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SOME FEDERAL TAX ASPECTS OF LIFE INSURANCE

RICHARD C. GROLL*

PEOPLE in all stations of life utilize life insurance, and as a result thereof, life insurance is one of the most popular investment forms. Life insurance has enjoyed traditional popularity. By 1860, the American people owned an estimated \$173 million in life insurance protection. By 1900, 13% of the American population owned more than \$7.6 billion. More than \$3.8 billion was paid out in 1962 to beneficiaries of policyholders who died during that year, and 65% of the population owned more than \$675.9 billion in life insurance protection.¹

Because of the magnitude of the life insurance protection held, and the policy proceeds paid each year to beneficiaries, attention has been continually drawn to the appropriate tax treatment to be accorded life insurance. This article first undertakes a discussion of the current estate tax treatment accorded life insurance proceeds plus certain recommendations for statutory reform. Second, the breadth of the estate tax provisions dealing with life insurance proceeds are questioned by an examination of three current problems—flight insurance, employee death benefits and insurance-annuity plans. Finally, the income tax aspects of certain life insurance plans are considered.

ESTATE TAX HISTORY

The estate tax treatment of life insurance proceeds has been subject to more vacillation and variation by the Treasury Department and Congress than any other asset area. There is still considerable controversy and discussion regarding life insurance and the estate tax. A discussion of the past and present treatment accorded life insurance plus a recommendation for future action follows.

¹ KILSEY & DANIELS, *LIFE INSURANCE* (2d ed. 1964).

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By means of the 1918 Revenue Act, the proceeds of life insurance contracts were first made subject to the federal estate tax. The prior Act made no express reference to life insurance.² The two basic subdivisions for the tax includibility of insurance proceeds in the estate of a decedent, found in the present Code, were also found in the 1918 provisions.³ First, proceeds payable to the estate of the insured were taxable to his estate. Second, proceeds payable to beneficiaries other than the estate of the insured could be taxed to the insured's estate to the extent that such proceeds exceeded \$40,000.

This original statute provided estate tax consequences where such insurance had been "taken out by the decedent upon his own life."⁴ When the proceeds were made payable to the insured's estate, no serious problems of statutory interpretation were presented, but interpretation of the phrase encountered considerable difficulty when the proceeds were made payable to beneficiaries other than the estate. This statutory requirement created uncertainty as to its precise meaning. The breadth of the includibility of insurance proceeds was often challenged, and the result hinged upon the court's interpretation of this vital phrase.

The ordinary and plain meaning of the phrase would indicate that the sole test was whether the insured had initially made application for the policy. The Treasury's position was that the phrase had a much greater scope than that limited interpretation. The Regulations promulgated in 1919, by the Treasury, first introduced the "premium payment test."⁵ They took the position that policy proceeds payable to beneficiaries other than the insured's estate were taxable only to the extent that the premium payments had been made by the insured. Ten years later, the Treasury modified its position and indicated that the insured must have possessed incidents of ownership in the insurance policies, in addition to his payment of premiums, in order to have the proceeds subject to the estate tax.⁶ The introduction of the "incidents

² The Revenue Act of 1916 made no direct reference to life insurance for estate tax purposes.

³ Revenue Act of 1918, ch. 4, § 402(f), 40 Stat. 1098, which stated as follows: "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated . . . (f) [t]o the extent of the amount receivable by the executor or insurance under policies taken out by the decedent upon his own life; and to the extent of all excess over \$40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life."

⁴ *Ibid.*

⁵ Treas. Reg. § 37 (1919).

⁶ Treas. Reg. § 70 (1929).

of ownership" test was the product of a 1929 decision of the Supreme Court.⁷

In 1934, the Regulations took the view that the premium payment test and the "incidents of ownership" test were alternatives, either one of which would cause the insurance proceeds to be taxable in the gross estate of the insured if the proceeds were payable to a beneficiary other than the estate of the insured.⁸ If the insured possessed any of the incidents of ownership in the policies or if he paid the premiums, the insurance was considered to have been taken out by the decedent upon his own life, and thereby subjecting the insurance to the tax.

In a final attempt to give precise meaning to this imprecise phrase, the Treasury proposed new Regulations in 1941. These took the position that the payment of premiums was the exclusive test for the taxability of the policy proceeds which were payable to beneficiaries other than the insured's estate.⁹

The statutory provision for the taxability of life insurance proceeds remained the same from 1918 to 1942. In 1942, Congress overhauled the Internal Revenue Code and produced more precise standards for the taxability of insurance.¹⁰ The \$40,000 exemption for proceeds payable to beneficiaries other than the insured's estate was removed. The phrase "taken out by the decedent upon his own life" was also removed, and Congress adopted the substance of the Regulations promulgated by the Treasury in 1934.¹¹ Where the policy proceeds were payable to the insured's estate, the result was the same as under the 1918 Act, and the proceeds were subject to the tax, regardless of who paid the premiums.

As to policy proceeds which were payable to beneficiaries other than the estate of the insured, they were subject to the tax if either one of two alternative requirements were satisfied. First, regardless of who met the premium payment obligation, if the insured at his death possessed any incidents of ownership under the policies, the proceeds were subject to estate tax. Secondly, where the insured paid the premiums on such policies, with or without possessing any of the

⁷ Chase National Bank v. United States, 278 U.S. 327 (1929).

⁸ Treas. Reg. § 80 (1934).

⁹ Treas. Reg. 80, as amended, T.D. 5032, 1941-1 CUM. BULL. 427.

¹⁰ INT. REV. CODE OF 1939, § 811(g), as amended by The Revenue Act of 1942, ch. 619, § 404, 56 Stat. 798.

¹¹ *Supra* note 8.

incidents of ownership, the proceeds were equally subject to the tax.

One wrinkle in the statutory provision was where the insured possessed none of the incidents of ownership under the policies and maintained only a portion of the premiums. Upon the insured's death, only the proportion of the proceeds which corresponded to the share of the premiums paid by the insured was made subject to the estate tax.

1954 CODE

In 1954, Congress viewed the past history of the estate tax treatment of life insurance and proceeded to eliminate the premium payment test for estate tax includibility.¹² Insurance proceeds which were paid to the estate of the insured remained fully taxable, as they were under all Revenue Acts since 1918, but with regard to the proceeds of life insurance payable to beneficiaries other than the insured's estate, the sole test for estate tax includibility became whether the insured possessed, at his death, any of the incidents of ownership under the policies. If the insured possessed any of these incidents, exercisable alone or in conjunction with any other person, the proceeds are includible in the estate tax, regardless of who paid the premiums.

In addition to this major change, the 1954 Code provides that a reversionary interest in the insurance policy is an incident of ownership, provided that it had a value of more than five per cent immediately prior to the insured's death.¹³ This is a departure from the definition of "incidents of ownership" under the 1942 Act.

Hence, the includibility of life insurance proceeds is determined by whether or not the insured possessed any of the requisite "incidents of ownership." Under the 1942 provisions of the Internal Revenue Code, premium payment was the crucial test for estate tax inclusion. The "incidents of ownership" test was not of the greatest importance, since in most instances, the insured could not avoid paying the premiums on his insurance, directly or indirectly, and consequently, the proceeds were includible under the premium payment test. While the premium payment test was in force, once the insured had started to pay the

¹² INTERNAL REVENUE CODE OF 1954, § 2042. All sections hereinafter mentioned are sections from the INTERNAL REVENUE CODE OF 1954, unless otherwise specified.

¹³ INT. REV. CODE OF 1954, § 2042(2), which provides that the term incidents of ownership includes "a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent."

premiums on a policy of insurance on his life, it was not possible for him, by transferring the policy, to remove all the proceeds from his gross estate. The test was a permanent roadblock to such a result.

Under the 1954 provisions of the Code, the insured can maintain the premium payments himself and still prevent tax includibility of the proceeds if he does not possess the incidents of ownership. The sole test described by the 1954 Code is whether or not the insured possessed any of the "incidents" at his death. It is, therefore, upon the interpretation of the phrase "incidents of ownership" that hinges the estate tax consequences of most insurance arrangements. The Regulations provide that the term is not limited in application to ownership of the insurance contract in the technical property law sense. It has reference to the right of the insured to the economic benefits of the contract. The term includes "the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan or to obtain from the insured a loan against the surrender value of the policy."¹⁴

To what extent the insured may have indirect control over the ownership rights in the policy while not having legal ownership, and yet subject the proceeds to estate tax, is not specifically set out in either the Code or the Regulations. The Regulations do, however, clearly suggest that if the insured possesses any of the enumerated rights under the insurance contract, then, even though legal ownership is held by another, the insured will have satisfied the requirement of possessing "incidents of ownership," and the policy proceeds will be fully taxable. In this connection, it should be remembered that an incident of ownership need only be "possessed" in order to include the proceeds. The word "retained" is not used in the section. Thus, a power to change the beneficiary given the insured by a third party is an incident of ownership.

The power to change the beneficiary is one of the most basic incidents of ownership. If the power to change a beneficiary is the sole incident of ownership possessed by an insured and such power is lost, the proceeds should become free of estate tax liability under section 2042 of the Code. An insured may rid himself of this incident of ownership by making an irrevocable designation of the beneficiary.¹⁵ Such irrevocable designation has been held sufficient to rid the in-

¹⁴ Treas. Reg. § 20.2042-1(c)(2) (1958).

¹⁵ Estate of Michael Collino, 25 T.C. 1026 (1956).

sured of the power even where the irrevocably designated beneficiary owner gave the insured a right to designate a relative to receive one-half of the proceeds.¹⁶ However, even though a beneficiary may be irrevocably designated, and thereby the insured no longer possesses the power, the insured may retain other powers or rights under the insurance contract sufficient to warrant inclusion of the proceeds.

In cases prior to 1942, in which the insured could change the beneficiary only by securing the consent of the beneficiary, the consent requirement was considered to have deprived the insured of any power.¹⁷ In 1942, the Internal Revenue Code was altered, and it now provides that the proceeds of life insurance on the life of a decedent will be included in an estate tax computation if the decedent possessed incidents of ownership "either alone or in conjunction with any other person."¹⁸ In interpreting this added phrase, it has been held that a decedent possessed incidents of ownership in policies transferred to a trust which could be altered, amended or revoked only upon the consent of the decedent, his wife, and daughter.¹⁹ This change has caused an expansion of the estate taxation of life insurance proceeds, and estate tax inclusion should follow where an insured can change the beneficiary only upon securing the approval of the present beneficiary or where an insured's approval is necessary before a change of beneficiary can take place.²⁰

While indirect control by an insured over life insurance may constitute an incident of ownership under certain circumstances, it has been held that a right in an insured to give investment advice to the trustee of an insurance trust,²¹ or a power of veto over changes of investments by a trustee of an insurance trust²² do not constitute incidents of ownership.

¹⁶ John C. Morrow, 19 T.C. 1068 (1953), wherein an employer was the owner-beneficiary of a policy on the life on an employee and apart from the insurance contract, gave the employee the right to name a relative as the recipient of one-half the death proceeds. The court held that such contract right was not an incident of ownership.

¹⁷ Pennsylvania Co. for Insurance on Lives & Granting Annuities, Ex'rs v. Comm'r, 79 F.2d 295 (3rd Cir. 1935), *cert. denied*, 296 U.S. 651 (1935).

¹⁸ *Supra* note 13.

¹⁹ Estate of Karaghusian, 233 F.2d 197 (2d Cir. 1956).

²⁰ Estate of Goldstein v. United States, 129 Ct. Cl. 264, 122 F. Supp. 677 (1954), *cert. denied*, 348 U.S. 942 (1955).

²¹ Estate of Mudge, 27 T.C. 188 (1956).

²² Estate of Carlton v. Comm'r., 298 F.2d 415 (2d Cir. 1962).

While the Regulations specifically indicate that the Treasury contemplates the scope of section 2042 to include ownership of a policy by a corporation of which the insured is the sole stockholder,²³ it has been held that ownership of a 50% share of a partnership by an insured does not constitute an incident of ownership over policies owned by the partnership entity.²⁴

In a practical manner, the changes in the law have now encouraged many estate planners to devise numerous methods of holding and dealing with life insurance contracts while avoiding the estate tax. Under the 1942 provision, estate planners sought to keep the insurance out of the estate of an insured by arranging to have the premiums paid and incidents of ownership held by someone other than the insured. This was a formidable task to say the least. Since the premium payment test is no longer relevant, estate planners now devote their attention to excluding the insurance proceeds from the estate of the insured by having the incidents of ownership held by someone other than the insured. The 1954 Code provision affords the tax planner a great amount of latitude in the manipulation of life insurance.

Since the enactment of the 1954 Code, which eliminated the payment of premium test, there have been many proposals to reintroduce the tests.²⁵ The most basic objection rendered against the re-enactment of the test is that when the insured does not possess any of the incidents of ownership in the insurance contract, it is maintained that nothing is transferred from the insured to the beneficiary owner at the death of the insured. Furthermore, it has been suggested that the death of the insured merely matures a contract right in favor of the beneficiary.²⁶

If this line of reasoning were accepted, the premium payment test could be considered unconstitutional, because it would constitute an unapportioned direct tax on property in violation of Article I of the Constitution. This type of contention was laid to rest in *United States*

²³ Treas. Reg. § 20.2042-1(c) (2) (1958).

²⁴ *Estate of Knipp v. Comm'r.*, 244 F.2d 436 (4th Cir. 1957), *cert. denied*, 355 U.S. 827 (1957).

²⁵ See generally, LOUNDES & KRAMER, *FEDERAL ESTATE AND GIFT TAXES* 277 (2d ed. 1962); *Hearings Before a Subcommittee of the House of Representatives Committee on Ways and Means*, 84th Congress, 1st Sess., at 868-69 (1955); *Hearings Before a Subcommittee of the House of Representatives Committee on Ways and Means*, 84th Cong. 2d Sess. (1956).

²⁶ Brown, *Facts of the Life Insurance Premium Payment Test*, 34 *TAXES* 727, 728 (1956).

*v. The Manufacturers National Bank of Detroit.*²⁷ In this case, the insured made a complete assignment and transfer of the policies on his own life. The insured retained no incidents of ownership after the assignment date, but he did pay all the insurance premiums prior to, and subsequent to, the assignment. While the Court recognized that the payment of premiums under such circumstances constituted an inter vivos gift, Congress was held to have the right to impose an estate tax upon such gifts if they were made with a view toward death. Therefore, a tax may be imposed on the final step, which is the maturing of the right to the proceeds at the death of the insured. The Court found that there was a transfer at the death of the insured, since the beneficiary's right to the proceeds ripens at the death of the insured.

