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FEDERAL TAXATION OF LIFE INSURANCE WEALTH

R. Dale Swihart†

Life insurance constitutes one of the most favored, as well as one of the most complex, forms of holding wealth. The favored treatment is given, *inter alia*, in the federal Bankruptcy Act, state inheritance acts, state exemption statutes, and the federal taxing statutes. Tax and insurance literature published since the passage of the 1954 Internal Revenue Code is replete with labors of love pleading that insurance is the panacea for the problems of the estate planner. Recent Congressional

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1. 11 U.S.C. § 110a(5) (1958) provides the following proviso: "That when any bankrupt, who is a natural person, shall have any insurance policy which has a cash surrender value payable to himself, his estate, or personal representatives, he may, within thirty days after the cash surrender value has been ascertained and stated to the trustee by the company issuing the same, pay or secure to the trustee the sum so ascertained and stated, and continue to hold, own, and carry such policy free from the claims of the creditors participating in the distribution of his estate under the bankruptcy proceedings, otherwise the policy shall pass to the trustee as assets." This proviso is analyzed and the courts' use of it is discussed in Countryman, *For a New Exemption Policy in Bankruptcy*, 14 Rutgers L. Rev. 678, 732-38 (1960).

2. For example, IND. ANN. STAT. § 7-2401 (Burns 1953) provides: "Proceeds of life insurance policies on the life of a decedent payable in such a manner as to be subject to claims against his estate and to distribution as a part thereof shall be hereunder held to be a part of the estate, but payable either directly or in trust for the use of any person or persons other than the estate so that it does not become a part thereof or subject to such claims, said proceeds shall not be taxed."


5. See, among a myriad of others, Hoxie, *Four Uses of Life Insurance: Tax Favored Features for Estate Planning*, 99 Trusts & Estates 722 (1960); Hammer, *The Role of Life Insurance*, 9 U. Fla. L. Rev. 442 (1956); Katz, *Life Insurance: Tax Treatment and Planning*, 35 Mich. S.B.J. 85 (March 1956); and Lawthers, *Federal Tax Consequences of Life Insurance in Buy and Sell Agreements*, 8 Tulane Tax Inst. 78 (1959). But voices have been raised in dissent to the proposition that life insurance is the ultimate weapon in the estate planner's arsenal. For what is perhaps the best job of sticking the pin in the balloon, see Wilkinson, *Life Insurance and Estate Planning Tax Aspects*, 38 Texas L. Rev. 167, 191-97 (1959). Professor Wilkinson concludes: "after a thoughtful analysis, that most of the tax benefits claimed for life insurance fall into one of three categories. They may be illusory; the use of life insurance may be the improper vehicle for securing the tax advantage; and finally "when the purported benefits actually..."
hearings dealing with the problems of the taxing base and taxes as a stimulant or depressant to economic development have produced recommendations by panelists to decrease the favoritism granted to life insurance wealth. In haphazard fashion, federal courts have rendered tax decisions both favorable and unfavorable to life insurance wealth. The thread of uniformity in these cases has been the disregard of the reality of the insurance investment, and the reliance on the form of the insurance contract as the criterion for decision.

The complexity of the insurance form of holding wealth arises from the multitude of policy provisions and combinations of investment and pure insurance which are available in individual life insurance contracts. A policy may represent little economic wealth to the owner and his family one day and a considerable addition to family wealth the next. The investment represented by the insurance policy is often confused with the policy itself. This complexity very likely accounts for certain of the favored provisions appearing in the Internal Revenue Code and for the courts’ difficulties in applying the Code provisions.

exist, they may merely represent one side of the enhanced gamble inherent in life insurance."


7. Among others Paul, Erosion of the Tax Base and Rate Structure, FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY, supra note 6, at 301 and Surrey, The Federal Income Tax Base for Individuals, TAX REVISION COMPENDIUM, supra note 6, at 6.

8. For a detailed discussion of the various provisions which may be included in a life insurance policy, see Krueger and Waggoner, THE LIFE INSURANCE POLICY CONTRACT (1953).

9. These combinations also vary over the life of an individual policy. See Table 9 in Vickrey, AGENDA FOR PROGRESSIVE TAXATION 410-11 (1947) which shows the breakdown of premiums into expenses, savings, and amount needed for current protection, as well as interest earned and cash surrender values for a sample policy over a 75 year span.

10. On the other hand, of course, the policyholder may suffer real economic loss if the premiums he pays and the interest that amount would have earned in another form of investment exceed the face value of the policy. See Wilkinson, supra note 5, at 191-92.

11. In only one area of the taxation of life insurance have the courts been willing to look beyond the contract to the investment. In the leading case on the valuation of life insurance for gift tax purposes, Guggenheim v. Rasquin, 312 U.S. 254, 257 (1941) the Supreme Court observed:

Surrender of a policy represents only one of the rights of the insured or beneficiary . . . . 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. . . . All of the economic benefits of a policy must be taken into consideration . . . . To single out one and to disregard the other is in effect to substitute a different property interest for the one which was the subject of the gift.
Wealth held in the form of life insurance may be analyzed from the point of view of each of the three elements of the life insurance transaction—the premiums paid, the investment and the proceeds.\textsuperscript{12} Amounts paid as premiums are divided among the principal of the investment which accrues interest until the time the policy matures, the amounts for current insurance protection and the amounts to cover cost and profit\textsuperscript{13} for the company. The investment itself, before maturity, represents the capital invested, the interest accretions and the right to pass on at death the face value or the right during life to surrender for cash value.\textsuperscript{14} The proceeds at maturity represent the amount of the investment, the interest earned on the investment and pure insurance gain or loss.\textsuperscript{15} It is submitted that difficulties in analysis arise when Congress and the courts overlook these three components of the insurance transaction and look to the forms of individual insurance contracts.

I. \textsc{Present Statutory Structure of Federal Life Insurance Taxation With Proposed Changes}

A. \textit{Policy Considerations.}

Two basic notions—equality and ability to pay\textsuperscript{16}—form the theoretical touchstones for the structure of the Internal Revenue Code. Although the concepts are interrelated,\textsuperscript{17} they may be distinguished as

\begin{itemize}
\item \textsuperscript{12} See \textsc{Vickrey, op. cit. supra} note 9, at 407-16.
\item \textsuperscript{13} A majority of life insurance investments are made in mutual companies. Mutual companies make surplus distributions only to their policyholders, and in this sense the companies operate on a non-profit basis. See \textsc{Krueger and Wagoner, op. cit. supra} note 8, at 250.
\item \textsuperscript{14} The text discussion assumes a whole life policy. If the insurance is term insurance the investment features discussed are usually lacking; however, most term policies contain a clause granting a right to convert into permanent insurance, and therefore are not completely non-investment policies. For a discussion of various types of insurance policies see \textsc{Patterson and Young, Cases and Materials on the Law of Insurance 718-22 (4th ed. 1961)}.
\item \textsuperscript{15} Gain accrues when the amounts held by the company as principal and the interest on those amounts do not total as much as the face value paid. Loss is suffered when those amounts exceed the face value of the policy.
\item \textsuperscript{16} For a study of the history of our progressive tax system see \textsc{Paul, Taxation in the United States 714-64 (1954)}.
\item \textsuperscript{17} Actually "interrelated" may be somewhat misleading. The concept of equality is the primary theoretical basis, while ability to pay is a secondary construct. The concept of equality could be complied with if all persons regardless of amount of income had included in gross income all economic income and then were taxed at a level rate. The construct of ability to pay divides "all persons" into groups with the equality of treatment then applied to all those falling within the particular group. \textsc{Alf Ross} has discussed this problem as follows:
\begin{quote}
It does not amount to much to maintain that wages shall be apportioned equally, taxes assessed equally. These are empty formulae unless it is further determined by what criteria 'equally' shall be determined. . . . The ideal of equality
\end{quote}
\end{itemize}
follows. The concept of tax equality is implemented by imposing approximately the same tax on persons who are similarly situated in relation to economic goods.\textsuperscript{18} Ability to pay is recognized by the ascending tax rate on levels of taxable incomes, gifts and estates.\textsuperscript{19} Subsumed by these notions are a range of value judgments which are beyond the range of the discussion in this article.\textsuperscript{20}

A uniform taxing base lends substance to the theory.\textsuperscript{21} Whenever the tax base is narrowed by exceptions and exclusions the tax structure does not adhere to the fundamental notions upon which it rests. For example, when income is excluded from one person's taxable income because it is derived from interest on an insurance investment\textsuperscript{22} or interest on municipal bonds\textsuperscript{23} and income is included in another person's gross income because it is from a non-preferred source, the same tax rate is not applied to individuals situated similarly in relation to economic

as such therefore simply means the correct application of a general rule (irrespective of which one). The general concepts or characteristics employed in the rule define a certain class of persons (or situations) with regard to whom a certain treatment shall take place. The equal treatment of all those within this class is then simply the necessary consequence of the correct application of the rule.


