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Life Insurance Proceeds - Their Protection From Taxes and Creditors

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LIFE INSURANCE PROCEEDS — THEIR PROTECTION FROM TAXES AND CREDITORS

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The bulk of life insurance proceeds are payable to persons whom the deceased is primarily interested in giving greatest security and protection. It would seriously thwart the intentions of most estate owners if the natural objects of their bounty suffered because the life insurance proceeds were diminished by taxes or creditors' claims.

It is only through an understanding of the various methods by which life insurance proceeds can be protected that the death-conscious estate owner will assure to his beneficiaries the maximum returns from an insurance program. Life insurance is favorably treated under our laws with reference to both taxes and creditors, but there are pitfalls along the way which constitute treacherous traps for the unwary. This article is designed to point out some of the more important traps which can be avoided. The article is concerned only with the proceeds of policies paid by reason of the death of the insured, and, therefore, it will be directed chiefly to problems which confront the insured in arranging, executing, and amending his life insurance program.

A. INCOME TAXES ON INSURANCE PROCEEDS.

Congress has recognized that life insurance has a great social value and has encouraged its use in many ways, not the least important of which is favorable treatment under the Federal income tax laws. The proceeds themselves are excluded from the gross income of the recipient whether he is an individual, partnership or corporation.[1] This is true even if the insured's estate is the beneficiary.

If the beneficiary is a corporation, the proceeds are not income to the corporation at the time of their receipt[2] but are taxable income to the shareholders when distribution is made to the shareholders as dividends.[3] The statutory exemption for insurance proceeds must be precisely met, or else the general definition of gross income contained in Section 22(a) of the Internal Revenue Code is broad enough to make the proceeds taxable. That this is a real threat is apparent from the Supreme Court's observation that there is a presumption in favor of taxation rather than exemption.[4]

[1] I.R.C. 22 (b) (1); Regs. 111, Sec. 29.22 (b) (1) -1.

[2] An interesting tax problem is raised by their receipt: will the proceeds so influence the corporation's surplus as to create a problem of unreasonably accumulated surplus under I.R.C. 102?

[3] Golden v. Comm., 113 F.(2d)590(C.C.A. 3rd, 1940); Cummings v. Comm., 73 F.(2d)447(C.C.A. 1st, 1934).

[4] U.S. v. Stewart, 311 U.S. 60, 85 (1940).

It is now well established that through appropriate use of the settlement options, payments to the beneficiary by the insurance company may include items of both principal and interest, and yet the entire amount so paid is not subject to income tax. The Treasury fought vigorously to sustain its view that so much of a payment under a settlement option selected by the beneficiary as could be regarded as interest should be taxable income to the recipient. However, the courts have consistently held that installment payments which include both principal and interest are not included in gross income regardless whether the insured or the beneficiary selected the mode of payment.[5]

If the proceeds are payable under a settlement option which provides for the payment of interest only, such payments are expressly taxable.[6] There may be some difficulty in recognizing just when a payment constitutes "interest." One insurance company agreed to pay a yearly "bonus" to a beneficiary of a policy in return for the right to use the principal for investment purposes. The court quite properly held this to be "interest" and taxable.[7] Another exception concerns installment payments to a divorced or legally separated wife. Even though the payments are installments of insurance proceeds, they may be taxed to the wife under a special provision of the law.[8]

In order to obtain the income tax advantage, the beneficiary's selection of the settlement option must be pursuant to the contractual obligations of the policy. If the insurance company voluntarily pays the beneficiary something more than was required by the policy, such as dividends, these payments are taxable income to the beneficiary. The necessity for a legally enforceable right contained in the policy itself is well illustrated in a case in which the government succeeded in taxing a beneficiary with reference to policies placed with two separate companies.[9] The proceeds were left with one of the companies, at interest. The beneficiary, with the company's consent, changed the option so as to require installment payments of principal and interest rather than interest alone. The court commented that the exemption is to be narrowly construed and that the alteration of the option was not pursuant to any right given under the contract. There were policies with another company in which the insured and not the beneficiary had the power to select the option. Even though the company allowed the beneficiary to exercise the option, the government's imposition of the tax was sustained.