Since the Constitutional objections have been laid to rest, the substantive merits of the premium payment test can be considered. Advocates of the re-enactment of the test suggest that the very nature of life insurance compels the conclusion that it is not like other investment assets, and therefore, that it should not receive the tax treatment given other investment assets. It is urged that life insurance is "testamentary" in nature for several significant reasons. The purchase of life insurance on one's own life is made for the avowed purpose of providing for a fund of money to pass at death to the objects of one's bounty. Life insurance was devised and perpetuated in popularity as an effective mechanism for creating this fund of money. The basic concept of life insurance is the accomplishment of this goal, and all other attributes of a life insurance contract are secondary in importance.²⁸

Under this view, the insured purchases a life insurance contract in order to create a fund of money which will pass to a named beneficiary at the death of the insured, and it can be termed testamentary in nature. While the insured can use the device of life insurance to satisfy divergent social and business responsibilities, the primary goal to be accomplished by the maintenance of such a contract is the creation of the fund and its passing at death. In the mind of an advocate

²⁷ 363 U.S. 194 (1960).

²⁸ H.R. REP. NO. 1337, 83rd Cong., 2d Sess. A316 (1954) (minority report): "It is sought to justify this change as merely putting life insurance on a par with other property which may be given away free from estate tax if the gift is not made 'in contemplation of death.' But life insurance is not like other property, it is inherently testamentary in nature. It is designed, in effect, to serve as a will regardless of its investment features. Where the insured has paid the premiums on life insurance for the purpose of adding to what he leaves behind at his death for his beneficiary, the insurance proceeds should be included in his taxable estate."

of the premium payment test, these inherent characteristics of life insurance lead to the inescapable conclusion that life insurance is testamentary.

Once concluding that life insurance is inherently testamentary, it is urged that it should receive tax treatment consistent with this basic characteristic.²⁹ The premium payment test then becomes a logical method of taxing the life insurance proceeds, and one which is particularly adapted to its nature. The basis of this conclusion is that the insured purchases the contract in order to produce the fund which will pass to the designated beneficiary at his death. This all-important fund is established through the payment of premiums. The premiums are paid to the insuring company, invested and reinvested by the company, and then paid over to the beneficiary at death. Therefore, when the economic source of the fund which passes to the beneficiary is the insured through his premium payments, the fund should be included in the taxable estate. The inclusion should be dependent upon whether the insured had been financially responsible for the transfer of the fund at his death.

While the arguments in favor of the premium payment test deserve consideration, there are cogent arguments against the test which should be considered.³⁰ The contention that life insurance is testamentary in nature is not seriously disputed. The significant argument presented is that life insurance is not unique in its possession of testamentary characteristics, and that the premium payment test unfairly singles out life insurance for discriminatory estate tax treatment. A United States Senate report put it in this manner:

The proceeds of life insurance on a decedent are subject to tax in his estate under present law if the policy is payable to the executor, if the decedent paid the premiums on the policy (in this case includible in proportion to the amount paid), or if the decedent possessed any elements of ownership in the policy at date of death. No other property is subject to estate tax where the decedent initially purchased it and then long before his death gave away all rights to the property and to discriminate against life insurance in this regard is not justified.³¹

In further support of the contention that the possession or non-possession of the economic benefits should be the decisive test rather

²⁹ Schlesinger, *Taxes and Insurance: A Suggested Solution to the Uncertain Cost of Dying*, 55 HARV. L. REV. 226, 230-35 (1941).

³⁰ Swihart, *Federal Taxation of Life Insurance Wealth*, 37 IND. L.J. 167 (1962); Brown, *supra* note 26.

³¹ S. REP. No. 1622, 83rd Cong., 2d Sess. 472 (1954).

than the premium payment test, it is pointed out that life insurance contracts have certain characteristics which are similar to other investment assets. The owner of an insurance contract has the right to use it as collateral security for a loan, he may borrow from the insuring company against the cash surrender value, and he has rights to assign the contract or change the beneficiary. Since an insurance contract does contain these features, its taxability should be determined on the basis of economic ownership.³²

PROPOSAL

In facing the problem of the proper estate tax treatment to be accorded life insurance, one is faced with the continual arguments in favor of the present tax treatment and those who favor the re-enactment of the premium payment test. The argument has been continually made that the premium payment test unfairly discriminates against life insurance. The reform enactment of 1954 was an attempt to place life insurance on a par with other investment assets, and Section 2042 of the 1954 Revenue Code exemplifies this attempt.³³ In basic effect, this section provides that when the taxpayer economically owns the life insurance contract during his lifetime, or when the policy proceeds are payable to his estate and thereby are available to meet his debts, then the proceeds are tax includible in his estate.

It is the situation where the taxpayer did not possess any of the requisite "incidents of ownership" during his lifetime, and yet is subject to estate tax on the policy proceeds because of his payment of premiums, which encounters the most objection. It strikes against the logic of many to include the proceeds of life insurance in the taxable estate of an insured as an asset of his estate, since the insured did not enjoy the benefits of ownership during his life-time.

The principal assault lodged against the present estate tax treatment is that life insurance is "inherently testamentary," and therefore should not receive the treatment accorded to "nontestamentary" investment assets. Aside from this discussion, the practical objection to the present tax treatment appears to be the comparable ease with which estate tax avoidance can be achieved without substantial sacrifice. The situation in which a close member of the insured's family owns the insurance policy and the insured maintains the premium payments is not uncommon. By the use of this simple device, compliance with the statute is achieved, and the policy proceeds go untaxed, while the

³² Swihart, *supra* note 30 at 180-1.

³³ *Supra* note 31.

economic benefits may remain, in a practical sense, available to the insured.

Applying the logic of the advocates of the present tax treatment, it should follow that the proceeds of life insurance contracts should be estate tax includible if the insured enjoys the economic benefits of the contract during his life-time. The consequences which are incident to such ownership rights should follow even where the insured does not technically own the policies. Even if we assume that life insurance is not "inherently testamentary" in nature, it does not necessarily follow that the policy proceeds should escape estate tax where the insured, in a practical sense, enjoys the living benefits and is financially responsible for the existence of the policy.

It should be pointed out that underlying any proposed amendment to section 2042 of the Internal Revenue Code is the assumption that life insurance does have a testamentary quality which sets it apart from other investment assets. Without this basic assumption, the current provisions of the Internal Revenue Code, which provide the estate tax treatment of life insurance, would have to be indorsed. If a taxpayer owns a share of stock which he intends his spouse to have at his death, he may provide for its transfer prior to death. However, the realities of the situation may show that during the transferor's life-time he retains practical economic control over the stock. This state of affairs does not cause the share of stock to be included in the transferor's estate, and indeed, it should not.

While most life insurance contracts contain numerous economic benefits accessible to the insured, during his lifetime, it is acquired and used to effect a transfer of property at death. But those who oppose the payment of premiums test do not squarely meet the contention that life insurance is testamentary in nature. Their underlying objection is that an asset should not be taxed as part of the estate of a nonowner.

If it is once conceded that a life insurance contract is a testamentary device, then an appropriate method of estate taxation must be developed. The argument that other testamentary devices may partially or wholly escape taxation are not relevant.³⁴ The fact that other taxing provisions are inappropriate should not impede the development of a method of taxing life insurance proceeds which is consistent with its basic characteristics. On this basis, it has been suggested that the por-

³⁴ Schlesinger, *supra* note 29 at 230-35.

tion of the insurance proceeds represented by the difference between the cash surrender value of the life insurance policy immediately prior to the insured's death and the full death proceeds should be the focus of attention for revision of the estate tax in this area.³⁵

This formulated amount arises as a result of an attempt to divide life insurance proceeds into two distinct funds of money. The first fund can be characterized as the "life fund" and is represented by the cash surrender value of the policy during the lifetime of the insured. Prior to the insured's death, a life insurance policy has a value represented by the cash surrender value.³⁶ It is this fund which the owner of a life insurance policy can consume, borrow against, or transfer to another. The "life fund" of an insurance contract is clearly an asset of the policy owner, and should the owner die holding this fund, it should be numbered among his estate assets.

Those who object to the premium payment test assert that if an insured does not have the economic benefit of this fund during his lifetime, then the policy proceeds should not suddenly be numbered among his assets at his death. This line of reasoning, however, genuinely proffers an argument only for noninclusion of the cash surrender value of a life insurance contract, since it is only this element which is deprived of an insured.

The second fund can be characterized as the "testamentary fund" of the full life insurance death proceeds and is represented by the excess of the death proceeds over the cash surrender value of the policy immediately prior to the insured's death. While the cash surrender value of a policy can be freely consumed or transferred by an order prior to the insured's death, the "testamentary fund" is not accessible until the insured's death. This element of the full death proceeds ripens at the death of the insured and passes to the named beneficiary solely by reason of the death of the insured.

Since the described fund springs into existence and passes to the named beneficiary at the death of the insured, it should be classified as the testamentary element of the full life insurance proceeds and taxed to the estate of the insured who has been financially responsible for its transfer. It is, therefore, proposed that where an insured has

³⁵ *Ibid.*

³⁶ *United States v. Ryerson*, 312 U.S. 260 (1941); and *Guggenheim v. Rasquin*, 312 U.S. 254 (1941) hold that the value of an insurance policy to an insured during his lifetime is the replacement cost. The cash surrender value has been chosen for purposes of the proposed amendment since it is definite and more easily ascertainable.

been the economic source of the insurance proceeds through his payment of premiums, the amount of the death proceeds represented by the excess over the cash surrender value immediately prior to the insured's death should be included in his taxable estate. This result should follow regardless of who was the owner of the policy.

It must then be considered whether this "testamentary fund" should be controlling for estate tax purposes where the insured possessed the incidents of ownership in the policy but did not maintain the premium payments. Under the present statutory provision, the entire death benefit is included in the insured's gross estate if he possessed the requisite incidents of ownership in the policies. This treatment is consistent with the estate tax treatment accorded other investment assets, and therefore, it should be maintained. While it may be asserted that unless the proceeds are payable to the insured's estate, he never enjoys the full benefit of the face amount of the policy, economically, the insured only has the benefit of the cash surrender value of the policy during his lifetime. Hence, unless he has been responsible for the premium payments, only the cash surrender value of the policy should be included in his estate.

However, assets other than insurance are includible in the decedent's estate when he has had ownership during his lifetime, regardless of who provided the economic source for such ownership. Therefore, insurance in this respect should receive similar tax treatment. When an insured has enjoyed the living benefits under the policy, whatever they may have been, the value as of the date of death should be estate tax includible.

Inclusion of the described "testamentary fund" should occur when ownership of a life insurance contract is held by someone other than the named insured and the insured has maintained the premium payments. Under these circumstances, the insured is using his economic resources to provide for a fund (i.e., that portion of the death proceeds over and above the cash surrender value immediately prior to his death) to pass to a named beneficiary at his death. The proposed test should be added to section 2042 as an additional circumstance under which proceeds of life insurance will be subject to estate tax liability. When an insured possesses the incidents of ownership in policies of insurance on his own life, then the full death proceeds should be included in his taxable estate, as now provided by section 2042.

If an insured does not possess any of the incidents of ownership in policies and does not make the premium payments, the proceeds should go untaxed. The proposed amendment seeks only to add to the present estate tax provisions the situation where an insured makes the premium payments for life insurance policies. Under this circumstance, the described testamentary element will be estate tax includible as a testamentary disposition of the insured's property. The amendment is proposed in order to avoid exclusion of the full policy proceeds, where an insured provides, through his premium payment, for a testamentary transfer. Finally, since the constitutionality of the premium payment test has been settled, the proposed amendment should encounter no objection in this area.

PREMIUM PAYMENT AND CONTEMPLATION OF DEATH

As previously indicated, the provisions of the 1954 Internal Revenue Code attempt to place the estate tax treatment accorded life insurance on a par with the treatment of other investment assets. Since the enactment of section 2042 of the 1954 Code, it has been the goal of estate planners to provide that the insured does not possess any incidents of ownership over the life insurance policies on his own life. If the insured avoids possessing any incidents of ownership, then the life insurance proceeds payable by reason of his death can be passed to a named beneficiary free of the estate tax.

While a variety of considerations must be weighed prior to making a final decision, it may be advisable under certain circumstances to have an insured make a complete transfer of the ownership of his life insurance policies to the intended beneficiary. In a typical situation, a husband will transfer a policy on his own life to his wife, the designated beneficiary. While the transfer of the policy constitutes a taxable gift,³⁷ the tax will be imposed only on the value of the policy at the time of the transfer.³⁸ If the transfer takes place early in the life of the insurance policy and before a substantial cash surrender value has been established, the replacement value as of the date of transfer will be decidedly smaller than the face amount of the policy. Should the beneficiary outlive the insured, a substantial net savings may result.

If the insured husband continues to pay the premiums on the life insurance policies he has transferred, a gift for federal gift tax purposes

³⁷ INT. REV. CODE OF 1954, § 2501.

³⁸ See *supra* note 36

is made at the time each premium is made.³⁹ Speculation has arisen as to possible estate tax consequences of this continuation of premium payments by the insured husband.⁴⁰ The scope of section 2035 may include these premium payments, under certain circumstances, and the result of such inclusion is open to question.

Section 2035 provides that the decedent's gross estate shall include the value of all property transferred by the decedent without valuable consideration in contemplation of death.⁴¹ The section further states that all such transfers made within three years of the death of the transferor decedent shall be presumed to have been made in contemplation of death.⁴² As the Treasury Regulations indicate, a transfer of a life insurance policy in contemplation of death falls within the scope of section 2035, and the proceeds of the policy are includible in the insured's gross estate.⁴³ Therefore, in the typical situation, if a husband transfers a policy of life insurance on his own life to his wife and he dies within three years of such transfer, the transfer will be assumed to have been made in contemplation of death. If such assertion is sustained, the full death proceeds of the life insurance policy will be includible in the insured's gross taxable estate.⁴⁴

If a life insurance policy is transferred by an insured husband and he survives three years after such transfer, then the transfer is brought within the protection of section 2035(b), which indicates that no transfer made more than three years prior to death shall be treated as having been made in contemplation of death.⁴⁵ The question then arises as to the consequences of the husband's continued payment of the policy premiums. The provisions of section 2042 and section 2035

³⁹ Treas. Reg. § 25.2511-1(b) (8) (1958).

