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IRREVOCABLE TERM LIFE INSURANCE TRUSTS AND GIFTS IN CONTEMPLATION OF DEATH UNDER § 2035

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The estate planner, in his quest to minimize gift and estate taxes while effecting the minimum reduction of his client's resources, is likely to have to deal with term life and accident insurance, since the use of such insurance is widespread not only as a fringe group insurance benefit but also as so-called mortgage (diminishing term) insurance and otherwise as a hedge against untimely death. The inclusion of the proceeds of such insurance in the insured's estate can cause unexpectedly heavy initial taxation; if the insured's taxable estate exclusive of life insurance totals $100,000.00, the addition of $100,000.00 of term and accident insurance will cause estate taxes (without marital deduction) to go from $20,700.00 to $50,700.00; or with the deduction to go from 0 to $20,700.00.[1]

Such inclusion can also cause an otherwise sound estate plan to become inappropriate. An estate of $100,000.00 might not justify a two-trust marital deduction will; the addition of $100,000.00 proceeds of term and accident insurance might well do so, with a consequent potential tax savings at the death of successive beneficiaries.

Term and accident insurance costs less than other types, such as whole life policies, which confer material benefits to the insured during his life.[2] Consequently their transfer *inter vivos* entails no (or little) reduction in the insured's resources; and results in no (or little) gift tax liability. This kind of property is therefore ideal, from an estate planner's viewpoint, for irrevocable *inter vivos* transfer.

Congress, the Internal Revenue Service, and the states[3] have

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[1] INT. REV. CODE OF 1954, § 2001.

[2] *See* Beadles, *Contracts — Term Insurance,* in LIFE AND HEALTH INSURANCE HANDBOOK, 55, 63 (D. Gregg & V. Lucas ed. 1973).

[3] *See* note 10 *infra.*

taken steps to encourage this kind of estate planning. Prior to 1954, a decedent's estate was taxed on a portion of the insurance proceeds paid on the decedent's life even if he had completely divested himself of all interest in the policy before his death. Under the "premium payment" test, that portion of the proceeds which represented the premiums paid by the insured was includable in his gross estate even if those premiums had been paid several years earlier.[4] Recognizing that the premium payment test discriminated against insurance,[5] Congress abandoned it in 1954 in favor of the incidents of ownership test in § 2042.[6] As a result of the 1954 amendments, a taxpayer can usually avoid the estate tax on life insurance proceeds by irrevocably transferring all of his incidents of ownership in the policy just as he would with any other property.[7]

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[4]Revenue Act of 1942, ch. 619, § 404, 56 Stat. 944 *amending* INT. REV. CODE OF 1939, ch. 3, § 811(g), 53 Stat. 122.

[5]In recommending the rejection of the premium payment test, the House Ways and Means Committee observed that "[n]o other property is subject to estate tax where the decedent initially purchased it and then long before his death gave away all rights to the property." H. R. REP. No. 1337, 83d Cong., 2d Sess., 91 (1954); U.S. CODE CONG. & AD. NEWS 4025, 4118 (1954). *See* Eliasberg, *The Estate Taxation of Life Insurance: A Survey of Recent Developments,* 26 SO. CALIF. TAX INST. 1 (1974).

[6]INT. REV. CODE OF 1954, § 2042, which provides in pertinent part:

> 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. . . .

Treas. Reg. § 20.2042 1(c)(2) (1958) defines the term "incidents of ownership" to include:

> [t]he 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. . . .

In addition, a reversionary interest in the policy or its proceeds in excess of 5% of the value of the policy constitutes an "incident of ownership." Treas. Reg. § 20.2042-1(c)(3) (1958).

[7]For examples of effective transfers of all of the incidents of ownership in an insurance policy by an insured *see* Berman v. United States, 367 F. Supp. 622 (S.D. Miss.), *rev'd on other grounds,* 487 F.2d 70 (5th Cir. 1973); Estate of Sidney F. Bartlett, 54 T.C. 1590 (1970); Estate of Powel Crosley, Jr., 47 T.C. 310 (1966); Berall, *Use of Life Insurance in Estate Planning—Recent Developments,* N.Y.U. 31ST INST. ON FED. TAX. 1053, 1064-79 (1973) (hereinafter cited as Berall). *See also* Commissioner v. Estate of Noel, 380 U.S. 678 (1965); Morton v. United States, 457 F.2d 750 (4th Cir. 1972).

The result reached in 1954 with regard to individual insurance applies to group life insurance. The Internal Revenue Service indicated in Rev. Rul. 69-54[8] that an individual insured's interest under a group policy could be assigned in such a manner as to escape § 2042 if state law permitted the assignment.[9] Accordingly, at least 41 of the 50 states have accepted this invitation and passed legislation sanctioning such assignments.[10]

Once the decision is made to rid the insured's estate of such insurance, the transfer can range from simple to sophisticated. Of the latter type, the transfer of the insurance policies may be into an irrevocable life insurance trust.[11] If proper provisions are included, the estate tax can not only be avoided in the estate of the insured,

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The trust instrument should prohibit any payment to or discharge of the settlor's own obligations or those of his estate. Otherwise, § 2036(a)(1) of the Code requires the inclusion of the trust assets in the gross estate of the settlor if the income or other enjoyment of the property transferred could be used to discharge a legal obligation of the transferor or "otherwise for his pecuniary benefit." Treas. Reg. § 20.2036-1(b)(2) (1958).

[8]1969-1 CUM. BULL. 221.

