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Taxation: Incidents of Ownership Tests for Inclusion of Life Insurance Proceeds in Decedents' Gross Estates

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INCIDENTS OF OWNERSHIP TESTS FOR INCLUSION OF LIFE INSURANCE PROCEEDS IN DECEDENTS' GROSS ESTATES

INTRODUCTION

By the end of 1968 the population of the United States owned almost $1.2 trillion of life insurance.[1] In that same year, $6.1 billion was paid to beneficiaries of policyholders who had died.[2] This widespread ownership of life insurance has resulted in over one-half of all the federal estate tax returns being filed with life insurance proceeds constituting part of the decedent's gross estate.[3] The Internal Revenue Code specifically provides that the gross estate shall include the value of life insurance proceeds receivable by the executor or the value of proceeds payable to other beneficiaries under policies in which the decedent possessed any of the incidents of ownership at the time of his death.[4] Other provisions of the Code could also make the value of policy proceeds includible as: (1) property owned by the decedent at the time of his death,[5] (2) property transferred in contemplation of death,[6] (3) a transfer in which the decedent retained an interest for his life,[7] and (4) a transfer to take effect at death.[8] However, these other provisions

[1] *The Record for 1968*, Life Association News, Feb., 1969, at 73.
[2] *Id.*
[3] U.S. TREASURY DEPARTMENT, INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, FIDUCIARY, GIFT, AND ESTATE TAX RETURNS, at 70, 72 (1965). Latest figures available show that out of 67,404 taxable estatae tax returns, 35,595 included life insurance proceeds in the gross estate.
[4] INT. REV. CODE of 1954, § 2042, Proceeds of Life Insurance

The value of the gross estate shall include the value of all property—

(1) RECEIVABLE BY THE EXECUTOR.—To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.

(2) RECEIVABLE BY OTHER BENEFICIARIES.—To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. For purposes of the preceding sentence, the term "incident of ownership" includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent. As used in this paragraph, the term "reversionary interest" includes a possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him. The value of a reversionary interest at any time shall be determined (without regard to the fact of the decedent's death) by usual methods of valuation, including the use of tables of mortality and actuarial principles, pursuant to regulations prescribed by the Secretary or his delegate. In determining the value of a possibility that the policy or proceeds thereof may be subject to a power of disposition by the decedent, such possibility shall be valued as if it were a possibility that such policy or proceeds may return to the decedent or his estate.

[5] INT. REV. CODE of 1954, § 2033.
[6] INT. REV. CODE of 1954, § 2035.
[7] INT. REV. CODE of 1954, § 2036.
[8] INT. REV. CODE of 1954, § 2037.

are outside the scope of this article and are mentioned so as to point out that section 2042 is not the sole means by which life insurance proceeds are includible in a decedent's gross estate.

Incidents of ownership has reference to one or more of the economic benefits of the insurance policy and its meaning is not limited to ownership of the policy in the technical legal sense. These benefits include the power to change the beneficiary, the power to surrender or cancel the policy, the power to make an assignment, the power to revoke an assignment, the power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy.[9] There are also other incidents recognized by the Regulations and the courts which will be discussed at a later point.

It is the purpose of this article to examine the historical development of the inclusion of life insurance proceeds in a decedent's gross estate with regard to incidents of ownership and then examine the present estate tax laws and the impact of recent court decisions which may affect the estate planner in his use of life insurance as an estate planning tool.

History of Life Insurance in Estate Tax Prior to 1954

The proceeds of a life insurance policy were first explicitly subjected to estate taxation under the federal estate tax laws promulgated by the Revenue Act of 1918.[10] Prior legislation had made no provisions for including the proceeds of a life insurance policy in a decedent's gross estate.[11] The 1918 Act provided for the inclusion of life insurance proceeds for estate tax purposes when (1) the proceeds were received by the decedent's estate or (2) proceeds in excess of $40,000 were receivable by other beneficiaries or (3) the policies were taken out by the decedent upon his own life.

With regard to insurance proceeds payable to the decedent's estate, there has been little change in the law with respect to the inclusion of policy proceeds in the gross estate. While the 1918 Act required that the insurance contract must have been taken out by the decedent upon his own life, the 1942 Act[12] repealed this requirement and consequently insurance payable to the decedent's estate is presently taxed if the decedent is the named insured on the policy without regard to whether he actually applied for the policy.

