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Henry T. Lowe

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TRANSFER TAXES ON SURVIVOR ANNUITY BENEFITS

HENRY T. LOWE*

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I. INTRODUCTION

These summary comments address the exposure to federal transfer taxes (gift and estate) of the value of a survivor annuity death benefit. The subject has increased importance following repeal in 1984 of the estate tax exclusion for such benefits paid from a wide variety of tax favored plans.

In the context of these comments the term “annuity” is not easily defined. Normally an annuity is thought to be an annual payment to be made for the recipient’s life or some other time period, the emphasis being on manner of payment.¹ But any payment, including the proceeds of life insurance, may be made in the form of an annuity, and to preserve distinctions between sources of payments, the transfer tax focus should not be on the method of payment

* Professor of Law, University of Missouri-Columbia.

1. WEBSTER’S NEW UNIVERSAL UNABRIDGED DICTIONARY (2d ed. 1983).

but rather on the nature and source of the benefit itself.² With this emphasis, a lump sum payment may be an annuity for purpose of the estate tax. Similarly, where the presence of an annuity plan is important for purposes of transfer taxes, the term annuity *plan* is not limited to a plan calling for payments to be made over a period of time and may encompass any plan calling for payment of a lump sum benefit that is not life insurance.³

Before enactment of the Internal Revenue Code of 1954 there were no statutory provisions directed specifically to transfer taxes on annuity transfers, even though it was clear that a wealth transfer occurred when the creator of a fund received or had the right to receive payments from the fund for a period measured by his life and a survivor or survivors received payments from the fund after the creator of the fund died.⁴ If the fund creator received income from the fund during lifetime, the transfer to survivors of interests in the fund was an estate tax transfer under both the 1939 and 1954 Internal Revenue Codes.⁵ If, instead of income, the creator received annuity payments from the fund during lifetime, the Service successfully argued the application of the lifetime transfer provisions of the estate tax law in the 1939 Code to the value of the survivor benefits in the fund.⁶ But the courts experienced difficulty in fitting other survivor benefits to the 1939 Code language,⁷ and distinguishing survivor benefits under an annuity contract or plan from a life insurance death benefit.⁸ These and other problems prompted Congress to include specific provisions on annuities in both the federal estate and gift tax laws in the 1954 Code.⁹

II. SELF AND SURVIVOR BENEFITS—SECTION 2039

A. *Exclusion for Tax Favored Plans—1984 Repeal*

To encourage the growth of private pensions, Congress in the 1954 legislation excluded from the scope of section 2039 the value of survivor benefits

2. The estate tax section on annuities refers to an "annuity or other payment" other than life insurance. I.R.C. § 2039(a) (1984).

3. Treas. Reg. § 20.2039-1(b) (1984) (example 1).

4. For discussion of the law in effect under the 1939 Code see committee reports for the 1954 Code discussing the adoption of § 2039. 1954 U.S. CODE CONG. & AD. NEWS 4017, 4117; H.R. REP. NO. 2543 (Conference Report), 83d Cong., 2d Sess. 74 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 123-24, 469-72 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. 90-91, A314-16 (1954).

5. I.R.C. § 2036 (1954); I.R.C. § 811(c)(1)(B) (1939).

6. *Mearkle's Estate v. Comm'r*, 129 F.2d 386 (3d Cir. 1942); *Comm'r v. Clise*, 122 F.2d 998 (9th Cir.), *cert. denied*, 315 U.S. 821 (1941); *Comm'r v. Wilder's Estate*, 118 F.2d 281 (5th Cir. 1941), *cert. denied*, 314 U.S. 634 (1941).

7. Troublesome cases under the 1939 Code involved survivor annuity benefits paid under employee benefit plans where the employer funded the benefit and the employee elected to receive self and survivor annuity benefits. See *infra* note 92.

8. See *infra* text accompanying notes 56-65.

9. See *supra* note 4.

under many employer sponsored tax favored plans,¹⁰ later extended the exclusion to tax favored retirement plans created by individuals,¹¹ in 1982 limited the exclusion to \$100,000 in any estate for all tax favored plans,¹² and finally in 1984 came full circle and repealed the exclusion for all tax favored plans.¹³

The 1954 Code exclusion for the value of survivor's benefits from qualified plans had three limitations: (1) there was no exclusion for any amount paid to the decedent's executor (estate);¹⁴ (2) the exclusion applied generally to that portion of the survivor benefit attributable to income tax deductible contributions of an employer;¹⁵ and (3) there was no exclusion for that portion of the survivor benefit attributable to the decedent's contributions to the plan.¹⁶ The third limitation had wide application to qualified employee benefit plans which either required or permitted employees to make nondeductible contributions to the plan.

Although the primary beneficiaries of the exclusion were the surviving beneficiaries of participants in qualified employee benefit plans, the Congress extended the exclusion to retirement annuities acquired by certain educational, religious, and charitable organizations for their employees,¹⁷ to qualified plans of the self-employed,¹⁸ and eventually to individual retirement accounts.¹⁹ Common to the exclusion for this broad group of tax favored plans was the limitation that the exclusion applied only to the portion of the survivor benefit attributable to income tax deductible (or excludable) contributions to the plan.²⁰

10. I.R.C. § 2039(c) (1954).

11. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2039(e), 90 Stat. 1520 (1976) (IRA); The Economic Recovery Tax Act of 1981, Pub. L. No. 95-34, 95 Stat. 172 (1981) (codified as amended in scattered sections of 26 U.S.C. (1982)) (employee IRA).

12. The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, § 245(a), 96 Stat. 324 (1982) (effective for estates of decedents dying after December 31, 1982).

13. The Deficit Reduction Act of 1984, Pub. L. 98-369, § 525(a), 98 Stat. 873 (effective generally for estates of decedents dying after December 31, 1984).

14. I.R.C. § 2039(c) (1954).

15. I.R.C. § 2039(c) (1954) denied the exclusion to any portion of the survivor benefit attributable to contributions made by the decedent participant. Employer contributions to a qualified pension, stock bonus, or profit sharing plan, or a qualified annuity plan were not considered to have been made by the employee participant. Employer contributions to qualified plans and annuity contracts are deductible subject to limitations expressed in I.R.C. § 404, which provides for a carryforward deduction for excess employer contributions. An exempt organization, with no concern for deductible contributions, may have a qualified plan. In the case of a tax exempt organization maintaining an annuity plan for its employees, employer contributions to the plan were not imputed to the employee participant if they were income tax excludable.

16. I.R.C. § 2039(c) (1954).

17. I.R.C. § 2039(c)(3) (1954).

18. I.R.C. § 2039(c)(1) (1962).

19. I.R.C. § 2039(e) (1977).

20. I.R.C. § 2039(c), (e) (1977).

The estate tax exclusion for the tax favored plan with a lump sum option created an estate tax equity problem. A plan participant with a lump sum option exercisable until death in substance owned the account at the time of death. In response to this problem, the Internal Revenue Service urged the doctrine of constructive receipt and applied the general "ownership" language of the estate tax law to the value of these accounts.²¹ And in 1978, Congress denied the estate tax exclusion altogether to any tax favored lump sum distribution if the recipient survivor elected the favorable income tax averaging rules available to many tax favored lump sums.²²

In 1982, Congress for the first time since 1954 limited the estate tax exclusion for survivor benefits from all tax favored plans in which the decedent participated to \$100,000,²³ and finally, in 1984, repealed the exclusion entirely for estates of decedents dying after 1984.²⁴

Repeal of the estate tax exclusion for tax favored plans will affect the estate plans of many people. No longer may a plan participant ignore the estate and gift tax consequences of various payment provisions and options available under a tax favored plan. A participant in a tax favored plan must now look to the general language of section 2039 and other estate tax provisions and, if married, to the availability of the estate tax marital deduction.