[9]*Id.* The court in Landorf v. United States, 408 F.2d 461 (Ct.Cl. 1969), held that an interest in a non-contributory group life insurance policy can be assigned by the individual insured in such a way as to divest himself of all "incidents of ownership" and thereby avoid § 2042 if the assignment is not prohibited by the terms of the group policy or by provisions of state law. For an example of a successful assignment, *see* Estate of Max J. Gorby, 53 T.C. 80 (1969). *Contra,* Estate of Sidney F. Bartlett, 54 T.C. 1590 (1970); *In re* Estate of Lumpkin, 474 F.2d 1092 (5th Cir. 1973). For a more detailed discussion of other problems involved in assigning an interest in a group life insurance policy or other corporate-owned policy, see Berall, *supra* note 7; Dopheide, *Assigning Group Life Insurance: How Can the Current Problems be Overcome?,* 34 J. TAX. 220 (1971).

[10]A list of state statutes permitting the assignment of an individual's interest in a group policy is provided in 1 FED. EST. & GIFT TAX REP. ¶ 1670.052 (1974).

[11]The irrevocable trust may either be funded or unfunded. If funded, there may be a substantial gift tax on the transfer of the assets to the trust. With a funded trust, however, the insured does not pay any premiums after the original transfer which could be found to be transfers in contemplation of death under § 2035. *See* text accompanying notes 42-44 *infra.* If the trust is unfunded, the premiums paid by the insured or someone else could be taxable as gifts. *See* text accompanying notes 83-85 *infra.* In most instances, the inability of the settlor to spare the assets needed for adequate funding of the trust combined with the income tax complexities of § 677 (taxing the trust income in a funded trust) usually makes the selection of an unfunded trust the better decision. *See* Moses, *Irrevocable Life Insurance Trusts in Estate Planning,* 24 J. AM. SOC'Y. C.L.U. 44 (Oct. 1970). Section 677(a)(3) specifically provides that the grantor of a funded trust whose income is to be applied to the payment of premiums on an insurance policy on his life or that of his spouse may be taxed on that income. An additional advantage of an unfunded trust is that the trustee may make no charge for his services.

but also in those of his spouse and successive beneficiaries. Under such a trust, the wife can be given an unrestricted income interest and, for her additional protection, the trustee can be given the power to invade the trust corpus for her necessary support. At the death of the wife, the insured's children can be given life estates instead of receiving the corpus outright.[12] If the former alternative is chosen, the children can be given the power to take down the corpus of the trust annually in an amount not in excess of the greater of 5% of the corpus or $5,000.00 without having the trust taxed in their estates at death except to the extent of the power.[13] Thus, the use of an irrevocable trust will not only permit the avoidance of the estate tax in the insured's estate, but will also bar or minimize the estate taxation of any of the proceeds in the gross estates of any beneficiaries who are given life interests in and no or limited powers of encroachment upon the trust assets.

The creation of an irrevocable trust with term and accidental death insurance of course requires all the caution normally connected with these trusts: the possibility that the Rule against Perpetuities may be violated, or that circumstances may so change — as by the development of marital differences — as to cause the settlor to change his dispository wishes. One may avoid one of the Rule against Perpetuities traps (that the period of the rule begins to run when the trust is created) by naming beneficiaries living at the creation of the trust;[14] and the clients should frankly assess the chance that marital difficulties may require changes.[15] If circumstances do change, the disposition of property other than the term and accidental death insurance can be altered to effect a result at least approaching the donor's ultimate wishes. In addition, since these types of insurance accumulate little if any value, their abandonment in the event of a more fundamental change in the estate plan may not be of material consequence.

Although the proper use of an irrevocable insurance trust will permit the avoidance of the estate tax under § 2042, the transfer in

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[12]If the trust instrument names the insured's children, then they, as lives in being, may be given life interests in the trust, and the corpus could then be distributed to the insured's grandchildren when they reach 21 without violating the Rule against Perpetuities. *See* Leach, *Perpetuities in a Nutshell,* 51 HARV. L. REV. 638 (1938).

[13]INT. REV. CODE OF 1954, § 2041(b)(2).

[14]The irrebutable presumption under the Rule that a settlor can always have more children requires that the children be named in the trust instrument. *See* note 12 *supra.*

[15]The trust instrument can, however, provide for the termination of the spouse's interest on divorce or separation.

trust must still be such as not to bring into play the other sections of the estate tax designed to bring back into the gross estate those lifetime transfers which are substitutes for testamentary dispositions.[16] Of these other sections, the Commissioner has increasingly relied upon § 2035 to subject life insurance proceeds to the estate tax. Since the Commissioner to date has enjoyed a mild degree of success in this regard, a detailed analysis of the subtle methods by which the IRS utilizes § 2035 is, therefore, necessary.

I. *Estate Taxation of Life Insurance Under § 2035.*

Section 2035,[17] like other provisions of the estate tax, is intended to bring back into the gross estate of the transferor those transfers which are in effect substitutes for a testamentary disposition, but made during life as a means of avoiding estate taxes.[18] In order for § 2035 to apply, the government must show: (1) that the decedent has made a transfer; (2) that the transfer was made in "contemplation of death;" and (3) that the transfer was made for less than adequate consideration. The statute provides a rebuttable presumption that the transfer was in contemplation of death if made within three years of the transferor's death.[19] The presumption can be rebutted with evidence of a life motive for the transfer. On the other hand, the section includes an irrebuttable presumption that the transfer is not in contemplation of death if made more than three years prior to the

[16] INT. REV. CODE OF 1954, §§ 2035-2038.