[9] Treas. Reg. § 20.2042-1(c)(2) (1958).
[10] Revenue Act of 1918, ch. 4, § 402(f), 40 U.S.C. 1098.
[11] Lewellyn v. Frick, 268 U.S. 238 (1925), held that proceeds of a life insurance policy were not includible in a decedent's estate where a beneficiary had been designated in the policy before the enactment of the Revenue Act of 1918.
[12] Int. Rev. Code of 1939, § 811(g), as amended by the Revnue Act of 1942, ch. 619, § 404, 56 U.S.C. 798.

Policy proceeds payable to beneficiaries other than the estate of the insured presented some difficulties under the 1918 Act. For example, there was the problem of the $40,000 exemption from the gross estate being proportioned where the insurance proceeds arose from multiple policies on the insured's life and were payable to two or more beneficiaries neither of which was the estate of the insured. In such a case, the exemption was proportioned among each policy payable to the beneficiary by an exclusion ratio of the insurance which the individual beneficiary was to receive over the total amount of insurance payable to all such beneficiaries. A further twist was added when one of the beneficiaries qualified as a charity. In such a situation the non-charitable beneficiary's policy received the entire exemption.[13]

Another significant problem arose under the requirement that the policy must have been taken out by the decedent upon his own life. This would seem to connote that the decedent must have applied for the insurance and named himself as the insured. However, Treasury Regulations issued subsequent to the 1918 Act were quick to expand the interpretation to be given to this requirement. A 1919 Regulation[14] promulgated the "payment of premiums test" by stating that the insured's taking out a policy on his own life meant that he (the insured) had paid the premiums on the policy. Technical application for the policy by the insured was not to be the requirement. The Regulation contained the qualification, however, that insurance proceeds payable to beneficiaries other than the insured's estate were taxable to his estate only to the extent that the insured had paid the premiums on the policy.

The life insurance proceeds inclusion problem took another turn in 1929 with the decision of the Supreme Court in *Chase National Bank v. United States.*[15] In the *Chase* case, an insured had named his wife as the beneficiary of three separate policies of life insurance. The proceeds of these policies, minus the $40,000 exemption which existed at that time, were included in the husband's gross estate for tax purposes. It was argued by the husband's executor that the tax imposed on the life insurance proceeds was unconstitutional because it was a direct tax and therefore void under the apportionment precepts of the Constitution.[16]

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[13] In Commissioner v. Pupin's Estate, 107 F.2d 745 (2d Cir. 1939), the decedent had taken out life insurance policies with $51,122.20 payable to his daughter and $50,000 payable to a university. The estate tax return included in the gross estate $61,122.20 of the life insurance as the total amount of life insurance in excess of the $40,000 exemption and claimed a deduction from the gross estate for the $50,000 payable to the university. The Court of Appeals held this to be the correct application of the tax laws and in accord with Congressional intent. *See also* McKelvy v. Commissioner, 82 F.2d 395 (3d Cir. 1936).

[14] Treas. Reg. § 37 (1919).

[15] 278 U.S. 327 (1929).

[16] U.S. CONST. art. I, §§ 2, 9.

In rejecting this argument the Supreme Court held that the statute[17] imposes a tax on transfers and consequently:

> A power in the decedent to surrender and cancel the policies, to pledge them as security for loans and the power to dispose of them and their proceeds for his own benefit during his life which subjects them to the control of a bankruptcy court for the benefit of his creditors, (citations ommitted), and which may, under local law applicable to parties here, subject them in part to the payment of his debts, (citations ommitted), is by no means the least substantial of the legal incidents of ownership, and its termination at his death so as to free the beneficiaries of the policy from the possibility of its exercise would seem to be no less a transfer within the reach of the taxing power than a transfer affected in other ways through death.[18]

Shortly after the decision in *Chase*, a Treasury Regulation[19] based on the holding of the case set forth the Treasury's position that in addition to paying the premiums on the policy, the insured must have possessed certain "incidents of ownership" in the policy before life insurance proceeds would be included in the gross estate of the insured.

The Treasury again modified its position in 1934 when it issued a Regulation[20] which made payment of premiums and incidents of ownership alternative tests to be applied in the determination of whether the amount of the proceeds payable to beneficiaries other than the estate were to be included in the insured's gross estate for tax purposes. These alternative tests remained the standard until 1941 when the Treasury adopted the payment of premiums test as the exclusive test for inclusion of the amount of the proceeds of life insurance policies in the insured's estate.[21]

The test was again changed one year later, this time by statute, with the passage of the Revenue Act of 1942.[22] Under the Act, insurance proceeds were again divided into two classes: (1) insurance payable to the insured's estate and (2) insurance payable to beneficiaries other than the estate. Unlike prior laws, however, the 1942 Act did not contain the additional requirement that the insured must have taken out the policy on his own life and the $40,000 exemption from inclusion where insurance was payable to beneficiaries other than the decedent's estate was eliminated.

