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## The Appropriateness of Attributing Corporate Incidents of Ownership to Controlling Shareholders Under Estate Tax Section 2042

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# NOTES

## THE APPROPRIATENESS OF ATTRIBUTING CORPORATE INCIDENTS OF OWNERSHIP TO CONTROLLING SHAREHOLDERS UNDER ESTATE TAX SECTION 2042

The business use of life insurance provides flexibility for corporate and tax planners of closely held corporations.<sup>1</sup> The estate tax treatment of life insurance proceeds paid on the life of an insured decedent who was a controlling shareholder, however, has come within the long-standing controversy surrounding section 2042,<sup>2</sup> the estate tax statute governing life insurance. In the last decade the Internal Revenue Serv-

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1. See generally, e.g., L. KLINGER, *ESTATE AND FINANCE PLANNING FOR THE CLOSELY HELD CORPORATION* (1980); S. MONROE, *BUSINESS INSURANCE & ESTATE PLANNING AFTER THE TAX REFORM ACT OF 1976* (1977); E. WHITE & H. CHASMAN, *BUSINESS INSURANCE* (4th ed. 1974); Jacobs, *Back to Basics—Post TRA—76 Stock Interest Terminations in Closely-Held Corporations*, 36 N.Y.U. INST. FED. TAX. 3 (1978); MCGAFFEY, *Planning the Client's Life Insurance Program*, 35 N.Y.U. INST. FED. TAX. 1295 (1977).

2. I.R.C. § 2042 provides:

The value of the gross estate shall include the value of all property—

(1) RECEIVABLE BY THE EXECUTOR.—To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.

(2) RECEIVABLE BY OTHER BENEFICIARIES.—To the extent of the amount receivable by all other 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. For purposes of the preceding sentence, the term "incident 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. As used in this paragraph, the term reversionary interest includes a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate or may be subject to a power of disposition by him. The value of a reversionary interest at any time shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, pursuant to regulations prescribed by the Secretary. In determining the value of a possibility that the policy or proceeds thereof may be subject to a power of disposition by the decedent, such possibility shall be valued as if it were a possibility that such policy or proceeds may return to the decedent or his estate.

All references are to the 1954 Code, as amended, unless otherwise stated.

The confusing treatment accorded life insurance under the estate tax code has been well documented. See, e.g., 2 J. MERTENS, *LAW OF FEDERAL GIFT AND ESTATE TAXATION* §§ 17.03-.04 (1959); Schlesinger, *Taxes and Insurance: A Suggested Solution to the Uncertain Cost of Dying*, 55 HARV. L. REV. 226, 227 (1941); Swihart, *Federal Taxation of Life Insurance Wealth*, 37 IND. L.J.

ice promulgated several revenue rulings and a new regulation to deal specifically with life insurance policies owned by corporations insuring principal stockholders.<sup>3</sup> Whether this regulation is appropriate deserves consideration because insurance proceeds included in a decedent's estate can dramatically increase the taxable estate.

Carefully tailored insurance arrangements provide for a smooth transition of leadership when a corporate officer dies.<sup>4</sup> For example, a buy-sell agreement, financed through life insurance, guarantees retention of ownership and control of the business in the hands of the surviving stockholders while simultaneously reimbursing decedent's estate for the value of his stock in an equitable, prompt manner.<sup>5</sup> A split dollar plan accomplishes a variety of goals, such as funding a cross-purchase plan and providing direct estate liquidity when proceeds are payable to the estate.<sup>6</sup> The maintenance of a key-man life insurance policy improves the short and long term financial position of the close corporation by strengthening its credit standing and providing for additional cash flow when the officer dies.<sup>7</sup> Because insurance plays such a

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167, 177 (1962); Note, *Incidents of Ownership Tests for Inclusion of Life Insurance Proceeds in Decedents' Gross Estate*, 54 MARQ. L. REV. 370 (1971).

3. The Treasury Department promulgated Treas. Reg. § 20.2042-1(c)(6), the regulation at issue in this Note, in 1974. Revenue Rulings most relevant to a consideration of this regulation include Rev. Rul. 79-46, 1979-1 C.B. 330; Rev. Rul. 76-274, 1976-2 C.B. 278; Rev. Rul. 72-167, 1972-1 C.B. 307; and Rev. Rul. 71-463, 1971-2 C.B. 333.

4. See generally S. MONROE, *supra* note 1, at 1B-3B; E. WHITE & H. CHASMAN, *supra* note 1, at 271-80. Too often, the controlling interest passes to "inexperienced or disinterested heirs." *Id.* Thus, planning for continuity of aggressive management becomes vital.

5. The two basic types of buy-sell agreements are cross purchase agreements and stock redemption agreements. Under a cross purchase plan, surviving stockholders purchase the deceased stockholder's shares in the corporation with funding provided by each stockholder acquiring insurance on the life of the other. Under a stock redemption agreement, the corporation itself acquires the insurance and buys the shares of the deceased stockholder. See E. WHITE & H. CHASMAN, *supra* note 1, at 309.

For a general discussion of the factors influencing the choice of agreement and the tax ramifications see L. KLINGER, *supra* note 1, at 48-51; S. MONROE, *supra* note 1 at 3B-13B; Jacobs, *supra* note 1.

6. The term split-dollar plan covers various kinds of arrangements that allow a person to purchase insurance coverage by splitting the premium cost with another individual or entity, often an employer (corporation)-employee arrangement. The corporation usually is entitled to the cash surrender value and the remainder of the proceeds are payable to a beneficiary named by the insured. See generally E. WHITE & H. CHASMAN, *supra* note 1, at 485-507. See also Estate of Dimen v. Commissioner, 72 T.C. 198 (1979); Estate of Levy v. Commissioner, 70 T.C. 873 (1978); Estate of Schwager v. Commissioner, 64 T.C. 781 (1975); Genshaft v. Commissioner, 64 T.C. 282 (1975).

7. A key-man policy is owned by and payable to the employer corporation to indemnify the employer against the loss of an influential employee or director. It also serves to bolster the confi-

crucial role in corporate planning, Treasury Regulation section 20.2042-1(c)(6), the regulation at issue, should not be deemed appropriate without substantial congressional and judicial support.<sup>8</sup>

The Estate Tax Code specifically provides for life insurance taxation.<sup>9</sup> The current statute divides insurance into policies payable to the insured decedent's estate and policies payable to other beneficiaries.<sup>10</sup> The Code includes in a decedent's estate the proceeds of policies payable to other beneficiaries only if the decedent retained incidents of ownership.<sup>11</sup> Although Congress has not substantially modified the statute since 1954, the regulations have undergone extensive alteration.<sup>12</sup> The addition of section 20.2042-1(c)(6) in 1974<sup>13</sup> greatly expanded the scope of the former regulations as applied to insurance policies held by close corporations. Attribution of corporate incidents of ownership may now apply to sole *and* controlling stockholders.<sup>14</sup>

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dence of the corporation's creditors. *See* L. KLINGER, *supra* note 1, at 99-117; E. WHITE & H. CHASMAN, *supra* note 1, at 441-59. For a practical approach to insurance for lawyers see S. MONROE, *supra* note 1; Wright, *Life Insurance and Its Use in Estate Planning*, 23 OKLA. L. REV. 125 (1970).

8. This Note does not contend that Congress could not tax life insurance more broadly, but rather that in light of legislative history and judicial interpretations inadequate support exists to fully accept the scope of Treas. Reg. § 20.2042-1(c)(6). Treasury Regulations promulgated pursuant to statutory authority are entitled to deference and will be upheld if they represent a reasonable implementation of congressional intent. *See* I.R.C. § 7805. *See also* United States v. Cartwright, 411 U.S. 546, 550 (1973); Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 501 (1948). Regulations may be held invalid, however, if unreasonable, *see* Bingler v. Johnson, 394 U.S. 741 (1969), contrary to the statute, *see* M.E. Blatt Co. v. United States, 405 U.S. 267 (1938), or beyond the scope of a statute, *see* Panama Ref. Co. v. Ryan, 293 U.S. 388 (1935).

9. *See* I.R.C. § 2042, note 2 *supra*.

10. *See id.* § 2042(1)-(2), note 2 *supra*.

11. I.R.C. § 2042(2), note 2 *supra*. Full inclusion of the proceeds results to the extent the policies are payable to the decedent's estate. I.R.C. § 2042(1), note 2 *supra*.

Section 2042 is not an exclusive statute, however. Life insurance may be included in a decedent's estate, for example, under either section 2033 or 2035. *See* J. LEWIS, *THE ESTATE TAX* 237 (4th ed. 1979); C. LOWNDES, R. KRAMER & T. MCCORD, *FEDERAL ESTATE AND GIFT TAXES* 340-41 (3d ed. 1974). Additionally, if the decedent had powers over a policy in trust, the proceeds may be includable under either of two sections, 2036 or 2038. *See* Treas. Reg. § 20.2042-1(c)(4)(1958).

