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FEDERAL TAXATION OF INSURANCE TRUSTS

Allan F. Smith*

"... Every signpost points to increased and increasing taxes. Taxpayers may in a few years look back at the Revenue Act of 1940 with the nostalgia of taxpayers remembering in 1918 the happy days of 1916."¹

While these words are not designed to cheer the hearts of tax-conscious citizens, probably few will deny that they constitute a valid interpretation of the "signposts" along the road. The treasury surplus of 1925 which led to the reduction of income and estate tax rates in the Revenue Act of 1926 and the repeal of the gift tax in the same year² does not seem to be an event likely to recur in the near future. On the contrary, with increasing deficits and expanded spending programs, new sources of revenue will be sought, new principles of taxation may be applied, and changes in administrative policy may be expected³ with each passing month. The form which these changes may take is a matter of speculation⁴ but it is at least possible that a further attack may be made on the two instrumentalities which are at present the main havens for those seeking to minimize tax burdens—life insurance and the trust. The legislative and administrative attack on the latter has been constant since the insertion of section 219 (g) and (h) in the Revenue Act of 1924.⁵ It is still true today, as in 1933, that "One can read in the revisions of the revenue acts the record of the Government's endeavor to keep pace with the fertility of invention whereby taxpayers had contrived to keep the larger benefits of owner-

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¹ Paul, Studies in Federal Taxation, Third Series vi (1940).
³ Witness the frequent administrative changes under § 811 (g) of the Internal Revenue Code of 1939 (hereinafter cited I. R. C.), 53 Stat. L. 1 at 120, 26 U. S. C. (Supp. 1939), § 811 (g), discussed infra, pp. 223-225.
⁴ This article was prepared prior to the passage of the Revenue Act of 1941, which gives some indication of the methods which may be used to increase revenue. So far as the gift tax and estate tax are concerned, the changes serve only to increase the rates of taxation and to make the defense tax permanent. See H. R. 5417, Pub. L. 250, 77th Cong., 1st sess. (1941), §§ 401, 402. The income tax provisions, although they involve some innovations, involve no changes pertinent to this discussion.
ship and be relieved of the attendant burdens." The attack on the preferred tax status of insurance has started, and while it is likely that the taxability of insurance will be altered in the future, whether the changes will be toward clarification of the statutes and regulations or an assault upon its preferred tax status remains to be seen. There appear to be sound reasons of policy for a continuance of the preferential treatment generally accorded life insurance even though the result of such preference be to cause life insurance to be regarded as a "mechanism of tax avoidance" rather than as serving its original social functions of preserving estates and providing for dependents.

It is not the purpose of this article, however, either to justify the present tax status of insurance policies generally or to discuss the tax status of all trusts. Nor is it proposed to suggest the routes by which changes in the present status should be accomplished. Rather, the scope of the article is limited to an institution of comparatively recent origin in which both of these tax-avoiding instrumentalities are involved—that is, the life insurance trust. Because both insurance trusts and other trusts are taxed by the same provisions of the statutes, it is obviously impossible to exclude all cases involving trusts which do not contain insurance as a part of the corpus or to exclude all cases involving insurance not placed in trust. Indeed, many of the rules of taxation apply irrespective of the nature of the corpus of the trust. An effort will be made, however, to center attention on just those cases which do involve insurance held under a trust agreement, particularly if there are special rules applicable to this type of property arrangement. And, within the field of life insurance trusts, the discussion will be limited to a survey of (1) the present tax aspects under the federal

7 PAUL, STUDIES IN FEDERAL TAXATION, THIRD SERIES 352 (1940), in regard to income tax provisions, says: "Life insurance is a complex bundle of mathematics and legalism, and is not rendered any more simple by the necessity of providing, as in the case of wills, for a myriad of subjunctive eventualities. Words of art abound, and a wealth of specially directed language embodying years of judicial definition is all we have for tax statute and regulations."
8 Elrod, "Taxation of Insurance Proceeds—State Inheritance and Estate Taxes," 18 TAXES 668 at 698 et seq. (1940), points out admirably the social purposes served by life insurance justifying its continued preferential treatment, citing Holcombe, "Economical Functions of Insurance," 1 YALE INSURANCE LECTURES 39 (1904), and HUEBNER, LIFE INSURANCE 379 (1928) [cf. 1935 ed., 558].
9 PAUL, STUDIES IN FEDERAL TAXATION, THIRD SERIES 351 (1940).
10 It is not literally true that it is of recent origin, but its growth was not large until 1920. See Scully, INSURANCE TRUSTS, c. 1 (1927).
11 For the sake of brevity, only the personal insurance trust will be considered.
income, estate, and gift taxes; and (2) the possible tax savings by judicious use of such trusts, with only incidental reference to legislative or judicial innovations which may, in the future, render this article of only historical interest.

The life insurance trust may take many forms \(^{12}\) and serve a variety of purposes, \(^{13}\) but for present purposes it may be defined as a trust, at least part of the corpus of which is a policy of life insurance, \(^ {14}\) in which the duty of the trustee is to receive the proceeds of such policy and administer such proceeds as a trust. Such a trust, like any other, may be revocable or irrevocable, and may be funded or unfunded. \(^ {15}\) These various types will be considered separately only where the tax results vary with the type. The present objective is to survey the problems which may arise in the three major fields of federal taxation and to determine the solutions which have been pronounced.

I

The Income Tax

The principal problems raised with respect to the federal income tax and life insurance trusts are: (1) the taxability of the income of a funded life insurance trust to the grantor thereof; and (2) the taxability or exemption of the proceeds of life insurance and endowment policies.


\(^ {13}\) See Stephenson, Living Trusts, 2d ed., 64-100 (1937).

\(^ {14}\) Any kind of policy may be used, although it is not common to place endowment contracts or policies calling for installment payments in an insurance trust. The policy may be on the life of the grantor or on the life of another.

\(^ {15}\) The unfunded trust is one in which only the insurance policies constitute the corpus of the trust. The policies are either assigned to the trustee or the trustee is made beneficiary of the policies. The trust instrument provides for disposition of the proceeds upon the death of the insured, and normally the insured continues to pay the premiums on the policies from his own funds. The funded trust arises when, in addition to the insurance policies, the grantor of the trust transfers to the trustee certain income-producing property which forms a part of the corpus of the trust. The trustee is directed to use the income from such other property to pay the premiums on the insurance in the trust. There are other classifications which can be made: revocable and irrevocable; business and personal; passive, cumulative, discretionary, etc., but these terms are designed only to differentiate certain features which may be present in the trust agreement or the various powers retained by the grantor or given to the trustee.
A. The Taxability of the Income of a Funded Insurance Trust to the Grantor

By virtue of a specific taxing statute, the income of a funded insurance trust is to be taxed to the grantor thereof. Section 167 of the Internal Revenue Code of 1939 provides:

"(a) Where any part of the income of a trust—

"(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

"(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

"(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23 (c), relating to the so-called 'charitable contribution' deduction); then such part of the income of the trust shall be included in computing the net income of the grantor.

"(b) As used in this section, the term 'in the discretion of the grantor' means 'in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question.'"

1. Constitutionality and Application of the Present Statute

It is apparent that this section supplements section 166 16 by pro-

16 I. R. C. (1939), § 166, reads as follows:

"Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—

"(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or

"(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust shall be included in computing the net income of the grantor.

Cases are legion in which the courts have attempted to mark out what constitutes a "power to revest" and "a substantial adverse interest." It is apparent that this section, as well as § 167 (a) (3), will render the income of a life insurance trust taxable to the grantor. Space does not permit an extensive treatment of this section. It has been fully covered in PAUL, STUDIES IN FEDERAL TAXATION, THIRD SERIES 166-295 (1940).
viding for taxability of trust income to the grantor where he retains control of the income of the trust although detaching himself from any control of the corpus. Although it does not specifically refer to irrevocable trusts, there is no question but that subsection 3 applies to irrevocable\(^{17}\) as well as revocable\(^{18}\) insurance trusts. In the remainder of this discussion, it will be assumed, unless otherwise indicated, that the life insurance trust has been made sufficiently irrevocable as to be outside the scope of section 166, and we are concerned only with the application of section 167 (a) (3). The substantial portions of this provision appeared first in 1924,\(^{19}\) and the provision has direct and particular application to funded life insurance trusts. Justice Cardozo, in passing on the constitutionality of the act, in *Burnet v. Wells*,\(^{20}\) said, "The meaning of the statute is not doubtful, whatever may be said of its validity." Today, since the handing down of that decision, the reverse seems true, for, although there are still some questions as to the meaning of the statute, there is now no question of its validity.

It is doubtful whether a taxpayer could have found a stronger case to test the validity of the statute than the *Wells* case. Wells created at various times five irrevocable funded insurance trusts, reserving no control whatever over the management of the trusts. The policies included in the trusts were transferred to the trustee as effectively as can be done: some by a change of beneficiary with a renunciation of a power to change beneficiaries; some by assignment of the policies plus an irrevocable change of beneficiary. Only upon extremely remote contingencies could the corpus revert to his estate and never during his lifetime. The Court, by a five-four decision, upheld the commissioner's deficiency assessment and the constitutionality of the act, saying:\(^{21}\)

"The controversy is one as to the boundaries of legislative power. It must be dealt with in a large way, as questions of due process always are, not narrowly or pedantically, in slavery to


\(^{18}\) As indicated above, the income from a revocable insurance trust will be taxed to the grantor under § 166 without the necessity of looking to § 167 (a) (3). See George H. Whiteley, Jr., 42 B. T. A. 402 (1940); William J. Garland, 42 B. T. A. 324 (1940).


\(^{21}\) Id., 289 U. S. at 677-678, 681-682.
forms and phrases. . . . Liability does not have to rest upon the enjoyment by the taxpayer of all the privileges and benefits enjoyed by the most favored owner at a given time or place. . . .

"Trusts for the preservation of policies of insurance involve a continuing exercise by the settlor of a power to direct the application of the income along predetermined channels. In this they are to be distinguished from trusts where the income of a fund, though payable to wife or kin, may be expended by the beneficiaries without restraint, may be given away or squandered, the founder of the trust doing nothing to impose his will upon the use. . . .

"Congress does not play the despot in ordaining that trusts for such uses, if created in the future, shall be treated for the purpose of taxation as if the income of the trust had been retained by the grantor."

In view of this declaration it is apparent that the normal funded life insurance trust, even though irrevocable in the strictest sense, renders the grantor liable for tax upon the income. It does not matter whether the insurance be ordinary life insurance or endowment contracts. 22 However, the dividends received by the trustee and applied to the payment of premiums are not considered "income." 23 Nor is the grantor liable for sums which he contributes to the trust for the purpose of making up a deficiency in the income. 24

There still remain some questions as to the meaning of the various parts of the statute.

2. What is "Insurance on the Life of the Grantor"?

By its terms, the statute taxes the income to the grantor of the trust only if the insurance is "on the life of the grantor." The wording of the statute opened the way for avoidance by placing insurance in the trust which is not on the life of the grantor thereof. Such an arrangement is certainly not covered by the literal words of the statute, and there are cases which permit this method of avoiding the tax. 25 But it would be a bold prophet who would assert that such condition would remain for long on the statute books. He would be only slightly

22 Heffelfinger v. Commissioner, (C. C. A. 8th, 1937) 87 F. (2d) 991.
24 Id.
25 Lucy A. Blumenthal, 30 B. T. A. 591 (1934); Gail H. Baldwin, 36 B. T. A. 364 (1937). See, particularly, the very recent case of Frances S. Willson, 44 B. T. A. 583 (1941).
less bold who would assert that even under the present statute a taxpayer can be absolutely certain of escaping income taxation on the income of a funded insurance trust by the simple expedient of using insurance on the life of another.

In the first place, he may be taxable under section 166 if he retains a power to revest the title to the corpus in himself. He may be taxable under section 167 (a) (1) if the income is accumulated and there is some chance of his recapturing the corpus. But beyond those possibilities, transactions which appear to have been arranged for the special purpose of avoiding income taxation, particularly where they involve close family relationships, are being subjected to close scrutiny, and the courts and taxing authorities may go beyond the literal words of the statute. Thus in Purdon Smith Whiteley, petitioner and her brother executed cross trusts. The trust created by the brother contained policies of insurance on petitioner's life, income-producing stock, and a note of petitioner. The income of this trust was to be used for the payment of the premiums of insurance, and any balance was to be distributed to the petitioner. Petitioner was named cotrustee of the trust, and given power to call for any part of the corpus of the trust, subject to the consent of the grantor (her brother). The board held that the entire income of the trust was taxable to the petitioner, because she was the real grantor of the trust, saying: "we having held that petitioner should be regarded as the grantor of the trust within the meaning of section 166, it follows that so much of the income of the trust as was used to pay premiums on the policies of insurance covering petitioner's life is also taxable to her under the provisions of section 167 (a) (3)."