18. The fact that the equality is implemented by imposing the tax equally upon groups (persons similarly situated in relation to economic goods) does not seem to be a necessary criterion for equality. The formation of the groups on the basis of the similarity of economic gains of those within the particular class or group depends on the second construct—ability to pay.

19. The value judgment underlying ability to pay rests upon the hypothesis that as income increases it is easier for the taxpayer to spend a greater proportion of his dollar for taxes. Thus, the progressive tax is not proportional; as income increases the rate is increased at higher and higher levels. A man may pay more than twice as much tax when he earns twice as much income. "In this context ability to pay is the inverse of sacrifice, and a declining value for money up the scale of acquisition is part of the ability to pay doctrine." \textbf{PAUL, op. cit. supra} note 16 at 737-38.

20. Compare the statements of Ross, \textit{supra} note 17 with Edmond Cahn's analysis: "Through progressive taxation of economic relations, governments apply that proportionateness which Aristotle found the true substance of justice. \textit{The equality here is that of an ascending rate series.}" [emphasis added]. \textbf{CAHN, THE SENSE OF INJUSTICE} 40 (1949). I have great difficulty justifying the ability to pay doctrine on the grounds of equality, unless the equality sought is the equal distribution of wealth throughout the society. The ability to pay doctrine rests upon the value judgment that there should be a redistribution of wealth, and the comment that the ascending rate series results in an equality in \textit{taxation} is nonsense. The two touchstones rest on different value judgments: the group lines are formed by the ability to pay doctrine in order to redistribute the wealth; within the groups thus formed the principle of equality is applied to the individuals within each of the groups.

21. Note that it is essential to have a uniform taxing base to have equality of taxation within the groups, and further, it is necessary for redistribution of wealth between groups.

22. See \textit{infra} note 31, and accompanying text.

23. \textbf{INT. REV. CODE OF 1954, § 103.}
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There is inequality in the application of the tax, and the ascending rate does not function according to ability to pay.

As a practical matter, the tax structure is manipulated by the federal government to accomplish special goals other than the production of revenue. All too often these goals are sought by means which emasculate the basic theories underlying the taxing structure. Nevertheless, it is unrealistic to think that Congress will abandon all exclusions and deductions in favor of tax credits and an averaging system. In the absence of a sweeping reform of the Internal Revenue Code to bring it in line uniformly with the theories upon which it rests, a searching analysis of each individual grant of special dispensation seems in order.

B. Income Taxation.

Presently, interest earned on the insurance investment escapes income taxation. The amount of current increment on the investment which escapes is considerable—estimated for a recent year to be 1.1 billion dollars. Furthermore, when the policy proceeds are paid, no inclusion of the accrued interest is made in the gross income of the owner or beneficiary. Section 101 of the 1954 Code also offers an escape from taxation of the first $1000 each year of the interest on insurance proceeds left in the hands of the insurer to be paid in installments to the beneficiary-spouse.

There is no special reason why interest earned on the life insurance investment escapes taxation. No overriding economic goal distinguishes interest earned on the life insurance investment from other kinds of interest which are expressly included in gross income by Section 61 of

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25. If Congress decides that a subsidy to the oil and gas industries is necessary, a direct subsidy with specific goals in mind and the limitations on the subsidy to force an accomplishment of those goals would be far better than an inefficient indirect subsidy through the depletion allowance. In the case of humanitarian deductions and exemptions "the income tax suffers from the fatal flaw... it doles out an upside-down subsidy that grows in value with the size of income." Heller, Some Observations on the Role and Reform of the Federal Income Tax, Tax Revision Compendium, supra note 6, at 181, 191. Thus, a specific tax credit for the aged, the blind, persons with dependents, etc., would accomplish the aid without the sacrifice of a uniform tax base and without the inequity inherent in the deduction-exemption system. Note that the dollar value of a $600 exclusion ranges from $120 to $546 depending upon the rate group within which the taxpayer falls, while the need for the subsidy is in inverse proportion.
26. The real need for an averaging system is to prevent income earned over a period of years from being included in a particular taxable year's gross income. An averaging system would eliminate the policy argument behind a capital gains rate for income from sale of assets. See Vickrey, op. cit. supra, note 9, at 417-27.
the 1954 Code. As a matter of fact, no special provision of the Code provides for the exclusion from gross income of the interest earned on the life insurance investment. The special treatment granted seems to have arisen in haphazard fashion, rather than as a result of an express judgment of Congress. As a matter of sound taxing policy the interest earned on an investment in life insurance should be taxed in the same manner as interest earned on other types of investments.

There are several deterrents to taxing the interest as it accrues. Separating the investment principal and the interest from the costs of pure insurance and overhead for each individual policyholder is difficult. If the task were imposed on the company to make the separation for each individual policyholder it would be time consuming and expensive. If the individual were forced to compute for himself, many erroneous computations and failures to include at all would result. Finally, the difficulty in passing the necessary statutory provision over the objections of a powerful lobby may be not only difficult, but doomed from the outset. Undoubtedly the best way to handle these problems is to institute a withholding scheme, and place the burden on the insurance company to make the necessary computation. The interest computation for ease of administration might be the interest figure assumed by the company in the determination of premiums. In the absence of a withholding procedure the individual policy holder would be required to obtain the interest figure from the company. Under any scheme, the administrative chore for the company would be far from slight; however, the withholding plan presently in operation causes expense to employers, and there is no reason that insurance companies cannot absorb the cost in overhead as is true of employers presently withholding from wages.

If the owner of the policy has been taxed on the interest as it accrued, obviously no inclusion of that interest should be made when the policy matures. The exclusion of $1,000 of interest per year by the

32. Nevertheless, the job is not overly difficult or burdensome. The companies already have set up certain procedures for determining the policyholders' contribution to the surplus on hand for distribution through dividends. See Krueger and Waggoner, op. cit. supra note 8, at 250-63.
34. Except the last problem, for which there is no real answer except, perhaps, an informed Congress.
35. Surrey has suggested the withholding of life insurance interest as a part of a general program of interest withholding. Surrey, op. cit. supra note 7, at 6.
36. The actual rate of interest earned by a mutual company during the preceding year could be used. In the case of stock companies the statutory rate would be used.
beneficiary-spouse, however, is an exclusion of interest earned after the death of the insured. The exclusion is undoubtedly intended to aid the widow when financial troubles may be heaped on her distress at the husband's death. But there are better means to aid surviving spouses, and those who are not beneficiaries of insurance policies are probably in more financial trouble. The fairer procedure to follow in granting a subsidy to widows is a tax credit of a specific sum for a certain period of years after the husband's death.

One of the most critical problems is whether at the death of the insured the excess of the face value over the principal and interest should be included in gross income. Under the present provisions of the Code, regardless of who owns the policy, this amount escapes income taxation.

In order to determine whether this amount should be included it is essential that the insurance transaction be analyzed as an investment.

The use of insurance as an investment by the owner should not be treated differently than investments in other forms. An investment in land which is held at death by the investor receives a stepped-up basis in the hands of the devisee, but if a gift of the land is made by the owner-decedent before his death no stepped-up basis is received unless the gift was made in contemplation of death.

The same type of treatment should be accorded life insurance.

37. Int. Rev. Code of 1954, § 101(d)(1) provides "The amounts held by an insurer with respect to any beneficiary shall be prorated . . . over the period or periods with respect to which such payments are to be made. There shall be excluded from the gross income of such beneficiary in the taxable year received—(A) any amount determined by such proration, and (B) in the case of the surviving spouse of the insured, that portion of the excess of the amounts received under one or more agreements specified in paragraph (2)(A) [which defines an amount held by an insurer] . . . over the amount determined in subparagraph (A) of this paragraph which is not greater than $1000 with respect to any insured."

