Federal Estate Taxation of Community Property Life Insurance

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NOTES

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Under section 2042 of the Internal Revenue Code of 1954, proceeds of insurance policies on the life of the decedent payable to beneficiaries other than the decedent's executor are included in the gross estate only if the decedent possessed at the time of his death "any of the incidents of ownership [in the insurance policies], exercisable either alone or in conjunction with any other person."[1] To determine the extent of the decedent's "incidents of ownership," the Regulations provide for the application of state property law.[2] The problems inherent in relying upon state law to govern federal estate taxation of the proceeds of life insurance policies are compounded by the existence in several states of a community property system.[3] In these states, thought-provoking questions arise in two factual contexts.

When the insured husband predeceases his wife, the law is well settled that one half of the insurance proceeds is included in the husband's estate for federal estate tax purposes; the other half goes to the wife tax free.[4] This result is dictated by the nature of community property. Under California law, for example, property earned by either spouse during the marriage is regarded as community property in which each spouse has a "present, existing and equal" interest.[5]

1. INT. REV. CODE OF 1954, § 2042 states in part:

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. . . .

2. Treas. Reg. § 20.2042-1(c)(5) (1958) states: "As an additional step in determining whether or not a decedent possessed any incidents of ownership in a policy or any part of a policy, regard must be given to the effect of the State or other applicable law upon the terms of the policy. . . ." See Lang v. Commissioner, 304 U.S. 264 (1938); Blair v. Commissioner, 300 U.S. 5 (1937); Poe v. Seaborn, 282 U.S. 101 (1930).

3. Eight states have community property laws: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

4. Lang v. Commissioner, 304 U.S. 264 (1938); DeLappe v. Commissioner, 113 F.2d 48 (5th Cir. 1940); Treas. Reg. §§ 20.2042-1(b)(2), -1(c)(5) (1958); Cahn, *Selected Life Insurance Tax Problems*, TWELFTH ANN. TULANE TAX INST. 70, 82-84 (1963). The same rules apply to state inheritance taxes. *In re* Maxson's Estate, 30 Cal. App. 2d 566, 86 P.2d 922 (1939). However, it may be necessary to give the proceeds to the husband's administrators to pay their proportionate part of the estate's debts and expenses before the wife's community share is determined. Sieroty v. Silver, 58 Cal. 2d 799, 26 Cal. Rptr. 635, 376 P.2d 563 (1962). In New Mexico, where the wife has only an expectancy in the community property, all proceeds are included in the husband's estate. Hernandez v. Becker, 54 F.2d 542 (10th Cir. 1931).

5. CAL. CIV. CODE § 161a states: "The respective interests of the husband and wife

Although the wife is regarded as the owner of her half of the community property, the husband has complete control and management of her share in a fiduciary capacity, subject to the restriction that he cannot make an inter vivos or testamentary gift of her share without her written consent.[6] If a gift of community property is made without her consent, the wife has the right to revoke the entire gift during her husband's life, but after his death she can recall only her half of the gift.[7] Since the wife has the power to make a testamentary disposition of her share of the community property,[8] her representatives succeed to all of her rights.[9] Life insurance purchased with community funds is governed by the same community property principles that apply to all other forms of property;[10] thus, while both husband and wife are alive the wife has a vested interest in half of the

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in community property during the continuance of the marriage relationship are present, existing and equal interests under the management and control of the husband . . . ." Before the statutes were amended in 1927, the wife had an expectancy rather than a vested interest in community property. United States v. Robbins, 269 U.S. 315 (1926); Spreckels v. Spreckels, 116 Cal. 339, 48 Pac. 228 (1897). There are several exceptions to the community property rule. Property owned before the marriage or acquired during the marriage by gift, bequest, devise, or descent is regarded as separate property. CAL. CIV. CODE §§ 162, 163. Property acquired by a married woman by an instrument in writing is presumed to be her separate property. CAL. CIV. CODE § 164. Furthermore, property earned by the wife is subject to her control and management until it is commingled with community property. CAL. CIV. CODE § 171c. When a couple moves to California after their marriage, their property is reclassified as "quasi-community property" according to community property principles. CAL. CIV. CODE § 140.7; CAL. PROB. CODE § 201.5; see Schreter, *Quasi-Community Property in the Conflict of Laws*, 50 CALIF. L. REV. 206 (1963).

