g.*, as collateral to obtain a loan to assist him in his business.

Probably the most disastrous result of an incomplete transfer is that upon the husband's death, the Commissioner can move in several directions to attack his estate. He may contend, for example, that the husband never gave up incidents of ownership, with the result that at least fifty percent of the proceeds of the policy is includible in his gross estate; or he may argue that since the transfer is complete, the husband made a series of gifts to his wife by way of transfer of the policy or the premiums, which may be subject to gift tax. If gift tax returns were not filed at the time of such transfers, the husband's estate may be subject to a gift tax liability, with penalties and interest.

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<sup>57</sup> Howard v. United States, 125 F.2d 986 (5th Cir. 1942). *But see* Estate of Rule v. United States, 63 F. Supp. 351 (Ct. Cl. 1945) (taxpayer had burden of proving that premiums were paid out of post-1927, rather than pre-1927, California community property).

But even if we assume that the assignment of the policy to the wife were successful, it may be of little value from the standpoint of the over-all estate plan. If the wife should predecease the husband, the interpolated terminal reserve value of the *entire* policy (since it would be her separate property) would be includible in her gross estate. In addition, it not infrequently happens that where the policy is assigned to a wife, she is also named sole beneficiary. If she should predecease, the policy, or a portion of it, may well revert to the husband by virtue of her will, or by operation of the laws of intestacy.

2. *Use an unfunded irrevocable life insurance trust.* If the client's primary purpose is to provide liquidity of his estate without having the insurance proceeds taxed thereto, the unfunded irrevocable life insurance trust will normally be the wisest solution. Typically, this trust is established during the lifetime of the settlor with an independent trustee as assignee and beneficiary of the policy. The settlor makes annual gifts of sufficient monies to pay premiums on the policies on his own life. Then, at the death of the insured, the insurance company pays the proceeds of the policy to the trustee who, by the terms of the trust, has the power to purchase assets from the estate of the insured. The trustee purchases these assets, thereby providing liquid funds for the estate. To prevent the transfer of funds to pay premiums from being classified as gifts of present interests, it will be necessary, more often than not, to invest the trustee with broad discretion with respect to the administration of the trust. The result is that it may be necessary to forego the annual \$3,000 exclusions for donees. If it is desired to take advantage of these exclusions, section 2503(c) trusts may be used where the beneficiaries are minors, or the donor may set up a wholly separate gift program whereby property other than insurance or funds for the payment of premiums becomes the subject of the gifts.

### *Preserving the Family Business*

After the problems of liquidity and meeting the death tax burden have been resolved, the next major planning



objective is often the preservation of the decedent's interest in a family business. While this may be done by having an unfunded life insurance trust purchase the business assets from the decedent's estate, it is sometimes more satisfactory to arrange for the business to purchase the decedent's interest.

The buy-sell agreement funded with life insurance provides a convenient method for accomplishing this result. Where the only persons involved are members of the same family, the planning problems are quite different from those present when two or more business associates are dealing with one another at arm's length. In the latter case, the plan may have to be arranged with a view to liquidating the decedent's interest for the estate.

*Where Surviving Business Interests do not Belong to Members of the Decedent's Family*

Assume that two partners, *A* and *B*, have been operating a mercantile business for some years. A plan is adopted whereby the first to die will sell his interest to the survivor. The principal problem is finding the liquid assets in the hands of the surviving partner to buy out the deceased partner's interest. The solution is an insurance plan to provide the necessary liquidity.

A buy-sell agreement, drawn either as a separate agreement, or as a part of a revised partnership agreement, sets out the terms whereby the estate of the first to die will sell to the survivor. In a two or three-man partnership, each partner takes out insurance on the life of the other. The agreement provides that in the event of the death of a partner, the surviving partner(s) will buy the deceased partner's interest. With four or more partners, this "cross-purchase" arrangement becomes awkward, and the "entity" approach, whereby the partnership entity purchases the insurance, is used.

Both methods present planning problems: if the partners are of different ages, adjustments must be made for differences in premium costs. Moreover, the partner who most needs the insurance is often the least insurable. Family

facts are important: partner *A* may have a son capable of taking over his interest in the business, while partner *B* may be childless and unconcerned about the disposition of his interest at death. Or *A* may be a grandfather, while *B* is raising a family. Or the partnership may be of the personal service type, where much of the value dies with the death of the partner.

In drafting the buy-sell agreement, the planner carefully considers the nature of the business. One of his problems is its ever-changing value, with the resulting effect on the price which the surviving partners are willing to pay.

If the agreement is carefully drawn, the price fixed by arm's length bargaining will control the valuation of the partner's interest for estate tax purposes. The estate must be bound to sell either by giving the surviving partners an option or by binding all the parties. In addition, the price must not be so grossly inadequate as to make the agreement a "mere gratuitous promise."<sup>58</sup>