B. *Self and Survivor Annuities After 1984*

Section 2039 now subjects all survivor annuity benefits to the federal estate tax if four conditions are satisfied: (1) the source of the survivor benefit is a form of contract or agreement;²⁵ (2) the decedent either received or had the right to receive an annuity or other payment (herein called a "self" benefit);²⁶ (3) a beneficiary received an annuity or other payment by reason of surviving the decedent (herein called the "survivor benefit");²⁷ and (4) the survivor benefit is not insurance on the life of the decedent.²⁸ In order to reflect the "wealth transfer" concept of the federal estate tax law, Congress limited the estate tax on the value of the survivor benefit to the proportionate part of that

21. Treas. Reg. § 20.2039-2(b) (example 4). The Service indicated that the estate tax exclusion should be denied under the doctrine of constructive receipt only if the participant had constructively received the benefit for income tax purposes. Internal Office Technical Advice Memorandum, Letter Ruling 7926001.

22. I.R.C. § 2039(f) (1979).

23. The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, § 245(a), 96 Stat. 324 (1982) (effective for estates of decedents dying after December 31, 1982).

24. The Deficit Reduction Act of 1984, Pub. L. 98-369, § 525(a), 98 Stat. 873 (effective generally for estates of decedents dying after December 31, 1984).

25. I.R.C. § 2039(a) (1984).

26. *Id.*

27. *Id.*

28. *Id.*

benefit contributed by the decedent.²⁹ And in recognition of the fact that survivor benefits in employee benefit plans are a form of deferred compensation to the decedent participant or his beneficiaries, Congress provided that employer contributions to a plan shall be treated as employee contributions.³⁰ Thus section 2039 now expresses one basic idea: when the four conditions are met employer and employee contributions to an employee benefit plan when paid to a surviving beneficiary are wealth transfers by the employee, includible in the estate tax estate. A discussion of the four conditions follows.

1. Contract or Agreement

If an employer pays a survivor benefit to a beneficiary of a deceased employee pursuant to law or without any obligation to do so, the decedent's estate may fairly assert that the *decedent* has made no wealth transfer. A statutory death benefit or the voluntary payment by the employer or other entity is not wealth contributed, owned, or controlled by the decedent while alive.³¹ This notion finds statutory expression in the requirement that the source of the survivor benefit must be a form of contract or agreement.

A commercial or private annuity and the usual forms of employee benefit plans satisfy the statutory requirement. In its regulations the Internal Revenue Service asserts that any arrangement, understanding, or plan, or any combination of arrangements, understandings, or plans, arising by reason of decedent's employment satisfies the statutory requirement.³²

The Service asserts and the courts support the proposition that all employee benefit contracts and plans are to be considered together in determining whether the statutory conditions are met.³³ In the clear case a retirement benefit to the employee in one plan and a survivor benefit to a designated beneficiary in another plan will be combined.³⁴ Before the 1984 repeal of the estate tax exclusion the Service did not combine a qualified plan with a non-qualified

29. I.R.C. § 2039(b) (1984).

30. *Id.*

31. Treas. Reg. § 20.2039-1(b) (1984) (example 4); Estate of Barr v. Comm'r, 40 T.C. 227 (1963), *acq.* 1964-1 C.B. 4, *acq. withdrawn*, 1978-1 C.B. 1 as to I.R.C. § 2039 (1978) and acquiescence as to result substituted.

32. Treas. Reg. § 20.2039-1(b) (1984). See Neeley v. United States, 613 F.2d 802 (Ct. Cl. 1980), where resolution of board of directors of closely held company satisfied the statutory requirement and court applied the regulation. Estate of Courtney v. United States, (N.D. Ohio 1984) 84-2 U.S.T.C. para. 13580 (resolution of corporate board did not create enforceable contract or agreement).

33. Treas. Reg. § 20.2039-1(b) (1984) (example 6); *see also* Estate of Van Wye v. United States, 686 F.2d 425 (6th Cir. 1982) (no self benefit present); Estate of Schelberg v. Comm'r, 612 F.2d 25 (2d Cir. 1979) (no self benefit present); Gray v. United States, 410 F.2d 1094 (3d Cir. 1969); All v. McCobb, 321 F.2d 633 (2d Cir. 1963); Estate of Bahen v. United States, 305 F.2d 827 (Ct. Cl. 1962); Estate of Beal v. Comm'r, 47 T.C. 269 (1966); Rev. Rul. 77-183, 1977-1 C.B. 274.

34. Treas. Reg. § 20.2039-1(b) (1984) (example 6).

survivor benefit plan,³⁵ but once repeal of the estate tax exclusion for qualified plans is effective, the Service will likely combine all plans, qualified and unqualified, in applying the statute.³⁶

The Service's power under section 2039 to combine employee benefit plans to impose an estate tax on a survivor benefit from one or more plans places primary emphasis on the second statutory requirement, the "self benefit"—was the decedent at the time of death receiving or did the decedent at the time of death have the right to receive a self benefit from one or more plans.

2. A "Self" Benefit

The imposition of an estate tax on the survivor annuity benefit rests on the premise reflected in other lifetime transfer provisions of the federal estate tax law: a wealth transfer occurs at a decedent's death if a benefit passes to a survivor from a fund or other source, and decedent owned or controlled an interest in the fund or other source at the time of death.³⁷ In section 2039 the requirement is that decedent at death was receiving or had the right to receive "an annuity or other payment."

The phrase "annuity or other payment" (here called the "self" benefit), has been a continuing source of controversy and litigation in the most important area of application of the statute—employee benefit plans. Given a broad and literal interpretation, the phrase "annuity or other payment" can refer to any payment, periodic or single, the decedent participant was receiving or had the right to receive at the time of death. Under the broad reading any contract right reducible to a monetary sum held by the employee against the employer at the time of the employee's death would fulfill the statutory requirement, including any claim for accrued but unpaid salary and wages. In its regulations the Service does little to sharpen the meaning of the phrase, stating it refers "to one or more payments extending over any period of time."³⁸

The Service argued the broad and literal meaning of the phrase to the Tax Court in *Estate of Fusz v. Commissioner*,³⁹ a case where an employment contract called for payment of a survivor benefit to the employee's spouse when death occurred during the contract term. In a reviewed opinion the Tax Court rejected the contention that the employee's right to salary at the time of death was a "self" benefit. The court examined the legislative history of section 2039 and concluded that the term "other payment" was directed to a lump sum benefit, in contrast to a periodic or annuity benefit, and that the

35. *Estate of Brooks v. Comm'r*, 50 T.C. 585 (1968), *acq.* 1969-1 C.B. 20; Rev. Rul. 76-380, 1976-2 C.B. 270; Treas. Reg. § 20.2039-1(b) (1984) (example 6).

36. At the time of preparation of these comments there was no official Service action contrary to the references in note 35, *supra*.

