Group Term Life Insurance: Current Estate Tax Problems Under Internal Revenue Code Section 2035

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COMMENT

GROUP TERM LIFE INSURANCE: CURRENT ESTATE TAX PROBLEMS UNDER INTERNAL REVENUE CODE SECTION 2035

The estate tax treatment of group term life insurance proceeds under section 20351 (dealing with transfers deemed made within three years of death) remains surprisingly murky despite the widespread adoption of such policies.2 Even recent developments have merely substituted new uncertainty for old.

Three factors demand that estate planners better understand group term life insurance:

The continuing rapid growth of group insurance purchases by (a) employers providing an employee fringe benefit and (b) professional and trade groups providing a membership benefit option;3

The high rate of asset inflation that has continued since estate tax rates and exemptions were overhauled by the Tax Reform Act of 1976;4

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2. The Life Insurance Fact Book, states that 43% of all life insurance in force in the United States at the end of 1977 was issued on a group basis, and that term policies, including individual term policies and the term insurance portion of combination plans, accounted for 33.3% of all ordinary insurance in that same year. AMERICAN COUNCIL OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 27-29 (1978).
3. The amount of group life insurance in force at the end of 1977 was triple the amount in force at the end of 1967. At the end of 1973, 89.3% of the group life insurance master policies covered employer-employee groups, accounting for 86.1% of the total value of group life insurance in force. Other groups indirectly related to employment or occupation accounted for 0.6% of the group master policies and 4.8% of the total group coverage amount. Id. at 29-30.
4. Congressional committee reports discussing the 1976 Act noted that the purchasing power of the dollar had, by that time, decreased to less than one-third of its value in 1942, the year that the $60,000 exemption (to be replaced by the unified credit) was enacted. H.R. REP. No. 94-1380, 94th Cong., 2d Sess. 15-16 (1976); S. REP. No. 94-1236, 94th Cong., 2d Sess. 607-08 (1976).

Business Week cites a recent Salomon Bros. study showing the compound annual rate of inflation in various asset values since 1968: stocks 3.1%, gold 19.4%, diamonds 11.8%, single-family housing 9.6%, Money & Banking — The Death of Equities,
The proliferation of new policy combinations and permutations.\(^5\)

So while the Tax Reform Act of 1976\(^6\) raised the minimum value of estates subject to tax,\(^7\) the inflation of asset values will subject an increasing number of estates to taxation — and

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\(^7\) The unified credit will permit transfer free of estate taxation for the following combined gift and estate tax amounts (listed by year of decedent’s death): 1977, $120,667; 1978, $134,000; 1979, $147,333; 1980, $161,563; 1981 (and after), $175,625. See I.R.C. §§ 2010(a) & (b), 2505(a) & (b), and 2001(b) & (c). See also H.R. REP. No. 94-1380, 94th Cong., 2d Sess. 15-16 (1976); S. REP. No. 94-1236, 94th Cong., 2d Sess. 607-08 (1976). In addition, the estate tax marital deduction now generally permits deduction of bequests to a spouse not exceeding the greater of $250,000 or 50% of the value of the gross estate, thus allowing an estate as large as $425,625 to pass to a spouse free of estate tax.

Prior to the 1976 amendments, the estate tax exemption (now replaced by the unified credit) was $60,000. I.R.C. § 2052 (repealed 1976). Thus the maximum amount that could be transferred (in a noncharitable transfer) free of estate tax to a nonspouse by a decedent dying before 1977 was $60,000, compared to $175,625 after 1980.

Similarly, the pre-1977 Code limited the marital deduction to one-half the gross estate, even for estates of less than $250,000. I.R.C. § 2056(c)(1)(amended 1976 & 1978). If the entire estate were given to the spouse, the maximum tax-free estate would be $120,000 for decedents dying before 1977 and, as noted, $425,625 for decedents dying after 1976 (with some exceptions listed in Pub. L. No. 94-455, I.R.C. § 2001(d)(1)). Although this amount seems adequate for reasonable family needs, it should be noted that it took Congress thirty-four years to revise the $60,000 exemption and twenty-eight years to increase the marital deduction for estates of $250,000 or less, a sufficient period to permit the dollar to lose two-thirds of its purchasing power. See reports cited note 4 supra.

The Wisconsin inheritance tax is a tax levied on that which is received rather than on the estate itself. See Wis. STAT. § 72.11 (1977). Accordingly, exemptions are available to individual distributees in specific classes rather than to the estate itself. Wis. STAT. § 72.17 (1977). The spousal exemption has now been increased to $250,000. 1979 Wis. Laws ch. 1, § 47 (amending Wis. STAT. § 72.17). In addition, the inheritance tax rate varies according to the relationship of the distributee to the decedent. Wis. STAT. § 72.18 (1977). The marginal tax rate of a spouse receiving taxable property is half the marginal rate applicable to the equivalent amount received by the decedent’s children or parents. Compare Wis. STAT. § 72.18(1) (1977) with Wis. STAT. § 72.16(1)(1977).
increasing numbers of those estates are likely to include group term life insurance.\(^8\)

Because an employee is permitted to exclude from gross income each year the employer-paid premiums for the first $50,000 worth of group term life insurance coverage,\(^9\) this has

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8. See notes 2 & 3 supra.

9. I.R.C. § 79(a)(1). In contrast, employer premium payments for permanent insurance benefits (such as ordinary level premium or single-pay whole-life policies) must be included in the employee's gross income in the year of payment. Treas. Reg. § 1.61-2(d)(2)(ii) and Treas. Reg. § 1.79-1(f), T.D. 7623, 1979-26 I.R.B. 7 (for policies not meeting the requirements of I.R.C. § 79); Treas. Reg. § 1.79-1(d)(1), T.D. 7623, 1979-26 I.R.B. 7 (for permanent benefits combined with term insurance which meets the requirements of I.R.C. § 79).

Premium payments for group term insurance coverage in excess of the amount of group coverage allowable under state law must also be included in the employee's gross income. Treas. Reg. § 1.79-1(e), T.D. 7623, 1979-2 I.R.B. 7. Wisconsin limits group insurance coverage to $100,000 on any one insured life. Wis. STAT. § 632.55 (1977). Because Wisconsin does not limit wholesale insurance coverage (groups of individual policies purchased by an employer) and these policies are specifically included in the definition of "group policy" contained in Treasury Regulation § 1.79-0, T.D. 7623, 1979-26 I.R.B. 7, it would appear that larger amounts of coverage of Wisconsin residents under wholesale term life policies would be eligible for favorable section 79 income tax treatment of the portion includible in the employee's gross income. See note 11 and accompanying text infra.

It would also appear that coverage of a self-employed person such as a partner or sole proprietor would not be exempted from income tax under section 79 because such a person would fall outside the definition of "employee." This would be the case even though that coverage is under a plan also covering that person's employees. See Treas. Reg. § 1.79-0, T.D. 7623, 1979-26 I.R.B. 7.


 Permanent benefits may be combined with term insurance under section 79 and the I.R.S. will provide insurers with the allocation to be made between permanent and term benefits for a particular form of policy. Rev. Proc. 79-29, 1979-22 I.R.B. 24.

The one exception to all of the rules above is life insurance incidental (as defined in Rev. Rul. 74-307, 1974-2 C.B. 126 and Rev. Rul. 74-325, 1974-2 C.B. 127) to qualified pension, annuity or profit-sharing plans. There, only the approximate value of pure life insurance protection will be included in the employee's gross income in the year that the plan or trust pays the premiums. See I.R.C. § 72(m) and Treas. Reg. § 1.72-16, T.D. 6676, 1963-2 C.B. 41, 47. The amount so included is determined under the tables set forth in Revenue Ruling 55-747, 1955-2 C.B. 228, commonly referred to as P.S. 58 Tables, or an amount equal to the current published rates of the insurer for an individual one-year term life policy on a standard risk. Rev. Rul. 66-110, 1966-1 C.B. 12 and Rev. Rul. 67-154, 1967-1 C.B. 11. For a discussion of life insurance in qualified plans, see Nasuti, Taxation of Life Insurance in Qualified Plans, 1979 DUKE L.J. 449.
been a popular fringe benefit. Above the $50,000 level the income imputed to an employee by the Treasury Regulations is often less than the premium rate an employer can negotiate.

In addition to the attractive employee income tax treatment, the relatively low group term premium rates are advantageous to the employer. Not only are the low rates achieved through the obvious sales and administrative efficiencies group policies enjoy — they also reflect the relatively low mortality rates that actively working persons have compared to those older and retired.

The employer will usually receive an income tax deduction for the premiums paid for insurance policies on employees. It should be noted that the employer’s income tax deduction for the life insurance premiums on employees does not hinge on the classification of the policy as group term or some other type. Deductibility of premiums depends on the reasonableness of the total compensation package for employees covered and on whether the employer is directly or indirectly a benefi-


13. See Mortality Tables, AMERICAN COUNCIL OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 108-09 (1977). Recent developments may ultimately diminish the luster of group term life insurance as an employee fringe benefit. Because term life insurance rates must increase with increasing mortality rates, the new requirement that retirement not be mandatory before age seventy may reduce the attractiveness to the employer of group term insurance as employee compensation. See Age Discrimination in Employment Act Amendments of 1978, Pub. L. No. 95-256, § 12, 92 Stat. 189 (1978) (to be codified as 29 U.S.C. § 663a). The Senate committee indicated that it believed the law would permit employers to continue reducing coverage for older workers or to begin increasing the employee contribution required as the worker’s age increases. S. REP. No. 95-493, 95th Cong., 1st Sess. 5 (1977).