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[5] Bullard v. Comm., 5T.C.1346 (1945); Comm. v. Pierce, 146 F.(2d)388(C.C.A. 2nd 1944); Comm. v. Winslow, 113 F.(2d)418(C.C.A. 1st, 1940).

[6] I.R.C. 22 (b) (1); Regs. 111, Sec. 29.22 (b) (1)-1.

[7] U.S. v. Heilbroner, 22 F.Supp.368 (S.D., N.Y., 1938); aff'd 100 F.(2d) 379 (C.C.A. 2nd, 1938).

[8] I.R.C. 22 (k) and 22 (b) (2) (A); Regs. 111, Sec. 29.22 (b) (2)-4.

[9] Law v. Rothensis, 57 F.Supp.447 (E.D., Pa., 1944); aff'd. 155 F.(2d) 13 (C.C.A. 3rd, 1946).

There are important income tax considerations where policies are assigned for value. Transfers for love and affection raise problems as to gift taxes and, as will be discussed later, problems as to estate taxes; but if the transfer is for consideration, the law does not extend the income tax exclusion to the proceeds.[10] The assignee must pay an income tax upon the difference between the proceeds received and the total of the premiums paid by the assignee plus the amount of the consideration originally paid.[11] Of course, if the consideration given is greater than the ultimate amount of the proceeds, no income tax liability exists.[12]

There are several exceptions to the general rule of income tax liability upon assignments for value. If the insured himself is the beneficiary-purchaser, no income tax liability will be incurred.[13] This applies even if the insured buys the policy from a prior transferee for value. Thus, it can be said, generally, that if an insured acquires a policy on his own life from another owner, or if he gives such policy away, there will be no income tax liability in the absence of further transfers.

Another exception to the usual rule that policies assigned for value will result in income taxes relates to the situation wherein the basis for gain or loss in the hands of the transferee is the same as that of the transferor.[14] Thus, a transfer in accordance with Section 112 (b) (5) of the Internal Revenue Code, under which a partnership is changed to a corporation in a tax-free transfer, would permit the transferee of the policy to stand in the transferor's shoes. The same would apply to a transfer by a subsidiary corporation to a parent corporation on liquidation. Of course, if the transferor had acquired the policy for value there could be income tax liability to the second transferee without reference to the gain or loss nature of the second transfer.

The income tax aspects of a transferred policy are sufficiently serious to warrant circumspection in assigning a policy for value. In the *Premium Products Co.* case,[15] the taxpayer's acquisition of a $100,000.00 policy proved to be an expensive transaction. The taxpayer paid out $29,000.00 for the policy. Upon receipt of $100,000.00, at the insured's death, $71,000.00 of it was treated as ordinary income and subject to the current income tax rates for that year.

It frequently happens that it is not until after a policy has been issued that the insured, his underwriter or his attorney discovers that

[10] I.R.C. 22 (b) (2) (A); Regs. 111, Sec. 29.22 (b) (2)-3.
[11] Waters, Inc. v. Comm., 160F.(2d)596(C.C.A. 9th, 1947); St. Louis Refrigerating & Cold Storage Co. v. U.S., 66 F.Supp. 62 (E.D., Mo., 1946); Blum v. Higgins, 150F. (2d) 471 (C.C.A. 2nd, 1945).
[12] Lambeth v. Comm., 38 B.T.A. 351 (1938).
[13] Regs. 111, Sec. 29.22 (b) (2)-3.
[14] I.R.C. 22 (b) (2) (A); Regs. 111, Sec. 29.22 (b) (2)-3.
[15] Premium Products Co. v. Comm., 2 T.C. 445 (1943).