12. *See* notes 17-18, 26, 29, 31 *infra* and accompanying text.

13. T.D. 7312, 1974-1 C.B. 277.

14. Treas. Reg. § 20.2042-1(c)(6) (1974) provides:

In the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which the decedent is the sole or controlling stockholder, the corporation's incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation. Any proceeds payable to a third party for a valid business purpose, such as in satisfaction of a business debt of the corporation, so that the net worth of the corporation is increased by the amount of such proceeds, shall be deemed to be payable to the corpora-

This Note initially reviews the history of Treasury Regulation section 20.2042-1(c)(6) and considers the impact of the new regulations. The Note then analyzes the issue of the appropriateness of the regulations in light of the interpretation of the term of art “incidents of ownership” and the proportion of the proceeds that may be included in the controlling shareholder’s estate.<sup>15</sup>

## I. HISTORY OF TREASURY REGULATION SECTION 20.2042-1(c)(6)

Section 2042 has a rather complex history that involves three major changes.<sup>16</sup> Initially, the 1918 Revenue Act included in the decedent’s

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tion for purposes of the preceding sentence. See § 20.2031-2(f) for a rule providing that the proceeds of certain life insurance policies shall be considered in determining the value of the decedent’s stock. Except as hereinafter provided with respect to a group-term life insurance policy, if any part of the proceeds of the policy are not payable to or for the benefit of the corporation, and thus are not taken into account in valuing the decedent’s stock holdings in the corporation for purposes of section 2031, any incidents of ownership held by the corporation as to that part of the proceeds will be attributed to the decedent through his stock ownership where the decedent is the sole or controlling stockholder. Thus, for example, if the decedent is the controlling stockholder in a corporation, and the corporation owns a life insurance policy on his life, the proceeds of which are payable to the decedent’s spouse, the incidents of ownership held by the corporation will be attributed to the decedent through his stock ownership and the proceeds will be included in his gross estate under section 2042. If in this example the policy proceeds had been payable 40 percent to the decedent’s spouse and 60 percent to the corporation, only 40 percent of the proceeds would be included in decedent’s gross estate under section 2042. For purposes of this subparagraph, the decedent will not be deemed to be the controlling stockholder of a corporation unless at the time of his death, he owned stock possessing more than 50 percent of the total combined voting power of the corporation. Solely for purposes of the preceding sentence, a decedent shall be considered to be the owner of only the stock with respect to which legal title was held, at the time of his death, by (i) the decedent (or his agent or nominee); (ii) the decedent and another person jointly (but only the proportionate number of shares which corresponds to the portion of the total consideration which is considered to be furnished by the decedent for purposes of section 2040 and the regulations thereunder); and (iii) by a trustee of a voting trust (to the extent of the decedent’s beneficial interest therein) or any other trust with respect to which the decedent was treated as an owner under subpart E, part I, subchapter J, chapter 1 of the Code immediately prior to his death. In the case of group-term life insurance, as defined in paragraph (b)(1)(i) and (iii) of § 1.79-1 of this chapter (Income Tax Regulations), the power to surrender or cancel a policy held by a corporation shall not be attributed to any decedent through his stock ownership. (Reg. § 20.2042-1).

“Controlling” or “principal” shareholder in this Note refers only to the definition of control used in Treas. Reg. § 20.2042-1(c)(6), *i.e.*, a shareholder who owns more than 50% of the corporate voting stock. As perceived by the Supreme Court, the term is *not* a “[word] of art with a fixed and ascertainable meaning.” *United States v. Byrum*, 408 U.S. 125, 138 n.13 (1972); *see* note 107 *infra* and accompanying text.

15. This Note concerns only issues under section 2042(2)—the estate tax consequences of life insurance proceeds payable to beneficiaries other than the decedent’s estate.

16. *See* Revenue Act of 1918, Pub. L. No. 254, 40 Stat. 1098 (1918), Revenue Act of 1942, Pub. L. No. 753, 56 Stat. 944 (1942); Revenue Act of 1954, Pub. L. No. 591, 68A Stat. 387 (1954).

gross estate only “policies taken out” by the decedent on his own life.<sup>17</sup> The first regulations, attempting to define the inclusion criterion, ruled that proceeds were taxable if the insured paid the insurance premiums.<sup>18</sup>

The Supreme Court gave substance to the statutory phrase “incidents of ownership” more than a decade after the promulgation of the first regulations applicable to the forerunner of section 2042.<sup>19</sup> *Chase National Bank v. United States* involved a constitutional challenge to the estate taxation of life insurance policies.<sup>20</sup> The Court found that life insurance proceeds payable to other beneficiaries could be taxed as part of the decedent’s estate because the insured possessed incidents of ownership until death.<sup>21</sup> In sustaining the constitutionality of the statute the Court reasoned that the taxpayer’s death resulted in a shift of economic benefits.<sup>22</sup>

In the same year the Supreme Court decided *Chase National Bank* the “incidents of ownership” language appeared in Treasury Regulations, although the Service did not consider the phrase to be a determi-

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For a more thorough discussion of the history of the statute see J. LEWIS, *supra* note 11, at 237; C. LOWNDES, R. KRAMER & T. MCCORD, *supra* note 11, at 321-28; 2 J. MERTENS, *supra* note 2, at § 17; Schlesinger, *supra* note 2, at 226-46. See also Note, *Federal Estate Tax: Application of the Section 2042 Incidents of Ownership Concept to the Insured Fiduciary’s Estate*, 60 IOWA L. REV. 1319, 1321-27 (1975); Note, *A Decedent’s Powers as Trustee of a Life Insurance Trust—Taxable “Incidents of Ownership”*, 1977 WASH. U.L.Q. 95, 96-106.

17. Revenue Act of 1918, ch. 18 § 402(f), 40 Stat. 1098 (1918) (current version at I.R.C. § 2042). Up to \$40,000 was exempted for proceeds payable to beneficiaries other than decedent’s estate.

18. Treas. Reg. § 37, art. 32 (1919), *quoted in* Schlesinger, *supra* note 2, at 230.

19. See *Chase Nat’l Bank v. United States*, 278 U.S. 327 (1929).

20. *Id.* at 336-37. The taxpayer had named his wife as beneficiary on several policies, but a tax on policies transferred away during life arguably was unconstitutional because unapportioned, thus violating article 1, sections 2 and 9 of the Constitution, which require direct taxes—as opposed to taxes upon a transfer—to be apportioned. U.S. CONST. art. 1, §§ 2, 9. The Court refuted this argument: “A power in the decedent to surrender and cancel the policies, to pledge them as security for loans and the power to dispose of them and their proceeds for his own benefit during his life . . . is by no means the least substantial of the legal incidents of ownership.” *Id.* at 335.

21. *Id.* at 337-38.

22. The Court further explained the basis for its decision:

Termination of the power of control at the time of death inures to the benefit of him who owns the property subject to the power and thus brings about, at death, the completion of that shifting of the economic benefits of property which is the real subject of the tax

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*Id.* at 338.

native factor for inclusion at that time.<sup>23</sup> The Treasury fluctuated during the next decade between treating “incidents of ownership” in conjunction with, as an alternative to, or in place of the payment of premiums test.<sup>24</sup> Thus, the Treasury’s later interpretation of the phrase “incidents of ownership” to *require* inclusion of life insurance proceeds in a decedent’s estate represented a shift from the Supreme Court’s use of “incidents of ownership” as merely a rationale for inclusion.<sup>25</sup>

The Revenue Act of 1942 eliminated the “policies taken out” language. Thereafter, either “payment of premiums” or “possession of incidents of ownership” caused inclusion under the statute.<sup>26</sup> Unfortunately, no congressional explanation accompanied the statutory elevation of the phrase “incidents of ownership.”<sup>27</sup> The House and Senate committee reports did, however, list examples of “incidents of ownership” in an attempt to clarify the phrase. The language of these reports provided a foundation for the current regulations. The examples of “incidents of ownership” included the “right of the insured or his estate to the economic benefit of the insurance” and the “power to change the beneficiary reserved to a corporation of which the decedent is sole stockholder.”<sup>28</sup>

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23. The 1929 regulations were approved March 23, 1929. See Treas. Reg. § 70, art. 27 (1929), quoted in Schlesinger, *supra* note 2, at 232. See generally Schlesinger, *supra* note 2, at 233-34.

