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## Federal Taxation - Transferee Liability of Insurance Beneficiary

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**FEDERAL TAXATION—TRANSFEREE LIABILITY OF INSURANCE BENEFICIARY—**  
Nearly six years after taxpayer died income tax deficiencies were determined against his estate. Since his estate was insolvent the Commissioner sought to impose transferee liability under section 311 of the 1939 code (now I.R.C. section 6901)<sup>1</sup> on plaintiff, taxpayer's widow, as beneficiary of her husband's life insurance. The Tax Court,<sup>2</sup> applying federal law, held plaintiff liable for the entire deficiency since the proceeds received

<sup>1</sup> I.R.C. (1939), §311 was included in the 1954 code without substantial change. Now I.R.C., §6901, it provides:

“(a) The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liability was incurred:

“(1)(A) Transferees.—The liability, at law or in equity of a transferee of property—  
(i) of a taxpayer in the case of a tax imposed by subtitle A (relating to income taxes). . . .”

<sup>2</sup> P-H T.C. Mem. Dec. ¶56,023 (1956).

by her exceeded that amount. The court of appeals,<sup>3</sup> applying state law, reversed and ruled that the beneficiary was not a "transferee" within the meaning of section 311 even to the extent of the cash surrender value of the insurance. On certiorari to the United States Supreme Court, *held*, affirmed, three justices dissenting.<sup>4</sup> Recovery of unpaid federal income taxes from a taxpayer's transferee, in the absence of a federal tax lien, can be sustained only to the extent that state law imposes such liability.<sup>5</sup> *Commissioner v. Stern*, 357 U.S. 39 (1958).<sup>6</sup>

Prior to enactment in 1926 of the predecessor of section 6901 of the 1954 code,<sup>7</sup> if the taxpayer himself did not have sufficient funds to pay the tax due, the Commissioner had to seek recovery from a transferee of the taxpayer's property in a court of equity under the "trust-fund" doctrine.<sup>8</sup> This was a cumbersome and involved process compared with the summary procedure available against the taxpayer himself. The 1926 act was designed to implement the procedure for suing the transferee. It failed, however, to define the substantive liability of the transferee.<sup>9</sup> The Supreme Court upheld the constitutionality of the provision but specifically reserved the question whether federal or state law should control in determining the extent of transferee liability.<sup>10</sup> Prior to the decision in the principal case a majority of the courts of appeals<sup>11</sup> had felt that state law should apply, while the Tax Court<sup>12</sup> and a minority of the courts of appeals<sup>13</sup> thought federal law should govern. The initial

<sup>3</sup> *Stern v. Commissioner*, (6th Cir. 1957) 242 F. (2d) 322.

<sup>4</sup> Justice Black, joined by Chief Justice Warren and Justice Whittaker, dissented.

<sup>5</sup> The Kentucky statute in the principal case limited the life insurance beneficiary's liability to creditors of the insured to the amount of premiums paid by the insured in fraud of creditors. Ky. Rev. Stat. (1953) §§140, 297, 297.150. In the principal case there was no showing the taxpayer had paid any premiums in fraud of creditors.

<sup>6</sup> The rule of the *Stern* case was applied in *United States v. Ott*, (D.C. Mich. 1958) 27 U.S. LAW WEEK 2161, holding that there was no transferee liability on an insurance beneficiary under applicable state law.

<sup>7</sup> Revenue Act of 1926, §280.

<sup>8</sup> For an example of the application of the "trust-fund" doctrine, see *Udike v. United States*, (8th Cir. 1925) 8 F. (2d) 913.

<sup>9</sup> *Pearlman v. Commissioner*, (3d Cir. 1946) 153 F. (2d) 560; *Weil v. Commissioner*, (2d Cir. 1937) 91 F. (2d) 944; *Phillips v. Commissioner*, 283 U.S. 589 (1931). The 1926 act was "to provide for the enforcement of such liability to the Government by the procedure provided in the act for the enforcement of tax deficiencies" [S. Rep. 52, 69th Cong., 1st sess., p. 30 (1926)] "without in any way changing the extent of such liability of the transferee under existing law. . . ." [H. Rep. 356, 69th Cong., 1st sess., p. 43 (1926) (emphasis added)].

<sup>10</sup> *Phillips v. Commissioner*, note 9 supra.

<sup>11</sup> E.g., *United States v. Truax*, (5th Cir. 1955) 223 F. (2d) 229; *Rowen v. Commissioner*, (2d Cir. 1954) 215 F. (2d) 641; *Tyson v. Commissioner*, (6th Cir. 1954) 212 F. (2d) 16; *Botz v. Helvering*, (8th Cir. 1943) 134 F. (2d) 538; *Tooley v. Commissioner*, (9th Cir. 1941) 121 F. (2d) 350; *United States v. New*, (7th Cir. 1954) 217 F. (2d) 166.

<sup>12</sup> *Mary Stoumen*, 27 T.C. 1014 (1957); *Aura Grimes Bales*, 22 T.C. 355 (1954); *Christine D. Muller*, 10 T.C. 678 (1948).