Again, in Henry A. B. Dunning, the facts showed that petitioner had recently assigned policies of insurance upon his own life to his wife, and she, in turn, had placed the policies in an insurance trust. The petitioner then created an irrevocable trust, the income of which was to be paid to the wife, and at the "suggestion" of petitioner the

26 William J. Garland, 42 B. T. A. 324 (1940).
29 It was not shown whether this note was supported by consideration or not. For an interesting case where a taxpayer sought unsuccessfully to obtain an interest deduction by giving his own note to an insurance trust set up by his wife (the policies being on his life), see Johnson v. Commissioner, (C. C. A. 2d, 1936) 86 F. (2d) 710.
30 42 B. T. A. at 324.
31 36 B. T. A. 1222 (1937).
wife used that income to pay the premiums on the policies which she owned. The board held, despite the fact that the wife was not required to use the income for the insurance premiums, that so much of the income as had been used for that purpose was taxable to the petitioner.

A still further possibility for income tax liability appears in Commissioner v. Morton. In that case a husband took out $275,000 worth of insurance on his own life payable to his wife, and she alone had any powers in connection with the policies. His wife, as grantor, set up a trust of securities the income from which was to be used to pay the premiums on the policies. The trust was to terminate at the death of the wife (grantor), her husband (insured), or their daughter. The husband was given a power of revocation. Subsequently a similar trust was created by the wife for another insurance policy on the life of her husband but the policy was payable to the trustee rather than to her. Thus, none of the policies was on the life of the grantor, but the court held that the income of both trusts was taxable to the petitioner (grantor), relying in part on Douglas v. Willcuts. The opinion states:

"It is obvious that the income of these trusts was devoted solely to the grantor's own uses. She was the sole beneficiary of the eight policies involved in the first trust; she alone had the right to change the beneficiary; she alone was entitled to their cash surrender or loan value. With respect to the second trust, her title was somewhat less direct, but the policy was, in fact, payable to her, even though indirectly through the medium of the trustee."

Admitting that a literal interpretation might exclude this case from the operation of section 167, the court said:

"... no such literal interpretation is to be accorded the section. Looking to the practical facts, we find here the bulk of the income did remain, in contemplation of law, in substance, that of the grantor, used to purchase property for herself."

It thus appears that if the grantor of the trust has real interest in the policies which constitute the corpus of the trust, the income may

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32 The commissioner later sought to tax this grantor on the entire income of the trust, but was unsuccessful. 41 B. T. A. 1101 (1940).
34 296 U. S. 1, 56 S. Ct. 59 (1935).
35 108 F. (2d) at 1007.
36 Id. at 1007-1008.
be taxed to him even though they are not strictly "on the life of the grantor." In the light of Helvering v. Clifford, this reasoning will probably be upheld.

3. **Excess Income which "May Be Applied"

The statute by its terms purports to tax all income which may be applied to the payment of premiums on life insurance. In actual practice this particular clause is not so broadly construed. The mere provision in a trust indenture that the trustees "may invest in and/or pay the premiums upon any life insurance contracts or annuities for the benefit or welfare of any beneficiary . . . hereunder" is not enough to make the grantor liable to taxation on the income of the trust. This provision was inserted in the trust instrument involved in Genevieve F. Moore. No policies of insurance had ever been taken out, and the board refused to hold the grantor liable, saying:

"While on its face section 167 might appear to apply, it has, so far as can be discovered, never been considered applicable even by the respondent as broadly as is now suggested. In Charles Stewart Mott, where the Board held that payments which could have been made upon life insurance policies were to be taxed to the grantor, it is evident that respondent made no effort to tax the entire income of the trust to him, but only the comparatively small proportion which represented premiums on insurance policies then in force. . . .

"It follows that application of the provision in question depends upon the existence in the tax year of policies upon which

87 309 U. S. 331, 60 S. Ct. 554 (1940); noted in 53 Harv. L. Rev. 1050 (1940); 38 Mich. L. Rev. 885 (1940); 49 Yale L. J. 1305 (1940); Ray, "The Income Tax on Short Term and Revocable Trusts," 53 Harv. L. Rev. 1322 (1940); 24 Minn. L. Rev. 1005 (1940).

88 In construing § 166 the courts have adopted a literal construction and are concerned only with what may be done by the grantor. See Greenough v. Commissioner, (C. C. A. Ist, 1934) 74 F. (2d) 25.

89 A fortiori there is no basis for taxing the grantor on the income when there is not even such a provision in the trust instrument, and no policies are taken out. In Corning v. Commissioner, (C. C. A. 6th, 1939) 104 F. (2d) 329, the government sought to impose income tax on the grantor merely upon a showing that there was a general power in the trustee to "invest" the funds and a further showing that the trustee could choose insurance as an investment without liability under the state laws. See also, Ellsworth B. Buck, 41 B. T. A. 99 (1940); George H. Deuble, 42 B. T. A. 277 (1940).

40 39 B. T. A. 808 (1939).

41 Id. at 812-813.

42 30 B. T. A. 1040 (1934), discussed below.
it would have been physically possible for the trustees to pay premiums and upon the amount of the premiums so payable."

These two limitations—(1) that there must be policies in existence, and (2) that liability is limited to the amount actually used for life insurance premiums—appear to be engrafted on the statute. Whether there are policies in existence upon which the premiums may be paid may depend upon a construction of the instrument. In the *Mott* case (referred to in the above quotation), the grantor-trustee was authorized to pay premiums on policies which "may be taken out for the benefit of the beneficiary of the trust." At the time, the grantor of the trust already had taken out policies in favor of the beneficiaries of the trust, although such policies were not a part of the trust corpus. As indicated, the Board of Tax Appeals construed the instrument to mean that the trustee was authorized to pay premiums on those policies, even though they did not constitute a part of the trust corpus, and imposed liability to the extent of the total premiums on such insurance. This decision, however, was reversed by the circuit court of appeals, on the basis that the instrument did not authorize the payment of premiums upon existing policies, but only upon such policies as might be taken out in the future.

Liability was limited to the amount actually expended for premiums on insurance in *Rand v. Commissioner*. In that case the grantor-trustee was not specifically authorized to pay premiums and no policies constituted a part of the corpus of the trust. Nevertheless, in the tax years 1934 and 1935, the trustee "invested" substantial portions of the income in insurance policies, payable to himself as trustee for his children (the beneficiaries of the trust). He was held liable on the income of the trust only to the extent of the amount so paid as premiums. The board found an implied power to invest in insurance because it is "inconceivable that his action as trustee can be viewed as inconsistent with his intention as grantor since he is the same individual

43 (C. C. A. 6th, 1936) 85 F. (2d) 315.
44 40 B. T. A. 233 (1939), affd. sub. nom. Rand v. Helvering, (C. C. A. 8th, 1941) 116 F. (2d) 929. See Ellsworth B. Buck, 41 B. T. A. 99 (1940), where the grantor was relieved of liability entirely when his wife (life beneficiary of the income of the trust) used some of the income to purchase insurance on grantor's life in favor of the children (remainder beneficiaries under the trust).
45 Whether the payment of life insurance premiums is an "investment" in trust property does not seem settled. Compare the language in William Lea Taylor, 37 B. T. A. 875 at 880 (1938): "The payment of insurance premiums out of the income is but an investment in trust property," with the language in Corning v. Commissioner, (C. C. A. 6th, 1939) 104 F. (2d) 329 at 333: "The payment of life insurance premiums on the life of the grantor is not an investment of the funds of the trust."
in both instances, though acting in different capacities." The decision was upheld by the Circuit Court of Appeals for the Eighth Circuit.

In the ordinary funded trust, it is impossible to determine the exact income which will be produced by the securities, and there will usually be an excess of income over the amount necessary to pay the premiums on the insurance policies. Is this excess taxable to the grantor under any circumstances? There appear at least four possible dispositions which can be made of such excess income. It may be directed (1) that such excess income be distributed to the grantor; (2) that such excess income be distributed to a named beneficiary; (3) that such excess income be accumulated and added to the corpus of the trust; (4) that such excess income be applied to the purchase of additional insurance. In the absence of any such express direction, the trustee may be given discretionary power to apply the excess income in any of the four ways. The person to whom this excess income may be taxed depends, of course, upon the general principles of taxing trust income, and only a summary can be made here. If it is, by the terms of the trust, to be distributed to the grantor, it is taxable to him. Likewise, if, in the discretion of one not having a substantial adverse interest, it may be distributed to him, it is taxable to him. If it is accumulated and added to the corpus, but the grantor may recapture the corpus, it is taxable to him. If the excess is distributed to a named beneficiary and the trust is irrevocable, then it is income to the beneficiary, not to the grantor. Conversely, if the trust is revocable, the income is taxable to the grantor. If the excess is used to purchase additional insurance, on the life of the grantor, it is taxable to him. If the excess income is not taxable to the grantor, then it will be taxed either to the trust or the beneficiary, depending upon conditions which need not concern us here.

49 I. R. C. (1939), § 167 (a) (2).
50 Id.
51 I. R. C. (1939), § 167 (a) (1); William Lea Taylor, 37 B. T. A. 875 (1938).
54 This would seem to be covered by § 167 (a) (3).
B. The Taxability of Proceeds of Life Insurance and Endowment Contracts as Income

1. In General

It has always been the policy of the federal income tax statute to exempt the proceeds of life insurance policies from the provisions of the income tax statute where they are paid by reason of the death of the insured. Section 22 (b) \(^{55}\) provides for such exemption as follows:

"The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

"(1) Life insurance.—Amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or otherwise (but if such amounts are held by the insurer under an agreement to pay interest thereon, the interest payments shall be included in gross income)..."

Under the present regulations, \(^{56}\) this exemption is applicable to corporate \(^{57}\) as well as individual beneficiaries and is applicable even where the proceeds are payable to the estate. \(^{58}\) It is inapplicable, however, when the proceeds are paid to a transferee of the policy who paid a valuable consideration therefor. \(^{59}\) It is clear, therefore, that the normal unfunded life insurance trust involves few income tax problems, the policies constituting the only assets of the trust, and the proceeds being exempted as income to the trust. After the collection of the proceeds, of course, the trust becomes an ordinary trust of personalty, and the income therefrom is taxable to the trust or to the beneficiary as the case may be. \(^{60}\)

2. Instalment Payments

It would be an unusual insurance trust which provided that the proceeds of the policies should be paid to the trustee in instalments rather than a lump sum, since the purpose of the trust is to provide for a flexible distribution of the proceeds to the beneficiaries, and a lump sum payment to the trustee is usually contemplated. No case appears to

\(^{55}\) I. R. C. (1939). At least since 1918, this exemption has been present in the statute. Revenue Act of 1918, § 213 (b) (1), 40 Stat. L. 1065.

\(^{56}\) Treas. Reg. 101, art. 22 (b) (1)-1 (1939); Treas. Reg. 103, § 19.22 (b) (1)-1 (1940).


\(^{58}\) Treas. Reg. 103, § 19.22 (b) (1)-1 (1940).

\(^{59}\) Id.

have arisen where such instalment payments were made to a trustee under a life insurance trust, although they have arisen where the policy provides for periodic instalment payments from the insurance company directly to a beneficiary. Are these sums, or any part thereof, taxable income? The difficulty arises because of the distinction drawn in the statute between amounts "paid by reason of the death of the insured, whether in a single sum or otherwise" and interest payments on amounts "held by the insurer under an agreement to pay interest thereon," the former being exempt, the latter includable in the gross income. The present statute is a result of a series of changes, and it was originally the practice of the commissioner to exempt the instalment payments in full. A case arose, however, in which the board held taxable certain payments made by an insurance company to the beneficiary under an insurance contract in which the insured had provided that the insurance company should retain the proceeds. The commissioner thereupon construed the statute as meaning to exclude only the sum which would be payable in a lump sum upon the death of the insured, regardless of the fact that the insurance contract itself calls for payment of the full sum covered by the instalment payments. Under this interpretation the commissioner has attempted to tax all proceeds which exceeded the commuted value of the policies at the date of insured's death. Such an interpretation has been refused by the courts in the cases which have come before them, the cases resting on the words of the statute and the legislative history of the taxing statute. The courts are ready, however, to include in gross income any payments by the insurance company which are really made by the insurance company as interest in return for the use of the proceeds left with them.

3. Endowment Contracts

It is likewise not customary for an endowment contract to be made the subject of an insurance trust. It is entirely possible, however, and

61 I. R. C. (1939), § 22 (b) (1).
63 Id. 362.
64 Edith M. Kinnear, 20 B. T. A. 718 (1930).
66 Commissioner v. Winslow, (C. C. A. 1st, 1940) 113 F. (2d) 418.
68 The opinion of the Board of Tax Appeals in Sidney W. Winslow, 39 B. T. A. 373 (1939), gives a good account of the legislative history of this exemption.
since the proceeds of an endowment contract are not entirely exempted as income,\textsuperscript{71} it may be well to determine their taxable status.

The Supreme Court has held\textsuperscript{72} and the statute\textsuperscript{78} provides that if an insured survives the endowment period, the excess of the proceeds over the total aggregate consideration paid is taxable income. It is ordinary income and not capital gain.\textsuperscript{74} The insurance contract may, however, contain both endowment features and insurance features, whereby, in case the insured dies before the expiration of the endowment period, the named beneficiary is entitled to the proceeds. If the insured does die before the expiration of the endowment period, the proceeds are then "paid by reason of the death of the insured"\textsuperscript{76} and are exempt. It appears to follow, then, that if an endowment contract were placed in an insurance trust, and the insured survived the endowment period, the excess proceeds over the total cost of the endowment contract would be treated as taxable income. This income would be taxable to the grantor if he were taxable on the income of the trust,\textsuperscript{76} or to the trustee or to the beneficiary, depending upon the provisions in the trust instrument.