the policy should have been owned by someone else. To effect an assignment will leave the insured between the Scylla of income tax liability (because of an assignment for value) and the Charybdis of estate tax liability (because of a gratuitous transfer in contemplation of death). Can the error be corrected with tax safety? If the error is promptly discovered and the insured is still able to pass the medical examination, it may be best to cancel the policy and have a new contract applied for by the desired owner, with the premiums paid by such owner. If that avenue is closed, and if the premiums were in fact paid by the proper owner, and endorsement may be written in the policy by the insurance company setting up the fact of the issuance in error and amending the policy to show ownership in the correct person. This course may evoke a contest by the government and should be taken only after determining that the facts will establish that the endorsement does no more than make the policy read as it was always intended it should. The Commissioner will probably contend that the endorsement is in fact a taxable assignment. Under no circumstances should there be an attempt made to pretend that the first policy was never issued; if this involves destruction of records or otherwise presenting a false picture of the facts, it would seem that fraud penalties might follow.

The mere fact that a policy does not have a cash surrender value at the time of its transfer will not deter the Treasury from asserting that it was assigned for value. This is because a policy has economic value other than its cash value, if it be no other than the right to continue the contract without further medical examination. The insured will be in a better position if he has kept records showing that the transfer was a gratuitous one. By hypothesis, the insured will be dead at the time this question arises, and, accordingly, it is only through the presentation of letters or other memoranda that there can be a showing made that the transfer of the policy was intended to be a gift as opposed to a transfer for value. In this connection caution must be exercised to see that the assignment form used on a transfer, in which income tax consequences are not intended, avoids the standard phrase "for value received." If these words appear on the form supplied by the insurance company, it is important to strike them and supplant them with a phrase such as "for love and affection."

The Wisconsin statute does not distinguish between assigned and non-assigned policies.[16] It exempts from income taxation all insurance received in payment of a death claim. However, insurance paid to a corporation or partnership upon policies upon the lives of officers, partners or employees are subject to the Wisconsin income tax.

[16] Wis. Stats. (1945) Sec. 71.05 (c).

B. ESTATE TAXES ON INSURANCE PROCEEDS.

With the passage of the Revenue Act of 1948,[17] it can be expected that many policy holders will do well to reexamine their beneficiary arrangements so as to gain the marital deduction afforded by the new statute. However, there is a more fundamental question which each estate owner must determine: is the policy part of his estate? Prior to 1942, the first $40,000.00 of insurance proceeds payable to named beneficiaries were excluded for estate tax computations, but no such exclusion is now authorized. Section 811 (g) of the Internal Revenue Code provides that a decedent's gross estate will include the proceeds of policies upon the life of the decedent

(1) If they are payable to the decedent's executor, or

(2) If the premiums were paid directly or indirectly by the decedent, or,

(3) If the decedent at the time of his death possessed any of the policy's incidents of ownership.

When is a premium paid "indirectly" by an insured? The regulations give examples which indicate that the Treasury will use a broad definition of the word.[18] It should be anticipated that the government will seek to include the proceeds where premiums are paid by an alter ego corporation or one which the decedent controls; by a trust the income of which is taxable to the insured; by an employer of the insured in a manner which suggests a substitute for salary; and, finally, where the decedent has transferred funds to the person paying the premiums. In the last situation, a husband will frequently make a gift of money to his wife and permit her to pay the premiums. It is unlikely that this device will be fruitful regardless of the discretion employed in transferring the funds. It is usually an invitation to litigation to utilize this method. Of course, if the wife has independent wealth, there is no danger; and, if the wife had originally applied for the insurance on her husband's life and paid the premiums, it is clear that the proceeds will not be a part of his gross estate.

The test required under the statute relative to premium payments is one of the rare instances in which life insurance is discriminated against. The case has been well stated in a report to the House Ways and Means Committee:

> The law was amended in 1942 to provide that the proceeds of an insurance policy on a decedent's life must be included in his taxable estate, if he paid the premiums on the policy. This is true, even though the decedent had given the policy away and had no remaining interest in it whatever, yet (except for trans-

[17] Revenue Act of 1948, 80th Cong., 2nd Session, April 2, 1948.
[18] Regs. 105, Sec. 81.27 (a).

