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ESTATE TAX—The Failure of I.R.C. Section 2039 To Reach Death Benefits Arising Out of the Employment Relationship—*Estate of Fusz**

Decedent's employment contract provided for a salary payable to him and monthly payments to his widow for life if he died during the term of the contract. No post-retirement benefits were payable to decedent under the contract or pursuant to any other agreement

* 46 T.C. 214 (1966) [hereinafter cited as principal case].

with the employer. After decedent's death during the term of the contract the payments to his widow commenced; their commuted value, however, was not included in the gross estate of decedent. The Commissioner of Internal Revenue, ruling that the payments to the widow constituted an annuity, the commuted value of which was includable in decendent's gross estate under section 2039 of the Internal Revenue Code of 1954,[1] assessed a deficiency in decedent's estate tax return. In a case of first impression, the Tax Court rejected the Commissioner's contention.[2] The payments to decedent's widow are not includable in decedent's gross estate because before his death decedent had no right to receive an annuity or other payment under the employment contract.

Section 2039 is designed to sweep into the net of the estate tax certain annuities and death benefits payable to beneficiaries by virtue of the terms of a decedent's employment contract.[3] Includability of such payments in the decedent's gross estate depends upon the satisfaction of two conditions: the beneficiary's right to the payments must arise by reason of surviving the decedent, and the decedent, at the time of his death, must either have been receiving or have had a right to receive an "annuity or other payment" under the terms of the employment contract. It is the latter requirement which is the source of the controversy in the principal case, since the meaning of the words "annuity or other payment" as used in section 2039 is by no means clear.[4] The Commissioner seized upon this vagueness and argued that the decedent's salary was an "other payment" within the meaning of the statute so that the payments to the beneficiary were properly includable. In rejecting this contention, the court held that "the phrase 'other payment' is qualitatively limited to post-employment benefits which, at the very least, are

1. INT. REV. CODE OF 1954, § 2039(a) provides:

SEC. 2039. ANNUITIES. (a) GENERAL.—The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement entered into after March 3, 1931 (other than as insurance under policies on the life of the decedent), if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.

2. The Tax Court's decision was reviewed by the full court.

3. H.R. REP. No. 1337, 83d Cong., 2d Sess. 90 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 123 (1954).

4. In connection with both decedent and beneficiary, "annuity or other payment" refers to one or more payments extending over any period of time; such payments may be "equal or unequal, conditional or unconditional, periodic or sporadic." Treas. Reg. § 20.2039-1(b)(1)(ii) (1958). The phrase is meant to cover a lump sum payment to decedent, whether in lieu of an annuity or not. S. REP. No. 1622, 83d Cong., 2d Sess. 470 (1954). Similarly, it is immaterial whether payments to the beneficiary are in the form of a lump sum, installments, or are for an amount different from those payable to the decedent. H.R. REP. No. 1337, 83d Cong., 2d Sess. A315 (1954). As to the distinction between annuities and life insurance payments, see Treas. Reg. § 20.2039-1(d) (1958).

paid or payable during decedent's lifetime."[5] Although this holding may be a correct construction of the unclear statutory language, it has effectively insulated from estate taxation death benefit arrangements which ought properly to be reached.

To illustrate the tax avoidance potential of the holding of the principal case, suppose that an employee, like decedent in the principal case, owns one-third of the stock of the corporation by which he is employed as one of its officers. His employment contract provides for salary payable to him during his employment and death benefits to his wife upon his death. At the normal retirement age, he resigns his position and becomes a member of the board of directors of the corporation under a contract pursuant to which he receives a reduced, but still adequate, compensation and his wife remains entitled to the death benefits. This arrangement continues until his death, and his widow thereafter would, under the holding of the court in the principal case, take her payments free of all estate taxes[6] since at no time did the decedent ever receive, nor was he eligible to receive—since, after all, he never had retired—any post-retirement annuity or other payment. Surely the number of employees in a position to take advantage of this windfall cannot be inconsiderable, particularly when one includes employees whose retirement comfort is assured by arrangements for income from other sources and whose sole bargaining concern would thus be to insure an income for their widows.