The perplexing problems raised in the income tax field by annuities of various sorts are not discussed because this type of policy is hardly usable in an insurance trust.\textsuperscript{77} Likewise omitted are the problems which arise when the proceeds of insurance, taken out by a corporation or other business enterprise upon the life an officer or employee, are distributed to the stockholders of the corporation.\textsuperscript{78}

II

THE ESTATE TAX

The creation of a life insurance trust, revocable or irrevocable, funded or unfunded, will involve many possible impacts with the federal estate tax provisions, and a thorough understanding of the present place of life insurance proceeds under that tax is necessary if the trust is to serve the grantor in minimizing his taxes. Of course, the normal insurance trust involves insurance which, upon the death of the insured,

\textsuperscript{71} I. R. C. (1939), § 22 (b) (2).
\textsuperscript{72} Lucas v. Alexander, 279 U. S. 573, 49 S. Ct. 426 (1929).
\textsuperscript{78} I. R. C. (1939), § 22 (b) (2).
\textsuperscript{74} Avery v. Commissioner, (C. C. A. 9th, 1940) 111 F. (2d) 19.
\textsuperscript{75} Estate of William G. Thompson, 41 B. T. A. 901 (1940).
\textsuperscript{76} I. R. C. (1939), §§ 166, 167.
\textsuperscript{77} The question of the income tax status of annuity payments is extensively treated in Paul, Studies in Federal Taxation, Third Series 369-403 (1940).
is payable to a beneficiary other than the estate of the insured, and hence the decedent’s estate is entitled to a $40,000 deduction from the gross estate \(^7^9\) in addition to the $40,000 specific exemption provided for in the estate tax.\(^8^0\) (This statement is subject to qualification if the trust instrument provides that the proceeds shall, in whole or in part, be used for expenses of administration of the estate. More will be said of this later.) Our problem is once more to determine the present status of the insurance trusts, the possible tax savings, and, incidentally, the possible changes to be expected in the taxing statute.

The present statute\(^8^1\) dealing specifically with life insurance proceeds has been unchanged since its original enactment in 1918.\(^8^2\) It is brief, but it has been charged that its “misleading simplicity”\(^8^3\) is responsible for the perplexing problems which have arisen and the numerous shifts in interpretation which have been witnessed during the course of years. It reads:

“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, real or personal, tangible or intangible, wherever situated, 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 on 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.”

A. Constitutionality as Applied to Insurance Trusts

The discussion here will be confined to policies whose proceeds are received by beneficiaries other than the decedent’s estate.\(^8^4\) As might be expected, taxpayers who first felt the impact of the act charged that it violated the Fifth Amendment in that there was really no transfer from the decedent which could be the legitimate subject of a transfer

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\(^7^9\) I. R. C. (1939), § 811 (g).

\(^8^0\) This specific exemption, of course, varies with the date of decedent’s death, and in computing the basic estate tax and the additional estate taxes. See, generally, Treas. Reg. 80, arts. 1-7 (1937).

\(^8^1\) I. R. C. (1939), § 811 (g). This should not be taken to imply that this is the only section under which insurance may be taxed. See, e.g., Estate of Mary Hughes, 44 B. T. A., No. 184 (1941), where an annuity was held taxable as a gift to take effect at death.

\(^8^2\) Originally Revenue Act of 1918, § 402 (f), 40 Stat. L. 1098. It appears as § 302 (g) of the Revenue Act of 1924 and subsequent acts.


\(^8^4\) As to insurance “receivable by the executor,” see infra, pp. 228-231.
tax. Today the constitutionality of this provision is settled, even as applied to policies which are payable to beneficiaries other than the estate, at least if the decedent retained any incidents of ownership. The Supreme Court in *Lewellyn v. Frick* 85 was called upon to pass upon the applicability of the 1918 act to policies taken out before the act was passed, and which had also been assigned by the insured before the act was passed. Some of the policies had been irrevocably assigned, while in others there was retained a power to revoke the assignment which was not exercised. Without drawing any distinction between the two types of policies, the Court ruled that the act was to be construed to avoid any question of constitutionality, and in order to reach that end, held that the proceeds of the policies were not to be included in the gross estate. They did not pass directly on the issue of whether there was really a transfer of anything at the death of the decedent which could properly be made the subject of the tax. Subsequent cases 86 have largely limited the effects of the *Frick* case, indicating that it is only when all incidents of ownership were irrevocably disposed of before 1918 that the act will not be retroactively applied, but it is not entirely certain that the case is actually so limited. 87

In *Chase National Bank v. United States*, 88 the policies were procured after the 1918 Revenue Act, and the insured retained a power to change the beneficiary, which power was never exercised. The Court there upheld the 1921 act against objections that nothing was transferred because the interests of the beneficiaries “vested” prior to death; that the tax was a direct tax on the property; and that the measure of the tax was so arbitrary as to violate the Fifth Amendment. The Court said: 89

“... But until the moment of death the decedent retained a legal interest in the policies which gave him the power of disposi-

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88 278 U. S. 327, 49 S. Ct. 126 (1929).
89 278 U. S. at 334.
tion of them and their proceeds as completely as if he were himself the beneficiary of them. The precise question presented is whether the termination at death of that power and the consequent passing to the designated beneficiaries of all rights under the policies freed of the possibility of its exercise may be the legitimate subject of a transfer tax, as is true of the termination by death of any of the other legal incidents of property through which its use or economic enjoyment may be controlled."

Then, relying on a decision holding that the remainder interest in a trust subject to a power of disposition in the grantor was properly subjected to a succession tax, the Court said:

"... Such an outstanding power residing exclusively in a donor to recall a gift after it is made is a limitation on the gift which makes it incomplete as to the donor as well as to the donee, and we think that the termination of such a power at death may also be the appropriate subject of a tax upon transfers."

In the remainder of the opinion the Court dismissed as having no merit the arguments that the "transfer" came from the insurance company and not the insured, and that the method of computing the transfer tax was violative of due process.

This case clearly appears to rest its decision regarding the constitutionality of the taxing provision upon the fact that the decedent insured had at the time of his death some incident of ownership which was thereby extinguished. The Court mentions in addition to the power to change beneficiaries, the power to surrender and cancel the policies, to pledge them as security for loans and the power to dispose of them and their proceeds for his own benefit during his life which subjects them to the control of a bankruptcy court for the benefit of his creditors.

A brief summary of the changes in the administrative regulations is necessary at this point to determine the constitutional problems which exist at the present time, for, although the language of the statute has remained unchanged, the administrative interpretations have been frequently revised. The statute provides that in order to be taxable

91 278 U. S. at 336-337.
92 "As it is the termination of the power of disposition of the policies by the decedent at death which operates as an effective transfer and is subjected to the tax, there can be no objection to measuring the tax or fixing its rate by including in the gross estate the value of the policies at the time of death, together with all the other interests of decedent transferred at his death." 278 U. S. at 339.
the insurance must be "taken out by the decedent upon his own life." It is with the meaning of this phrase that the administrative body has been concerned. The earliest regulations provided that insurance was "taken out by the decedent upon his own life" if he "pays the premiums, either directly or indirectly, whether or not he makes the application." 88 Before the decision in the Chase National Bank case, the regulations provided for the inclusion of all insurance in excess of $40,000 receivable by beneficiaries other than the estate "irrespective of the retention of such legal incidents of ownership." 84 This latter provision was eliminated in 1930, 85 shortly after the Chase National Bank decision. The 1934 regulations provided that "Insurance is considered to be taken out by the decedent in all cases, whether or not he makes the application, if he pays the premiums, either directly or indirectly, or they are paid by a person other than the beneficiary, or decedent possesses any of the legal incidents of ownership. . . ." 86 They thus provided three tests of determining whether a policy was "taken out by the insured"—payment of premiums by the insured, payment of premiums by one other than the beneficiary, and the retention of legal incidents of ownership by the decedent. 87 Administrative practice during the time, however, was to include only the proceeds of policies in which decedent retained the legal incidents of ownership. 88 In 1937, this practice was embodied in the regulations, 89 apparently upon the authority of the Chase National Bank case, 100 and until recently the sole test of

88 Treas. Reg. 37, art. 32 (1921); Treas. Reg. 63, art. 27 (1922); Treas. Reg. 68, art. 25 (1924); Treas. Reg. 70, art. 25 (1929).
89 Treas. Reg. 70, art. 27 (1929).
91 Treas. Reg. 80, art. 25 (1934).
93 There has always been the possibility of including the proceeds of insurance policies under some other section of the statute. Thus, after some wavering, it now seems likely that a policy transferred in contemplation of death would be taxable under the provisions of § 811 (c), I. R. C. (1939). See G. C. M. 16932, 15-2 Cum. Bull. 299 (1936), partially revoking G. C. M. 1164, 6-1 Cum. Bull. 315 (1927); May Billings, 35 B. T. A. 1147 (1937). See generally, Oppenheimer, "Proceeds of Life Insurance Policies under the Federal Estate Tax," 43 Harv. L. Rev. 724 (1930).
94 T. D. 4729, 16-1 Cum. Bull. 284 at 288 (1937). Art. 25 of Treas. Reg. 80 (1937) reads: "Insurance is considered to have been taken out by the decedent, whether or not he made the application, if he acquired the ownership of, or any legal incident thereof in, the policy . . . ." It was also provided that the old regulations, Treas. Reg. 70, art. 25 (1929), would apply to decedents dying before November 7, 1934.
95 There is marked similarity between the language in the Chase National Bank case and the language in art. 25, Treas. Reg. 80 (1937).
determining whether insurance was "taken out by the decedent" was the test of retention of legal incidents of ownership. But today the administrative regulations have completed the cycle and are back to the test of payment of premiums as being decisive on the question whether the policies are "taken out by the decedent upon his own life." Article 27 of the Treasury Regulations, as a result of the recent amendment, reads as follows:

"The amount in excess of $40,000 of the aggregate proceeds of all insurance on the decedent's life not receivable by or for the benefit of his estate must be included in his gross estate as follows:

"(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

"(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."

Article 25 of the Treasury Regulations, also amended by T. D. 5032, now reads:

"The term 'insurance' refers to life insurance of every description, including death benefits paid by fraternal beneficial societies operating under the lodge system. Insurance receivable by beneficiaries other than the estate 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. 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

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\[102\] T. D. 5032, 1941-3 INT. REV. BULL. 13.
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.’’

As a matter of construction, the language of the statute is broad enough to support this administrative regulation, and to make the proceeds of all policies, regardless of retention of incidents of ownership, subject to the tax. As said in a very recent decision of the Circuit Court of Appeals for the Second Circuit:

“The language of section 302 (g) is of the broadest kind. It in terms includes in the gross estate of a decedent amounts receivable by all other beneficiaries. Only because of the regulations and certain judicial decisions has section 302 (g) not been extended to cases where the insured has retained no interest in a policy taken out on his own life. As an original question, even such a policy might have been thought to fall within section 302 (g) because of its inherent testamentary character.’’

While this language was pure dictum (the ultimate decision was based upon the fact that the decedent had retained a possibility of reverter in case the beneficiary predeceased him and the proceeds were thus includable under the decision in Helvering v. Hallock) it nevertheless indicates that the court regarded insurance as inherently testamentary. Similar expressions may be found in the original opinion in the Bailey case.

It is upon this basis that the new regulations attempt to impose the tax upon insurance proceeds regardless of retention of legal incidents of ownership. It seems clear that this attempt is a “stark, unadorned amendment of the law.” And it is to be noted that the commissioner has carefully refrained from giving the new regulations any retroactive effect. Under the doctrine which the Supreme Court announced in Helvering v. Reynolds Tobacco Company, it is doubtful whether any

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109 Sec. 302 (g) of the 1926 Revenue Act, 44 Stat. L. 71, which is identical with § 811 (g), I. R. C. (1939).
such retroactive effect could be given.\textsuperscript{110} It is also to be noted that only
the proportion of the proceeds allocable to premiums paid by the
insured are included, a limitation which will aid in saving the consti­
tutionality of the new regulations.

Nevertheless, this constitutional question must now be answered:
Can Congress levy a transfer tax upon the proceeds of life insurance
policies, regardless of whether the decedent possessed any legal inci­
dents of ownership in the policies, merely because the decedent had
paid the premiums upon such policies?