24. Compare Treas. Reg. § 70, art. 27 (1929) (“incidents of ownership” language in conjunction with payment of premiums test) and Treas. Reg. § 80, art. 25 (1934), quoted in Schlesinger, *supra* note 2, at 234 (changed “retained” incidents of ownership to “possessed” and made it an alternative test) with Treas. Reg. § 80, art. 25 (1941), T.D. 5032, 1941 C.B. 427, 427-28 (incidents of ownership adopted as exclusive test).

25. See generally C. LOWNDES, R. KRAMER & T. MCCORD, *supra* note 11, at 323-24.

26. Revenue Act of 1942, Pub. L. No. 753, 56 Stat. 944 (1942). The \$40,000 exemption was also eliminated. *Id.* This is the first time the statute itself made the “incidents of ownership” language applicable.

There were challenges to the inclusion of proceeds of policies on which the decedent had paid premiums but retained no incidents of ownership. See generally Swihart, *supra* note 2, at 178. *United States v. Manufacturer’s Nat’l Bank*, 363 U.S. 194 (1960), upheld the validity of this test on grounds that the beneficiary’s right to the proceeds does not mature until death of the insured. *Id.* at 198-99.

27. See H.R. REP. NO. 2333, 77th Cong., 2d Sess. 162-63 (1942), reprinted in 1942-2 C.B. 372, 491. The Report gives only a blunt guideline: “This provision is intended to prevent avoidance of the estate tax and should be construed in accordance with this objective.” *Id.*

Generally, the motivation for the 1942 statutory change was assumed to be an attempt to lessen the confusion already shrouding the statute. See, e.g., *United States v. Rhode Island Hosp. Trust Co.*, 355 F.2d 7, 10 (1st Cir. 1966) (Congress trying to introduce “some certitude in a landscape of shifting sands”); *Estate of Levy v. Commissioner*, 70 T.C. 873 (1978) (an effort to eliminate problems of interpretation).

28. Both the House and Senate Reports specifically stated:

In 1954 Congress amended the statute again. Congress retained the “incidents of ownership” test as the sole criterion for determining whether the proceeds from life insurance, payable to others, should be taxable to a decedent’s estate.<sup>29</sup> Some courts and commentators have concluded from the relatively meager legislative history that Congress intended section 2042 to parallel the Code’s treatment of other property interests and powers.<sup>30</sup>

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There is no specific enumeration of incidents of ownership, the possession of which at death forms the basis for inclusion of insurance proceeds in the gross estate, as it is impossible to include an exhaustive list. Examples of such incidents are the right of the insured or his estate to the economic benefits of the insurance, the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign it, the power to revoke an assignment, the power to pledge the policy for a loan, or the power to obtain from the insurer a loan against the surrender value of the policy. Incidents of ownership are not confined to those possessed by the decedent in a technical legal sense. *For example*, a power to change the beneficiary reserved to a corporation of which the decedent is sole stockholder is an incident of ownership in the decedent.

H.R. REP. NO. 2333, 77th Cong., 2d Sess. 162 (1942), *reprinted in* 1942-2 C.B. 372, 491; S. REP. NO. 1631, 77th Cong., 2d Sess. 235 (1942), *reprinted in* 1942-2 C.B. 504, 676-77 (emphasis added).

29. *See* Revenue Act of 1954, Pub. L. No. 591, 68A Stat. 387 (1954) (codified at I.R.C. § 2042(2)). Elimination of the payment of premiums test primarily motivated Congress in taking this action. *See* S. REP. NO. 1622, 83d Cong., 2d Sess. 124, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4757; note 30 *infra*. The statute itself never defined “incidents of ownership.”

30. *See* Estate of Lumpkin v. Commissioner, 474 F.2d 1092, 1095 (5th Cir. 1973) (“by enacting § 2042 Congress intended to give life insurance policies estate tax treatment roughly equivalent to that accorded other types of property”); Estate of Skifter v. Commissioner, 468 F.2d 699, 702 (2d Cir. 1972) (strong inference that Congress intended that § 2042 “should operate to give insurance policies estate tax treatment that roughly parallels the treatment that is given to other types of property by § 2036 . . . § 2038 . . . and § 2041”). *But cf.* Estate of Connelly v. United States, 551 F.2d 545, 551 (3d Cir. 1977) (“more logical that Congress intended to equate incidents of ownership with the right to economic benefits of the policy”); 48 NOTRE DAME LAW. 995, 1002-03 (1973) (*Skifter* reliance on legislative history unjustified).

The rationale for the parallel treatment approach springs from the explanation of the Senate Finance Committee for eliminating the payment of premiums test from the 1954 enactment of section 2042: “No other property is subject to estate taxation 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.” S. REP. NO. 1622, 83d Cong., 2d Sess. 124, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4757. *Accord*, H.R. REP. NO. 1337, 83d Cong., 2d Sess. 91, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4025, 4117-18. The same Committee strengthened the inference of the correctness of this approach by emphasizing that the addition to the statute of the 5% reversionary interest rule was necessary “[t]o place life insurance policies in an analogous position to other property.” S. REP. NO. 1622, 83d Cong., 2d Sess. 124, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4757.

It has been stated that Congress has the power to tax life insurance even more broadly but instead chose to limit itself when it adopted the 1954 version of section 2042. *See* United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7, 10 (1st Cir. 1966). *Cf.* United States v. Manufacturers Nat’l Bank, 363 U.S. 194, 198 (1960) (any taxable event that could fairly be considered a “transfer” “is clearly constitutional without apportionment”). The *Rhode Island Hospital* court apparently found some intent to make section 2042 analogous to other sections of the Code:



Congress again failed to explain why it retained the “incidents of ownership” test as the sole criterion for inclusion. In 1958 the Treasury Department promulgated regulations to interpret the phrase.<sup>31</sup> These regulations, however, merely adopted the language of the committee reports that accompanied the Revenue Act of 1942, with one significant change. The committee reports listed “the right . . . to the economic benefits of the policy” as *an example* of an incident of ownership; the regulations elevated this “example” to a general definitional phrase.<sup>32</sup>

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What (Congress) was attempting to reach in Section 2042 and some other sections was the power to dispose of property, the same power that the Supreme Court recognized as a basis for exercise of the tax instrument in *Chase National Bank v. United States* . . . . Power can be and is exercised by one possessed of less than complete legal and equitable title. The very phrase “incidents of ownership” connotes something partial, minor and even fractional in its scope. It speaks more of possibility than probability.

*Id.* at 10.

The basic theory of the estate tax is to tax the privilege of transferring property at death, and other transfers that are in substance testamentary substitutes. See Lowndes, *An Introduction to the Federal Estate and Gift Taxes*, 44 N.C. L. REV. 1, 4 (1965). Whether life insurance is in substance a testamentary transfer then becomes a relevant question. When the premium payments test was eliminated in 1954, see note 23 *supra* and accompanying text, the minority of the House Ways and Means Committee objected on grounds that life insurance is inherently testamentary in nature. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 91, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4025, 4608. Although the sentiment is to a certain degree still present, the view that life insurance has sufficient indices of investment property to be treated as other property under the estate tax prevails. Compare C. LOWNDES, R. KRAMER & T. MCCORD, *supra* note 11, at 326-28 (life insurance should not be taxed like other property because unlike other property decedent can “pass along unlimited amounts of property . . . without encountering the estate tax”) with Swihart, *supra* note 2, at 179 n.78 (“[any] investment [property] is used to secure a return and to form a savings”).

31. Treas. Reg. § 20.2042-1(c) (1958) T.D. 6296, 1958-2 C.B. 432, provided in pertinent part: Receivable by other beneficiaries: (1) Section 2042 requires the inclusion in the gross estate of the proceeds of insurance on the decedent’s life not receivable by or for the benefit of the estate if the decedent possessed at the date of his death any of the incidents of ownership in the policy, exercisable either alone or in conjunction with any other person . . . .

(2) for purposes of this paragraph, the term “incidents of ownership” is not limited in its meaning to ownership of the policy in the technical legal sense. *Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy.* Thus, it 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 insurer a loan against the surrender value of the policy, etc. Similarly, the term includes a power to change the beneficiary reserved to a corporation of which the decedent is sole stockholder.

*Id.* (emphasis added). Current regulation § 20.2042-1(c) remains substantially unchanged but the last sentence in the above quote has been deleted because of the addition of Treas. Reg. § 2042-1(c)(6). See Treas. Reg. § 2042-1(c) (1974).