⁴⁰ For a detailed discussion of this topic, see Brown & Sherman, *Payments of Premiums as Transfers in Contemplation of Death*, 101 TRUSTS & ESTATES 790 (1962); Goodson, *Are Life Insurance Proceeds Gifts in Contemplation of Death?* 103 TRUSTS & ESTATES 25 (1964).

⁴¹ INT. REV. CODE OF 1954, § 2035(a), which states: "The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, in contemplation of death."

⁴² INT. REV. CODE OF 1954, § 2035(b).

⁴³ Treas. Reg. § 20.2035-1(a) (c) (1958). See Estate of Garrett, 8 T.C. 492 (1950).

⁴⁴ Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945).

⁴⁵ *Supra* note 42, which indicates that "no such transfer, relinquishment, exercise or release made before such 3-year period shall be treated as having been made in contemplation of death."

indicate that if the proceeds of a life insurance policy are payable to a designated beneficiary other than the insured's estate, and if the insured possessed none of the incidents of ownership over the policy, and the transfer of the policy was not made in contemplation of death, the proceeds should not be includible in the insured's gross taxable estate.

Some writers suggest, however, that this result is not certain where the insured continues to meet the premium payment obligation after the transfer.⁴⁶ A premium payment, by an insured, made to continue a policy which is owned by another constitutes a gift for federal gift tax purposes. A premium payment made within three years of death will, by the terms of section 2035, be presumed to have been made in contemplation of death. At first blush, it may be assumed that only the cash value of the premiums paid would be includible in the taxable estate of the insured if such premium payment is classified as a transfer in contemplation of death. However, it has been suggested that the taxable estate should include that portion of the death proceeds attributable to the premium payments made in contemplation of death.⁴⁷

The indicated contention stems from a case involving a transfer of a life insurance policy in contemplation of death. In *Liebman v. Hassett*,⁴⁸ an insured transferred a policy of life insurance on his own life to his wife. The insured died within two years after the transfer, and the wife had paid the two annual premiums subsequent to the transfer. The wife, who was the policy beneficiary, conceded that the policy had been transferred in contemplation of death, but she argued that her husband's estate should only include the cash surrender value of the policy as of the transfer date. The court held that the face amount of the policy less that proportionate amount of the insurance proceeds purchased with the premiums paid by the transferee was to be included in the gross taxable estate. The court's method of excluding that portion of the insurance proceeds attributable to the wife's subsequent premium payments has given rise to speculation that similar reasoning would follow where the policy was transferred free of the three year limitation period, but where the insured made premium

⁴⁶ See generally, Mannheimer, Wheeler and Friedman, *Gifts of Life Insurance by the Insured*, N.Y.U. INST. ON FED. TAX 260 (1955); Schwartz, *Life Insurance Planning*, 35 So. CAL. L. REV. 1 (1962).

⁴⁷ *Ibid.*

⁴⁸ *Liebman v. Hassett*, *supra* note 44.

payments which could be classified as transfers in contemplation of death. This result might be sustained by taking the position that the gift of the life insurance policies to a transferee without funds to continue the premium payments, followed by the transferor's premium payments, should be considered as a continuing gift which is not completed until the death of the insured.⁴⁹

Returning to the typical situation, if the insured husband transferred a life insurance policy on his own life to his wife and the policy was nine years old when the insured died, and if the husband maintained the premium payments during the last three years prior to his death, then one-third of the death proceeds would be included in his gross taxable estate under the suggested reasoning. An extension of this concept might lead to the same conclusion where no prior transfer of the life insurance policy had occurred. Where the wife initially purchases a life insurance policy on her husband's life and solely possesses the incidents of ownership, section 2042 would indicate that the proceeds payable to the beneficiary wife should pass free of the estate tax. However, it might be argued that if the husband maintained the premium payment obligation, then that portion of the insurance proceeds attributable to his premium payments made in contemplation of death should fall into his taxable estate, even though there was no prior ownership of the insurance policy.

In opposition to the indicated result, it may be argued that all premium payments made by an insured within three years of his death on policies owned by another are not necessarily made in contemplation of death. It has been held that a gift of life insurance made within three years of death is not necessarily a gift in contemplation of death where there has been a sufficient showing of "life motives."⁵⁰ Even if it is conceded that a policy was transferred to save estate taxes, it should not be conclusively presumed that subsequent premium payments were similarly motivated. The motivation behind the premium payments might be to confer a present benefit upon the policy owner by discharging his current liability.

Even if the premium payments are made in contemplation of death,

⁴⁹ Cf. *Allen v. Trust Co. of Georgia*, 326 U.S. 630 (1946), wherein the release of a power of revocation by a settlor at age 82, and within three years of death, was held to perfect an earlier transfer, but it was held not to have been made in contemplation of death.

⁵⁰ *Estate of Hull*, 325 F.2d 367 (3rd Cir. 1963).

the theorized result should not be accepted. Where an insured pays premiums in contemplation of death, the actual dollar value of the premiums paid only should be estate tax includible. Section 2035 causes estate tax inclusion where a "transfer" is made in contemplation of death. The payment of premiums by an insured is a transfer of the sum of money used to pay the premiums. This sum of money is all that is transferred by the insured. The insured owns nothing else prior to the transfer. The word transfer indicates prior ownership, and in order to sustain the proposed result, it must be alleged that the insured, immediately prior to his premium payment, owned more than the funds used to make the premium payment, namely, an interest in the policy itself.

This reasoning is inconsistent with the facts. Where an insured transfers the life insurance policy to his wife, the insured must divest himself of all interest in the policy in order to escape the inclusion of the proceeds under the coverage of section 2042. If the insured, after the transfer, holds no interest in the policy, then no interest should be created merely from his continued payment of insurance premiums.⁵¹ The value of that fund used only to make premium payments should be included in the taxable estate of an insured when such payments are deemed made in contemplation of death. That fund represents the totality of the interest held by an insured decedent and transferred to another in contemplation of death.

The theorized result is an attempt to re-enact the premium payment test as a basis for the estate tax inclusion of life insurance proceeds. This test was expressly abandoned by Congress in 1954 and should not be reestablished by judicial interpretation of section 2042. If the result is one which is considered desirable, then section 2042 should be amended to reintroduce the test.

WHAT IS LIFE INSURANCE?

Section 2042 includes within the taxable estate, for estate purposes, property which is described as "insurance under policies on the life

⁵¹ Cf. *Goodnow v. United States*, 157 Ct. Cl. 526, 302 F.2d 516 (1962), wherein the decedent paid premiums on policies on her deceased husband's life which were payable to a trust created by him of which she was the income beneficiary for life. The question was whether the proceeds of these policies should be included in her gross estate on the theory that she made a transfer retaining a life interest, within the meaning of section 2036(a). The court held that the proceeds in which she had a life interest could not be equated with the premiums which she had paid, but rather was attributable to the policies transferred in trust by her husband.

of the decedent."⁵² The question then arises as to the interpretation of this vital phrase. Three problems involving the proper scope of section 2042 are considered.

FLIGHT INSURANCE: THE NOEL CASE

A serious question of the proper interpretation to be given to the phrase "insurance under policies on the life of the decedent" has arisen and been presented to the Supreme Court in the *Estate of Marshall L. Noel*.⁵³ The Supreme Court granted certiorari in order to review the decision of the court of appeals which held that flight insurance could not be classified as life insurance for the purpose of applying section 2042.

The Treasury's position with regard to this type of situation is clear and is set forth in a 1957 Revenue Ruling.⁵⁴ The facts which prompted the Ruling were that an insurer undertook to pay all damages assessed by law against the insured, including liability for passenger death resulting from an airplane accident. The payment of a sum-certain was available to a decedent passenger's personal representative upon a release of all damages. While these basic facts did not involve accidental death insurance or flight insurance, the Treasury indicated in the course of setting forth its position that if the contract between the insurance carrier and the owner of the airplane had provided that the insurance company would unconditionally pay an agreed amount to the estate of a passenger who died as a result of an airplane accident, then the proceeds of such an agreement would be characterized as life insurance for the purpose of section 2042.⁵⁵

While the question of flight insurance proceeds had not been resolved by court decision prior to the *Noel Case*, the question had been considered settled in the minds of many as a result of a 1929 decision of the Board of Tax Appeals. The Board, in the *Estate of Ackerman*,⁵⁶ did not deal with the question of flight insurance, but rather considered whether amounts received under accident policies and life insur-

⁵² INT. REV. CODE OF 1954, § 2042(2), which states in part: "The value of the gross estate shall include the value of all property . . . (2) [t]o the extent of the amount receivable by . . . beneficiaries as insurance, under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person."

⁵³ 380 U.S. 678 (1965).

⁵⁴ Rev. Rul. 57-54, 1957-1 Cum. Bull. 298.

⁵⁵ *Id.* at 298.

⁵⁶ 15 B.T.A. 635 (1929).

ance policies, which provided for double indemnity in the case of death from accidental means, should be included in the taxable estate of the decedent insured under the application of section 302(g) of the 1924 Revenue Act.⁵⁷ The Board realized and considered the distinction between life insurance and accident insurance, but it concluded that for purposes of the application of the relevant Code section, they were identical. In explaining the differences between the two types of agreements, the Board indicated that life insurance insures against death in any event, while accidental death policies insure against death under certain contingencies. The Board concluded by stating “[I]n each case the risk assumed by the insurer is the loss of the insured’s life, and the payment of the insurance money is contingent upon the loss of life.”⁵⁸

The Board further considered the distinction drawn between life and casualty insurance for the purpose of taxing the insurance company. The applicable section of the Internal Revenue Code provided for a tax on insurance companies upon the issuance of insurance policies and stated specifically the rates applicable to the different types of insurance agreements.⁵⁹ In comparing this provision of the Code and the distinction drawn, the Board presented the following argument in support of its findings:

Since we have in one part of the Act a distinction made between the different types of insurance policies and in another a general term which could well include two of these types, Congress would not have used the general term had it intended that it should be applicable to only one class. The provisions of Section 302(g) are broad enough to include both classes of insurance.⁶⁰

The Board of Tax Appeals in the *Ackerman* case argued that the proceeds of the accidental death benefit insurance policies were logically includible within the broad scope of the relevant Code provision.

The facts of this case are as follows: Marshall L. Noel, immediately prior to embarking upon an airplane trip to South America, made

⁵⁷ Revenue Act of 1924, ch. 234, § 302(g), 43 Stat. 253-35, which states in part: “The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated— . . . (g) [t]o extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life, and to the extent of all the excess over \$40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life.

⁵⁸ *Supra* note 56 at 637.

⁵⁹ Revenue Act of 1918, ch. 5, § 503, 40 Stat. 1104.

⁶⁰ *Supra* note 56 at 638.

written application for two flight insurance policies in the aggregate amount of \$125,000. The policies were delivered upon issuance to his wife, who was the named beneficiary. The policies reserved to the insured the sole right to assign the policy benefits. The premium for the policies were paid by the beneficiary. The policies were similar, in most respects, to the commonly issued flight insurance policies which provide for the payment of the principal amount should the insured be killed by reason of a flight accident. In addition to the protection afforded against the death of the insured, the policies included certain dollar benefits, in the event of the insured's sustaining one of the enumerated injuries by reason of an accident.

While en route to South America, the plane on which Noel was a passenger crashed and all were killed. After the death of the insured, the beneficiary affected collection of the insurance proceeds from the insurance companies, but they were not included in the estate tax return for the insured's estate. In resisting the inclusion of the proceeds in the taxable estate, it was contended that flight insurance is not the equivalent of "insurance under policies on the life of the decedent" within the meaning and scope of section 2042.

The Tax Court,⁶¹ in dealing with this novel situation, rendered the expected decision and held that the proceeds were includible in the estate and taxable as life insurance proceeds. As to defining life insurance so as to include a contract of flight insurance, the court recognized a distinction between accidental death insurance and life insurance, but it held that the question was settled as to their being identical for the purposes here involved. The Tax Court based its decision on the opinion rendered in the *Ackerman* case.

The case was then brought before the court of appeals.⁶² After a recital of the basic facts of the case, the court considered the distinction between life insurance and accidental death insurance, the distinction being considered extremely important. Life insurance was defined by the court to be a contract by which the insurer, in return for the payment of the prescribed premiums, agrees to pay a specified sum upon the occurrence of an *inevitable* event. The contingency insured against is the death of the insured, regardless of its cause, assuming that the cause is not one which is excepted under the terms of the policy. On the other hand, accident insurance is a contract

⁶¹ Estate of Marshall L. Noel, 39 T.C. 466 (1962).

⁶² Estate of Marshall L. Noel, 332 F.2d 950 (3rd Cir. 1964).

which by its terms the insurer agrees to indemnify the insured in the case of bodily injury, or the designated beneficiary in case of the death of the insured, for any loss sustained by reason of an event which is *evitable* (or not likely to occur). The contingency insured against is the accident. In the view of the court of appeals, death was only one of several liability-creating consequences.

The court hinged its decision on the basic difference in the risk to which the insurance company is exposed, under the two types of insurance contracts. It was indicated that once a policy of life insurance is taken out, the exposure of the company is fixed, and the company faces absolute liability, since the death of the insured is inevitable. The exposure of an insuring company under a policy of flight insurance is not absolute. The company would be forced to pay only if an unlikely event does occur. Evidently, the court felt that this latter exposure was in the nature of "casualty insurance," rather than life insurance, although the term was never used by the court. The court argued that "[a]n accident policy which provides for the payment of the principal sum in the event of the insured's accidental death is not thereby converted into a life policy; such a feature does not alter the essential nature of the insurance."⁶³

In the view of the court of appeals, the essential nature of the insurance is not life insurance, but casualty insurance. On this basis, the proceeds of such policies are not includible in the gross taxable estate.

At first blush, the reasoning of the court of appeals in rendering the *Noel* decision might appear merely to allow the proceeds of the flight insurance policies to escape estate tax liability. However, potential income tax consequences are presented by an attempt to distinguish flight insurance from life insurance. If a distinction is drawn between life insurance proceeds and the proceeds of accidental death insurance, for estate tax purposes, the question arises as to whether a distinction thus exists or should exist for purposes of income taxation.

