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TAXATION-FEDERAL ESTATE TAX-TRANSFERS OF LIFE INSURANCE IN CONTEMPLATION OF DEATH

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TAXATION—FEDERAL ESTATE TAX—TRANSFERS OF LIFE INSURANCE IN CONTEMPLATION OF DEATH—Insurance policies on the life of a decedent are ordinarily included in his gross estate according to the

provisions of section 811(g) of the Internal Revenue Code.[1] Where the policy is payable to a beneficiary other than the executor, it is taxable under section 811(g)(2): (1) if the decedent paid premiums on the policy, in proportion to the amount of premiums paid by him in relation to the total premiums paid, or (2) if the decedent possessed at his death any of the incidents of ownership. However, these provisions are not exclusive; even though section 811(g) is inapplicable, insurance policies transferred by the decedent during his lifetime may still be subject to estate tax if the transfer falls within section 811(c),[2] as a transfer "in contemplation of death" or "intended to take effect in possession or enjoyment at or after death."[3] At present, the interpretations of the "possession or enjoyment" clause would indicate that where the transfer is irrevocable, the transfer of insurance would not be taxable as intended to take effect in possession or enjoyment at or after death.[4] Although it is not easy in all cases to distinguish the two clauses, our principal concern is with the contemplation of death provision.

Since 1916,[5] the Federal estate tax has provided for the taxation of transfers made in contemplation of death. The purpose of this provision, [and 811(c) generally] was to reach substitutes for testamentary dispositions and thus prevent evasion of the estate tax. Since the enactment of the gift tax has done much to prevent such avoidance, and because of the government's somewhat unfavorable record of litigation, some writers have suggested that the contemplation of death provision should be eliminated except for transfers within a short time before death which would be presumed to be in contemplation of death.[6]

[1] "The value of the gross estate of the decedent shall be determined by including . . . all property . . .

(g)(2) to the extent of the amount receivable by all other beneficiaries as insurance under policies upon the life of the decedent (A) purchased with premiums . . . paid directly or indirectly by the decedent, in proportion that the amount so paid by the decedent bears to the total premiums paid for the insurance, or (B) with respect to which the decedent possessed at his death any of the incidents of ownership. . . ." 26 U.S.C. (1946) §811(g)(2).

[2] "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. . .

(c) to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death. . . ." 26 U.S.C. (1946) §811(c).

[3] Cf. Treas. Reg. 105, §81.25; Cohn, "Gifts of Life Insurance in Contemplation of Death," 26 TAXES 156 (1948).

[4] Flick's Est. v. Comm., (C.C.A. 5th, 1948) 166 F. (2d) 733. But cf. Thomas v. Graham, (C.C.A. 5th, 1946) 158 F. (2d) 561.

[5] 39 Stat. L. 777.

[6] Pavenstedt, "Taxation of Transfers in Contemplation of Death: A Proposal for Abolition," 54 YALE L. J. 70 (1944); I PAUL, FEDERAL ESTATE AND GIFT TAXATION (1942) §6.26; id., 1946 Supp.; cf. H. REP. 2087 on Revenue Revision Act of 1948, 80th Cong., 2d sess., p. 6 (May 28, 1948).

However, the tendency of recent decisions of the Federal courts would seem to indicate a broadening of the scope of 811(c), rather than a restriction of its application, with respect to the application of the contemplation of death provision to life insurance transfers.

A. Types of Transfers

Three common types of transfers have been involved in the cases. First is the outright assignment of the policies to the donee, with the donor retaining no incidents of ownership. If the donor pays all the premiums on the policies until his death, and the transfer occurs after January 10, 1941, under sec. 811(g) the entire proceeds would be taxable to the donor's estate, and there is no need to apply 811(c). But if the transfer occurred prior to January 10, 1941, the Treasury regulation[7] provides that the proceeds are included only in the proportion that the premiums paid after that date bear to the total premiums paid. If transferred in contemplation of death, however, the policies are treated the same as if the transfer had not been made and the donor had continued to own them until his death,[8] and the full value of the policies at death is taxable.