Insurance is a unique type of property inasmuch as economic bene­
fits accrue to the beneficiary upon the death of the insured in a larger
measure than he theretofore had held. In that respect it is closely
analogous to the taxation of joint tenancies and property in which the
deceased made an inter vivos transfer of a remainder, retaining in him­
self a life interest. Both of these latter have been held constitutionally
includable in the gross estate. While there are some cases\textsuperscript{111} which
indicate that payment of premiums alone is not sufficient to justify the
inclusion of the proceeds of insurance policies in the absence of retain­
ing some other legal incidents of ownership, it appears entirely probable
that the Supreme Court, when called upon to do so, will uphold the
constitutionality of the new regulations, at least in so far as they are
prospectively applied, and in so far as they include in the gross estate
only the proceeds allocable to premiums paid by the decedent.\textsuperscript{112}
The case would be somewhat more doubtful, however, if an attempt were
made to include the proceeds of policies of insurance which had been
applied for by another and on which all premiums had been paid by
another, in which the decedent never had held any interest. Thus, if
a wife of a decedent, who has a sufficient insurable interest to permit
her to do so, should apply for insurance upon her husband’s life and pay
all the premiums on the insurance, it might be difficult to find a basis

\textsuperscript{110} The Court there announced that the re-enactment of a statute without altera­
tion will be held to mean that Congressional approval is given to the administrative
construction, and thereby give such construction “the force of law.”

\textsuperscript{111} Levy’s Estate v. Commissioner, (C. C. A. 2d, 1933) 65 F. (2d) \textsuperscript{412} at
415, in which the court said: “The fact that the insured continued to pay premiums
after the applicable Revenue Acts were passed, does not affect the result [excluding
the proceeds from the gross estate].”\textsuperscript{2} Also Anna Rosenstock, 41 B. T. A. 635 (1940),
holding that proceeds of policies were to be excluded from the gross estate of the
insured because they had been orally assigned by the insured to his wife, even though
the premiums were paid thereafter from funds from a partnership composed of the
insured and the wife-beneficiary.

\textsuperscript{112} See an able discussion in Paul, “Life Insurance and the Federal Estate Tax,”
52 \textit{HARV. L. REV.} 1037 at 1052–1056 (1939).
for including the proceeds of such a policy in the husband's estate. Much the same arguments could be made as to the proportion of the proceeds allocable to premiums actually paid by the beneficiary of a policy, even though the decedent had paid part of the premiums. It is not inconceivable, however, that even under these circumstances, inclusion of the proceeds would be held constitutionally permissible.

B. Problems of Interpretation

Problems of constitutionality aside, at the present time there are three possibilities as to the inclusion of life insurance proceeds in the gross estate of a decedent: (1) they may be included in the full amount; (2) they may be included to the extent that they exceed $40,000; (3) they may be entirely excluded from the gross estate of the insured. Any of these possibilities may occur in the following situations.

I. Taxability of Proceeds of Policies Payable to Executors

Insurance proceeds are to be included in the full amount under the present statute "to the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life...." 113 In addition to the determination of whether the insurance is "taken out by the decedent upon his own life," 114 it is also necessary to determine the meaning of the phrase "receivable by the executor." Although nominally all insurance held in an insurance trust is payable to a named trustee and not to the estate or the executor, there are nevertheless instances where the insurance proceeds are includable in full without benefit of the $40,000 exemption.

The regulations 115 at present provide:

"The statute requires the inclusion in the gross estate of all insurance receivable by the executor or administrator or payable to the decedent's estate, and all insurance which is in fact receivable by, or for the benefit of, the estate. It includes insurance effected to provide funds to meet the estate tax, and any other taxes, debts, or charges which are enforceable against the estate. The manner in which the policy is drawn is immaterial so long as there is an obligation, legally binding upon the beneficiary, to use the proceeds in payment of such taxes, debts or charges. The

113 Sec. 811 (g), I. R. C. (1939).
114 See discussion supra, pp. 212-215.
full amount of the proceeds so receivable, without the benefit of any exemption, forms a part of the gross estate, though all the premiums or other consideration wherewith the insurance was acquired may have been paid by a person other than the decedent. If the decedent procured insurance in favor of another person or corporation as collateral security for a loan or other accommodation, the insurance is considered to be receivable for the benefit of the estate. The amount of the loan outstanding at decedent's death will be deductible in determining the net estate, and the interest thereon will be deductible in accordance with the provisions of article 36."

There are several points to be noted in connection with these regulations as they affect life insurance trusts. First of all, in determining whether the insurance is "receivable by the executor" the payment of premiums is immaterial.\(^{116}\) Thus, even in a funded, irrevocable trust, if the proceeds were subjected to the payment of debts of the estate or taxes thereon, the proceeds would to that extent be includable. Of course the payment of premiums will be important, as shown above, in determining whether the insurance was "taken out by the decedent upon his own life."

Second, since one of the primary functions of the life insurance trust, funded or unfunded, is to provide ready assets "for the payment of death taxes and other probate estate obligations, and thus avoid estate shrinkage through forced liquidation of non-liquid estate assets,"\(^{117}\) it is apparent that the trust instrument must be carefully drawn to prevent the loss of the $40,000 exemption and yet enable the trustee to fulfill this function. As indicated by the regulations,\(^{118}\) the $40,000 exemption is not lost unless there is a mandatory duty upon the trustee to use the insurance proceeds for the payment of expenses of administration or debts of the estate. Three methods have been suggested\(^{119}\) for reaching this result: (1) limiting the trustee to the proceeds of particular policies for such purposes; (2) making the power to use the proceeds for estate purposes discretionary with the trustee; and (3)

\(^{116}\) This is the principal change effected by the 1941 amendment (T. D. 5032) of the 1937 regulations.

\(^{117}\) Tye, "Federal Taxation of Life Insurance," 18 TAXES 79 (1940).

\(^{118}\) "The manner in which the policy is drawn is immaterial so long as there is an obligation, legally binding upon the beneficiary, to use the proceeds in payment of such taxes, debts or charges." (Italics supplied.) Art. 26, Treas. Reg. 80 (1937), as amended by T. D. 5032, 1941-3 INT. REV. BULL. 14.

permitting the trustee to purchase assets from the estate at their assessed value or their fair market value. 120

If the first course is followed, then the $40,000 exemption could be used on all other policies. 121 The second method (which appears to be the most dangerous since the instrument might be construed to create a mandatory duty) has received the approval of the Board of Tax Appeals. In Old Colony Trust Company, Executor, 122 the trust instrument provided, in addition to granting permission to the trustee to purchase any property in the estate, that the trustee was authorized “To use and apply the principal and accumulated income of the trust estate to such extent as it may deem necessary for the payment of any debt of the Donor or for taxes, however denominated, which may be or become due or be payable from the estate of the Donor. . . .?” The commissioner refused to permit a deduction of $40,000 from the amount of the proceeds, but the board reversed his ruling, declaring that, because the power was purely discretionary with the trustee and he was under no legal obligation to pay such debts, taxes, or expenses, the insurance was not “receivable by the executor.” To the extent that proceeds were used under a discretionary power to meet obligations of the estate, they would be included in the estate without benefit of the exemption, but the exemption is allowable against the remainder of the policies. 123

The third method would almost certainly be without the statute, and the $40,000 exemption should still be available. If the trust indenture actually subjects the proceeds of policies, even though not otherwise includable in his estate, to payment of expenses of his last illness and burial, the proceeds are to that extent includable in a decedent’s estate. 124

If the insurance is payable to a nominal trustee, who is also executor under the will, and the proceeds are mingled with the assets of the estate and used in the payment of the expenses, such proceeds are includable. 125 Or, conversely, if the insurance is payable to the estate, even though a trust be declared in the will specifically including the policies, and even though the proceeds are not actually used for the

120 This method is also suggested in Paul, “Life Insurance and the Federal Estate Tax,” 52 Harv. L. Rev. 1037 at 1058 (1939).
121 Cf. Estate of Waldo Rohnert, 40 B. T. A. 1319 (1939).
123 Estate of Waldo Rohnert, 40 B. T. A. 1319 (1939).
estate expenses, the proceeds are includable.\textsuperscript{126} On the other hand, it has been held on very similar facts that if insurance is payable to a named trustee, who is also executor under the will, and no beneficiaries are named but the terms of the will provide for a trust of all "property over which I may have any power of disposition," the exemption of $40,000 is to be allowed.\textsuperscript{127} These last two cases can be reconciled only on the technical grounds that in the first case the proceeds were payable to the estate, and in the second they were payable to a trustee who was also executor under the will.

The final point to be noted concerns policies which have been pledged by the insured as collateral for a personal obligation. It is possible that such a policy may be placed in an insurance trust.\textsuperscript{128} In such a case, particularly if the pledgee should enforce his rights against the proceeds, it would seem likely that such proceeds would constitute a part of decedent's gross estate. Likewise, if the trust agreement directed the trustee to satisfy any obligation of the insured, to that extent the proceeds would be included in the gross estate.\textsuperscript{129}

2. Taxability of Proceeds of Policies Reserving Incidents of Ownership to Insured

(a) In General

Apart from the situations noted in the preceding sections, the proceeds of insurance policies placed in an insurance trust, if included in the gross estate at all, will be given an exemption of $40,000. Our problem here is to determine the circumstances under which the proceeds will be included and the circumstances under which they will be excluded.

Under the new regulations,\textsuperscript{130} if insurance is procured after Janu-

\textsuperscript{126} First Nat. Bank of Memphis, Exr., 41 B. T. A. 1299 (1940). See also John Bromley, Exr., 16 B. T. A. 1322 (1929) (insurance payable nominally to executors, but showing that decedent's husband had paid all the premiums).


\textsuperscript{128} Frederick H. Frazier, 41 B. T. A. 146 (1940) (an income tax case).

\textsuperscript{129} Mathilde B. Hooper, Admx., 41 B. T. A. 114 (1940); Treas. Reg. 80, art. 26 (1937), as amended by T. D. 5032, 1941-3 Int. Rev. Bull. 14. Note, of course, that the amount of the debt would be deductible from the gross estate in determining the net taxable estate. For a discussion of the probable inclusion of proceeds of policies taken out directly by the creditors as collateral security for loans, see Paul, "Life Insurance and the Federal Estate Tax," 52 Harv. L. Rev. 1037 at 1059-1060 (1939).

\textsuperscript{130} T. D. 5032, 1941-3 Int. Rev. Bull. 15.
ary 10, 1941, then the payment of premiums by the insured will be sufficient to justify the inclusion of the proceeds in his gross estate, and nothing else need be considered. If this regulation be constitutional, it is clear that the unfunded trust, as normally used, can never result in complete exclusion of the proceeds of the policies from the gross estate, since it is always contemplated that the insured will continue to pay premiums during his life. It may be, too, that the proceeds of policies in a funded trust would be covered by the present regulations. It has been pointed out that the income of a funded insurance trust (at least to the extent necessary to pay the premiums on the policies) is regarded as that of the grantor for the purposes of income taxation. An argument might be made, therefore, that the grantor "paid the premiums" for the purpose of establishing liability for the estate tax. There is no authority on this point, however, and a contrary result is possible.

As to insurance procured before January 10, 1941, it is possible that the insurance proceeds of an insurance trust will not be included in the gross estate. Section (2) of article 27, Treasury Regulations now provides:

"The amount in excess of $40,000 of the aggregate proceeds of all insurance on the decedent's life not receivable by or for the benefit of his estate must be included in his gross estate as follows: . . ."

"(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."

It thus appears that insurance proceeds will be included only if they are "taken out by the decedent upon his own life," and he possessed legal incidents of ownership after the date mentioned or at the date of his death. The question thus becomes one of determining

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181 See discussion, supra, pp. 221-228.
182 See discussion, supra, pp. 221-228.
184 As amended by T. D. 5032, 1941-3 INT. REV. BULL. 15.
185 The regulations list several examples of incidents of ownership. See infra, note 137.
186 See discussion as to the meaning of this phrase, supra, pp. 212-215.
what are the legal incidents of ownership in a life insurance policy. Clearly the incidents of ownership named in the regulations are sufficient to justify the inclusion in the gross estate. The power to change beneficiaries, the power to surrender the policy or borrow upon it, the power to revoke the trust or the assignment of the policy, are all sufficient incidents of ownership to render the proceeds includable in the gross estate. A complete power of revocation, or a power to withdraw the policies from the trust would probably render the proceeds includable. Some of the other "incidents of ownership" require more elaborate treatment.

(b) Effect of Possibility of Reverter

It is a not uncommon provision in life insurance policies that the proceeds shall revert to the estate of the insured in case the beneficiaries shall predecease him, which appears to be the equivalent of the "possibility of reverter" in an ordinary trust. Prior to 1937, the regulations provided that "The decedent possesses a legal incident of ownership if the rights of the beneficiaries to receive the proceeds are conditioned upon the beneficiaries surviving the decedent." The Treasury Department apparently decided against such a construction

186 It is believed that in order to determine what powers are reserved by the grantor both the policy and the terms of the trust should be examined. Thus, a trust agreement might be drawn, made irrevocable by its express terms, and the policies made payable to the trustee. Yet, if the policies themselves reserved to the insured the right to change beneficiaries or to surrender the policies for cash, the irrevocable trust would be a "shell without a kernel." It has been held in such a case that the transfer was not sufficiently complete to prevent the imposition of an estate tax. Old Point Nat. Bank, Exr., 39 B. T. A. 343 (1939).