<sup>13</sup> *United States v. Bess*, (3d Cir. 1957) 243 F. (2d) 675, *affd.* 357 U.S. 51 (1958); *Pearl-*

problem presented is to determine what the congressional committees meant when they said in 1926 that courts should continue to apply "existing law" regarding the extent of the transferee's liability. This problem is nearly impossible to solve. The pre-1926 cases did not involve "exemption" statutes in which the court would have been forced to choose between federal or state law. These cases generally were actions against shareholders of dissolved or insolvent corporations based on the "trust-fund" doctrine, in which federal courts applied a "general law" since that doctrine had almost uniform application in all states.<sup>14</sup> The situation did not become acute until the Commissioner sought to recover deficiencies from the insurance beneficiaries of delinquent taxpayers, and was confronted with "exemption" statutes which varied among the states. Since reference to "existing law" would be of no assistance in resolving the question whether federal or state law should apply to determine the substantive liability of a transferee, the difficulty ultimately stemmed from the failure of Congress precisely to define such substantive liability. The dissenting justices in the instant case argued that in light of the general scheme of uniform taxation, revenue laws should not be taken as subject to state limitation unless Congress made it clear from the tenor of the act that it desired the courts to do so. This position has found support in the Supreme Court on previous occasions.<sup>15</sup> The majority adopted the opposite view, asserting that if Congress intended federal law to apply, it should have made it clear in the statute.<sup>16</sup> In support of this position it may be argued that since Congress did provide that the transferee "shall be personally liable" with respect to estate and gift taxes,<sup>17</sup> the absence in the income tax context of a declaration of federal liability in both section 311 and its successor, section 6901, shows congressional intent to make state law applicable. As the majority pointed out, the extent and incidence of federal taxes are sometimes affected by state law.<sup>18</sup> What the Court failed to note was that although state law may determine the relevant facts, uniform federal law is applied to these facts and divergent results are reached only because the underlying facts may be different.<sup>19</sup>

man v. Commissioner, note 9 supra; *Kieferdorf v. Commissioner*, (9th Cir. 1944) 142 F. (2d) 723, cert. den. 323 U.S. 733 (1944).

<sup>14</sup> See 94 UNIV. PA. L. REV. 434 (1946).

<sup>15</sup> *Helvering v. Stuart*, 317 U.S. 154 (1942); *United States v. Pelzer*, 312 U.S. 399 (1941). Stating the general proposition that federal courts should apply federal law is *Clearfield Trust Co. v. United States*, 318 U.S. 363 (1943).

<sup>16</sup> Even the writers in the area have been in disagreement as to which is the better view. See 55 COL. L. REV. 98 (1955), 68 HARV. L. REV. 1280 (1955), 52 N.W. UNIV. L. REV. 693 (1957), 36 TAXES 89 (1958).

<sup>17</sup> See I.R.C., §6324(a)(2) and §6324(b).

<sup>18</sup> See Norman, "State Legislation and Federal Taxation," 26 TAXES 35 (1948).

<sup>19</sup> This distinction was carefully discussed in *Blair v. Commissioner*, 300 U.S. 5 (1937),

Most of the recent cases of transferee liability have involved insurance beneficiaries, and the courts may have been moved in their decisions by the plight of the widow left with nothing but a small amount of insurance proceeds.<sup>20</sup> The policy of protecting insurance proceeds in the hands of certain beneficiaries from the reach of creditors of the insured has had legislative backing in a majority of the states and the decision in the principal case effectuates this rather general statutory policy. Moreover, the end result will likely be the uniformity the Commissioner contended was necessary. It will not be surprising to see the few states not already having protective statutes for life insurance beneficiaries enact them at the insistence of its tax-conscious citizenry. It is questionable, however, whether it is wise in an area of federal taxation for state law to control liability when the history of our tax law has been one of uniform treatment no matter where the taxpayer happened to reside. If it is desirable to exclude an insurance beneficiary from transferee liability, perhaps Congress should now act in this area rather than leave this to state laws which vary at least in detail. It has done so with regard to federal tax liens, the problem before the Court in the companion case of *United States v. Bess*.<sup>21</sup>

The result in the principal case does not leave the Commissioner completely without remedy in the insurance area. In the *Bess* case the Court held that the state "exemption" statutes would not apply to the cash surrender value of a policy where a federal tax lien had attached prior to the time of "transfer."<sup>22</sup> Thus in this rather limited situation recovery is permitted of the same amount from the beneficiary as could have been collected from the deficient taxpayer. But the government will be injured in a situation like that in the principal case where assessment and demand for the tax in question are not made before the taxpayer's death. In some cases this may be due to government delay, while in others it may be due simply to a lack of sufficient time or facilities to determine the deficiency prior to death. It will be interesting to see what the government will do to protect itself in these situations. The results of these two cases have certainly left the door open for federal legislation in the area.

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and *Helvering v. Stuart*, 317 U.S. 154 (1942), where the Court said state law should be applied in determining what rights or interests the parties have, but federal law should be applied to determine what interest should be taxed.

<sup>20</sup> It has even been suggested that Congress never intended the transferee liability provisions to cover insurance beneficiaries. 1955 UNIV. ILL. L. FORUM 168.

<sup>21</sup> 357 U.S. 51 (1958).

<sup>22</sup> State exemption statutes have consistently been held ineffective against a statutory tax lien. E.g., *Fried v. New York Life Ins. Co.*, (2d Cir. 1957) 241 F. (2d) 504; *Knox v. Great West Life Ins. Co.*, (6th Cir. 1954) 212 F. (2d) 784; *United States v. Heffron*, (9th Cir. 1947) 158 F. (2d) 657, cert. den. 331 U.S. 831 (1947).