If the donor pays only the premiums prior to the transfer, and the donee makes the payments thereafter (either from his own funds or from loans or dividends on the policies), and the transfer occurs after January 10, 1941, section 811(g) taxes only the proportion of the proceeds purchased with premiums paid by the donor, excluding the proportion purchased by the donee's premium payments. This result should not be changed, even if the transfer were in contemplation of death, since that portion of the proceeds purchased by the donee's payments was not transferred by the donor.[9] But if the transfer was before January 10, 1941, none of the proceeds would be taxable under 811(g), while a transfer susceptible to attack under 811(c) would still be taxed in proportion to the premiums paid by the donor.

If the donor has made no premium payments at any time, but all

[7] Treas. Reg. 105, §81.27, ". . . in determining the proportion of the premiums . . . paid directly or indirectly by the decedent (but not the total premiums paid) the amount so paid by the decedent on or before January 10, 1941, shall be excluded if at no time after such date the decedent possessed an incident of ownership in the policy."

[8] Iglehart v. Comm., (C.C.A. 5th, 1935) 77 F. (2d) 704. Cf. Heiner v. Donnan, 285 U.S. 312 at 330, 52 S.Ct. 358 (1932).

[9] Liebmann v. Hassett, (C.C.A. 1st, 1945) 148 F. (2d) 247. In Est. of Cronin, 7 T.C. 1403 at 1411 (fn. 3) (1946), the court pointed out that the issue was not raised and there was no proof of the proportion of premiums paid by the donee; therefore the face value of the policies was taxed.

payments have been made by another, none of the proceeds is taxable under 811(g). But if transferred in contemplation of death, the proportion of the proceeds purchased by premiums paid before the transfer would be taxable, since that portion of the policy was transferred by the donor.[10]

In the second common type of transfer, the unfunded insurance trust, the policies are transferred to trustees in trust for specified beneficiaries. Since the premiums may be paid by either the settlor or others, the considerations as to taxability are essentially the same as in the outright assignment. In addition, however, it has been quite common to provide that the trustees may (or must) use the proceeds of the policy to purchase assets of the estate or make loans to it, in order to provide a source of ready cash and avoid costly forced sales of other assets of the estate. As will be seen, such provisions may increase the likelihood that the transfer to the trust will be taxable as in contemplation of death.

The third type of insurance transfer is the funded insurance trust, in which securities or other income-producing properties are transferred to the trust, in addition to the policies of insurance, with a provision that the income is to be used to pay premiums on the policies. Under the present provisions of 811(g), premium payments are regarded as having been made by the insured whether made directly or indirectly, and the insurance premiums paid by the funded trust are therefore regarded as paid by the donor. Where the transfer to the trust occurred before January 10, 1941, application of 811(c) will result in greater taxability than 811(g), as in the case of the unfunded trust or outright assignment.[11] In addition, the Tax Court in the *Garrett* case[12] held that where the transfer was in contemplation of death, not only are the insurance proceeds taxable, but the proportion of the securities, the income from which was used to pay the premiums, is also taxable as transferred in contemplation of death. Although there was a vigorous dissent in the *Garrett* case, to date there seems to be no indication of a

[10] Cf. H. REP. 2333, 77th Cong., 2d sess., p. 163 (1942); S. REP. 1631, 77th Cong., 2d sess., p. 236 (1942).

[11] It has been argued that the portion of insurance purchased by premiums paid by the trust after creation and before January 10, 1941, should be excluded even under 811(c), on the theory that such payments were not transferred by the donor, but are additions to the property made by the donee-beneficiary within Treas. Reg. 105, §81.15. Guterman, "Transfers of Life Insurance and the Federal Estate Tax," 48 COL. L. REV. 37, 51 (1948). Even so, the portion purchased by premiums paid before the transfer would be taxable under 811(c), although tax-free under 811(g).

[12] Est. of Paul Garrett, 8 T.C. 492 (1947).

change in the viewpoint of the Tax Court.[13] Since the courts apparently consider the funded insurance trust places additional emphasis on the inherent testamentary character of the insurance involved, the tax advantages of the funded trust would seem largely to have disappeared.