Where the proceeds were payable to the insured's estate the test for inclusion remained the same as in 1918 with the deletion of the requirement that the insured must have taken out the policy on his own life.

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[17] *Supra* note 10, as amended by the Revenue Act of 1921, ch. 136, § 402(f), 42 U.S.C. 278.
[18] *Supra* note 15, at 335.
[19] Treas. Reg. § 70 (1929).
[20] Treas. Reg. § 80 (1934).
[21] T.D. 5032, 1941-1 Cum. Bull. 427.
[22] *Supra* note 12.

Thus, the value of any life insurance payable to the estate on the death of the insured was to be included in his gross estate. However, where the proceeds were payable to beneficiaries other than the estate of the insured, the Act adopted the alternative test of the 1934 Regulation. This made the test of inclusion either (1) the insured paid the premiums, directly or indirectly,[23] for the insurance or (2) the insured possessed incidents of ownership in the policy at the time of his death which were exercisable either alone or in conjunction with another person.[24] If the insured possessed any incidents of ownership at his death, the entire amount of proceeds were taxable regardless of who paid the premiums.[25] Also, if the insured had divested himself of all the incidents of ownership during his lifetime but had continued to pay the premiums the amount of the proceeds would again be included in his gross estate. However, where the insured had paid only part of the premiums and divested himself of all incidents of ownership, only the proportion of the insurance which corresponded to premiums paid by the insured was taxed in his estate.[26]

LIFE INSURANCE PROCEEDS UNDER THE 1954 CODE

The provisions of the 1942 Act remained the law until the overhauling of the federal tax laws in the 1954 Code.[27] Like prior laws, life insurance was categorized for estate tax purposes into two classes: (1) insurance payable to the insured's estate[28] and (2) insurance payable

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[23] If the insured supplied some other person with funds to pay the premiums, the premiums were treated as paid by the insured and not the nominal payor. Clarence H. Loeb Estate, 29 T.C. 22 (1958), *aff'd per curiam,* 261 F.2d 232 (2d Cir. 1958); Dunning v. Commissioner, 3 B.T.A. 1222 (1937); *cf.* Booth v. Commissioner, 3 T.C. 605 (1944). *See also* Estate of Albert Dudley Saunders, 14 T.C. 534 (1950), where a wife applied for policies on life of her husband and held all incidents of ownership, but under payment of premiums test, part of the proceeds were included in the husband's estate because the wife could not prove that *she* had paid all of the premiums.

[24] As to incidents of ownership exercisable alone or in conjunction with another person, *see* Goldstein v. United States, 122 F. Supp. 677 (Ct. Cl. 1954), *cert. denied,* 348 U.S. 942 (1955).

[25] Goldblatt v. Commissioner, 16 T.C. 204 (1951).

[26] Walker v. United States, 83 F.2d 103 (8th Cir. 1936); Helvering v. Reybine, 83 F.2d 215 (2d Cir. 1936).

[27] INT. REV. CODE of 1954.

[28] Treas. Reg. § 20.2042-1(b)(1) (1958) provides:

> It makes no difference whether or not the estate is specifically named as the beneficiary under the terms of the policy. Thus, if under the terms of an insurance policy the proceeds are receivable by another beneficiary but are subject to an obligation, legally binding upon the other beneficiary, to pay taxes, debts, or other charges enforceable against the estate, then the amount of such proceeds required for the payment in full (to the extent of the beneficiary's obligation) of such taxes, debts, or other charges is includible in the gross estate. Similarly, if the decedent purchased an insurance policy in favor or another person or a corporation as collateral security for a loan or other accommodation, its proceeds are considered to be receivable for the benefit of the estate.

to beneficiaries other than the estate of the insured.[29] While the Code retained the provisions that insurance payable to the insured's estate was to be fully taxable without regard to the payment of premiums or the possession of any incidents of ownership in the policy an important change was made with respect to insurance proceeds payable to beneficiaries other than the insured's estate. For the estates of persons dying after August 16, 1954, the incidents of ownership test was adopted as the sole criterion for inclusion of the value of the proceeds of a life insurance policy in the insured's estate.

The Regulations are careful to point out that incidents of ownership include certain powers arising from the insurance policy itself.[30] This emphasis on the power to affect certain changes or dispositions is a crucial factor in determining whether the proceeds of a life insurance policy are to be included in the insured's gross estate. It is therefore important to distinguish between technical legal ownership of the policy and legal rights or powers under the same policy since it is possible for A to be the legal owner of the policy with certain rights or powers in B, the insured, which would constitute incidents of ownership and thus make the proceeds includible in B's gross estate upon his death.