6. Vai v. Bank of America Nat'l Trust & Savings Ass'n, 56 Cal. 2d 329, 15 Cal. Rptr. 71, 364 P.2d 247 (1961); Fields v. Michael, 91 Cal. App. 2d 443, 205 P.2d 402 (1949); Bazzell v. Endriss, 41 Cal. App. 2d 463, 107 P.2d 49 (1940). The husband has no management power over the separate property of the wife. See note 5 *supra*.

7. *E.g.*, Britton v. Hammell, 4 Cal. 2d 690, 52 P.2d 221 (1935); Travelers Ins. Co. v. Fancher, 219 Cal. 351, 26 P.2d 482 (1933); Lynn v. Herman, 72 Cal. App. 2d 614, 165 P.2d 54 (1946). See also 11 U.C.L.A.L. REV. 26 (1963).

8. CAL. PROB. CODE §§ 21, 201. The wife appears to have this power in all community property states except New Mexico, where all the community property belongs to the husband if the wife dies first. N.M. STAT. § 29-1-8 (1907).

9. See, *e.g.*, *In re* Field's Estate, 38 Cal. 2d 151, 238 P.2d 578 (1952); Mendenhall v. Mendenhall, 182 Cal. App. 2d 441, 6 Cal. Rptr. 45 (1960).

10. See, *e.g.*, United States v. Stewart, 270 F.2d 894 (9th Cir.), *cert. denied*, 361 U.S. 960 (1959); Mendenhall v. Mendenhall, *supra* note 9. A life insurance policy in California may pass by transfer, will, or succession to any person. CAL. INS. CODE § 10130. Insurance may be separate property, community property, or mixed, depending upon the source of the premium payments. If both separate property and community property have been used to pay the premiums, the proceeds of the policy will be prorated, according to the ratio of separate premiums to community premiums. See, *e.g.*, Grimm v. Grimm, 26 Cal. 2d 173, 157 P.2d 841 (1945); *In re* Sear's Estate, 182 Cal. App. 2d 525, 6 Cal. Rptr. 148 (1960); Mears v. Mears, 180 Cal. App. 2d 484, 4 Cal. Rptr. 618 (1960). Washington follows the same rule of proportionate ownership of proceeds based on amount of premiums paid with community funds, *In re* Towey's Estate, 22 Wash. 2d 212, 155 P.2d 273 (1945), while Texas has apparently rejected it, Warthan v. Haynes, 155 Tex. 413, 288 S.W.2d 481 (1956).

community property life insurance,[11] and her husband has the power of management of that half. When the insured husband predeceases his wife, she merely receives the management and control of insurance which she already owns. Even if her husband names his executor or some other party as beneficiary, and even if the policy makes no reference to her interest and names only the husband as owner, the wife can still claim her community share of the proceeds as against the named beneficiary.[12] Although the insured husband may possess the usual incidents of ownership which would make the entire life insurance proceeds part of his estate in a non-community property state, California law regards him as owning only half of the insurance, and therefore only one half of the proceeds is included in his estate for both federal estate tax and state inheritance tax purposes.

On the other hand, if the wife dies before her insured husband, the problem becomes more complex. The amount included in the wife's estate under section 2033 of the Internal Revenue Code[13] is one half of the cash surrender value of the policies at the time of her death.[14] In order to establish the amount which should subsequently be included in the husband's estate at his later death, it is

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11. *In re* Compton's Estate, 198 Cal. App. 2d 766, 18 Cal. Rptr. 416 (1962); Mendenhall v. Mendenhall, 182 Cal. App. 2d 44, 6 Cal. Rptr. 45 (1960); Cooke v. Cooke, 65 Cal. App. 2d 260, 150 P.2d 514 (1944).