37. See *supra* note 4.

38. Treas. Reg. § 20.2039(b)(1) (1984).

39. 46 T.C. 214 (1966).

phrase "other payment" is qualitatively limited to post-employment benefits, which at the very least are paid or payable during decedent's lifetime.⁴⁰ The Service acquiesced in this decision,⁴¹ and later cases⁴² involved the narrowed interpretation of the phrase "other payment." After the *Fusz* case it became important to determine whether a payment under an employment contract calling for long term or life time employment was for current services rendered⁴³ or was a post-employment payment, for past services rendered.⁴⁴ Particularly controversial is the right of an employee to receive employer financed disability payments, an issue on which there is no consensus; an early decision by the Court of Claims⁴⁵ that a contingent right to receive permanent disability benefits is a self benefit has not been followed in recent appellate decisions.⁴⁶ The decisions reflect a distinction between temporary payments for disability, wage and salary continuation,⁴⁷ and permanent disability payments, a post-employment benefit.⁴⁸

A statutory requirement for the "self" benefit is that the benefit be payable to the decedent at death or decedent had the right to receive the benefit at the time of death.⁴⁹ The Service in its regulations asserts,⁵⁰ and courts have agreed,⁵¹ that it is sufficient that decedent at the time of death has a vested right to the benefit whether or not in fact the benefit is being paid or is payable at the time of death. Thus an employee with a vested pension right who dies before retirement has a self benefit;⁵² but if the employee's right to the self benefit has not vested at the time of death, the statutory requirement is

40. *Id.* at 218.

41. 1967-2 C.B. 1.

42. See *infra* cases cited in notes 43-48, decided after *Fusz*, many of which refer with approval to the *Fusz* interpretation of the self benefit requirement.

43. *Kramer v. United States*, 406 F.2d 1363 (Ct. Cl. 1961).

44. *In re Estate of Wadewitz v. Comm'r*, 339 F.2d 980 (7th Cir. 1964); *Eichstedt v. United States*, 354 F. Supp. 484 (N.D. Cal. 1972); *Estate of Silberman v. United States*, 333 F. Supp. 1120 (W.D. Pa. 1971); *Hetson v. United States*, 75-2 U.S. Tax Cas. (CCH) para. 13098 (Ct. Cl. 1975), *aff'd*, 209 Ct. Cl. 591 (1976).

45. *Estate of Bahen v. United States*, 305 F.2d 827 (Ct. Cl. 1962); *accord Estate of Looney v. United States*, 569 F. Supp. 1569 (D. Ga. 1983).

46. *Estate of Van Wye v. United States*, 686 F.2d 425 (6th Cir. 1982); *Estate of Schelberg v. Comm'r*, 612 F.2d 25 (2d Cir. 1979).

47. *Estate of Siegel v. Comm'r*, 74 T.C. 613 (1980); Rev. Rul. 77-183, 1977-1 C.B. 274.

48. *Silberman v. United States*, 333 F. Supp. 1120 (W. D. Pa. 1971); *Hetson v. United States*, 75-2 U.S. Tax Cas. (CCH) para. 13098 (Ct. Cl. 1975), *aff'd*, 209 Ct. Cl. 691 (1976); *Gaffney v. United States*, 200 Ct. Cl. 744 (1972).

49. I.R.C. § 2039(a) (1984).

50. Treas. Reg. § 20.2039-1(b) (1984) (example 3). The example states that the result is the same if the employee's right is forfeitable in the event of separation from service for any reason other than death before the stated retirement date.

51. *Gray v. Comm'r*, 410 F.2d 1094 (3d Cir. 1969); *In re Estate of Wadewitz v. Comm'r*, 339 F.2d 980 (7th Cir. 1964).

52. See *supra* note 49.

not met and section 2039 does not apply to the survivor's benefit.⁵³ Since the self benefit is measured at the time of death, if the employee receives a plan benefit before death and at the time of death has no further right to a self benefit, section 2039 does not apply to the survivor benefit.⁵⁴

If, as expected, the Service asserts that after repeal of the exclusion for tax favored plans it may combine all employee benefit plans in applying section 2039, the reach of section 2039 will be greatly extended. The primary employee benefit plan for many employers is a tax favored pension, profit sharing, or other plan designed to provide a self benefit for the employee participant. This primary plan can sweep into section 2039 all satellite plans maintained by the employer whether or not tax favored. Before repeal of the estate tax exclusion the primary tax favored plan could not be used for this purpose.⁵⁵

3. Life Insurance—Excluded

Section 2039 does not apply to a survivor benefit from insurance on the decedent's life.⁵⁶ Proceeds of life policies are subject to other provisions of the federal estate tax law,⁵⁷ and Congress did not want any overlap between the annuity and life insurance sections of the law.⁵⁸

Before enactment of section 2039 the Supreme Court in *Helvering v. Le Gierse*⁵⁹ drew the basic distinction between contracts providing annuity and life insurance benefits and stated that elements of risk shifting and risk distribution are essential to a life insurance contract.⁶⁰ The death benefit in a life insurance contract is not dependent on the amount of premiums paid; the survivor benefit in an annuity contract is dependent on the amounts contributed to the contract.⁶¹

Where life insurance and annuity benefits are combined in the same or separate contracts it is possible for the insurer to hedge the life insurance risk by the terms of the annuity contract. This occurred in *Le Gierse* where the decedent at age 80 purchased separate single premium insurance and annuity contracts without any requirement for a physical examination. The court denied a life insurance estate tax exemption for the proceeds for lack of risk

53. Treas. Reg. § 20.2039-1(b) (1984) (see example 2).

54. Treas. Reg. § 20.2039-1(b) (1984) (example 5).

55. See *supra* note 35.

56. I.R.C. § 2039(a) (1984).

57. I.R.C. §§ 2042, 2035 (1984).

58. See *supra* note 4.

59. 312 U.S. 531 (1941); see also *Estate of Keller v. Comm'r*, 312 U.S. 543 (1941).

60. *Le Gierse*, 312 U.S. at 539.

61. *All v. McCobb*, 321 F.2d 633 (2d Cir. 1963) (unfunded survivor benefit was life insurance under § 2042); *Estate of Montgomery v. Comm'r*, 458 F.2d 616 (5th Cir.), cert. denied, 409 U.S. 849 (1972); see *Edgar v. Comm'r*, 39 T.C.M. (CCH) 816 (1979).

elements in the life policy.⁶²

Even though a combination insurance and annuity policy may negate the element of risk to the insurer both the Supreme Court⁶³ and the Service⁶⁴ have held that if the insured irrevocably transfers the life policy before death and retains the annuity policy, the contracts are separate properties for the estate tax and the proceeds from the insurance policy are not to be included in the insured's gross estate.