38. Int. Rev. Code of 1954, § 101(a)(1) provides: "Except as otherwise provided in paragraph (2) [where transfer of insurance policy was for valuable consideration] and in subsection (d) [when amount is held by insurer for period after death of insured], gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured."

39. Professor William Vickrey has suggested that life insurance should be treated much as crop or accident and health insurance, so the premiums paid would be deductible expense, except for the amount accumulated as savings; the policy holder would have the interest on the savings included in his gross income as it accrues; and the beneficiary would include in his gross income the difference between the face value and the investment component of the insurance. Vickrey suggests an avrging device for the inclusion in the beneficiary's gross income so inclusion of a pro rata amount would be made during the remaining actuarial life expectancy of the insured-decedent. Vickrey, Agenda for Progressive Taxation 64-67 (1947).


There are three types of fact patterns which may occur at the death of the insured. These may be discussed more easily by using the following cast of characters: B is the beneficiary; C is the insured (the cestui que vie) and O is an owner who is neither the insured nor the beneficiary. Under present Code provisions, in the absence of a transfer-for-value, no income tax consequences ensue regardless of who owns the policy at the date of C’s death. Thus, unlike other investments, a stepped-up basis is allowed the insurance investment whether or not the value of the property is included in C’s gross estate. There is no cogent reason for this favored treatment of the insurance method of holding wealth. In the two cases where B or O own the insurance policy at the date of C’s death, income tax consequences should apply. As in the case of other kinds of investments, these consequences under our present tax structure should be capital gain. If B is the owner of the policy at the death of C the Internal Revenue Code should force B to recognize capital gain in the amount of the difference between the face value of the proceeds and his basis in the policy. If O is the owner of the policy the same income tax consequences should apply. If C is the owner of the policy the stepped-up basis rule should be effective, and thus no capital gain.

If the life insurance transaction is taxed as an investment and capital gain or loss is to be computed, some method of arriving at a basis in the property needs to be determined. Clearly, the amount of the contribution to the reserve for the policy and the interest on that contribu-

43. INT. REV. CODE OF 1954, § 101(a) (2) provides “In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee. The preceding sentence shall not apply in the case of such a transfer—

(A) if such contract or interest therein has a basis for determining gain or loss in the hands of the transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or

(B) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.”

44. INT. REV. CODE OF 1954, § 101(a) (1). See note 38 supra.

45. The definition of capital gain in INT. REV. CODE OF 1954, § 1221 is clearly broad enough to encompass insurance policies. A special provision would be necessary to allow capital gain treatment, since the maturing of the policy would not comply with the requirement of a “sale or exchange.” INT. REV. CODE OF 1954, § 1222. Since the death of the decedent is the event which determines gain or loss on the life insurance policy, the maturing of the policy at that time should be considered a sale or exchange of the policy.

46. Even in the absence of § 101, this result would be reached under § 1014(b) (9) of the 1954 Code.

47. Since this is the investment basis, the total amount paid as premiums would not suffice.
tion (upon which income tax has been paid) should be included in the basis. The difficult question is whether the amount devoted to current insurance protection and the amount siphoned off to pay for company overhead should be included in determining basis. The amount paid for company cost and profit should be included in determining basis, in the same manner as broker’s fees are added to the basis for an investment in stock.\textsuperscript{48} The amount paid for current insurance protection, however, bears more resemblance to a current personal expense\textsuperscript{49} than it does to an investment cost, and for this reason should not be included in basis. In summary, the basis for the investment should be determined by adding (1) the premiums paid (less the amount paid for current pure insurance protection) and (2) interest on the investment which has been included in gross income by the owner.

Section 101 of the 1954 Code provides that if a life insurance policy is transferred for valuable consideration the general rule excluding from gross income amounts paid under a life insurance contract, by reason of the death of the insured, does not apply.\textsuperscript{50} The transfer-for-value rule appears to be an attempt by Congress to limit the tax favoritism to intra-family transfers of life insurance\textsuperscript{51} as the rule does not apply when a gift is made, and ordinarily such a gift will occur only within the family.\textsuperscript{52} Also excepted under the rule are transfers to a partner of the insured, a partnership of which the insured is a partner, a corporation in which the insured is a shareholder or officer\textsuperscript{53} and to transfers in connection with tax exempt reorganizations.\textsuperscript{54} Under the proposal made here no transfer-for-value rule would be appropriate, since any

\textsuperscript{48} INT. REV. CODE OF 1954, § 1016(a) (1). Some amount of these charges are properly allocable to current pure insurance protection. Therefore, the full amount should not be allowed in adjusting basis. Since the job of allocating is somewhat guesswork, and the amount is not overly significant, it seems, nevertheless, best to allow the full amount in adjusting basis.

\textsuperscript{49} No part of this amount is added to the individual insurance contract investment, or is needed to fund the payment which would be made should the insured survive his actuarial life-span. The amount is needed to fund a reserve to meet the costs of paying proceeds on contracts where the insureds have not survived their actuarial life-spans. The individual insured joins other in a joint reserve to meet these latter payments of proceeds. See VICKREY, op. cit. supra note 39, at 410-11, for a table illustrating the composition of insurance premiums and proceeds.

\textsuperscript{50} INT. REV. CODE OF 1954, § 101(a) (2). See note 43 supra. See the discussion of the rule in Bowe, Tax Problems in Ownership of Life Insurance Contracts by Persons Other than the Insured, 49 GEO. LJ. 1, 10-13 (1960).

\textsuperscript{51} Although even when a gift is intended within the family the transfer-for-value rule may be applicable. Bowe suggests that the rule should be applied only when there is a transfer to a person with no insurable interest in the insured. Id. at 11.

\textsuperscript{52} INT. REV. CODE OF 1954, § 101(a) (2) (B). See note 43 supra.

\textsuperscript{53} INT. REV. CODE OF 1954, §101(a) (2) (A). See note 43 supra.
owner of the policy at the death of the insured, except the insured himself, would be subject to capital gain or loss treatment.

C. Gift Taxation.

When a life insurance policy is irrevocably transferred the gift tax provisions of the Internal Revenue Code are applicable, and when the owner of the policy is neither the insured nor the beneficiary, as a general rule, there is a gift of the proceeds to the beneficiary from the owner when the insured dies. Life insurance is accorded the same tax treatment as other property in the application of the gift tax, but the valuation problems which arise are somewhat more complex. Generally the value of a gift of life insurance is the replacement cost of the policy. This value is not the cost to the transferor nor the cash sur-

55. Note it is the owner who recognizes the gain or loss, not the beneficiary (unless he is also the owner). The owner holds the investment and should be the one to recognize the gain or loss even though the proceeds are payable to the beneficiary. In this situation, the owner will also be subject to payment of a gift tax, as well as being subject to the capital gain or loss treatment. See note 59 infra, and accompanying text.


57. Int. Rev. Code of 1954, § 2511. The Gift Tax Regulations state: "If the insured purchases a life insurance policy, or pays a premium on a previously issued policy, the proceeds of which are payable to a beneficiary or beneficiaries other than his estate, and with respect to which the insured retains no reversionary interest in himself or his estate and no power to re vest the economic benefits in himself or his estate or to change the beneficiaries or their proportionate benefits (or if the insured relinquishes by assignment, by designation of a new beneficiary or otherwise, every such power that was retained in a previously issued policy), the insured has made a gift of the value of the policy, or to the extent of the premium paid, even though the right of the assignee or beneficiary to receive the benefits is conditioned upon his surviving the insured." Treas. Reg. § 25.2511-1(h)(8) (1958), as amended, T.D. 6542, 1961 Int. Rev. Bull. No. 12, at 8.

58. Int. Rev. Code of 1954, § 2511. The Gift Tax Regulations provide that "the gift tax also applies to gifts indirectly made. Thus, all transactions whereby property or property rights or interests are gratuitously passed or conferred upon another, regardless of the means or device employed, constitute gifts subject to tax." Treas. Reg. § 25.2511-1(c) (1958), as amended, T.D. 6542, 1961 Int. Rev. Bull. No. 12, at 8. In Goodman v. Commissioner, 156 F.2d 218 (2d Cir. 1946), the taxpayer created a revocable trust and transferred, inter alia, certain policies of insurance to the trust. The power of revocation was reserved during the taxpayer's husband's life. When he died the Commissioner contended the face value of the policies were a completed gift to the beneficiaries of the trust. The court held for the Commissioner on the grounds that when the husband died the gift was complete and the policies matured. Therefore, the death of the husband had several consequences; "it instantaneously terminated the taxpayer's power to revoke her trust and therefore perfected the gift, and it also matured the policies of insurance upon his life." Goodman v. Commissioner, supra at 219.