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<sup>58</sup> Rev. Rul. 59-60, 1959-1 CUM. BULL. 237; Rev. Rul. 54-76, 1954-1 CUM. BULL. 194 (binding option to purchase controlling where corporation exercises option). Many cases have upheld estate tax valuations based on various types of buy-sell agreements. See, e.g., *Brodrick v. Gore*, 224 F.2d 892 (10th Cir. 1955) (date-of-death book value controls where partner's estate was bound to sell deceased partner's interest to co-partners); *Worcester County Trust Co. v. Commissioner*, 134 F.2d 578 (1st Cir. 1943) (restrictions on stock transfer affected value); *Lomb v. Sugden*, 82 F.2d 166 (2d Cir. 1936) (value of closely held stock based on stockholders' agreement); *Wilson v. Bowers*, 57 F.2d 682 (2d Cir. 1932) (value reduced by virtue of binding option effective at death); *Citizens Fidelity Bank & Trust Co. v. United States*, 209 F. Supp. 254 (W.D. Ky. 1962) (valid option agreement fixed value for estate tax purpose; agreement not valid under rule against perpetuities or as restraint on alienation); *Davis v. United States*, 5 Am. Fed. Tax R.2d 1902 (D. Utah 1960) (value determined by binding and valid partnership agreement); *Angela Fiorito*, 33 T.C. 440 (1959) (value of decedent's partnership interest limited to option price); *Estate of Orville B. Littick*, 31 T.C. 181 (1958); *Estate of Albert I. Salt*, 17 T.C. 92 (1951) (restrictive agreement controlling); *Estate of Lelia E. Coulter*, 7 T.C. 1280 (1946); *Estate of John Q. Strange*, 42 P-H TAX Cr. MEM. 605 (1942) (option price held controlling); *Estate of John T. H. Mitchell*, 37 B.T.A. 1 (1938) (value based on purchase agreement); *Anson v. Prouty*, 5 B.T.A. 107 (1926). On the other hand, there have been a number of cases where the agreement was not so strictly drafted as to affect the value of the business interest. *United States v. Land*, 303 F.2d 170 (5th Cir. 1962) (discount on value when sold during life did not affect value at death); *Armstrong's Estate v. Commissioner*, 146 F.2d 457 (7th Cir. 1944) (value not affected by purchase agreement); *Estate of Harry W. Hammond*, 55 P-H TAX Cr. MEM. 69 (1955); *Estate of James H. Matthews*, 3 T.C. 525 (1944); *Estate of Virgil D.*

Some buy-sell agreements provide that the deceased partner's interest shall be bought at a fixed price or at a price determined from the book value of the assets, often without any allowance for good will. Others provide for an appraisal of the deceased partner's interest upon his death. Still other agreements set prices which are contingent upon future earnings expectations. Whatever the method, the planner must provide an arrangement which will be equally valid if a partner should die tomorrow, or thirty years hence.

By combining some of these methods, the planner can reach a realistic result. He may provide that the assets should be periodically revalued (*e.g.*, once a year, or once every two years), and in the event of a failure to do so over a long period of time (*e.g.*, five years), book value, or a value to be derived by some appraisal method, should be controlling. Whatever method is chosen, he must make certain that the life insurance proceeds will be sufficient to purchase the decedent's interest from his estate. Thus, a periodic review of the client's business assets and estate becomes essential.

If the planner's method produces too low a valuation the results can be disastrous. Low valuation for estate tax purposes may cause the deceased partner's estate to have an undesirable basis for the partnership interest, or for the consideration received upon the liquidation of such interest.

An unrealistic valuation may result in burdensome litigation with the decedent's heirs. In one case, a young man convinced his senior partner, who was much older, that an extremely low valuation in the buy-sell agreement would be desirable for estate tax purposes. Upon the death of the senior partner, the young man bought the deceased's interest in the partnership at the low price fixed in the agreement. Thereupon, the deceased partner's widow sought to have the contract nullified as unconscionable. The court ruled for her, and required the young man to pay her the fair market value of the deceased partner's interest. Needless to say,

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Giannini, 2 T.C. 1160 (1943), *aff'd without discussion of point*, 148 F.2d 285 (9th Cir. 1945) (decedent had full power to dispose of property during life, option in brother arose only on decedent's death).

the Internal Revenue Service revalued the deceased partner's interest in the light of this decision.<sup>59</sup>

If the partnership continues to increase in value, there may be insufficient insurance proceeds to purchase the deceased partner's interest. Or, conversely, if it appears that the proceeds will be in excess of the amount needed to purchase the interest of the partner at death, provision must be made for the disposition of the excess. The partnership should consider whether insurance is the best method for funding the agreement. In some situations, it may be more desirable to provide a combination of life insurance with other forms of investment, thus providing flexibility in the total funds available.

If the cross-purchase plan is used, the interpolated terminal reserve value of the cross-insurance owned by a partner on the life of another partner will be included in the *owner's* gross estate for estate tax purposes if he should predecease the insured. Similarly, a pro rata portion of the proceeds of entity insurance may be included in a partner's estate, unless the parties are careful to eliminate all individual incidents of ownership. Cross-insurance should be payable to and owned by the surviving partners. Entity insurance should be payable to and owned by the partnership. This is true, despite some case law which indicates the desirability of having key-man insurance payable to the family of the insured.<sup>60</sup> Insurance should be *incidental* to the buy-sell agreement, not an integral part of the arrangement. While insurance is only one method of funding a buy-sell agreement, in most cases it is the most desirable. Since the insured has no incidents of ownership, nothing is includible in his gross estate for estate tax purposes. The surviving partners are not liable for any income tax, since the proceeds are payable by reason of the death of the insured.

No gain or loss is realized by the partner's estate on the sale of the interest since it receives a stepped-up basis

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<sup>59</sup> Cf. *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957) (minority stockholder entitled to establish fairness of transaction on remand).