Regulations interpreting section 2039 address the combination annuity and life insurance policy and place primary emphasis on the relation of the terminal reserve value of the policy at the time of decedent's death to the value of the survivor benefit. When the terminal reserve value equals the amount of the survivor benefit the element of insurance risk ceases, and the survivor benefit may then be subject to section 2039.⁶⁵

4. Survivor Benefit—Valuation

The statutory language which describes the "self benefit" also describes the "survivor benefit." In each case the benefit is described as "an annuity or other payment" paid or payable "under any form of contract or agreement." For the survivor benefit there is the added requirement that it be "receivable by any beneficiary by reason of surviving the decedent," reflecting Congressional concern in 1954 to impose an estate tax on the survivorship portion of a joint and survivor annuity.⁶⁶

A contribution rule applies to the value of the survivor benefit at the estate tax valuation date; the proportionate cost of the benefit contributed by the decedent and the decedent's employer is applied to the value of the survivor benefit to determine the estate tax value.⁶⁷ Repeal of the estate tax exclusion will simplify the application of the contribution rule to determine the estate tax value of the survivor benefit. For a decedent dying after 1984 all contributions to an employee benefit plan by an employee and his employer are attributed to the employee.⁶⁸ There is no indication in the legislative history for the

62. See authorities cited *supra* note 59; see also *Estate of Montgomery v. Comm'r*, 458 F.2d 616 (5th Cir.), *cert. denied*, 409 U.S. 849 (1972).

63. *Fidelity-Philadelphia Trust Co v. Smith*, 356 U.S. 274 (1958).

64. Rev. Rul. 65-69, 1965-1 C.B. 440.

65. Treas. Reg. § 20.2039-1(d) (1984).

66. See authorities cited *supra* note 4.

67. I.R.C. § 2039(b) (1984); Treas. Reg. § 20.2039-1(e) (1984).

68. Treas. Reg. § 20.2039-1(c) (1984). Before 1985 the estate tax exclusion for tax favored plans extended only to the survivor benefit attributable to employer contributions to the plan. Where the employer and others contribute to a defined benefit plan (contributions not allocated to a separate account for each participant) the estate tax regulations indicate how to determine the employer's contribution. Treas. Reg. § 20.2039-2(c) (1984) (example). With repeal of the estate tax exclusion all employer and employee contributions will be aggregated to determine the proportionate part of the survivor benefit from a tax favored plan to be included in the participant's estate

1984 act of any intent to preserve the exclusion for amounts attributable to contributions made before the effective date of the repeal.⁶⁹ For most employee benefit plans the only contributions will be employer and employee contributions which, under section 2039, will be treated as employee contributions. Hence after 1984 the contribution rule to be applied to the value of the survivor benefit will in most cases be one hundred percent, i.e., the entire value of the survivor benefit will be exposed to the federal estate tax.

A survivor benefit that terminates on remarriage or some other contingency will pose valuation problems reflected in other areas of the estate tax law.⁷⁰ If a survivor has the right to receive a lump sum, the estate tax value of the survivor benefit will be the amount of the lump sum.⁷¹ If a survivor has the right to receive an annuity for life or a fixed period of time, the estate tax value of the survivor benefit will be the discounted value of the future payments.⁷²

III. SURVIVOR BENEFIT ONLY

When it enacted the "self and survivor" provision Congress recognized that a survivor benefit paid by an employer to a beneficiary of a deceased employee might be subject to other provisions of the transfer tax statutes.⁷³ The same warning is expressed in the estate tax regulations: "The fact that an annuity or other payment is not includible in a decedent's gross estate under section 2039 (a) and (b) does not mean that it is not includible under some other section."⁷⁴ With this broad license the Service may seek to classify a survivor benefit as (1) property subject to a general power of appointment; (2) proceeds of life insurance; (3) property owned at death; (4) a property transfer during lifetime over which decedent retained the power to designate the beneficiary or to revoke or change a beneficiary designation; (5) a property transfer during lifetime taking effect at decedent's death; or (6) a gift tax transfer. The application of one or more of these alternative theories for taxing the survivor benefit will depend on the terms of the plan or agreement, the circumstances

tax estate. If there are any contributions to such a plan, other than from the employer and the employee, presumably the Service will apply the method reflected in the example.

69. The repeal is effective for individuals who die after December 31, 1984; the only exception is for a plan participant in "pay status" on that date who irrevocably elected the form of the survivor benefit before the enactment date of the 1984 legislation. Deficit Reduction Act of 1984, P.L. 98-369, § 525(b), 98 Stat. 874 (1984).

70. See *Estate of Allen v. Comm'r*, 39 T.C. 817 (1963), *acq.* 1964-1 C.B. 4; see also *Comm'r v. Maresi*, 156 F.2d 929 (2d Cir. 1946). For actuarial computation by the Service, see Treas. Reg. § 20.2031-7(e) (1984).

71. Treas. Reg. § 20.2039-1(c) (1984).

72. Treas. Reg. § 20.2031-7(b) (1984). For a decedent dying after November 30, 1983, a single 10% unisex table is used to value a lifetime annuity for a male or female survivor.

73. See authorities cited *supra* note 4.

74. Treas. Reg. § 20.2039-1(a) (1984).

leading to its execution, and the nature of the fund, if any, from which the benefit is paid.

A. *General Power of Appointment*

Even though a deceased employee has no other estate tax ownership of the survivor benefit, the Service may assert he owns a power to appoint the survivor benefit if he may designate or change the designation of the beneficiary at any time until death.⁷⁵ Adverse estate tax consequences depend on possession at death of a general power of appointment—one exercisable in favor of the decedent, his estate, or the creditors of his estate.⁷⁶ Whether a power to designate or change a beneficiary of the survivor benefit may be classified as a general power of appointment will depend on the scope of the power. An unrestricted power to direct payment of the survivor benefit to any person designated in decedent's will may constitute a general power of appointment,⁷⁷ but if the power of designation is limited to a class or group of persons excluding the decedent's estate and creditors of his estate, the power will not be general.⁷⁸ The general power of appointment theory is not a significant threat to many employee survivor benefits because the benefit plan will not give the employee an unrestricted power of designation, as, for example, a plan that limits the power of designation to specified family members.

B. *Life Insurance*

Many employee benefit plans are funded in whole or part with life insurance. A survivor benefit funded by insurance on the life of a plan participant will be subject to the estate tax in the participant's estate if payable to the participant's estate⁷⁹ or if the participant owns at death any of the incidents of ownership in the policy.⁸⁰ Absence of policy assignability or a cash surrender

75. Whether a decedent had a power of appointment over a death benefit will depend on the source and nature of the benefit and the extent of the control by the decedent over disposition of the benefit. If a decedent has at death a vested right to designate the beneficiary of a benefit to be paid from a fund, the Service may assert the power of disposition is a power of appointment. Treas. Reg. 20.2041-1(b) (1984) states that the term "power of appointment includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations." In *Estate of Bogley v. United States*, 514 F.2d 1027 (Ct. Cl. 1975), a death benefit paid to decedent's estate was not subject to a power of appointment where the right to the benefit was not fixed at death. There is a conflict of decision on whether a death benefit payable to decedent's personal representative or estate is subject to a power of appointment. *Estate of Keeter v. United States*, 461 F.2d 714 (5th Cir. 1972) (general power of appointment); *Second Nat'l Bank v. Dallman*, 209 F.2d 321 (7th Cir. 1954) (no power of appointment).

