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TAXATION — FEDERAL ESTATE TAXATION OF LIFE INSURANCE —
EFFECT OF TREASURY DECISION 5032¹ AMENDING ARTICLES 25 AND
27 OF THE ESTATE TAX REGULATIONS — First enacted in 1918, the
provision of the Internal Revenue Code providing for the estate taxa-
tion of life insurance proceeds has remained unchanged to date:

“The value of the gross estate of the decedent shall be de-
termined by including the value at the time of his death of all
property, real or personal, tangible or intangible, wherever sit-
uated, except real property situated outside of the United States...

“(g) To the extent of the amount receivable by the executor
as insurance under policies taken out by the decedent upon his own
life; and to the extent of the excess over $40,000 of the amount
receivable by all other beneficiaries as insurance under policies
taken out by the decedent upon his own life.”

The number of this section has been changed from time to time,²
but it will hereinafter be referred to as section 811(g). This language
is simple and unambiguous except for the one phrase—“taken out
by the decedent.” It is impossible to ascribe with certainty any one mean-
ing to this phrase. To the layman it would probably mean “applied for
and issued to.” But this would be too restricted a definition from the
standpoint of tax administration. From the tax authorities’ point of
view there are only two significant factors in regard to any insurance
policy—payment of premiums and control over the policy. The first is

¹ 1941:1 Cum. Bull. 427, approved January 10, 1941, now incorporated in
Treas. Reg. 105 (1942), §§ 81.25, 81.27. For a thorough analysis of problems arising
before the case of Bailey v. United States, (Ct. Cl. 1939) 27 F. Supp. 617, rehearing
(Ct. Cl. 1939) 30 F. Supp. 184, second rehearing (Ct. Cl. 1940) 31 F. Supp. 778,
see I Paul, Federal Estate and Gift Taxation, c. 10 (1942); Smith, “Federal
and the Federal Estate Tax,” 52 Harv. L. Rev. 1037 (1939); Fraenkel, “Federal
Taxation of Life Insurance Policies,” 5 Brook. L. Rev. 140 (1936); Oppenheimer,
724 (1930).

² 40 Stat. L. 1097, § 402 (f) (1919); 42 Stat. L. 278, § 402 (f) (1921); 43
Stat. L. 304, § 302 (g) (1924); 44 Stat. L. 70, § 302 (g) (1926); 53 Stat. L. 120
(1939), § 811 (g), 26 U. S. C. (1940), § 811 (g).
a simple, definite and easily proven fact, while the second is an intangible and shadowy question of degree.

The Commissioner of Internal Revenue from the first defined "taken out" as meaning "having paid the premiums," and until 1930 the Estate Tax Regulations stood steadfastly by premium payment as the sole criterion of taxability. Meanwhile, however, the federal courts had indicated that when the decedent, prior to death, assigned all incidents of ownership and control over the policy to another, he retained no property interest in the policy which could be deemed to pass on his death, and therefore, under the due process clause of the Fifth Amendment, no event taxable to the decedent existed as to the proceeds of such policy. It was not until an amendment of Article 25 on March 18, 1937, that the Estate Tax Regulations were revised to conform with the tenor of the courts' decisions by clearly indicating that policies would not be taxed unless some incident of ownership was retained by the decedent.

The commissioner, unsatisfied with such limitation, recently utilized one Bailey as a means for a test case to serve as the basis for a proposed amendment to the regulations. Disregarding the clear language of the regulations, the commissioner resisted Bailey's suit for refund of an estate tax paid on the proceeds of a policy the ownership of which had been assigned by the decedent prior to his death. The Court of Claims, in Bailey v. United States, without reference to the then applicable regulations, sustained taxability on the ground that the continued payment of premiums was a sufficient indication of ownership. The estate tax provisions of the taxing act specifically provided without exception for the inclusion in the gross estate of such insurance as in question. All prior Supreme Court decisions requiring a retention of legal incidents of ownership are distinguishable because they referred to policies taken out prior to the Revenue Act of 1918. As to policies taken out after said Revenue Act, assignment of legal incidents is immaterial because the insured was on notice when he took out policies that they would be taxable.