[17] INT. REV. CODE OF 1954, § 2035 provides:

> (a) GENERAL RULE. —The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, in contemplation of his death.
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> (b) APPLICATION OF GENERAL RULE —If the decedent within a period of 3 years ending with the date of his death (except in case of a bona fide sale for an adequate and full consideration in money or money's worth) transferred an interest in property, relinquished a power, or exercised or released a general power of appointment, such transfer, relinquishment, exercise, or release shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this section and sections 2038 and 2041 (relating to revocable transfers and powers of appointment); but no such transfer, relinquishment, exercise, or release made before such 3-year period shall be treated as having been made in contemplation of death.

[18] United States v. Wells, 283 U.S. 102 (1931); Milliken v. United States, 283 U.S. 15 (1931).

[19] INT. REV. CODE OF 1954, § 2035(b).

transferor's death.[20] Thus, § 2035 requires the inclusion in the decedent's estate of property transferred within three years of the decedent's death unless the estate can show that the transfer was not made in contemplation of death.

Whether and to what extent § 2035 applies to the transfer of a life insurance policy depends upon the particular facts of each case. The question has been much litigated and discussed.[21] Although some uncertain areas remain, the law appears to be sufficiently settled to predict the scope of § 2035 in most situations.

A. *Someone Other Than the Insured Purchases and Transfers the Policy into Trust.*

In construing § 2035 with reference to life insurance, the courts have interpreted the term "transfer" rather broadly. In *Bel v. United States,*[22] the insured paid for a policy on his own life but designated his children as the owners and beneficiaries thereof. The Fifth Circuit held that, although the decedent never actually owned the policy, his action constituted a "transfer" of that policy under § 2035.[23] The court found that the policy would never have been taken out had it not been for the insured's "conception, guidance, and payment";[24] and held that since the transfer occurred within three years of the insured's death, § 2035 required the inclusion of the full amount of the proceeds in his gross estate.

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[20]*Id.*

[21]Berall, *supra* note 7; Coale, *The Ghost of the Premium Payment Test Lives On,* 59 A.B.A.J. 1327 (1973); Eliasberg, *The Estate Taxation of Life Insurance: A Survey of Recent Developments,* 26 So. CALIF. TAX INST. 1 (1974); Miller, *Decision Making In Estate Planning: Try Flipping a Coin,* 111 TRUSTS & ESTATES 264, 329 (1972); Rosenberg, *Section 2035—Premium Payments Made in Contemplation of Death,* 51 TAXES 468 (1973); Shelnut, *Estate Taxation of Insurance Policies Transferred in Contemplation of Death,* 46 FLA. B.J. 674 (1972); Walker, *Contemplation of Death in Payment of Life Insurance Premiums: Where Do We Now Stand?,* 38 J. TAX. 348 (1973).

[22]452 F.2d 683 (5th Cir. 1971), *cert. denied,* 406 U.S. 919 (1972). Relying on Chase Nat'l Bank v. United States, 278 U.S. 327 (1929), the court in *Bel* interpreted transfer broadly:

> [t]he word "transfer" is not limited to the passing of property directly from the donor to the transferee, but encompasses a donation "procured through expenditures by the decedent with the purpose, effected at his death, of having it pass to another."

452 F.2d at 691. In Rev. Rul. 71-497, 1971-2 CUM. BULL. 329, issued after the decision in *Bel,* the Commissioner argued for the same interpretation of "transfer" for the purposes of § 2035.

[23]452 F.2d at 691.

[24]*Id.*

Under the broad interpretation of transfer in *Bel*, it is nevertheless implicit in the court's holding that when someone other than the insured purchases the policy and transfers it to the trustee, § 2035 cannot apply to the insured since he will have made no transfer.[25] Nor can § 2042 apply since the insured has never possessed any of the incidents of ownership in the policy.[26] For these reasons, the possibility of having someone other than the insured purchase the policy, transfer it, and then pay the premiums should always be seriously considered. One of the insured's parents might be willing to assume this obligation, perhaps by establishing a testamentary trust to purchase insurance policies on the life of the son. Should it not be suitable for a parent of the insured to purchase the policy, the next most likely suggestion would be to have the wife of the insured take out the policy.[27] However, if she should do so, she will have to forego a

[25]If someone other than the insured takes out the policy and owns it at his death, then the value of that policy will be includable in the owner's gross estate under § 2033. *See* Estate of Ethel M. Donaldson, 31 T.C. 729 (1959). Where someone other than the insured purchases the policy and transfers it, there appears to be no reason why § 2035 could not be invoked to tax the value of the policy in the estate of the purchaser/transferor.

[26]*See* Morton v. United States, 457 F.2d 750 (4th Cir. 1972), where the insured took out the policy but paid no premiums thereon. First his father-in-law, then a corporation owned by the insured's wife and sister, and finally his wife paid the premiums on the policy. The court held that § 2042 could reach none of the proceeds paid on the policy, since the insured held no incidents of ownership therein at his death.

Residents of the Fifth Circuit were reminded recently that § 2042 will require that the proceeds be included in the insured's gross estate if he is named the trustee of a life insurance trust in which the fiduciary is given any right to control the time or manner of enjoyment of the trust *res*. Rose v. United States, CCH 1975 STAND. FED. TAX REP., U.S. TAX CAS. (75-1 at 8863-63) ¶ 13,063 (5th Cir. April 11, 1975). The court relied upon Treas. Reg. § 20.2042-1(c)(2) (1958), stated that it was following *In re* Estate of Lumpkin, 474 F.2d 1092 (5th Cir. 1973) (where the decedent was not acting as trustee); and distinguished Estate of Skifter v. Commissioner, 468 F.2d 699 (2d Cir. 1972).