B. *Transfers in Contemplation of Death*

The classic interpretation of the contemplation of death provision is found in *United States v. Wells*,[14] where Chief Justice Hughes said:

> "The dominant purpose is to reach substitutes for testamentary dispositions and thus to prevent the evasion of the estate tax. . . . As the transfer may otherwise have all the indicia of a valid gift inter vivos, the differentiating factor must be found in the transferor's motive. Death must be 'contemplated', that is, the motive which induces the transfer must be of the sort which leads to testamentary disposition."[15]

It is generally agreed that the dominant motive or impelling cause of the transfer must be testamentary in order for the transfer to be in contemplation of death.[16] Whether or not the transfer was made in contemplation of death is primarily a fact question, and the conclusion of the court may depend on any one or a combination of several factors. In addition to the ordinary elements considered in any contemplation of death case, such as the age and physical condition of the donor and the nearness of the transfer to the date of death, there are a number of factors which seem to have been sufficiently important in deciding the cases involving insurance transfers to warrant individual consideration.

1. *The Testamentary Nature of Insurance*

The "inherent testamentary nature" of insurance was used by the courts as a justification for a Congressional classification of insurance transfers as subject to the estate tax under section 811(g) of the Internal

[13] Cf. Thomas v. Graham, (C.C.A. 5th, 1946) 158 F. (2d) 561, in which the entire corpus of a funded insurance trust was taxed, where the income was not sufficient to pay all the premiums, and the settlor made up the deficiencies. But the same court, in Flick's Est. v. Comm., (C.C.A. 5th, 1948) 166 F. (2d) 733, indicated that the previous holding was based on the implied retention of a reversionary interest rather than a finding that the transfer was made in contemplation of death.

[14] 283 U.S. 102, 51 S.Ct. 446 (1931).

[15] Id. at 116.

[16] Id. at 118; Farmers Loan and Trust Co. v. Bowers, (C.C.A. 2d, 1938) 98 F. (2d) 794, cert. den., 306 U.S. 648, 59 S.Ct. 589 (1939); Cf. Bell v. United States, (D.C. Minn. 1947) 74 F. Supp. 295.

Revenue Code.[17] The commissioner then used this argument as a justification for the application of the contemplation of death provisions to transfers of life insurance.[18] While it is true that death does make the face value of the policy payable to the beneficiary, so that the policy is by nature testamentary, it seems now to be recognized that while the subject matter of the transfer may be testamentary, this does not mean that the transfer itself is necessarily testamentary.[19]

Certainly there is some difference between an irrevocable inter vivos transfer of insurance and a testamentary transfer which is always ambulatory during the life of the testator. In the *Flick* case, the court said:

> "Even though it be true, as the Tax Court reasoned, that all life insurance reaches its greatest value at the death of the insured, nevertheless Congress has not undertaken to convert a valid, absolute, complete gift inter vivos into a gift causa mortis or a substitute for a testamentary disposition merely because the gift will have a greater value after the death of the donor."[20]

But while it may thus be denied that the nature of the subject matter should determine the motives of the transferor, it is apparent that the court will not altogether ignore the "inherent testamentary character" of insurance.

2. *Desire to Avoid Estate Tax*

In several cases not involving transfers of insurance, the desire to save estate tax was recognized as one of the factors to be considered. The motive to avoid estate tax was not considered sufficient alone to make the gift one in contemplation of death,[21] but when such a motive was combined with others of a testamentary nature the transfer was held taxable.[22] Where insurance policies were transferred to decedent's wife, who created a trust, the fact that the only apparent purpose was to save estate tax

[17] Bailey v. United States, (Ct. Cl. 1939) 27 F. Supp. 617 at 621; Colonial Trust Co. v. Kraemer, (D.C. Conn. 1945) 63 F Supp. 866. Both justified the test of premium payments by the decedent as sufficient to justify taxation.

[18] Vanderlip v. Comm., (C.C.A. 2d, 1946) 155 F. (2d) 152, cert. den., 329 U.S. 728, 67 S.Ct. 83 (1946).

[19] Est. of Ruthrauff, 9 T.C. 418 (1947); Cronin's Est. v. Comm., (C.C.A. 6th, 1947) 164 F. (2d) 561, reversing 7 T. C. 1403 (1946); Flick's Est. v. Comm., (C.C.A. 5th, 1948) 166 F. (2d) 733.

[20] Flick's Est. v. Comm., (C.C.A. 5th, 1948) 166 F. (2d) 733 at 740.

[21] Denniston v. Comm., (C.C.A. 3d, 1939) 106 F. (2d) 925.