187 Treas. Reg. 80, art. 27 (1937), amended by T. D. 5032, 1941-3 Int. Rev. Bull. 15, lists the following: "Legal incidents of ownership in the policy include, for example, the right of the insured or his estate to its economic benefits, the power to change the beneficiary, to surrender or cancel the policy, to assign it, to revoke an assignment, to pledge it for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc."


190 Helvering v. City Bank Farmers' Trust Co., 296 U. S. 85, 56 S. Ct. 70 (1935) (even though the power to revoke was held jointly with a beneficiary).

191 Bessie M. Ballinger, Ex'x, 23 B. T. A. 1312 (1931).

192 Treas. Reg. 80, art. 25 (1934).
and deleted that provision in March, 1937. At the present time, however, it seems fairly certain that a provision that the proceeds are to revert to the insured in case of the prior death of the beneficiary is sufficient to render the proceeds includable in the estate. The Supreme Court, in *Helvering v. Hallock* (a case not involving insurance) held that the value of the corpus of a trust should be included in the grantor's gross estate because the trust provided that it was to revert to the grantor in case the beneficiary predeceased the grantor. Prior to that decision there had been a number of decisions to the effect that such a provision in an insurance policy was not sufficient to make the proceeds includable. Since that time, however, the Circuit Courts of Appeals for the First Circuit and for the Second Circuit as well as the Court of Claims have all held that the decision in the *Hallock* case is applicable to such a provision in an insurance policy. A seemingly contrary decision of the Board of Tax Appeals will probably not be followed, and the regulations now specifically provide that such an interest is an "incident of ownership."

(c) Effect of Power to Alter Beneficial Interests in the Trust

Even though the policies be irrevocably assigned or made payable to the trustee-beneficiary, it seems likely that if the grantor of the trust retains the power in the trust instrument to alter the interests of the beneficiaries, even though he expressly excludes the possibility of making himself the beneficiary, the proceeds will be included in his gross estate. There seem to be no decisions on the precise point, but such a

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148 T. D. 4729, 16-1 CUM. BULL, 284 at 289 (1937).
149 309 U. S. 106, 60 S. Ct. 444 (1940). See also the companion cases, Rothensies v. Huston and Bryant v. Helvering, decided at the same time and by the same opinion, and Estate of John S. Conant, 41 B. T. A. 739 (1940).
154 Estate of William G. Thompson, 41 B. T. A. 901 (1940).
155 Tress. Reg. 80, art. 27 (1937), as amended by T. D. 5032, 1941-3 INT. REV. BULL. 15.
power in a trust not including insurance has been held sufficient\textsuperscript{151} and it would seem to be just as effective control on the part of the insured as a power to change the beneficiary of the policy.\textsuperscript{152}

\textbf{(d) Effect of the Payment of Premiums}

It has already been noted that the continued payment of premiums by the insured after divesting himself of all other "incidents of ownership" will be enough, under the new regulations, to render the proceeds of all insurance taken out after January 10, 1941, includable in the gross estate.\textsuperscript{153} Still unanswered, however, is the question: If an insured has taken out insurance prior to January 10, 1941, and divested himself of all other incidents of ownership, will the fact that he pays premiums thereon after January 10, 1941, make the proceeds includable in the gross estate? There have been cases which point to a negative answer. Thus, in \textit{Levy's Estate v. Commissioner}\textsuperscript{154} the court excluded from decedent's gross estate the value of an annuity which his wife was to receive from the proceeds of certain policies of life insurance, because the deceased-insured had irrevocably designated the wife as beneficiary of such annuity. The case is distinguishable, however, since the irrevocable designation had been made in May, 1916, prior to the enactment of the estate tax. The court said,\textsuperscript{155} "The fact that the insured continued to pay premiums after the applicable Revenue Acts were passed, does not affect the result. To the extent of this annuity only the order should be modified, for it may not be taxed." So, too, in a recent case before the Board of Tax Appeals\textsuperscript{156} the board excluded the proceeds of policies which had been orally assigned by the insured to his wife, even though the premiums had been paid by funds from a partnership composed of the insured and the wife-beneficiary. This holding was entered despite the fact that the policies retained to the insured the right to change beneficiaries, the board ruling that the oral assignment was sufficient to transfer all legal incidents of ownership and divest the insured of such right to change beneficiaries.

\textsuperscript{151} Porter v. Commissioner, 288 U. S. 436, 53 S. Ct. 451 (1933); In re Tyler's Estate, (C. C. A. 3d, 1940) 109 F. (2d) 421. For the effect of this holding on the gift tax problem, see Sanford's Estate v. United States, 308 U. S. 39, 60 S. Ct. 51 (1939), Rasquin v. Humphreys, 308 U. S. 54, 60 S. Ct. 60 (1939), and discussion, infra, p. 246.

\textsuperscript{152} In which case it would be included, note 138, supra.

\textsuperscript{153} See discussion infra, pp. 231-232.

\textsuperscript{154} (C. C. A. 2d, 1933) 65 F. (2d) 412.

\textsuperscript{155} Id. at 415.

\textsuperscript{156} Anna Rosenstock, 41 B. T. A. 635 (1940).
But the fact remains that the modified opinion in the *Bailey* case\(^{157}\) has this to say:

"The case was originally tried and submitted upon the proposition that the proceeds of insurance policies could not under the provisions of sections 302 and 401 [Revenue Acts of 1926 and 1932, respectively] be included in the gross estate for the purpose of determining the net estate subject to tax, even if the decedent had continued after the assignments to pay the premiums. The former opinion of the court stands as authority that this may not be done. . . . The former opinion is modified only to the extent that it may be regarded as holding that sections 302 and 401 require the inclusion in the gross estate of insurance proceeds under policies unconditionally assigned where the premiums are subsequently paid by the beneficiary, or the person to whom assigned, from his or her own funds."

It is apparent that under the present gift tax regulations\(^{158}\) the irrevocable transfer of a policy of insurance to an insurance trust calls for payment of a gift tax, and each subsequent payment of premium is a taxable gift.\(^{159}\) If, in addition, the proceeds are to be included in the gross estate, the unfunded trust will lose a considerable portion of its utility as a tax minimizer. This seems probable for insurance trusts in the future, at any rate, in view of the amendment in the regulations which makes the payment of premiums decisive of the question whether the policies are "taken out by the decedent."

3. **Taxability of Other Property of Funded Trusts**

If the insurance trust be funded, it contains property other than the insurance policies, and an additional question arises as to whether that property is to be included in the gross estate. Throughout the remainder of this section of the article the word "corpus" will refer only to such other property. This question may perhaps be answered by reference to the provisions of section 811 of the Internal Revenue Code other than paragraph (g). These provisions are applicable to all transfers in trust. One cannot, however, ignore the peculiar situation occupied by the insurance trust, and the possibility of achieving a logical and equitable correlation between the gift tax, the estate tax, and the income tax.

\(^{157}\) *Bailey v. United States*, (Ct. Cl. 1939) 30 F. Supp. 184.

\(^{158}\) Treas. Reg. 79, art. 2 (5) (1936).

\(^{159}\) Id., art. 2 (6).
It is only an irrevocable transfer which offers much difficulty. The corpus is clearly includable in the gross estate if the grantor reserves a power to revoke, a power to alter beneficial interests in the trust, or a possibility of reverter. Likewise, if the transfer be made in contemplation of death or intended to take effect at or after the death of the grantor, or if a power of revocation be relinquished in contemplation of death, the value of the corpus of an insurance trust, just as the value of the corpus of other trusts, constitutes part of the gross estate.

But, assume that a transfer is made by way of an irrevocable funded insurance trust. Assume further that the provisions of the trust instrument are such that if it were not for the fact that the income is to be used to pay premiums on insurance policies, the transfer would be a completed gift and the value of such property would not be included in the gross estate. Does the fact that the transfer is made through an insurance trust result in any different taxable status?

It has already been noted that the income of the property will still be regarded as that of the grantor so far as income tax liability is concerned. It will be shown later that the Supreme Court, in order to achieve correlation between the gift tax and the income tax, has held that an irrevocable transfer to an insurance trust does not require the payment of a gift tax on the full value of the property transferred. Instead, the taxpayer is permitted to deduct the capitalized value of the income necessary to pay premiums during his life. Thus, he is regarded as having an interest in the corpus so far as the gift tax is concerned. It might well be argued, therefore, that as long as the taxpayer is regarded as having an interest for the purposes of the gift tax and the income tax, he should also be regarded as having an interest for the purposes of the estate tax. Certainly, one who transfers property (outside of an insurance trust) but reserves a life interest will be subjected to an estate tax on such property. The interest which renders the grantor of a funded insurance trust liable for an income tax and not liable for a gift tax appears to be closely analogous to a life interest.

160 Sec. 811 (d), I. R. C. (1939).
163 Sec. 811 (c), I. R. C. (1939).
164 Id.
165 Sec. 811 (d), I. R. C. (1939).
166 Supra, pp. 210-212.
167 Infra, pp. 255-256.
Moreover it could hardly be argued by the decedent's estate that it was inequitable to levy an estate tax in view of the fact that no gift tax had been collected on the value of the interest retained by the taxpayer.

On the other hand, it is possible that this line of reasoning will prevail: the "interest" of the grantor of a funded life insurance trust which makes him liable for tax on the income thereof is purely fictional, designed to prevent evasion; since he must pay tax on the income it is only equitable to permit him a deduction on the gift tax; but it is not necessary to carry the fiction further and charge him an estate tax; the government revenue will not be appreciably diminished if each premium payment is regarded as a gift; consequently, the inclusion of the corpus of an insurance trust in the gross estate rests on the same basis as the corpus of a trust not involving insurance. It is submitted that this latter argument would serve the interests of tax uniformity better than the rather tenuous argument outlined above which is based on the faint hope of achieving an exact correlation between the three taxes.

4. Miscellaneous Problems of the Estate Tax
   (a) Charitable Beneficiaries

   Section 812 (d) of the Internal Revenue Code of 1939 provides that there shall be deducted from the gross estate all bequests, legacies, devises, or transfers which are for charitable purposes. If the grantor of an insurance trust makes a provision for a bequest to charity from the proceeds of the policy, this deduction, despite a contrary provision in the regulations, is to be allowed in addition to the $40,000 exemption allowed on insurance payable to beneficiaries other than the estate of the insured. In a recent case a decedent left $41,122.20 in insurance proceeds to his daughter. Another policy of $50,000 was payable to Columbia University. The administratrix claimed the $40,000 exemption on the insurance payable to the daughter, and a full exemption for the insurance payable to the charitable beneficiary. The commissioner claimed that the $40,000 insurance exemption should be prorated between the two policies in proportion to their face values, which would result in a larger tax. The Board of Tax Appeals ruled in favor of the taxpayer and was affirmed by the Circuit Court of Appeals for

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169 Whether this result will be attained has not yet been decided. The question was specifically reserved in Martin Beck, 43 B. T. A., No. 23 (1940).
170 Treas. Reg. 80, art. 27 (1937).
171 Estate of Michael I. Pupin, 38 B. T. A. 1218 (1938).
the Second Circuit.\textsuperscript{172} The latter court said the purpose of the exemption of charitable gifts was

"... to encourage bequests or similar transfers to charities by by relieving the estate from tax on the bequeathed or transferred property, quite as fully as though that property had had no existence. ... With the property transferred to Columbia out of the case, the daughter's insurance would take the full benefit of the $40,000 exemption. On the other hand, the apportionment proposed by the commissioner would make the estate pay a larger tax than if there had been no insurance payable to Columbia, a result never intended by Congress."\textsuperscript{178}

Since the beneficiaries of a trust, and not the trustee, are the real recipients of the trust property,\textsuperscript{174} the rule would appear to be applicable if the insurance were placed in trust, with an outright gift to the charitable institution.

A rather more common provision, however, is to provide that the income from the trust shall go to a named beneficiary, with the remainder interest in the corpus to the charitable institution. In such a case only the value of the remainder interest would be deductible.\textsuperscript{175} And, if the amount to be received by the charitable beneficiary is indefinite (as, e.g., if the trustee can invade the corpus during the life beneficiary's interest, or if the power to call for parts of the principal is given to the life beneficiary), probably no deduction will be allowed for the charitable bequest,\textsuperscript{176} since it has an unascertainable value.

(b) Liability for the Estate Tax

The payment of the estate tax is the primary liability of the executor or administrator of the estate of the decedent\textsuperscript{177} and if none has been appointed, then "all persons in actual or constructive possession of any property of the decedent are liable for and required to pay the tax to

\textsuperscript{172} Commissioner v. Pupin's Estate, (C. C. A. 2d, 1939) 107 F. (2d) 745.
\textsuperscript{178} 107 F. (2d) at 746.
\textsuperscript{174} Helvering v. Hutchings, 312 U. S. 393, 61 S. Ct. 653 (1941); United States v. Pelzer, 312 U. S. 399, 61 S. Ct. 659 (1941); and Ryerson v. United States, 312 U. S. 405, 61 S. Ct. 656 (1941), all decided by the Supreme Court on March 3, 1941.
\textsuperscript{175} Treas. Reg. 80, art. 44 (1937); Brown v. Deputy, (D. C. Del. 1940) 30 F. Supp. 860.
\textsuperscript{176} Treas. Reg. 80, arts. 44, 47 (1937); Brown v. Deputy, (D. C. Del. 1940) 30 F. Supp. 860.
the extent of the value of such property."\textsuperscript{178} Specific provision is made, however, for subjecting the insurance proceeds to the estate tax in case the executor or administrator does not pay it. First, the statutes provide that "If any part of the gross estate consists of proceeds of policies of insurance upon the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds, in excess of $40,000, of such policies bear to the net estate."\textsuperscript{179} The executor is thus entitled to "require beneficiaries under insurance policies to bear their proportion of the tax."\textsuperscript{180} Beyond that, however, the statutes\textsuperscript{181} also provide that a lien for the proportionate amount of the estate tax shall apply to insurance proceeds payable to a beneficiary other than the executor, and personal liability is imposed upon the "transferee, trustee, or beneficiary"\textsuperscript{182} who receives such property.