Under the 1954 Code, the proceeds of a life insurance contract, whether received in a single sum or otherwise, are not included in the gross taxable income of the recipient beneficiary if they are paid by reason of the death of the insured. To be excluded from income under the application of section 101, two requirements must be satisfied: the amounts must have been received under a "life insurance

⁶³ *Id.* at 953.

contract," and such amounts must "be paid by reason of the death of the insured."⁶⁴ On this basis, the decision and reasoning of the court of appeals could be used to support the contention that the proceeds of an accidental death insurance contract (e.g., flight insurance) are not the product of a life insurance contract, and therefore, should not fall within the scope of the income tax exemption afforded under section 101.

Since the language of the statutory definition of gross income is broad enough to include life insurance proceeds, it was deemed necessary to provide specifically in the statute for the exclusion of them from gross income.⁶⁵ Certainly, the definition of gross income is equally broad enough to include the proceeds of accidental death insurance. It is wondered whether the court of appeals would hold that the proceeds of Mr. Noel's flight insurance policies, not being the product of a life insurance contract, are subject to income tax liability.

Carrying this contention one step further, it might be argued that such proceeds would be excluded from income tax liability under the terms of section 104.⁶⁶ This section excludes from gross income, among other things, amounts received under accident or health insurance policies for personal injury. With respect to amounts received under accident insurance, sections 104-106 form a statutory unit and should be considered together in weighing the taxability of sickness or injury insurance benefits. It appears, however, that sections 104-106 should be limited to "personal injury or sickness," rather than death benefits, and that Congress intended section 101 to afford an income tax exemption to death benefits which satisfies its statutory qualification. The 1954 Senate report stated, in part, that "[d]eath benefit[s] . . . under accidental and health insurance contract[s] which have the characteristics of life insurance proceeds payable by reason

⁶⁴ INT. REV. CODE OF 1954, § 101(a), which states, "[e]xcept as otherwise provided . . . , gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured."

⁶⁵ INT. REV. CODE OF 1954, § 61(a), which states, "except as otherwise provided . . . , gross income means all income from whatever source derived, including (but not limited to) the following items: . . . (10) income from life insurance and endowment contracts."

⁶⁶ INT. REV. CODE OF 1954, § 104(a) excludes from gross income amounts received as compensation for personal injury or sickness under workman's compensation acts; damages received for personal injuries or sickness, whether received by suit or under a settlement agreement; and amounts received under accident or health insurance."

of death" are excluded under section 101(a) as death proceeds of life insurance.⁶⁷

If the distinction, drawn by the court of appeals, between life insurance and accidental death insurance had been upheld and made applicable to the income tax sections of the Internal Revenue Code, a strong argument could have been made that accidental death proceeds would be subject to income tax liability. It appears likely that these potential income tax complications formed part of the basis for the Supreme Court's grant of certiorari.

In addition, it was reported that should the reasoning of the court of appeals be sustained, the result would directly affect, for estate tax purposes, similar airplane accident payments which, for the loss of life, amounted to \$7 million in 1963. Accidental death payments from insurance contracts totaled approximately \$73 million in 1962.⁶⁸

The Supreme Court granted certiorari in the *Noel Case*⁶⁹ and on April 29, 1965, the Court handed down its decision reversing the court of appeals and holding that the proceeds of Mr. Noel's flight insurance policies were subject to estate tax liability under the coverage of section 2042 of the Internal Revenue Code. In a brief opinion, written by Mr. Justice Black, the Court hinged its decision on the rationale of the Board of Tax Appeals in the *Ackerman* case and tacit Congressional approval of the *Ackerman* result.

In short fashion, the Supreme Court set aside the distinction drawn by the Court of Appeals between an insurance policy which is payable upon the happening of an *inevitable* event and one payable upon the occurrence of an *evitable* event, holding that there is no meaningful distinction between the two types of policies for estate tax purposes. The Court, in reaffirming the rationale of *Ackerman* stated:

This view of the Board of Tax Appeals is wholly consistent with the language of the statute itself which makes no distinction between "policies on the life of the decedent" which are payable in all events and those payable only if death comes in a certain way or within a certain time.⁷⁰

After approving the reasoning of the Board of Appeals in *Ackerman*, the Supreme Court pointed to the tacit Congressional approval of estate tax inclusion by indicating the continual re-enactment of

⁶⁷ S. REP. NO. 1622, 83rd Cong., 2d Sess. 180; H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A29 (1954).

⁶⁸ THE WALL STREET JOURNAL, December 8, 1964, p. 5.

⁶⁹ *Supra* note 53.

⁷⁰ *Id.* at 681.

section 2042 or its equivalent in a manner which never limited the *Ackerman* result.⁷¹

The court of appeals, in the *Noel Case*, hinged its decision on the distinction drawn between life insurance and accidental death insurance. The proceeds of an accident policy, not being the product of a life insurance contract in the view of the court, are not within the taxability provisions of section 2042. This statutory section covering insurance is limited to those amounts receivable as insurance under policies on the life of the decedent. "The term insurance refers to life insurance of every description" is the single statement of the Treasury Regulations as to the inclusiveness of the term, except that the Regulations also include fraternal benefits.⁷²

If the Congressional intention, previously indicated,⁷³ was that the proceeds of accidental death insurance were in the nature of life insurance proceeds, for the application of section 101, then it can be argued that such proceeds should be characterized as life insurance proceeds for the application of section 2042. The question in both situations is whether the proceeds are the product of a life insurance contract, within the meaning of the Code provisions, where the statute affords no mentioned distinction between the two types of insurance.

The authorities are meager as to what constitutes life insurance. In various contexts, the courts have attempted definitions, but none have evolved for the solution of the problem at hand. In considering whether payments made under a contract were to be classified as life insurance or the proceeds of an annuity, it was stated as follows:

A contract of insurance is generally regarded as one whereby, for a stipulated consideration, a party undertakes to indemnify another against loss by a specified contingency, or peril called a risk. In the case of life insurance the contingency is the death of the insured.⁷⁴

The fact that the contingency insured against in an accidental death policy is more narrowly defined by the terms of the policy so as to expose the insurer to liability only as to accidental death should not destroy its validity as a life insurance contract. Every policy, regardless of the purported liability of the insurance company, contains

⁷¹ *Ibid.*

⁷² Treas. Reg. § 20.2042-1(a)(1) (1958).

⁷³ *Supra* note 67.

⁷⁴ *Old Colony Trust Co. v. Comm'r*, 102 F.2d 380, 382 (1st Cir. 1941).

substantial qualifications and limitations to the insurance company's liability.

The basic test of defining insurance is that payments to qualify as insurance must be in settlement of a contract which has exposed the payor-company to a risk of financial loss. This requires that the contract provide for an amount payable at death in a sum fixed by a ratio of premiums paid to the probabilities of the risk occurring.⁷⁵ In consideration of this definition of life insurance, it does not appear that there is a substantial difference between a policy which covers the life of the decedent for death by accidental means and the straight life insurance contract. The premiums, in each instance, are determined on the basis of the ratio of the premiums paid to the probabilities of the occurrence of the risk insured against. The premiums charged by the insurance companies in the *Noel Case* for the accidental death protection were levied in consideration of this all important ratio.

A definite distinction between life insurance contracts and accident and health insurance contracts has been made in those cases which considered the taxation of insurance companies. In *United States v. New York Life Insurance Company*,⁷⁶ premiums collected by the insurance company for accidental death benefits of a life insurance contract were classified as payment for casualty insurance, under the terms of section 504 of the 1917 Revenue Act. The court stated as follows:

All life policies are paid in the event of death, but the liability of the company to pay double indemnity under such a policy depends, not upon the mere fact of death, but upon the existence of the additional circumstance, namely, an accident resulting in death.⁷⁷

This distinction was drawn, since the taxation of the insurance company depended upon the classification of the type of insurance written. The policies were classified as life insurance, marine, inland and fire insurance, and casualty insurance. The tax rates established and imposed were based upon the type of insurance agreements entered into by the taxpaying insurance company.

It appears that the court of appeals hinged its decision on the basis that accident insurance policies (e.g., flight insurance) have the characteristics of casualty insurance rather than life insurance. While

⁷⁵ *Helvering v. Le Gierse*, 312 U.S. 531, 539-40 (1941).

⁷⁶ 12 F.2d 643 (2d Cir. 1926).

⁷⁷ *Id.* at 646

the Court did not expressly use the term "casualty insurance," the characteristics of accident insurance, deemed determinative by the court, allow the conclusion that it made the distinction because it felt that such policies were in the nature of casualty insurance. The two types of insurance are clearly distinguishable in an insurance underwriting sense. The underwriter fixes the premiums in an accidental death policy, based on the probabilities of the risk being realized within the term of the policy. It is not certain that the risk will be realized. The premiums charged for a life insurance policy are calculated upon the probabilities of *when* the risk (the death of the insured) will be realized. The risk is certain to occur. The distinction drawn by the court of appeals may be meaningful in an insurance underwriting sense, but it should be clear that this type of distinction is not meaningful within the context of section 2042.

While the Supreme Court merely held in the *Noel* case that the proceeds of flight insurance policies are the product of policies on the life of the decedent within the meaning and scope of section 2042, the rationale of this decision has more extensive meaning. The decision should set adrift the notion that the scope of section 2042 is dependent upon underwriting concepts of life insurance. Technical underwriting differences should not affect the applicability of the taxing provisions of the section.

The distinction inferentially drawn by the court of appeals between life insurance and casualty insurance should hold no meaningful place in consideration of the taxability of insurance proceeds paid by reason of the death of an insured. In the history of the Internal Revenue Code, only in those sections governing the taxation of insurance companies has a distinction been drawn between ordinary life insurance and accidental death insurance. For estate tax purposes, it appears mandatory that since accidental death policies are merely a variant of the life insurance concept, their proceeds should fall within the coverage of section 2042. The wording of section 2042 and the corresponding Regulations indicate that the section should have application to flight insurance, accidental death insurance, double indemnity provisions and ordinary life insurance contracts, plus term insurance and all variations of these policies.

EMPLOYEE DEATH BENEFITS

One of the most common forms of life insurance protection arises by reason of the employment relationship. On this basis, a discussion

of the taxation of employee death benefits will follow, and certain recommendations are made regarding the appropriate estate tax to be accorded the proceeds of employee based life insurance.

Section 2039 was added to the Internal Revenue Code in 1954 in an attempt to supply a satisfactory method of taxing employee death benefits.⁷⁸ Section 2039(a) provides that the decedent employee's gross estate shall include the value of an annuity or any other payment receivable by a beneficiary under any form of contract or agreement. For the section to have application, the death benefit must be payable under the same contract or agreement under which an annuity or other payment was payable to the decedent, or under which the decedent possessed a 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 did not in fact end before his death.⁷⁹

Section 2039(b) defines the amount which is subject to estate tax inclusion under section 2039(a). The taxable amount is limited to that portion of the death benefit proportionately attributable to the decedent's contributions to the purchase price of the contract. However, in determining the decedent's contribution, the section provides that any contributions by the decedent's employer or former employer shall be attributed to the decedent when made by reason of the employment relationship.⁸⁰

While section 2039 is a comprehensive attempt to subject employee death benefits to the estate tax, the section leaves much to be desired and some inadequacies will be considered.⁸¹ While the section is not limited in its scope to employee death benefits, the following consideration will focus on this element of the taxing provisions of the section.

Section 2039 states that there is no tax liability imposed unless under a contract or agreement, either an annuity or other payment was

⁷⁸ H.R. REP. NO. 1337, 83rd Cong., 2d Sess. 90 (1954).

⁷⁹ INT. REV. CODE OF 1954, § 2039(a), which states that "[t]he gross estate shall include the value of an annuity or other payment receivable by a beneficiary by reason of surviving the decedent under any form of contract or agreement . . . 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."

⁸⁰ INT. REV. CODE OF 1954, § 2039(c), which indicates that employer contributions are not attributable to the employee if the plan qualifies under section 401 of the Code.

⁸¹ See Kramer, *Employee Benefits and Federal Estate and Gift Taxes*, 1959 DUKE L.J. 341 (1959); Comment, 66 YALE L.J. 1217 (1957).

payable to the employee or the employee possessed the right to receive such annuity or other payment for his life, or for any period not ascertained without reference to his death, or for a period which does not in fact end before his death. While the section leaves the phrase "was payable" undefined, a literal reading would indicate that a contractually enforceable right to such payment must have existed. The Treasury Regulations,⁸² however, temper this interpretation and take the position that the phrase includes any situation where, at death, the employee was in fact receiving payments from a benefit plan, even if his right to receive such payments was unenforceable. This construction of the statutory language considers the phrase "was receiving" to be synonymous with the phrase "was payable." While such interpretation appears to be in conflict with a literal reading of the statute, it is at least indirectly supported by the Committee Reports.⁸³

However, if the decedent was not actually receiving payments at his death, then he must have possessed a right to receive payments in the future in order to incur the tax imposed by the section. The section has no application if the decedent at his death had no enforceable right to receive inter vivos payments. The Regulations⁸⁴ state that a legally enforceable right includes a forfeitable one if, prior to death, the employee has complied with all his contractual obligations and there has been no forfeiture.

In this connection, it should be remembered that the required contract or agreement "includes any arrangement, understanding, plan or combination of arrangements, understandings, or plans arising by reason of the decedent's employment."⁸⁵ On this basis, the Regulations indicate that while purely voluntary benefit payments are not within the coverage of section 2039 since they are not paid pursuant to a contract or agreement, such payments may be subject to tax under the section where the employer has consistently made such payments in all cases irrespective of the lack of any legal rights thereto.⁸⁶

In an attempt to enlarge the scope of section 2039, with regard to this requirement that the decedent must have been receiving or have possessed a right to receive inter vivos payments, it has been suggested

⁸² Treas. Reg. § 20.2039-1(b)(1) (1958).

⁸³ H.R. REP. NO. 1337, *supra* note 78 at A314-5, ex. 1-3.

⁸⁴ *Supra* note 82.

⁸⁵ Treas. Reg. § 20.2039-1(b)(2), ex. 6 (1958).