[27]It might be possible for the husband's employer to purchase the policy on the life of the husband. Section 79(a) of the Code states that up to $50,000.00 of group term coverage can be provided with no income tax consequences to the employee. Problems can arise with this technique, however, as the husband will be deemed to possess incidents of ownership in a corporate-owned policy under § 2042 if he is a controlling stockholder in the corporation. On this and other problems involved with corporate-owned life insurance *see* Osborn, *Corporate-Owned Life Insurance: Recent Developments in Estate Planning*, N.Y.U. 32ND INST. ON FED. TAX. 293 (1974). Where the employer pays for the policy, it could be argued that the employee has indirectly purchased the policy for purposes of § 2035. *Cf.* Berall, *Use of Life Insurance in Estate Planning—Recent Developments*, N.Y.U. 31ST INST. ON FED. TAX. 1053, 1103 (1973). In this instance it might be advisable to have the wife either pay the employer or repay her husband.

major benefit that the life insurance trust would otherwise confer upon her estate. By purchasing the policy and transferring it into a trust under the terms of which she has a life estate, the amount of the trust assets to the extent that they represent the insurance proceeds can be included in her estate under § 2036 as she would be considered to have made a transfer while retaining a life estate.[28] If the wife does not need an interest in the trust, there appears to be no reason why she should not purchase the policy and transfer it to the trust. Indeed, for reasons of the gift tax, this would be the most desirable method.[29]

When it is decided that someone other than the insured will purchase the policy and transfer it to the trustee, the entire arrangement will have to be bona fide in all respects. The purchaser will have to pay for the policy and any premiums out of his own separate funds. The insured cannot indirectly provide any of the consideration, for the Commissioner will be alert to argue that the insured actually furnished the consideration for the policy and thereby constructively transferred the policy to the trust for the purposes of § 2035. Such an argument was accepted by the Sixth Circuit in *Detroit Bank & Trust Co. v. United States*.[30] In *Detroit Bank*, the insured had transferred a sum of money into an irrevocable trust for the express purpose of having the trustee purchase a life insurance policy on his life. The court found that the insured had made a transfer of the policy even though the trustee had actually purchased it. The court reasoned that the trustee was merely an agent of the insured and that in effect, the insured had purchased the policy and transferred it into the trust.[31] Thus, applying *Bel* and *Detroit Bank*, a transfer can occur for the purposes of § 2035 when either the insured originally owns a policy and transfers it, or when he purchases it in the name of another and never actually owns it himself.[32]

The extent to which the *Bel* and *Detroit Bank* interpretation of transfer can be applied is uncertain. It seems safe to say, however, that a transfer by the insured will be found whenever the insured indirectly furnishes the consideration for the policy. Accordingly,

[28] *See* Kasishke v. United States, 426 F.2d 429 (10th Cir. 1970); *In re* Pyle's Estate, 313 F.2d 328 (3d Cir. 1963).

[29] *See* notes 84-85 and accompanying text *infra*.

[30] 467 F.2d 964 (6th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973). On remand, the transfer was held not to have been made in contemplation of death. 369 F. Supp. 672 (E.D. Mich. 1974).

[31] 467 F.2d at 969.

[32] The broad interpretation given "transfer" in *Bel* and *Detroit Bank* has been endorsed by other courts. *See* First Nat'l Bank v. United States, 488 F.2d 575 (9th Cir. 1973); Kahn v. United States, 349 F. Supp. 806 (N.D. Ga. 1972). *But see* Mercantile Trust Co. Nat'l Ass'n v. United States, 312 F. Supp. 108 (E.D. Mo. 1970), decided prior to the decision in *Bel*. In *First Nat'l Bank*, the court held the husband made a transfer of insurance policies on his life when he paid the premiums even though his wife had signed the applications. The court found the wife took out the policies as a result of

whenever it is decided that someone other than the insured is to purchase and transfer the policy, the insured should be careful to avoid any financial involvement with the purchase arrangements. Nor should it appear that the policy was purchased at his instigation.[33] His role throughout should be as passive as possible. If the wife purchases the policy, it must be made clear that she is using her own separate funds, such as money she had before marriage or which she has inherited or earned herself.

B. *Insured Purchases the Policy, Transfers it to a Trust and Continues to pay the Premiums.*

Until recently it was uncertain whether § 2035 could be invoked to require the inclusion of the proceeds paid on life insurance policies transferred by an insured, and if so, to what extent. Much of the confusion was caused by the position taken by the Internal Revenue Service in Rev. Rul. 67-463.[34] In the ruling, the Commissioner announced that when an insurance policy is transferred by an insured more than three years before his death, the pro-rata amount of the proceeds paid on the policy which reflect the amount of premiums paid in contemplation of death by the insured within the three year presumptive period would be included in his gross estate under § 2035. The position taken in Rev. Rul. 67-463 was widely rejected by the courts[35] and, as a result, the IRS issued Rev. Rul. 71-497[36] which revoked the earlier ruling. As a result of the position taken in Rev. Rul. 71-497 and the holdings in several recent United States circuit court decisions,[37] a consensus of opinion has now emerged concerning the applicability of § 2035 to the proceeds of life insurance policies transferred by an insured. Whether § 2035 can reach any of the proceeds paid on a policy transferred by the insured depends upon when the transfer occurred in relation to the three year presumptive period.[38] If transferred within the three year period before the insured's

[33] *See* First Nat'l Bank v. United States, 488 F.2d 575 (9th Cir. 1973).

[34] 1967-2 CUM. BULL. 327. Prior to the issuance of Rev. Rul. 67-463 several decisions held that the amount of proceeds paid on a policy transferred in contemplation of death within the presumptive period was includible in the insured's gross estate. *See* Vanderlip v. Commissioner 155 F.2d 152 (2d Cir. 1946), *cert. denied,* 329 U.S. 728 (1946); Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945).