60. See Guggenheim v. Rasquin, 312 U.S. 254 (1941). See the quotation from the case in note 11 supra.

61. "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 by the company of comparable contracts. As valua-
render value of the policy;" rather it is the amount necessary to purchase a similar policy on the date of the transfer. If this amount is impossible to determine, the value of the gift is the interpolated terminal reserve value of the policy. The rationale underlying the imposition of the gift tax on transfers of life insurance is proper. The transfer is taxed as the transfer of an investment; thus, the issue in determining value is not the amount the owner could receive by cancelling the policy (cash surrender value) but the value of the investment (replacement cost or interpolated terminal reserve value).

D. Estate Taxation.

The provision for the inclusion of the value of life insurance proceeds in the gross estate has probably been subject to more alteration and confusion than has been engendered by any other provision in the history of the estate tax. Prior to 1942 the Code called for the inclusion of amounts received as insurance by the executor and amounts in excess of $40,000 receivable by all other beneficiaries of policies taken out by the decedent on his own life. The phrase "taken out by the decedent" was interpreted in many ways, including policies for which...
the decedent had signed the application; where the decedent owned the policies at death; and where the decedent paid the premiums on the policies. The Revenue Act of 1942 eliminated the phrase and the $40,000 exclusion and provided that the proceeds of all policies receivable by beneficiaries as insurance upon the life of the decedent would be included in the gross estate if the policies had been purchased with premiums paid directly or indirectly by the decedent or if the decedent had possessed at his death any of the incidents of ownership over the policy. In several cases litigated under the 1942 provision, the taxpayer contested the validity of including proceeds of policies which had been purchased with premiums paid by the decedent, but over which the decedent had retained no incidents of ownership. This constitutional objection was laid to rest by United States v. Manufacturers Nat'l Bank.

Section 2042 of the 1954 Code includes in the gross estate amounts receivable by the executor under policies on the life of the decedent, and amounts receivable by all other beneficiaries as insurance on the life of the decedent under policies with respect to which the decedent possessed at his death any incident or incidents of ownership. The

69. Seemingly this test was rejected by the Commissioner from the beginning. See Treas. Reg. 37 (1919) Art. 32, reprinted in Schlesinger, supra note 66, at 230.
70. See Paul, supra note 68, at 1046-47, and cases there cited.
71. See Schlesinger, supra note 66, at 230-35.
72. Int. Rev. Code of 1939, ch. 2, § 811(g), 53 Stat. 1, as amended by the Revenue Act of 1942 provided as follows:
(g) PROCEEDS OF LIFE INSURANCE.—
(1) RECEIVABLE BY THE EXECUTOR.—To the extent of the amount receivable by the executor as insurance under policies upon the life of the decedent.
(2) RECEIVABLE BY OTHER BENEFICIARIES.—To the extent of the amount receivable by all other beneficiaries as insurance under policies upon the life of the decedent (A) purchased with premiums, or other consideration, paid directly or indirectly by the decedent, in proportion that the amount so paid by the decedent bears to the total premiums paid for the insurance, or (B) with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. . . .
73. See especially Kohl v. United States, 226 F.2d 381 (7th Cir. 1955). Also see cases cited by the Supreme Court in United States v. Manufacturers National Bank, 363 U.S. 194, 197 (1960).
74. 363 U.S. 194 (1960). The following is the significant language of the Court: "Under the statute, the occasion for the tax is the maturing of the beneficiaries' right to the proceeds upon the death of the insured. . . . That disposition, which began with the payment of premiums by the insured, is completed by his death. His death creates a genuine enlargement of the beneficiaries' rights. It is the 'generating source' of the full value of the proceeds. . . . The maturing of the right to proceeds is therefore an appropriate occasion for taxing the transaction to the estate of the insured." 363 U.S. at 198-99.
75. Int. Rev. Code of 1954, § 2042 provides: "The value of the gross estate shall include the value of all property—
(1) RECEIVABLE BY THE EXECUTOR.—To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.
1954 Code eliminated the payment-of-premiums test, but various proposals have been made for Congress to re-introduce the payment-of-premiums test, and of course no unconstitutionality argument would lie should Congress do so. Before another change is made in the estate taxation of life insurance, however, a critical evaluation of the ends sought should be made. The problem, stated in the terms of the thesis of this article, is whether life insurance should be given estate tax treatment similar to that given other investments. As is true of

(2) Receivable by other Beneficiaries.—To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. . . .


78. Lowndes and Kramer beg the question by stating that "Life insurance should not be taxed like other property, because it is not like other property." Lowndes and Kramer, op. cit. supra note 64, at 280. In reality, what they seem to mean is, by transferring life insurance, estate tax advantages accrue which do not follow the transfer of other kinds of property; but their analysis falls under inspection. Three basic distinctions are accorded merit by Lowndes and Kramer: (1) The gift tax is less a deterrent to transfer of life insurance than it is to transfers of other property, since the tax is levied only on the replacement cost rather than the face value. The simple answer to this argument is that at the time the investment is transferred it is worth only what it costs to replace it; the fact that the transferee may build up its value by the payment of premiums does not retroactively increase the value at the time of transfer. The transfer of a $15,000 house with a $10,000 mortgage does not make the value of the transfer $15,000 because the transferee may make the mortgage payments. Nor does the gamble inherent in life insurance (see note 5 supra) increase the worth at the time of transfer; the total payments and interest earned may still exceed the face value of the policy. Lowndes and Kramer make the further statement that the replacement cost "in the case of a new policy will only be a minor fraction of the face amount of the policy." (1) Ibid. The value of the policy is obviously the cost to the transferor in the case of a new policy; its worth in the hands of the transferee is that cost—the transferee could have purchased the policy himself for that amount (assuming he has an insurable interest, which is more than likely). (2) The insured may be able to pay the premiums through gifts to the insured which do not exceed the annual exclusion. This is obviously true, but the amounts could also be used to purchase the policy (take out the policy) by the beneficiary. The fact that gifts are made to use up the annual exclusion and are used to pay premiums on insurance policies is no more argument for including the transferred insurance policies, than it would be for including stocks or bonds which were purchased with the gift. The only point made is that the estate tax may be circumvented by making annual gifts. (3) Finally, Lowndes and Kramer argue that it is easier to rid the gross estate of insurance through transfer than other property, since there is less possibility of loss of enjoyment through transfer of insurance policies. For medium income families (and lower income families) the loss of the loan value may make impossible the sending of children to college, the necessary cash to weather a serious illness or the meeting of the trauma of loss of income in later years. Naturally, in the high income families, the insurance policy may be transferred without noticeable loss of any enjoyment—but so might 1,000 shares of A.T.&T. Lowndes and Kramer make the statement: "A person does not purchase insurance on his life in order to use and enjoy it as he would an automobile." Ibid. This is true of any investment property; an investment is used to secure a return and to form a savings. Insurance is not unique in this
other investments, the purchaser of life insurance assumes a risk of loss or a possibility of gain. If the insured lives beyond a certain age the amount of premiums paid and the interest which would have accrued had the investment been made in another form of property will be greater than the face value of the policy, and an economic loss is suffered by the owner. On the other hand, should the insured die before the premiums paid and the interest thereon equal the face value of the policy, a gain is made by the owner. An investment in life insurance is subject to the same vagaries of gain or loss as other investments—the single difference is that the gain or loss depends upon the time of death of the insured and not upon market price variations.

Because the death of the insured is the critical element in determining gain or loss, the argument is often made that life insurance is really “death insurance,” and should not be given the same estate tax treatment as other investments. Thus, it is suggested that the insured should include in his gross estate the value of the proceeds if he owns the policy (and therefore holds the wealth at death) or if he provided the economic source of the wealth (through the payment of premiums). There are many persuasive arguments against this analysis. There are

regard. An attempt to differentiate insurance from other investments for estate tax purposes fails.