> fers in contemplation of death) no other property which the decedent does not own is included in his gross estate. We see no reason why insurance should thus be discriminated against. We therefore recommend that these provisions (sec. 811 (g) (2) (a)) be eliminated so that insurance payable to an individual beneficiary will only be included in the decedent's estate if he possessed incidents of ownership of the policy.[19]

Where are the incidents of ownership, possession of which causes the proceeds to be taxed in an insured's estate? Generally, the "incidents" are the economic benefits of the policy. The statute expressly eliminates reversionary interests.[20] It is probable that possession of any of the following rights or powers will render the proceeds includible:[21]

(1) The power to change the beneficiary.
(2) The power to surrender or cancel the policy.
(3) The power to assign it.
(4) The power to revoke an assignment.
(5) The power to pledge it for a loan.
(6) The power to obtain from the insurer a loan against the surrender value of the policy.

For purposes of the Wisconsin inheritance tax law, the incidents of ownership are defined by the statute.[22] If the insured wishes to avoid the inclusion of the proceeds of a policy in his gross estate, he must make a comprehensive examination of the policy to be certain that he has divested himself of all ownership rights. The contracts of the various companies differ in their designation of ownership rights; in fact, policies of the same company have enough variations to command scrutiny of each policy.

If a policy is transferred as a gift, the estate tax can be avoided under certain limited circumstances. There will be a gift tax to pay[23] but the more serious hazard is that the transfer will be considered to be one in contemplation of death or one intended to take effect at death. The principal question is the motive of the decedent.[24]

In *Cronin v. Commissioner,* a man, 53 years of age, active, in good health, gave away a large amount of insurance five years before his death. The Tax Court found that the transfer was made in contemplation of death stating that the subject matter of the gift, insurance policies, were "inherently testamentary in character."[25] The Circuit Court

[19] Report of Special Tax Study Committee of Committees on Ways and Means of House of Representatives, Nov. 1947, p. 30.
[20] I.R.C. 811 (g) (2).
[21] Regs. 105, Sec. 81.27 (a).
[22] Wis. Stats. (1945) Sec. 72.01 (7) (a).
[23] Supra. n. 17; Sec. 372 adds a marital deduction to I.R.C. 1004 (a).
[24] Wells v. U.S., 283 U.S. 102 (1931).
[25] 7 T.C. 1403, 1410 (1946).

reversed[26] on the ground that it was established that the insured was in the course of an extremely uncertain business program and that this critical condition was the motive for the transfer. However, the Circuit Court expressly agreed with the Tax Court concerning the testamentary character of insurance. In a report of the House Ways and Means Committee, the same concept relating to the testamentary character of insurance was expressed:

> Recognizing the testamentary nature of insurance on the life of the decedent both where premiums are paid directly or indirectly by him and where he possessed at the time of his death some incident of ownership, your Committee proposes to include all proceeds of such insurance in the gross estate.[27]

The case of *Slifka v. Johnson*[28] further illustrates the dangers in connection with gratuitous transfers of policies. The insured, while in good health, at age 45, transferred certain policies. The government claimed the gift was in contemplation of death, and that the primary motive was to reduce the Federal estate tax thereon. It was shown that the insured's underwriter addressed a communication to the insurance company explaining that the transfer was "to avoid payment of taxes." The court upheld the government's contention.