76. I.R.C. § 2041(b)(1) (1984).

77. See *supra* note 75.

78. I.R.C. § 2041(b)(1) (1984); Treas. Reg. § 20.2041-1(c)(1) (1984).

79. I.R.C. § 2042.

80. *Id.*

value are not important if the participant retains until death the right to designate the beneficiary of the insurance proceeds.⁸¹ An irrevocable assignment by the participant of all incidents of ownership in the policy more than three years before death may be effective to avoid the estate tax.⁸² Whether a survivor benefit is considered proceeds of life insurance will depend on factors considered before.⁸³

C. *Property Owned at Death*

If a plan or agreement calls for payment of a survivor benefit and if the participant has no interest in or control over the survivor benefit, the courts have uniformly rejected the assertion that the employee "owned" the benefit at death.⁸⁴ This conclusion appears consistent with other decisions holding that benefits that come into existence *after* and as a result of death are not property owned at death.⁸⁵

D. *Lifetime Transfer With Retained Power*

A lifetime property transfer by an individual who retains until death the power to revoke, alter, amend, or terminate the transfer,⁸⁶ or to receive income from or designate who shall receive the property⁸⁷ is subject to the estate tax. The power to designate or change the beneficiary of a survivor benefit may be viewed as a forbidden estate tax power if the required lifetime transfer is present, and the Service asserts that a transfer may occur in the employment context.⁸⁸

81. Estate of Riefberg v. Comm'r, 43 T.C.M. (CCH) 519 (1982); Estate of Perl v. Comm'r, 76 T.C. 861 (1981).

82. I.R.C. § 2035 (1984); see Lowe, *Combining Life Insurance With Other Estate Assets*, 47 Mo. L. Rev. 661, 667-68 (1982).

83. See *supra* notes 56-65.

84. Estate of Porter v. Comm'r, 442 F.2d 915 (1st Cir. 1971); *In re Estate of Wadewitz v. Comm'r*, 339 F.2d 980 (7th Cir. 1964); *Harris v. United States*, 72-1 U.S. Tax Cas. (CCH) para. 12845 (C.D. Cal. 1972); *Molter v. United States*, 146 F. Supp. 497 (E.D.N.Y. 1956); *Estate of Tully v. United States*, 528 F.2d 1401 (Ct. Cl. 1976); *Kramer v. United States*, 406 F.2d 1363 (Ct. Cl. 1969). If, however, a decedent at death has a vested right to receive an annuity benefit which may pass to his estate, § 2033 will apply to that amount. *Estate of Silberman v. Comm'r*, 61 T.C. 605 (1974); *Estate of Kleemeier v. Comm'r*, 58 T.C. 241 (1972).

85. For example proceeds from recovery for wrongful death are not subject to the estate tax. *Connecticut Bank & Trust Co. v. United States*, 465 F.2d 760 (2d Cir. 1972); *Vanek v. United States*, 32 Aftr. 6230 (S.D. Iowa 1973); *Lang v. United States*, 356 F. Supp. 546 (S.D. Iowa 1973); *Morgan v. United States*, 356 F. Supp. 546 (S.D. Iowa 1973); Rev. Rul. 75-127, 1975-1 C.B. 297.

86. I.R.C. § 2038 (1984).

87. I.R.C. § 2036 (1984).

88. Rev. Rul. 76-304, 1976-2 C.B. 269; Rev. Rul. 76-490, 1976-2 C.B. 300; Rev. Rul. 79-47, 1979-1 C.B. 312; Rev. Rul. 82-13, 1982-1 C.B. 132; Rev. Rul. 84-147, 1984-2 C.B.

The "transfer theory" rests on the premise that the employee by virtue of past and future promised services has made a transfer of the survivor benefit. Although several published rulings⁸⁹ state the "transfer theory" and reflect the official Service position, court decisions offer only limited support for it. In *Estate of Fried v. Commissioner*,⁹⁰ a 1970 case, the Tax Court was ambivalent on whether rendition of services under an employment contract constitutes a transfer of the survivor benefit. The case involved transfer of assets of a partnership to a corporation and later execution of employment agreements with survivor benefits by the corporation and the former partners. The Tax Court concluded an estate tax transfer of the survivor benefit occurred either by virtue of the transfer of the partnership assets to the corporation or the promise to work in the future,⁹¹ but in affirming the decision on the transfer issue the Court of Appeals for the Second Circuit relied only on the transfer of partnership assets.⁹² Some other cases⁹³ have adopted the "promise to work"

89. See authorities cited *supra* note 88.

90. 54 T.C. 805 (1970), *aff'd*, 445 F.2d 979 (2d Cir. 1971), *cert. denied*, 404 U.S. 1016 (1972), *Fried* involved application of § 2037, *infra* notes 95-98.

91. 54 T.C. 822-824 (1970).

92. 445 F.2d at 984.

93. *Estate of Porter v. Comm'r*, 442 F.2d 915 (1st Cir. 1971) (transfer in contemplation of death); *Estate of Siegel v. Comm'r*, 74 T.C. 613 (1980) (decendent's right to designate the beneficiary of the survivor benefit is a § 2038 power); *Estate of Bogley v. United States*, 514 F.2d 1027 (Ct. Cl. 1975) (employee survivor annuity involved transfer intended to take effect at death); *Estate of Tully v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) (transfer made without retention of § 2038 power). *But see* *Harris v. United States*, 72-1 U.S. Tax Cas. (CCH) para. 12485 (C.D. Cal. 1972) (court rejects the transfer theory applied to an employee annuity). The attitude of the Tax Court on the transfer issue has wavered. Leading cases under the 1939 Code were *Higg's Estate v. Comm'r*, 184 F.2d 427 (3d Cir. 1950), and *Comm'r v. Twogood's Estate*, 194 F.2d 627 (2d Cir. 1952), both of which involved employee elections under employer financed annuities. In *Higg's* the Tax Court held that an election for self and survivor payments constituted an estate tax transfer under the 1939 Code, but the Third Circuit reversed and held there was no estate tax transfer under then § 811(c)(1)(B), predecessor to § 2036 in the 1954 Code. In *Twogood* the Tax Court held that an election by the employee to take a lesser annuity for life in favor of a survivor annuity for his spouse was not an estate tax transfer, and the Second Circuit affirmed. In its *Twogood* opinion the Tax Court agreed with reasoning of the appeals court in *Higg's* and concluded that Twogood retained no interest in the survivor benefit elected for the spouse. *Twogood's Estate v. Comm'r*, 15 T.C. 989, 997-99 (1950). In its published rulings, *supra* note 88, the Service omits any reference to the appellate opinion in *Higg's*, a clear precedent for the interpretation of § 2036. The omission is significant because the appellate opinions in *Higg's* and *Twogood* were important precedents leading to the enactment of § 2039 in 1954. See S. REP. NO. 1622, 83rd Cong., 2d Sess. 123-24 (1954). For the Service view of the appellate decisions in *Higg's* and *Twogood*, see Rev. Rul. 158, 1953-2 C.B. 259. For extended discussion of the transfer and other theories advanced by the Service see Walk, *The Pure Death Benefit: An Estate and Gift Tax Anomaly*, 66 MINN. L. REV. 229-282 (1982), and Zelinsky, *Transfer Taxation Without Transfer: Reflection on Employer-Provided death Benefits, Section 2039, Disclaimer, New Forms of Wealth and the Evaluation of the Federal Estate Tax*, 58 TUL. L. REV. 974 (1984).

theory in finding an estate tax transfer, and the Service relies on these decisions for support in its published rulings.⁹⁴ Unless Congress clarifies the law, the "transfer theory" based on work and the promise to work will be a fertile ground of controversy in the future.