79. See note 5 supra.

80. See Bittker, supra note 76. In 1954 the Democratic minority of the House Ways and Means Committee made the following statement:

It is sought to justify this change [eliminating the payment of premiums] as merely putting life insurance on a par with other property which may be given away free from estate tax if the gift is not made “in contemplation of death.” But life insurance is not like other property. It is inherently testamentary in nature. It is designed, in effect, to serve as a will, regardless of its investment features. Where the insured has paid the premiums on life insurance for the purpose of adding to what he leaves behind at his death for his beneficiaries, the insurance proceeds should be included in his taxable estate.

We predict that if this provision becomes law, it will virtually do away with the estate taxation of life insurance. To avoid the tax, the insured need only assign the policy to his wife or other beneficiary. Since estates of less than $60,000 are nontaxable, only the wealthy will benefit.

H.R. REP. No. 1337, 83d Cong., 2d Sess. B14 (1954). A comment needs to be made about the statement that only the wealthy will benefit. Even if the premium-payment test were re-enacted, the wealthy would merely make an inter-vivos gift of some other property or investment. The imposition of unfavorable estate tax treatment on life insurance would, as a matter of fact, affect the wealthy least of all. For the middle income group, life insurance is probably the chief investment, and, therefore, an unfavorable rule for life insurance operates against that group. Further, life insurance is no more “inherently testamentary” than any savings, investment or asset which is not likely to be consumed during the life of the owner.

81. Schlesinger, supra note 66, at 246-51 suggests a composite test (as opposed to the either-or test of the 1942 Revenue Act) whereby the amount of the proceeds equal to the cash surrender value would be included only if the decedent possessed incidents of ownership at death, and the rest of the proceeds would be tested by the premium-payment theory.
other advantages in investing in an insurance policy besides assuring the family of some wealth at the insured's death. The utilization of the policy for loan purposes and the ready liquidity offered by the cash surrender value provision are examples. The life insurance policy is not exclusively a death-oriented instrument.\textsuperscript{82} Further, there are many other kinds of property purchased which, as a general rule, the owner does not intend to dispose of before his death such as the family home and the family business. There are many other occasions when the decedent has invested in other kinds of property with full intention to hold the property and pass it on to his family. Yet, with any of these other kinds of investments, if an inter-vivos, irrevocable and complete transfer is made there is no inclusion in the gross estate in the absence of the applicability of the contemplation of death section.\textsuperscript{83} Certainly if a transfer of life insurance was made by the decedent within the time when the contemplation of death presumption is raised,\textsuperscript{84} that provision should be used to determine whether there is an inclusion as it is in the case of transfers of other kinds of property and investments.

The present basis for inclusion of the value of life insurance in the gross estate is desirable. No clear reason appears for distinguishing life insurance from other investments.\textsuperscript{85} The inclusion of the value of life insurance because the decedent retained control over the economic value of the asset is proper. This places life insurance on an equal estate tax basis with other kinds of economic wealth—the desirable result.

II. TREATMENT OF THE TAXATION OF LIFE INSURANCE

By The Courts

A. The Insurance-Annuity, Trust-Annuity, Private Annuity Problem: The Emasculation of Section 2036.

Under the Revenue Act of 1926 Congress exempted from the gross

\textsuperscript{82} Bittker believes that the premium-payment test should be re-enacted since "it is basically an instrument for providing for one's heirs." Bittker, \textit{supra} note 76, at 868.

\textsuperscript{83} \textsc{Int. Rev. Code of 1954, § 2035.}

\textsuperscript{84} \textsc{Int. Rev. Code of 1954, § 2035(b).}

\textsuperscript{85} Except the preferential income tax treatment the transferee-owner receives. See Part (B) of this Section \textit{supra}. The income tax suggestions I have made earlier would very likely lessen the possibility of insurance policies being transferred in order to reduce the gross estate. If a paid-up policy were transferred in order to remove the investment from the gross estate, of course, the income tax treatment suggested would not be a deterrent. The real difficulty in that case, it is submitted, is the failure of Congress to correlate the gift and estate taxes. As a matter of sound policy, taxable gifts made and the gross estate should be combined and taxed in a progressive rate scale together.
estate $40,000 of proceeds of policies taken out by the decedent on his own life received "as insurance" by beneficiaries other than the decedent's estate. In Helvering v. LeGierse, the Supreme Court construed the phrase "as insurance" not to refer to proceeds of an insurance contract purchased in concert with an annuity contract in order to eliminate the element of insurance risk ordinarily carried by the company. Although the decedent in LeGierse was eighty years of age when she executed the single-premium life insurance contract and the single-premium annuity contract, she was not required to take a physical examination. In all respects but one the contracts were separate, with independent applications, premium computations and payments, and reserves. The insurance policy, however, would not have been issued without the purchase of the annuity contract. The Court made two precise holdings in LeGierse. Since the element of risk necessary to call a transaction "insurance" was absent, the proceeds were not received "as insurance" by the beneficiary, and the exemption therefore would not be allowed; and, since the decedent had retained the insurance policies, the proceeds could only be enjoyed by the beneficiary at or after the decedent's death, so the proceeds would be included in the decedent's gross estate. Left unanswered by LeGierse was the effect of an inter-vivos transfer of the insurance policies by the decedent.

This question was answered by the Supreme Court in Fidelity-

86. See note 67 supra.
87. 312 U.S. 531 (1941). See also the companion case to LeGierse, Keller v. Commissioner, 312 U.S. 543 (1941).
88. In Commissioner v. Keller's Estate, 113 F.2d 833 (3d Cir. 1940), affirmed in the companion case to LeGierse, see note 87 supra, the court stated "It is plain in our estimation that Congress used the word 'insurance' with the economic rather than the purely contractual aspects of the term in mind. The statute prescribes an exemption prompted by a settled policy favoring the institution of life insurance." 113 F.2d at 835.
89. The Court stated about the "two independent contracts": "The two contracts must be considered together. To say they are distinct transactions is to ignore actuality, for it is conceded on all sides and was found as a fact by the Board of Tax Appeals that the 'insurance' policy would not have been issued without the annuity contract. Failure, even studious failure, in one contract to refer to the other cannot be controlling." 312 U.S. at 540.
90. "Considered together, the contracts wholly fail to spell out any element of insurance risk. It is true that the 'insurance' contract looks like an insurance policy, contains all the usual provisions of one, and could have been assigned or surrendered without annuity. Certainly the mere presence of the customary provisions does not create risk, and the fact that the policy could have been assigned is immaterial since, no matter who held the policy and the annuity, the two contracts, relating to the life of the one to whom they were originally issued, still counteracted each other . . . . Any risk that the prepayment would earn less than the amount paid to respondent as an annuity was an investment risk similar to the risk assumed by a bank; it was not an insurance risk as explained above." 312 U.S. at 541-42.
91. 312 U.S. at 542.
Philadelphia Trust Co. v. Smith.\textsuperscript{92} Essentially the facts were the same as in\textit{LeGierse}, except the decedent in\textit{Fidelity} had made an irrevocable and complete inter-vivos transfer of the life insurance policy.\textsuperscript{93} The Government sought to include the proceeds under the section of the revenue code which required the inclusion in the gross estate of the value of property transferred under which the decedent had retained for life the right to the income from the property.\textsuperscript{94} The district court\textsuperscript{95} found an inclusion improper since the annuity contract and the insurance policy were separable after they had been issued to the decedent.\textsuperscript{96} The court of appeals\textsuperscript{97} reversed, holding the inclusion proper since "the substance of the matter is that a capital fund—the premium—was deposited with the insurance company for a guaranteed annual return and repayment of the residue to beneficiaries on the death of the depositor."\textsuperscript{98} The Supreme Court reversed the court of appeals and held the inclusion improper since no amount of the annuity payments could be considered proceeds from the property represented by the transferred insurance policy.\textsuperscript{99} To make the case for inclusion, the Court argued, the Govern-

\textsuperscript{92} 356 U.S. 274 (1958).
\textsuperscript{93} Actually there were three life insurance policies and three annuity contracts, but for purposes of discussion one combination will be used.
\textsuperscript{94} Int. Rev. Code of 1939, ch. 2, § 811(c)(1)(B), 53 Stat. 1. This provision is now found in Int. Rev. Code of 1954, § 2036(a), which in its entirety reads as follows:

"(a) General Rule.—The value of the gross estate shall include the value of all property (except real property situated outside of the United States) to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or
(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