32. Compare the listing of *examples* of incidents of ownership in the 1942 committee reports, *supra* note 28, with the italicized language in § 20.2042-1(c)(2), *supra* note 31. Because of the distinction, § 2042(2) arguably applies only to powers exercisable for the insured’s benefit. See

These regulations developed the “sole stockholder” rule: A sole stockholder’s estate must include the full amount of any proceeds paid to a corporation or other beneficiary when the corporation retains any incidents of ownership in a policy on the shareholder’s life.<sup>33</sup> No taxpayer challenges to the validity of this rule occurred<sup>34</sup> until the Service announced Revenue Ruling 71-463.<sup>35</sup> In that Ruling a corporation was owner and beneficiary of a life insurance policy insuring a seventy five percent controlling stockholder. Among other ownership rights, the corporation reserved the right to change beneficiaries, assign the policy,

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Estate of Skifter v. Commissioner, 468 F.2d 699, 702 (2d Cir. 1972); Note, *Federal Estate Tax—“Incidents of Ownership” in Group Life Insurance, A Phrase Searching for Definition*, 52 N.C. L. REV. 671, 678-79 (1974). See generally Estate of Connelly v. United States, 551 F.2d 545, 547-49 & 549 n.7 (3d Cir. 1977). See also Chase Nat’l Bank v. United States, 278 U.S. 327 (1929) (right to economic benefits of the policy); Prichard v. United States, 397 F.2d 60 (5th Cir. 1960) (same); Commissioner v. Chase Manhattan Bank, 259 F.2d 231 (5th Cir. 1958), *cert. denied*, 359 U.S. 913 (1959) (same).

33. See note 31 *supra*.

34. See, e.g., Hall v. Wheeler, 174 F. Supp. 418 (D. Me. 1959).

In a few early cases courts did not indicate that corporate control could be a basis for inclusion, even though the decedent was controlling shareholder and the corporation owned several policies on the insured decedent’s life. See generally Newell v. Commissioner, 66 F.2d 102 (7th Cir. 1933) (question of valuation of stock when insurance proceeds payable to corporation); *In re Kennedy*, 4 B.T.A. 330 (1926) (same). The courts did not face the issue of corporate attribution, however, because the phrase “policies taken out by the decedent” determined inclusion at the time and presented much confusion in itself. See text accompanying notes 17 and 18 *supra*.

The litigation that did occur involving business insurance actually related to the line of cases that developed the concept of an incident of ownership. An early case under the incidents of ownership test allowed an exception that taxpayers in later cases attempted to seize upon. In Estate of Doerken v. Commissioner, 46 B.T.A. 809 (1942), the corporation insured decedent’s life, paid premiums, credited itself with the cash surrender value, kept possession of the policies, and received the entire amount of proceeds at decedent’s death. The policy form, however, reserved to decedent the right to change beneficiaries, to surrender, and to cancel the policy, though the decedent never exercised these powers. The court held the proceeds *excludable* upon the theory that intent of the parties controls over the wording of the policy. That is, the decedent insured is merely a “nominal owner” when it clearly appears he intended to transfer all rights and retain no incidents of ownership.

Several later cases dealt with the intent argument when the decedent shareholder attempted to disclaim any incidents of ownership. Rejecting the argument upon the facts, these courts instead focused upon the “in conjunction with any other person” language of section 2042(2). See Estate of Piggott v. Commissioner, 340 F.2d 829 (6th Cir. 1965) (taxpayer failed to factually prove he *intended* to divest himself of all incidents of ownership); Hall v. Wheeler, 174 F. Supp. 418 (D. Me. 1959) (even assuming decedent could not have changed beneficiary without consent of corporation they could have done so acting together). In Kearns v. United States, 399 F.2d 226 (Ct. Cl. 1968), the court drew upon the Supreme Court decision of Commissioner v. Estate of Noel, 380 U.S. 678 (1965), to refute the “nominal owner” theory by suggesting the rationale is obsolete under the 1954 Code. *Accord*, Cockrill v. O’Hara, 302 F. Supp. 1365 (M.D. Tenn. 1969).

35. 1971-2 C.B. 333.

and surrender or cancel the policy. The Ruling maintained that the "sole stockholder" language of the regulation constituted an example rather than an exclusion. Thus, inclusion results when the decedent has power to exercise incidents of ownership.<sup>36</sup> The Ruling held the regulation "applicable in circumstances where the insured decedent could exercise voting control of the corporation."<sup>37</sup>

The rationale given as underlying this premise paralleled the arguments the Commissioner would make in a landmark case the following year.<sup>38</sup> The Service reasoned that because decedent, as controlling shareholder, had power to dissolve the corporation, he effectively could cancel or distribute the policy.<sup>39</sup> The decedent's power to maintain himself as president and to elect other officers allowed him the advantages of incidents of ownership "without the necessity of acquiring the policy itself."<sup>40</sup>

The Service cited no supporting cases in its Ruling.<sup>41</sup> Commentators extensively criticized the Ruling and began to scrutinize the sole stockholder rule more carefully.<sup>42</sup> A review of this criticism is relevant to an analysis of the present regulations not only as a historical development but also because the present regulations still attribute incidents of own-

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36. *Id.* at 334.

37. *Id.* at 333.

38. The same emphasis on de facto powers supported the Commissioner's arguments in *United States v. Byrum*, 408 U.S. 125 (1972). See notes 100-03, 107-08 *infra* and accompanying text.

39. 1971-2 C.B. 333.

40. *Id.* at 334. The Service did rule that because the proceeds were includable in the decedent's estate, they should not be reflected in the value of his stock interest for inclusion under section 2033. *Id.*

41. Implicit support for the Ruling arguably existed. In *Landorf v. United States*, 408 F.2d 461 (Ct. Cl. 1969), the Commissioner argued that the decedent, who was president and 50% shareholder of the corporation, could combine with another shareholder to terminate a group life insurance policy. The court rejected that argument as exceeding the thrust of section 2042, but added in dictum that a different decision might result upon convincing evidence of such control. *Id.* at 471. *Cf.* *Cockrill v. O'Hara*, 302 F. Supp. 1365 (M.D. Tenn. 1969) (regulation as applied to sole stockholder rule cited in support of holding that decedent's veto power over trust that owned policy on decedent's life constituted incident of ownership because decedent could act in conjunction with others to change beneficiary). For a discussion that the economic benefit rationale underlying these cases does not apply to the type of situation in a ruling like 71-463 see Howard, *Corporate Control as an Incident of Ownership Under Section 2042 of the Internal Revenue Code*, 13 ARIZ. L. REV. 619, 632-34 (1971).

42. See, e.g., Howard, *supra* note 41; Osborn, *Corporate-Owned Life Insurance: Recent Developments in Estate Planning*, 32 N.Y.U. INST. FED. TAX. 293 (1974); Simmons, *How to Handle the IRS's Attack on Corporate-Owned Life Insurance*, 36 J. TAX. 142 (1972); Walker, *What Will Effect of Proposed Regulations on Corporate Owned Life Insurance Be?*, 39 J. TAX. 206 (1973).

ership to a controlling stockholder to the extent that proceeds from a corporate owned life insurance policy are payable to a personal beneficiary.<sup>43</sup>

One major objection was that the Ruling violated the tax principle recognizing a wholly owned corporation as a distinct, separate entity.<sup>44</sup> An income tax case, decided in the same year that the Service proposed section 20.2042-1(c)(2),<sup>45</sup> illustrated that a controlled corporation is not merely a majority stockholder's alter ego. In *Casale v. Commissioner* the Tax Court maintained that the taxpayer's ninety-eight percent owned corporation "was no more than a conduit."<sup>46</sup> Thus, premiums paid by the corporation on a key-man insurance policy amounted to a distribution of a dividend and must be included in the taxpayer's gross income.<sup>47</sup> The Second Circuit reversed the Tax Court and declared the "controlled" corporation a separate entity.<sup>48</sup>

Commentators argued that in the absence of any definite congressional support Revenue Ruling 71-463 deviated too much from accepted notions of a corporation's identity as a separate entity.<sup>49</sup> As one commentator stated, the Ruling "must certainly have marked a record tremor on the Richter scale of the estate planning world."<sup>50</sup> The "sole stockholder rule" itself was merely an example—a statement only of what the House and Senate Committees in 1942 *assumed* the law to be.<sup>51</sup>

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43. See note 14 *supra*.

44. See generally authorities cited in note 42 *supra*. One commentator delineated three factors of attribution that the ruling failed to account for: (1) Estate and gift tax law rarely recognizes attribution principles judicially nor does it statutorily sanction them; (2) though attribution is commonly recognized in the income tax area, the "normal rule is [still] to respect the corporate entity"; (3) Congress generally defines "control" when attribution is to be recognized. See Howard, *supra* note 41, at 625-26.

The Estate Tax Code does statutorily recognize attribution currently where stock has been placed in trust but the grantor retains voting control. See I.R.C. § 2036(a)(2), note 104 *infra*.

45. The Regulations were initially published in the Federal Register (21 Fed. Reg. 7850) on October 16, 1956. See T.D. 6296, 1958-2 C.B. 432.

46. *Casale v. Commissioner*, 26 T.C. 1020, 1025 (1956), *rev'd*, 247 F.2d 440 (2d Cir. 1957).