<sup>60</sup> See *Ducros v. Commissioner*, 272 F.2d 49 (6th Cir. 1959). The Commissioner will not follow this decision. Rev. Rul. 61-134, 1961-2 CUM. BULL. 250.

equal to the fair market value of the partnership interest at the date of the death of the partner. In handling the purchase of the interest, the purchasers must be careful to provide for any optional inside basis adjustment among the surviving partners.<sup>61</sup> Care must be taken that the sale generates no ordinary income to the seller by reason of the sale of "unrealized receivables" or substantially appreciated inventory.<sup>62</sup>

*Where Surviving Business Interests Belong to Members of the Same Family*

When we turn to the problems of planning the estate for one whose business interests will pass to members of his own family, the planning problems must be approached in a different manner. To illustrate these problems, assume a more or less typical situation involving a family corporation:

Father, now age sixty, formerly owned all of the outstanding stock of Widgets, Inc. By some earlier planning, he transferred one-fourth of the outstanding stock to Son, who is married and has three children. Son works in Father's business as vice-president in charge of production. Father also transferred another one-fourth of the stock to a trust for the benefit of Daughter. By the terms of the trust, the trustee might pay or accumulate income for the benefit of Daughter during her lifetime, and at her death, distribute the principal and accumulated income to her then living children. Daughter is married to a doctor and has two children. Since Widgets, Inc., has followed a policy of not paying a dividend, Daughter has never realized any income from the trust.

How might life insurance be used to accomplish Father's estate objectives, and preserve the family business?

As applied to Son and Daughter, Father's estate objectives are quite different. Daughter's interest in Widgets, Inc., is that it may some day pay her a dividend income, and provide her children with an appreciated investment.

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<sup>61</sup> INT. REV. CODE OF 1954, §§ 743, 754.

<sup>62</sup> INT. REV. CODE OF 1954, § 751.

Son's primary interest in the business will be to improve the Company along lines envisioned by Father. He wants Widgets, Inc., to expand, and perhaps eventually "go public," becoming a strong growth stock.

Not to be forgotten is Widow. Upon Father's death, if she survives him, one-half of his holdings will go to her either as her one-half of the community property, or through a marital deduction trust if Father's stock is his separate property. Assuming Father's will provides that she shall take this one-half, and that the remaining one-half of Father's interest will pass to Son outright and to Daughter's trust, in equal shares, after the death of Father, Widow will own 25 per cent of Widgets, Inc., while Son and the trust for Daughter will each own  $37\frac{1}{2}$  per cent.

What arrangements should Father make to insure a satisfactory disposition of his estate at death?

First of all, assuming Father is insurable, Widgets, Inc., can insure his life. The premiums paid will not constitute income<sup>63</sup> to Father, nor will they be deductible<sup>64</sup> to Widgets, Inc. On Father's death, Widgets, Inc., will use the funds to redeem Father's stock. No gain will be recognized to Father's estate, since the estate will acquire a stepped-up basis on Father's death.<sup>65</sup> To the extent that the proceeds from the redemption are used to pay death taxes or funeral and administration expenses under section 303, there is no danger of the redemption being treated as a dividend.<sup>66</sup> To qualify for this special treatment, Father's stock ownership in Widgets, Inc., must equal more than 35 per cent of his gross estate or 50 per cent of his taxable estate.<sup>67</sup> If quali-

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<sup>63</sup> *Sanders v. Fox*, 253 F.2d 855 (10th Cir. 1958); *Prunier v. Commissioner*, 248 F.2d 818 (1st Cir. 1958); *Casale v. Commissioner*, 247 F.2d 440 (2d Cir. 1957). The Internal Revenue Service will follow these cases. Rev. Rul. 59-184, 1959-1 CUM. BULL. 65.

<sup>64</sup> INT. REV. CODE OF 1954, § 264(a)(1); Treas. Reg. § 1.264-1. Premiums may be deductible as a business expense of the employer, Widgets, Inc., under § 162, where premiums represent additional compensation to employees. In that event, the added income is includible in the employee's gross income. Such a plan might be used to avoid an excessive accumulation of profits or where it was feared that compensation of Father might otherwise be deemed excessive.

<sup>65</sup> INT. REV. CODE OF 1954, § 1014.

<sup>66</sup> INT. REV. CODE OF 1954, § 303(a).

<sup>67</sup> INT. REV. CODE OF 1954, § 303(b)(2)(A).

fiction under section 303 is impossible, or if additional liquidity is desired, additional redemptions after Father's estate is closed may proceed under the special rules of section 302.

In working out a substantially disproportionate redemption, or a redemption of stockholder's entire interest, the planner must proceed with utmost caution.

After Father's death, Widow will own 25 per cent, Son  $37\frac{1}{2}$  per cent, and the trust for Daughter  $37\frac{1}{2}$  per cent. Under the new rules for attribution to estates, while Father's estate is in administration, it will be deemed to own 100 per cent of the stock.<sup>68</sup> A stock redemption under section 302 at this time will be treated as a dividend.<sup>69</sup> But suppose the parties wait until the estate is closed. Now, for purposes of section 302, Widow will be deemed as owning 100 per cent of the stock,<sup>70</sup> while Son and the trust for Daughter will each be deemed to own  $62\frac{1}{2}$  per cent of the stock.<sup>71</sup> Hence, if all of the stock ( $37\frac{1}{2}$  per cent) owned by the trust for Daughter is redeemed, such a redemption would qualify as a substantially disproportionate redemption,<sup>72</sup> although it would not qualify as a redemption of a stockholder's entire interest.<sup>73</sup>

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<sup>68</sup> INT. REV. CODE OF 1954, § 318(a)(3)(A). Attribution from the estate causes the stock to be deemed as owned in proportion to the beneficiaries' interest. INT. REV. CODE OF 1954, § 318(a)(2)(A).