Another problem on the horizon is increasing employee interest in post-retirement coverage. In addition to the problem posed by the the reluctance of insurers to maintain coverage past age seventy, the employer faces funding difficulties. Retired lives reserves have become a major area of controversy. For a discussion of that controversy, see Salem & Schmalbeck, Group-Term Life Insurance: IRS Creates New Solutions, Questions and Challenges, 51 J. TAX. 130 (1979).
The cost advantage of group term coverage can also be gained in the case of employees who contribute part or all of the premiums. In such a situation, however, the employee’s contributions are in after-tax dollars, as are premiums paid by members of sponsoring professional or trade associations.

But regardless of who pays the premiums, the amount of proceeds available to an insured’s beneficiaries will obviously be diminished by the amount of any additional federal estate tax imposed because of them. Thus, the estate planner should understand as much as possible about the includibility of group term life insurance proceeds in an insured’s estate.

The proceeds of life insurance are includible in the insured’s gross estate under section 2042 if: (a) They are receivable by the insured’s personal representative (executor); and (or) (b) The decedent possessed any incidents of ownership in the policy at the time of death.

"Receivable by the executor" has been broadly construed; proceeds are so classified when received by policy beneficiaries other than the executor when those beneficiaries are legally bound to use them “to pay taxes, debts, or other charges enforceable against the estate." An irrevocable life insurance trust can be structured to help meet these needs, but the terms of the trust should effectively prohibit the trustee from

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17. See I.R.C. § 2001(a)-(c). For a discussion of whether an estate is large enough to be subject to federal estate tax, see note 7 supra.


paying the taxes or debts of the decedent's estate.\textsuperscript{20} Even if the insurance proceeds are not "payable to the executor," they will, nevertheless, be included in the insured's gross estate under section 2042 if he possessed "incidents of ownership" at the time of death.\textsuperscript{21} An insured, covered through his employer, who made no attempt to assign his interest in the policy to a third party will clearly have incidents of ownership at his death.\textsuperscript{22} In addition, the insured decedent may have possessed such incidents at death because of incomplete assignments, third-party attribution or third-party assignment to decedent.\textsuperscript{23} But the crucial question for the estate

\textsuperscript{20} One means of removing the policy from the gross estate while retaining the possibility of using the proceeds to provide liquidity is a carefully drafted irrevocable inter vivos trust. Such a trust would be given the power to loan assets to the estate or buy assets from it, but would be effectively forbidden to pay the debts and taxes of the estate. \textit{See} Rev. Rul. 73-404, 1973-2 C.B. 319. It may be possible to accomplish this by permitting the trustee to pay the debts and taxes of the estate only if the estate's assets are insufficient, making the trust assets part of the gross estate only if the trust actually pays the debts and taxes, but the question is whether that is effective as a complete prohibition in the life insurance situation.


\textsuperscript{21} I.R.C. § 2042.


\textsuperscript{23} Treasury Regulation § 20.2042-1(c), T.D. 7623, 1979-26 I.R.B. 7, sets out the basic tests for incidents of ownership. While a complete discussion of incidents of ownership is beyond the scope of this paper, a few examples should be mentioned. Revenue Ruling 79-117, 1979-15 I.R.B. 12, suggests that the value of an insured decedent's power to designate disposition of insurance proceeds can be reduced to less than 5\% of the proceeds, thus escaping inclusion in the decedent's gross estate, by making the exercise of the power contingent upon surviving the policyowner and reserving the right to revoke the power. A related issue is whether the use of a revocable beneficiary designation to create a power makes it a power over a mere expectancy rather than a power to appoint property. The Tax Court has held that there is no property to which such a power can attach for purposes of section 2041 and that such a power is not an incident of ownership. Estate of Margrave, 71 T.C. 13 (1978). The power in \textit{Margrave} was the insured decedent's power to revoke or amend his revocable inter vivos trust. The trust was named under a revocable beneficiary designation as beneficiary of an insurance policy owned by the decedent's wife. \textit{Id.}

A corporation's incidents of ownership will be attributed to a sole or controlling stockholder to require inclusion of proceeds to the extent the proceeds are not payable to, or for the benefit of, the corporation. Estate of Levy, 70 T.C. 873 (1978). \textit{See also} Treas. Reg. § 20.2042-1(c)(6), T.D. 7623, 1979-26 I.R.B. 7 (but that regulation also states that the power of the corporation to surrender or cancel a policy qualified
planner and the insured policyowner is whether the incidents of ownership of a group term policy (and proceeds) can be successfully removed from the insured’s estate by an assignment.

I. ASSIGNMENT OF CONVERSION RIGHTS IN GROUP TERM POLICIES

Treasury regulations have long classified the power to surrender or cancel a life insurance policy as an incident of ownership. However, with respect to employer-paid group term life insurance the Internal Revenue Service (I.R.S. or the Service) has acknowledged that the power to cancel an insurance policy solely by terminating employment is not an incident of ownership; such a power is merely “a collateral consequence of the power that every employee has to terminate his employment.”

for favorable income tax treatment under section 79 will not be attributed to the stockholder).

The right to change the time or manner in which proceeds are paid to the beneficiary by changing a settlement option has been held an incident of ownership. Estate of Lumpkin v. Commissioner, 474 F.2d 1092 (5th Cir. 1973). Contra, Estate of Connelly, Sr. v. United States, 551 F.2d 545 (3d Cir. 1977). The courts are also divided on the question of whether the decedent’s possession of incidents of ownership in a fiduciary capacity requires inclusion in his gross estate regardless of circumstances. See Terriberry v. United States, 517 F.2d 286 (5th Cir. 1975), cert. denied, 424 U.S. 977 (1976); Estate of Skifter v. Commissioner, 468 F.2d 699 (2d Cir. 1972); Estate of Fruehauf v. Commissioner, 427 F.2d 80 (6th Cir. 1970). But see Treas. Reg. § 20.2042-1(c)(4), T.D. 7312, 1974-1 C.B. 277, 278. See also Rev. Rul. 76-261, 1976-2 C.B. 276.

The Internal Revenue Service has taken the position that the power to cancel a group term policy solely by terminating employment is not an incident of ownership. Rev. Rul. 72-307, 1972-1 C.B. 307. At least under some circumstances, the I.R.S. also does not view an employee’s right to later apply for group insurance as an incident of ownership, provided that the right is contingent upon an existing third party owner’s ceasing to qualify as an eligible owner. Rev. Rul. 76-421, 1976-2 C.B. 280. An employee’s right to prevent cancellation of a policy owned by the employer may be an incident of ownership. Rev. Rul. 79-46, 1979-6 I.R.B. 17. Though the situation in Revenue Ruling 79-46 was one in which the employer named the employee’s spouse as beneficiary, the same principle could be used to include in the employee’s gross estate a key man policy payable to the employer, provided that the employee has the power to prevent cancellation (by purchase or other means, presumably). However, the Tax Court has since rejected this view where a key man policy was payable to the corporation and the deceased employee did not have a significant stock ownership interest. See Estate of Smith, 73 T.C. No. 27, ¶ 73.27 P-H T.C. (1979).

25. Rev. Rul. 72-307, 1972-1 C.B. 307. This ruling is consistent with the holdings of two cases decided before it was issued. Estate of Lumpkin v. Commissioner, 56 T.C. 815 (1971), rev’d on other grounds, 474 F.2d 1092 (5th Cir. 1973); Landorf v.
This ruling probably does not extend to a situation in which the policyowner has a contractual or statutory right to convert the coverage from term to whole life, and failure to convert by the end of the term will permit the coverage to lapse. Lapse of insurance coverage due to failure to exercise a conversion right is something more than a collateral consequence of the insured's power to terminate his employment. Such a conversion right would thus constitute an incident of ownership, causing inclusion of the policy in the insured's gross estate. Therefore, an insured under a group term policy would be well advised to assign away any existing conversion rights. In fact, for a time, the I.R.S. required that group term policies be convertible as a prerequisite to their assignability. The response was a flurry of enabling-clarifying state legislation as to both assignability and convertibility. Aside from statutory requirements, the provisions of the master policy for each group generally determine the formalities needed

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27. See Rev. Rul. 69-54, Situation 3, 1969-1 C.B. 221. Statutory conversion rights may also affect the completeness of the assignment. For example, the Wisconsin statute creating conversion rights for group life insurance policies gives the insurer the right to terminate the master policy, or amend it to exclude classes of persons, during the first five years that the policy is in effect without providing conversion rights for the persons whose coverage is so terminated. Wis. Stat. § 632.57(4)(1977). Thus, the right to convert upon termination or amendment takes effect five years after coverage begins. See Rev. Rul. 79-231, 1979-31 I.R.B. 9. Obviously, there would be similar problems if a policy were assigned in a state lacking a conversion statute and the state later enacted one. Therefore, it is highly desirable that the policy contract specifically provide for conversion rights upon termination of employment or membership in the eligible group and upon termination or amendment of the group policy.
29. Murphy, Assignment of Group Life Insurance for the Purpose of Estate Tax Avoidance, 55 Taxes 476, 478 n.19 (1977). See, e.g., 1975 Wis. Laws, ch. 375, (codified as Wis. Stat. §§ 632.47 & 632.57 (1977)). A note in the session law states that section 632.47 was intended to permit Wisconsin residents to make effective assignments under Revenue Ruling 68-334. (Revenue Ruling 69-54, 1969-1 C.B. 221 changed this ruling in only one respect: it sought to make clear that the word "solely" did not mean that any incident of ownership could be safely retained merely by requiring that it be exercisable only in conjunction with another person.)
GROUP TERM INSURANCE for an effective assignment.\textsuperscript{30} Even prohibitions stated in an individual policy certificate may not be binding if they are not reflected in the master policy.\textsuperscript{31}