The *Slifka* case produces a clear *caveat.* The gratuitous transfer will not produce an estate tax deduction unless an independent motive can be shown which is not in contemplation of death. Such motive might be the hazardous business enterprise of the *Cronin* case, or any other strong motive definitely associated with life. For example, where the policy was transferred to a wife in connection with a property settlement on the occasion of the parties' divorce, the Tax Court held the gift was not in contemplation of death.[29]

Where insurance is included in the decedent's estate, unless the will provides otherwise, the tax will be so apportioned that the executor can recover from the insurance beneficiary such portion of the total tax paid as the proceeds of the policies bear to the sum of the net estate.[30] The Revenue Act of 1948 amends the Internal Revenue Code so that the proceeds received by a spouse are liable only to the extent that the proceeds exceed the marital deduction.[31] The proceeds of National Service Life Insurance policies are includible in a decedent's estate, just as proceeds of other life insurance policies.[32] Although the

[26] 164 F. (2d) 561 (C.C.A. 6th, 1947).
[27] H.R. Report No. 2333, 77th Cong., 2nd Session, July 14, 1942, p. 52.
[28] 63 F. Supp. 289 (S.D., N.Y., 1945); 161 F. (2d) 467 (C.C.A. 2nd, 1947); cert. den. 68 S. Ct. 57 (1947).
[29] Hurd v. Comm. 9 T.C. 681 (1947).
[30] I.R.C. 826 (c).
[31] Supra n. 17; Sec. 365.
[32] Ltr. dtd. Oct. 21, 1943, signed by D. H. Bliss, Deputy Commissioner of Internal Revenue.

executor cannot obtain contributions for estate tax from the proceeds of National Service Life Insurance,[33] and although the government cannot levy upon such proceeds, the tax claim may be enforced against other property belonging to the decedent's estate.[34]

The State of Wisconsin inheritance tax law provides for a $10,000.00 exemption as to insurance otherwise taxable, provided the insurance is payable to beneficiaries other than the insured's estate.[35]

C. Estate Taxes and the 1948 Revenue Act.

The Revenue Act of 1948 has caused a terrific upheaval in estate planning. One of the more important aspects of the new law relates to the marital deduction under the Federal estate tax. The marital deduction can aggregate up to fifty per cent of the value of the adjusted gross estate[36] and, accordingly, can bring about startling reductions in estate taxes. A man who dies leaving an adjusted gross estate of $120,000.00 formerly had to pay an estate tax of $9,500.00, which represents the applicable rates on that portion of his estate which is in excess of the specific exemption of $60,000.00. Through optimum use of the marital deduction, he can reduce his estate tax to zero provided compliance is had with the conditions of the new statute.

Section 361 (e) (1) (G) of the 1948 Act adds the following marital deduction to Section 812 of the Internal Revenue Code in computing the net estate for tax purposes:

> In the case of proceeds of insurance upon the life of the decedent receivable in annual or more frequent installments commencing within one year after the decedent's death, if under the terms of the policy all amounts payable during the life of the surviving spouse are payable only to such spouse, and if such spouse has the power to appoint all amounts payable after such spouse's death (exercisable in favor of the estate of such spouse, whether or not the power is exercisable in favor of others)—
>
> (i) such proceeds shall, for the purposes of subparagraph (A), be considered as passing to the surviving spouse, and (ii) no part of such proceeds shall, for the purposes of subparagraph (B) (i), be considered as passing to any person other than the surviving spouse.
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> This subparagraph shall be applicable only if, under the terms of the policy, such power in the surviving spouse to appoint, whether exercisable by will or during life, is exercisable by such spouse alone and in all events.

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33 Ltr. dtd. Apr. 29, 1946, signed by D. H. Bliss, Deputy Commissioner of Internal Revenue.

34 Ltr. dtd. Mar. 14, 1946, signed by D. H. Bliss, Deputy Commissioner of Internal Revenue.

35 Wis. Stats. (1945) Sec. 72.01 (7) (b).

36 Supra n. 17; Sec. 361 (e) (H).

This section raises the problem as to the manner in which life insurance proceeds shall be made payable. Where the primary beneficiary is the wife, it is submitted that the marital deduction may be lost if there are named contingent beneficiaries. The naming of the contingent beneficiaries may be construed to deprive the wife of the completeness of ownership which the statute contemplates. The apparent intent of the new law is to permit the marital deduction only where the proceeds pass to the surviving spouse in such a manner that the proceeds will be subjected to a transfer tax in the estate of the surviving spouse upon the latter's death.