<sup>69</sup> The chances of qualifying the redemption under § 302(b)(1) are so negligible that they may be ignored.

<sup>70</sup> Widow is deemed as owning the stock of both Son and the trust for Daughter. INT. REV. CODE OF 1954, § 318(a)(1)(A)(ii). The interest owned by the trust for Daughter is treated as owned by Daughter by virtue of the language "directly or indirectly."

<sup>71</sup> While Widow's ownership (25%) is attributed to both Son and the trust for Daughter, § 318(a)(1)(A)(ii), the attribution to them cannot cause their stock to be attributed to each other. INT. REV. CODE OF 1954, § 318(a)(5)(B). Sidewise attribution for partnerships, estates, trusts and corporations was not eliminated until 1964. See § 318(a)(5)(C).

<sup>72</sup> INT. REV. CODE OF 1954, § 303(b)(2). The ratio of the stock attributed to the trust for Daughter after the redemption (40%) is less than 80% of the ratio of the stock attributed to the trust for Daughter before the redemption ( $62\frac{1}{2}\%$ ), as required by § 302(b)(2)(C). The trust for Daughter also owns less than 50% of the outstanding stock after the redemption, as required by § 302(b)(2)(B).

<sup>73</sup> The 25% of the stock owned by Widow would still be attributable to the trust for Daughter, thereby preventing a redemption of Daughter's entire interest. Cf. § 302(b)(3). The family attribution rules can, of course, be avoided by Father's redeeming his interest prior to his death.

By providing additional liquid funds for the corporation to redeem more than that amount of stock necessary to meet death taxes and funeral and administrative expenses, the planner gives additional flexibility to the estate. The trust for Daughter may use this additional liquidity to purchase a diversified portfolio of investments thereby achieving the estate objective of Father insofar as Daughter was concerned. On the death of Widow, her 25 per cent ownership may pass directly to Son, thereby giving him complete control of Father's business.

Alternatively, of course, if Son has been successful in causing Widgets, Inc., to "go public," the stock may have acquired sufficient liquidity that some of the problems that characterized Father's estate will have disappeared.

While the provision for liquidity—having the business purchase life insurance on its key men—is obviously advantageous from the standpoint of resolving many of the problems that center around the demise of the principal leader of a business, the income tax advantages to the business must not be forgotten.

One of the principal advantages, of course, is the absence of any realization of gain on the difference between the consideration paid in the form of premiums and the proceeds received upon the death of the insured.<sup>74</sup> This advantage

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§ 302(c). This approach, however, requires that Father realize a substantial capital gain which could be avoided by postponing the redemption until after death.

<sup>74</sup> INT. REV. CODE OF 1954, § 101(a)(1). Death benefits having characteristics of life insurance proceeds are likewise excluded. Treas. Reg. § 1.101-1(a). If the contract involves no risk, it will not qualify as "insurance" resulting in a loss of the exclusion. Rev. Rul. 55-313, 1955-1 CUM. BULL. 219 (single premium deferred annuity; no risk where insurer required to pay the higher of consideration paid or cash surrender value in event insured died before first payment); Rev. Rul. 65-57, 1965-1 CUM. BULL. 56 (no risk in single premium insurance-annuity combinations). Similarly, the life insurance proceeds will not qualify where one who takes out insurance has no insurable interest in insured. *Atlantic Oil Co. v. Patterson*, 331 F.2d 516 (5th Cir. 1964). *But cf. Ducros v. Commissioner*, 272 F.2d 49 (6th Cir. 1959) (transfer by corporation, having insurable interest in its president, to stockholder-beneficiary; applicant of policy had insurable interest in insured). At times, whether a particular payment constitutes life insurance or non-excludable death benefits varies with the circumstances. *Estate of Clarence L. Moyer*, 32 T.C. 515 (1959) (stock exchange "gratuity fund" held to be life insurance proceeds); Rev. Rul. 63-76, 1963-1 CUM. BULL.



can be lost, however, if one runs afoul of the transfer for value rule.

Under the terms of the rule, the exemption for life insurance proceeds payable by reason of the death of the insured is lost where the policy was acquired for a valuable consideration.<sup>75</sup> The rule does not apply, however, in two situations: (1) where the basis of the transferee is determined by reference to the transferor; and <sup>76</sup> (2) where the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.<sup>77</sup>

The second of these two exceptions presents a significant tax break for the insured: the corporation in which the insured is a stockholder or officer may buy from the insured a policy on which he may have paid substantial premiums. The insured acquires substantial cash from the corporation without suffering the consequences of a dividend (or even capital gain, if the corporation pays an amount equal to the insured's investment in the policy) and transfers the policy without any gift or estate tax consequences.<sup>78</sup> Indeed, such a transfer would be at least partially excluded from the gross estate of the insured even if made in contemplation of death, since section 2043 exempts such transfers to the extent that they are made for an adequate and full consideration in money or money's worth.

The transfer for value rule is not without some tax traps. Quite often, transfers of life insurance policies will be made among the insured, the corporation, or the beneficiary without the careful planning essential for success.

23 (payments to beneficiary after death of one who had enjoyed retirement plan). *But cf.* *Essenfeld v. Commissioner*, 311 F.2d 208 (2d Cir. 1962).

<sup>75</sup> INT. REV. CODE OF 1954, § 101(a)(2); Treas. Reg. § 1.101-1(b).