47. *Id.* at 1027.

48. 247 F.2d at 445. The court emphasized: "We have been cited to no case or legislative provision which supports the proposition that the entity of a corporation which is actively engaged in a commercial enterprise may be disregarded for tax purposes merely because it is wholly owned or controlled by a single person." *Id.*

49. See generally authorities cited in note 42.

50. Walker, *supra* note 42, at 206.

51. See *id.* This "assumption" provided the foundation for what became an expanded, inflexible rule with Treas. Reg. § 20.2042-1(c)(6) (1974). Other criticisms levied against the ruling

The criticism was quite effective, apparently, because the Service withdrew Revenue Ruling 71-463 the following year, before taxpayers could challenge the Ruling in the courts.<sup>52</sup> In 1974 the Treasury Department promulgated Treasury Regulation section 20.2042-1(c)(6),<sup>53</sup> which provides that corporate-owned life insurance payable for valid business purposes to either the corporation or a third party will not be included in a decedent's estate. The regulation also precludes attributing the corporation's incidents of ownership to decedent because of his stock ownership.<sup>54</sup> To the extent that proceeds from a policy owned by the corporation are payable to a personal beneficiary, however, the reg-

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included: (1) The ruling gave no explanation for the income tax consequences regarding the basis of the stock; (2) the ruling provided inadequate guidelines for valuing the stock itself; (3) the ruling ignored the legal obligations directors and controlling shareholders owed creditors and minority shareholders. See Howard, *supra* note 41; Osborn, *supra* note 42; Simmons, *Final Regs on Corporate-Owned Life Insurance: Greatly Improved But Still Questionable*, 41 J. TAX. 66 (1974); Walker, *supra* note 42.

Significantly, Congress declined to incorporate the ruling into the Internal Revenue Code in 1954 when the Code was revised. The "incidents of ownership" test became the sole criterion for inclusion, but no change in the interpretation of the phrase was suggested, with the exception of the reversionary interest. See notes 29-30 *supra* and accompanying text. It has also been judicially recognized that neither the 1954 revision of the Code nor Treas. Regs. § 20.2042-1(c) was intended to change the concepts already evolved to explain the term "incidents of ownership." See *Estate of Piggott v. Commissioner*, 340 F.2d 829, 834 (6th Cir. 1965). See also Howard, *supra* note 41, at 62 n.12; Osborn, *supra* note 42, at 298.

Though possession of any of the specific examples set out in § 20.2042-1(c)(2) generally results in inclusion, see, e.g., *Commissioner v. Estate of Noel*, 380 U.S. 678 (1965) (right to change beneficiary or assign the policy); *Prichard v. United States*, 397 F.2d 60 (5th Cir. 1968) (right to pledge policy for a loan); *Commissioner v. Treganowan*, 183 F.2d 288 (2d Cir.), *cert. denied*, 340 U.S. 853 (1950) (right to surrender or cancel policy), the concept has been broadened since the Court in *Chase Nat'l Bank v. United States*, 278 U.S. 327 (1929), equated incidents of ownership with substantial control over the policy. See generally Note, *Federal Estate Tax: Application of the Section 2042 Incidents of Ownership Concept to the Insured Fiduciary's Estate*, 60 IOWA L. REV. 1319, 1325 (1975); Note, *supra* note 32, at 676.

The new regulations under section 2042 and the controversy regarding the insured fiduciary are only part of the Service's push toward an expanded definition of the term "incidents of ownership." Despite the language of *United States v. Rhode Island Hosp. Trust Co.*, 355 F.2d 7 (1st Cir. 1966), see note 30 *supra*, some rights held over insurance policies have been found too insignificant to constitute incidents of ownership. See, e.g., *Landorf v. United States*, 408 F.2d 461 (Ct. Cl. 1969) (right to cancel or force conversion of group policy by terminating employment causes no inclusion), *acq.* Rev. Rul. 72-307, 1972-1 C.B. 307; *Estate of Smith v. Commissioner*, 73 T.C. 307 (1979) (option to take assignment of policy if decedent's employer decides to stop paying premiums causes no inclusion); *Bowers v. Commissioner*, 23 T.C. 911, 917 (1955) (right to receive dividends on policy causes no inclusion).

52. See Rev. Rul. 72-167, 1972-1 C.B. 307. The Service simply announced that new regulations were under consideration. *Id.*

53. T.D. 7312, 1974-1 C.B. 277.

54. See Treas. Reg. § 20.2042-1(c)(6) (1974), note 14 *supra*.

ulation attributes the incidents of ownership to the insured decedent who is a controlling shareholder.<sup>55</sup>

The Service reportedly has not changed its position. In the Treasury Decision announcing the new amendment the Service stated that section 2042 treats a controlling stockholder the same as a "sole stockholder." The Service allows exclusion only because it is unnecessary to include proceeds payable to a corporation in decedent-insured's estate.<sup>56</sup>

## II. IMPACT OF CASE LAW

Few cases have been litigated under the new regulations and only one directly challenged the regulations. In *Estate of Huntsman v. Commissioner*<sup>57</sup> the decedent was the president and sole owner of two corporations that owned key-man insurance policies on his life. The issue was not whether section 20.2042-1(c)(6) and section 20.2031-2(f), a coordinated valuation section, should apply, but how to value decedent's stock for inclusion in his estate.<sup>58</sup> The Commissioner argued the proper approach is to ascertain the value of the stock without the insurance proceeds, and then simply add the value of the proceeds.<sup>59</sup> The only change from existing law effected by the regulation, according to

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55. *Id.* Note that a parallel amendment was made to § 20.2031-2(f) providing that the portion of the proceeds excludable from decedent's estate shall be considered in determining the value of decedent's stock at his death. Paragraph (f) of § 20.2031-2 was amended to read as follows:

§ 20.2031-2 Valuation of stocks and bonds.

.....

(f) *Where selling prices or bid and asked prices are unavailable.* If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: . . . In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such non-operating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity . . . .

56. *See* T.D. 7312, 1974-1 C.B. 377.

57. 66 T.C. 861 (1976), *acq.* 1977-1 C.B. 1.

58. 66 T.C. at 862.

59. *Id.* at 872. The Commissioner's conclusion rested on the assumption that former regulations were consistent with legislative purpose and approved by the courts. *Id.*

the Commissioner, was to prorate life insurance proceeds over the shares of stock when the insured owns a majority, but not all, of the stock.<sup>60</sup> The taxpayer responded that such proceeds are simply another corporate asset to be considered in determining valuation. The court agreed with the taxpayer that the regulation required a practical approach to valuation. The policies must be considered, but the total amount of the proceeds need not be added per se.<sup>61</sup>

*Estate of Clarke*<sup>62</sup> also addressed the issue of valuation under the Regulation. The *Clarke* court, purporting to follow *Huntsman*, simply added the approximate face value of the proceeds to the decedent's shares, and then discounted the entire amount for nonmarketability.<sup>63</sup>

In *Estate of Levy v. Commissioner*<sup>64</sup> the decedent's estate squarely challenged the validity of the regulations. Decedent owned 80.4 percent of Levy Brothers, Inc. voting stock at the time of his death but had never been the sole stockholder. Levy Brothers owned two split-dollar insurance policies on decedent's life, reserving the rights to change the beneficiary, to assign or borrow against the cash policy, and to modify the policies. Mrs. Levy was designated beneficiary, and the beneficiary could not be changed without her consent.<sup>65</sup>

The decedent's estate first alleged that the new regulation was inconsistent with the incidents of ownership test in 2042(2).<sup>66</sup> The language of the 1942 committee reports, essentially adopted by the 1958 regulations, in effect precluded attribution of corporate incidents of ownership to any stockholder other than a sole stockholder; if Congress intended a broader inclusion it would have stated so.<sup>67</sup> The Commis-

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60. *Id.* at 873-74.

61. *Id.* at 874. The court made a significant perception as to the practical effect the proceeds would have upon the value of the corporation: "In determining the price a willing buyer would pay, it is obvious that life insurance proceeds must be given 'consideration' but it is equally obvious that the price paid by a willing buyer would not necessarily be increased by the amount of the life insurance proceeds." *Id.* at 874-75.

62. 45 T.C.M. (P-H) ¶ 76,328 (1976).

63. The court reached a value of \$4,040 per share for the class of stock primarily in dispute. The proceeds from the life insurance policy received by the corporation approximately equaled \$40,000. The court then added a value of \$40 per share to the stock held by decedent to reach a total value of \$4,080 per share—discounted by 20 percent—to equal \$3,520 per share. *Id.* at 1478-79.

64. 70 T.C. 873 (1978).

65. *Id.* at 875. The decedent possessed no incidents of ownership in the policies other than those attributed through his stock ownership.