[22] Farmers Loan and Trust Co. v. Bowers, (C.C.A. 2d, 1938) 98 F. (2d) 794, cert. den., 306 U.S. 648, 59 S.Ct. 589 (1939); Commonwealth Trust Co. of Pittsburgh v. Driscoll, (D.C. Pa. 1943) 50 F. Supp. 949, affd. per curiam, (C.C.A. 3d, 1943) 137 F. (2d) 653, cert. den., 321 U.S. 764, 64 S.Ct. 521 (1944).

was considered nearly, if not quite, conclusive that it was a substitute for a testamentary disposition.[23] And in the *Vanderlip* case,[24] where the parties stipulated that the sole motive for the transfer was to avoid estate tax, the Second Circuit Court of Appeals emphasized that a gift differs from a bequest only insofar as it secures present enjoyment to the donee, and since a donor interested in saving taxes is not concerned with the donee's present enjoyment, the desire to avoid estate taxes is necessarily testamentary and not donative. Since the desire to save estate tax is almost always one of the motives for an inter vivos transfer of life insurance, such a view would seem to leave little possibility of making a transfer of life insurance which would not be held taxable under 811(c). In non-insurance cases, the force of a motive to avoid estate taxes was limited by the Supreme Court, where it was not the dominant motive, but only incidental to the decedent's original purpose to provide for his children.[25] It was emphasized that the controlling or impelling motive must be testamentary, and a modification of the original plan to avoid taxes in order to retain the original character of a tax-free transaction was not such a controlling motive. The Second Circuit Court of Appeals has indicated that the desire to avoid estate tax may not be absolutely conclusive, if the decedent has parted with all control over the policies.[26] But at present it seems that in the absence of present enjoyment by the donee, or controlling life motives, the desire to avoid estate tax is a particularly potent factor in holding that a life insurance transfer was in contemplation of death.

3. *The Insurance Transfer as Part of an Over-all Testamentary Plan*

Since the purpose of the contemplation of death provisions is to reach substitutes for testamentary dispositions, any indication that the insurance transfer is part of an over-all testamentary plan is naturally an important factor in reaching the conclusion that it was a transfer in contemplation of death. It has been a common practice to establish a trust of the proceeds of insurance policies with a provision that the trustees

[23] First Trust and Deposit Co. v. Shaughnessy, (C.C.A. 2d, 1943) 134 F. (2d) 940.

[24] Vanderlip v. Comm., (C.C.A. 2d, 1946) 155 F. (2d) 152, cert. den., 329 U.S. 728, 67 S.Ct. 83 (1946); cf. Slifka v. Johnson, (C.C.A. 2d, 1947) 161 F. (2d) 467.

[25] Allen v. Trust Co. of Ga., 326 U.S. 630, 66 S.Ct. 389 (1946); cf. the statement in Est. of O'Neal, P. H. TAX CT. MEMO. DEC., ¶ 47,167 at p. 47-596, (1947), that: "No prudent man would make a substantial transfer of his property without some consideration of the tax consequences. . . ."

[26] Slifka v. Johnson, (C.C.A. 2d, 1947) 161 F. (2d) 467, 469. Cf. Treas. Reg. 105, §81.16, which indicates that a transfer to avoid estate tax is in contemplation of death.

could use the proceeds to purchase assets of the estate of the insured or make loans to it, in order to provide a source of ready cash with which to pay estate taxes or meet other obligations without depleting the estate through forced sales. Such provisions have been regarded by the courts as indications of the decedent's testamentary motive in establishing the trust.[27] The execution of a will at the same time as the insurance transfer, or the existence of a will favoring the same beneficiaries as the insurance, have also been regarded as indicative of a testamentary motive.[28] While the former may provide some evidence of the decedent's motive, the latter would seem to mean little in most cases. That the decedent has chosen the same natural objects of his bounty as recipients of both inter vivos and testamentary gifts appears to indicate nothing as to the character of the gifts themselves. At least one decision has indicated that where life motives are present, neither the existence of a will favoring the same beneficiaries nor provisions for purchasing assets of the estate will be sufficient to make the transfer taxable under 811(c).[29]