In *United States v. Rhode Island Hospital Trust Co.*[31] a father had purchased an insurance policy in the amount of $50,000 naming his son as the insured. The father named himself and his wife as beneficiaries with the proceeds going to the survivor if one should predecease the son. The father paid all of the premiums and retained custody of the policy by keeping it in his safe deposit box. The policy contained the provisions that the "insured" had the power to assign the policy, to change the beneficiaries, and to surrender the policy for its cash surrender value. Thus, when the wife died, it was perfectly permissable for the son to execute a change in beneficiary order naming his father as the principal beneficiary. Approximately six years later the son died with his father surviving him. The District Court[32] refused to hold that the insurance proceeds were includible in the son's estate under section 2042. In its decision, the court relied on certain acts of ownership exercised

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[29] State law will determine whether insurance proceeds are receivable by or for the benefit of the decedent's estate or for the benefit of other beneficiaries. For example, insurance payable to the insured's estate was not receivable by the executor, but by his widow and children where local law makes any insurance on a husband's life pass to his widow and children free from any claims of the estate. Estate of Proutt v. Commissioner, 125 F.2d 591 (6th Cir. 1942); Webster v. Commissioner, 120 F.2d 514 (5th Cir. 1941).

[30] Treas. Reg. § 20.2042-1(c)(2) (1958) provides:

> Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.

[31] 355 F.2d 7 (1st Cir. 1966).

[32] 241 F. Supp. 586 (D. R.I. 1965).

by the father in that he had: (1) applied for and obtained the policy on the life of his son, (2) paid all the premiums on the policy and (3) retained physical custody of the policy by placing it in his safe deposit box. The court then held that the son had not possessed any of the requisite incidents of ownership in view of these facts although it was aware of the recitals in the policy that the insured had the power to assign the policy, to change the beneficiary, to pledge the policy for a loan, and a further recital that if the designated beneficiaries did not survive the insured the proceeds were payable to his estate.[33] In reversing the Distirct Court, the Court of Appeals for the First Circuit held that the powers to change the beneficiary, to assign the policy or to pledge it for a loan were certainly within the intent of Congress in enacting section 2042.[34]

While the precise holding in *Rhode Island Hospital Trust Co.* was not entirely novel, it is significant in view of the court's discussion of legal ownership of the policy. The court clearly indicated that while legal ownership of the policy belongs to none other than the insured, the proceeds will be includible if he possessed any of the incidents of ownership under the contract, "For decedent had some powers—perhaps not

[33] *See* note 4 *supra.* Treas. Reg. § 20.2042-1 (c) (3) (1958) provides:

> The term "incidents of ownership" also includes a reversionary interest in the policy or its proceeds, whether arising by the express terms of the policy or other instrument or by operation of law, but only if the value of the reversionary interest immediately before the death of the decedent exceeded 5 percent of the value of the policy. As used in this subparagraph, the term "reversionary interest" includes a possibility that the policy or its proceeds may return to the decedent or his estate and a possibility that the policy or its proceeds may become subject to a power of disposition by him.... The terms "reversionary interest" and "incidents of ownership" do not include the possibility that the decedent might receive a policy or its proceeds by inheritance through the estate of another person, or as a surviving spouse under a statutory right of election or a similar right.

See also Schultz v. United States, 140 F.2d 945 (8th Cir. 1944); Broderick v. Keefe, 112 F.2d 293 (1st Cir. 1940), *appeal dismissed,* 311 U.S. 721 (1940); Estate of Charles H. Thieriot, 7 T.C. 1119 (1946).

[34] S. Rep. No. 1622, 83d Cong., 2d Sess. 472 (1954) provides:

> This section (2042) is a revision of section 811(g) of the 1939 Code. Under existing law, proceeds of insurance under a policy upon the life of the decedent receivable by beneficiaries other than the executor are includible in the decedent's gross estate in the proportion that the amount of premiums or other consideration paid directly or indirectly by the decedent bears to the total amount of the premiums paid for the insurance. Under existing law, premiums paid by the decedent on or before January 10, 1941, are excluded in applying the proportion mentioned if the decedent at no time after that date possessed any of the incidents of ownership in the policy. This section revises existing law so that payment of premiums is no longer a factor in determining the taxability under this section of life insurance proceeds. Insurance proceeds payable to the executor will continue to be taxed as under existing law. This section also requires the inclusion in the decedent's estate of insurance proceeds receivable by all other beneficiaries under a policy on the decedent's life with respect to which the decedent at death possessed any of the incidents of ownership exercisable either alone or in conjunction with any other person.

rights, but powers—which could, if exercised alone or in conjunction with another, affect the disposition of some or all of the proceeds of the policy."[35] The decision distinguished between "intent facts", those relating to the conduct and understanding of the father and his son, and the "policy facts," those revealed by the insurance policy itself. It was a direct consequence of the holding of the Supreme Court in *Commissioner v. Noel*[36] and indicated that lower federal courts were going to follow the doctrine that policy facts were to control over the expressed or implied intentions of the insured and the legal owner of the policy where the policy provisions were in conflict with such intentions.