66. *Id.* at 878.

67. *Id.* at 879-80. See also note 28 *supra* and accompanying text.

sioner characterized the regulations as an amplification, rather than a departure, from prior law.<sup>68</sup>

The court held that the “sole stockholder rule” was only an illustration adopted by the earlier regulation and was not intended to be an exclusive rule.<sup>69</sup> No meaningful distinction existed between a sole stockholder and the decedent because the decedent “had the power to elect corporate officers who would be amenable to decedent’s wishes as to the exercise of the incidents of ownership held by the corporation.”<sup>70</sup>

The court cited no authorities for its belief that the original regulations under 2042(2) were not limited in application to sole shareholders. In fact, only Revenue Ruling 71-463 could have provided direct authority for the court’s conclusion, but the Service had withdrawn that ruling because of harsh criticism.<sup>71</sup> Congress’ intent to attribute corporate incidents of ownership to stockholders with less than one hundred percent stock ownership was less clear to others.

The estate, citing *Casale v. Commissioner*,<sup>72</sup> also argued that application of the sole stockholder example to a controlling stockholder violated the separate entity concept of a corporation.<sup>73</sup> *Casale* failed to persuade this court, however, because the Second Circuit decided that case under a different Code section.<sup>74</sup>

The estate further contended that any incidents of ownership held by decedent’s corporation were restricted by a fiduciary capacity.<sup>75</sup> In dismissing this argument the court noted that the estate had not proven

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68. 70 T.C. at 878.

69. *Id.* at 880. The court bluntly stated:

In either situation the stockholder possesses the power over the activities of the corporation so as to effect the disposition of the insurance proceeds. Clearly, Congress did not intend to attribute corporate incidents of ownership to a sole stockholder while excluding a stockholder owning 99 percent of the voting stock of a corporation or 80.4 percent in the instant case.

*Id.* The court later detailed what “power” the decedent could exercise through the corporation:

Although the parties did not stipulate the specific terms of the policies, it is apparent that the corporation, by the exercise of its rights in the policies, had the power to realize all or at least the greater portion of the proceeds of the policies prior to decedent’s death and thus prevent decedent’s widow from receiving much of the insurance proceeds.

*Id.* at 881.

70. *Id.*

71. See notes 42-52 *supra* and accompanying text.

72. 247 F.2d 440 (2d Cir. 1957). See notes 46-48 *supra*.

73. 70 T.C. at 880.

74. *Id.*

75. *Id.* The estate relied upon *Estate of Freuhauf v. Commissioner* in which the Sixth Circuit rejected a broad rule of inclusion, which stated that merely because a decedent could exercise the



the decedent to be a corporate officer or director. Thus, if decedent acts in a fiduciary capacity, he must be acting as a shareholder, because incidents of ownership are attributable to him through his stock holdings. In this capacity, the court stated, "it is difficult to see how the corporation or minority shareholders could be injured by exercising the incidents of ownership to defeat the widow."<sup>76</sup>

The most recent case decided under the regulations illustrates the difficulties of attempting to avoid attribution of incidents of ownership. In *Estate of Dimen v. Commissioner*<sup>77</sup> decedent's corporation owned a split-dollar life insurance policy on his life. An agreement between the corporation and decedent's daughter, the policy's beneficiary, required written consent of the daughter before the corporation could change the beneficiary or the manner of payment. The agreement further provided that the corporation would refrain from exercising other incidents of ownership without obtaining her consent or giving her the right to purchase the policy. Either party could cancel the arrangement upon thirty days notice, and the beneficiary had the option to purchase the policy within that period of time.<sup>78</sup> The estate analogized the daughter to an irrevocably designated beneficiary whose rights and requests must, by the supplemental agreement, be respected by the corporation.<sup>79</sup>

The Commissioner argued that decedent's corporation retained substantial incidents of ownership despite the supplemental agreement.<sup>80</sup> The court, agreeing with the Commissioner, focused on a broad definition of "incidents of ownership" as including something fractional in nature.<sup>81</sup> The court emphasized that the regulations required inclusion in decedent's estate of the proceeds payable to the daughter if decedent possessed *any* incidents of ownership in the policy, exercisable alone *or*

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incidents of ownership only in a fiduciary capacity, such capacity was no bar to inclusion. See *Estate of Freuhauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970).

76. 70 T.C. at 882. *But see* notes 109-11 *infra* and accompanying text.

77. 72 T.C. 198 (1979). The Second Circuit affirmed the Tax Court decision. No. 80-4025 (2d Cir., May 15, 1980).

78. 72 T.C. at 200-02. The beneficiary shared the cost of premium payments with the corporation. *Id.* at 202.

79. *Id.* at 205.

80. *Id.* at 203. The corporation still possessed the right to surrender or cancel the policy, the right to assign the policy or borrow against it, and the right to change the beneficiary as exercisable in conjunction with Muriel Dimen. *Id.* at 205.

81. *Id.* at 204 (citing *United States v. Rhode Island Hosp. Trust Co.*, 355 F.2d 7, 10 (1966)). The *Rhode Island Hospital* definition is quoted in note 30 *supra*.

in conjunction with any other person.<sup>82</sup>

The decedent's estate argued that the policy fell within the scope of Revenue Ruling 76-274,<sup>83</sup> in which a similar agreement gave a third party power to change the beneficiary and exercise settlement options. The Service ruled that section 2042 did not require inclusion in decedent's estate of the proceeds because the corporate owner's powers were restricted by agreement with the third party.<sup>84</sup> The *Dimen* court distinguished decedent's case from the Ruling on grounds that the agreement at issue in the ruling clearly prohibited the corporation from taking any action that would endanger the interest of the "subowner" or the payment of proceeds in excess of the cash surrender value. The agreement in *Dimen* provided the decedent's corporation with much greater power; thus, section 2042 required inclusion of the proceeds in decedent's estate.<sup>85</sup>

Only in a footnote did the court acknowledge Revenue Ruling 79-46,<sup>86</sup> which asserts that the right to purchase the policy, held by the daughter in *Dimen*, is an incident of ownership. The court found the remaining incidents of ownership held by the corporation to be substantial enough to cause inclusion of the proceeds.<sup>87</sup>

### III. ARE THE REGULATIONS APPROPRIATE?

The criticisms leveled at Revenue Ruling 71-463 apply as well to the present regulations. The one case that considered the validity of the regulations cited only legislative reports of the 1942 Act to support expansion of the sole stockholder example, even though the Service had acquiesced to critics who considered the same reports inadequate to

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82. 72 T.C. at 203-04. The court actually seems to have fully conceptualized the decedent and his corporation as one entity, as illustrated in its elaboration of the incidents of ownership possessed by the corporation:

It makes no difference whether the decedent had the power to initiate the exercise of a power or whether his consent is simply required. In this sense, a negative or veto power of the decedent over any of the incidents of ownership is sufficient to require inclusion of the policy proceeds in the gross estate.

*Id.* at 204.

83. *Id.* at 205 (citing Rev. Rul. 76-274, 1976-2 C.B. 278).

84. Rev. Rul. 76-274, 1976-2 C.B. 278.

85. 72 T.C. at 198.

86. 1979-1 C.B. 303.

87. 72 T.C. at 205 n.11.

sustain Revenue Ruling 71-463.<sup>88</sup>

Although the few cases decided under the regulations involved sole stockholders or stockholders with a considerable percentage of control,<sup>89</sup> the regulations themselves are quite broad. They apply to controlling stockholders with interests greater than fifty percent. The closer the actual control is to fifty percent and the greater the number of minority shareholders, especially if unrelated, the greater the need for critical analysis.<sup>90</sup>

In *Estate of Lumpkin v. Commissioner*<sup>91</sup> the Fifth Circuit espoused a new approach to section 2042(2). The court found that the beneficiary's right to alter the time and manner of enjoyment of life insurance proceeds "affords its holder the kind of control over the proceeds that will make it an 'incident of ownership' within meaning of § 2042(2)."<sup>92</sup> It reached this conclusion by evaluating the estate tax scheme under sections 2036 and 2038.<sup>93</sup> The court inferred from the examples given in section 2042's legislative history<sup>94</sup> that Congress intended to tax "the value of life insurance proceeds over which the insured at death still possessed a substantial degree of control."<sup>95</sup> The court, coupling that intent with the congressional intent to give life insurance estate tax

88. Revenue Ruling 71-463 was withdrawn even before it was challenged in the courts. See note 52 *supra* and accompanying text.

89. In both *Dimen* and *Huntsman* the decedent owned all voting stock. See 72 T.C. at 199; 66 T.C. at 862. In *Clarke* and *Levy* decedents owned 55% and 80.4%, respectively, of the voting stock. See 45 T.C.M. (P-H) ¶ 76,328, at 1456; 70 T.C. at 873.