<sup>76</sup> INT. REV. CODE OF 1954, § 101(a)(2)(A); Treas. Reg. § 1.101-1(b)(5), Examples (2), (3), and (4).

<sup>77</sup> INT. REV. CODE OF 1954, § 101(a)(2)(B); Treas. Reg. § 1.101-1(b)(5), Examples (5) and (7). The partnership or corporation may purchase a policy from the insured at his cost, thereby causing him to receive cash without tax detriment.

<sup>78</sup> In the absence of this exception, the fact that the transfer was in contemplation of death will not prevent the proceeds from being included under the transfer for value rule. *Bourne Bean*, 14 C.C.H. TAX CT. MEM. 786 (1955).

Recently, for example, on an estate tax audit of a wealthy lady (W), who had been the major stockholder of a family corporation, the following facts were discovered: the corporation had many years previously taken out a \$500,000 policy on the life of W (the widow of the founder and former president of the corporation), and had subsequently borrowed the maximum loan value (\$100,000) on the policy. Thinking that the policy would cause the stock in W's estate to have an inflated value at her death, the corporation transferred the policy, subject to the debt, to W's children. It was thought that this would provide the children with the necessary liquidity to meet the estate tax liability on their mother's death. The children then discovered that they would be recipients of a transfer for value by virtue of their assumption of the debt.<sup>79</sup> Accordingly, it was decided to transfer the policy back to W, since section 101(a)(2)(B) specifically exempts from the transfer for value rule a transfer to the insured. None of these transactions were reported at the time they occurred, but on the audit of W's estate tax return, the Commissioner contended:

1. At the time the policy was transferred by the corporation to the children, W received a dividend equal to the interpolated terminal reserve value of the policy, less the debt assumed;
2. W made a taxable gift to the children of the same amount;
3. When the children transferred the policy back to W, they made a taxable gift back to her. While they eliminated the difficulty of the transfer for value rule, they unfortunately

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<sup>79</sup> See *Spokane Dry Goods Co.*, 43 P-H TAX CT. MEM. 559 (1943); *cf.* *Desks, Inc.*, 18 T.C. 647 (consideration greater than proceeds; proceeds not taxed). Policies merely pledged are not considered transferred. Proceeds received by the creditor are regarded as ordinary collection of a debt. But, if creditor receives tax benefit by taking bad debt deduction, proceeds are fully taxable. *St. Louis Refrigerating & Cold Storage Co. v. United States*, 66 F. Supp. 62 (E.D. Mo.), *aff'd.*, 162 F.2d 394 (8th Cir. 1947); *T.O. McCamant*, 32 T.C. 824 (1959); *cf.* *Durr Drug Co. v. United States*, 99 F.2d 757 (5th Cir. 1938) (not taxable where taxpayer creditor induced individual debtor to insure himself for creditor's benefit, even though creditor had taken bad debt deduction).

caused the \$500,000 proceeds of the policy to be included in W's gross estate, since she now possessed the incidents of ownership.

Had the children discovered their unfortunate situation after the transfer by the corporation to them, a wiser course would have been to have the policy cancelled for its cash surrender value and to use the proceeds to purchase a new policy on their mother's life. The amount of gain on such cancellation would be small, since their basis would equal the basis which W acquired by virtue of having realized the dividend, plus the \$100,000 of debt which they assumed.

### *Planning the Employees' Insurance Program*

Once the problems of liquidity of the estate, and the preservation of the family business have been resolved, the planner turns to a consideration of various approaches for improvement of the client's life insurance program through his employer. Since our hypothetical client, Father, is an employee of Widgets, Inc., several employee plans are available to assist him in the building and conservation of his estate.

#### *Group Life Insurance*

One of the oldest fringe benefits recognized by the tax law is group-term life insurance. Where the employer pays the premiums on such policies, he is entitled to a deduction,<sup>80</sup> although the premiums are not taxed as income to the employee.<sup>81</sup> In 1964, Congress limited this tax benefit by providing that the cost of protection over \$50,000 constituted income to the employee.<sup>82</sup> Income to the employee on this

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<sup>80</sup> O. 1014, 2 CUM. BULL. 88 (1920) (deduction allowed as ordinary business expense for premiums paid on group policies where employees designated beneficiaries); Rev. Rul. 400, 1956-2 CUM. BULL. 116 (deduction allowed on group life and hospitalization policies for commission salesmen, whether or not employer-employee relation exists).

<sup>81</sup> O. 1014, 2 CUM. BULL. 88 (1920) (premiums paid by employer on lives of employees not taxable as income to employees); G.C.M. 16069, XV-1 CUM. BULL. 84 (1936).

<sup>82</sup> INT. REV. CODE OF 1954, § 79, added by Revenue Act of 1964, 78 Stat. 36 (1964).

excess is based on rates for term insurance without loading charges.<sup>83</sup>

There are several exceptions to the new rule: (1) an employee retired for age or disability is fully exempt;<sup>84</sup> (2) the employee is not taxed to the extent that the employer is a beneficiary directly or indirectly,<sup>85</sup> or if a charity is the sole beneficiary;<sup>86</sup> (3) the rule does not apply to any group life insurance which is part of a qualified pension or profit sharing plan.<sup>87</sup>

The statute does not affect the tax status of group *permanent* life insurance. The purchase by the employer of such insurance constitutes income to the employee in the same way as the purchase of individual life policies.<sup>88</sup> The employer receives a corresponding deduction as a business expense, so long as he is not a direct or indirect beneficiary of the insurance.<sup>89</sup>

If the right of the employee to permanent insurance is forfeitable on termination of his employment, the premiums are not taxable to the employee,<sup>90</sup> nor are they deductible to the employer.