Noel involved the question of whether certain flight insurance policies were to be included in the insured's gross estate. The insured had applied for the policies at the airport and named his wife as the beneficiary of each policy. The insured had directed the sales clerk to "give them to my wife They are hers now, I no longer have anything to do with them."[37] There was uncontradicted testimony that the wife had paid the $2.50 premium on each policy and had retained the custody of the policies upon delivery from the clerk. A short time after take-off the husband was killed and the insurance claims on the policies were paid to the wife. However, the proceeds of the policies were not included in the husband's estate tax return filed by his executors.

In argument before the Supreme Court the executors' contention was that Mrs. Noel was the owner of the policies and that her husband had no exercisable incident of ownership in them at the time of his death. In the Court's view, this contention rested on three alternative claims:

(1) that Mrs. Noel had purchased the policies and therefore owned them;

(2) that even if her husband owned the policies, he gave them to her, thereby depriving himself of powers to assign the policies or change the beneficiary;

(3) even assuming the husband had contractual power to assign the policies or make a change in the beneficiary, this power was illusory since he could not possibly have exercised it in the interval between take-off and the fatal crash.[38]

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[35] *Supra* note 31 at 11.
[36] 380 U.S. 678 (1965).
[37] *Id.* at 679.
[38] It is interesting to note that 4 years prior to the decision in *Noel,* Rev. Rul. 123, 1961-2 CUM. BULL. 151 provided:

> That a decedent at his death possessed an incident of ownership within section 2042(2) in a flight insurance policy which he purchased at an airport. He had mailed the policy to his wife after filling in the beneficiary designation. Even though he was unable to change the designation while flying, he was given the right by the terms of the policy to change beneficiaries. This was deemed sufficient to constitute an incident of ownership.

In answering these contentions and holding that the policy proceeds should be included in Mr. Noel's gross estate the Court emphasized the technical "policy facts" to be paramount over the "intent facts" of the insured and his wife. The Court found that while Mrs. Noel may have paid the premiums, the policies themselves gave the insured, Mr. Noel, both the power and the right to assign the policies or to change the beneficiaries. The exectors' contention that the policies had been assigned to Mrs. Noel was also rejected based on a finding that the policies could not be assigned without a written endorsement on the policy by the insured. No such endorsement had been made and the power to assign remained with the insured until his death.

The executors' third contention was particularly interesting in that the Court recognized that the insured had had no opportunity to affect changes in the policies[39] and he had died within three hours of obtaining the insurance. However, the Court answered this contention when it said:

> It would stretch the imagination to think that Congress intended to measure estate tax liability by an individual's fluctuating, day-by-day, hour-by-hour capacity to dispose of property which he owns. We hold that estate tax liability for policies 'with respect to which the decedent possessed at his death any of the incidents of ownership,' depends on a general, legal power to exercise ownership without regard to the owner's ability to exercise it at a particular moment.[40]

The decision in *Noel* makes it clear that the Court was overruling earlier decisions, notably *Doerken*,[41] by lower courts which had held that the intent of the parties is controlling and that where it clearly appeared that the insured's intent was to transfer all rights under the policy such intent would control over the wording of the policy giving the insured any incidents of ownership. This contention had been followed by the sixth Circuit as late as 1965 in *Estate of Piggot*.[42] In that case the court did adopt the reasoning of *Doerken* but held that on the facts there was sufficient evidence to warrant a finding by the Tax Court that the decedent had retained certain incidents of ownership in the policies insuring his life.[43] It is interesting to note the factual circumstances surrounding

[39] Mrs. Noel retained custody of the policies at all times after delivery by the clerk at the insurance counter. However, delivery of a policy to another does not necessarily destroy the insured's right of ownership in the policy. Farwell v. United States, 243 F.2d 373 (7th Cir. 1957); Fried v. Granger, 105 F. Supp. 564 (W.D. Pa. 1952), *aff'd per curiam*, 202 F.2d 150 (3d Cir. 1953).