[35] First Nat'l Bank v. United States, 423 F.2d 1286 (5th Cir. 1970); Gorman v. United States, 288 F. Supp. 225 (E.D. Mich. 1968); Estate of Inez Coleman, 52 T.C. 921 (1969).

[36] 1971-2 CUM. BULL. 329.

[37] *See* cases listed in note 38 *infra.*

[38] *See* Bel v. United States, 452 F.2d 683 (5th Cir. 1971), *cert. denied,* 406 U.S. 919 (1972); Detroit Bank & Trust Co. v. United States, 467 F.2d 964 (6th Cir. 1972), *cert. denied,* 410 U.S. 929 (1973); First Nat'l Bank v. United States, 488 F.2d 575 (9th Cir. 1973); Berman v. United States, 487 F.2d 70 (5th Cir. 1973); Estate of Maurice H. Honickman, 58 T.C. 132 (1972), *aff'd,* 481 F.2d 1399 (3d Cir. 1973).

death, § 2035 requires that all of the proceeds[39] be included in the gross estate unless the estate shows that the transfer was not made in contemplation of death.[40] If the transfer is made more than three years before the insured's death, the irrebuttable presumption in § 2035(b) operates to insulate the entire amount of proceeds from § 2035. Thus, in determining whether any of the proceeds of a policy are includable in the insured's gross estate, it must always be determined as a first step when the policy was transferred.

In most instances, it is easily determined when the transfer of an insurance policy occurs. However, because of the expansive definition given the term transfer in cases such as *Bel* and *Detroit Bank,*[41] the time of transfer is not so readily ascertained when the insured or anyone else has continued to pay the premiums on a policy previously transferred into trust. The problem is one of determining whether these later premiums are paid merely to sustain the original policy, or whether at some point these premiums cease to sustain the first policy and instead are used for the purchase of a new policy. For example, if a five year term policy is taken out by the insured and immediately transferred to an irrevocable trust with the insured continuing to pay the premiums, the question arises whether the premium paid at the start of the sixth year would go to sustain the original five year term policy or to purchase some new policy. In this situation, a court following *Bel* and *Detroit Bank* could decide that the premium payment in the sixth year was a purchase of a new policy by the trustee with the funds of the insured and, therefore, a constructive transfer of a new policy to the trust by him for the purposes of § 2035. If this transfer is made within three years of the insured's death, then § 2035 would be triggered even though the original transfer of a policy to the trustee occurred prior to the three year presumptive period. As a result, the proceeds paid on the present policy in the trust could well be taxed in the insured's estate.

Even if § 2035 cannot be utilized to include the entire proceeds paid on an insurance policy because it was purchased by the insured more than three years before his death, the section can still apply in

[39]Treas. Reg. § 20.2035-1(e) (1958) states that the amount to be included in the gross estate when property is brought back under § 2035 is the value of the property as of the applicable valuation date. It has been held that the value of a life insurance policy brought back under § 2035 is the amount of the proceeds. Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945); Estate of Maurice H. Honickman, 58 T.C. 132 (1972), *aff'd,* 481 F.2d 1399 (3d Cir. 1973). It is difficult to quarrel with this result since § 2035 is intended to bring property back into the gross estate which has been transferred beyond the reach of other sections in the Code. Thus the result obtained under § 2035 should be the same as if the transfer had not occurred and § 2042 had applied. Since § 2042 includes the amount of the proceeds in the gross estate of a decedent who owned a life insurance policy at his death, § 2035 should produce the same result.

[40]*See* note 48 *infra.*

[41]*See* notes 22-32 and accompanying text *supra.*

a more limited manner if the insured paid any of the premiums on the policy within the three year period. Although the Commissioner made some concessions in Rev. Rul. 71-497, he reiterated his position that the amount of premiums paid by the insured in contemplation of death within the three year period on a policy transferred prior to that time is includable in his gross estate under § 2035.[42] This position has been sustained in the courts.[43] Thus, even though the insured has made a transfer of a policy into trust that avoids § 2035, his later transfers of premiums will be included in his gross estate if made in contemplation of death within three years of his death.[44]

As long as the insured decides to pay the premiums himself, it is certain that he will be deemed to have transferred at least the value of the insurance premiums, if not more, within the crucial three year period. It is absolutely necessary, therefore, that the estate attempt to rebut the presumption that accompanies such transfers. Although it is often difficult to find a sufficient life motive for the transfer to rebut the presumption, the point should never be conceded. To be sure, there is a frequently expressed bias in the courts against finding life motives in the transfers of life insurance policies,[45] but the principle is settled that a transfer of life insurance is not inherently in contemplation of death.[46] If, therefore, a proper factual situation can be shown that will indicate a motive for the transfer other than the

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[42] 1971-2 CUM. BULL. 329, 330.

[43] First Nat'l Bank v. United States, 423 F.2d 1286 (5th Cir. 1970); Estate of Inez Coleman, 52 T.C. 921 (1969).

[44] *Id.* It has been suggested that premiums paid on any type of life insurance policy by the insured can always escape the application of § 2035 if the insured prepays three years of premiums in addition to paying the first annual premium when he originally takes out the policy and transfers it. In each succeeding year, the insured then pays the annual premium for the ensuing fourth year. After the initial three year period, no premiums can be reached under § 2035 since there are no transfers within three years. Yohlin, *Ownership and Transfer of Life Insurance,* N.Y.U. 28TH. INST. ON FED. TAX. 765, 777 (1970). If the above argument is successful with respect to premiums, then it should also work to prevent the finding of a constructive transfer of a policy within three years. If sufficient funds are available, however, a single payment policy which requires no premium payment at all should be purchased.