<sup>83</sup> The following table is used to compute the cost of group-term life insurance on an employee's life for purposes of determining the amount includible in his gross income:

<i>5-year age bracket</i>	<i>Cost per \$1000 of Protection for 1-month period</i>						
Under 30	....	....	....	....	....	....	\$.08
30-34	....	....	....	....	....	....	.10
35-39	....	....	....	....	....	....	.14
40-44	....	....	....	....	....	....	.23
45-49	....	....	....	....	....	....	.40
50-54	....	....	....	....	....	....	.68
55-59	....	....	....	....	....	....	1.10
60-64	....	....	....	....	....	....	1.63

The age of the employee is his attained age on the last day of his tax year. If he has attained an age greater than age 64, he is treated as if he were 63. INT. REV. CODE OF 1954, § 79(c); Rev. Rul. 65-28, 1965-1 CUM. BULL. 527.

<sup>84</sup> INT. REV. CODE OF 1954, § 79(b) (1).

<sup>85</sup> INT. REV. CODE OF 1954, § 79(b) (2) (A).

<sup>86</sup> INT. REV. CODE OF 1954, § 79(b) (2) (B).

<sup>87</sup> INT. REV. CODE OF 1954, § 79(b) (3).

<sup>88</sup> Mem. 6477, 1950-1 CUM. BULL. 16.

<sup>89</sup> Rev. Rul. 56-400, 1956-2 CUM. BULL. 116 (deduction allowed for premiums on group life and hospitalization policies, benefits of which accrue to commission salesmen, whether or not employer-employee relationship exists).

<sup>90</sup> Mem. 6477, 1950-1 CUM. BULL. 16.

Group-term, obviously, is the best policy for Widgets, Inc. It provides the employer with a deduction without income to the employee. If the employee leaves the service of the employer, he may convert to a permanent form of life insurance without adverse tax consequences.<sup>91</sup> Most life insurance policies permit this conversion within a certain period (*e.g.*, 30 days) after termination of employment without the necessity of a physical examination.

Although group-term policies have been a favorite of the income tax law, they are not necessarily exempt from estate tax. Whether they are depends upon the absence of incidents of ownership in the insured. Some group policies have provisions prohibiting the assignment of the policy.<sup>92</sup> Such provisions might be removed from the policy or waived by the insurer so that the insured can make an assignment. The insured should also assign his conversion privilege so that the assignee can convert the policy to permanent life if the insured should terminate his employment.

If assignment of the policy is impossible, the insured may make an irrevocable designation of beneficiary. While it has been contended that such a designation does not survive the term of the contract,<sup>93</sup> with the result that one would have to make repeated assignments with the commencement of each new term, the sounder view is that the group life contract is a continuing one, and the rights of one who had been irrevocably designated beneficiary would continue despite subsequent renewals of the contract.<sup>94</sup>

Under *Treganowan*,<sup>95</sup> the insured has an incident of ownership by virtue of his power to terminate his employment, and thereby to terminate the insurance. He can remove this incident, however, by assigning the right to

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<sup>91</sup> Rev. Rul. 54-165, 1954-1 CUM. BULL. 17.

<sup>92</sup> The validity of provisions against assignments in group life policies has been upheld. *Metropolitan Life Ins. Co. v. Brown*, 300 S.W. 599 (Ky. 1927).

<sup>93</sup> See, *e.g.*, *Frey v. Feller*, 127 N.Y.S.2d 302 (Sup. Ct. 1953), holding that an irrevocable beneficiary designation did not survive the one year term in which it was made where there was a substitution of new group policies and new insurers.

<sup>94</sup> *In re Johnson's Estate*, 208 N.Y. Supp. 655 (Sup. Ct. 1925); see *Garner v. Germania Life Ins. Co.*, 110 N.Y. 266, 18 N.E. 130 (1888).

<sup>95</sup> *Commissioner v. Estate of Strauss*, 183 F.2d 288 (2d Cir.), *cert. denied*, 340 U.S. 853 (1950) (New York Stock Exchange death gratuity held includible since insured could terminate benefit under the fund by selling his seat).

convert the policy in the event of such termination. If assignment is impossible, the conversion privilege may be irrevocably waived by an instrument signed by the employer, insurer and insured.

### *Pension and Profit Sharing Plans*

A qualified pension or profit sharing plan may be used to incorporate the advantages of group life insurance and has additional tax advantages. There are, of course, a variety of ways for funding such plans. Life insurance is used either alone or in conjunction with other types of investment to provide funds for the employer to pay the employee upon the latter's death or retirement. The tax advantages of the qualified plan are well known. The employer's contributions are deductible to the employer,<sup>96</sup> and are not income to the employee.<sup>97</sup> Death benefits attributable to the employer's contributions are not subject to estate tax.<sup>98</sup> If the employee receives a lump sum settlement, he is entitled to long-term capital gains treatment.<sup>99</sup> If benefits are paid to the employee upon retirement in the form of an annuity, the favorable tax rules of section 72 for the taxation of annuities are applicable. Since a qualified pension or profit sharing plan is itself a tax-exempt organization, accretions to the fund are tax-free.