It seems likely that the liability will be placed upon both the trustee of an insurance trust and the beneficiary of the trust. In a recent case\textsuperscript{183} a decedent left insurance which was includable in his estate. Under certain settlement options the proceeds of the policies were to be retained by the insurance companies and paid out in deferred installments. The estate was completely insolvent, and the commissioner sought to collect the estate tax from the insurance companies. The board upheld the commissioner and permitted recovery. In the opinion it was said:\textsuperscript{184}

"... Where the proceeds of a policy of insurance are paid to a beneficiary in a lump sum upon the insured’s death then of course the beneficiary of the insurance policy is the transferee of the proceeds of the insurance policies and not the insurance companies. The respondent so concedes."

Under this language the trustee, receiving the proceeds in a lump sum, would be liable as a transferee. It has also now been settled, at least in connection with the gift tax,\textsuperscript{185} that the beneficiaries of a trust are the

\textsuperscript{178} Treas. Reg. 80, art. 79 (1937).
\textsuperscript{179} Sec. 826 (c), I. R. C. (1939); § 314 (b), Revenue Act of 1926, 44 Stat. L. 79, is substantially the same.
\textsuperscript{180} Treas. Reg. 80, art. 87 (1937).
\textsuperscript{181} Sec. 315, Revenue Act of 1926, 44 Stat. L. 80, as amended by § 613 (b) of the Revenue Act of 1928, 45 Stat. L. 875, and as further amended by § 803 (c) and § 809 of the Revenue Act of 1932, 47 Stat. L. 283; § 827 (b), I. R. C. (1939).
\textsuperscript{182} Sec. 827 (b), I. R. C. (1939).
\textsuperscript{183} John Hancock Mutual Life Ins. Co., 42 B. T. A. 809 (1940).
\textsuperscript{184} Id. at 818.
\textsuperscript{185} See the three Supreme Court cases cited note 174, supra.
real recipients of the trust, and hence liability might be imposed on them. This would certainly be true if the trustee were merely a conduit of the funds, directed to perform no other function than to deliver the proceeds to the beneficiary. If, however, the usual condition existed, and the trustee was to invest the funds, paying only the income to the beneficiary, liability might stop with the trustee. Certainly the trustee would be liable. In the case cited above, the board went on to say:

"... But where upon the death of the insured the insurance company at the direction of the decedent pays over the proceeds of the policy to itself, to be held on deposit for deferred settlements with the named beneficiaries, it is a transferee. ... we think the word transferee as used in section 315 (b) is broad enough to cover that situation and that the insurance companies should be liable for the tax, limited of course to the extent provided in section 315 (b)."

This language would apply equally to trustees receiving the proceeds and holding them for deferred payments. The board ignored the contention that the insurance company would not be interested in the correctness of the assessment and the beneficiaries would have no opportunity to litigate the amount of the assessment, saying merely that the beneficiaries might have a right to intervene, though not deciding that point.

### III

**The Gift Tax**

The federal gift tax, after a considerable struggle\(^\text{187}\) made its first appearance on the statute books in 1924,\(^\text{188}\) was repealed in 1926,\(^\text{189}\) and reappeared (with some changes)\(^\text{190}\) in 1932.\(^\text{191}\) With some modifications,\(^\text{192}\) the law is in substantially the same form now as in 1932.

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\(^{187}\) For an interesting account of the legislative history of the gift tax, see Harriss, "Legislative History of Federal Gift Taxation," *18 Taxes* 531 (1940).
\(^{188}\) Secs. 319 et seq., Revenue Act of 1924, 43 Stat. L. 313.
\(^{189}\) Sec. 324, Revenue Act of 1926, 44 Stat. L. 86.
\(^{190}\) For an excellent analysis of the gift tax, see Magill, "The Federal Gift Tax," *40 Col. L. Rev.* 733 (1940); Harriss, *Gift Taxation in the United States* (1940).
\(^{191}\) Sec. 501 et seq., Revenue Act of 1932, 47 Stat. L. 245.
\(^{192}\) E.g., lowering the specific exemption, \$ 301, Revenue Act of 1935, 49 Stat. L. 1023; lowering the annual exclusion on single gifts, \$ 505, Revenue Act of 1938, 50 Stat. L. 565; removing the $4,000 annual exclusion on gifts in trust, id.; increasing the rates, \$ 520, Revenue Act of 1934, 48 Stat. L. 761, \$ 301, Revenue Act of 1935, 49 Stat. L. 1023, \$ 207, Revenue Act of 1940, 54 Stat. L. 521.
Section 1000 of the Internal Revenue Code of 1939 reads as follows:

"(a) For the calendar year 1940 and each calendar year thereafter a tax, computed as provided in section 1001, shall be imposed upon the transfer during such calendar year by any individual, resident or nonresident, of property by gift. Gift taxes for the calendar years 1932-1939, inclusive, shall not be affected by the provisions of this chapter, but shall remain subject to the applicable provisions of the Revenue Act of 1932, except as such provisions are modified by legislation enacted subsequent to the Revenue Act of 1932.

"(b) The tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; but in the case of a nonresident not a citizen of the United States, shall apply to a transfer only if the property is situated within the United States."

Section 1001 sets out the progressive rate of taxation, the rates being three-fourths of the corresponding estate tax rates. This lesser rate was apparently adopted to encourage gifts and secure immediate revenue.

Section 1002 includes transfers not made for "an adequate and full consideration in money or money's worth" to the extent that the property transferred exceeds the value of the consideration. Section 1003 provides that the first $4,000 of each gift made to any person during the taxable year shall not be included in the "net gifts," except

203 53 Stat. L. 144 (1939). This is the successor to § 501, Revenue Act of 1932, 47 Stat. L. 245, which was amended by § 511, Revenue Act of 1934, 48 Stat. L. 758. This 1934 amendment repealed subsection (c) of the original § 501 (relating to the inapplicability of the gift tax in the case of a transfer of property in trust subject to the power in the donor to revest title in himself) after the decision in Burnet v. Guggenheim, 288 U. S. 280, 53 S. Ct. 369 (1935), which declared that the gift tax would be inapplicable even without the statutory exclusion.

204 Sec. 207 of the Revenue Act of 1940, 54 Stat. L. 521, amends § 1001 by increasing the rate of the gift tax for the years 1940-45 for defense tax. This defense tax has been made permanent by the Revenue Act of 1941. See supra, note 4.


206 Formerly $5,000, Revenue Act of 1932, § 504, 47 Stat. L. 247. It is very probable that this amount will be lowered still further. An attempt was made by the House of Representatives in 1938 to reduce this exclusion to $3,000. See H. Rep. 1860, 75th Cong., 3d sess. (1938), p. 61. Further reduction is advocated in a recently published book in which the gift tax is comprehensively analyzed. Harriss, Gift Taxation in the United States 68-70 (1940).
in case of gifts of future interests or gifts in trust, when no such exclusion is permitted. Section 1004 grants to citizens or residents a specific exemption of $40,000 on gifts made during the year and excludes gifts to charities. Section 1005 provides that "If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift."

These are the statutory provisions under which the creation of a life insurance trust may be subject to gift tax. It is clear that a very important tax saving can be made by any person of considerable wealth by utilizing the $40,000 exemption to gifts and eliminating at least that sum from his gross estate. Likewise the $4,000 annual exemption permits as many separate gifts of that amount each year to go free from tax. Actually the savings which can be made by making inter vivos gifts rather than leaving the property in the estate is greater than the difference in the rates of the two taxes, because a gift, even though taxable, will fall in the lower brackets of the gift tax and be removed from the upper brackets of the estate tax. A life insurance policy is "property" and a transfer thereof is a proper occasion for the imposition of a gift tax. As with any transaction, the problems raised may be grouped in three principal classes: (1) What type of transfer is subject to the tax? (2) Assuming that the tax is to be imposed, what value is to be placed on the property transferred? (3) What is the extent of the deductions to be allowed under the statute?

A. What is a Taxable Transfer?

If, as has been frequently stated, the gift tax was adopted as a supplement to the estate tax and to the income tax, there is a sound basis for the conclusion which seems to be developing in the decisions that the general test to be applied in determining whether a transfer is subject to a gift tax is this: Is the transfer sufficiently complete so

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197 Sec. 505, Revenue Act of 1938, 52 Stat. L. 565, now denies the exclusion of the first $4,000 when the gift is made in trust. See infra, p. 258.

198 Formerly $50,000, Revenue Act of 1932, § 505, 47 Stat. L. 247. This exemption "may be taken in its entirety in a single year, or be spread over a period of years in such amounts as he [donor] sees fit, but after the limit has been reached no further exemption is allowed." Treas. Reg. 79, art. 12 (1936).

199 Subsequent sections deal with the requirements for tax returns (time and place of making and persons by whom they are required), time of payment, methods of collection, procedure, deficiency assessments, penalties, refunds, etc., but are not of particular concern here.


that the value of the property transferred will not be included in the estate of the transferror and thereby subjected to the estate tax? If it is not sufficiently complete, then no gift tax is to be imposed. The leading cases which announce this principle of exclusiveness are the companion cases *Estate of Sanford v. Commissioner* 202 and *Rasquin v. Humphreys*, 203 both involving the general question whether a gift in trust with the power reserved in the grantor to alter the interests of the beneficiaries but not in a manner to benefit himself was a completed gift. The rationale of the decision that no gift tax was to be imposed was that the transfer was sufficiently incomplete to render the property subject to an estate tax and therefore it should not be subject to a gift tax. In the former case the Court said: 204

"There is nothing in the language of the statute, and our attention has not been directed to anything in its legislative history to suggest that Congress had any purpose to tax gifts before the donor had fully parted with his interest in the property given, or that the test of the completeness of the taxed gift was to be any different from that to be applied in determining whether the donor has retained an interest such that it becomes subject to the estate tax upon its extinguishment at death. The gift tax was supplementary to the estate tax. The two are in *pari materia* and must be construed together."

The Court recognized that "The two taxes are not always mutually exclusive," mentioning specifically "gifts made in contemplation of death which are complete and taxable when made, and are also required to be included in the gross estate for purposes of the death tax." 205 Nevertheless, it reached the conclusion "that the gift tax statute does not contemplate two taxes upon gifts not made in contemplation of death, one upon the gift when a trust is created or when the power of revocation, if any, is relinquished, and another on the transfer of the same property at death because the gift previously made was incomplete." 206

This principle of correlating the gift tax and the estate tax has been

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203 308 U. S. 54, 60 S. Ct. 60 (1939).
204 308 U. S. 39 at 44.
205 308 U. S. 39 at 45. Sec. 811 (c), I. R. C. (1939), provides specifically for the inclusion in the gross estate of gifts made in contemplation of death. Sec. 811 (d) provides for the inclusion in the gross estate of all revocable transfers.
206 308 U. S. 39 at 45.
reiterated with increasing frequency. The position defined in these cases has now been adopted by the commissioner by a change in the regulations. With this general view in mind, we look at the particular problems of the insurance trust. How may a gift be made? When is the gift so incomplete as to be not subject to gift tax? What possibilities are there that there will be imposed both a gift tax at the time of the transfer and an estate tax on the proceeds at maturity?

B. Revocable Insurance Trusts

1. Unfunded Trusts

In the unfunded trust, the policies only are transferred to the trust, and our question here is limited to the powers reserved which are equivalent to a power to revoke. It has already been noted that one must look both to the insurance policy and the terms of the trust instrument in order to determine what powers are retained to the grantor of the trust.

The Treasury Regulations provide with respect to insurance:

"If the insured assigns a life insurance policy, or designates a beneficiary in such a policy, but does not retain what amounts to a power of revocation (as, for example, the right to surrender or cancel the policy, the right to obtain a loan against the policy or its surrender value, or a right to change the beneficiary or assignee, if by the exercise of such latter right the proceeds of the policy might be made payable to the insured, his estate, or otherwise for his benefit), such assignment or designation constitutes

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208 T. D. 5010, 1940-40 INT. REv. BULL. 13, issued September 19, 1940, amends art. 3, Treas. Reg. 79 (1936), so that it is now provided: "But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over the disposition thereof, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. ... A gift is incomplete in every instance where a donor reserves the power to revest the beneficial title to the property in himself. A gift is also incomplete where and to the extent that a reserved power gives the donor the right to name new beneficiaries or to change the interests of the beneficiaries as between themselves."