Although the court may have been justified in concluding that the mere payment of salary to an employee does not require the inclusion in the employee's estate of death benefits made to his widow, at least one of the reasons articulated by the court seems

5. Principal case at 218.

6. The Commissioner expressly disclaimed includability under any other section of the estate tax portion of the Code, and his disclaimer seems well founded. Section 2033, which taxes property in which decedent had an interest at his death, seems to require that the decedent have "enforceable vested rights" to the property. Pincus, *Estate Taxation of Annuities and Other Payments*, 44 VA. L. REV. 857, 867 (1958). Such rights are clearly absent in the principal case.

Can the arrangement in the principal case be considered a revocable transfer, and thus taxable under § 2038? To so hold requires (1) that there be an *inter vivos* transfer by decedent and (2) that decedent, during his life, have a power to revoke or alter the benefits payable to the beneficiary, or the power to change beneficiaries. There is a line of cases decided under the 1939 Code, *e.g.*, Worthen v. United States, 192 F. Supp. 727 (D. Mass. 1961); Paul G. Leoni, 1948 P-H Tax Ct. Mem. ¶ 48213, which considered contracts similar to the one in the principal case and found a "transfer" of property from the employee to the beneficiary in the fact of continued employment under the contract which established the death benefits, but another line of cases also decided under the 1939 code, *e.g.*, Estate of Davis, 27 T.C. 378 (1956), seemed to find a power to alter or revoke only when such a power is expressly granted in the employment contract. Thus, unless the employer and employee in fact understood that the employee had the right to alter or revoke, or unless the employee's position in the company clearly indicated that he had such power, it would seem that the arrangement in the principal case is not within the scope of § 2038.

totally inapposite. The court noted that the Treasury Regulations[7] provide that when decedent has received everything to which he is entitled under the contract or agreement, subsequent payments to his beneficiary will not be includable in the decedent's gross estate; conversely, when the decedent dies with payments under the contract still owing, the payments to his beneficiary are includable. The court stated that if the Commissioner's construction were read in the light of this regulation, then if the employee dies in the middle of his pay period, with salary owing, the payments to his beneficiary would be included in his gross estate whereas if the employee should die at the beginning of his pay period, with no salary owed to him, the payments to the beneficiary would not be included—clearly an absurd result. In assessing the merit of this argument, it is necessary to keep in mind that the requirement of an annuity or other payment to decedent is satisfied if at the time of his death the decedent was in fact receiving payments, regardless of whether he had an enforceable right to them.[8] This would seem to cover the employee who dies at the beginning of his pay period, since he has in fact been receiving his salary payments as they have accrued under his employment contract. The only employees who would seemingly not be covered would be those whose contracts are conterminous with their pay period, typically a class of employees—such as day laborers—not usually the subject of death benefit contracts of the type under consideration.

The court's second reason for rejecting the Commissioner's construction, a much stronger, and indeed dispositive one, is that if "annuity or other payment" is read to include salary payments, then the phrase would encompass all payments and the words "annuity or other" would be nullities. Such a result would violate the rule of statutory construction that a statute should be read so as to give effect to all of its words.[9] But this, it might be argued, is only a rule of construction which could be displaced by more compelling considerations. Arguably, it was the intent of Congress to foreclose the kind of loophole mentioned above, by dealing with, once and for all, all annuity payments arising out of the employment relation. Consequently, given both the vagueness of the phrase "annuity or other payment" and the ambiguous legislative history of the section,[10] the court may have been excessively reverent toward a mere

7. Treas. Reg. § 20.2039-1(b)(2), example (5) (1958).

8. Treas. Reg. § 20.2039-1(b)(2), example (2) (1958).

9. See, *e.g.*, McCaffrey, Statutory Construction 55 (1953).

10. S. Rep. No. 1662, *supra* note 3, at 470; H.R. Rep. No. 1337, *supra* note 3, at A315, give the following example of an includable item:

> (4) A contract or agreement entered into by the decedent and his employer under which at decedent's death, prior to retirement or prior to the expiration of a stated period of time, an annuity or other payment was payable to a designated beneficiary if surviving the decedent.

rule of construction, to the point of foiling Congress' purpose in enacting the section.[11]

In support of the court's holding, however, it should be pointed out that it is not completely clear that Congress intended to reach the type of death benefit arrangement present in the principal case. Indeed it appears that Congress was primarily concerned with self and survivor and joint and survivor post-retirement annuities, neither of which were present in the principal case.[12] Two difficulties had frustrated attempts to reach these employment annuities before the enactment of section 2039:[13] the absence, in many instances, of a "vested right" in the decedent to the funds payable to his beneficiary;[14] and the absence of a transfer of property from decedent to his beneficiary where the employer had created the benefits and named the beneficiary.[15] Section 2039, as interpreted by the Treasury Regulations,[16] quite clearly solves these two problems, but there