90. At least one commentator foresees the possibility that the I.R.S. will attempt to expand the incidents of ownership attribution rules to officers and directors as a result of their positions in a corporation that owns split-dollar policies on the lives of the officers and directors, even though the officers and directors are not controlling shareholders. See Rollyson, *Keyman/Split-Dollar Life Insurance: Attribution to Employee's Estate*, 62 A.B.A.J. 801, 803 (1976).

91. 474 F.2d 1092 (5th Cir. 1973).

92. *Id.* at 1097. The group term life insurance policy that covered the decedent as an employee of Humble Oil & Refining Company included an optional settlement provision. By exercising various options the insured employee could extend or diminish the payment period to a beneficiary. *Id.* at 1093-95.

93. Specifically, the Fifth Circuit discussed the Supreme Court decisions of *United States v. O'Malley*, 383 U.S. 627 (1966), and *Lober v. United States*, 346 U.S. 335 (1953). *Lober* held that a decedent who retains the right to alter the time of enjoyment by trust beneficiaries holds a § 2038 power to "alter, amend, revoke or terminate." 346 U.S. at 336-37. See I.R.C. § 2038. Similarly, *O'Malley* held that a power over the time and manner of a beneficiary's enjoyment amounted to a right to "designate" who will enjoy certain trust property within § 2036. 383 U.S. at 632-33. See I.R.C. § 2036.

94. See note 28 *supra*.

95. 474 F.2d at 1095. See *United States v. Rhode Island Hosp. Trust Co.*, 355 F.2d 7, 10 (1st Cir. 1966) (cited in *Estate of Lumpkin v. Commissioner*, 474 F.2d 1092, 1095 n.8 (5th Cir. 1973)).

treatment similar to that of other property under the Code,<sup>96</sup> reasoned that identifying an incident of ownership depends on what constitutes “substantial control” under sections 2036 and 2038.<sup>97</sup> An anomaly would result if a power sufficient to cause inclusion under 2036 and 2038 was insufficient to constitute an incident of ownership under section 2042.<sup>98</sup>

If *Lumpkin*'s approach to identifying an incident of ownership is correct,<sup>99</sup> then the “substantial control” sought to be taxed by section 20.2042-1(c)(6) theoretically should be tested against sections 2036 and 2038 to determine whether the same power would cause inclusion under those sections. The United States Supreme Court in *United States v. Byrum* proscribed attribution of certain powers per se to voting control.<sup>100</sup> The Court firmly rejected the argument that the majority shareholder who had transferred voting stock into a trust retained the power to designate possession or enjoyment under section 2036 because of his de facto power to regulate the flow of corporate dividends.<sup>101</sup> The Supreme Court specifically found that inclusion under section 2036(a)(2) results only from a legally enforceable right and not from de facto control; Byrum's right to influence corporate directors, as a majority shareholder, was not legally enforceable.<sup>102</sup> As a fiduciary, the majority shareholder may not “[promote] his personal interests at the expense of corporate interests . . . ; directors also have a fiduciary duty to promote the interests of the corporation.”<sup>103</sup>

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96. 474 F.2d at 1095 & n.9 (citing *Estate of Skifter v. Commissioner*, 468 F.2d 699 (2d Cir. 1972)). The extent to which Congress actually intended section 2042 to parallel other sections of the Code has not been settled. See note 30 *supra*.

97. 474 F.2d at 1095-96.

98. *Id.* at 1097. The “only significant distinction” between sections 2036 and 2038, and section 2042 recognized by the court is that under the latter section the decedent need not have retained any power; inclusion results from *possession* of an incident of ownership under section 2042. *Id.*

Although the exact statutory language of section 2038 apparently makes the section applicable to a power merely possessed and not necessarily retained in some manner, see I.R.C. § 2038, that language has been interpreted in a more limited manner. See *Estate of Skifter v. Commissioner*, 468 F.2d 699, 703-04 (2d Cir. 1972).

99. The Commissioner actually relied on the *United States v. O'Malley*, 383 U.S. 627 (1966) and *Lober v. United States*, 346 U.S. 335 (1953) decisions as support for arguing that the decedent in *Lumpkin* possessed an incident of ownership. 474 F.2d at 1096.

100. 408 U.S. 125 (1972). In *Byrum* the taxpayer controlled 71% of the voting stock but 11 minority shareholders held voting stock as well.

101. *Id.* at 138-44.

102. *Id.* at 136-37.

103. *Id.* at 137-38.

Admittedly, Congress enacted its own view of the proper application of section 2036,<sup>104</sup> but the Court's perception of voting control is not necessarily totally rejected.<sup>105</sup> At the very least, the regulations under section 2042 should impose only a presumption of control and not a *per se* rule.<sup>106</sup> The *Byrum* Court noted that deeming the shareholder to be in "control" of a corporation is problematic.<sup>107</sup> The court maintained that the concept was "too variable and imprecise to constitute the basis *per se*" of taxation under section 2036(a).<sup>108</sup>

The argument made by the estate in *Levy*—that any incidents of ownership are restricted by a fiduciary capacity—merits greater consideration than given by the Tax Court.<sup>109</sup> Merely to state that the corporation may exercise its incidents of ownership to defeat the widow begs the question. The key consideration should be whether the corporation exercised its incidents of ownership in its own best interests as a corpo-

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104. I.R.C. § 2036, as amended in 1978, provides in pertinent part:

(a) *General Rule.*—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 the 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 has retained 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—

(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 the income therefrom.

(b) *Voting Rights.*—

(1) *In general.*—For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.

(2) *Controlled corporation.*—For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of section 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.

105. See generally Gaubatz, *The Nontaxation of Nontestamentary Acts: Will Byrum Survive the Tax Reform Act of 1976?*, 27 CASE W. RES. L. REV. 623, 626-27 (1976).

106. See generally Simmons, *supra* note 42; Walker, *supra* note 42.

107. 408 U.S. at 138 n.13. The Court recognized that deeming a 50% or greater shareholder to be in control of a corporation is both an overinclusive and underinclusive test. A stockholder with such voting power may "control" the corporation "in the sense that he may elect the board of directors, [b]ut . . . would not control . . . certain corporate transactions such as mergers and sales of assets." *Id.* Conversely, corporate variables such as "size of the corporation, the number of shareholders, and the concentration . . . of ownership" may effectively insure a stockholder with considerably less voting stock the right to elect the board of directors. *Id.*

108. *Id.*

109. See Estate of Levy v. Commissioner, 70 T.C. 873, 880 (1978); note 75 *supra* and accompanying text.

rate entity or solely in the best interests of the controlling shareholder. The *Levy* court, considering the stock controlled by decedent and the regulations, ignored the same economic and fiduciary restraints that the Supreme Court recognized in *Byrum*.<sup>110</sup> Every corporate action that benefits or might benefit the corporation should not be attributed entirely to the controlling shareholder, whose personal motives may differ entirely from corporate motives.<sup>111</sup>

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110. See notes 100-03, 107-08 *supra* and accompanying text.

111. It may be the minority interests who would demand, for example, that the corporation borrow against the policy to obtain a low rate of interest where the noncorporate beneficiary is a relative of the majority shareholder. Yet the majority shareholder cannot ignore the wishes of the minority because of his fiduciary duty to promote the corporate interest. When the controlling shareholder exercises his vote, the result is not necessarily a "fraud on the minority" or "oppression of the minority" or "unfair" to the minority. See generally H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 477 (2d ed. 1970) and authorities cited therein. Though admittedly the precise scope of the controlling shareholder's fiduciary duty is difficult to ascertain and still developing, the trend is toward an expanded duty—"a comprehensive rule of good faith and inherent fairness" that may be stringently applied in the case of a close corporation. See F. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS 508-19 (1975); *id.* at 98-100 (Supp. 1978). See also *United States v. Byrum*, 408 U.S. 125, 137 n.11 (1972).

The proper approach to finding an incident of ownership and the weight to be accorded fiduciary constraints on a decedent remain unsettled under another regulation of section 2042—Treas. Reg. § 20.2042-1(c)(4). The issue concerns the includability of insurance proceeds in the estate of a decedent insured who was a trustee over a trust containing the policies on his own life. In *Estate of Freuhauf v. Commissioner*, 427 F.2d 80 (6th Cir. 1970), the Sixth Circuit specifically rejected a holding that "mere possession by a decedent of any powers in the nature of incidents of ownership in a fiduciary capacity invariably requires inclusion of the proceeds of the policies on the decedent's life in his gross estate." *Id.* at 86. Although recognizing the inherent constraints imposed upon a decedent in a fiduciary capacity, the Sixth Circuit nevertheless found the proceeds includable on alternative grounds. The trust agreement specifically authorized the decedent trustee to surrender the policies on his life for the cash surrender value by transforming non-income producing assets into income producing assets; thus he could exercise his "incidents of ownership" to benefit himself as income beneficiary. *Id.* at 86.