12. *In re* Castagnola's Estate, 68 Cal. App. 732, 230 Pac. 188 (1924); New York Life Ins. Co. v. Bank of Italy, 60 Cal. App. 602, 214 Pac. 61 (1923). If the wife does not object to the third party receiving all of the proceeds, she will be regarded as having made an inter vivos gift of her share, which is subject to a gift tax, but not an estate tax. Chase Nat'l Bank, 25 T.C. 617 (1955). See also Commissioner v. Allen, 108 F.2d 961 (3d Cir. 1939). If an insurance company has paid the proceeds to the beneficiary in accordance with the terms of the policy, the company is fully discharged from all claims under the policy unless the wife has given written notice of her adverse claim. CAL. INS. CODE § 10172. See also Blethen v. Pacific Mut. Life Ins. Co., 198 Cal. 91, 243 Pac. 431 (1926).

13. INT. REV. CODE OF 1954, § 2033 states: "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

14. United States v. Stewart, 270 F.2d 894 (9th Cir.), *cert. denied*, 361 U.S. 960 (1959); California Trust Co. v. Riddell, 136 F. Supp. 7 (S.D. Cal. 1955); Quigley v. United States, 59-2 U.S. Tax Cas. 74162 (W.D. Wash. 1959); Louisa M. Carroll, 29 B.T.A. 11 (1933); Thompson v. Calvert, 301 S.W.2d 496 (Tex. Civ. App. 1957); Estate of Leuthold, 52 Wash. 2d 299, 324 P.2d 1103 (1958); Rev. Rul. 48, 1953-1 CUM. BULL. 392; Annot., 73 A.L.R.2d 157, 229 (1960); see Mendenhall v. Mendenhall, 182 Cal. App. 2d 441, 6 Cal. Rptr. 45 (1960); Treas. Reg. § 20.2042-1(c)(5) (1958); Rev. Rul. 54-272, 1954-2 CUM. BULL. 298; Rev. Rul. 232, 1953-2 CUM. BULL. 268. *Contra*, United States v. Waechter, 195 F.2d 963 (9th Cir. 1952), *affirming* 98 F. Supp. 960 (W.D. Wash. 1951). However, since the decision upon which *Waechter* rested, *In re* Knight, 31 Wash. 2d 813, 199 P.2d 89 (1948), has been reversed by Estate of Leuthold, *supra*, *Waechter* appears to have little weight.

It has been suggested that the replacement cost of the policy should be used as the basis for the method of valuation as is done in non-community property states when the owner of a policy on the life of another dies before the insured. LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES 284 & n.50 (1962); see authorities cited note 29 *infra* and accompanying text.

necessary to determine whether the interest over which the wife had testamentary power was limited to one half of the cash surrender value of the policy measured at the time of her death, or extended to a one-half interest in the full amount of the policy, including the proceeds. In *Donald Scott*,[15] a recent case of first impression, the Tax Court reasoned that since the wife's interest in the proceeds was only an expectancy terminated by her death, her heirs had received only a right to the half of the cash surrender value which had been included in her estate. Thus, the court concluded that the husband's estate must include all of the insurance proceeds received by the beneficiaries, less the half of the cash surrender value previously included in the wife's estate.[16]