209 See supra, note 136.

a gift even though the right of the assignee or beneficiary to receive the proceeds is conditioned upon his surviving the insured."

By inference, when any of the powers named are reserved by the policy to the settlor, the creation of a life insurance trust does not involve a taxable gift.\textsuperscript{211} Or, if a power of revocation is reserved in the trust instrument, no taxable gift occurs until such power is relinquished.\textsuperscript{212} A power reserved to alter the beneficial interests,\textsuperscript{213} or to revoke after ten years,\textsuperscript{214} will result in no gift tax liability until the power ends.

(a) \textit{Effect of Possibility of Reverter}

Until recently there appeared little question that a reservation of what is termed a "possibility of reverter" was not enough to prevent the gift tax from being due. The regulations\textsuperscript{215} provide that "even though the right of the assignee or beneficiary to receive the proceeds is conditioned upon his surviving the insured," the transfer of a policy would constitute a completed gift. Such an interest conversely was not sufficient to render the proceeds subject to an estate tax.\textsuperscript{216} It has been pointed out, however,\textsuperscript{217} that recent cases have rewritten the law in regard to the estate tax, and the retention of a "possibility of reverter" by the decedent now renders the property includable in the gross estate because there is a "shifting of economic benefits" brought about by the death of the holder of such possibility of reverter. If these cases constitute the present rule with respect to estate tax, and if the gift tax regulations previously quoted\textsuperscript{218} constitute the rule for imposition of the gift tax, then a transfer of an insurance policy, in trust or other-

\textsuperscript{211} It is extremely important in this connection to determine whether to create the trust by a change of beneficiary or by assignment. See generally, \textit{Stephenson, Living Trusts}, 2d ed., 245-254 (1937). Note, however, that the reservation of such powers subjects the proceeds to estate tax under § 811 (g), I. R. C. (1939).
\textsuperscript{212} Orrin G. Wood, 40 B. T. A. 905 (1939).
\textsuperscript{213} Emory May Holden Norweb, 41 B. T. A. 179 (1940); Estate of Sanford v. Commissioner, 308 U. S. 39, 60 S. Ct. 51 (1939); Rasquin v. Humphreys, 308 U. S. 54, 60 S. Ct. 60 (1939); T. D. 5016, 1940-40 INT. REV. BULL. 13.
\textsuperscript{214} Emily Trevor, 40 B. T. A. 1241 (1939).
\textsuperscript{215} Treas. Reg. 79, art. 2 (5) (1936).
\textsuperscript{217} Supra, pp. 233-234.
\textsuperscript{218} Supra, at note 215.
wise, where the policy (or the trust instrument) provides for the payment of proceeds to the estate of the insured if he survives the beneficiary, will subject the transaction to a gift tax and still leave the proceeds includable in the gross estate. 219

Such a result is entirely possible and, indeed, seems to be the present rule. The present estate tax regulations 220 provide that "the insured possesses a legal incident of ownership if his death is necessary to terminate his interest in the insurance, as, for example, if the proceeds would become payable to his estate, or payable as he might direct, should the beneficiary predecease him."

In *Chase National Bank of the City of New York v. United States*, 221 the court was engaged with the question whether the proceeds were includable in the gross estate, and, as indicated above, followed the *Hallock* decision 222 in imposing the estate tax. It is of interest, however, to note the language of the court: 222

"... The theory of taxation closely resembles that applied to joint tenancies. There, upon the death of one of the joint tenants, the entire res must be included in his gross estate so far as it was derived from his property."

It is familiar learning that joint tenancies, 224 along with gifts made in contemplation of death, 225 are subjected to both gift and estate taxation. If the language quoted can be taken at its face value, it may indicate that the transfer of an insurance policy will take its place beside those two types of transfer, and be subjected to both taxes. 226

219 Such a result has been predicted. See Nash, "Implications of Some Recent Developments in the Taxation of Trusts," 18 *Taxes* 267, 319 at 325 (1940).


221 (C. C. A. 2d, 1940) 116 F. (2d) 625. The same result was reached in Broderick v. Keeffe, (C. C. A. 1st, 1940) 112 F. (2d) 293.


223 116 F. (2d) 625 at 627.


225 See Treas. Reg. 80, art. 16 (1937); United States v. Wells, 283 U. S. 102, 51 S. Ct. 446 (1931).

226 See Treas. Reg. 80, art. 16 (1937); United States v. Wells, 283 U. S. 102, 51 S. Ct. 446 (1931).


On the other hand, if the rationale of the *Sanford* and *Rasquin* cases\(^{227}\) be applied, the fact that the proceeds are includable in the estate will be ground for withholding the imposition of the gift tax at the time of the transfer. Withholding the gift tax on a transfer where the grantor had only a "possibility of reverter" would weaken this tax to that extent, and it has been suggested that no such action will be taken.\(^{228}\)

(b) *Effect of Payment of Premiums*

The unfunded insurance trust, as most often used, always contemplates that the insured-grantor pay the premiums upon the insurance in the trust, even after the trust is established. A serious question has arisen as to whether a trust of insurance where the grantor continues to pay the premiums on the insurance shall be considered an incomplete gift regardless of his surrender of all other incidents of ownership. Again the matter is closely tied up with the provisions of the estate tax,\(^ {229}\) and the treatment accorded such insurance in connection with the estate tax.

Assuming now that the grantor has placed insurance in trust, and has surrendered all rights to change beneficiaries, to surrender the policy for cash, to obtain loans against the policy or to revoke an assignment of the policy, and all other recognized "incidents of ownership," does the fact that he continues to pay premiums constitute an incident of ownership so as to render the proceeds taxable in his estate? If so (and it seems very likely that such is the case), should it therefore be held that there is not a taxable gift or shall both taxes be imposed?

The gift tax regulations apparently contemplate that a gift tax on the value of the policy is to be imposed at the time the insured divests himself of the above-named rights,\(^ {230}\) and specifically provide that the subsequent payments of premiums shall be considered gifts.\(^ {281}\) Assuredly the beneficiary named in such a policy acquires vested rights which cannot be taken away from him without his consent.\(^ {282}\) There

\(^{227}\) Supra, notes 202 and 203. See also cases cited supra, note 207.

\(^{228}\) Nash, "Implications of Some Recent Developments in the Taxation of Trusts," 18 *TAXES* 267, 319 at 325 (1940).

\(^ {229}\) Sec. 811 (g), I. R. C. (1939); formerly § 302 (g), Revenue Act of 1926, 44 Stat. L. 70.

\(^ {230}\) Treas. Reg. 79, art. 2 (5) (1936).

\(^ {281}\) Id., art. 2 (6).

seems to be no reason for a change in this aspect of taxation. If one chooses to make a gift of an insurance policy, he must pay the tax thereon, and the payment of added premiums constitutes an indirect gift to the beneficiary named in the policy.

There has been an attempt made, however, to include the proceeds of policies on which the insured paid the premiums, regardless of whether he retained any other incidents of ownership. The complete history of the estate tax regulations in this regard has been discussed, and for present purposes it is enough to recall that articles 25 and 27 of the 1937 edition of Treasury Regulations 80 were revised on January 10, 1941, and under these revised regulations the proceeds of all insurance "taken out by the decedent" are to be included in the gross estate. Whether a policy is "taken out by the decedent" depends upon whether he paid a part or all of the premiums, at least as to insurance taken out after January 10, 1941. If the insurance is taken out before that date, the old regulations apply, and the taxability of the proceeds under the estate tax depends upon whether the insured retained "incidents of ownership."

This change in the regulations is probably an attempt of the commissioner to take advantage of the original and the modified opinion in the Bailey case. While there are cases which will have to be reconciled when a final test of the matter is made, it seems clear that at the present time, the creation of an unfunded life insurance trust will, if the policies be irrevocably assigned, result in the imposition of a gift tax on the value of the policy; a gift tax on the amount of each annual premium paid thereafter; and an estate tax on the proceeds of the policies in excess of the $40,000 specific exemption. Just as it would weaken the gift tax to fail to impose a gift tax where the settlor of a trust retained a "possibility of reverter," so would it

288 Supra, pp. 221-228.
285 Id.
286 (Ct. Cl. 1939) 27 F. Supp. 617.
287 (Ct. Cl. 1939) 30 F. Supp. 184.
289 Since 1938, no $4,000 exclusion is permitted to gifts in trust, Revenue Act of 1938, § 505, 52 Stat. L. 565, and it may be that the gift of a premium payment on insurance placed in trust would be considered a "gift in trust." In such case it would be better for the taxpayer to transfer the cash to the beneficiary outright.
240 Supra, note 228.
weaken the gift tax so far as the transfer of life insurance policies is concerned to fail to impose a gift tax at the time the insured divested himself of all rights under the policies and vested them in someone else. Consequently, it seems unlikely that the doctrine of mutual exclusiveness announced in the Sanford case will be applied to this situation.

2. Funded Trusts

In the funded revocable trust, income-producing property is transferred together with the insurance policies, the trustee being directed to apply the income from such property to the payment of the premiums on the insurance. This fact does not give rise to any additional problems in connection with the determination of what constitutes a taxable transfer. Since the question again to be determined is whether the powers reserved in the trust instrument are sufficient to render the gift incomplete or whether the settlor has parted with control over the property transferred, the principles discussed in the previous section will apply as well to the transfer of the securities as to that of the insurance policies.

Likewise no separate discussion will be made of irrevocable transfers, it being implicit in the foregoing discussion that, if the transfer is found to be complete and irrevocable, a gift tax will be imposed, and the sole questions become those of valuation and possible deductions which are discussed in the following sections.

C. Valuation of Life Insurance Gifts

1. Unfunded Trusts

In the unfunded trust, only the insurance policy or policies are transferred, and the problem of valuation is just the same in the insurance trust as it is in the case of an irrevocable assignment of the policy or in the case of irrevocably naming a beneficiary of a policy.

Section 1005 of the Internal Revenue Code of 1939 provides that "If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift." The original regulations issued by the Bureau of Internal Revenue in 1932 provided that "The irrevocable assignment of a life insurance policy, or the naming of the beneficiary of a policy without retaining any of the legal

241 The funded trust raises a question of valuation, discussed infra, pp. 255-256.
incidents of ownership therein, constitutes a gift in the amount of the net cash surrender value, if any, plus the prepaid insurance adjusted to the date of the gift." Under these regulations a long line of cases established the rule that the cash surrender value was the criterion for valuation of gifts of life insurance.  

In 1936, the regulations were changed to provide that

"The value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. As valuation through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated, unless because of the unusual nature of the contract such approximation is not reasonably close to the full value, by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date."

Several examples are given.

It is apparent that the exceptional character of insurance policies makes for difficulty in determining "value." But the principal question now is whether an insurance contract has a greater value than the mere cash surrender value.

(a) Single Premium Policies and Paid Up Policies

The question of value of single premium policies has been settled by the Supreme Court in three cases decided February 3, 1941, with opinions by Justice Douglas, resolving a conflict which had existed among the circuit courts of appeals.

In Guggenheim v. Rasquin, the taxpayer had purchased single

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premium life insurance policies at a cost of $852,438.50, the face amount of such policies being $1,000,000. At about the same time she assigned them irrevocably to three of her children, and in making her gift tax return she listed the policies at a value equivalent to their cash surrender value of $717,344.81. A deficiency was determined by the commissioner who placed a value on the policies equivalent to the cost of the policies. The suit was for a refund of the tax paid under the deficiency assessment. The circuit court of appeals upheld the commissioner, and the Supreme Court affirmed the decision, saying:

"... Surrender of a policy represents only one of the rights of the insured or beneficiary. Plainly that right is one of the substantial legal incidents of ownership. ... But the owner of a fully paid life insurance policy has more than the mere right to surrender it; he has the right to retain it for its investment virtues and to receive the face amount of the policy upon the insured's death. That these latter rights are deemed by purchasers of insurance to have substantial value is clear from the difference between the cost of a single-premium policy and its immediate or early cash-surrender value—in the instant case over $135,000. All of the economic benefits of a policy must be taken into consideration in determining its value for gift-tax purposes. To single out one and disregard the others is in effect to substitute a different property interest for the one which was the subject of the gift. In this situation as in others [citing case] an important element in the value of the property is the use to which it may be put. Certainly the petitioner here did not expend $852,438.50 to make an immediate gift limited to $717,344.81. Presumptively the value of these policies at the date of the gift was the amount which the insured had expended to acquire them. Cost is cogent evidence of value. And here it is the only suggested criterion which reflects the value to the owner of the entire bundle of rights in a single-premium policy—the right to retain it as well as surrender it."