A variety of methods are available to fund a pension or profit sharing plan through life insurance. Retirement income policies are used in a fully insured plan. Such policies provide death benefits in the event the insured fails to live to retirement. A combination plan makes use of ordinary life insurance policies convertible upon retirement. In such a plan, part of each annual employer contribution is used to pay the life insurance premium, and the balance is placed in trust, or left with the life insurance company under a deposit administration agreement. If the insured dies prior to retirement, his beneficiary receives the proceeds of the ordinary life policy. If he lives to retirement, the cash value of the policy plus amounts from the trust or

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<sup>96</sup> INT. REV. CODE OF 1954, § 404.

<sup>97</sup> INT. REV. CODE OF 1954, § 403.

<sup>98</sup> INT. REV. CODE OF 1954, § 2039(c).

<sup>99</sup> INT. REV. CODE OF 1954, § 403(a) (2).

deposit administration fund provide the corpus for his retirement benefits.

In a profit sharing plan, as much as 30 per cent of the aggregate contributions may be invested in life insurance. In some plans such an investment is required; in others, the participant is given a choice to place a portion of his funds in either life insurance or other investments. Since the investments of a qualified pension or profit sharing plan in life insurance will qualify for purposes of bond investment, other trust assets will be freed for equity investments.

### *Non-qualified Plans*

Group life insurance and pension and profit sharing plans require a wide participation of all, or nearly all, employees. While Father will profit from participation in these plans, the planner may desire to use one of several alternative plans which do not require such wide participation. Non-qualified pension plans, split-dollar insurance, minimum deposit insurance, and deferred compensation contracts are all available for the further development of the client's estate plan.

Under a non-qualified pension or profit sharing plan, contributions of the employer are income to the employee<sup>100</sup> and are deductible by the employer<sup>101</sup> if the employee's rights in the plan are nonforfeitable. If his rights are forfeitable at the time of contribution, the contributions are neither deductible by the employer<sup>102</sup> nor are they income to the employee.<sup>103</sup>

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<sup>100</sup> INT. REV. CODE OF 1954, § 403(c); Treas. Reg. § 1.403(c)-1(a).

<sup>101</sup> INT. REV. CODE OF 1954, § 404(a) (5). The deduction is available (1) in the tax year that it is paid, (2) to the extent allowed for pension plans, generally, and (3) if the employees' rights arising from the contribution are nonforfeitable when the contribution is paid.

<sup>102</sup> *River Fuel Corp. v. Kohler*, 266 F.2d 190 (8th Cir.), cert. denied, 361 U.S. 827 (1959) (no deduction where employee received only his contributions on severance of employment or withdrawal from plan); *Wesley Heat Treating Co. v. Commissioner*, 267 F.2d 853 (7th Cir. 1959); *Russell Mfg. Co. v. United States*, 175 F. Supp. 159 (Ct. Cl. 1959) (deduction denied for amount contributed, but allowed for amount paid employee where employee's rights vested at time of contribution, but were lost if employee left company before a certain date). *But see* Rev. Rul. 59-383, 1959-2 CUM. BULL. 456 (the Internal Revenue Service will not follow *Russell Mfg. Co.*).

<sup>103</sup> Treas. Reg. § 1.403(a)-1(b). If rights subsequently become nonforfeit-

Whether the death benefits under a non-qualified plan are subject to the federal estate tax depends upon the applicability of several different sections of the estate tax law to the terms of the plan.

*a. Section 2033*

Avoidance of section 2033 is obtained by making sure that the decedent has no "interest in property" at death. The line drawn between situations where the decedent has the unilateral power to designate the beneficiary at his death<sup>104</sup> and where such a designation can only be exercised in conjunction with another<sup>105</sup> is much too tenuous a distinction for planning. A better approach is to make sure that the decedent has no power at all to change the designation of the beneficiary.

*b. Section 2039*

Making the beneficiary designation irrevocable would not necessarily remove death benefits under a non-qualified plan from the sweep of section 2039. The test of includibility under this section is whether the decedent's rights to the death benefits are forfeitable.<sup>106</sup>

Section 2039(a) provides that the gross estate shall include "the value of an annuity or other payment" receivable by a beneficiary

if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.

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able, the employee includes in his gross income the value of the contract attributable to the contribution in the year that the change occurs. Treas. Reg. § 1.403(d)-1. Such amount goes to increase his investment in the contract. INT. REV. CODE OF 1954, § 403(b) (6).

<sup>104</sup> G.C.M. 27242, 1952-1 CUM. BULL. 160.

<sup>105</sup> Estate of Edward H. Wadewitz, 39 T.C. 925 (1963), *aff'd on another issue*, 339 F.2d 980 (7th Cir. 1964).

<sup>106</sup> *Ibid.*



In *Bahen's Estate*,<sup>107</sup> the Court of Claims considered an unqualified pension plan of the Chesapeake and Ohio Railroad. By the terms of the plan, the employee was entitled to (1) deferred compensation, whereby he or his beneficiary would receive a certain amount either before or after retirement, and (2) a death benefit, whereby the decedent's beneficiary would receive a continuation of salary.

The decedent died prior to reaching retirement, and the employer paid his widow \$100,000 in sixty equal monthly installments under the deferred compensation plan, and a sum equal to three-months salary as a death benefit. The Court of Claims first ruled that the value of the right to \$100,000 was includible:

1. The plan under which the payment was made, though adopted unilaterally by the company, was a "contract or agreement" within the meaning of the statute.

2. The payments received by the widow were an "annuity or other payment."

3. The decedent "possessed the right to receive an annuity or other payment."

4. While the amounts were not payable to the decedent at death, he did possess the "right to receive," and this includes his interest in future contingent benefits.