⁸⁶ Treas. Reg. § 20.2039-1(b)(2), ex. 3 (1958).

that if the decedent was receiving a salary at the time of his death, such salary payments might qualify as payments payable to the decedent employee at his death.⁸⁷ This suggestion arises from an ambiguous example in the Committee Reports, wherein an annuity which was payable to a designated beneficiary of a deceased employee who died prior to retirement was said to be taxable, without any direct reference to the existence of a right in the employee to receive *inter vivos* payments in the future.⁸⁸ However, there appears to be no direct authority either in the Code or the Regulations for this conclusion, and it appears doubtful that this position would be judicially upheld.

For application of the tax consequences under section 2039, the interest payable to the surviving beneficiary must be payable under a contract or agreement. While the Regulations⁸⁹ indicate that such contract or agreement includes any arrangement, understanding, plan or combination thereof, it appears that the survivor's benefit is not taxed under the section unless a contractual right to such payment exists.

The Regulations take the position that if the benefits are payable to decedent under one contract and to the surviving beneficiary under another, the two agreements will be construed as a single contract in order to impose the tax under the section.⁹⁰ Further, the Committee Reports state that the benefits of the beneficiary are receivable under a contract even if they are fixed by an option or election exercised or exercisable by the employee, rather than directly by contract.⁹¹

It is clear that the scope of section 2039 is not limited to the taxation of annuity payments. The "annuity or other payments," as to either the employee or the beneficiary, includes equal or unequal payments, periodic or sporadic, lump or multiple payments.⁹² While the payments to the surviving beneficiary may take any form, life insurance is expressly excluded from the application of the section. If an employee death benefit is in the nature of life insurance, section 2039 has no application, and the benefit will be subject to the provisions of

⁸⁷ Kramer, *supra* note 81 at 356.

⁸⁸ H.R. REP. NO. 1337, *supra* note 78 at A315, ex. 4; S. REP. NO. 1622, *supra* note 67 at 470.

⁸⁹ Treas. Reg. § 20.2039-1(b)(1) (1958).

⁹⁰ *Supra* note 85.

⁹¹ S. REP. NO. 1622, *supra* note 67 at 470, ex. 3.

⁹² *Supra* note 89.

section 2042.⁹³ It appears that section 2039 and section 2042 were intended to be mutually exclusive in their coverage.

In determining the application of section 2039 to any given employee death benefit, the benefit must be classified either as the product of an insurance contract or a noninsurance contract. This determination is crucial, since taxability under section 2039 is based on entirely different standards than under section 2042. Under section 2042, the test for estate taxability of insurance proceeds of a policy on the decedent employee's life payable to a beneficiary other than his estate is the possession or nonpossession of the requisite incidents of ownership.⁹⁴ Under section 2039, however, the possession of incidents of ownership under the employee death benefit plan is not decisive, and if all other requirements are satisfied, then the proceeds are subject to the tax regardless of who possessed the incidents of ownership.

While an employee can rid himself of the incidents of ownership in policies of insurance on his own life, and thereby rid himself of liability under section 2042, such tax avoidance is not unilaterally possible under an employee death benefit which is not characterized as life insurance.

Since the estate tax consequences of an employee death benefit can vary sharply depending upon its classification as life insurance or noninsurance, the question of defining life insurance must be discussed again. The statutory provision covering life insurance includes amounts receivable as insurance under policies on the life of the decedent.⁹⁵ The Regulations expand this definition by stating that the term "insurance" refers to life insurance of every description.⁹⁶ While Congress apparently used the term with economic rather than purely contractual aspects in mind, death benefit plans outside the commercial insurance field are always open to question.

In *Helvering v. Le Gierse*,⁹⁷ the Supreme Court indicated that the basic test in defining insurance is that payments must be in settlement

⁹³ Treas. Reg. § 20.2039-1(d) (1958).

⁹⁴ *Supra* note 52.

⁹⁵ *Ibid.*

⁹⁶ Treas. Reg. § 20.2042-1(a)(1) (1958).

⁹⁷ *Supra* note 75 at 539: "Historically and commonly insurance involves risk shifting and risk distributing. That life insurance is desirable from an economic and social standpoint as a device to shift and distribute risk of loss from premature death is unquestionable. That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators."

of a contract which has exposed the payor company to a risk of financial loss. One test suggested by the Court was that the contract provides for an amount payable at death in a sum fixed upon a ratio of the premiums paid to the probabilities of the risk insured against.

In this regard, one case has established what appears to be the high-water mark for plans which contain the essential characteristics of life insurance so as to expose their proceeds to the estate tax under section 2042. In *Commissioner v. Treganowan*,⁹⁸ death benefits were payable to certain dependents of members of the New York Stock Exchange. The beneficiary was determined under the rules of the Exchange, and the benefits arose from assessments imposed upon the surviving Exchange members. The Tax Court⁹⁹ held that the death benefit was not life insurance since no insurance risk was presented. The court further ruled that the required insurance risk was not present since no premium was exacted in ratio to life expectancy. In reviewing this fact situation, the court of appeals held that the plan contained the essential elements of life insurance, since the risk of death was shifted to, or diffused among, a group of people. On this basis, the proceeds were subject to the estate tax under the coverage of section 2042. In the opinion of the court of appeals, a death benefit will be classified as life insurance where the risk of death is diffused among a number of people, and the requirement that premiums must be exacted in ratio to life expectancy is not essential. While the result in this case can be described as merely an extension of the craft, guild, or trade union concept of insurance, which is based upon a common occupation and follows assessment principles,¹⁰⁰ this type of decision should not be the basis of extending the concept of insurance to include all employee death benefits.

The Treasury Regulations under section 2039 set out several principles for determining the nature of an employee death benefit.¹⁰¹ The principles and examples contained in the Regulations involve the relationship between the reserve values established under a plan to the death benefit under a plan. While the principles set forth can readily be used to determine whether an insurance risk exists under a com-

⁹⁸ 183 F.2d 288 (2d Cir. 1950), *cert. denied*, 340 U.S. 854 (1950).

⁹⁹ Estate of Max Strauss, 13 T.C. 159 (1949), *rev'd, supra* note 98.

¹⁰⁰ *Id.* at 166-68 (dissenting opinion).

¹⁰¹ Treas. Reg. § 20.2039-1(d) (1958).

mercial insurance policy, neither these principles nor the case decisions in the field lay down practical standards for making a predictable decision with regard to plans outside the commercial insurance field.

The difference in tax consequences between death benefits characterized as life insurance and those which are the product of self-funded or unfunded employee plans should not depend upon a finding of risk-shifting, risk-distributing, diffusion or the requisite relationship between reserve values and the ultimate death benefit. It is, therefore, proposed that all employee death benefits should receive identical estate tax treatment, irrespective of their classification as insurance or noninsurance.

As indicated, while section 2039 is an attempt to subject employee death benefits to estate tax liability, serious questions exist as to the breadth of its application. If a decedent was not receiving, or was not contractually entitled to receive, an inter vivos payment at the time of his death, section 2039 may have no application. In addition, voluntary payments made to a surviving beneficiary of a decedent employee do not appear to come within the scope of the section.

An example in the Treasury Regulations¹⁰² demonstrates a curious tax situation under the application of section 2039. Under an employment plan, an employee is entitled to receive upon retirement (at age sixty) a lump-sum payment equal to one-half the amount credited to his account, and he may designate a beneficiary to receive the other half at his death after retirement. Should the employee die before retirement, the entire amount in his account is payable to the designated beneficiary. If the employee dies one day before his sixtieth birthday, he has a right at his death to payment of one-half of his benefit, and therefore, the entire lump payment to the beneficiary is included in his gross estate under section 2039. If the employee dies one day after his sixtieth birthday, the employee no longer has any right to any payment since he already had received his one-half payment before death. Therefore, the lump sum payment to the beneficiary is not taxable under section 2039.

The solution to the problems presented by section 2039 should not be the expansion of the definition of life insurance to include within the scope of section 2042 all death benefits which fail to come within the coverage of section 2039. Section 2039 should be expanded to provide that all payments made either to the decedent's estate or to

¹⁰² Treas. Reg. § 20.2039-1(b)(2), ex. 5 (1958).

any beneficiary should be included in the decedent's gross estate to the extent that they are paid by reason of the employment relationship.

The inconsistencies in estate tax treatment accorded to employee life insurance proceeds as against those accorded employee death benefits which arise under self-funded or unfunded plans are unwarranted, and therefore, the proposed scope of section 2039 should include the death proceeds of employee benefit insurance. Employee life insurance plans, as well as the benefits paid under self-funded or unfunded plans, are received by reason of the employment relationship and are in the form of compensation. On this basis, they all should receive estate tax treatment separate and distinct from other life insurance arrangements.

INSURANCE-ANNUITY PLANS

In an attempt to define life insurance for estate tax purposes, the Supreme Court decision in *Helvering v. Le Gierse*¹⁰³ has been most often quoted. In this case, an eighty year old woman purchased a single-premium life insurance contract on her own life, in the face amount of \$25,000. While the woman was otherwise uninsurable and no medical examination was required, the purchase was made possible because she simultaneously purchased an annuity contract from the same insurance company. She paid \$22,946 for the life insurance contract, and \$4,179 was paid for the annuity, which paid an annual stipend of \$589.80.

Upon the death of the insured, the executor contended that the proceeds payable by reason of death to a designated beneficiary should be classified as the product of a life insurance contract and thereby entitled to the \$40,000 exemption.¹⁰⁴ Since the exemption was considered a matter of legislative grace, accorded only to the proceeds of life insurance contracts,¹⁰⁵ the Court considered the issue very carefully. The Court held that the proceeds of the so-called life insurance contract could not be classified as life insurance within the contemplation of the statute. The Court reasoned that there was no element of insurance risk undertaken by the insurance company.

In reaching its decision, the Supreme Court laid considerable emphasis on the mathematics of the involved fact situation. Since the insurance company received \$27,125 from the sale of the two con-

¹⁰³ *Supra* note 75.

¹⁰⁴ *Supra* note 57.

¹⁰⁵ Treas. Reg. § 20.2042-1(a)(2) (1958).

tracts, it received more than the proceeds needed to meet the death benefit, and therefore, no economic risk was undertaken with respect to the decedent's untimely death. The benefit afforded under the annuity contract exposed the insurance company to no risk of financial loss, since the annual payments could be paid out of the interest derived from the single-premium payment without impairing the proceeds to be paid at her death. In substance, the Supreme Court considered the two contracts to be interrelated and inseparable for estate tax purposes.

In spite of the result reached in the *Le Gierse* case, a situation involving a combination insurance-annuity plan has developed and evoked controversy. The basis of the controversy is the result reached in *Fidelity-Philadelphia Trust Company v. Smith*.¹⁰⁶ The facts are basically the same as those in *Le Gierse*; the decedent during her lifetime purchased a single-premium policy of life insurance along with an annuity contract. Since the decedent was uninsurable, the insurance company accepted the life insurance contract, because the aggregate premiums paid for both policies exceeded the face amount of the life insurance contract. The facts are distinguishable from *Le Gierse* in that the decedent, during her lifetime, irrevocably assigned the insurance contract to her daughter and completely divested herself of all incidents of ownership in the policy.

While the government sought inclusion of the proceeds of the so-called life insurance contract, it conceded that such proceeds were not taxable under the life insurance section of the Internal Revenue Code, since the basic characteristics of the contract were such that the insurance company had not undertaken an insurance risk within the standards set down by the *Le Gierse* case. The government did contend however, that the proceeds of insurance contract were estate tax includible on the ground that, in substance, the transaction was a transfer with a reservation of a life income interest.¹⁰⁷ The govern-

¹⁰⁶ 356 U.S. 274 (1958).

¹⁰⁷ Revenue Act of 1939, ch. 26, § 811(c)(1)(B) (now INT. REV. CODE OF 1954, § 2036), which states: "[t]he value of the gross estate shall include the value of all property . . . to the extent of any interest therein the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth) by trust or otherwise, under which he retained for his life or for any period . . . which does not in fact end before his death . . . (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or income therefrom."

ment looked at the entire transaction and argued that the decedent had deposited a sum of money with the insurance company to be paid over to her designated beneficiary at her death and reserved the income from that amount during her lifetime.

Faced with the government's new approach to the insurance-annuity plan, the court of appeals sustained the government's position and held that the realities of the fact situation indicated that a capital fund had been deposited with the insurance company for a guaranteed annual return and payment of the capital fund at the decedent's death to the beneficiary.¹⁰⁸ The Supreme Court reversed¹⁰⁹ and held that, while the two contracts arose from a single, integrated transaction, the two contracts were separable for estate tax purposes. The prime basis for this assertion was that the insurance company would have sold the annuity contract without the life insurance contract. In the view of the Court, the income paid under the annuity contract represented income paid under *that contract*. It did not represent a right to income from the single-premium payment made for the life insurance contract.

While the Supreme Court did not expressly overrule the decision in *Le Gierse*, the result reached in the *Fidelity* case is based upon a reverse assumption of the key element of the prior decision. In *Le Gierse*, the Court looked at the entire transaction and held that the two contract rights derived from the transaction were inseparable. The two contract rights were viewed together and considered as a unit for the purpose of characterizing the transaction and each element of the transaction. The *Fidelity* Court conceded that the two contract rights were "the product of a single, integrated transaction,"¹¹⁰ but held that the single transaction gave rise to two separate contracts. After the purchase was completed, the decedent was free to deal with the contracts separately.

The Supreme Court, in *Fidelity*, indicated that the government would have to show that the annual annuity payments were generated as income from the investment made by the decedent, via her payment of premiums on both contracts, in order to sustain its contention for estate tax inclusion. The Court, thereby, placed this type of transaction on a par with the treatment of private annuities. When

¹⁰⁸ *Fidelity-Philadelphia Trust Co. v. Smith*, 241 F.2d 690 (3rd Cir. 1957), *rev'd.*, *supra* note 106.

¹⁰⁹ *Supra* note 106.

¹¹⁰ *Id.* at 280.

a decedent transfers money or other property to another, upon the return promise that a specified sum of money will be paid each year to the decedent, during his lifetime, the true nature of the transaction may be open to serious question.

A *life* annuity, which a decedent purchased for himself during his lifetime, is not taxable as part of his estate at death. If the decedent purchases an annuity from a member of his family, this annuity will be treated on the same basis as a commercial annuity plan where adequate consideration is paid.¹¹¹ Whether such a family or private annuity will be treated, for estate tax purposes, on a par with a commercial annuity, is dependent in many instances upon the realities of the situation. The transaction may be nothing more than a sham transfer of title to the property, with the reservation of the income from the property to the transferor. Generally, the court will inquire into all the circumstances of the transaction in order to make its determination. If the so-termed annuity payment is really the payment to the transferor of the income generated from the transferred property, then the plan will fall within the scope of section 2036.¹¹² If, however, a complete transfer of the property is made and the transferor does not retain any interest in the transferred property, the transaction will be treated as a commercial annuity, so long as the promised payments are not in fact payments of the income from the property.