It is apparent that a payment to the surviving spouse exclusively will meet the requirements of the statute so as to authorize the marital deduction. The naming of contingent beneficiaries, however, creates the possibility, at least, that persons other than the surviving spouse will be considered as having an interest in the proceeds. It is to be expected that the Treasury's regulations will clarify this question, but at this juncture it would appear to be the safer policy to name the wife as the only beneficiary.

A lump sum payment to the wife, based upon her survival, should be safe, regardless of the naming of contingent beneficiaries; but the same cannot be said of periodic payments under a settlement option—and it would be far safer to eliminate the contingent beneficiaries entirely.

Some companies will permit a primary beneficiary, after the insured's death, to choose a settlement option and to name the successor beneficiaries. In such instances, the estate owner can eliminate the contingent beneficiaries on the expectation that his widow will be able to name their children as the successor beneficiaries after his death. The insured thereby will gain the estate tax deduction and have reason to expect that his children will receive a portion of the proceeds pursuant to payments under the settlement options. The danger in this, however, is that the selection of the option and the appointment of successors may be permissible only in the event the insured does not designate the option; this would mean a lump sum payment to the widow—and a husband may properly be reluctant to leave a large amount of proceeds to his widow in the hope that she will be wise enough to leave it with the insurer pursuant to a settlement option selected by her.

It is reasonably clear that the law does not intend to bar the marital deduction merely because the payments under the policy are made to the widow in installments. In the Senate Report accompanying the bill, the following explanations are given:

> The entire proceeds of an insurance policy on the life of the decedent are payable to the surviving spouse and the value of such proceeds is included in determining the value of the gross

> estate. A marital deduction is allowed with respect to the value of the proceeds because no person other than the surviving spouse has an interest in the proceeds. The result will be the same whether such proceeds are payable in a lump sum; are payable in installments to the surviving spouse, her heirs, or assigns, for a term; or are payable to the surviving spouse for her life with no refund of the undistributed proceeds or with such a refund to her estate. It is also immaterial whether any such mode of payment is determined by an option exercised by the decedent or exercised by the surviving spouse.[37]
>
> Subparagraph (G) of section 812 (e) (1), which was not contained in the bill as passed by the House, also provides an exception to the terminable interest provisions of subparagraph (B) of section 812 (e) (1). The exception is for the purpose of allowing the marital deductions in the case of proceeds of life insurance upon the life of the decedent where the surviving spouse is entitled to installments of the proceeds and has the same type of power possessed by the surviving spouse in the case of a trust to which subparagraph (F) applies. Subparagraph (G) applies only if the proceeds of the insurance are receivable in installments, commencing within 1 year after the decedent's death. The amounts payable to the surviving spouse must be installments which have the effect of reducing during her lifetime the aggregate proceeds of the policy available for future payments.[38]

An unanswered question relates to the power of the primary beneficiary to withdraw the proceeds. If there are contingent beneficiaries, but the contract requires periodic payments to the widow who has the unfettered power to withdraw any or all of the proceeds held by the insurance company, is the marital deduction allowable? The answer, in the writer's opinion, is in the affirmative; but there is sufficient uncertainty at this time to recommend removal of the contingent beneficiaries whenever possible. It would appear that an absolute right to withdraw the proceeds should make the surviving spouse the owner of the proceeds and be the equivalent of a general power of appointment.

A possible argument against this position is that the widow might be limited as to the number, time and amount of withdrawals by the insurance company, and, therefore, the power would not be exercisable by her "alone and in all events." This position is unsound and the right to withdraw should be a sufficiently outright transfer to the widow so as to warrant the marital deduction, whether or not there are contingent beneficiaries. The Senate Report includes a definition of a

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[37] Senate Finance Committee Report, No. 1013, dated Mar. 16, 1948, U.S. Code Congressional Service, 1948, No. 3, p. 644.