II. THE REVIVAL OF THE PREMIUM PAYMENT TEST

Even before conceding that the incidents of ownership of a group term life insurance policy were assignable, the Service attempted to reach a portion of life insurance proceeds under section 2035, the section which brings gifts made within three years of death back into the decedent's gross estate. The means used was the resurrection of the payment of premium test that was deleted from the 1954 Code for purposes of section 2042.\textsuperscript{32} In Revenue Ruling 67-463 the I.R.S. applied some rather novel reasoning to conclude that premiums paid by an insured within three years of death — as a proportion of total

\textsuperscript{30} It has been held that no effective assignment can be made where the master policy prohibits assignment, despite a state statute specifically authorizing assignment. Estate of Bartlett v. Commissioner, 54 T.C. 1590 (1970). Because the statute in Bartlett was an enabling statute which merely validated assignments made pursuant to the terms of any given policy, it would seem that a statute sharply restricting the insurer's right to prohibit assignments would control over a master policy provision which prohibited assignment. \textit{E.g.}, 1975 Wis. Laws, ch. 375, (codified as Wis. STAT. § 632.47 (1977)) (A note in the session law strongly implies that a complete prohibition of assignment in the master policy will have no effect under the statute.) Although Revenue Ruling 79-231, 1979-31 I.R.B. 9, stops just short of stating that an assignment is ineffective for estate tax purposes unless effective as against the insurer, one writer has suggested that the I.R.S. lacks standing to assert a nonassignability clause as a bar to valid transfer and indicates that this argument should be especially effective if the insurer has waived the clause or state courts have refused to enforce it (and presumably also if state statute holds such a bar ineffective for any purpose but avoiding double payment). \textit{See Murphy, Assignment of Group Life Insurance for the Purpose of Estate Tax Avoidance, 55 TAXES 476, 479 n.26 & 27, 484 n.71 (1977).}


The I.R.S. apparently began using the premium payment theory to attempt to reach proceeds of policies never owned by the insured decedent (or transferred more than three years before death) in approximately 1962 and included a discussion of that position in its 1965 field manual. Simmons, "Contemplation of Death Aspects of Life Insurance," \textit{U. Miami 2d Inst. on Est. Plan.}, ¶ 68.1106 & n.53 (1968).
premiums paid — required inclusion of a pro rata portion of the insurance proceeds in the insured's estate.\textsuperscript{33}

The newly revived theory fared poorly in the courts. First, in \textit{Gorman v. United States}, in the context of a premium payment by the insured for a term policy purchased within three years of death, a federal district court chose to focus on the history of section 2035 and bring back only the specific assets transferred within three years of death.\textsuperscript{34} Thus, it concluded that only the premiums paid by the insured during that period were includible in the insured's estate.\textsuperscript{35}

Next the Tax Court, in \textit{Estate of Coleman v. Commissioner} noted that Congress enacted section 2035 to prevent the diversion of assets from an estate, and concluded that only the actual premiums paid by the insured decedent during the three years before death were so diverted.\textsuperscript{36} As the court observed that the payment of premium test had been abolished with respect to section 2042, the court was, in effect, holding that the test was similarly irrelevant under section 2035.\textsuperscript{37}

The Tax Court noted that the premiums merely maintained the policyowner's rights under the policy; they neither created nor recreated them.\textsuperscript{38} Thus, no new interest was being transferred within three years of death by the payment of premiums during that period, exempting the interest from inclusion under section 2035. The Fifth Circuit endorsed this maintenance of rights theory in \textit{First National Bank of Midland v. United States}.\textsuperscript{39} In rejecting the payment of premium test, the Fifth Circuit held that the right to life insurance proceeds vested in the owner at the policy's inception. The court emphasized that the daughter-owner of the policy could just as easily have paid the premiums herself and was under no duty to allow her father, the insured, to pay them. Under these circumstances the court concluded that the insured's premium payments were essentially cash gifts, rather than a

\begin{footnotes}
\item 33. 1967-2 C.B. 327.
\item 35. Id.
\item 37. Id.
\item 38. Id.
\item 39. First Nat'l Bank v. United States, 423 F.2d 1286 (5th Cir. 1970).
\end{footnotes}
transfer of insurance proceeds, so that none of the proceeds was includible under section 2035.40

The courts were apparently not accepting the theory that each premium payment transferred a pro rata portion of the proceeds. In Bel v. United States, however, the Service was successful in persuading the Fifth Circuit to salvage the premium payment test, at least with respect to a term policy renewed within three years of death.41

Bel involved an annually renewable accidental death policy owned by the insured's children and originally purchased more than three years before the insured's death.42 Because the policy was renewed annually, the Service contended that only the most recently paid premium engendered all of the rights under the policy.43

The district court had accepted the government's position that the premium payments fell within the terms of section 2035, but found that insufficient to require the inclusion of the entire policy proceeds in the insured's gross estate.44 The court followed essentially the same line of reasoning as did the Tax Court in the Coleman case: if the payment of premiums no longer required inclusion of the policy proceeds under section 2042, it followed that the mere payment of premiums could not constitute a transfer of an interest in the policy proceeds for purposes of section 2035.45

One week after the district court ruled for the taxpayer in Bel, the Fifth Circuit issued its decision in Midland.46 In Midland, it will be recalled, the court rejected the theory that the payment of premiums on a policy brought into existence more than three years before the insured's death could amount to a transfer of an interest in that policy.47 But in Bel, the Fifth Circuit, in overruling the district court, reached the opposite result with respect to the payment of the premiums on the

40. Id.
41. See Bel v. United States, 452 F.2d 683 (5th Cir. 1971), cert. denied, 406 U.S. 919 (1972).
42. Id.
43. Id.
45. Id.
47. Id.
policy in that case.\textsuperscript{48} The court asserted the distinction lay in the nature of the annually renewable policy before it, finding that each renewal essentially created a new policy.\textsuperscript{49} Thus, the policy was brought into being within three years of death, but section 2035 also requires that a \textit{transfer} be made by the decedent within three years of death.\textsuperscript{50} The Tax Court in \textit{Coleman} had, after all, pointed out that the purpose of section 2035 was to prevent the diversion of assets from the decedent’s estate prior to death.\textsuperscript{51} What more was diverted in \textit{Bel} than the amount of the premiums paid?

To grapple with this problem the \textit{Bel} court, in effect, rejected the "diversion" theory of section 2035 and adopted an "indirect transfer" theory.\textsuperscript{52} The court based this theory on the United States Supreme Court case, \textit{Chase National Bank v. United States}.\textsuperscript{53} The taxpayer in \textit{Chase} had contended that the estate taxation of life insurance proceeds was an unconstitutional direct tax. It could not be classified as a tax on the privilege of transfer, since the proceeds were transferred by the insurance company, not by the insured. The Court disposed of this argument by broadly interpreting the notion of a transfer by the decedent as including the situation where a third party was induced by the decedent, who controlled the disposition of the proceeds until his death, to make a transfer.\textsuperscript{54} Lifting this reasoning from the very different context of the \textit{Chase} case, the Fifth Circuit applied it to hold that the

\begin{footnotesize}
\begin{enumerate}
\item Bel v. United States, 452 F.2d 683 (5th Cir. 1971), \textit{cert. denied}, 406 U.S. 919 (1972).
\item Apparently the court meant that the policies at issue in those cases were whole life policies rather than annually renewable term policies. The \textit{Midland} opinion does imply a whole life policy, but nowhere does the \textit{Coleman} opinion indicate whether the policy in that case was term or whole life. \textit{See} Bel v. United States, 452 F.2d 683 (5th Cir. 1971), \textit{cert. denied}, 406 U.S. 919 (1972); First Nat’l Bank v. United States, 423 F.2d 1286 (5th Cir. 1970); Estate of Coleman v. Commissioner, 52 T.C. 921 (1969).
\item Section 2035 applies to transfers from the decedent within three years of death and has been substantially unchanged (except for removal of the contemplation of death requirement in 1976) from its predecessor section in the 1939 Code. \textit{See} I.R.C. \textsection{811(c)} (1939 Code) (current version at I.R.C. \textsection{2035}).
\item Estate of Coleman v. Commissioner, 52 T.C. 921 (1969).
\item \textit{See} 452 F.2d at 691-92.
\item 278 U.S. 327 (1929).
\item \textit{Id.} at 338-39.
\end{enumerate}
\end{footnotesize}
renewal of a term policy, rather than its initial creation, was the operative transfer of the policy. Chase does indeed hold that the fact that the policy proceeds come from the insurer does not bar ascribing them to the insured for purposes of considering him to have transferred them. But that does not compel a conclusion as to when that transfer is to be considered to have taken place with respect to a renewable term policy. The Fifth Circuit's view that a renewal premium buys a discrete policy, and that payment of the renewal premium by the insured constitutes an indirect transfer of a new policy that transfer is to be considered to have taken place with respect to a renewable term policy. The Fifth Circuit's view that a renewal premium buys a discrete policy, and that payment of the renewal premium by the insured constitutes an indirect transfer of a new policy does not follow from the Court's reasoning in Chase. Rather, this view grafts the old section 2042 premium payment test onto Chase, overlooking the fact that the insured has surrendered all of his ownership rights, including the right to designate the beneficiary, long before paying the last renewal premium.