4. *The Presence of Life Motives*

If it can be shown that the donor was motivated by concerns connected with life rather than death, it seems quite unlikely that the transfer will be considered to have been made in contemplation of death. Thus where the transfer was made pursuant to a divorce decree, to satisfy the donor's obligations to his divorced wife, the transfer was not subject to estate tax.[30] Where the donor's father had lost his fortune and the donor wished to guard against a repetition of such a family misfortune, the transfer to accomplish that purpose was not taxable.[31] If the desire to provide for one's family in case of business reverses during life, or to provide a stable income for a dependent unable to earn a living, can be shown, then it seems that the transfer will probably not be considered in contemplation of death.[32] The presence of such life motives is ordinarily a question of fact and will be determined by the trial

[27] Sloan's Est. v. Comm., (C.C.A. 2d, 1948) 168 F. (2d) 470; Est. of Satuloff, P. H. TAX CT. MEMO. DEC., ¶ 47,312 (1947); Est. of Rhodes, P. H. TAX CT. MEMO. DEC., ¶ 47,037 (1947); Davidson's Est. v. Comm., (C.C.A. 10th, 1946) 158 F. (2d) 239.

[28] Diamond's Est. v. Comm., (C.C.A. 2d, 1947) 159 F. (2d) 672; cf. the Satuloff, Rhodes, and Davidson cases, supra, note 27.

[29] Flick's Est. v. Comm., (C.C.A. 5th, 1948) 166 F. (2d) 733.

[30] Est. of George Hurd, 9 T.C. 681 (1947).

[31] Est. of Ruthrauff, 9 T.C. 418 (1947).

[32] Cronin's Est. v. Comm., (C.C.A. 6th, 1947) 164 F. (2d) 561, reversing 7 T.C. 1403 (1946); Flick's Est. v. Comm., (C.C.A. 5th, 1948) 166 F. (2d) 733; cf. Allen v. Trust Co. of Ga., 326 U.S 630, 66 S.Ct. 389 (1946).

court. The mere allegation of a desire to avoid creditors will be scrutinized by the courts and will probably not be sufficient to establish a life motive, however.[33] If the finding of the trial court is sustained by substantial evidence, it will be upheld by the appellate court.[34] But the inferences drawn by the trial court must be "reasonable" in order to be upheld, and the appellate court may evaluate the facts decided so as to reach a different result.[35]

5. *Present Enjoyment by the Donee*

The presence or absence of present enjoyment by the donee has been a particularly important factor in the decisions involving transfers of life insurance. Thus in the *Vanderlip* case, where the parties stipulated that the sole motive for a transfer of policies was a motive to avoid estate tax, the Second Circuit Court of Appeals emphasized the absence of present enjoyment by the donee in holding that the transfer was in contemplation of death.[36] The absence of payment of income to the donee tends to emphasize the testamentary aspects of the transfer, and usually this has meant that the transfer was taxable.[37] In the case of insurance its "inherent testamentary nature" means that the primary benefits will always accrue at death. Although absolute control may be passed to the donee at the time of transfer, there are seldom obvious present benefits to accompany the transfer.[38] Thus where policies were transferred to the donor's wife, and she created a trust, retaining the right to revoke it and to exercise the privileges of the owner of the policy, the court said it was not intended that the privileges would be exercised, and since the only apparent purpose was to avoid estate tax, the transfer was a substitute

[33] Diamond's Est. v. Comm., (C.C.A. 2d, 1947) 159 F. (2d) 672; Est. of Satuloff, P. H. TAX CT. MEMO. DEC., ¶ 47,312 (1947).

[34] Under the rule laid down in Dobson v. Comm., 320 U.S. 489, 64 S.Ct. 239 (1943), no appellate court could reverse the Tax Court except for a clear-cut error of law. But by P.L. 773, 80th Cong., 2d sess. (June 25, 1948), the appellate courts are given the same power over Tax Court decisions that they have over decisions of the district court in cases tried without juries.

[35] Cf. Cronin's Est. v. Comm., (C.C.A. 6th, 1947) 164 F. (2d) 561, reversing 7 T.C. 1403 (1946); Flick's Est. v. Comm., (C.C.A. 5th, 1948) 166 F. (2d) 733.

[36] Vanderlip v. Comm., (C.C.A. 2d, 1946) 155 F. (2d) 152. Cf. Sloan's Est. v. Comm., (C.C.A. 2d, 1948) 168 F. (2d) 470.