It was with these basic principles regarding private annuity plans in mind that the Supreme Court rendered the *Fidelity* decision. The Court's rationale is that unless the government could establish that the yearly annuity payments were derived from the transferred property, its case for estate tax inclusion as a retained life income interest fails.

If these standards are applicable to the involved transaction, then the Court's application of the facts to the standards is quite correct. As previously indicated, while the life insurance contract would not have been undertaken by the insurance company without the purchase of the annuity, the annuity was not dependent upon the life insurance contract for its existence. Indeed, the contract rights under the two policies were severable and not interdependent in a contract sense.

¹¹¹ See Sarah Bergan, 1 T.C. 543 (1943), wherein it is indicated that if the annuitant pays more than the consideration needed to purchase an annuity, the balance may be considered a gift to the transferee.

¹¹² *Supra* note 107.

The decedent was allowed, under the terms of the life insurance contract, to transfer the life insurance policy without adversely affecting her rights under the annuity contract.

Once the decedent transferred the life insurance contract to another person, the transferee would be free to sell or cash in the insurance contract. If such a surrender did take place, the transferee would receive the cash surrender value, and the insurance company could not use that amount as the income source in order to satisfy the annual annuity payments. This should suggest that the annual annuity payments were not necessarily made from the income derived from the decedent's total capital investment in purchasing the two contracts.

The decision has been criticized as failing to look to the true nature of the transaction, and as too strictly adhering to the property rights created by the transaction.¹¹³ The basic objection underlying this criticism is the estate tax treatment presently accorded private annuities. In basic effect, the courts have held, in dealing with private annuities, that no right to income from the transferred property is retained by the transfer or if the payment is not derived from the transferred property specifically.¹¹⁴

It can be argued that where a pre-death transfer of property is made by a decedent, in exchange for a return promise to make annual payments, the transaction is similar in operation to a retained life income interest, as contemplated by section 2036. While this contention may have merit, the logical consequence of it would be to modify section 2036 so as to include the value of property transferred where any return annual payment is made *because of* the transfer.¹¹⁵ This type of provision would cause the downfall of all annuity plans, both commercial and private, for the existence of the annuity payment is always dependent upon the transfer of the property. While the estate tax accorded private annuities may be subject to discussion, the problems presented by the *Fidelity* case should be considered apart from such discussion.

Thus far, the application of section 2036 and section 2042 have been drawn in focus in determining the estate taxability of the death proceeds under an insurance-annuity plan. It should now be consid-

¹¹³ See Swihart, *supra* note 30 at 182-89; LOUNDES & KRAMER, *op. cit. supra* note 25 at 290.

¹¹⁴ *Hirsh v. United States*, 68 Ct. cl. 508, 35 F.2d 982 (1929).

¹¹⁵ Swihart, *supra* note 30 at 189.

ered whether the provisions of section 2039 of the Internal Revenue Code¹¹⁶ have application to the problem. Section 2039 was added to the Code in 1954 in an attempt to provide an adequate method of taxing employee death benefits. Although this was the primary purpose of enacting the section, the language is sufficiently broad to include survivorship annuities apart from employment relationships.

Section 2039(a) provides that the gross estate shall include the value of an annuity or any other payment receivable by a beneficiary by reason of surviving the decedent, under any form of contract or agreement, provided that under the same contract or agreement, an annuity or other payment was payable to the decedent for his life. In addition to the survivorship annuity situation, the section also has application to refund annuities, where a refund is to be paid to one other than the estate of the purchasing annuitant. The scope of the section, moreover, is not limited to a situation where the payment to the surviving beneficiary takes the form of an annuity, but includes any "other payment" receivable by the survivor. It does not make any difference, for the application of the section whether the fund paid to the surviving beneficiary is paid in the form of an annuity or in a lump sum.¹¹⁷

A literal reading of section 2039 indicates that the decedent and the surviving beneficiary must receive their respective payments by reason of the existence of a contract or other agreement. This would appear to demand that both recipients must receive their payments by reason of the same contract or agreement, as opposed to the existence of separate contracts granting each his individual payment. This literal language is, however, tempered by the Treasury Regulations which indicate that the contract or agreement under which the payments are made includes any arrangement, understanding or plan.¹¹⁸

On this basis, both parties need not receive their respective payments under the same identical contract. The Regulations take the position that if the benefits are payable to the decedent under one contract and to the surviving beneficiary under another contract, the two agreements will be construed as a single contract for the purpose of imposing the estate tax under section 2039.¹¹⁹

¹¹⁶ *Supra* note 79.

¹¹⁷ H.R. REP. NO. 1337, *supra* note 78 at A315; Treas. Reg. § 20.2039-1(b)(2), ex. 5 (1958).

¹¹⁸ Treas. Reg. § 20.2039-1(b)(2), ex. 4 (1958).

¹¹⁹ Treas. Reg. § 20.2039-1(b)(2), ex. 6 (1958).

Applying the indicated provisions of section 2039 to the facts which existed in both the *Le Gierse* case and the *Fidelity* case, it may well be argued that the death proceeds paid to the surviving beneficiary should be estate tax includible under this section. In both cases, the decedent purchased an annuity contract under which she was to receive annual payments for her life. By reason of the same transaction, a life insurance contract was purchased whereby the beneficiary was to receive a lump sum payment at the death of the insured annuitant. Since the death payment to be paid to the beneficiary arose from the same transaction by which the annuitant gained the right to receive the payments for her life, it can be asserted that both payment rights should be treated as having arisen from a single plan or arrangement, within the contemplation of section 2039, and thereby subject the death benefit to estate tax inclusion.

There is one serious question which clouds the indicated result. Although section 2039 provides that the payments to the surviving beneficiary can take any form, life insurance is explicitly excluded from the tax imposed under the section.¹²⁰ The Regulations suggest that, "if an annuity or other payment receivable by a beneficiary under a contract or agreement is in substance the proceeds of insurance under a policy on the life of the decedent, section 2039(a) and (b) does not apply."¹²¹

Hence, it must be determined whether the payments to the surviving beneficiary constitute life insurance, for if the benefits payable at death are in the form of life insurance, they will not be subject to the coverage of section 2039 but must be governed by the provisions of section 2042.

The test of life insurance is the existence of an insurance risk, and it can be determined by an examination of the reserve value under the contract.¹²² If the reserve value under the contract is less than the death benefit, the entire proceeds of the contract are classified as insurance, but if the reserve value under the contract is more than or equal to the death benefit, then the death proceeds are not properly life insurance and can be subject to section 2039.¹²³

In order to conclude that section 2039 has application to the insurance-annuity plans, it is necessary to find that the contract rights of the annuitant and the surviving beneficiary arose from a single inte-

¹²⁰ Treas. Reg. § 20.2039-1(d) (1958).

¹²¹ *Ibid.*

¹²² *Ibid.*

¹²³ *Ibid.*

grated transaction. This finding is required in order to assert that the reserve value for the two contracts should be considered together in determining whether an insurance risk exists. Considered separately the reserve value on the life insurance contract is less than the death benefit. However, if the reserve value of the annuity and life insurance are considered together, the combined reserve value is larger than the death benefit.

In resolving this issue, we return to the Supreme Court opinions rendered in both the *Le Gierse* case and the *Fidelity* case. As previously indicated, the Supreme Court in *Le Gierse* stated that no insurance risk existed under the combined insurance-annuity plan. This decision was reached because the insuring company received more than the death proceeds in premiums for the two contracts.

On this basis, it can be asserted that where such an insurance-annuity arrangement arises from a single integrated transaction, as existed in both the *Le Gierse* and *Fidelity* cases, then the death benefits should be taxable under the scope of section 2039. The two contracts should be considered the product of one contract, as provided in the Treasury Regulations under section 2039.¹²⁴ Where, however, a decedent purchases a life annuity contract and a life insurance contract under separate and distinct transactions, section 2042 should govern the taxability of the death benefit.

It is asserted that the insurance-annuity problem should not be allowed to stand in its present form. It appears illogical that the death proceeds of such plans should remain completely free of the estate tax. The application of section 2039 should be given serious consideration. However, it might be argued that the provisions of section 2042 should cover the death proceeds.

Considering another solution to the problem, the Court, in the *Le Gierse* case, held that the entire purchase transaction should be considered as a unit for the purpose of determining its true nature relative to the estate tax. While the the Court considered the annuity contract and the life insurance contract as inseparable, it should be remembered that the decision was rendered in the context of the estate tax provisions then in existence. At that time, life insurance payable to beneficiaries other than the estate of the insured was entitled to the benefit of a \$40,000 exemption. The protection of this exemption

¹²⁴ *Supra* note 119.

from tax avoidance devices motivated the Court in rendering its opinion.

The Court in the *Fidelity* case considered the nature of the entire purchase transaction and held that the two contracts were separable. The annuity was not dependent upon the life insurance contract for its existence. The annuity contract could have been purchased from the insurance company in an isolated unrelated transaction. Therefore, it can be asserted that the annuity contract must be considered separate and apart from the life insurance contract. The basic motivation of the insured in entering into the integrated transaction must, therefore, have been the purchase of the otherwise unattainable life insurance contract. If the decedent paid the same amount for the annuity contract as would have been charged had it been sold without the insurance contract, then the two contracts should be considered separately in determining the estate tax treatment.

The cloud which hangs over the *Fidelity* decision can be considered as not resulting from the treatment rendered by the Court, but the conditions for dealing with the situation as established by the *Le Gierse* decision. Since the decedent paid less than the full amount of the face value for the life insurance contract, the insurance company subjected itself to a risk of financial loss should the decedent die immediately. Considering the life insurance element alone, an insurance risk was undertaken by the insurer, and therefore, this alleged insurance contract should be termed an insurance contract for estate tax purposes.

Under this line of reasoning, the life insurance element would be subject to the same estate tax provisions as accorded other life insurance contracts, and thereby subjected to the same policy considerations. The restrictions imposed by the *Le Gierse* case should not be made applicable to present insurance-annuity plans, since the circumstances present at the time of the *Le Gierse* case are no longer present.

However, under the present state of decisions in this area, the death benefit paid to the surviving beneficiary under an insurance-annuity plan is not the product of a life insurance contract. This view has now been expressly adopted by the Treasury. In addition, the Supreme Court has set aside the attempt to classify the plan as one resulting in a retained life income interest, within the coverage of section 2036, and the Treasury has now, at least partially, conceded to this position.¹²⁵

¹²⁵ Rev. Rul. 65-69, 1965 INT. REV. BULL. No. 11, takes a position consistent with the decision reached by the Supreme Court in the *Fidelity* case, and holds that the life

On this basis, the death benefit which flows to the surviving beneficiary under an insurance-annuity plan should fall within the taxable estate of the annuitant by reason of the provision of section 2039 of the Internal Revenue Code.

INCOME TAX

Certain tax advantages granted to life insurance, plus its widespread popularity have caused the development of diverse tax-savings and tax-avoidance devices, which utilize the life insurance contract. Certain of the currently popular life insurance arrangements and those provisions of the Internal Revenue Code which render them advantageous follow.

FINANCED INSURANCE PLANS

As a general rule all interest paid or accrued within a taxable year on an indebtedness is deductible by the taxpayer in computing his taxable income.¹²⁶ This provision coupled with the nature of life insurance contracts has afforded certain taxpayers the opportunity to utilize an insurance plan whereby an insured can purchase an insurance contract at little or no cost.¹²⁷ In a simplified manner, the insurance

insurance portion of an insurance-annuity plan will not be included in an insured's taxable estate under section 2036 of the Code, as long as the proceeds are payable to a named beneficiary and all rights in the insurance policy have been irrevocably and completely assigned.

Rev. Rule 65-67, 1965 INT. REV. BULL. No. 11 takes the position that the proceeds of a life insurance policy under an insurance-annuity plan (which could not have been acquired except in combination with a non-refund annuity contract purchased for a premium equal to the face amount of the insurance contract) are not excluded from income tax liability under section 101(a) of the Code.

Since the Supreme Court has, in substance, indicated that the proceeds of the so-called insurance portion of an insurance-annuity plan are not the product of an insurance contract for the application of the estate tax under section 2042 of the Code, it is not completely unrealistic to take the position that such death proceeds should not receive the income tax exemption afforded by section 101(a), *supra* note 64. The rulings do not, however, deal with the possible exposure of such proceeds to estate tax liability under the coverage of section 2039. In addition, the decision in the *Fidelity* case would indicate that section 2036 has no application to an insurance-annuity plan, even where the insured retains the incidents of ownership over the life insurance element. On this point, the Treasury has not expressed agreement.

¹²⁶ INT. REV. CODE OF 1954, § 163(a), which states that "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year of indebtedness."

¹²⁷ See Van Cleve, *The Bank Loan Plan: One Point of View*, 10 J. AM. Soc'y. C.L.U. 167 (1956); Becker & Sloan, *Split-Dollar and Bank-Financed Insurance Plan*, 35 TAXES 842 (1957); Lynch, *Insurance and Related Plans Under the Revenue Act of 1964*, 18 J. AM. Soc'y. C.L.U. 348 (1964).

contract is purchased and then used as collateral security for a bank loan. The proceeds of the bank loan are then used to pay the insurance premiums. The plan was effective for taxpayers in the higher income tax brackets, since the interest on such loans was income tax deductible, and the dividends on the insurance contract were not currently tax reportable.¹²⁸ The net cost of the interest paid on the loan would be offset in whole or in part by the insurance contract dividend. There appear to be countless variations on this basic plan, but all rely on the validity of two assumptions: first, that the interest paid on the bank loan is currently tax deductible, and secondly, that the insurance contract dividends are currently non-tax reportable.