[38] Ibid, p. 650.

power of appointment which is broad enough to include the power to withdraw.[39]

The new statute on estate taxes works a considerable benefit to the estate owner whose wife has only a small personal estate. In such case, the husband can rearrange his beneficiary structure and accomplish a substantial diminution of estate taxes on his death, without shifting the ultimate burden to his wife's estate on her death. The man whose wife is the owner of a large personal estate is in a different position. He is faced with the alternative of foregoing the marital deduction or increasing the estate tax on his wife's subsequent death. The trust device and use of insurance options which would give the wife a life interest are still available to him, but it does not give him the same amount of ultimate tax saving which others may accomplish through the marital deduction. There will be $60,000.00 exemption at the wife's death, but there will also be increased state inheritance taxes as well as greater probate charges.

Even if the wife has a large personal estate, a man whose concern is for the financial security of his wife as opposed to that of his children will nevertheless choose to take advantage of the marital deduction despite the fact that a second estate tax at the time of the wife's death will result in diminished proceeds for the children.

There is sufficient uncertainty as to the permanence of the marital deduction feature of our new tax law to merit this caution. It is frequently a grave error to alter a carefully composed estate plan solely to accomplish a tax saving. The man who has a desire to provide adequate support for his wife during her lifetime with the principal of his estate passing thereafter to his children could have such plan ruined by an outright transfer at death to his widow; the widow might dissipate the money either through wild self-indulgence, innocent misguidance or possible fleecing upon remarriage. Even though a will were executed by the wife at the time the proceeds were made payable to her, there would be uncertainty that she would leave her will unchanged after her husband's death. The use of the trust device in the widow's will can reduce to some extent the likelihood of such an unfortunate result, but basically the estate owner must determine whether it is more important to him to protect his children or to accomplish an estate tax saving.

D. Rights of Creditors.

While an insured lives and is the owner of a policy of insurance, his creditors have the right to compel the application of his policies to the satisfaction of their claims. Upon the insured's death, however, and

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[39] Ibid, p. 649. "A 'power to appoint' the corpus includes any power which in substance and effect is such a power regardless of the nomenclature used in creating the power and local property-law connotations."

assuming that the policy is payable to someone other than his estate, the proceeds are, by law, free from the claims of his creditors.[40] This constitutes a tremendously important advantage to the use of life insurance in assuring financial security for one's survivors. It is an essential feature for the man who can anticipate large claims against his estate at his death.

We have seen that by statute insurance proceeds will be reached by estate taxes unless the decedent has taken steps to exempt them; but an insured's creditors will ordinarily be able to reach the proceeds only if the decedent has them payable to his estate or subjects the policies to the creditors' control during his lifetime.[41] The creditors of the beneficiary, however, in the absence of a statutory bar or a spendthrift clause, are permitted to reach the proceeds to the extent of the debtor-beneficiary's interest in the proceeds.[42]

To the limited extent of $5,000.00, proceeds payable to a married woman are exempt from creditors in Wisconsin.[43] The problems relating to the determination of marital status were well brought out in *Luebke v. Vonnekold*[44] where the insured named an unmarried woman as beneficiary under a $500.00 policy. The same man later took out an additional policy payable to her in the sum of $1500.00; at the time that the latter insurance was taken out the beneficiary was married, although not to the insured. A creditor garnished the insurance company for the full $2,000.00, but the court held that only $500.00 was subject to garnishment since she was single at the time it was made payable to her and was, therefore, not exempt. The court ruled that the status of a married woman is determined at the time when the policy is taken out and not when the proceeds become payable.

Insurance proceeds enjoy an additional protection in Wisconsin if they are in the nature of a fraternal society benefits. $5,000.00 of such insurance is exempt against the creditors of the insured or his beneficiary where the insured pays the premiums, and all proceeds are exempt "if some other person pays the premiums."[45]

E. Creditors and Spendthrift Provisions.

The mere use of the term "spendthrift" invokes unflattering connotations for a clause which can play an important role in protecting insurance proceeds from creditors of the beneficiary. Lawyers have long employed such clauses in both inter-vivos and testamentary trusts.