\textsuperscript{96} "The determination should rest upon the realities of the situation and the essential nature of the donee's ownership. The realities of the situation are that this decedent made investments which were not true insurance because no risk element to the insurer was involved. However, the life policies and annuity contracts were, on their faces, separate contracts and, while they must be read together to determine the realities, no valid reason is advanced by the defendant to hold that such an obligatory joint perusal welds them together permanently and indissolubly for all purposes." 142 F. Supp. at 567.
\textsuperscript{97} Fidelity-Philadelphia Trust Company v. Smith, 241 F.2d 690 (3d Cir. 1957).
\textsuperscript{98} 241 F.2d at 692.
\textsuperscript{99} "The annuities arose from personal obligations of the insurance companies which were in no way conditioned on the continued existence of the life insurance contracts. These periodic payments would have continued unimpaired and without diminution in size throughout the life of the insured even if the life insurance policies had been extinguished. Quite clearly the annuity payments arose solely from the annuity policies. The use and enjoyment of the annuity policies were entirely independent of the life insurance policies." 356 U.S. at 280-81.
ment had to show that the premiums of the two contracts were aggregated and the annuity payments derived as income from the entire investment. The Court indicated that this showing could not be made since annuity payments in the same amount could have been purchased separately for the same premium paid by the decedent. Although it is true, the Court admitted, that the insurance policy was dependent on the annuity policy for its existence, the same dependency was not true of the annuity policy. Since the annuity in fact was separate, the Court reasoned, payments under it could not be considered income from the total investment made by the decedent.

As a matter of substance, the annuity contract and the insurance policy were purchased by the decedent with a total investment of 110% of the face value of the insurance policy, with the face value of the insurance policy to be paid on the death of the decedent and the annuity to be paid for life. The face amount of the insurance policy determined the total cost of the investment, with the investment then divided into two amounts by the company—one allocated to the insurance policy and one to the annuity contract. A minimum level of annuity cost was dictated by the face value of the insurance policy. The annuity payments represented a return of approximately 2½% yearly on the total investment, after deducting the amount of overhead required by

100. "To establish its contention, the Government must aggregate the premiums of the annuity policies with those of the life insurance policies and establish that the annuity payments were derived as income from the entire investment." 356 U.S. at 280.

101. Compare this reasoning with the analysis of the Court in Helvering v. LeGierse, 312 U.S. 531 (1941). In LeGierse the Court clearly recognized the investment transaction for what it was—the prepayment of the face sum of the insurance policy, with interest payments from that face sum to be made as the annuity payments. "Here the total consideration was prepaid and exceeded the face value of the 'insurance' policy. The excess financed loading and other incidental charges. Any risk that the prepayment would earn less than the amount paid to respondent as an annuity was an investment risk similar to the risk assumed by a bank . . . ." 312 U.S. at 542.

102. Compare this analysis with the construction of the transaction viewed by the Third Circuit in the Keller case. See note 88 supra. "In other words, the sure thing (loan) is artificially separated into doubtful bet (life insurance) and hedge (annuity) . . . . That being so, we can detect no substantial economic distinction between the conjoint effect of the two policies issued, and that of an engagement to repay Mrs. Keller, or her order, $20,000 upon her death with interest at almost exactly 2½ per annum . . . . in the meantime." Commissioner v. Keller's Estate, 113 F.2d 833, 834-35 (3d Cir. 1940).

103. One of the single premium life insurance policies was purchased for a premium of $179,358 and had a face value of $200,000. The annuity was purchased for a premium of $40,642 and provided for annual payments of $5,026 for life. The two premiums added together total precisely $220,000 or 110% of the face value of the life insurance policy.

104. If the uninsurable applicant desired a $100,000 face value insurance policy, the total premiums of the two contracts would have to equal $110,000 (110% of the face value), which was true of a second policy and annuity contract taken out by the decedent in Fidelity.
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If the insurance policy were not surrendered for its cash value by its owner before the death of the decedent, the simple structure of the transaction would be a yearly payment to the decedent of \( 2\frac{1}{2}\% \) on the total investment, with the face amount of the investment, less company overhead costs, payable on the death of the decedent.\(^{106}\)

Rigid notions of "property," caused by a refusal to look at the investment, lead to the result in *Fidelity*. The Court concedes that the insurance-annuity combination was "the product of a single, integrated transaction,"\(^{107}\) this concession was necessary unless the Court was ready to overrule *LeGierse*. But *LeGierse* went further to hold that the insurance policy received from the company by the decedent was not an "insurance" policy for purposes of the estate tax; rather, it was a document representing certain rights resulting from the original integrated transaction. In *Fidelity* the court finds that after the initial transaction each of the indicia of property interest held by the decedent, i.e., the annuity contract and the insurance policy are not only divisible but actually are two separate items of property.\(^{108}\) This is completely unrealistic. Merely because the insurance company gives two contracts as documentation of the rights of the decedent in the original investment does not make the two pieces of paper two separate pieces of property; rather, the two contracts represent interests retained by the decedent in the original indivisible investment.\(^{109}\)

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105. See note 103 supra.
106. See note 102 supra.
108. In *Ogleheart v. Commissioner*, 174 F.2d 605 (7th Cir. 1949) the taxpayer had purchased single premium policies from the insurance company, paying the face value of the policy in return for annual payments and the right to payment of the fixed sum on surrender of the contract or payment of the fixed sum to designated beneficiaries upon his death. The issue before the court was whether the sums received annually were annuities. The court held "that the phrase, 'amounts received as an annuity,' as now used in Code Sec. 22(b)(2) has reference only to periodic payments which represent a combined return of capital and interest. The formula adopted was never intended to exempt payments which in their entirety represent interest and do not deplete the principal sum invested." 174 F.2d at 607. The *Fidelity* case is not distinguishable from *Igleheart* as long as the purchaser or transferee of the insurance policy retains the insurance policy. It is not until the policy is surrendered for cash value that any amount of principal is needed to meet the annuity payments.
109. In *Bohnen v. Harrison*, 199 F.2d 492 (7th Cir. 1952) the Seventh Circuit, in reaching a decision in accord with the Supreme Court's *Fidelity* decision, said: "Though the Supreme Court has decided that such an arrangement is in the nature of a single investment program . . . it does not follow that this investment program, made up of the two contracts, was indivisible." 199 F.2d at 493. Obviously, a division may be made on the basis of the interests in the original investment; one an interest (right) to receive income and the other was an interest in having the face value paid to the beneficiaries at death. Compare the *Bohnen* opinion with the *Igleheart* decision, note 108 supra. Precisely the same investment is made in both cases, but the Seventh Circuit comes to different conclusions based on the terms of the contracts, rather than the nature of the in-
the decedent after the company issues two contracts are still the income right and the right to pass to named beneficiaries the remainder.

It is submitted that the real difficulty which the Court encountered was a hypothetical possibility which was not presented by the facts in *Fidelity*. Suppose the transferee of the insurance policy had surrendered the policy for its cash value? Obviously the payments received by the decedent after that surrender could not be income from the total investment. In the case of the surrender of the policy, the payments to the decedent would come from the income earned on the part of the investment retained by the company plus a portion of the corpus of the investment itself. The court then points to a series of cases involving the private annuity in the lower courts, and lends implied approval to the notion that in order to have "income from the transferred property" the amount paid must be income actually produced by the transferred property and not income received for life because of the transfer of property. There are two basic objections to the Court's argument: first, in the facts of *Fidelity* the policies were not surrendered by the transferee, nor is it likely in any normal case that they would be; and secondly, even if the policies were surrendered the result the Court should reach is inclusion of the face value of the life insurance policies.

If the policies were surrendered the income right retained by the decedent investment. In *Igleheart* there is a pre-payment of the face amount of the insurance policy; but the right to receive income during the life of the insured is a part of that insurance policy—it is not separated into a separate instrument. Further, the annuity right is lost in *Igleheart* should the contract be surrendered for the face value; in *Bohnen* and *Fidelity* the value of the annuity right is lost (even though the annuity will continue to be paid) through a payment by the company of less than the face value of the insurance policy if it is surrendered during the life of the insured. In fact, the economic consequences of the investment in both kinds of cases is precisely the same.