As originally devised, single-premium life insurance policies or single-premium endowment policies were usually recommended for such plans. Prior to 1942, a taxpayer could purchase a single-premium policy, and no tax restrictions existed for his deducting the interest charges incurred. The 1942 Internal Revenue Code addressed itself to this problem, and the interest deduction was expressly disallowed with respect to single-premium contracts.¹²⁹

The life insurance underwriters responded to this restriction and plans were devised whereby the taxpayer would pre-pay the premiums not yet due. The single-premium contract was abandoned for the plan, and instead, monies were deposited with the insurance company to pay the future premiums on policies requiring annual premiums over a specified number of years as they fell due. In 1954, Congress undertook to further curtail the market for financed single-premium life insurance plans and the described variation by denying the interest deduction for single-premium contracts and for those plans whereby the taxpayer pre-paid premiums for a substantial number of years.¹³⁰

¹²⁸ INT. REV. CODE OF 1954, § 72(e)(1)(B); and Treas. Reg. § 1.72-11(b)(1) (1956) allow dividends on life insurance policies which are in the nature of a return of the premium to be tax exempt. If the dividends are left with the insurance company to accumulate at interest, the dividends themselves are tax-exempt. However, the interest earned on these dividends is income in the year credited if it is subject to annual withdrawal under Treas. Reg. § 1.61-7(d) (1957, as amended, 1964). If the taxpayer cannot withdraw the interest, it will not be taxed in the year credited, but when eventually received.

¹²⁹ INT. REV. CODE OF 1939, § 24(a)(6), as amended by Revenue Act of 1942, ch. 619, § 129, 56 Stat. 798 (1942).

¹³⁰ INT. REV. CODE OF 1954, § 264(a)(2), which states: "[n]o deduction shall be allowed for . . . (2) [a]ny amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract." INT. REV. CODE OF 1954, § 264(b): "For purposes of Subsection (a) (2), a

Eleven years ago, it may have been believed that these provisions would effectively end financed insurance plans. The facts indicate, however, that the life insurance underwriter responds quickly to affect maximum tax benefits and maintain the desirability of his product. Therefore, financed plans have continued to remain possible.¹³¹

The 1964 Revenue Act contains a lengthy provision designed to end the financed insurance plan, which developed to maintain such plans within the indicated restrictions.¹³² After 1954, the taxpayer purchased an insurance contract with an annual premium for a specified number of years, and then he borrowed the increase in cash value on the insurance contract each year in order to pay the premiums. While this type of plan was more complicated to maintain, it perpetuated the plan, and the taxpayer still reaped the benefits afforded by the earlier methods.

The 1964 Act contains a provision which denies an interest deduction on "indebtedness incurred or continued to pay premiums . . . under a plan to systematically borrow amounts equal to the increase in the cash value of the contract to pay part or all of the premiums".¹³³ This language is similar to that found in section 265 of the Internal Revenue Code which disallows an interest deduction for indebtedness incurred to purchase or carry tax-exempt securities.¹³⁴ It appears that the denial of the interest deduction for financed insurance plans was enacted as an extension of the policy to deny an interest deduction

contract shall be treated as a single premium contract . . . (1) if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or (2) if an amount is deposited after March 1, 1954, with insurer for payment of a substantial number of future premiums on the contract."

¹³¹ *Hearings Before a Subcommittee of the House of Representatives Committee on Ways and Means*, 84th Cong., 2d Sess. 168 (1955-56). Mr. G. S. Brown, representing the National Association of Life Underwriters, indicates that the Association has denounced the use of financed insurance plans for some time.

¹³² INT. REV. CODE OF 1954, § 264(a) (3), added by 78 Stat. 55 (1964), which states: "[n]o deduction shall be allowed for . . . (3) . . . any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise)."

¹³³ *Ibid.*

¹³⁴ INT. REV. CODE OF 1954, § 265: "No deduction shall be allowed . . . interest on indebtedness incurred or continued to purchase or carry obligations . . . the interest on which is wholly exempt from the taxes imposed by this subtitle."

where such deduction can be combined with the receipt of non-taxable income.

A part of every premium used to purchase a permanent life insurance contract is used to establish and maintain the policy reserve. These reserve funds are invested by the insurance company, and a portion of the return from the investments is added to the cash surrender value of the policy.¹³⁵ These returns are, in general, not taxable to the insured,¹³⁶ and it is the existence of this non-taxable element which apparently has caused the enactment of the prohibitive provisions of the Code. While it may be asserted that the dividend element of an insurance contract does not constitute an income element, it is in the nature of a return on an investment and such return is not subject to income taxation.

For the new section to have application, the crucial test is that the taxpayer is following a plan of systematically borrowing part or all of the increase in the cash value of the insurance contract in order to pay part or all of the premiums. Thus, the provision does not apply to irregular borrowing to pay premiums, although it must be indicated that the line between systematic and irregular is unclear. Any regular borrowing, even if not followed every year or for any particular year, can be "systematic" for this purpose. Furthermore, the borrowing need not be over the life of the policy, it being sufficient if the premiums are financed for a substantial number of years.

In furtherance of the restrictions to this life insurance arrangement, the prescribed borrowing need not be secured by the life insurance contract itself, but may fall within the scope of the provision even though the taxpayer borrows on other property or on his general credit. This raises complex problems of enforcement, because it would appear that taxpayers who would be likely to avail themselves of a financed insurance plan may be in the habit of borrowing. The money flowing through the hands of such taxpayers is likely to be a mixture of borrowed money, earned money and accumulated money. One may wonder how carefully an individual must show that his premium money is not his borrowed money.

There are four exceptions to the application of this section.¹³⁷ The

¹³⁵ *Supra* note 131 at 325 (statement of Mr. H. F. Johnson).

¹³⁶ *Supra* note 128.

¹³⁷ INT. REV. CODE OF 1954, § 264(c), added by 78 Stat. 55 (1964), provides that the deduction shall not be denied under the section "if no part of 4 of the annual premiums

interest deduction may be allowed where a plan fits the standards set down by one of the exceptions. The first exception appears to lay the principle foundation for the future work of the life insurance underwriter in perpetuating financed insurance plans. The exception in effect provides that if any four annual premiums out of the first seven are paid entirely in cash, without borrowing of any kind, then the premiums may be freely financed from then on. The proposed Regulations adopt a strict view of this provision and suggest that even when four premiums are paid in cash during the first seven years, any subsequent borrowing to pay premiums in excess of that amount necessary for current premiums will be construed as at least partial borrowing to pay the prior premiums.¹³⁸ The provisions of the Regulations endanger any loan taken out after the initial time period beyond that necessary to pay current premiums. While this impedes the use of financed insurance arrangements, this does not make their use impossible. The individuals in higher income tax brackets who would have the most interest in such plans are those who can most easily overcome the new hurdles encountered in this section.

Apparently, even the rather comprehensive provisions of the 1964 Act will not end financed insurance arrangements completely. The question can be asked whether further provisions should be enacted by Congress in an attempt to end the use of the interest deduction to procure low cost or no cost insurance.

The Treasury and Congress have directed considerable attention to the elimination of financed insurance plans. As of today, the Internal Revenue Code denies the interest deduction for single-premium financed insurance plans under the coverage of section 264(a)(2), added by the 1954 Act, and interest incurred under a plan of "systematic" borrowing is now denied under section 264(a)(3), added by the 1964 act.

While Congress has repeatedly attempted to end the tax advan-

due during the 7-year period (beginning with the date of the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness, . . . if the total of the amounts paid or accrued by such person during such taxable year for which (without regard to this paragraph) no deduction would be allowed, . . . if such amount is paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in his financial obligations, or . . . if such indebtedness was incurred in connection with his trade or business."

¹³⁸ Treas. Reg. § 1.264-4(d)(1)(ii) (1964).

tages of financed insurance plans, an important factor in weighing the advisability of more extensive restrictions in the area is the very existence of the interest deduction. It has been argued that it is the interest deduction itself which should be eliminated.¹³⁹ Since the payment of interest is in many instances a purely personal expense and totally unrelated to business activity, the legitimacy of allowing a deduction for this personal expense may be questioned. Certainly, if the basic problem is the existence of an illogical deduction, the solution is the elimination of the deduction. This solution is without question the simplest. Without the interest deduction, the development of such tax-savings plans would be nonexistent.

The interest deduction may have initially arisen in a haphazard way, but it appears that it is now deeply entrenched in the minds of most people as a legitimate tax deduction. If it is assumed that the problem must be solved and the solution must be found without the total elimination of the interest deduction, then the merits of the present Code provisions should be considered.

An insurance contract owned by a taxpayer constitutes a part of his total net worth. On this basis, when an individual seeks a loan on his general credit, a lender will consider this asset along with all others in granting the loan. The fact that the proceeds of such loan, based on the taxpayer's general credit, are used in whole or in part to pay insurance premiums should not necessarily cause the defeat of the interest deduction. The entire circumstances of the loan transaction should be taken into account in weighing the merits of the claimed deduction. What is objectionable is the situation where the taxpayer creates the deduction for the sole purpose of purchasing or continuing an insurance contract, not where the taxpayer uses an insurance contract as collateral, directly or indirectly, to borrow funds in order to meet his financial need apart from a plan.

Quite properly, section 264(a)(3) of the 1964 act focuses its attention on the "systematic" nature of such transactions as prime indicia of the tax avoidance device. The section, coupled with the coverage of section 264(a)(2), which applies to single-premium contracts, provide well-developed restrictions at the elimination of the problem. More extensive restrictions in this area could endanger the entire interest deduction, since most individuals in debt are also meeting the yearly financial responsibility of maintaining life insurance. Apparent-

¹³⁹ SMITH, FEDERAL TAX REFORM 98 (1961).

ly, Congress has attempted to maintain a reasonable balance between the extremes of allowing the plan and totally destroying the interest deduction.

In its attempt to avoid the granting of the interest deduction where the taxpayer engages in a financed insurance plan, it is unclear why Congress included the first exception to the application of section 264(a)(3).¹⁴⁰ This exception provides that if any four annual premiums out of the first seven are paid entirely in cash, then the restriction of the section is inapplicable to the insurance contract. This exception grants unwarranted license to taxpayers to engage in financed plans, after the expiration of the initial time period. Since the general terms of the provision strike only at "systematic" plans of borrowing and the other exceptions afford adequate protection against the denial of the interest deduction under bona fide circumstances, this first exception should be eliminated. Such elimination would further tighten the restrictions against financed insurance plans, without endangering the interest deduction as a whole.

SPLIT-DOLLAR PLAN

One of the original Treasury proposals for action by Congress in the enactment of the 1964 Revenue Act involved the treatment of the Split-Dollar Plan.¹⁴¹ Fundamentally, the plan is part of employment fringe benefits whereby the employee is afforded the opportunity to purchase life insurance protection at low cost because of his employer's financial assistance.

While there are many variants, the basic plan has the employee purchasing an ordinary life insurance contract on his own life and making the initial premium payment. After the first year, as the policy acquires a cash surrender value, the employer pays that portion of the annual premium which equals the increase in the policy cash surrender value. The employee pays the balance of the annual premiums due not covered by the employer. It is contemplated by the participants of such plans that the employer is making an interest free loan to employee. The loan is secured by the employer's designation as beneficiary of the policy proceeds, to the extent of the loan amount extended. In the normal course, when the employee dies

¹⁴⁰ *Supra* note 137.

¹⁴¹ *Hearing on H.R. Rep. No. 8363 Before Senate Finance Committee, 88th Cong., 1st Sess., pt. 1, at 142 (1964).*

the employer's investment is repaid from the proceeds of the policy, and the balance of the proceeds is paid to those other beneficiaries designated by the employee.¹⁴²

Generally, the value of life insurance protection purchased by an employer and made payable to beneficiaries named by the employee is taxable income to the employee.¹⁴³ However, since the situation involved in the Split-Dollar Plan is described as a loan transaction between the employer and his employee, the employee is not taxed on the amounts of his employer's contributions.

A 1955 Revenue Ruling indicates the Treasury's past position with respect to this plan.¹⁴⁴ The Ruling supports the contention that such plans are, in fact, in the nature of an interest free loan, and furthermore, the forbearance of the interest by the employer does not result in taxable income to the employee. In addition, the Ruling suggests that the return of the policy proceeds to the employer, upon the death of the employee, is merely a return of a loan, and therefore non-taxable. This ruling afforded the opportunity for employers to engage in this type of insurance plan, and through his contributions to premium payments, his employees received the benefit of life insurance protection at minimal cost.

The Tax Court dealt with a similar type situation in the case of *J. Simpson Dean*.¹⁴⁵ While the parties did not engage in a Split-Dollar Plan, a corporation made substantial interest free loans to its controlling shareholders. The government sought to include in the stockholder's gross income imputed interest from the gratuitous use of the corporate funds. The argument was similar in nature to that rendered where an employee or stockholder is afforded the opportunity to use corporate property rent free.¹⁴⁶

In finding that the taxpayer did not realize taxable income as a result of the transaction, the Tax Court argued that if the stockholder had paid interest for the use of the borrowed corporate funds, a de-

¹⁴² See also: Becker & Sloan, *supra* note 127; Bloom, *Life Insurance and the Revenue Act of 1964*, 18 J. AM. Soc'y C.L.U. 233 (1964).

¹⁴³ Treas. Reg. § 1.61-2(d) (2) (1963) provides that employer contributions to group-term life insurance are not income tax includible to the employee, while contributions to permanent life insurance are tax includible under 1950-1 CUM. BULL. 16.

¹⁴⁴ Rev. Rul. 713, 1955-2 CUM. BULL. 23.

¹⁴⁵ 35 T.C. 1083 (1961).

¹⁴⁶ *Sam Rosania v. Comm'r.*, CCH Tax Ct. Mem. 580 (1956).

duction would have been received which would offset any interest income they may have realized.

While this rationale may be open to criticism,¹⁴⁷ it may presently afford the Treasury an opportunity to end the tax advantages presently allowed under the plan. In consideration of the new provisions of the 1964 Revenue Act relating to the allowance of the interest deduction for financed insurance plans,¹⁴⁸ the Treasury may adopt the view that no interest deduction should be allowed unless the plan provides that the employee pays the full premiums for the first four years.¹⁴⁹ If we characterize this plan as merely a variant of the basic financed insurance arrangement, and thereby falling within the contemplation of section 264(a)(3) of the Code, then unless the employee qualified under the first exception to that section, the imputed deduction would be denied and the imputed interest could be fully taxable.