3 T. D. 4296, 912 CUM. BULL. 427 (1930).
4 Paul, "Life Insurance and the Federal Estate Tax," 52 HARV. L. REV. 1037 (1939). Lang v. Commissioner of Internal Revenue, 304 U. S. 264, 58 S. Ct. 880 (1938), might be cited to modify this statement. There decedent retained a power to change the beneficiaries but under the local law of community property had no right to do so. The court approved the then subsisting Treasury Regulations, which provided for taxability of insurance proceeds to the estate of the insured on the basis of premium payments and without regard to retention of incidents of ownership by the insured. However, the force of this opinion as authority for the proposition that incidents of ownership need not be retained in order to tax proceeds to the insured's estate is weakened by the fact that it did not affirmatively appear that other incidents of ownership were not held by decedent. Also, the question of the constitutionality of taxing in the absence of such retention was not even raised by counsel. The entire argument was directed to whether one-half only or the entire proceeds should be included in view of the community property doctrine.

6 (Ct. Cl. 1939) 27 F. Supp. 617. The opinion contained this analysis: The estate tax provisions of the taxing act specifically provided without exception for the inclusion in the gross estate of such insurance as in question. All prior Supreme Court decisions requiring a retention of legal incidents of ownership are distinguishable because they referred to policies taken out prior to the Revenue Act of 1918. As to policies taken out after said Revenue Act, assignment of legal incidents is immaterial because the insured was on notice when he took out policies that they would be taxable.
ment of premiums by decedent after the assignment, coupled with the
death of the decedent, were necessary events to the full culmination of
insurance benefits, and in the light of the inherently testamentary char-
acter of insurance were sufficient to provide taxability to decedent’s
estate.

This first Bailey decision was reversed on a rehearing when new
evidence revealed that the assignee paid all the premiums after assign-
ment, but the first decision was reaffirmed as to facts found therein.7

The commissioner interpreted the Bailey case as not merely elimi-
nating the retention of legal incidents in decedent as a prerequisite to
taxability, but also as providing that payment of premiums by decedent
at any time is ground for including the insurance proceeds in the gross
estate. This concept was the basis for the amendment to the regulations
embodied in Treasury Decision 5032.

Before entering into a detailed analysis thereof, two preliminary
questions should be discussed. First, was payment of premiums neces-
sary before the Bailey case to sustain taxability, or was retention of legal
incidents the sole test? In almost all of the reported cases either
premium payments were made by the insured decedent or the question
was not raised, but there was at least one decision by the Board of Tax
Appeals holding the proceeds taxable to the decedent where none of the
premiums were paid by her.8 The third decision of the Bailey case9
also indicates that premium payments were unnecessary to support
taxation. While the second decision held the policy exempt when it
was shown that the assignee paid all premiums after assignment, the
decision was reversed when it was further shown that decedent did
retain a legal incident.10

7 Bailey v. United States, (Ct. Cl. 1939) 30 F. Supp. 184. These two opinions
by the same court are seemingly reconcilable only on the theory that in so far as pay-
ment of premiums is the basis of taxing proceeds to decedent, he must continue to pay
the premiums until his death. That such was the theory adopted by the court is cor-
raborated by the following expression in the first opinion, 27 F. Supp. 617 at 622:
“We think Congress in section 302(g) and (h) of the Revenue Acts of 1924 and
1926 and subsequent acts has clearly expressed an intention to include the proceeds of
life-insurance policies thereafter taken out by the decedent upon his own life notwith-
standing an assignment by him of his right to receive the cash-surrender value or to
change the beneficiary, especially where he continues after such assignment to pay the
premiums upon the policies.” (Italics supplied.) Thus, although the court did not ex-
pressly say that such continued payment is essential to taxability, it indicated that this
is an important factor in sustaining taxability.