[45] The court in Berman v. United States, 487 F.2d 70 (5th Cir. 1973), remarked that the burden of rebutting the presumption in § 2035(b) "is seldom a light burden, and where the property transferred is so inherently death-oriented as life insurance, it is even heavier." *Id.* at 72. *See* Estate of Ross H. Compton, 33 CCH Tax Ct. Mem. 1453 (1974);.Vanderlip v. Commissioner, 155 F.2d 152 (2d Cir. 1946), *cert. denied,* 329 U.S. 728 (1946).

[46] *See* Estate of Hector R. Skifter, 56 T.C. 1190 (1971), *aff'd,* 468 F.2d 699 (2d Cir. 1972).

desire to avoid estate taxes,[47] there is a good chance that the presumption can be rebutted.

A proper life motive will be found and the presumption rebutted if the transferred policy confers a present benefit on the donee.[48] This will be the case where the policy has a cash or loan value of some sort which enables the donee to borrow money on the policy or otherwise improve his financial position. In addition, the transfer can be justified on the basis that it is but one of a series of lifetime gifts by a generous donor,[49] or that the gift was made to insulate the policy from the insured's creditors,[50] or from the risks of his business.[51] In short, evidence of life motives must be amassed in order to rebut the § 2035(b) presumption. Otherwise, when the insured has continued to pay the premiums, his estate tax will surely be increased. The amount of the increase will be governed by the determination as to whether or not one of the premiums paid within the three year period is deemed to have effected a transfer of the whole policy.

C. *Insured Purchases the Policy, Transfers it to the Trust and Someone Else Pays the Premiums.*

The likelihood that § 2035 applies is substantially lessened when the insured purchases the policy, transfers it to the trustee, and pays no premiums thereafter. If he survives the transfer by three years, § 2035 cannot apply to any extent since he will not have made any transfers of policy or premiums within the presumptive period. Since the insured has ceased paying premiums, the only inquiry under § 2035 will be whether the policy itself was transferred within the three year period prior to the insured's death.

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[47]A transfer is made in contemplation of death if the *dominant purpose* of the transfer is to avoid estate taxes. Allen v. Trust Co. of Ga., 326 U.S. 630, 635 (1946); Treas. Reg. § 20.2035-1(c) (1958).

[48]Sufficient life motives were found in the following cases: Estate of Hull v. Commissioner, 325 F.2d 367 (3d Cir. 1963) (insured transferred policies with a substantial cash value to daughter to provide her with financial security; made a gift in equal amounts to other daughters in accordance with desire to treat children equally); Landorf v. United States, 408 F.2d 461 (Ct.Cl. 1969) (gift of policy to decedent's wife was one of a series of lifetime gifts by husband in good health and assisted the wife in her estate planning); Detroit Bank & Trust Co. v. United States, 369 F. Supp. 672 (E.D. Mich. 1974) (gift of life insurance policy in trust to enable the insured's son to remain with the family corporation by providing him with funds to assure him a controlling stock interest); Mercantile Trust Co. Nat'l Ass'n v. United States, 312 F. Supp. 108 (E.D. Mo. 1970) (premiums paid by husband within three years of death were paid to preserve domestic tranquility by relieving wife of her concern that he might die suddenly).

[49]Landorf v. United States 408 F.2d 461 (Ct.Cl. 1969).

[50]Estate of Verne C. Hunt, 14 T.C. 1182 (1950).

[51]Estate of Louis Richards, 20 T.C. 904 (1953), *aff'd.* "per curiam," 221 F.2d 808 (9th Cir. 1955).

There is another significant advantage in having someone other than the insured take over the premium payments after the transfer of the policy. There is respectable authority that even if the transfer of the policy is found to have been made in contemplation of death within three years of the insured's death, the entire amount of the proceeds will not be included in the insured's gross estate if someone other than the insured has paid any of the premiums since the transfer. That portion of the proceeds paid on the policy which corresponds to the amount of premiums paid by someone other than the insured within the three year period is not included in his gross estate.[52] Therefore, for example, where the insured has paid only the initial premium before transferring the policy, and others have since made several payments, only a small portion of the proceeds will be includable in the insured's gross estate under § 2035.

As in the case where someone other than the insured originally purchases the policy and transfers it to the trust, someone must be found who is willing to pay the premiums and perhaps even incur gift tax liability on the payments. However, unlike the situation when the wife purchases the policy,[53] there is no reason why in this context the insured's wife could not pay the premiums out of her separate property. Where the husband purchases the policy and transfers it to the trust but the wife pays some or all of the premiums, the courts to date have nevertheless held that the wife makes no transfer and therefore § 2036 does not apply.[54] Additionally, definite gift tax savings can usually be achieved if the wife pays the premiums.[55] But the wife must pay the premiums out of her separate property, for if the insured indirectly furnishes the consideration, he could be found to be the transferor of those premiums paid within three years of his death.[56]

D. *Application of § 2035 to Individual Term, Group Term and Accidental Death Policies.*

While term and accident policies may be the most desirable ones to exclude from the insured's estate, as pointed out in the introduction to this article, they are in many ways the most difficult. While

[52]Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945); Estate of Morris R. Silverman, 61 T.C. 338 (1973); *See* Yohlin, *Ownership and Transfer of Life Insurance,* N.Y.U. 28TH INST. ON FED. TAX. 765, 775 (1970).

[53]*See* notes 27-29 and accompanying text *supra.*

[54]*See* National City Bank v. United States, 371 F.2d 13 (6th Cir. 1966); Goodnow v. United States, 302 F.2d 516 (Ct.Cl. 1962). The Commissioner may argue at some point by analogy to Rev. Rul. 71-497, 1971-2 CUM. BULL. 329 that the amount of the premiums paid by the payor should be included in his gross estate under § 2036.