While the Treasury actively sought a statutory cure for the Split-Dollar Plan, Congress suggested that the proper course of action might be by way of administrative action.¹⁵⁰ Responding to this suggestion, the Treasury revoked its long standing ruling¹⁵¹ and announced that for all such insurance plans after November, 1964, an employee will be taxed each year in amounts equal to the one-year cost of the declining life insurance protection to which the employee is entitled less any portion of the premiums paid by him.¹⁵²

This Treasury position is consistent with the treatment currently afforded life insurance provided employees under a qualified pension or profit-sharing plan.¹⁵³ Under such plans, if life insurance is taken out on the life of an employee and an employee designated beneficiary

¹⁴⁷ Bloom, *supra* note 142.

¹⁴⁸ *Supra* note 132.

¹⁴⁹ *Supra* note 137.

¹⁵⁰ H.R. REP. NO. 749, 88th Cong., 1st Sess. 62 (1964).

¹⁵¹ *Supra* note 144.

¹⁵² REV. RUL. 64-328, 1964 INT. REV. BULL. NO. 51.

¹⁵³ Treas. Reg. § 1.402(a)(1)(3) (1956, as amended 1960): "If a trust . . . purchases under the plan retirement income, endowment or other contracts providing life insurance protection, payable upon the death of the employee participant, and either (a) [t]he proceeds of such life insurance are payable to a beneficiary of the employee participant other than the trust . . . then the portion of the premium paid for the life insurance protection provided under such contracts from either the contributions of the employer or earnings of the trust will constitute income to the employee for the year or years in which the contribution or earnings are applied toward the purchase of the life insurance."

is entitled to receive the proceeds at death, then the employee is liable for income tax on "the portion of the premiums paid for the life insurance protection . . . from either the contributions of the employer or earnings of the trust".¹⁵⁴ Only the excess of the proceeds payable during the year over the cash surrender value at the end of such year is deemed taxable life insurance protection. The sum and substance of both provisions is to tax the employee on the value of the current life insurance protection made available by reason of the current employer payments.

While the Split-Dollar Plan may be characterized as a loan transaction between the employer and the employee, the indicated method of taxation is appropriate. The economic interest in the life insurance contract, held by an employer under such a plan, is equal to the cash surrender value. Under this taxing method, only the value of that portion of the insurance protection in excess of the cash surrender value, attributable to the employer's contributions, would be subject to income taxation. It is the benefit of this amount of insurance which the employee genuinely obtains from the utilization of the plan. It appears likely that the current Treasury position will be judicially upheld. Even if this view is not supported judicially, such plans will undoubtedly occupy a position of concern in the Treasury, and the employer contributions should fall prey to income tax liability.

GROUP-TERM LIFE INSURANCE

In recent years, employment fringe benefits have become increasingly more popular. Diverse arrangements involving life insurance have been developed to provide executives and other classes of employees with maximum benefits at little or no cost. Group-term life insurance is one of the most popular forms of employee benefit plans.

The popularity of group-term life insurance is based on two important tax considerations. First, neither the annual premiums nor the death benefits under such policies constitute income to the employee or his beneficiaries.¹⁵⁵ Second, the employer is entitled to a deduction for the cost of the insurance provided for his employees.¹⁵⁶ The exemption from income dates from a 1920 Legal Opinion, which indicated that the plan afforded an employee no real dollar benefit. The Opinion indicated that the prime benefit received by the employee

¹⁵⁴ *Ibid.*

¹⁵⁵ Treas. Reg. § 1.61-2(d)(2) (1963).

¹⁵⁶ INT. REV. CODE OF 1954, § 162(a)(1).

was "the feeling of contentment that provision had been made for his dependents".¹⁵⁷

The tax treatment should be contrasted with premiums paid by an employer for individual life insurance or group permanent life insurance which carries a loan or surrender value which are required to be included in the employee's gross income.¹⁵⁸ If the question of the tax treatment of group-term life insurance should first have arisen today, it is unlikely that the Commissioner would rule in the same manner. However, the principle of non-taxability has become firmly entrenched in the Regulations.

In 1964, Congress addressed itself to this situation. While it was recognized that the entire cost of this type of life insurance protection could properly be characterized as compensation to the employee, Congress indicated that it was economically desirable to encourage employers to provide a limited amount of life insurance protection for its employees.¹⁵⁹

The problem sought to be solved was not the defeat of group-term life insurance plans, but the placing of a limit on the amount held by high ranking business executives who were granted excessive amounts of tax free group-term life insurance.¹⁶⁰ To correct the situation, Congress enacted a lengthy provision which provides that an employee must include in his gross income the cost of any group-term life insurance coverage in excess of \$50,000 provided for him under a policy carried, directly or indirectly, by his employer.¹⁶¹

¹⁵⁷ L.O. 1014, 1920-2 CUM. BULL. 88.

¹⁵⁸ *Supra* note 143.

¹⁵⁹ S. REP. NO. 830, 88th Cong., 2d Sess. 46 (1964).

¹⁶⁰ *Hearings on H.R. Rep. No. 8363 Before the Senate Finance Committee*, 88th Cong., 1st Sess. pt. 1, at 142 (1964) (statement of Secretary of the Treasury Mr. Dillon): "Within recent years, wide spread use of this exclusion privilege has developed beyond its original purpose. The provision of 'jumbo' group term insurance coverage for high income executives has become a rather common method of providing substantial tax-free compensation for service. In some cases, executives have enjoyed, without payment of any tax on the premiums, the benefits of life insurance coverage of close to \$1 million, which protects their families and may substantially augment their estate."

¹⁶¹ INT. REV. CODE OF 1954, § 79, which states: "[t]here shall be included in the gross income of an employee for the taxable year an amount equal to the cost of group-term life insurance on his life provided for part or all of such year under a policy (or policies) carried directly or indirectly by his employer (or employers); but only to the extent that such cost exceeds the sum of . . . (1) the cost of \$50,000 of such insurance, and (2) the amount (if any) paid by the employee toward the purchase of such insurance."

The imposition of this dollar limit presented potentially complicating situations, which the provisions of the new Code section attempt to handle. If the insurance is carried by more than one employer, the employee must combine the total coverage in determining the amount taxable to him. The employee is entitled to offset against the cost of coverage in excess of the \$50,000 limit any contributions which he makes toward the overall coverage provided by the employer. Therefore, where the employee makes a contribution to each dollar block of insurance protection afforded, this cost may be used to offset the taxable income otherwise attributable to him for the protection in excess of the limit.

The cost of the insurance, for purposes of the taxation of the employee, is to be determined from a uniform premium table computed on the basis of five-year age brackets, which will be published in the Treasury Regulations. The uniform premium table will not, however, affect the employer's deduction. The employer's deduction is still based on his actual cost.

There are three basic exceptions to the application of this dollar limit.¹⁶² Group-term life insurance in any amount may be provided tax free for an individual who has reached his normal retirement age or has become disabled, if the practice is normally followed by his employer. Where an employer is directly or indirectly the beneficiary of the insurance policy, the limit does not apply, since the employer is really providing for his own economic interests rather than those of his employee.

In addition, the new provision covers the situation where the employer provides in his employment plan for insurance coverage in excess of the \$50,000 limit and the employee wishes to avoid the income tax consequences. The employee may avoid being taxed on the insurance cost by designating a charity as the sole beneficiary. Apparently, the employee may qualify under this exception by naming a charity as the sole beneficiary only for the amount in excess of the \$50,000 limit. It should be noted, however, that the employee who designates a charity as beneficiary should not receive a charitable contribution deduction with respect to such designation.

If uniformity of tax treatment is sought, it would appear that the cost of group-term life insurance expended by an employer should be

¹⁶² INT. REV. CODE OF 1954, § 79(b), added by 78 Stat. 36 (1964).

tax includible to the benefited employee. There is an economic difference between term life insurance and permanent life insurance, however, and as indicated by Congress, the benefits extended to an employee under such a plan could properly be characterized as taxable income. Since the tax-exempt status is so entrenched in business planning, it appears reasonable to continue the treatment. In addition, if group-term insurance does create a desirable economic result, as indicated by Congress,¹⁶³ then the present tax treatment affords a reasonable method of accomplishing it. The tax-exempt status should, however, be limited to group term life insurance.

TRANSFEEE-FOR-VALUE RULE

Since the statutory definition of gross income is broad enough to include life insurance proceeds, a special provision has been inserted in the Internal Revenue Code which specifically provides for their exclusion from gross income when paid by reason of the insured's death.¹⁶⁴

Section 101 (a) provides that gross income does not include amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured. An important exception to this tax-exempt status contained in section 101 (a) (1) applies where a policy has been transferred for valuable consideration. Unless the transferee qualifies under one of the exceptions to the rule, the recipient of the life insurance proceeds will be subject to ordinary income taxation. The transferee-for-value is liable for ordinary income on the proceeds paid by reason of the death of the insured in excess of his basis.¹⁶⁵

The Transferee-for-Value Rule was initiated by Congress in 1954 in an attempt to avoid intra-family transfers of life insurance. Without this provision, an insured could transfer the policy on his own life to a close family member for consideration, and thereby avoid the estate tax which would be levied on the proceeds paid at his death, since he would no longer possess the incidents of ownership under the policy.¹⁶⁶ At the same time, the insured would avoid the gift tax consequences of a gratuitous transfer.

¹⁶³ *Supra* note 159.

¹⁶⁴ INT. REV. CODE OF 1954, § 61(a): "Except as otherwise provided . . . gross income means all income from whatever source derived, including (but not limited to) the following items: . . . (10) income from life insurance and endowment contracts; . . ."

¹⁶⁵ The transferee's basis includes his premium contributions and other amounts subsequently expended by the transferee.

¹⁶⁶ INT. REV. CODE OF 1954, § 2042.

The reasoning behind the Transferee-for-Value Rule is open to serious question. If a transfer is made for a consideration which equals in value the current replacement cost of the policy or a similar policy, there is no gift. If the consideration which the insured receives is less than this replacement cost, a gift has been made to the extent of the difference between the actual consideration received and the replacement cost.¹⁶⁷ If full consideration is received by an insured for a policy which he has transferred, his asset holdings are not diminished by reason of the transfer, and, therefore, the estate tax is protected. If less than full consideration is received by an insured, he must pay a gift tax on that amount which is not subject to the estate tax as part of the insured's asset holdings. On this basis, a sale transaction of a life insurance contract effectuates no genuine overall estate tax savings.

Considering the rule as it now stands, the provision specifically enumerates that the transfer shall be exempt from the application of the rule if the transfer was made to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.¹⁶⁸ Since the intra-family situation was evidently underlying the passage of the restrictive section, the exceptions were included to provide that the rule should not apply where life insurance is used for the accomplishment of business purposes.

There is, however, one business situation which has not been specifically excepted from the application of the rule. The transfer to a fellow stockholder by the owner of a life insurance contract is not covered by the enumerated exceptions. If the stockholders of a closed corporation wish to establish a cross purchase buy-sell arrangement upon the death of one stockholder, the life insurance policy which the decedent held on the life of his co-stockholder cannot be sold by his estate to a surviving stockholder without subjecting the transfer to the tax consequences of the Transferee-for-Value Rule. There are other situations which are adversely affected by the absence of a specific provision covering a transfer from one stockholder to a co-stockholder.¹⁶⁹

Since the exceptions establish a pattern of excluding business arrangements involving the holding and subsequent transfer of life in-

¹⁶⁷ Treas. Reg. § 25.2512-6 (1958, as amended in 1961, 1963).

¹⁶⁸ INT. REV. CODE OF 1954, § 101(a)(1)(B).

¹⁶⁹ Kronrod, *Income Taxation as it Relates to Life Insurance*, 18 J. AM. Soc'y C.L.U. 348, 350 (1964).

insurance contracts, the provisions of the relevant Code section relating to the Transferee-for-Value Rule should be amended to except the transfer of a life insurance contract from one stockholder to his co-stockholder from the application of the rule. While the proposed addition to the statutory exception would afford more uniformity to the indicated Code section, it may be reasonably argued that the entire rule should be abolished.

CONCLUSION

Since life insurance has received almost universal acceptance, the appropriate tax treatment to be accorded it should occupy a position of concern in the mind of the tax planner. While the life insurance contract does possess characteristics common to other assets, it does have a testamentary quality which makes it a unique investment form. Since the life insurance contract possesses unique characteristics which are not genuinely analogous to other investment assets, the appropriate tax treatment to be accorded life insurance proceeds involves complex considerations.

Traditionally, the estate tax has been imposed upon the passage of wealth from its owner in one generation to the recipient member of the succeeding generation. The key to the imposition of estate tax has hinged upon the passage of wealth from the owner to a subsequent taker by reason of the death of such owner.

The estate taxation of life insurance should not be limited by the treatment accorded to other investment assets. The application of the traditional ownership test is not appropriate for life insurance. Estate taxation of life insurance should be consistent with its unique characteristics. Since the estate tax is aimed at the passage of wealth from one generation to a succeeding generation, that fund of wealth which does pass under an insurance contract at the death of a member of one generation should be subject to estate tax liability. It is on this basis that it has been proposed that the testamentary element of an insurance contract should be subject to estate taxation regardless of the ownership of the insurance contract prior to the insured's death where the insured has been responsible through his payment of premiums for the passage of the wealth at his death. The testamentary element is that portion of the insurance proceeds which arises at the death of the insured and passes to the beneficiary by reason of the death (i.e., that

portion of the death proceeds over and above the cash surrender value immediately prior to the insured's death).

While the Internal Revenue Code imposes an estate tax on the proceeds of a life insurance contract, serious question has arisen as to the definition of a life insurance contract. While attempts have been made to limit the definition, for tax purposes, to technical insurance concepts, such attempts should not succeed. A contract should be considered as having undertaken an insurance risk, and thereby subject to the estate tax, where one undertakes to indemnify another for loss of life upon receipt of a consideration calculated on the basis of the probabilities of the risk (i.e., the death of the insured) being realized.

Where life insurance is utilized as part of a total benefit plan, all the circumstances of such plan should be taken into consideration in applying the appropriate estate tax. It appears that the present provisions of the Internal Revenue Code are not adequate to deal with the complex benefit plans which have become increasingly more popular, and on this basis a uniform method of taxing employee death benefits should be enacted.

In addition to the recommendations for the appropriate estate tax treatment to be accorded life insurance, certain recommendations have been made with regard to the tax treatment of life insurance plans. Since life insurance has enjoyed traditional popularity and such popularity appears to be growing, it can be assumed that life insurance plans will become increasingly more complex and thereby offer continual problems in both the income and estate tax areas.

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