III. POLICIES FIRST PURCHASED (OR ASSIGNED) WITHIN THREE YEARS OF DEATH

Other circuits have applied the Bel payment of premium rationale to life insurance policies never owned by the insured, but first purchased within three years of death. Since inclusion of the proceeds in the gross estate was, in these cases, required solely because of the date of purchase or assignment, no distinctions between whole life and term policies were required.

55. See 452 F.2d at 690-92.
56. 278 U.S. at 338-39.
57. Cf. Treas. Reg. § 20.2042-1(c)(2), T.D. 7312, 1974-1 C.B. 277, 278 (listing some of the incidents of ownership which must be surrendered to avoid taxation under I.R.C. § 2042).
58. First Nat'l Bank of Oregon v. United States, 488 F.2d 575 (9th Cir. 1973); Detroit Bank & Trust Co. v. United States, 467 F.2d 964 (6th Cir. 1972), cert. denied, 410 U.S. 929 (1973). If a policy is assigned within three years of the insured's death, the assignment itself fulfills the transfer requirement, removing the need for the premium payment test. See, e.g., Estate of Silverman v. Commissioner, 521 F.2d 574 (2d Cir. 1975); Peters v. United States, 572 F.2d 851 (Ct. Cl. 1978) (In Silverman, only a pro rata share of the proceeds was included in the gross estate where the assignee paid the premiums after the assignment. Though the Second Circuit affirmed the lower court's decision, it expressed doubt about this result and indicated that it might have held oppositely if this issue had been appealed.)
Transfers of life insurance policies within three years of death are affected by a recent amendment to section 2035. The Revenue Act of 1978 requires that the gross estate of a decedent dying after 1976 include “any transfer with respect to a life insurance policy” made after 1976 and within three years of death. According to the committee reports, premium payments are excepted from section 2035, to the extent they are not required to have been included on a gift tax return because of the $3,000 annual exclusion, unless they would have “resulted in the inclusion in the gross estate of the proceeds of the policy under law prior to the 1976 Act if the transfer were made within three years of death.” The committee reports made reference to the premium payment test as an example of a circumstance which would have required inclusion under prior law. At the same time, the reports also imply that premium payments which, together with other gifts to the same donee, do not aggregate to more than $3,000 in a year will be covered by the exclusion from section 2035. It is thus not clear to what extent the premium payment test applies under section 2035, so the ambiguities surrounding the premium payment test continue. The open-ended phrase

61. See id. Transfers of other property within three years of death are not taxed unless required to be included in a gift tax return under section 6019 of the Code. Id. at (b)(2). Code section 6019 exempts transfers excluded by Code section 2503(b), which in turn excludes $3,000 of the aggregate value of gifts made to any one donee during a taxable year (unless it is a gift of a future interest). Note also that the language of section 702(f) of the Act (codified at I.R.C. section 2035(b)), is broad enough to require that the entire value of aggregate gifts exceeding $3,000 (for the year) at the time of transfer be included (no deduction of the $3,000 annual exclusion). In addition, the value of the gift to be included in the gross estate is “grossed-up” by the amount of any gift tax paid. I.R.C. § 2035(c). These amendments apply to the estates of all decedents dying after December 31, 1976, but only as to transfers made after that date. Id.
63. See reports cited note 62 supra.
64. See text accompanying notes 70-95 infra. Prior to the 1976 Act, transfers made within three years of death were included in the gross estate if the decedent made them “in contemplation of death.” I.R.C. § 2035 (1954 Code prior to amendment by the Tax Reform Act of 1976, Pub. L. No. 95-455, § 2001(a)(5)(d)(1)).

"any transfer with respect to a life insurance policy" may be particularly vexing to pursue: amounts may be small and transfers indirect and obscure. But a rather small premium can transfer a substantial amount of group term life insurance proceeds.

Another development worthy of note is the recent ruling that the three-year period begins anew if the employer or group changes insurance carriers, even though the new policy is identical to the old one. The Service rejected the view that a yet-to-be-acquired policy can be presently assigned, even where the purported assignment is binding under state law. While this position is consistent with past rulings on the assignability of group term life insurance, bringing this point out into the open should cause knowledgeable employers to hesitate to change group carriers if valued employees have previously assigned their policies.

IV. Policies Initially Purchased or Assigned More Than Three Years Before Death

Because most group insurance policies are renewable annually or monthly, the degree of acceptance of the Bel hold-

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the two-year period has expired, a transfer may be taxed under section 72.12(4)(a), but the burden has shifted to the state to prove that the transfer was made in contemplation of death. Will of Daniels, 225 Wis. 502, 274 N.W. 435 (1937). It has rarely been possible to remove the contemplation of death presumption as to life insurance. Wolfson, "Gifts Within Three Years of Death Under the Tax Reform Act of 1976 — Contemplation of Death: A Dying Issue," 35th N.Y.U. Inst. on Fed. Tax. 1429, 1444 (1977). However, a group term life insurance policy was once successfully shown not to have been transferred in contemplation of death. Landorf v. United States, 408 F.2d 461 (Ct. Cl. 1969). Though the case is not controlling under Wisconsin inheritance tax law, the pattern of lifetime giving used there to rebut the presumption has been recognized in Wisconsin. See, e.g., Estate of Gallun, 215 Wis. 314, 254 N.W. 542 (1934). But cf. Estate of Compton v. Commissioner, 532 F.2d 1086 (6th Cir. 1976) (difficulty of establishing a pattern of lifetime giving).

65. Examples include premium payments by the employer, premium payments to a plan administrator rather than an insurance company, and decedent's failure to retain the plan booklet or records of an assignment.

66. See 1979 monthly rates per $1,000 of coverage, A.I.C.P.A. Insurance Trust C.P.A. Plan, on file with the Marquette Law Review; annual premiums per $1,000 of coverage, HUEBNER & BLACK, supra note 11, at 408, table 34-1.


68. Id.


70. HUEBNER & BLACK, supra note 11, at 407-09; W. MEYER, LIFE AND HEALTH
ing that each renewal premium purchases a new policy\textsuperscript{71} will determine whether the proceeds of a group term insurance policy on the life of a premium-paying decedent can ever be beyond the reach of section 2035.\textsuperscript{72} Having the insured’s employer pay the premiums will not eliminate the problem for the employee will be considered to have made a constructive gift to the policy owner.\textsuperscript{72} The staff of the Joint Committee on Taxation implied early in 1979 that policy renewal rights are relevant to the includibility of proceeds under section 2035,\textsuperscript{74} but a discussion will show that the law is unclear on this point.

The annually renewed policy in \textit{Bel}\textsuperscript{75} was an accidental death policy, but some writers have expressed the view that the same principles would require inclusion of an annually renewable term life insurance policy in the gross estate of the premium-paying insured.\textsuperscript{76} The Fifth Circuit, after \textit{Bel}, made an ambiguous statement, in \textit{Bintliff v. United States}, that could be interpreted as either limiting or overruling \textit{Bel}:

\begin{quote}
It is settled law in this court that the premiums paid in contemplation of death, not the whole of the life insurance proceeds, are includable in the decedent’s gross estate under Section 2035. \textit{See} First National Bank of Midland v. United States. \textit{But see} Bel v. United States.\textsuperscript{77}
\end{quote}

The government had argued that the policies insuring dece-
dent's life first purchased by his wife five and six years before
his death were includible in his estate under section 2035 by
virtue of the decedent's premium payments within three years
of death.\textsuperscript{76} The court held that decedent's community prop-
erty incidents of ownership (section 2042) had been effectively
conveyed prior to the three year period and cited \textit{Midland} as
authority for the proposition that only the premiums paid
within three years of death would be included under section
2035.\textsuperscript{79}

The applicability of \textit{Bintliff} to annually renewable term
policies assigned more than three years before death is un-
clear. The second policy in that case arose from the conver-
sion of two term insurance policies owned by the insured's
wife, which took place within three years of his death. A new
assignment instrument was executed at that time.\textsuperscript{80} The ques-
tion of whether this constituted a new assignment within
three years of death was discussed by neither the district
court nor the Fifth Circuit.\textsuperscript{81} Nor did either court address the
issue of whether the decreasing term policies in \textit{Bintliff} were
distinguishable from the annually renewable policy in \textit{Bel} for
purposes of determining whether each renewal premium pur-
chased a new policy.\textsuperscript{82} Indeed, neither the district court nor
the Fifth Circuit even mentioned that there might be a differ-
ence in this respect between a whole life policy and a term
policy renewed within three years of death.\textsuperscript{83} Apparently the
Fifth Circuit intended to leave the door sufficiently open in
\textit{Bintliff} to enable it to distinguish the case easily if it should

\textsuperscript{78} Bintliff v. United States, 329 F. Supp. 1356 (E.D. Tex. 1971), rev'd on other
grounds, 462 F.2d 403 (5th Cir. 1972).