[40] *Supra* note 36, at 679. *See also* Nelson v. Commissioner, 101 F.2d 568 (8th Cir. 1939), which held that the proceeds of life insurance policies were includible in the insured's estate even though exercise of ownership rights by the insured was prevented by a pledge of the policies for a loan.

[41] Estate of Edward Doerkin, 46 B.T.A. 809 (1942).

[42] Estate of Piggot v. Commissioner, 340 F.2d 829 (6th Cir. 1965).

[43] *See also* Hall v. Wheeler, 174 F. Supp. 418 (S.D. Me. 1959); Estate of Michael Collino, 25 T.C. 1026 (1956) recognizing the rule of *Doerken* but holding that such intent had not been proved.

Piggot and *Doerken.* In both cases life insurance policies were payable to the respective insured's corporate employer which had paid all of the premiums and there was proof in each case that it was the intent of the parties that the respective corporations "owned" the respective policies. While sufficient evidence was presented in Doerkin to exclude the proceeds from his gross estate and the burden of proof was not met in Piggot following Noel's introduction of the "policy fact rule" two factually similar cases reject the holding in *Doerkin* and the use of the *Doerken* rationale in *Piggot.*

In *Kearns v. Commissioner*[44] suit was brought to recover $6,900 in estate taxes assessed on the proceeds of two life insurance policies. Oscar Kearns had applied for th policies and named the family business as the beneficiary of each. All of the premiums were paid by the corporation and the policies were carried on the corporate books and financial statements as assets of the corporation. The corporation retained the custody of the policies in the company vault, except for a period when the policies had been assigned as collateral for loans. Under the terms of the policies, certain rights and privileges were granted to Oscar Kearns, including the right to change beneficiary, to exercise a conversion privilege, to choose a method of utilizing the surrender value and to elect a settlement option. The executors of Kearn's estate contended that Kearns had assigned all his rights in the two policies to the corporation, and that any incidents of ownership he retained were held by him as a mere nominee of the corporation.

In holding that the proceeds of the policies were includible in Kearns' gross estate, the Court of Claims relied on *Noel's* notion that "policy facts" are not easily rebutted by reference to "intent facts" or external circumstances. The policies in question provided that the insured, without the consent of the beneficiary, may exercise every right and receive every benefit reserved to the insured, or the owner of the policy. The words "owner" and "insured" were used separately in the policy and while the corporation had been designated as the owner, Kearns continued to refer to himself as the "insured." Since the insured's right to assign the power to change the beneficiary had to be in writing, and no such assignment had been made, the court concluded that Kearns had retained at least one right under the policy, the power to change the beneficiary,[45] and thus possessed an incident of ownership within the meaning of section 2042.

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[44] 399 F.2d 226 (Ct. Cl. 1968).

[45] The power to change the beneficiary is one of the most common incidents of ownership possessed by an insured. Chase National Bank v. United States, 278 U.S. 327 (1929); Singer v. Shaughnessy, 198 F.2d 178 (2d Cir. 1952); Seward v. Commissioner, 164 F.2d 434 (6th Cir. 1947); Helvering v. Reybine, 83 F.2d 215 (2d Cir. 1936); Goldstein v. United States, 122 F. Supp. 677 (Ct. Cl. 1954), *cert. denied,* 348 U.S. 942 (1955); Fried v. Granger, 105 F. Supp. 564 (W.D. Pa. 1952), *aff'd per curiam,* 202 F.2d 150 (3d Cir. 1953).

The intent question was not resolved by *Kearns,* however, and the question of corporate ownership versus retention of incidents of ownership by an insured was again before the courts in *Cockrill v. O'Hara.*[46] In this case the insured was president and sole stockholder of a corporation which was the beneficiary of three life insurance policies written on the president's life. The corporation had paid all of the premiums and apparently retained custody of the policies. The executors did not deny that two of the policies listed the decedent as "owner" and that the policies granted him such rights and powers as: (1) the power to assign his rights in the policies, (2) the power to revoke any assignment of the policies, (3) the power to change the beneficiaries, (4) the power to change the form, kind, or plan of insurance, (5) the right to exercise any one of several options with regard to the payment or use of dividends, (6) the right to convert the policies to participating fully paid-up whole life insurance or to endownments, (7) the power to borrow the loan value of the policy, (8) the power to elect any one of several options in the event of surrender or lapse of the policies, (9) the right to elect the manner in which the benefits would be paid, and (10) the power to revoke or change the election as to the manner in which the beneficiaries would be paid.[47] In spite of this impressive list of rights and powers retained by Mr. Cockrill, his executors argued the intent question raised in *Doerken* by claiming that there was a genuine issue of material fact as to whether the decedent possessed any incidents of ownership in the policies at the time of his death. The court, relying on *Noel,* stated:

> The Supreme Court's summary rejection of clear evidence of the decedent's intent in favor of the express terms of the insurance contract can only be interpreted, in this court's opinion, as a holding that so called "policy facts" (reservation of rights in the policy) cannot be rebutted by reference to "intent facts" or external circumstances.[48]

With regard to the policy, it was undisputed that the incidents of ownership in the policy, including the power to change the beneficiary, were possessed from the date of the issuance of the policy by the decedent's corporation. Based on this fact, the court held that the decedent, as sole stockholder of the company, possessed incidents of ownership in the policy which he could exercise in conjunction with the company and the proceeds of this policy, as well as those of the other two, were includible in his gross estate under section 2042.[49]

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[46] 302 F. Supp. 1365 (M.D. Tenn. 1969).
[47] *Id.* at 1367.
[48] *Id.* at 1369.
[49] Treas. Reg. § 20.2042-1(c)(2) (1958) provides:
> Similarly, the term [incidents of ownership] includes a power to change the beneficiary reserved to a corporation of which the decedent is sole stockholder.

While *Cockrill's* implications are clear in the case of a one stockholder corporation, it did not suggest any limits of ownership that would take a case out of the rule. For example, when a wife and children own shares in a family corporation the husband would not technically be a sole stockholder although he in fact exercises complete control over corporate affairs. The Regulations do not define "sole stockholder" and it is arguable that in a family owned corporation the husband might exercise such control over the other stockholders as to be a sole for all practical purposes. One court, *in dicta,* has given a partial answer to this question.

While *Landorf v. United States*[50] was primarily concerned with a transfer in contemplation of death,[51] the government had argued that by reason of Mr. Landorf's stock ownership (50 per cent) and presidency of the corporation he could have surrendered or cancelled the policy on his life by acting together with the other 50 per cent stockholder. The court stated that in cases of less than 100 per cent ownership while the mere fact of stock ownership is insufficient to establish that the deceased stockholder possessed an incident of ownership, it may be different if it were proved that a particular stockholder had control over a sufficient number of other stockholders to effectuate a change or cancellation at his will.

TRUSTEED LIFE INSURANCE

Insurance policies may form the corpus of a trust in which case the policy facts and the provisions of the trust instrument, including a will in the case of a testamentary trust, will determine whether sufficient incidents of ownership have been retained by the insured to make the policy proceeds subject to inclusion in the insured's gross estate. Treasury Regulations[52] make it clear that a decedent will be considered to have an incident of ownership in trusteed insurance on his life if under the terms of the policy the insured has the power, exercisable alone or with another, to change the beneficial ownership of the policy or its proceeds or the time or manner of enjoyment thereof. While the Regulation is clear where the policy terms give the insured incidents of ownership, there is judicial precedent for finding that the insured retained incidents of ownership where the trust instrument gives the insured rights or powers.

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[50] 408 F.2d 461 (Ct. Cl. 1969).

[51] *Supra* note 6.

[52] Treas. Reg. § 20.2042-1(c)(4) (1958) provides:

> A decedent is considered to have an 'incident of ownership' in an insurance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner or enjoyment thereof, even though the decedent has no beneficial interest in the trust.

In *Estate of Fruehauf*,[53] Mrs. Fruehauf had several life insurance policies written on the life of her husband. Mrs. Fruehauf paid all of the premiums on each of the policies until her death and by the express provisions of each policy, the ownership and control of each policy were to be possessed and exercisable solely by Mrs. Fruehauf, or her personal representatives, successors and assigns.[54] The residuary clause of Mrs. Fruehauf's will created a trust with her husband as the beneficiary.[55] A later clause named her husband as a co-trustee of this trust but at his death no distribution to the trust had been made by the co-executors of the estate, one of whom was Harry Fruehauf.

Harry Fruehauf's estate tax return did not include the proceeds of the insurance policies in question. It was the government's contention that he had possessed incidents of ownership in the policies in that he had the power as a co-trustee under his wife's will to do most of the acts that the Regulations say will constitute incidents of ownership and therefore the proceeds should have been included in the computation of his gross estate. The majority of the Tax Court looked to the provisions in the will giving broad powers to Harry Fruehauf when acting as and with the co-trustees and co-executors to retain the policies for such periods as they deemed advisable, to cause themselves to be designated beneficiaries, to sell or assign the policies to Harry Fruehauf, for the surrender value, to surrender any of the policies for its cash surrender value, and to convert any policy into a paid-up policy of insurance.[56] The court then concluded that the possession of such powers affecting the beneficiary's enjoyment of the proceeds would be sufficient to constitute the possession of "incidents of ownership" within the meaning of section 2042.