111. See, for example, *Hirsh v. United States*, 35 F.2d 982 (Ct.Cl. 1929) where the decedent transferred $50,000 worth of securities to his son (with three identical transfers to his daughters), agreeing to receive in consideration therefore $2,000 per year for life as an annuity payable to his wife and then to himself for life should he survive her. The court found that "the transfer was absolute, and decedent completely divested himself of all title, right, or interest in the securities conveyed. It is clear also that the securities were not chargeable with the annuity." 35 F.2d at 986. Therefore the court concludes, "the case presented is simply one where a gift and purchase of an annuity were combined." 35 F.2d at 986.
112. See the comment in *Burr v. Commissioner*, 156 F.2d 871, 872 (2d Cir. 1946): "But they chose not to surrender them; and the unexercised power to do so did not change the factual realities of the transaction. While the power was unexercised, the investment was analogous to a simple annuity with principal payable at death, a transfer which—even when irrevocable—is taxable under § 811 (e)."
113. Since the result would be an economic loss to the family of the difference between the cash surrender value and the face value of the policy, it is not likely the transferees would cash in the policies.
114. The inclusion should be made under INT. REV. CODE OF 1954, § 2036. See note 94 supra.
would be met by payment of both income and corpus. Under the framework of the original investment, however, the right is still an income right. This is also true in the private-annuity transaction. The mere fact that the annuity need not be paid out of the exact income produced by the transferred property does not preclude the finding that the right to receive the income arises from the transferred property. The precise wording of the Code section is: “the right to the income from the property”—the substance of the private annuity transaction is that the transferor receives the right to the income from the transferred property payable by means of income not “physically” produced by the transferred property.

For the estate planner, the Fidelity case in its holding and in its implied approval of the private-annuity cases opens wide the play of imagination in planning property dispositions which prevent the application of Section 2036 of the 1954 Code. The key factors to consider are (1) a change in the form of the property transferred when it reaches the hands of the transferee and (2) gearing the yearly income payments to an ordinary rate on the value of the economic wealth represented by the transferred asset, rather than the actual income produced by the particular form of the economic wealth which is transferred. The utility of the Fidelity decision for the estate planner extends even to the trust transaction as demonstrated by Becklenberg v. Commissioner.

In 1938 the decedent, age 66, and her husband and son created a trust to which all three contributed property in the form of a revocable trust’s assets. The decedent had contributed $379,000 to the original trust, and the amount had appreciated somewhat by the time the second trust was created. The second trust was irrevocable, but the decedent retained the right to a payment of $10,000 per year until the trust pur-

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115. The only reported recognition of this in the federal courts is a dissenting opinion by Judge O’Connell in Commissioner v. Kann’s Estate, 174 F.2d 357 (3d Cir. 1949). In Kann’s Estate the taxpayer transferred to her children and their respective spouses 1,120 shares of stock in return for their unsecured promises to pay her $24,672 per year. The value of the transferred shares was greater than that necessary to produce $24,672 per year. The issue before the court was whether the transaction resulted in taxable gain for the transferor. The majority held no, but Judge O’Connell, in dissent, indicated that the transferor should be forced to include in gross income $24,672 per year as income from the property transferred. “In practical effect, decedent seems to me to have done no more than pass legal title to 1,120 shares, in return for a reserved life estate as to $24,672 per annum of the income therefrom, and a power to invade the corpus, if necessary to supplement the income if less than $24,672 per annum.” 174 F.2d at 360.


117. A transfer of cash, with a retained right to 6% of the amount per year, would not be taxable under the private annuity-Fidelity doctrine, since the obligation might be paid out of the corpus of the gift, rather than its income.

118. 273 F.2d 297 (7th Cir. 1959).
chased an annuity for the decedent which would pay $10,000 per year. The decedent died before the annuity was purchased, and had received over a period of eleven years amounts which ranged per year from $1,300 to $10,000. The executor of the estate argued that even if the decedent had retained a right to receive $10,000 per year, she had not retained the right to income from any property she had conveyed to the trust, since the payment could have been made out of income or corpus of any of the three contributions to the trust. The Tax Court found that the trustee could have made the distribution solely out of income from the property transferred by the decedent, and that this was sufficient for finding inclusion in the gross estate regardless of whether the payment had actually been made out of income of the decedent’s contribution. In reversing the Tax Court, the Seventh Circuit found as controlling that the decedent’s right to receive was not limited to income from the transferred property. Payment could have been made by the trustee out of property transferred by decedent’s husband and son or the income from that property or from the property (rather than income from it) transferred by the decedent. The Seventh Circuit pointed to the Supreme Court’s approval of the private-annuity case results and compared the transaction in Becklenberg to those cases.

The Becklenberg decision is in accord with the principle which led to the result in Fidelity. The basic theory of the Fidelity case is that no right to income from the transferred property is retained if the right to the payment retained by the transferor is not a right to be paid directly out of income produced specifically by the transferred property and from no other source. In Becklenberg the payment could have been made out of other income or property, although the right to the payment arose because of the transfer to the trust by the decedent. It is submitted that the construction of the language of the Code is overly restrictive. The

120. "In any event, we think the lack of a specific clause providing the $10,000 payment be made solely from income is immaterial. The retention of an annual distribution from income is present when the settlor retains the right to annual payments of a stipulated amount which, at the discretion of the trustee, can be made from either the corpus or income of the property contributed by the settlor. The test of the statute is whether decedent retained a right to income." 31 T.C. at 410. The Tax Court evaded the implied approval of the private-annuity cases by Fidelity, indicating that they would not apply to the trust transaction. 31 T.C. at 410.
121. 273 F.2d 297 (7th Cir. 1959).
122. "We agree that the decedent retained a right to receive $10,000 annually, by way of annuity or by distribution from the trust . . . . Unlike the Tax Court, we believe that the Trust had an obligation to pay decedent $10,000 annually, and that her right to receive it was not limited to the property transferred by her or the income therefrom." 273 F.2d at 301.
123. 273 F.2d at 301-2.
substance of both the Becklenberg and Fidelity transactions is that the de-
cedent transferred property and retained an income right because of the
transfer. No income right would have arisen without the transfer, and
the transfer caused the income to flow to the transferor. In this sense,
although the transferred property does not produce the actual dollars
which meet the retained right, the retained right to income is a product
of the transferred property. The phrase "income from the transferred
property" is unduly restricted by an interpretation which changes the
language to "dollars actually produced by the transferred property." In
a practical economic sense, if ten dollars is transferred into a share of
stock which then produces income, the income is derived from the eco-
nomic wealth formerly represented by the initial ten dollars. Where
property is exchanged for a contractual right or other right to receive
income, in substance, the income received is a product of the transferred
property. Therefore, the courts err in accepting the theory of the deci-
sions in the private-annuity cases, since under any meaningful reading of
Section 2036 and its predecessors, the private-annuity cases are incor-
correctly decided.

Since the Fidelity, Becklenberg and private-annuity cases tend to de-
feat any meaningful application of Section 2036, the writer suggests a
revision of that section to the construction which follows: 124

The value of the gross estate shall include the value of all prop-
erty (except real property situated outside of the United States)
to the extent of any interest therein of which the decedent has at
any time made a transfer (except in case of a bona fide sale for
an adequate and full consideration in money or money's worth),
by trust or otherwise, under which he has retained for his life
or for any period not ascertainable without reference to his
death or for any period which does not in fact end before his
death—

(1) the possession or enjoyment of the property, or
(2) the right to receive income as a condition of the trans-
fer of the property, or
(3) the right, either alone or in conjunction with any per-
son to designate the persons who shall possess or en-
joy the property or the income received as a condition
of the transfer of the property.

124. Compare with the present language of INT. REV. CODE OF 1954, § 2036(a), re-
ported in note 94 supra.
The absence of the enactment of this provision, however, should not dissuade the Supreme Court from reconsidering the insurance-annuity problem, withdrawing its implied approval of the private-annuity cases, and refusing to allow in the *Becklenberg* type trust transaction the avoidance of the operation of Section 2036.