\textsuperscript{79} Bintliff v. United States, 462 F.2d 403 (5th Cir. 1972). If the insured decedent
has not executed an effective control clause showing clear intent to make a gift of his
or her community property interest in the policy, the incidents of ownership thus
retained will subject one-half of the proceeds to estate taxation under section 2042.
Simply naming one's spouse as owner does not overcome the rebuttable presumption
of community property raised by the payment of premiums from community funds.
See, e.g., Freedman v. United States, 382 F.2d 742 (5th Cir. 1967); Estate of Madsen
v. Commissioner, 1979 T.C.M. 289, P-H Memo T.C. ¶ 79,289 (1979), appeal taken,
(9th Cir. Nov. 13, 1979).

\textsuperscript{80} 462 F.2d at 404-05.

\textsuperscript{81} See Bintliff v. United States, 329 F. Supp. 1356 (E.D. Tex. 1971), rev'd on
other grounds, 462 F.2d 403 (5th Cir. 1972).

\textsuperscript{82} See district court and fifth circuit opinions cited note 81 supra.

\textsuperscript{83} See district court and fifth circuit opinions cited note 81 supra.
choose to continue to apply Bel to annually renewable policies assigned more than three years before death.

Another case, decided by the Fifth Circuit within months after Bel, also creates some ambiguity about how the court would treat the facts of Bel in the future. In Parson v. United States, as in Bel, the policy at issue was an accidental death policy originally assigned to a family member more than three years before the death of the insured. The government argued in the district court that each premium purchased a one-year policy. The Parson and Bel appeals were tried before two different panels of Fifth Circuit judges. The circuit court opinion in Parson does not indicate whether the section 2035 issue had been appealed or whether the court was aware of the Bel decision; it focuses instead on the effectiveness of the control clause transferring the decedent's community property incidents of ownership. At most, the opinion indicates a willingness to let the district court's rejection of the Section 2035 argument stand. Although Parson was later cited somewhat ambiguously in Bintliff, the Bintliff court seemed primarily concerned with the effectiveness of the Parson control clause. The Fifth Circuit has subsequently followed Bel where the initial assignment of a flight insurance policy was made immediately before death, but Bintliff appears to be the court's latest word about life insurance policies purchased or assigned more than three years before death.

Even if Bintliff or Parson were to be viewed as having clearly overruled Bel in the Fifth Circuit, it would appear that dicta in one circuit court case would be the only obstacle to a renewal of the premium payment argument in other circuits. The issue remains undiscussed in other circuits because they have been faced only with policies initially purchased or as-

84. Parson v. United States, 460 F.2d 228 (5th Cir. 1972).
87. See cases cited at note 85 supra.
88. See 460 F.2d 228 (5th Cir. 1972).
89. See Bintliff v. United States, 462 F.2d 403 (5th Cir. 1972).
91. See Silverman v. Commissioner, 521 F.2d 574 (2d Cir. 1975).
signed within three years of death.92

The existing revenue rulings dealing with annually renewable term insurance under section 2035 are sufficiently narrow to permit revival of the “annual transfer by premium” argument without having to revoke a single ruling.93 Revenue Ruling 71-497 uses broad transfer reasoning like that in Bel for its discussion of an accidental death policy purchased nine months before death, but leaves open the question of whether the same reasoning would be applied to the renewal of an annually renewable accidental death or group term policy purchased or assigned more than three years before death.94 The ruling also fails to state whether the one-year accidental death policy purchased nine months before death was renewable, thus easily avoiding the issue of whether guaranteed-renewable policies would be viewed differently from policies renewable only at the option of the insurer.95

Revenue Ruling 79-231 holds that an employer’s change of insurance carriers is a purchase of a new policy, and the same principles seem equally applicable to any group’s change of carrier.96 It may be reasonable to infer from that position that it is otherwise not deemed to be a new purchase made whenever a premium is paid, but the ruling does not necessarily imply that the policy would not be includible if the employer had not changed carriers.97 The discussion is carefully confined solely to the consequences of changing carriers within three years of death.98 This revenue ruling may or may not be the first stage of a new drive to tax group term life insurance under section 2035. Additional cases or legislation will be necessary before the status of annually renewable policies under the premium payment test of section 2035 can be deemed

92. See cases cited at note 58 supra.
95. See id.
97. See id.
98. See id.
settled.

The five-year renewable group term life policy is somewhat less vulnerable under the Service's view of the premium payment test. Revenue Ruling 71-497 states that such a policy is outside the scope of section 2035 in the case of a policy purchased four years before the death of the insured. 99 It is left unclear in the ruling whether renewal of the policy would start the three-year premium payment test period over again and whether the I.R.S. would view guaranteed renewability differently from renewability at the option of the insurer. 100 It would also appear that the principles of Revenue Ruling 79-231 would be applicable to a change of carrier at the expiration of the term, 101 but a five-year policy contract would at least reduce the frequency of the insured's exposure to that danger.

V. IS A DISTINCTION BETWEEN TERM LIFE INSURANCE AND WHOLE LIFE INSURANCE DEFENSIBLE FOR ESTATE TAX PURPOSES?

If an insured dies within three years after assigning the incidents of ownership in a life insurance policy, it is clear that the entire amount of the proceeds will be part of the estate for tax purposes, regardless of whether the policy was term or whole life. 102 It is also settled that if an insured survives the assignment (or purchase by another) of a whole life policy by more than three years, the proceeds will not be part of the estate even though the insured actually or constructively paid the premiums during the three years preceding death. 103

As discussed in the preceding sections, what is left unsettled by case law is the question of whether an insured, who is deemed to have continued to pay the premiums and survives the assignment (or initial purchase by a third party) of an annually renewable term life insurance policy by more than three years, will have the proceeds included in his gross es-

100. See id.
102. See I.R.C. § 2035. See also Peters v. United States, 572 F.2d 851 (Ct. Cl. 1978).
tate. Some writers have concluded that the proceeds should be so includible. This view, in the author's opinion, results from an exaggeration of the significance of certain distinctions between whole life and term insurance policies.

These distinctions are: (a) the manner of funding the proceeds; and (b) the extent of the policyowner's resulting right to maintain an interest in the policy after ceasing to pay premiums. It has been argued on the basis of these distinctions that a whole life policy is a different species of contract from a term policy because different consequences flow from the cessation of premium payments. It will be shown that while the contract provisions for funding and continuation may have certain gift tax or income tax implications during an insured's life, they have no influence on the proceeds received by a beneficiary upon the death of the insured. Thus, it will be demonstrated, in the author's view, that there is nothing inherent in the nature of term policy proceeds which would justify distinguishing their death tax treatment from that of the proceeds of a whole life policy.

A. The Significance of Funding

A whole life policy is an installment purchase of the single premium cost for whole life protection computed at the insured's age of issue. Consistent with other types of long term debt amortization payments, the early payments (premiums) are largely expenses and prefunding of insurance cost, with a slowly building equity (described by such industry


106. See authorities cited at note 104 supra.

107. See HUEBNER & BLACK, supra note 11, at 4-8; MEYER, supra note 70, at § 3:1; Mehr, The Concept of the Level-Premium Whole Life Insurance Policy — Reexamined, 1975 J. OF RISK & INS. 419. [hereinafter cited as Mehr].

108. Mehr, supra note 107, at 423-25. See also HUEBNER & BLACK, supra note 11, at 268.
terms as "cash surrender value" or "non-forfeiture value.").\textsuperscript{109}

Were single premium coverage to be purchased, that single premium would be merely the discounted value of the annual term insurance premiums otherwise payable over a lifetime. Thus the spreading of payments over the remaining lifetime of the insured is just a funding mechanism which makes a major purchase affordable by large numbers of persons.\textsuperscript{110} Naturally, the equity which builds over time can be used in a variety of ways: to secure a (policy) loan; to buy a paid-up policy of lesser face value if the premiums are discontinued (i.e., a single premium policy at the insured's then-attained age equal in cost to the amount of the equity built up to that point); to buy term insurance if premiums are discontinued; or to provide cash upon surrender of the policy.\textsuperscript{111}

In contrast to the whole life funding mechanism, annually renewable term insurance premiums merely pay for each year's coverage.\textsuperscript{112} These costs are lower in a person's younger years than they are as he grows older, reflecting the normal mortality risk inherent in life insurance.\textsuperscript{113} In a whole life pol-

\textsuperscript{109} See HUEBNER & BLACK, supra note 11, at 291-92, 307-08, table 26-3 at 317; Williams, Contracts — Whole Life and Endowment, in LIFE AND HEALTH INSURANCE HANDBOOK 70, table 6-3 (D. Gregg & V. Lucas ed. 1973).