However, the *Scott* case is subject to criticism on two grounds. First, it is based on a mistaken understanding of California community property theory, and in particular the nature of the wife's interest in community property life insurance. To maintain that the wife has only an expectancy in the proceeds while the husband has a vested interest is contrary to the statutory declaration that the interests of each spouse shall be "equal."[17] Furthermore, as pointed out previously, when the husband dies first the wife's vested right to half of the proceeds prevails over the rights of all others.[18] Moreover, since the wife has the statutory power to make a testamentary disposition of all her ownership rights,[19] there is no authority for holding that she cannot bequeath her community share of the policy, including the proceeds. The fact that the proceeds do not come into existence until after the wife's death should not defeat the right of the wife's heirs eventually to acquire the proceeds attributable to the community premiums. Her heirs are merely collecting her share of the community property which was under the husband's management and did not become payable until the later death of the husband, just as the wife collects her share of the property if the husband dies first. Furthermore, the mere fact that the wife's heirs do not acquire immediate possession of her share of the community property should not impair their eventual right to the proceeds upon the later death of the husband. Just as the husband has fiduciary

15. 43 T.C. 920 (1965), appeal pending before the Court of Appeals for the Ninth Circuit. For an analysis of the *Scott* case in terms of California divorce law, see 13 U.C.L.A.L. Rev. 406 (1966).

16. In *Scott*, the Commissioner treated the small amount of premiums paid from the husband's separate property before his marriage as *de minimis*. This was also apparently true of the small difference in premiums paid after the wife's death by the husband (approximately $1850) and the sons, who were beneficiaries of the policy and heirs of the wife (approximately $2700). Thus, the insurance policy in this case was regarded as a community property policy in its entirety.

17. Cal. Civ. Code § 161a; see note 5 *supra*.

18. See cases cited note 12 *supra* and accompanying text.

19. Cal. Prob. Code § 201.

responsibilities to his wife during her life, he likewise has fiduciary responsibilities to her representatives after her death, and can be held accountable for improperly consuming or disposing of his wife's share of the community property.[20] The husband is even authorized by statute to maintain control of community property during the administration of his wife's estate unless distribution is necessary to carry the wife's will into effect.[21] Obviously, the distribution of the proceeds is not possible at the time of the wife's death when the insured husband is still living. Finally, the wife's right to set aside an improper inter vivos or testamentary gift of her share of the community property survives her death and may be exercised by her representatives.[22] Thus, to be consistent with community property theory, the wife's interest in the life insurance should pass to the heirs. It is arguable that they should be able to maintain their pro rata interest in the policy by either paying their share of the proceeds after the wife's death or by reimbursing the surviving spouse for premiums advanced on their behalf. If, however, on the death of the wife the heirs wished to terminate the policy contrary to the wishes of the husband, it would appear that the community property policy could be partitioned into two separate policies, one to be controlled by the heirs and the other by the husband.[23]

The second criticism which can be made of the *Scott* holding is that the Tax Court misconstrued *United States v. Stewart*,[24] its sole authority for the proposition that a wife's only interest in the proceeds of community property insurance on her husband's life is an expectancy terminated by her death. The *Stewart* decision, which was concerned only with the value of the wife's rights in the policy at the time of her death and not with the extent of her rights in any future proceeds, simply followed the established rule that the value of the decedent wife's interest in her surviving husband's life insurance was one half of the cash surrender value of the policy.[25] The Tax Court based its interpretation of *Stewart* on a statement in the opinion that at the wife's death the right to half of the cash surrender value of the policy passed to the husband, who then became the sole owner of the insurance.[26] This was construed by the Tax Court to

20. Knego v. Grover, 208 Cal. App. 2d 134, 25 Cal. Rptr. 158 (1962).

21. CAL. PROB. CODE § 202.

22. Harris v. Harris, 57 Cal. 2d 367, 19 Cal. Rptr. 793, 369 P.2d 481 (1962), 10 U.C.L.A.L. REV. 664 (1963); *In re* Field's Estate, 38 Cal. 2d 151, 238 P.2d 578 (1952).

23. Brawerman, *Life Insurance in Community Property Estate Planning*, 1951 So. CALIF. TAX INST. 47, 74-75; Thurman, *Federal Estate and Gift Taxation of Community Property Life Insurance*, 9 STAN. L. REV. 239, 266 (1957).