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[40] Wis. Stats. (1945), Sec. 272.18 (19); See, also, amendment in Ch. 137, Laws of 1947, approved May 19, 1947.
[41] Oldenburg v. Central Life Assurance Society, 243 Wis. 8, 9 N.W. (2d) 133 (1943).
[42] First Wisconsin Nat'l. Bank v. Strelitz, 209 Wis. 335, 245 N.W. 74 (1932).
[43] Wis. Stats. (1945), Sec. 246.09.
[44] 250 Wis. 496, 27 N.W. (2d) 458 (1947).
[45] Wis. Stats. (1945), Sec. 272.18 (19).

Despite vigorous attacks by creditors, such clauses have generally enjoyed acceptance and enforcement by the courts. Designed in theory to prevent a wastrel from an anticipatory dissipation of his wealth, the spendthrift clause is now broad enough to protect the most thrifty and pennypinching beneficiary from assigning or otherwise losing his rights to protected assets. In trusts, this is accomplished by authorizing the trustee to withhold payments of interest and principal in the event the trustee suspects that creditors are hovering over a beneficiary's shoulder.

About three-fourths of the states have legislative expressions on the subject of spendthrift clauses in policies of life insurance. Some of the states provide that the protection is automatic and need not be set forth in the policy. In many of these statutes, however, there are limitations as to the type of policy covered[46] or as to the annual premium paid.[47]

In about twenty-five states the statutes merely authorize the insurance contract to provide this protection. In Wisconsin, for example, the legislature has gone no further than to pass an enabling statute.[48] The courts have given support to the spendthrift clauses in insurance contracts when efforts to penetrate them have been made by creditors.[49] While it is certain that the beneficiaries will be protected from creditors where the insured has selected the option, certainty thins into doubtfulness where either of the following circumstances apply: (a) the beneficiary has selected the settlement option, or (b) the settlement option gives the beneficiary the power to withdraw the principal on deposit with the insurance company.

Suppose that the policy authorizes the insured's widow to select the insurance option and after his death she selects an installment option and includes a spendthrift clause. Can her creditors reach the proceeds? Is there a distinction to be made between the case of a husband establishing the protective clause for his wife and the case of the wife setting up such a clause for herself? The prospect of sustaining the validity of the clause is far better where someone other than the debtor has established the clause. Although there is authority for sustaining the clause even in the case of the beneficiary's selection,[50] it would seem more prudent to have the insured insert the clause in the policy and thereby circumvent disputes as to whether the beneficiary's selection is enforceable.

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[46] See, for example, Tenn. Code, 1932, Sec. 6398, limiting protection to proceeds paid by fraternal benefit society.

[47] See, for example, Nevada Comp. Laws, Supp. (1941) Sec. 8844, limiting protection to proceeds of policies with annual premiums of $500.00.

[48] Wis. Stats. (1945), Sec. 206.39.

[49] Annis v. Pilkewitz, 287 Mich. 68, 282 N.W. 905 (1938); Crossman v. Rauch, 263 N.Y. 264, 188 N.E. 748 (1934).

[50] Provident Trust Co. v. Rothman, 321 Pa. 177, 183 Atl. 793 (1940).

In an effort to accomplish some of the flexibility realized with the trust device, it is quite common for settlement options to grant the beneficiary the right to withdraw a portion or all of the proceeds on deposit. Does this unqualified right of withdrawal remove the portion subject to withdrawal from the protective wing of the spendthrift clause? Although the New York Court of Appeals has answered this question in the negative,[51] it would appear to be the wiser policy for the insured to decide which is more important to him: (a) that his beneficiaries have the power to withdraw the principal on deposit or (b) that they be sheltered from their creditors. It is recommended that only the more vital of the two benefits be employed.

[51] Genesee Valley Trust Co. v. Glazer, 295 N.Y. 219, 66 N.E. (2d) 169 (1946).