In *United States v. Ryerson*, decided at the same time, the insured had acquired single premium policies and retained them five or six years before the irrevocable assignment was made. At the time of the gift the cash surrender value was greater than the cost price, and the cost of replacement of the policies at the then age of the insured was greater than the cash surrender value. The Supreme Court held

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248 Id., 312 U. S. 254 at 257-258.
249 312 U. S. 260, 61 S. Ct. 479 (1941), reversing (C. C. A. 7th, 1940) 114 F. (2d) 150.
that the replacement cost at the time of the gift was the proper basis for valuation under the gift tax statute, saying:

"... We think that such cost of replacement, as held by the District Court, is the best available criterion of the value of the policies for the purposes of the gift tax. The elapse of time between issuance and assignment of the policies does not justify the substitution of the cash-surrender value for replacement cost as the criterion of value. We cannot assume with respondents that at the dates of the gifts the policies presumably had no insurance, as distinguished from investment, value to the donor. Here, as in the case where the issuance of the policies and their assignments as gifts are simultaneous, cash-surrender value reflects only a part of the value of the contracts. The cost of duplicating the policies at the dates of the gifts is, in the absence of more cogent evidence, the one criterion which reflects both their insurance and investment value to the owner at that time."

Powers v. Commissioner, the third case, merely affirmed the proposition that cost of replacement at the date of the gift was the criterion to be used for determination of value.

While all of these cases involved single premium contracts of insurance, it appears that the same result would follow in case of a fully paid insurance contract. But where the gift is of an ordinary life policy, or any insurance contract upon which premiums are being paid, the question remains unanswered.

(b) Where Premium Payments are to Continue After the Date of the Gift

Assuming that the continued payment of premiums by the insured is not sufficient to make the gift incomplete, the creation of the normal unfunded insurance trust would not involve the transfer of a fully paid policy, but would rather contemplate the continued payment of premiums by the insured-grantor. As indicated, the present regulations provide in such cases that the gift of the policy is measured by the interpolated terminal reserve value at the date of the gift plus the proportionate part of the gross premium last paid before the date

250 Id., 312 U. S. at 261.
252 See the language in Guggenheim v. Rasquin, 312 U. S. 254, 61 S. Ct. 507 (1941). See also 54 HARV. L. REV. 894 (1941), suggesting that a policy transferred after the insured had become uninsurable would have a still greater value to the insured.
of the gift which covers the period extending beyond that date, and indicate further that "valuation through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made." The Supreme Court cases above cited do not purport to pass upon the question of value of any other type of policy than those before the Court, but have this to say with regard to the administrative regulations:

"Petitioner, however, argues that cash-surrender value was made the measure of value by Article 2 (5), Treasury Regulations 79, promulgated October 30, 1933, which provided that the 'irrevocable assignment of a life insurance policy ... constitutes a gift in the amount of the net cash surrender value, if any, plus the prepaid insurance adjusted to the date of the gift.' The argument is that under this regulation the reserve in case of a single-premium policy covers the prepaid insurance and represents the entire value of the policy. The regulation is somewhat ambiguous. But in our view it applied only to policies upon which current premiums were still being paid at the date of the gift, not to single-premium policies. Accordingly, the problem here involves an interpretation of the meaning of 'value' in section 506, unaided by an interpretative regulation."

Whether this is an approval of the regulations as applied to policies upon which current premiums are still being paid is far from clear. It may well be that the opinions will result in an effort to assess a greater value to insurance policies where premiums remain to be paid. While the interpolated terminal reserve value may fairly be said to represent the investment value of a partly paid insurance contract, it seems clear that there is an insurance value to such a contract which under the present regulations is measured by the amount of premium paid to secure such insurance. The question will be whether the premium paid does or does not represent the "insurance" value. Any attempt to assess a greater value would certainly be contrary to the general provision for determining value, that is, the market value in a willing-buyer-willing-seller relation, since the premium is just the cost of

253 Treas. Reg. 79, art. 19 (9) (1936), and examples given.
256 The predecessor of present Treas. Reg. 79, art. 19 (9).
obtaining such insurance. It seems likely, therefore, that the regulations will continue to represent the method of assessing value of policies.

Where assignee or beneficiary contributes to the payment of premiums, that proportion of the value represented by the proportion of premiums paid by the beneficiary or assignee will be excluded from the gift.\(^{257}\) But where premiums are paid by the insured from community funds (in a community property state), the entire value of the contract at the date of the gift is considered the value of the gift.\(^{258}\)

2. Funded Trusts

In the funded trust, in addition to the life insurance policies, the grantor transfers income-producing property to the trustee, the income from which is to be utilized to pay the premiums on the insurance. Until recently there appears to have been no dispute over the inclusion of the value of these securities under the gift tax statute. However, it should be remembered that such of the income used to pay the premiums on insurance on the grantor's life is taxable to the grantor.\(^{259}\) If the securities are thus considered "owned" by the grantor to the extent of taxing him on the income, should they not be considered as still owned by him and excluded from the gift tax? This argument was made successfully before the Board of Tax Appeals in the recent case of *Martin Beck.*\(^{260}\) There the taxpayer had created an irrevocable funded insurance trust, transferring securities of a value of $172,000 and seven policies of insurance. The income from the securities was to be used to pay premiums on the insurance, and any balance was to be distributed to the wife and daughters of the grantor who were also beneficiaries of the trust after the death of the taxpayer. The trust was to continue during the lives of the wife and daughters, with remainders over, with no possibility of reversion to the grantor. The taxpayer reported the total value of the securities and the insurance policies, but deducted therefrom $49,926.65, which he claimed was the capitalized value of the income necessary to pay the premiums during his life, based on the amount of annual premiums and the life expectancy of the insured-grantor. The commissioner objected to the


\(^{260}\) 43 B. T. A., No. 23 (1940).
deduction, but the board agreed with the taxpayer and permitted it. The board, after noting that the income was taxable to the grantor under the statute and the authority of the *Wells* case, said: 261

"The Court in the *Wells* case reached the conclusion that the insured in such cases, by providing that the income of the trust shall be used to pay premiums on policies of insurance on his own life, has reserved to himself economic benefits in the property. If those benefits are of sufficient importance to justify taxation to him of the income used to pay the premiums, then it is difficult to see why they are not of sufficient importance to prevent the imposition of a gift tax. 262 In other words, the petitioner in effect reserved to himself a life estate in the income sufficient to pay the premiums on his contracts of insurance. . . . We have seen that the value of a retained life estate must be subtracted before the value of the taxable gift can be determined. It follows that the present petitioner made a gift of less than the total value of the securities and insurance policies at the time of the transfer."

The reasoning of the board would appear to be sound if an exact correlation is to be reached between the gift tax and the income tax as well as between the gift tax and the estate tax. It should be noted, of course, that the board reserved the question whether the annual payments of premiums made from the income of the trust would be considered gifts in themselves, just as annual payments of premiums are considered gifts when they are made directly by the insured and not by means of the funded trust. 263 This would appear to be a natural consequence of such a holding, since if such income is "owned" by the grantor and expended for insurance, the fruits of which are irrevocably assigned to another, such expenditure is a gift to the one who will receive the fruits. 264

261 Id. at p. 4.
262 A footnote at this point reads: "The case of Commissioner v. Krebs [(C. C. A. 3d, 1937) 90 F. (2d) 880] would appear on its face to be to the contrary, but the question now decided and the possible effect of the Wells case were not considered in the Krebs case. See also J. C. Hormel [39 B. T. A. 244 (1939), revd. Helvering v. Hormel, (C. C. A. 8th, 1940) 111 F. (2d) 1, cert. granted 311 U. S. 626, 61 S. Ct. 35 (1940)], where the Commissioner conceded that the gift tax was due only in case the income was not taxable to the grantor." The decision of the circuit court in the Hormel case was later affirmed. Hormel v. Helvering, 312 U. S. 552, 61 S. Ct. 719 (1941).
263 See footnote 2 in the opinion in Martin Beck, 43 B. T. A., No. 23 (1940).
D. Deductions

Until 1938, a taxpayer was entitled, in the case of a gift made in trust, to his specific deduction of $40,000;\(^{265}\) in addition the first $5,000 of any gift made to a person (except future interests in property) was not included in determining the net taxable gift.\(^{266}\) These deductions would apply as well to insurance trusts as to trusts of other property. Among the questions which arose under this latter provision were: (1) Where there are several beneficiaries of a trust, is the taxpayer entitled to a deduction for each beneficiary, or entitled to only one deduction for the gift to the trust? (2) Where there are multiple trusts, each for the same beneficiary, is the taxpayer entitled to a deduction for each trust or only for the beneficiary? Both these questions involve merely the problem who is the donee of a gift in trust—the trustee or the beneficiary; but strangely enough cases arose holding in favor of the taxpayer in both instances, allowing deductions for each beneficiary,\(^{267}\) and allowing deductions for separate trusts for the same beneficiary.\(^{268}\) It has now been resolved by the Supreme Court that the

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\(^{265}\) Sec. 505, Revenue Act of 1932, 47 Stat. L. 247: “In computing net gifts for any calendar year there shall be allowed as deductions: (a) in the case of a citizen or resident—(1) An exemption of $50,000, less the aggregate of the amounts claimed and allowed as specific exemption for preceding calendar years.” This amount was reduced to $40,000 by § 301 (b), Revenue Act of 1935, 49 Stat. L. 1025.

\(^{266}\) Sec. 504 (b), Revenue Act of 1932, 47 Stat. L. 247: “In the case of gifts (other than of future interests in property) made to any person by the donor during the calendar year, the first $5,000 of such gifts to such person shall not, for the purposes of subsection (a), be included in the total amount of gifts made during such year.” (Amended by § 505, Revenue Act of 1938, 52 Stat. L. 565, denying the exclusion to gifts in trust and reducing the amount to $4,000.)


\(^{268}\) Commissioner v. Wells, (C. A. 7th, 1937) 88 F. (2d) 339; Commissioner v. Krebs, (C. A. 3d, 1937) 90 F. (2d) 880 at 881, stating: “Inasmuch as the term ‘person’ is defined by section 1111 of the act to include a trust or estate the trust estates here involved must be held to be those persons to whom the gifts were made within the meaning of section 504 (b).” See also Edwin B. Cox, 38 B. T. A. 865 (1938).
beneficiaries of the trust are the real donees of a gift in trust.269 For gifts made at the present time, however, no such questions will arise, due to an amendment introduced by the Revenue Act of 1938, which, in addition to lowering the deduction to $4,000, provided that no deduction was to be allowed in cases of gifts to trusts.270 The Senate Committee on Finance, in introducing the amendment said: 271

"... The Board of Tax Appeals and several of the Federal courts have held, with respect to gifts in trust, that the trust entities were the donees and on that account the gifts were of present and not of future interests. The statute, as thus construed, affords ready means of tax avoidance, since a donor may create any number of trusts in the same year in favor of the same beneficiary with a $5,000 exclusion applying to each trust, whereas the gifts, if made otherwise than in trust, would in no case be subject to more than a single exclusion of $5,000."

Thus, for gifts made after 1938, if the gift is made by way of an inter vivos trust, no deduction of the first $4,000 is permitted. Only the specific exemption of $40,000 is accessible to the creator of a trust.272

The two major conclusions which may be drawn from the foregoing discussion appear somewhat contradictory, but are nevertheless conclusions faced by every attorney who seeks to advise a client concerning the advisability of creating or the provisions to be included in an insurance trust.

The first is very nearly a truism: no one can or should recommend or attempt to draft an insurance trust agreement without a thorough-going knowledge of the tax consequences of each particular provision. The present laws and administrative regulations, interpreted by hundreds of judicial decisions, leave open to the intelligent estate planner numerous ways of lightening the taxpayer's burden. The counsellor's

But see the three cases decided by the Supreme Court on March 3, 1941: Helvering v. Hutchings, 312 U. S. 393, 61 S. Ct. 653 (1941); United States v. Pelzer, 312 U. S. 399, 61 S. Ct. 659 (1941); and United States v. Ryerson, 312 U. S. 405, 61 S. Ct. 479 (1941).

269 See the three Supreme Court cases cited supra, note 268.
271 S. Rep. 1567, 75th Cong. 3d sess. (1941), p. 41. It might also be noted that the original bill introduced in the House had recommended that the deduction be reduced to $3,000 (H. Rep. 1860, p. 61), which figure was raised to $4,000 in joint conference after the Senate had reinstated the $5,000 deduction.
272 I. R. C. (1939), § 1004. An attempt was made by the Committee on Ways and Means in 1938 to combine this exemption with the $40,000 estate tax exemption and permit only one $40,000 exemption on either gift tax or estate tax. H. Rep. 1860, 75th Cong., 3d sess. (1938), p. 60.
task is to be constantly aware of the methods which have been legis­
latively or judicially approved for reaching this result.

The second conclusion is this: despite their importance, tax con­
siderations must frequently yield to other desires of the creator of the
insurance trust. It is clear that the real justification, the real basis for
establishing an insurance trust lies in the efficacy with which such a
property arrangement can serve to create or preserve an estate or to
provide for dependents. These ends must first be attained. That the
best laid plan for tax avoidance can be rendered nugatory overnight, by
a statute, judicial decision, or administrative action, must be evident
from the foregoing pages. Faced with this prospect, it would be folly
to upset the wishes of the grantor of the trust solely for the purpose
of saving taxes. That is, if a choice must be made between provisions
which may lessen tax liability and provisions which will clearly effec­
tuate the beneficent purposes sought by the creator of the trust, the
latter must prevail.