\textsuperscript{110} The gross level premium for a insurance policy consists of a net premium plus an amount to cover expenses and contingencies (loading). HUEBNER & BLACK, supra note 11, at 253-54. The net level premium, in turn, is based on the net single premium for a given policy, being nothing more than "a life annuity for the premium-payment period that is equivalent to the net single premium on the particular policy." HUEBNER & BLACK, supra note 11, at 270 (emphasis in original). The net single premium for a whole life policy is calculated on the basis of the cost of term insurance for each year the policy is expected to be in force, discounted to the present value for the year the policy is issued. HUEBNER & BLACK, supra note 11, at 257-58. Though the whole life insurance net premium is based on the term insurance net premium, the gross premium for term policies may be adjusted upward by some companies who have experienced higher mortality rates for term insurance policies than for whole life policies. Beadles, Contracts — Term Insurance, in LIFE AND HEALTH INSURANCE HANDBOOK 55, 61-62 (D. Gregg & V. Lucas ed. 1973) [hereinafter cited as Beadles]. However, this increase may be offset by the absence of the higher agents' commissions paid on sales of whole life insurance. See Moffitt, Gaddy's Unconventional Tactics Guide Fast-Growing Life Insurance Concern, Wall St. J., Nov. 20, 1979 at 6, col. 2 (Midwest ed.).

\textsuperscript{111} HUEBNER & BLACK, supra note 11, at 314-18; H. KRUEGER & L. WAGGONER, THE LIFE INSURANCE POLICY CONTRACT § 10.1-11.4 (1953); MEYER, supra note 70, at § 3:1.

\textsuperscript{112} HUEBNER & BLACK, supra note 11, at 254-55; Mehr, supra note 107, at 423.

\textsuperscript{113} Beadles, supra note 110, at 55, 64; HUEBNER & BLACK, supra note 11, at 5-6; Mehr, supra note 107, at 423-24.
icy, the higher cost of insurance coverage in later years is spread over the entire life of the insured; in a term policy, this cost is incurred as it accrues, leading to larger premiums in later years. But these graduated premiums are merely annual rents for an increasingly expensive (or valuable) benefit, as compared to the mortgage-amortization approach of the whole life contract purchase.

These differences in equity values and in the flow of cash premiums have led some writers to justify different estate tax treatment of identical benefits. Such writers acknowledge that premiums for term insurance are purely for the cost of insurance. However, those writers describe the premiums for whole life insurance as building an individual reserve which is later used to fund a portion of the proceeds. This view of whole life insurance as a combination of decreasing term insurance and a savings account (with the sum always equal to the face of the policy) implies that any proceeds in excess of the cash value of the policy at death are, in essence, term insurance proceeds. If term insurance proceeds in fact cannot be effectively assigned out of an estate unless the assignee (or other third party) pays the premiums, this view would also require inclusion of the "term insurance portion" of the whole life proceeds in the insured's gross estate under section 2035, a result supported by no case law.

B. Continuity of Contract

The question of effective assignment of a term insurance policy has often turned on the perception of whether a term insurance policy is a continuous contract. One view, which was expressed in Bel, holds that all of the rights under an annually renewable term policy are created by the last annual pre-

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114. Compare note 110 supra with text accompanying notes 112-13 supra.
115. See, e.g., authorities cited at note 104 supra.
116. See, e.g., authorities cited at note 104 supra.
117. See, e.g., authorities cited at note 104 supra. For a discussion of the accounting distortions that can result from the use of this approach for valuing policies owned by a given policyholder, see Falk, Accounting for Cash Value Policies, 1975 J. Risk & Ins. 403.
118. Indeed, this approach has been proposed. See S. Surrey, W. Warren, P. McDaniel & H. Gutman, Federal Wealth Transfer Taxation 269 (1977).
mium paid. Thus, each annual premium payment constitutes a new creation and transfer of the policy — necessarily within three years of death so that the entire policy proceeds will be includible under section 2035.120

This view would treat group term life insurance as a series of discrete contracts which, if assignment is to be made at all, would require annual assignment, thus dooming to failure under section 2035 any attempt to make a permanent assignment. Such a view ignores the importance of state law in determining the nature of life insurance policy contracts.

Though it is true that the question of how an interest in property is to be federally taxed is a federal question, the nature of that interest in property is a question of state law.121 Thus, state court pronouncements that guaranteed-renewable group term life insurance policies are continuous contracts kept in force by the payment of premiums are relevant to the question of whether those continuity rights are sufficient to require their treatment as continuous contracts for federal tax purposes. The courts of several states have treated guaranteed-renewable group term policies as continuous contracts.122

In addition, the Oregon Supreme Court has gone so far as to hold that a group health insurance policy subject to cancellation at the option of the insurer was nevertheless a continuous contract, apparently because it provided for renewal unless the entire group's insurance was cancelled.123

Similarly, the federal courts have continued to recognize that state regulation of life insurance affects the nature and assignability of policies for purposes of federal tax law.124 State statutes creating rights surviving the nonpayment of premiums for group term policies125 cast doubt upon the rea-

120. See id.
121. See Morgan v. Commissioner, 309 U.S. 78, 80-81 (1940).
124. See, e.g., Parson v. United States, 460 F.2d 228 (5th Cir. 1972); Estate of Madsen, 1979 T.C.M. 289, P-H Memo T.C. D 79,289 (1979), appeal taken Nov. 13, 1979, 9th Cir.
125. See HUEBNER & BLACK, supra note 11, at 411-12. See also authorities cited at note 29 supra.
sonableness of a blanket assertion that term policies are discrete contracts for purposes of federal taxation.

The classification of term insurance policies as continuous contracts flows from their various continuity features. Such policies commonly provide for continuity through a variety of contractual and (or) statutory features. One is the previously mentioned right of guaranteed renewability at the option of the insured without further evidence of insurability and at the rate for the insured’s age at the time of renewal. Continuity is thus based on facts established at the time of the initial purchase, so logically all rights based on those facts could be considered to date from that time. By the same token, the rights of an assignee of a policy arise at the time of assignment and continue therefrom.

Another common feature of term policies is the right to purchase whole life insurance without further evidence of insurability. The purchase may be in replacement of the term insurance (commonly called a conversion feature) or in addition to the term insurance. The right of conversion often persists, either by contract provision or state statute, beyond the termination of the policy for nonpayment of premium. The right also persists in many cases after the insured leaves the group.

Assuming that these rights have been validly vested in the insured’s assignee (or other third-party owner), their subsequent exercise by the owner should not constitute a new transfer by the insured. Even the insured’s payment of a premium subsequent to conversion should constitute no more than a gift of the premium — not a transfer of the previously assigned proceeds.

126. Beadles, supra note 110, at 57-58; HUEBNER & BLACK, supra note 11, at 407-08; MEYER, supra note 70, at § 9:1.
128. See authorities cited at note 127 supra.
129. HUEBNER & BLACK, supra note 11, at 411-12. See, e.g., WIS. STAT. §§ 632.44(2) & 632.57(3)-(5) (1977). Cf. WIS. STAT. § 625.12(2) (1977) (which permits modification of rates for individual risks if section 632.57(3) is not applicable).
131. But see text accompanying notes 58-101 supra.
Where a group of employees constitutes the group covered by a term insurance policy, the only "right" which may not be assignable by an insured is the "right" of the employer to pay the premiums. Since the employer's payment of premiums is compensation to the employee and the Service has ruled that the employee makes a constructive gift of the premium to the assignee, the amount of the premium payment would seem a reasonable measure of the value of the constructive gift.\textsuperscript{132}

Yet another common feature of term policies is a waiver of premium clause. In the event of the insured's permanent disability the policy becomes paid-up insurance for the remainder of the insured's lifetime without further premium payments.\textsuperscript{133} Obviously, in such a situation nonpayment of premium has not resulted in termination of all rights under the policy.

These rights of continuity in term insurance policies are obviously valuable. They guarantee more than insurability. In Wisconsin, for instance, they also prevent an individual insured's health history subsequent to the date of inception of the term policy from adversely affecting premium levels if the statutory conversion right is later exercised.\textsuperscript{134} This protection can be especially desirable in those common situations where a group's life insurance carrier is closely affiliated with that group's medical insurance carrier.

The existence of these rights of continuity in term life insurance policies weakens the view that they are merely a series of separate and discrete annual contracts. The continuity provisions merely exist in a different format in a term policy than they do in a whole life policy because of the different funding techniques previously discussed. If this continuous contract view is taken, and the continuity rights are recognized as valuable, it may be that gift tax ramifications should follow from an assignment of those rights. By comparing an

\textsuperscript{132} See Rev. Rul. 76-490, 1976-2 C.B. 300 (Note that the "economic benefit" language applied to each premium payment is broad enough to convey the proceeds under section 2035 if the policy matures during the period covered.)

\textsuperscript{133} Beadles, supra note 110, at 61. See, e.g., A.I.C.P.A. Insurance Trust C.P.A. Plan, on file with the Marquette Law Review.

insured’s premium rating (based on health and occupation) at the time of a policy assignment to the insured’s premium rating at the inception of the coverage, it may be possible to value those continuity rights for gift tax purposes.

On the other hand, the interpolated terminal reserve value frequently applied to whole life policy transfers for gift tax purposes is essentially the cash or nonforfeiture value of the policy, plus a forfeiture charge. Whole life policies offer similar continuity rights. These continuity rights include the right to exchange the policy for paid-up term insurance or whole life insurance of a lesser amount upon cessation of premium payments, as well as the waiver of premium clause. These rights generally involve a change in the policy, resulting in a policy with new terms. While it is true that the exercise of these rights is funded by the interpolated terminal reserve value, that is merely a funding mechanism rather than a measure of the value of these continuity rights. If continuity rights can be ignored in valuing transfers of whole life insurance policies, there is no more reason to consider them in valuing term insurance transfers.