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Since there is no mention in the example of an annuity payable to decedent, a possible inference arises that salary is sufficient to require inclusion of the benefits in the decedent's gross estate. It has been suggested, however, that example (4) is ambiguous, that none of the examples in the Regulations includes salary payments, and that had Congress intended such a marked change in the estate tax law, it would have announced the change with greater firmness. Pincus, *supra* note 6, at 866-67. Bittker, in *Estate and Gift Taxation Under the 1954 Code: The Principal Changes*, 29 TUL. L. REV. 453, 469-70 n.58 (1955), argues that example (4) is not reconcilable with the rest of the statute unless one construes the example so as to exclude salary payable to decedent as a basis for includability. See also Comment, 10 U.C.L.A.L. REV. 619, 627 (1963) (example (4) must be read as requiring an annuity payable to decedent; otherwise, "annuity or other" would be nullities). *But see* LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES 207 (2d ed. 1962) (suggesting that there is a slight chance that salary will be a sufficient basis for inclusion); Kramer, *Employee Benefits and Federal Estate and Gift Taxes*, 1959 DUKE L.J. 341, 356 (it is unclear whether salary is meant to be a sufficient basis for includability).

11. For a case construing another part of § 2039 with great liberality so as to be consistent with the presumed intent of Congress, see Commissioner v. Estate of Albright, 356 F.2d 319 (2d Cir. 1966).

12. See, *e.g.*, H.R. REP. No. 1337, 83d Cong., 2d Sess. 90 (1954):

> Under present law the value at the decedent's death of a joint and survivor annuity purchased by him is includible in his gross estate. It is not clear under existing law whether an annuity of that type purchased by the decedent's employer, or an annuity to which both the decedent and his employer made contribution is includible in the decedent's gross estate.
>
> The bill requires the inclusion of a joint and survivor annuity in the gross estate . . . .

This would seem to support the argument that by speaking solely of joint and survivor annuities, Congress contemplated that § 2039 would operate only where decedent had a right to an annuity of some sort. Salary payments, then, would not be a sufficient basis for includability.

13. See Kramer, *Employee Benefits and Federal Estate and Gift Taxes*, 1959 DUKE L.J. 341.

14. See, *e.g.*, Dimock v. Corwin, 19 F. Supp. 56 (E.D.N.Y. 1937), *aff'd on other grounds*, 99 F.2d 799 (2d Cir. 1938); Estate of M. Hadden Howell, 15 T.C. 224 (1950); Estate of William S. Miller, 14 T.C. 657 (1950).

15. See, *e.g.*, Estate of William S. Miller, *supra* note 14; Estate of Eugene F. Saxton, 12 T.C. 569 (1949).

16. Treas. Reg. § 20.2039-1(b)(2), example (2) (1958).

seems to be no reason to assume that Congress also meant to reach death benefits in which the decedent had no interest. Moreover, the form of the section itself, by including a requirement of some sort of payment to decedent, seems to belie such an intent. It would have been quite simple to reach death benefits paid to the beneficiary, for Congress merely had to omit any requirement of payments to decedent, and, instead, frame the statute so that all annuities or death benefits arising out of an employment relationship would be includable in decedent's gross estate. However, Congress opted for a statute which, if it reaches death benefits at all, does so only by tortuous indirection. Indeed, this was the reasoning of the court in *Bahen's Estate v. United States*,[17] in which the court by dictum rejected the same contention as was made by the Commissioner in the principal case. Finally, most of the critical commentary has suggested that section 2039 must be construed so as to exclude death benefits in which the decedent's only interest arises from his having received salary owing to him.[18]

It seems that the Tax Court in the principal case has correctly construed what may be an ill-conceived statute. The requirement of a post-retirement annuity or other payment payable to decedent, which leads to the loophole mentioned above, is irrelevant to the underlying purpose of the section. Death benefits payable to a widow are part of the employee's compensation, are transferred at his death, and therefore should be taxable to his estate. This irrelevant requirement should be eliminated, and it must be done by legislative revision of section 2039 since it is evident from the result in the principal case that it cannot be eliminated by a construction of the section as it is presently phrased.

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17. 305 F.2d 827 (Ct. Cl. 1962).
18. See authorities cited note 6 *supra*.