The Second Circuit on facts similar to *Freuhauf* took the approach delineated by the *Lumpkin* court to determine whether a power possessed at death constitutes an incident of ownership, *i.e.*, to look to whether such a power would cause inclusion under sections 2036 or 2038. See notes 92-99 *supra* and accompanying text. On this basis the Second Circuit in *Estate of Skifter v. Commissioner*, 468 F.2d 699 (2d Cir. 1972), concluded that no inclusion results under section 2042 where the power was conveyed to the decedent long after he divested himself of all interest in the policies and he could exercise the powers only in a fiduciary capacity, not to benefit himself. *Id.* at 703-04. Critical to the court's holding was its belief that no inclusion would result under section 2038 for such a power because the power had not been retained by the decedent, *see* note 98 *supra*; thus, no inclusion should result under 2042. *Id. Accord*, *Estate of Hunter v. United States*, 624 F.2d 833 (8th Cir. 1980).

The Fifth Circuit in *Terriberry v. United States*, 517 F.2d 286 (5th Cir. 1975), and *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975), rejected the *Freuhauf-Skifter* analysis. Purporting to adhere to the rationale for its decision in *Lumpkin* that section 2042 "roughly parallels" other sections of the Estate Tax Code, the *Rose* court refused to find that section 2042 applies only to

Furthermore, a recent case illustrates that the different treatment accorded corporate and personal beneficiaries under section 20.2042-1(c)(6) is merely an arbitrary distinction. In *Estate of Smith v. Commissioner* the Commissioner asserted that the decedent died possessed of an incident of ownership in life insurance policies owned by and payable to his employer.<sup>112</sup> The employment agreement provided that if the company elected to stop paying premiums or to surrender or terminate the policies, the decedent could take an assignment of the policies for their cash value.<sup>113</sup> The decedent, arguably, could thus prevent a change of beneficiaries.<sup>114</sup> The Commissioner, basing the argument on an extension of a factually similar Revenue Ruling,<sup>115</sup> maintained that the identity of the beneficiary should not be a distinguishing factor in *Smith* and that inclusion of the proceeds should result.<sup>116</sup> The court agreed with the Commissioner that identity of the beneficiary is *not* a critical factor for inclusion.<sup>117</sup> The court, however, pointed out that the Commissioner, in other instances, does distinguish situations on this basis, specifically referring to the disparity of treatment under section

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*retained* incidents of ownership. 511 F.2d at 263-65. According to the *Rose* court, Congress intended to tax under section 2042 whatever is possessed at death. Thus, economic benefit is irrelevant so long as the decedent could exercise "substantial control" under the *Lumpkin* approach. *Id.* at 263. *Terribery* is consistent with the *Rose* decision. See 517 F.2d at 289-90. *Accord*, Rev. Rul. 76-261, 1976-2 C.B. 276.

Commentators appear equally split on the issue, thus underscoring the need for Congress to reexamine the regulations under section 2042 and clarify the scope of incidents of ownership. See, e.g., Baker, *When Will Insurance be Included in the Trustee-Insured's Gross Estate?* 47 J. TAX. 198 (1977) (Estate Tax Code generally focuses on beneficial rather than legal interests); Note, *Federal Estate Tax: Application of the Section 2042 Incidents of Ownership Concept to the Insured Fiduciary's Estate*, 60 IOWA L. REV. 1319 (1975) (bifurcated definition of incidents of ownership proposed based on assumption that treatment of insurance should exactly parallel that of other property); Note, *Estate Taxation of Life Insurance Under § 2042: Recent Decisions Defining Incidents of Ownership*, 33 WASH. & LEE L. REV. 776 (1976) (managerial powers of trustee alone should not be taxed as incidents of ownership because Congress did not intend parallelism between section 2042 and other sections); Note, *A Decedent's Powers as Trustee of a Life Insurance Trust—Taxable "Incidents of Ownership"?*, 1977 WASH. U.L.Q. 95 (capacity in which powers are exercisable should be considered although section 2042 should not be paralleled to other sections). See generally 32 MD. L. REV. 305 (1972); 52 N.C.L. REV. 671 (1974).

112. 73 T.C. 307, 308-09 (1979).

113. *Id.* at 308.

114. *Id.* at 308-09.

115. See Rev. Rul. 79-46, 1979-1 C.B. 303. The critical difference is that in the ruling a decedent's spouse, rather than his employer, was the designated beneficiary of the policies. See also note 86 *supra* and accompanying text.

116. 73 T.C. at 309-10.

117. *Id.* at 310.

20.2042-1(c)(6) between corporate and personal beneficiaries.<sup>118</sup> The Commissioner's inconsistency certainly weakens the position taken in the regulation.

Another aspect of the regulations that merits consideration is the method of evaluation utilized when proceeds are payable to both the corporation and a personal beneficiary, specifically the 60/40 example given in the regulations.<sup>119</sup> It is conceivable that the method of valuation could, through a "ripple effect," result in double taxation. A corporation that borrows against the full cash surrender value of a policy, invests the money wisely enough to repay the loan, and reinvests the profits, will cause the stock value to increase in a proportionately greater amount than the percentage of the proceeds payable to it.<sup>120</sup> The same principle applies when others are induced to invest in the corporation because of their confidence in the monetary stability of a corporation that owns a substantial key-man policy on the life of its most valuable employee, director, or shareholder. The value of the stock may be increased proportionately greater than the value of the proceeds, though only indirectly.

#### IV. CONCLUSION

An examination of the legislative history of section 2042 demonstrates a lack of support for the broad rule mandated by section

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118. *Id.* The court held the right to take an assignment of the policies in this case too contingent to constitute an incident of ownership for purposes of section 2042. The decedent controlled no power over the policies or over the companies decisions. *Id.* at 312.

119. See note 14 *supra*.

120. Consider the following illustration:

The corporation borrows 100X, invests the money and receives a return of 200X; the loan is then repaid. A corporation with stock previously valued at 100X, and in which proceeds from the policy are payable 60/40, will be valued at decedent's death as being worth 200X stock plus an additional amount due to the consideration of 60% of the proceeds as specified in the regulation. The decedent's estate is *fully* taxed upon the 40% of the proceeds payable to a personal beneficiary plus the *value* of his proportionate share of stock. For a stockholder with considerably less than a 100% interest in the corporation, *i.e.*, a 55% controlling stockholder, there may be a greater amount being taxed to his estate than 100% of the proceeds from the policy because of the increase in value of the corporate stock resulting from borrowing against the policy plus the 40% taxed under section 2042.

The decedent's estate may have great difficulty in proving the exact increase in value of the corporate stock due to borrowing against the insurance policy, but if the conceptualization is accurate it should not be denied merely because an insurmountable burden of proof is placed upon a taxpayer.



20.2042-1(c)(6).<sup>121</sup> A tax court decision upheld the validity of the regulation,<sup>122</sup> but the Circuit Courts of Appeal disagree both as to the proper approach to identify what constitutes an "incident of ownership" within section 2042 and as to the scope of the statute itself.<sup>123</sup> The Supreme Court's distinction between de facto powers and legally enforceable rights in *United States v. Byrum*<sup>124</sup> emphasizes the need to scrutinize attribution to controlling shareholders of corporate incidents of ownership in insurance policies. Furthermore, the disparity of treatment under the regulation based on the identity of the beneficiary lacks consistent enforcement by the Commissioner in other instances.<sup>125</sup> In sum, inadequate support exists to perfunctorily assume that the regulation appropriately treats the broad range of shareholders affected.

In light of meager congressional support,<sup>126</sup> conflicting interpretations of legislative history,<sup>127</sup> the Commissioner's own position on the relevance of identity of the beneficiary,<sup>128</sup> and the potential impact of the regulations themselves,<sup>129</sup> the current treatment of corporate owned life insurance policies is far from satisfactory. If such a broad rule is to be applied, Congress should enact appropriate legislation.

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121. See notes 16-29 *supra* and accompanying text.

122. See *Estate of Levy v. Commissioner*, 70 T.C. 873 (1978); notes 64-69 *supra* and accompanying text.

123. See notes 30, 91-98 *supra* and accompanying text.

124. 408 U.S. 125, 139 n.14 (1972). See notes 100-03, 107-08 *supra* and accompanying text.

125. *Estate of Smith v. Commissioner*, 73 T.C. 307 (1979). See notes 112-18 *supra* and accompanying text.

126. See notes 27-29 *supra* and accompanying text.

127. See notes 30, 111 *supra*.

128. See notes 114-15 *supra* and accompanying text.

129. See notes 100-03, 111 *supra* and accompanying text.