E. *Transfer Taking Effect at Death*

Even though a benefit plan may deny the employee participant the power to designate or change beneficiaries of a survivor benefit, the Service may seek to classify the survivor benefit as a transfer taking effect at death,⁹⁵ a further application of the "transfer theory" involving past and future services. For estate tax purposes a transfer takes effect at death if a transferor retains a greater than five percent reversionary interest in the transferred property⁹⁶ and a survivorship condition is satisfied,⁹⁷ i.e., the beneficiary may receive the benefit only by surviving the transferor.

An employee benefit contract or plan may establish a priority order for payment of a survivor benefit and require a beneficiary to survive the participant. If the plan or contract also specifies a contingent reversionary interest to the participant's estate, the statutory conditions may be met and the survivor benefit or some part thereof may be exposed to the estate tax.⁹⁸

F. *Irrevocable Designation of Survivor Benefit—Gift Transfer*

A benefit plan participant may have the right to make an irrevocable lifetime survivor designation. Were this to happen the estate tax transfer theories described above⁹⁹ would not apply since the participant retained no power at death over the benefit and the irrevocable assignment could negate any reversionary interest or survivorship conditions under the "taking effect at death" provision. The transfer tax issues in such event turn on the application of the three year rule¹⁰⁰ and the federal gift tax.

The three year rule, successor to the contemplation of death rule, is a transfer tax valuation provision. Certain irrevocable lifetime transfers made within three years of death are considered as made at death, i.e., on the estate tax return the property is valued at the time of death or alternate valuation date instead of the date of the transfer.¹⁰¹ Congress repealed the three year

94. See authorities cited *supra* note 88.

95. I.R.C. § 2037 (1984).

96. I.R.C. § 2037(a)(2) (1984).

97. I.R.C. § 2037(a)(1) (1984).

98. Estate of Fried v. Comm'r, 54 T.C. 805 (1970), *aff'd*, 445 F.2d 979 (2d Cir. 1971), *cert. denied*, 404 U.S. 1016 (1972); Estate of Bogley v. United States, 514 F.2d 1027 (Ct. Cl. 1975); Rev. Rul. 78-15, 1978-1 C.B. 289.

99. See *supra* notes 86-98.

100. I.R.C. § 2035 (1984).

101. I.R.C. §§ 2035, 2031 (1984).

rule for persons dying after 1981,¹⁰² except for transfers relating to life insurance policies and transfers otherwise subject to the retained interest provisions and to the "taking effect at death" provision.¹⁰³ Thus if death occurs within three years of the irrevocable designation of a beneficiary of a survivor benefit under a life insurance policy, the policy proceeds may be an estate tax transfer of the participant.¹⁰⁴ Also if the Service is correct in its transfer theory discussed above, the death of a participant within three years of an irrevocable designation of the survivor beneficiary may cause the full value of the survivor benefit to be reported as an estate tax transfer of the participant. Similarly, a participant who made an irrevocable assignment of a reversionary interest within three years of death would have the same estate tax exposure if the Service is correct in its transfer theory.¹⁰⁵

Where an irrevocable beneficiary designation of a survivor benefit occurs more than three years before a participant's death, the three year rule will not apply but the federal gift tax may apply.¹⁰⁶ The risk of a gift tax transfer in the situations mentioned above will depend on the scope of the designation right and whether the survivor benefit is found in a tax favored or other contract or plan. When Congress in 1984 repealed the estate tax exclusion for tax favored plans it retained a generous gift tax exclusion for the exercise of an irrevocable beneficiary election under a tax favored plan,¹⁰⁷ limited to the portion of the benefit attributable to employer contributions.¹⁰⁸ Corrective legislation now pending will repeal this gift tax exclusion,¹⁰⁹ and once repeal is effective an irrevocable designation under a qualified or non-qualified contract or plan may involve a gift tax transfer.¹¹⁰ The result will turn on the nature of the plan and possibility of placing a value on the survivor benefit when the irrevocable designation is made.¹¹¹ If a participant has an unrestricted right to designate the beneficiary of a survivor benefit, the right might also be classified as a general power of appointment, and an irrevocable designation may constitute an exercise of the power and a gift tax transfer.¹¹²

G. *Gift Complete at Death—The Hybrid*

An employer may condition the right to and amount of a survivor benefit on future events: the rendition of future services, compensation levels in effect

102. I.R.C. § 2035(d)(1) (1984).

103. I.R.C. § 2035(d)(2) (1984).

104. See also I.R.C. § 2038(a)(1) (1984) (release of a § 2038 power within three years of death is an estate tax transfer).

105. I.R.C. § 2035(d)(2) (1984).

106. Rev. Rul. 55-388; 1955-1 C.B. 233; Treas. Reg. § 25.2511-1(h)(10) (1984).

107. I.R.C. § 2517 (1984).

108. I.R.C. § 2517(b) (1984).

109. H.R. 1800, 99th Cong., 1st Sess., § 152(e)(2)(a) (1985).

110. See authorities cited *supra* note 106.

111. Estate of Fusz v. Comm'r, 46 T.C. 214.

112. See *supra* note 75; see also I.R.C. § 2514(b) (1984).

at death, retirement, or disability, and survivorship of one or more beneficiaries. Even if a beneficiary has a vested right to a benefit, the amount of the benefit may not be known until the date of payment. In these common situations there is an obvious difficulty in establishing the *amount* of any gift tax transfer when the beneficiary designation is made or as services are rendered.¹¹³ In *Fusz*,¹¹⁴ an estate tax case, the employer agreed to pay a survivor benefit to the employee's spouse if the employee died during employment or after cancellation of the employment contract. The Tax Court rejected the application of section 2039, the self and survivor provision, when death occurred while the employment contract was in effect. A later published ruling¹¹⁵ seeks to rectify the result in *Fusz* by application of the gift tax. The situation in the ruling involved an unfunded survivor benefit payable to a spouse based on the amount of the employee's salary at the time of death. Recognizing the difficulty of valuing any gift tax transfer on a yearly basis, the Service ruled that a gift tax transfer, incomplete while the employee lived, occurred at the employee's death.¹¹⁶

The theory of a gift tax transfer being completed by death is a hybrid of dubious ancestry. Historically, the gift and estate tax laws have been separate: the gift tax applying to completed lifetime transfers, the estate tax to testamentary and other incomplete transfers effective at death. In effect, the hybrid theory adds a new dimension to the estate tax without Congressional action.¹¹⁷

H. Comment

The survivor benefit not subject to section 2039 can be a wealth transfer derived in the common situation from employment services of a plan participant. The Service has announced a willingness to apply the entire scope of the estate and gift tax laws to a survivor benefit not subject to section 2039. Despite historical difficulties with its theory,¹¹⁸ the Service in its rulings stresses application of the estate tax transfer provisions even to the point of inconsistency—on the one hand insisting a transfer occurs when services are rendered or promised and on the other concluding a transfer is incomplete until death.¹¹⁹ The wide variety of contractual and plan arrangements for payment of survivor benefits do not lend themselves to strict classification, and without

113. Treas. Reg. § 25.2511-2(b) (1984) (a gift tax transfer is incomplete where donor reserves power over disposition of the interest, e.g., performance of future services).

114. 46 T.C. 214.

115. Rev. Rul. 81-31; 1981-1 C.B. 475.

116. *Id.*

117. See *Estate of Sanford v. Comm'r*, 308 U.S. 39, 51, *reh'g denied*, 308 U.S. 637 (1939), for discussion of coordination of gift and estate taxes; see also Treas. Reg. § 25.2511-2(f) (1984) (comment by Service that the gift tax is confined to transfers "by living donors").