8 John Bromley, Exr., 16 B. T. A. 1322 (1929).


10 Under Helvering v. Hallock, 309 U. S. 106, 60 S. Ct. 444 (1940), it ap-
peared for the first time that such retention of a possibility of reverter was a sufficient
interest in decedent to make the proceeds subject to the estate tax. See Ray, “The Estate
Tax on Transfers Intended to Take Effect in Possession or Enjoyment at or after
Second, if a decision such as the Bailey case could be reached under the existing regulations, why did the commissioner think it necessary to amend the regulations? A complete answer would require an extended discussion of the interrelation of statutes, regulations, and court decisions, beyond the scope of this article. In short, however, the answer appears to lie mainly in the established policy of not applying new statutory interpretations retroactively to the prejudice of those relying on inconsistent regulations. It is clear that the regulations prior to T. D. 5032 were not consistent with the decision of the Bailey case. While there is apparently no doctrine of estoppel to prevent the commissioner from seeking in the courts a decision contrary to existing regulations, it would obviously be bad tax administration to retain such regulations unaltered when he is successful.

Article 25 of the Estate Tax Regulations as amended by T. D. 5032 now provides:

"... Insurance... is considered to have been taken out by the decedent where he paid, either directly or indirectly, all the premiums or other consideration wherewith the insurance was acquired, whether or not he made the application. Such insurance is not considered to have been so taken out, even though the application was made by the decedent, if no part of the premiums or other consideration was paid either directly or indirectly by him." 12

Previously the regulations defined policies as taken out by the decedent "if he acquired the ownership of, or any legal incident thereof in, the policy." 13 Does this change in language indicate that the commissioner has abandoned the ownership of legal incidents as a positive basis for the inclusion of insurance proceeds? Further provisions of the regulations substantiate an affirmative answer. Article 25 continues:

"... Where a portion of the premiums or other consideration was actually paid by another and the remaining portion by the decedent, either directly or indirectly, such insurance is considered to have been taken out by the latter in the proportion that the payments therefor made by him bear to the total amount paid for the insurance." 14

Article 27 provides for inclusion of proceeds over $40,000

"(1) To the extent to which such insurance was taken out by the decedent upon his own life (see article 25) after January 10, 1941, the date of Treasury Decision 5032, and

12 T. D. 5032, 1941:1 CUM. BULL. 427, TREAS. REG. 105 (1942), § 81.25.
13 TREAS. REG. 80 (1937 ed.), art. 25.
14 T. D. 5032, 1941:1 CUM. BULL. 427, TREAS. REG. 105 (1942), § 81.25.
“(2) To the extent to which such insurance was taken out by the decedent upon his own life (see article 25) on or before January 10, 1941, and with respect to which the decedent possessed any of the legal incidents of ownership at any time after such date or, in the case of a decedent dying on or before such date, at the time of his death.”\(^\text{15}\)

The implication of these provisions is that the commissioner now considers retention of legal incidents of ownership to be relevant only in determining whether or not premiums paid by decedent before January 10, 1941, are to be taken into account in fixing the proportion of the proceeds attributable to payments by decedent.

For two reasons it is surprising that the commissioner should abandon ownership of the policy as a positive basis for inclusion, rather than preserving it as an alternative to the payment of premium basis. First, such action opens up a new loophole for tax avoidance. For instance, if a wife applied for a policy on her own life, retaining incidents of ownership in herself, the proceeds would not be taxable either to her estate or to that of her husband if he paid all the premiums. It would not be taxable to the husband’s estate since he did not “take out” the policy on his own life. It would not be taxable to the wife’s estate since, under T. D. 5032, she did not “take out” the policy at all. If the retention of legal incidents of ownership had been retained as a basis for tax, clearly the proceeds would be taxable to the wife’s estate. Second, in the case where the insured decedent possessed legal incidents at his death but another has paid part of the premiums, part of the proceeds are not included in decedent’s estate under the present formula of the regulations whereas they could all be taxed on the basis of ownership in the decedent.

There would be no inconsistency in the maintenance of such a dual basis of taxability. The Court of Claims suggested such action in the Bailey case when on the third hearing\(^\text{16}\) it decided that a possibility of reverter in the insured decedent was grounds for taxation, although failure of insured to continue premium payments after assigning the policy was held on the second hearing\(^\text{17}\) to exclude taxability under the payment of premiums theory.