[55]*See* notes 84-85 and accompanying text *infra.*

[56]*See* notes 30-33 and accompanying text *supra.*

it is rarely a difficult matter to avoid § 2042 by means of a proper divestiture of the incidents of ownership in these policies, it may be quite another matter to steer clear of § 2035.

The avoidance of the estate tax on life insurance proceeds in the insured's estate is the primary purpose for establishing an irrevocable life insurance trust. This purpose, however, can be totally frustrated in the case of term insurance if the Commissioner can find a constructive transfer through the payment of a premium by the insured once the trust is already in existence. If the insured should die within three years of the constructive transfer, the proceeds could well be included in his gross estate under § 2035. If someone other than the insured pays the premiums on the policy after the transfer into the trust, and any of these premiums are deemed to have purchased a new policy, then the payor could be held to have made a transfer of that new policy to the trust. Should the person paying the premiums have a life interest in the insurance trust, he could be held to have made a transfer while retaining a life estate and § 2036 would apply.[57]

Accordingly, to insure that the trust will fulfill its purposes, there should be transferred into the trust a term policy which remains in effect for as long as insurance coverage is needed by the insured.[58] Of course, whenever the insured purchases any life insurance policy and transfers it, there is always the chance that he might die within three years of the transfer and the proceeds would be taxed under § 2035 unless the contemplation of death presumption is rebutted. This chance, however, must always be taken, and from a sound planning viewpoint it would be desirable to subject the insured to only one three year period of vulnerability.

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[57]*See* note 28 and accompanying text *supra*.

[58]A significant drawback to term policies is that term coverage is usually not available to the insured past certain ages, usually ending at age 65 or 70. Beadles, *Contracts—Term Insurance*, LIFE AND HEALTH INSURANCE HANDBOOK 55, 58 (D. Gregg & V. Lucas ed. 1973). Employer furnished insurance may also end at this time when the employee retires. If continued coverage can be obtained, the cost may well be prohibitive. One insurance company offers a term policy with increasing premiums which remains in force until the insured reaches his 99th birthday. Using the most favorable rate, the annual premium at age 80 for each $1,000.00 of coverage is $130.42, $281.86 at age 90, and $671.09 at age 98. If the primary purpose for establishing the irrevocable insurance trust is to provide financial protection for the insured's immediate family in case of his untimely death, then the cessation of coverage at age 65 or 70 should not be a serious problem. By the time the husband has reached 70 years of age, his children have probably grown up, completed their education, and left home. His other assets at that point are probably adequate to support his wife. Thus the need for a substantial amount of insurance may have essentially ended. The husband may well decide that having his coverage end at age 65 or 70 is more than compensated by the substantially lower premiums required when he is younger and short of funds.

The proceeds paid under a term policy of more than three years' duration which is transferred into trust prior to the three year period before the insured's death are immune from § 2035 even if the insured continued to pay the premiums during the period.[59] It is equally well established that a one year accidental death or term policy or any policy written for less than three years duration can only be purchased, and therefore, transferred within three years of the purchaser's death.[60] The premiums paid at the start of each new term of such a policy would represent the purchase of a new policy rather than a payment on the original policy transferred to the trust. Indeed, one writer has interpreted *Bel* as requiring the taxation of proceeds in an insured's gross estate whenever the premiums paid in any given year engender the entire right to the proceeds for that year.[61] .

While the IRS position on whole life and non-renewable term policies is clear, the service has not yet taken a formal position on renewable term policies, perhaps the most common type of term policy in existence today. Certainly if a renewable term policy is taken out and transferred by the insured within three years of his death it will be included in his gross estate under § 2035 unless it can be shown that the transfer was not made in contemplation of death. But the result is not clear if the policy is originally transferred by the insured outside of the three year period and is renewed within the three years. Since the right to the insurance proceeds arises anew with each renewal of the policy, the renewal could be considered a purchase of a new policy and, therefore, a transfer of that policy by the insured under *Bel* and *Detroit Bank.* The Commissioner may assert that a renewable term policy is nothing more than a series of successive term policies of the term length which should be treated accordingly.[62] On this basis, the Commissioner can argue that a re-

[59]Rev. Rul. 71-497, 1971-2 CUM. BULL. 329 (Situation 1—five year term); *cf.* First Nat'l Bank v. United States 488 F.2d 575 (9th Cir. 1973) (20 year term). The premiums paid within the three year period will be taxed if paid in contemplation of death. *See* notes 42-44 and accompanying text *supra.*

[60]Bel v. United States, 452 F.2d 683 (5th Cir. 1971), *cert. denied,* 406 U.S. 919 (1972) (one year term accidental death); Rev. Rul. 71-497, 1971-2 CUM. BULL. 329 (Situation 2—one year term accidental death).

[61]Note, *Insurance Policies Transferred in Contemplation of Death—The Premium Payment Test Revived?* 44 U. COLO. L. REV. 633 (1973).

[62]Whenever the premiums paid in a year on any type of policy purchase the entire insurance coverage for that year, the IRS may argue that the policy is a one year policy which in effect must be purchased annually. Applying the broad definition of "transfer" found in *Bel* and *Detroit Bank,* it could be held that such a policy can only be transferred within three years of death for the purposes of § 2035. See Eliasberg, *The Estate Taxation of Life Insurance: A Survey of Recent Developments,* 28 SO. CALIF.

newal by the insured within the three year presumptive period would require the taxation of the proceeds in his gross estate unless the contemplation of death presumption is rebutted.