118. See authorities cited *supra* note 93.

119. See *supra* notes 88, 114.

Congressional clarification there is no choice but to leave this issue to the process of administrative interpretation and judicial decision.

IV. MARITAL DEDUCTION FOR SURVIVOR BENEFIT

Since 1982 the unlimited estate tax marital deduction is available for the value of any interest in property passing from a decedent to a surviving spouse in a qualified form if the value of the interest is included in the decedent's estate tax gross estate.¹²⁰ After the 1984 repeal of the estate tax exclusion for survivor benefits in tax favored plans¹²¹ the value of survivor's benefits in many tax favored plans will for the first time be reflected in the estate tax estate of a plan participant. The availability of the estate tax marital deduction for the value of the survivor benefit passing to a spouse becomes important to the estate plans of many participants in employee benefit plans. If the marital deduction is not available for the value of the benefit passing to the survivor spouse, an unanticipated and perhaps unnecessary transfer tax will be imposed on the participant's estate. If the marital deduction is available for the value of the survivor benefit, transfer tax deferral¹²² and mitigation¹²³ become possible.

The estate tax marital deduction legislation specifies those interests in property which *pass* from a decedent to a spouse for purposes of the deduction.¹²⁴ Although specific as to the proceeds of life insurance,¹²⁵ property owned jointly with right of survivorship,¹²⁶ and property passing by exercise or failure to exercise a general power of appointment,¹²⁷ the statute is silent on survivor benefits derived from annuity contracts and plans. This omission may reflect the difficulty in phrasing a rule that encompasses the wide variety of contracts and employee benefit plans providing survivor benefits. If a decedent participant contributes directly to the plan and the plan provides survivorship benefits to the spouse, general language in the statute (an interest transferred by the decedent at any time)¹²⁸ will satisfy the passing requirement. But if the plan is funded solely or in part by an employer or other entity, the participant's transfer (the passing of a benefit from the decedent to his spouse) is

120. I.R.C. § 2056(a) (1984).

121. See *supra* notes 13, 24.

122. Potentially the qualifying interest will be subject to transfer taxes in the estate of the surviving spouse. See I.R.C. § 2056(b) for terminable interest rule and exceptions for interests that are exposed to the estate tax in the survivor's estate, particularly I.R.C. § 2056(b)(5), (6), (7), and (8) (1984).

123. Estate planning for survivor interests will seek to mitigate and avoid transfer taxes, particularly through use of the transfer tax credit (exemption) available to the surviving spouse.

124. I.R.C. § 2056(c) (1984).

125. I.R.C. § 2056(c)(7) (1984).

126. I.R.C. § 2056(c)(5) (1984).

127. I.R.C. § 2056(c)(6) (1984).

128. I.R.C. § 2056(c)(4) (1984).

indirect and not clearly covered by statutory language.¹²⁹ Nevertheless, the estate tax regulations make no distinction between contributory and noncontributory plans (direct and indirect transfers) and state unequivocally that the survivor's interest in an annuity or other payment is considered as having passed from the decedent to the survivor if the value of the interest is included in the estate tax estate of the participant under section 2039.¹³⁰

A. *Nondeductible Terminable Interests*

Not only must the interest pass from the decedent to a spouse, it must also meet the requirements of the terminable interest rule¹³¹ or one of several exceptions¹³² to that rule. Unless an exception applies, an interest passing to a surviving spouse is terminable and nondeductible if, (1) the interest terminates or fails due to passage of time or some contingency,¹³³ (2) an interest in the property passes by a donative transfer from the decedent to someone other than the spouse;¹³⁴ and (3) the other person may possess or enjoy any part of the property after termination or failure of the spouse's interest.¹³⁵ As indicated below an annuity for life to a surviving spouse may be a deductible terminable interest if no interest passes to any one except the spouse. A nondeductible terminable interest is subject to a contingency which *may* benefit someone other than the spouse.¹³⁶ A survivor benefit may contain one or more of these contingencies, and in that case the marital deduction will not be available unless one of the statutory exceptions to the nondeductible terminable interest rule applies.

B. *Exceptions for Otherwise Nondeductible Terminable Interests*

Two important exceptions to the nondeductible terminable interest rule have been a part of the marital deduction since its inception in 1948.¹³⁷ Each of these requires the surviving spouse to have an unrestricted power of appointment over the fund producing the benefit exercisable by the spouse alone and in all events.¹³⁸ The presence of the power of appointment insures that the value of the fund producing the benefit will be included in the estate tax of the survivor. These power of appointment exceptions to the nondeductible terminable interest rule will have limited application to survivor benefits under

129. See *Estate of Allen v. Comm'r*, 39 T.C. 817 (1963), *acq.* 1964-1 C.B. 4.

130. Treas. Reg. § 20.2056(e)(1)(6) (1984); Prop. Treas. Reg. § 20.2056(b)(7)(e)(2) (lifetime annuity interest in QTIP disposition).

131. I.R.C. § 2056(b)(1) (1984).

132. I.R.C. § 2056 (b)(3), (5), (6), (7), (8) (1984).

133. I.R.C. § 2056(b)(1) (1984).

134. *Id.* at § 2056 (b)(1)(A).

135. *Id.* at § 2056 (b)(1)(B).

136. Treas. Reg. § 20.2056(b)(1)(g) (1984) (example 3).

137. I.R.C. § 2056(b)(5), (6) (1984).

138. *Id.*

many employee benefit plans unless the plan permits the participant owner or the plan itself is designed to utilize one of them.

The first exception requires that the surviving spouse have the right to the income from the fund during lifetime.¹³⁹ Although not limited to trusts, this exception is commonly used in trust dispositions. A plan participant having a lump sum option under a tax favored plan may elect to have his interest in the plan paid on death to a power of appointment trust established in his estate plan. The plan benefit may in this way qualify for the estate tax marital deduction. But if the plan participant does not have the lump sum option exercisable at death, this exception may not be available where someone other than the surviving spouse has an interest in the survivor's benefit unless the plan itself is designed to comply with the exception.¹⁴⁰

The second exception will have even more limited application to survivor benefits than the first. It applies to the proceeds of an annuity contract held by "an insurer" only if the surviving spouse receives "interest" on the proceeds or receives the proceeds "in installments" and has the proper form of unrestricted power of appointment over the proceeds.¹⁴¹ This exception accommodates the payment of insurance and annuity proceeds under commercial insurance and annuity contracts. It may apply when a plan is funded with a commercial annuity contract and the contract permits the participant to elect or the plan provides for distribution to the spouse in a manner described in the exception. It is not likely that the Service or the courts will extend the application of the second exception to a plan not funded with a commercial annuity contract.¹⁴²

Unlike the first two exceptions the third exception to the nondeductible terminable interest rule is "elective" by the participant's estate and omits the power of appointment requirement. This is the so-called QTIP exception, first enacted in 1981¹⁴³ and later amended to apply specifically to "annuity" interests.¹⁴⁴ The elective QTIP exception authorizes a marital deduction for an interest passing to a surviving spouse who has a "qualifying income interest for life," which under a 1983 amendment includes an annuity interest to be specified in regulations issued by the Service. In proposed regulations interpreting this amendment the Service states: "a surviving spouse's lifetime annuity interest shall be treated as a qualifying income interest for life for purposes of

139. I.R.C. § 2056(b)(5) (1984).

140. In 1984 Congress enacted pension equity legislation which mandates qualified plans to provide survivor annuity benefits for a spouse unless the spouse consents to a different disposition. Tax favored plans must comply with this legislation, and as a consequence the plan design may then meet requirements for the marital deduction. I.R.C. §§ 401(a)(11), 417; Retirement Equity Act. of 1984, Pub. L. 98-397, § 203, 98 Stat. 1440-45 (1984).