**B. Life Insurance and the Estate Tax Marital Deduction: The Epitome of the Triumph of Form over Reality.**

Various options are available to the owner of a life insurance policy in directing in what manner the proceeds of the policy shall be paid to the beneficiary. In many cases where the decedent leaves a medium or small sized estate, insurance comprises the bulk of the wealth. It is in these cases that the selection of a particular option is most critical. In large estates, on the other hand, careful thought should be given to a lump sum payment into a trust where investment in equity securities would form a better hedge against inflation. There are a number of reasons why the insured would choose an option for payment rather than having a lump sum paid to the beneficiary, e.g., to prevent immediate loss by unwise investments; warding off claims of creditors; and to control the use of proceeds not consumed by the primary beneficiary, among others. The use of an option, obviously, should be a carefully planned move designed to accomplish a specific purpose, and care should be taken that the use of some other plan would not accomplish the goal more efficiently.

In general there are four basic options which may be chosen with many variations designed to meet special objectives. The interest option provides for immediate investment at a guaranteed rate of interest with the principal sum held by the company to be paid to ultimate beneficiaries selected by the insured or paid under various options available to the beneficiary. The fixed-period option provides for ratable payment of principal and interest over a certain term of years. A fixed-amount option calls for the payment of a specific amount monthly or yearly until the principal sum and interest have been exhausted. Also available is a life income option which provides for a continuous payment of a particular amount during the life of the beneficiary. These various options

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125. For a discussion of the various options of payment see 1 CASNER, ESTATE PLANNING 284-300 (3d ed. 1961).
126. Further, consideration should be given to the establishment of a funded insurance trust. See SHATTUCK AND FARR, AN ESTATE PLANNER'S HANDBOOK § 8 (1953).
127. It is also wise to use an insurance trust when it is likely that minors will be the beneficiaries.
128. The various uses of particular options to cover specific needs are discussed in REDEKER AND REID, LIFE INSURANCE SETTLEMENT OPTIONS 60-96 (1957).
may be combined to form a hybrid. For example, a life income option guarantying a life income to the beneficiary with a fixed period during which the payments will be made to the life beneficiary or a contingent beneficiary should the life beneficiary die before the expiration of the period.

In choosing a particular option the insured should consider the wisdom of qualifying the proceeds for the marital deduction.\(^{129}\) It may be in the insured's best interests to forego the marital deduction in order to accomplish a goal which could not be attained by qualifying the proceeds for the marital deduction. It is foolhardy, however, to forego the marital deduction by selecting a particular option when the same goal could have been accomplished by a means which would allow a marital deduction as well. After the determination that it is in the best interests of the insured to qualify the proceeds for the marital deduction the option should be analyzed carefully to see if it falls within the terminable interest rule of Section 2056 of the Code.\(^{130}\) Even after the statute is complied with, the insured needs to build a record which will be accepted in the courts. Since the courts disregard the investment made by the owner of an insurance policy, the life insurance contract itself should spell out each step of the transaction indicating how the insurer is forced to handle the invested funds (the proceeds) in complying with the option chosen by the insured.

The refusal of the courts to analyze the investment made by the insured of the life insurance proceeds is demonstrated by the Supreme

130. INT. REV. CODE OF 1954, § 2056(b) contains the terminable interest rule limiting the application of the marital deduction. The provision reads as follows:

(b) LIMITATION IN THE CASE OF LIFE ESTATE OR OTHER TERMINABLE INTEREST—

(1) GENERAL RULE.—Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest—

(A) If an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and

(B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse; and no deduction shall be allowed with respect to such interest (even if such deduction is not disallowed under subparagraphs (A) and (B))—

(C) if such interest is to be acquired for the surviving spouse pursuant to directions of the decedent, by his executor or by the trustee of a trust.

For purposes of this paragraph, an interest shall not be considered as an interest which will terminate or fail merely because it is the ownership of a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term.
Court's decision in *Meyer v. United States*.\(^{131}\) The decedent had selected an option which provided for the payment of equal monthly installments to his wife for her life, with 240 installments guaranteed, and further provided that if the wife should die before receiving the 240 installments his daughter would receive the remainder of them. If both the wife and daughter died before receiving the 240 installments the commuted value of those unpaid was to be paid in one sum to the estate of the last one of them to die. The life insurance policy was silent on the question of dividing the proceeds into two funds to cover the period certain and the wife's annuity following the expiration of the period, but the insurer made a determination of the amount needed for each of the two guaranteed payments.\(^{132}\) The Government disallowed the marital deduction for any of the proceeds over the taxpayer's argument that the interest of the surviving spouse in the amount necessary to fund her annuity payments after the expiration of the period certain could only be enjoyed by the surviving spouse and therefore was not a terminable interest.\(^{133}\) The district court upheld the position of the taxpayer,\(^{134}\) but the Second Circuit reversed,\(^{135}\) reasoning that there is a single property, the proceeds, which would terminate and pass to the daughter should the wife not survive for 240 months after the decedent's death. The Supreme Court affirmed the judgment of the Second Circuit,\(^{136}\) and the opinion of the Court, speaking through Mr. Justice Whittaker, pinpoints the improper manner which courts generally follow in deciding insurance tax cases:

> Whether a policy of life insurance may create several 'properties' or funds, either terminable or nonterminable or both, we need not decide, for we think the policy here involved constituted only one property .... The policy made no provision for the creation of two separate properties .... The wife and daughter were, respectively, primary and contingent beneficiaries of

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132. The insurance company calculated a certain sum needed to fund the monthly income for 20 years, and secondly the amount needed to fund the monthly income thereafter for the surviving spouse.
133. By directing the investment of the proceeds in this manner the decedent secured two interests to pass to his beneficiaries. One was an interest in having the specified amount paid for a term certain—twenty years. The second was an interest in having the specific amount paid to his wife for as long as she should live after the expiration of twenty years. By looking only at the contract, and not at the investment, the interests seem to be: the wife is to receive the specific amount per month for life, but if she dies within twenty years the amount is to go to the daughter for the remainder of the twenty year period. The latter construction disregards the reality of the investment made by the decedent.
136. See note 131 supra.
The Court refused to consider the investment of funds secured by the deceased in selecting the particular option; the policy alone may be considered. As Judge Waterman, in dissenting in the Second Circuit opinion, observed, "I interpret the difference between my colleagues and me to turn on the fact that they are unwilling to consider as done what actually was done. They believe that, because there was no specific contract authorizing segregation, it is improper for estate tax purposes to divide the insurance proceeds into two funds."

The Meyer case stands as a symbol, a nightmarish blueprint, for the manner in which insurance tax cases should not be analyzed. The stubborn refusal to consider the manner in which the decedent has invested his funds and the unimaginative literal reading of the life insurance contract—these stand as the marks of gross inadequacy in analyzing the tax consequences of the life insurance transaction. For the estate planner and the life underwriter the case clearly delineates the necessity for spelling out in the life insurance contract the investment made if tax advantages flow from the investment. If adverse tax advantages might accrue from the investment, two contracts should be executed (as in Fidelity) to assure the courts' bestowing undue tax favoritism caused by their preoccupation with contract terms and their inability or refusal to "consider as done what actually was done."

III. Summary

The federal statutory income taxation of life insurance is replete with special tax advantages not bestowed on many other forms of invested wealth. This discrimination violates the basic principles upon which the taxing structure is based, and no valuable goal is attained by continuing the discrimination. The statutory income taxation of life insurance wealth should be modified to achieve a similarity in the treatment of life insurance and other forms of invested wealth. Statutory

137. 364 U.S. at 413-14.
138. Implicit in Mr. Justice Douglas' dissent is the analysis of the insurance investment. "Plainly there may be more than one 'interest' in a single 'property.' A deduction is not denied merely because the surviving spouse and someone else each have an 'interest' in the same 'property.' . . . These insurance policies created, of course, no fund or res. . . . Yet that seems immaterial. Each represented a chose in action. The wife or daughter, as the case might be, could sue for the one during the 20-year period. Only the wife could enforce the claim here in question." 364 U.S. at 419.
139. 275 F.2d at 88.
140. See Part (A) of this section supra.
141. See note 139 supra, and accompanying text.
federal estate and gift taxation, however, places life insurance on a par with other investment property. Congress should not heed the call for the reintroduction of the payment-of-premiums test since this would destroy the equality of estate tax treatment and would discriminate against the middle income families. In analyzing insurance tax cases, federal courts have evidenced a complete disregard for the realities of the insurance investment and have hinged their decisions on the form of the life insurance contract. A reversal of performance in life insurance tax cases is essential; a critical analysis of the actualities of the investment made should control the result. Until effort along these lines is made by Congress and the courts, the taxation of life insurance will continue to be a haphazard combination of inequity and unreality.