5. He possessed this right to receive for a period that did not end before his death.

6. The employer's contributions are attributed to the decedent by virtue of the statute.

7. The statute is not confined to the situation where the decedent is receiving the benefit of a survivorship annuity at the time of his death.

8. The construction adopted by the court is in harmony with the basic concepts of the estate tax.

While the court was unable to find that the payments under the death benefit plan fell within the language "an-

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<sup>107</sup> *Bahen's Estate v. United States*, 305 F.2d 827 (Ct. Cl. 1962).

nuity or other payment," the payments were includible in the decedent's gross estate since the court felt that the Regulations required that the "plans of the C. & O. . . . be deemed a coordinated whole for the purposes of section 2039."<sup>108</sup>

That death benefits must be considered as part of the overall plan for employees was re-emphasized in another recent case involving an unqualified plan for some executives of Standard Oil Company of New Jersey.<sup>109</sup> The plan was unfunded and provided for twelve equal payments to certain surviving dependents of the decedent equal to twelve times the monthly retirement allowance payable to a retired employee under the company's annuity plan. The annuitant had no power to designate the beneficiary, but he could exclude any person from the stated classes of eligible beneficiaries. The district court held that the payments were "insurance" specifically excluded by the language of section 2039. They were not includible under section 2042 since the decedent possessed no incidents of ownership. Nor were they includible under sections 2035 through 2038 since they did not consist of any property with reference to which the decedent had made a transfer. Finally, they were not includible under section 2033 or 2041 since the decedent had no interest in the payments at his death.

On appeal by the Government, the second circuit reversed<sup>110</sup> and held that, considering the annuity plan and the death benefit plan together, the payments under the latter were not insurance.

Whether qualified or not, all pension plans will have a variety of benefits for employees. One benefit will be a death payment to the employee's beneficiary in the event of his death prior to retirement. If he lives until retirement, he will receive an annuity, taxable to him under section 72 during the retirement period. At his death, his beneficiary will receive a death benefit, such as in *McCobb*, a survivorship

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<sup>108</sup> *Id.* at 835.

<sup>109</sup> *McCobb v. All*, 206 F. Supp. 901 (D. Conn. 1962).

<sup>110</sup> *All v. McCobb*, 321 F.2d 636 (2d Cir. 1963). The holding of the Court of Appeals was in accord with the Commissioner's Regulations under Section 2039. Treas. Reg. § 20.2039-1(b) (2), Example (6).

annuity. In either event, whether the death benefit arises before or after retirement, it will be included under section 2039. The one possible exception, according to *Wadewitz*, is where the decedent's rights are forfeitable.

A wiser approach is to qualify the plan so that all benefits attributable to the employer's contributions will be expressly exempt from the estate tax.

### *Split Dollar and Minimum Deposit Insurance*

In recent years, two plans for the purchase of life insurance with a minimum expense to the employee have become increasingly popular. The first is "split dollar" insurance. The employer pays a portion of the life insurance premium on the life of the employee.<sup>111</sup> Such payments may be viewed either as loans from the employer or as payments of additional compensation. In 1955, the Commissioner took the former view,<sup>112</sup> but in 1964, he revoked this ruling, and held that the employee must include as income the value of any insurance protection provided by his employer in excess of the portions allocable to premiums paid by him.<sup>113</sup> There would be no corresponding deduction for the employer.<sup>114</sup>

Minimum deposit life insurance operates in much the same way as split dollar, with the exception that the insurer, bank or other lender, advances the sums to pay the excess portion of the premiums. Such loans are interest bearing and, if bona fide, the interest would be deductible by the employee.<sup>115</sup>

The addition of section 264(c) to the Code in 1964 has made minimum deposit insurance much less attractive. This section requires the insured to pay the full amount of the premiums for the first four years of a contract if the amount

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<sup>111</sup> The employer pays an amount equal to the annual increase in cash value each year, and the employee pays the balance. On death of the employee, the employer recovers amounts advanced by him, and the employee receives the balance of proceeds.

<sup>112</sup> Rev. Rul. 55-713, 1955-2 CUM. BULL. 23.

<sup>113</sup> Rev. Rul. 64-328, 1964-2 CUM. BULL. 11. The rule applies to all policies brought under such an arrangement after November 13, 1964.

<sup>114</sup> *Ibid.*

<sup>115</sup> *Cf. Knetsch v. United States*, 364 U.S. 361 (1960).

of interest that would otherwise be deductible exceeds one hundred dollars per year.

#### INTEGRATING LIFE INSURANCE INTO THE CLIENT'S OVERALL ESTATE PLAN

Planning of the life insurance program within every estate plan must be carefully coordinated with the overall estate objectives of the client. We have seen how the client may use life insurance to provide the necessary liquidity for the payment of taxes and other claims against the estate; how he may use life insurance, along with buy-sell, as a means to control the size of his estate; and how life insurance plans are developed in conjunction with the client's status as an employee.

Different approaches are used with different clients, depending upon the size of their estates and their objectives. The net cost of these varying approaches must be determined and compared. Ultimately, the planner produces an optimum life insurance program for the client.

The final step is the integration of this insurance plan into the client's total estate plan. This, of course, is beyond the scope of this article.

The possibilities for the development of flexible estate plans using life insurance as a primary ingredient are unlimited. We have suggested a few that have posed interesting problems in the programming of typical estates. As the years go by, new problems will arise and new solutions will be developed. But whatever the future holds, life insurance will always play an important, if not dominant, role in nearly every estate plan.