C. Public Policy and the Taxation of Term Life Insurance Proceeds

In addition to the fallacies inherent in trying to distinguish term insurance proceeds from whole life insurance proceeds for estate tax purposes, sound public policy dictates equal treatment. The policy reason is the social desirability that a family have a means of support in the event of the death of a member whose labor provides significant financial support. The likely duration of the need for support is generally longest when a family is young and the surviving spouse and children may have little earning capacity compared to their long term needs. Yet, at the very time when the support obligation is the greatest, the financial ability to provide it is gen-

135. See Treas. Reg. § 25.2512-6(a), T.D. 6680, 1963-2 C.B. 417, 419. Note that the regulation implies that outstanding indebtedness may be subtracted from the terminal reserve to arrive at gift tax value, but unearned premiums must be added. Id.
136. The terminal reserve value used in the regulation is a key figure used in determining nonforfeiture values. HUEBNER & BLACK, supra note 11, at 289.
137. See authorities cited at note 111 supra.
138. See notes 108-13, 135-36 and accompanying text supra.
erally the least: the young family has had little opportunity to accumulate savings, and a young worker’s earning capacity often is not yet fully developed.

Life insurance is recognized as a primary means of providing for the cost of support at an affordable price because it is a risk-distributing funding mechanism. Group term life insurance is generally the least costly source for a given amount of pure insurance protection for the young worker’s family.

To prevent the dissipation of this family protection through the estate tax before it is available for its intended social use, group term life insurance should not be put at a tax disadvantage compared to whole life insurance. The I.R.S. understood this point well when it administratively initiated the income tax approach that ultimately became section 79, which treats group term insurance more advantageously than whole life insurance. To further fulfill its social policy role, term insurance must have essentially the same estate planning flexibility accorded whole life insurance.

On the other hand, because of its increasing cost as the insured ages, term insurance seems unlikely to contribute to the increase or preservation of already large estates. Most deaths occur after retirement age when either conversion to whole life insurance or continuation of term insurance would be prohibitively expensive. Premiums after retirement age are also increased by adverse selection, i.e., that tendency for persons in good health to discontinue life insurance and those in poor health to continue it.

Accordingly, life insurance — particularly term life insurance — is not likely to be the primary means after retirement for providing surviving family members with a support fund. Private retirement plans, Social Security, accumulated savings or investments, and other programs play a far greater role in

139. See HUEBNER & BLACK, supra note 11, at 2-5, 8-9. See also Beadles, supra note 110, at 63-64; M. DORFMAN, INTRODUCTION TO INSURANCE 204 (1978).
140. See text accompanying notes 12-13 supra. For a comparison of individual annually renewable term premium rates to those for whole life policies, see HUEBNER & BLACK, supra note 11, at 7, graph 1-1.
142. See authorities cited at notes 11 & 13 supra.
143. HUEBNER & BLACK, supra note 11, at 5-6, 402-03.
GROUP TERM INSURANCE

funding the generally diminished long term need for survivorship benefits which exists after retirement.\textsuperscript{144}

Although a decedent insured under a term insurance policy is likely to be relatively young and not have a large estate, inflation may increasingly expose such estates to death taxes, even as inflation increases the amount of money needed to support the decedent's dependents.\textsuperscript{145} Therefore, tax policy should not be implemented in a manner which frustrates all attempts to remove group term life insurance from the reach of the estate tax.

VI. ESTATE PLANNING WITH GROUP TERM LIFE INSURANCE

The estate planner who advises the removal of the proceeds of group term life insurance from the client's estate, regardless of whether the policy is to be owned by a natural person or an irrevocable trust,\textsuperscript{146} is likely to encounter as many

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\item \textsuperscript{144} But see note 13 supra.
\item \textsuperscript{145} See notes 4-8 and accompanying text supra.
\item \textsuperscript{146} Though most of the problems in assigning life insurance policies to natural persons also apply to assignments to trusts, there are significant differences. Life insurance transfers in trust present special difficulties, as does designating a trust as beneficiary. See, e.g., note 23 supra. For a good basic discussion of irrevocable life insurance trusts, see Keydel, "Irrevocable Life Insurance Trusts: The Current Scene," U. Miami 10th Inst. on Est. Plan. ¶ 500 (1976). See also Hodges, \textit{Tax Planning for Gifts of Life Insurance}, 11 \textit{TAX ADVISER} 4, 12-16 (1980). Cf. Rev. Rul. 79-47, 1979-6 I.R.B. 19 and Rev. Rul. 76-490, 1976-2 C.B. 300 (availability or nonavailability of the gift tax annual exclusion for premium payments).
\item A revocable trust containing an insurance policy on the life of the decedent will result in inclusion of the proceeds in the decedent's gross estate, the applicable section depending primarily upon whether the decedent owned and transferred the policy to the trust. If he did, the policy proceeds will probably be the amount includible and will be included under section 2038. See Estate of Margrave, 71 T.C. 13 (1978). If a third party transferred the policy to the revocable trust, that third party becomes the grantor as to the insurance policy and the insured grantor of the revocable trust is deemed to have a section 2041 general power of appointment unless he lacks the power to appoint the proceeds to himself, his estate, his creditors, or the creditors of his estate. Id. See also I.R.C. § 2041. If the revocable trust is unfunded and the trust grantor pays the premiums, he may be deemed to have replaced the third party as grantor to the extent that the proceeds are attributable to his premium payments, making section 2038 applicable to that extent.
\item An \textit{irrevocable} trust offers the significant advantage of assuring that the proceeds will not be included in the gross estate of a policyowner who dies before the insured. See I.R.C. § 2033. While the includible amount in that situation would appear to be limited to one year's premium for a term life insurance policy, the amount includible can become substantial for a whole life policy. See Treas. Reg. § 20.2031-8(a), T.D. 6680, 1963-2 C.B. 417. Similarly, there is some danger that a third-party owner will select settlement options which would cause inclusion of substantial amounts in the
\end{itemize}
practical as technical problems in implementing the advice. The practical problems include:

1. Access to reliable information about policy provisions.
2. Lack of control over policy provisions by the insured.
3. Reluctance of a third party administering the policy (e.g., employer or association) to modify general procedures to accommodate the advisor's recommendations.

Obtaining a copy of the master policy for group term life insurance is the first step in determining how to assign an insured's interest. However, the individual insured often has no more than a certificate indicating coverage under a certain master contract, and perhaps a booklet explaining the coverage. Since statements in the booklet are probably not binding (a point often emphasized by a disclaimer in the booklet), the sponsoring employer association must furnish the master policy. Provisions of the master policy will constitute the framework for the advisor concerning the appropriate mechanical steps needed to remove the client-insured's coverage from the reach of section 2035. Unless the insured is influential enough to have the master policy amended to suit his situation, the framework will be inflexible.

Continuation of the master policy with a particular insurer is also out of the insured's control. As pointed out in Revenue Ruling 79-231, the substitution of a new insurer begins the three-year period anew. Any suggestion that the insured employee and the employer contract to maintain a particular policyowner's gross estate under section 2036, a danger avoided by a well-drafted irrevocable trust instrument. See Savage v. United States, 220 F. Supp. 745 (E.D.N.Y. 1963), aff'd, 331 F.2d 678 (2d Cir. 1964); Estate of Pyle, 36 T.C. 1017 (1961), aff'd sub nom. Estate of Pyle v. Commissioner, 313 F.2d 328 (3d Cir. 1963).

If a natural person is chosen as assignee or third-party owner, that person will need to avoid potential gift tax problems. If the owner of the policy survives the insured, the payment of the proceeds to a person other than the policyowner is probably a constructive gift to that person from the owner. The easiest way to prevent the problem is to designate the owner as beneficiary and avoid settlement options which create irrevocable rights in others upon the death of the insured. See Commissioner v. Chase Manhattan Bank, 259 F.2d 231 (5th Cir. 1958), cert. denied, 359 U.S. 913 (1959). If that has not been done, it may still be possible to effect a last-minute solution to the gift tax problem through the use of state statutes giving an assignee rights superior to those of the beneficiary. See, e.g., Wis. Stat. § 632.47(2)(1977).

147. See Meyer, supra note 70, at §§ 20:2, .5.
148. Id.
master policy is probably impractical. Employers or associations will be reluctant to surrender the right to terminate or change insurers because of the premium increases that are commonly permissible on each anniversary. Economic uncertainty may also make employers reluctant to lock themselves into a five-year contract despite the estate tax advantages of five-year term insurance over annually renewable term life insurance. Nor does contracting address the control problems associated with employees who change employment or memberships and thus leave one group and join another. The estate planner should advise the client-insured (or any third party policyowner) whether to convert the group term coverage to whole life individual coverage or to let that particular coverage lapse. Obviously this is feasible only if the client is aware that employment changes result in a need to review the insurance coverage. Thus, a particular group term insurance problem may not stay solved indefinitely. Considering the possibilities of change in the insured's marital status or the death of the assignee before the insured, a possibility of reverter may be desirable if the third-party owner is a natural person.