[37] Est. of Rhodes, P. H. TAX CT. MEMO. DEC. ¶ 47,037 (1947) (spendthrift provisions); Est. of Paul Garrett, 8 T.C. 492 (1947); Thomas v. Graham, (C.C.A. 5th, 1946) 158 F. (2d) 561 (but cf. note 13, supra).

[38] Present benefits to the beneficiary or assignee of an insurance policy would seem to be limited to utilization of the loan and surrender values, receipt of dividends, or receipt of disability benefits if the policy so provides. The addition of disability benefits to a policy shortly before transfer might in some cases be of assistance in establishing life motives as well as present enjoyment by the donee.

for a testamentary disposition.[39] But in the *Flick* case,[40] where the trustees could cash in the policies and collect dividends, the court emphasized these facts as showing the decedent was not thinking of results to be achieved after death, and the fact that the rights to present enjoyment were not exercised was not regarded as important. In the *Cronin* case[41] the Tax Court had relied in part on the lack of intent that the donee should use the present rights of the owner of the policies transferred. But the Sixth Circuit Court of Appeals, in overruling the Tax Court's holding that the transfer was in contemplation of death, stressed that premiums on the policies had been paid in part from the proceeds of loans on the policies, and said,

> "... we think it may not, in truth, be said that financial security residing in complete control of loan and surrender value is not present enjoyment of the subject matter of a gift, even though its actual utilization may prove to be unnecessary."[42]

Certainly it seems that if control of loan and surrender values is not to be recognized as present enjoyment by the donee, it would be almost impossible to make an inter vivos transfer which would not be taxable under 811(c). The reasoning of the circuit court of appeals in the *Cronin* case seems sound in recognizing that control of the policy by the donee does result in something different from a testamentary disposition.

C. *Conclusion*

The purpose of the contemplation of death provision is to reach substitutes for testamentary dispositions and thus prevent evasion of the estate tax. According to the classic interpretation, whether or not the transfer is a substitute for a testamentary disposition depends on the motive of the donor. The position of the Treasury Department,[43] as exemplified in the attacks on life insurance transfers under 811(c), seems to be that the transfer is made in contemplation of death not only if made with the intent that it shall serve as a substitute for a testamentary disposition, but also if the transfer has the effect of serving as a substitute for a testamentary disposition. Such an objective test, when applied to life insurance which reaches its greatest value at death, makes a tax-free inter vivos transfer of insurance almost impossible. This posi-

[39] First Trust and Deposit Co. v. Shaughnessy, (C.C.A. 2d, 1943) 134 F. (2d) 940.
[40] Flick's Est. v. Comm., (C.C.A. 5th, 1948) 166 F. (2d) 733.
[41] 7 T.C. 1403 (1946).
[42] Cronin's Est. v. Comm., (C.C.A. 6th, 1947) 164 F. (2d) 561 at 566.
[43] Cf. Treas. Reg. 105, §81.16.

tion seems to be a distortion of the *Wells* case. The provision of 811(g) exempting the proportionate share of the proceeds purchased by premiums paid before January 10, 1941, where an absolute transfer was made before that time, seems to indicate a Congressional recognition that all transfers of insurance are not necessarily made in contemplation of death. The enactment of the gift tax has eliminated at least some of the necessity for a broad use of the contemplation of death provisions. But at the present time, the broad application of the contemplation of death provision to insurance transfers means that life insurance has not only lost its favored position in the decedent's estate,[44] but seems to occupy a less favorable position than other property.[45]

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[44] E.g., the $40,000 exemption allowed for insurance proceeds under 811(g) prior to the 1942 act.

[45] Cf. the dissent in the Garrett case, 8 T.C. 492 at 508 (1947). It may be that the life insurance cases are only an indication of a general broadening of the scope of the contemplation of death provision of 811(c) in relation to all types of property. On the other hand, the 80th Congress considered (but adjourned without passing) a proposal to eliminate the application of the contemplation of death provision except to transfers within three years of death, which would be presumed to be made in contemplation of death. Revenue Revision Bill of 1948, H.R. 6712, 80th Cong., 2d sess., § 204(a); H. REP. No. 2087 on Revenue Revision Act of 1948, 80th Cong., 2d sess., p. 6 (May 28, 1948).