141. I.R.C. § 2056(b)(6) (1984).

142. See *supra* note 59.

143. I.R.C. § 2056(b)(7) (1984) (effective for estates of decedents dying after December 31, 1981).

144. I.R.C. § 2056(b)(7)(B) (1984) (effective for estates of decedents dying after December 31, 1981).

the QTIP provision."¹⁴⁵ The QTIP election should have broad application to survivor's annuity benefits under tax favored plans since a common form of survivor benefit is an annuity payment to a spouse for life.

Each of the three exceptions to the nondeductible terminable interest rules requires that the income, installment, interest, or annuity paid to the spouse continue for life¹⁴⁶ without possibility of interruption and that no person other than the spouse have any right to benefit from the fund during the spouses's lifetime.

C. *Surviving Spouse Sole Beneficiary—Deductible Terminable Interest*

If the surviving spouse of a participant in an employee benefit plan is the sole beneficiary of a survivor benefit reportable in decedent's estate tax estate, the marital deduction will be available for the value of the benefit whether paid in a lump sum or otherwise.¹⁴⁷ A lump sum survivor benefit passing to the surviving spouse will have the same estate tax status as life insurance proceeds passing directly to the spouse. The result is the same if the survivor benefit is an annuity payable to the surviving spouse for life.¹⁴⁸ The annuity is a terminable interest, ending on the spouse's death, but is nevertheless deductible since the surviving spouse is the sole beneficiary. This availability of the marital deduction for an annuity payable until death of the spouse is clearly expressed in committee reports for the original marital deduction legislation and regulations and rulings issued by the Service.¹⁴⁹ A survivor benefit that does not terminate on the surviving spouse's death may also qualify for the marital deduction if the surviving spouse controls the disposition of the benefit at the time of the spouse's death. Control may be reflected by a requirement that the benefit be paid to the spouse's estate¹⁵⁰ or that the spouse otherwise designate who shall receive the benefit.¹⁵¹

Loss of the marital deduction may occur when a plan provides on termination of the spouse's interest that a benefit shall be paid to any person other than the spouse, the spouse's estate, or the spouse's designees. The spousal interest then becomes a nondeductible terminable interest unless one of three exceptions is available, and the Service and the courts will deny the marital deduction to the estate.

145. Prop. Treas. Reg. § 20.2056(b)(7).

146. Under I.R.C. § 2056(b)(6) proceeds may be payable in installments rather than for life.

147. Treas. Reg. § 20.2056(b)-1(g) (1984) (example 3).

148. *Id.*

149. S. REP. NO. 1013, Part 2, 80th Cong., 2d Sess., 12-13; Treas. Reg. § 20.2056(b)-1(g) (1984) (example 3); Rev. Rul. 64-310, 1964-2 C.B. 342; Rev. Rul. 77-404, 1977-2 C.B. 333.

150. See authorities cited *supra* note 146.

151. See *supra* notes 136-41.

D. Surviving Spouse Not the Sole Beneficiary

A benefit payable to a surviving spouse that terminates on remarriage is a nondeductible terminable interest if the plan directs that a benefit then be paid to another individual,¹⁵² as for example, the dependent children of the decedent until they attain the age of 21. Presumably any donative benefit to be paid to another after termination of the surviving spouse's interest will create a nondeductible terminable interest.¹⁵³

One approach to avoid the loss of the deduction is to assert that the benefit for the surviving spouse and for the other beneficiary are separate property interests or funds. In *Estate of Meyer v. United States*,¹⁵⁴ the Supreme Court of the United States rejected this theory and denied the marital deduction where a decedent insured selected a policy option directing payment of the proceeds to his surviving spouse in 240 guaranteed installments or for her life, if longer, and in the event of her death before receipt of the 240 installments any unpaid guaranteed payments to be paid to a daughter or her estate if she survived the spouse. The estate argued that based on the spouse's life expectancy, some part of the proceeds was allocated in the insurers' accounts as a fund payable to the spouse for the period following the guaranteed payment, and to this extent there was a deductible terminable interest. The court, however, held in this instance that the insurance policy "constituted only one property," and left open the question whether one policy or plan may create several properties or funds.¹⁵⁵

In a published ruling¹⁵⁶ the Service applied the two fund theory to an insurance policy payment plan calling for fixed monthly payments for life to a surviving spouse and smaller fixed monthly payments to a child until age 21 or earlier death. The Service ruled that the interests of the spouse and child were severable and that the spouse's interest was a deductible terminable interest.

Application of the separate fund theory to a contributory benefit plan will depend on the terms of the plan. If decedent's or the employer's contributions to the plan are segregated in such a way to insure their payment solely to the surviving spouse, the marital deduction may be available for some part of the survivor's benefit even though the spouse is also beneficiary of a nondeductible terminable interest. The Tax Court, in a reviewed decision,¹⁵⁷ applied the separate fund theory to an employer's contributions which reverted to the employer in the event of early death of the participant's surviving spouse. The court held that a reversion in favor of the employer did not create a nondeductible terminable interest in the survivor benefit attributable to the employer's contributions.

152. Rev. Rul. 76-404, 1976-2 C.B. 294.

153. Treas. Reg. § 20.2056(b)-1(g) (1984); Rev. Rul. 85-100, 1985-29 I.R.B. 10.

154. 364 U.S. 410 (1960).

155. *Id.* at 413.

156. Rev. Rul. 77-130, 1977-1 C.B. 289.

157. *Estate of Allen v. Comm'r*, 39 T.C. 817 (1963), *acq.* 1964-1 C.B. 4.

When the surviving spouse is not the sole beneficiary under the plan and the separate fund theory is not available for the spouse's interest, the marital deduction will not be available unless one of the three exceptions¹⁵⁸ to the nondeductible terminable interest rule applies. As indicated before, the power of appointment exceptions may have limited application to tax favored plans, but the elective marital deduction¹⁵⁹ for qualified income and annuity interests may be available for a benefit passing to a surviving spouse payable until the death of the spouse even though a benefit may continue for another beneficiary after the spouse's death.

V. CONCLUSION

Survivor annuity benefits paid from tax favored and other plans are an increasingly important part of total wealth transfers occurring at death, and repeal of the estate tax exclusion in section 2039 increased significantly the scope of the federal estate tax on these benefits. For those survivor benefits not subject to section 2039 the Service will rely on several transfer tax theories to impose an estate tax on the estate of the individual whose efforts produced the benefit. A survivor benefit paid in a qualifying form to a surviving spouse may qualify for the unlimited transfer tax marital deduction and present an opportunity for transfer tax mitigation and deferral.

158. I.R.C. § 2056(b)(5), (6), (7) (1984); *supra* notes 132-41.

159. I.R.C. § 2056(b)(7) (1984).