In addition, a sled-length adoption of the payment of premiums theory as the sole test of taxability constitutes a fundamental departure from the basic theory of estate taxation. In determining whether other property is includable in decedent’s gross estate, one does not ask, “Did he pay for it?” for this is regarded as irrelevant. Rather it is asked, “Did he

\(^{15}\text{Id., § 81.27.}\)

\(^{16}\text{(Cr. Cl. 1940) 31 F. Supp. 778.}\)

\(^{17}\text{(Cr. Cl. 1939) 30 F. Supp. 184.}\)
own it when he died?" While the payment of premiums theory is a convenient and possibly justifiable device for the prevention of tax avoidance, it seems that it should be confined to effectuating this purpose and not utilized so as to constitute a basic change in the approach to estate taxation.

The possible reluctance of the courts to give up ownership as a basis for taxability is indicated by a decision of the Board of Tax Appeals under the regulations in force prior to 1930. Such regulations, like the present ones, declared the payment of premiums to be the test for "taking out"; they provided "the insurance is not deemed to be taken out by the decedent, even though the application is made by him, where all the premiums are actually paid by the beneficiary." The board held that insurance applied for by the wife on her own life payable to her estate in which she retained incidents of ownership was taxable to her estate although her husband paid all the premiums. Expressly reserving its opinion as to the correctness of the regulations' interpretation of the statute, the board reconciled its decision with these regulations on the technical ground that in the case before it the premiums were not paid by the beneficiary.

The effect of the "January 10, 1941" clauses may best be summed up by the following fact situations: (1) where after January 10, 1941, decedent possessed no legal incidents but did pay premiums, only the proportion of the proceeds attributable to such premiums as are paid by decedent after January 10 are includable in his gross estate; (2) where decedent possessed legal incidents after January 10, premiums paid by decedent at any time are considered in determining the taxable portion of the insurance, regardless of whether decedent assigns the legal incidents before death; (3) where decedent died before January 10 possessing no legal incidents, no part of the proceeds is taxed; (4) where decedent died before January 10 possessing some legal incidents, the premiums paid by decedent determine the amount to be taxed. As

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19 Treas. Reg. 68 (1924 ed.), art. 25.
20 It will be noted that, in referring to the situation where decedent will not be deemed to have taken out the policy, the regulations as amended by T. D. 5032 do not use the phrase of Treas. Reg. 68 and 70 "where all the premiums are actually paid by the beneficiary" but state that insurance is not included in the estate "if no part of the premiums or other consideration was paid either directly or indirectly by" the decedent. If this change was a studied one, it might well have been intended to remove the above possibility of taxing proceeds where decedent has not paid premiums. On the other hand, although the present regulations provide, "Such insurance is not considered to have been so taken out, even though the application was made by the decedent," if he paid no part of the premiums, there is not added the words "and even though he possessed legal incidents of ownership therein." Such a qualification might very well have been inserted in view of the language of previous regulations.
previously noted, the reason for introducing this dividing line date, January 10, 1941, was to give effect to the well-established policy of not applying new interpretative regulations retroactively.\textsuperscript{21}

It remains to be considered whether the regulations as now amended, embodying the idea of taxability on the basis of payment of premiums, are constitutional. As a general rule when a man transfers property during his lifetime, it is clearly arbitrary under the Fifth Amendment to classify and tax such transfer as one at death.\textsuperscript{22} If he retains no strings or control, nothing is transferred from decedent at his death and no control expires in decedent so as to give others greater rights, which might constitute a taxable event. While it is true that the beneficiaries cannot realize full enjoyment of the proceeds until his death, this fact alone will not support taxability.\textsuperscript{23} Where decedent applies for insurance on his own life, pays premiums, and retains incidents of ownership for a substantial period of time and then, after January 10, 1941, assigns the policy with all incidents of ownership to his wife (without condition of survivorship), but continues to make all premium payments until his death, no taxable incident seems to be created by the death of decedent. No interest in the policy passes at his death. The additional factor of decedent’s continued payment of premiums after assignment is nothing more than a series of inter vivos gifts.\textsuperscript{24}

There are, however, certain arguments which can be made in favor of constitutionality.\textsuperscript{25} Life insurance is inherently testamentary in nature—a substitute for testamentary disposition. When a man transfers ownership in a policy during his life, he does not dispose of all the benefits of the policy. At most the transferee has rights to the cash surrender value of the policy. Before the face value of the policy can be enjoyed by anyone, the remaining premiums must be paid and the insured must die. Thus upon decedent’s death, two previously non-existent “rights” or benefits come into being—the cessation of obligation to make premium payments, and the right to the full enjoyment of the face value of the policy. This “springing up” of previously non-existent property rights, coupled with the termination of the obligation to pay premiums, constitute the constitutionally required taxable event. Such enlargement of the beneficiary’s rights without any shift of bene-