24. 270 F.2d 894 (9th Cir.), *cert. denied*, 361 U.S. 960 (1959), *reversing* 158 F. Supp. 25 (N.D. Cal. 1957); 14 Sw. L.J. 526 (1960).

25. See authorities cited note 14 *supra* and accompanying text.

26. "[I]f the husband took the cash surrender value before the wife's death, it would remain community property in which she had a one-half interest, but if he took the cash surrender value after her death he would be the sole owner. In other words, the

mean that the wife's vested interest in the policy was limited to one half of the cash surrender value, and that her interest in the proceeds was a mere expectancy. However, the husband in *Stewart* became the sole owner of the policy not because his wife's interest in the proceeds was an expectancy that terminated, but because she passed all her interests in the insurance to him. Furthermore, by limiting the wife's interest to one half of the cash surrender value of the policy, the Tax Court's interpretation destroys the equality of interests in community property between the spouses that was established by legislative mandate[27] and recognized by *Stewart*.[28]

The underlying motivation that induced the court in *Scott* to limit the wife's interest to an expectancy was probably a fear that the wife's half of the proceeds would otherwise escape estate taxation. If the husband's estate includes only his half of the proceeds and the wife's estate at her earlier death included only half of the cash surrender value of the policy at that time, it is apparent that there will be no estate tax whatever on an amount equal to the difference between one half of the cash surrender value and one half of the proceeds. However, this is precisely the result reached in non-community property states when a person owning insurance on the life of another dies before the insured. The value of the policy included in the owner's estate for estate tax purposes is the replacement cost, or interpolated terminal reserve.[29] Thus, the estate tax is only on the value of the policy at the time of the owner's death. There is no further estate tax when the proceeds come into existence at the death of the insured, since the insured does not have any of the "incidents of ownership." Just as there is no justification for including the insurance proceeds in the estate of the insured when the policy is owned by another person, there is no reason for including the community half of the proceeds owned by the wife in the estate of her insured husband. In both situations, the owner's interest in the insurance has already been taxed at its value at the time of the owner's death.

If the *Scott* decision is upheld, the tax burden that it imposes by including all of the proceeds in the estate of the husband may be

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right to one-half of the cash value of the policies passed to the husband upon the death of the wife." United States v. Stewart, 270 F.2d 894, 898-99 (9th Cir. 1959).

27. CAL. CIV. CODE § 161a.

28. In reversing the lower court's holding that the wife's interest was only a "right of protection" that was extinguished by her death, the *Stewart* court stated that at her death the wife had a present, existing and equal interest with her husband. United States v. Stewart, 270 F.2d 894, 902 (9th Cir. 1959).

29. DuPont v. Commissioner, 233 F.2d 210 (3d Cir.), *cert. denied*, 252 U.S. 878 (1956), *affirming* 18 T.C. 1134 (1952); Ethel M. Donaldson, 31 T.C. 729 (1959); INT. REV. CODE OF 1954, § 2033; Treas. Reg. § 20.2031-8(a) (1958). This method of valuation is also used for gift tax purposes. Treas. Reg. § 25.2512-6(a) (1958); LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES 287-88, 469 (1962).

avoided in other situations by dividing the insurance into two policies which are the separate property of each spouse.[30] The wife's separate insurance policy on the life of her husband would be subject to her testamentary disposition, and the proceeds could not be included in her husband's estate at his later death. While her interest in her separate policy may be valued at the higher replacement cost or interpolated terminal reserve rather than the cash surrender value at the time of her death,[31] this should be more than offset by the lessening of the tax burden that will result from keeping her half of the proceeds out of her husband's estate at his later death.

30. There is no gift tax imposed upon the division of community property into equal shares of separate property. Commissioner v. Mills, 183 F.2d 32 (9th Cir. 1950).

31. See note 29 *supra* and accompanying text.