150. See HUEBNER & BLACK, supra note 11, at 409.
151. See text accompanying notes 99-101 supra.

Because Revenue Ruling 79-117 indicates that the value of the insured's right to designate disposition of the proceeds of the assigned policy by will (if he survives the policyowner) would be less than 5% of the value of the insurance proceeds ultimately paid, any retained rights would not be taxed under section 2037 or section 2042. But cf. Sherman v. United States, 79-1 U.S.T.C. ¶ 13288 (E.D. Va. 1979) (Court found proceeds of a life insurance policy includible under section 2037 without even discussing the value of the reversionary interest or the 5% test of the statute). If the possibility of reverter is created before the assignment, the fact that the nature of the right is within the scope of section 2037 should protect the proceeds from taxation under section 2041 (as a general power of appointment created and held by the assignee), though it is probably safer to use limiting language which would take the power clearly outside the scope of section 2041. See I.R.C. § 2041 and Treas. Reg. § 20.2041-1(b)(2), T.D. 6296, 1958-2 C.B. 432, 521. Though the reserved right would probably be includible in the insured's gross estate under section 2033, the less than 5% value established by the Service seems a small price for the flexibility gained.

If the policyowner does in fact predecease the insured, it would appear that the insured then has incidents of ownership of sufficient value to require inclusion of the proceeds in his gross estate under section 2042. However, so long as the beneficiary designation which creates his power is itself revocable, the person who receives ownership of the policy by inheritance or the terms of the original assignee's will would
Another means of keeping group insurance proceeds out of an insured’s estate may not be feasible in many situations. Having a third party make the initial purchase and pay premiums from separate funds avoids the question of transfer under section 2035. However, the economies sought in group coverage require uniformity, so the insured often must be the applicant and original owner. (Otherwise the insurer in Wisconsin, for example, has the burden of ascertaining whether the third-party purchaser has an insurable interest.)

On the other hand, if the Bel concept is followed (that each premium creates a new and discrete policy), a third-party assignee who paid the last premium would apparently be deemed to have purchased the policy ab initio, i.e., without assignment from the insured, at least for purposes of section 2035. Yet, even third-party payment may be difficult to arrange if the employer is paying part or all of the premiums.

have the ability to completely remove the insured’s incidents of ownership before the insured’s death. Obviously, if the insured becomes the policyowner again, any subsequent assignment he might make would cause inclusion of the proceeds in the insured’s gross estate if he fails to survive for three years after the assignment.

If the insured did not create the reversionary right before assignment and it is instead created by the assignee as in Revenue Ruling 79-117, the beneficiary designation creating it should limit the class of persons the insured is permitted to designate by will so that he cannot designate himself, his estate, or the creditors of either as recipients of the proceeds. Otherwise, even though the insured dies before the assignee and the assignee actually receives the proceeds, there may be a question of whether there was property to which a general power of appointment could attach for purposes of inclusion of the proceeds in his gross estate under section 2041. See Estate of Margrave, 71 T.C. 13 (1978).

But see text accompanying notes 162-63 infra. Ownership by the employer may solve the section 2035 problem, but care must be taken to avoid incidents of ownership problems under section 2042. See note 23 supra. The employer may also lose his income tax deduction for premium payments. See I.R.C. §§ 162 and 264(a); see also Treas. Reg. §§ 1.162-7(b)(1), T.D. 6291, 1958-1 C.B. 63, 70 and 1.264-1, T.D. 6228, 1957-1 C.B. 109, 110.


It may be possible to shelter part of the proceeds in a contributory plan if the assignee pays the employee’s share of the premiums. See Estate of Silverman v. Commissioner, 521 F.2d 574 (2d Cir. 1975) (but note that the court expressed doubt about affirming a pro rata approach and indicated that perhaps only the actual premiums paid by the assignee should be deductible for the purpose of estate taxation under section 2035).
One must also recognize that the increasing cost of term life insurance may become quite a burden on the third-party owner before the insured retires or leaves the group.

In a few instances where whole life insurance is coupled with term insurance, it might be feasible to assign the policy to a qualified pension or profit-sharing plan. As the proceeds would become part of the qualified plan distribution, they could be excluded from estate taxation. Even a lump sum distribution is exempt from estate tax if the recipient does not elect "ten-year averaging" for income tax purposes. However, if the income tax and estate tax burdens fall on different beneficiaries, the failure to so elect may be too high a price to pay. The terms of the plan itself will also affect the feasibility of such a transfer. Since the amount of life insurance includible in qualified plans is limited and taxation is complex, the estate planner must also analyze the income taxation of subsequent premium payments and retirement benefits, as well as the payment of proceeds to a particular beneficiary.

Given the apparent nominal value of a term life insurance policy, a bona fide sale might accomplish an assignment qualifying for exclusion under section 2035(b)(1). But this has the potential of subjecting the proceeds to income tax in the hands of some transferee-beneficiary. It would be feasible only if the tax brackets of the parties have, and will continue to have, a sufficient spread (assignor's estate tax bracket, as-
signee's income tax bracket), and it obviously has all of the other practical problems of group policy transfers discussed above.

Payment of premium problems may become even more complicated to analyze where the assignee or other owner of the group policy is the spouse of the insured and the policy is community property. Care must be taken in assigning the community property interest of the insured, and the owner would need separate funds to pay premiums in order to get the premiums out of the estate. Even in common-law states, caution dictates that premiums not be paid out of accounts held jointly with the insured. Also, the insured should not make gifts of cash to the owner of the policy in the amounts of the premiums and at the times premiums are due. Such gifts would seem to imply an understanding that the funds would be used to pay the premiums — thus destroying the separate funds argument.

In spite of all of the practical and technical problems of removing group term life insurance from an estate, any reasonable attempt may be worthwhile. If the assignment fails to remove the proceeds from the scope of post-1978 section 2035, special circumstances may make it possible to convince the I.R.S. that the proceeds are not taxable because the pre-1977 contemplation of death version of section 2035 is applicable and the presumption is rebutted or that the requirement of valuation at the time of death reduces the includible value sharply. If the proceeds are indeed includible in the gross

162. See note 79 supra. There may also be a question of whether the funds used for premium payments were community funds or separate property. See, e.g., Daly v. United States, 35 A.F.T.R.2d 75-1659 (D. Idaho 1975).


164. See Rev. Rul. 79-212, 1979-28 I.R.B. 35 (for assignments made before 1977). This would seem to apply only to deaths before 1980, but it could be argued, perhaps, that the date of purchase or initial assignment should be given effect where there was no possibility of the policyowner's assumption of premium payments after the Tax Reform Act of 1976 removed a relied-upon belief that the presumption could be rebutted. See authorities cited at note 64 supra.

165. See American Nat'l Bank & Trust Co. v. United States, 594 F.2d 1141 (7th
estate, the premiums paid within three years of death can probably be excluded.

Caution is indicated if either the assignment of the policy itself or the premiums to be paid by the insured, together with other gifts to the same donee during the taxable year, will exceed $3,000, requiring the filing of a gift tax return. This in itself would bring the premium payments by the insured decedent into the gross estate even if the proceeds are excludible.167

In addition, any post-1976 gift made within three years of death must be “grossed up” for estate tax purposes by the amount of any gift tax paid on the transfer.168 Though the estate receives a credit for the amount of gift tax paid on a gift includible under section 2035, the “gross-up” provision makes that gift part of the taxable base and the net result is an increase in the total tax.169 Thus, the tax cost of either of the situations in the preceding paragraph will be increased if gift tax must be paid at the time of transfer,170 either because the unified credit has already been consumed171 or because the gift tax marital deduction is not available for the gift.172 While such an assignment may be highly desirable for a reasonably young and healthy client, it is essential that the client understand that the transfer exposes his estate to increased taxes if he should die within the three year period.

If no gift tax has been paid, the failure of the assignment or purchase to shield the proceeds of the policy from inclusion under section 2035 will leave the estate in no worse position than it would have been in if the decedent had owned the pol-

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166. Peters v. United States, 572 F.2d 851 (Ct. Cl. 1978). But note that the 1978 Act creates ambiguities as to premium amounts of $3,000 and under. See text accompanying notes 61-64 supra. It is true that the language of Peters indicates a flat prohibition of the inclusion of both proceeds and premiums. However, it may be argued in an annually renewable term policy situation that application of the Bel rationale would permit inclusion of prior premiums because only the last premium ripens into proceeds.

167. See I.R.C. § 2035(b)(2) and text accompanying notes 61-64 supra.

168. I.R.C. § 2035(c).

169. See I.R.C. §§ 2035(a) & (c), 2012(a) & (b) and 2001(b) & (c).


171. See I.R.C. § 2505.

172. See I.R.C. § 2523.
icy and paid the premiums. 173 If any gifts of premiums were not required to be included in a gift tax return and the attempt to avoid the operation of section 2035 succeeds, 174 both the proceeds and any premiums paid by the insured decedent or his employer will escape inclusion in the decedent's gross estate. Though it is true that the policyowner's failure to survive the insured, in situations where an irrevocable trust is not chosen as the third-party policyowner, would result in the policy's inclusion in the policyowner's gross estate, the amount so includible for a term insurance policy would appear to be limited to the last premium paid 175 and seems generally a small risk compared to the potential benefit of removing the proceeds from the insured's gross estate.

Beverly J. Boyer

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174. This assumes that the courts adopt the position of the congressional committees that premiums not includible in a gift tax return (or transferring policy proceeds under pre-1976 law) are not includible in the gross estate under section 2035. As discussed in note 146 supra, it also assumes that the planner has avoided situations that may cause inclusion under sections 2036-2042. See also notes 23 & 79 and text accompanying note 158 supra.