Estate of Myron Selznick[57] is also relevant to the present discussion although it was decided under the predecessor to section 2042.[58] In

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[53] 50 T.C. 915 (1968).
[54] *Id.* at 916.
[55] *Id.*
[56] *Id.* at 916, 917. Mrs. Fruehauf's will provided:

> Tenth: My Executors and my trustees may retain for such periods as they determine advisable any insurance policies owned by me at my death on the life of any other person, and pay the premiums on such policies whenever they become due out of income and/or principal as they shall see fit, and cause themselves to be designated as the beneficiaries thereof, or they may, at any time, sell and assign any of such policies to the person whose life is insured for the cash surrender value thereof, or they may surrender any of such policies for their cash surrender value, or they may, at any time, convert any of such policies into paid up policies in whatever amounts may be provided by the terms of such policies. With respect to any policies retained by them, they may arrange for the automatic application of dividends in reduction of premium payments and they may borrow on any of such policies, make premium payments from the funds so derived, and repay such loans.

[57] 15 T.C. 716 (1950), *aff'd per curiam*, 195 F.2d 735 (9th Cir. 1952).
[58] INT. REV. CODE of 1939, § 811(g).

this case the decedent had placed certain policies in trust while retaining a power to cancel these policies with a further proviso that he retained the right to revoke the appointment of the trustee and name another to take his place. Under the trust agreement ,the proceeds of the cancelled policies were to be invested by the trustee with income payable to the decedent. In concluding that the policies in the trust were includible in his gross estate, the court emphasized that in addition to the previously mentioned powers retained by the decedent he had the right to direct the trustee in the investment of trust corpus and held that the right to receive income from such property was an incident of ownership possessed by him at his death so as to include the policy proceeds in his gross estate.

Wile emphasis in *Selznick* was placed on the right to control of the trustee, insurance proceeds have not been includible where there has been merely a reservation of the right to give investment advice to the trustee.[59] Also, *Estate of Carlton*[60] held that where the insured had the right under the trust provisions to withhold his approval of sales and investment of trust assets by the trustees the proceeds were not includible in his gross estate. The import of these cases lies in a determination of whether the insured was given purely administrative powers to exercise or whether he is given or has retained a power of control over the insurance policies forming the corpus of the trust. In the later instance, the tax consequences are clear while a factual demonstration of the former will permit exclusion of the proceeds from the gross estate.

CONCLUSION

Policy facts giving rise to incidents of ownership are going to present a significant problem for the estate planner who is going to make effective use of life insurance as an estate planning tool, even though the policy facts argument is not the only weapon in the Internal Revenue Service arsenal for the inclusion of life insurance proceeds in a decedent's gross estate.[61] It seems clear from *Noel* and the line of cases following that decision that technical language in the policy giving rise to what have been termed "policy facts" is going to overrule the "intent facts" in the determination of life insurance inclusion under section 2042 although an exception to this principle exists in a case where the policy

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[59] Estate of Mudge, 27 T.C. 188 (1956); Estate of Wilson, 13 T.C. 869 (1949).

[60] Estate of Carlton v. Commissioner, 298 F.2d 415 (2d Cir. 1962).

[61] In *Cockrill* one of the policies was included in the gross estate of the insured even though the policy was owned by a corporation and all incidents of ownership were possessed by the corporation by virtue of the insured's 100 percent ownership of the corporation. Also, in *Prichard v. United States*, 397 F.2d 60 (5th Cir. 1968), the court held that where a wife owned the policy and possessed all the incidents of ownership but made an assignment of the policy insuring her husband as security for a loan obtained by her husband, the husband obtained an economic benefit from the policy and the proceeds of the policy were includible in his gross estate.

does not reflect the *instructions* of the parties, as where an insurance agent improperly fills out the policy form.[62] While it may not always be advisable to divest an insured of all incidents of ownership in a policy from a practical standpoint, the estate planner should be alerted to the possibility that insurance policies and trust instruments will unwittingly make the proceeds of the insurance policy includible in the insured's gross estate by virtue of the technical provisions contained therein.

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62 Estate of Bert L. Fuchs, 47 T.C. 199 (1966); National Metropolitan Bank v. United States, 87 F. Supp. 773 (Ct. Cl. 1950); Schnogalla v. Hickey, 149 F.2d 687 (2d Cir. 1945).