\textsuperscript{24} They are so treated by the commissioner under the gift tax. Treas. Reg. 79 (1936 ed.), art. 2 (6).
\textsuperscript{25} See 1 Paul, Federal Estate and Gift Taxation 523-527 (1942).
fits from the estate has been held taxable to the decedent's estate in cases of joint tenancies and tenancies by the entirety. 26

Under careful scrutiny these contentions supporting constitutionality lose much of their force. Life insurance is testamentary in the sense that full enjoyment is postponed until death, but to no greater extent than an absolute trust to accumulate income until the death of the settlor and then distribute to the beneficiary or an absolute gift in escrow with possession postponed until the death of the donor. In neither of these cases could the property so disposed of before death be constitutionally included in the settlor's or donor's estate for tax purposes. 27 It has been well settled that the mere fixing of decedent's death as the time for transfer of possession does not create a taxable event to decedent's estate. 28 The unique and mystical concept of "springing up" of previously nonexistent property seems, in the last analysis, to be nothing more than the performance at the stated time of an executory contract. Whatever new rights arise in the beneficiary at the time of decedent's death clearly do not pass from the decedent.

There are two very material distinctions between the case of a joint tenancy and the case at hand which deprive the analogy of any supporting force. First, in the case of joint tenancies, until death the decedent has a very real and material interest in the half owned by the survivor—that is, the possibility of acquiring the entire ownership of such half by the prior death of the co-tenant. Such interest is comparable to, and at least the equivalent in magnitude of, a possibility of reverter upon the condition subsequent of nonsurvivorship. Such an interest in the property of an assignee of an insurance policy is entirely lacking when the assignment is without condition of survivorship. Second, in the case of joint tenants, the decedent has not done everything possible to divest himself of all interest in the fractional ownership of the survivor. He might effect a partition of the land, or change the joint tenancy to a tenancy in common. Either of these courses would result in nontaxability of the survivor's interest to decedent's estate. 29 But where there is an assignment of an insurance policy, the decedent has done everything possible to divest himself of all interest and control in the policy.

Perhaps the strongest reason for taxability is that the continued pay-

27 I PAUL, FEDERAL ESTATE AND GIFT TAXATION, c. 7 (1942).
29 See I PAUL, FEDERAL ESTATE AND GIFT TAXATION, § 8.07 (1942); Estate of L. L. Fletcher, 44 B. T. A. 429 (1941).
ment of premiums by decedent after assignment of the policy negatizes any plausible reason for the transfer other than to avoid the estate tax. Since courts have had no trouble in sustaining the estate taxation of property transferred by inter vivos gift in contemplation of death to prevent tax avoidance, they might on like grounds sustain the estate tax as applied to the facts under consideration.

Where the insured decedent not only lacked incidents of ownership at his death, but also discontinued paying the premiums before his death, it is even more difficult to find a taxable incident. The only basis for including that portion of the policy corresponding to the amount of premiums the decedent paid is to prevent tax avoidance. But here there would seem to be reasons other than tax avoidance for the decedent to assign the policy and stop paying premiums. For instance, he may assign to the beneficiary for the purpose of relieving himself of the burden of keeping up the policy. On the tax avoidance question a logical and reasonable line might well be drawn between those cases where decedent pays premiums until his death (or ceases payment in contemplation of death) and those cases where he does not continue to make payments. Such distinction was laid down by the second decision of the Bailey case and may reasonably be expected to be drawn by the courts in passing on the validity of the present regulations.

Stated briefly, the effect of T. D. 5032 has thus been to revert to the original test of payment of premiums for determining when insurance has been “taken out” by the decedent, and to abandon ownership of the policy as a basis for including the proceeds in decedent’s estate, thereby departing from the fundamental theory of estate taxation. Thus the regulations, in closing one door to tax avoidance, apparently open another. While this avenue of escape may be narrowed by judicial interpretation, a change in the regulations probably will be required to seal it completely.

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81 Id.