It should be noted that the Internal Revenue Service could make much the same argument with respect to group one year renewable term life insurance policies. Since the employer must renew the master policy annually, the contention can be made that an employee's assignment of his rights under the master policy (the transfer) can only be effective for one year. Thus, there would always be an assignment and therefore a transfer within the three year presumptive period and § 2035 would apply.[63] Some writers have remarked that this

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TAX INST. 1 (1974). The Commissioner advanced this argument, without success, in the pre-*Bel* decision of Parson v. United States, 308 F. Supp. 1159 (E.D. Tex. 1970), *aff'd in part, rev'd and remanded in part,* 460 F.2d 228 (5th Cir. 1972). The IRS should not be able to make the "annual policy" argument with respect to any level premium policy since the yearly premiums paid under such policies do not correspond with the cost of the insurance protection for the year in which they are paid. *Cf.* New York Life Ins. Co. v. Statham, 93 U.S. 24, 28 (1876). The net premium paid in an early year of a whole life policy, for example, will exceed the pure cost of insuance protection for that year. The excess is accumulated and becomes the policy's cash value. Because of the increasing cash value and the interest earned thereon, the net premium paid in later years may be substantially less than the actual cost of insurance protection for that year. Williams, *Contracts—Whole Life and Endowment,* in LIFE AND HEALTH INSURANCE HANDBOOK 66, 69 (D. Gregg & V. Lucas ed. 1973). Nor does the annual net premium paid on a level premium term policy of more than one year equal the cost of the insurance coverage for that year. In order to keep the premium level throughout the term, the premium paid in the early years of the term exceeds the cost of the insurance protection for those years. The excess is accumulated by the insurer and applied in the later years of the term when due to the insured's advancing age, the premium is no longer sufficient to cover the risk of death. H. HUEBNER & K. BLACK, LIFE INSURANCE, 63 (5th ed. 1958). *See* Rev. Rul. 71-497, 1971-2 CUM. BULL. 329 (Situation—five year term policy).

[63] *See* Yohlin, *Ownership and Transfer of Life Insurance,* N.Y.U. 28TH INST. ON FED. TAX. 765, 779 (1970); Berall, *Use of Life Insurance in Estate Planning—Recent Developments,* N.Y.U. 31ST INST. ON FED. TAX. 1053, 1098 (1973). The case for holding that a group one year renewable term policy is in effect an annual policy for the purposes of *Bel* and § 2035 is in some ways stronger than with an individual one year renewable term policy. Under the former, the insurer usually reserves the right to change the premiums, whereas he is held to an established schedule of premiums on the individual policy. Thus, it appears that the entire net premium paid on the group policy goes only for insurance protection, as opposed to the individual policy where a portion of the net premium paid compensates the insurer for his obligation to renew in the future at established rates. *See* note 67 *infra.* Since the premiums paid in a year correspond to the coverage provided in that year, the group policy could be held to be an annual policy. *But see* Dopheide, *Assigning Group Life Insurance: How Can the Current Problems be Overcome?* 34 J. TAX. 220, 223 (1971); Denenberg, *Implementing An Irrevocable Life Insurance Trust: An In-Depth Analysis,* 42 J. TAX. 42 (1975).

position would be untenable.[64] Where the insured is not the employer, the renewal by the employer should not constitute a transfer by the insured.[65] At any rate, those courts applying § 2035 to date to the assignment of group term policies have inquired only into when the original assignment was made.[66]

In response to the expected argument of the Commissioner concerning individual renewable term policies, the insured's estate should argue that substantial rights arise outside the three year period when the original policy is first taken out prior to the start of that period and, therefore, the renewal should not be deemed a transfer. The signing of the insurance contract and the other formalities all take place at the time of the original acquisition, while the renewal usually involves nothing more than the mailing of the next premium to the insurer. In addition, the obligation of the insurer to allow the renewal at the end of each term arises when the policy is originally taken out. This renewal right is a valuable one to the insured as the insurance company might not otherwise continue coverage if the condition of the insured changes. Finally, where the original policy is purchased outside the presumptive period, the renewal right will be at least partially paid for outside of the three year period.[67]

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[64]*See* Berall, *Use of Life Insurance in Estate Planning—Recent Developments,* N.Y.U. 31ST INST. ON FED. TAX. 1053, 1098 (1973), who argues that it would have been totally illogical for the IRS to permit the assignment of an employee's interest in a group term policy under Rev. Rul. 69-54, 1969-1 CUM. BULL. 221, on the one hand and then attack it as a gift in contemplation of death under § 2035 on the other. *But see* Miller, *Decision Making in Estate Planning: Try Flipping a Coin,* 111 TRUSTS & ESTATES 264 (1972).

[65]Even if a renewal of the policy can be considered a transfer, the Commissioner should be hard pressed to find a transfer when the employer renews the policy and the insured does nothing more than acquiesce in the continued coverage. *Cf.* Dopheide, *Assigning Group Life Insurance: How Can the Current Problems be Overcome?* 34 J. TAX. 220, 223 (1971).

[66]*See* Landorf v. United States, 408 F.2d 461 (Ct.Cl. 1969); Kahn v. United States, 349 F. Supp. 806 (N.D. Ga. 1972); Estate of Ross H. Compton, 33 CCH Tax Ct. Mem. 1453 (1974).

[67]This point is best illustrated through a comparison of a renewable one year term policy with a non-renewable one-year term policy. Under the latter, the net premium paid covers only the pure insurance risk of death in the one year term of the policy. The net premium under a renewable policy, however, is higher since the premium includes not only the cost of insuring for that one year, but also includes additional consideration to compensate the insurer for the increased risk created by his obligation to renew the policy to a certain point in the future regardless of the condition of the insured. Thus to some extent at least, some part of the premium paid in year #1 of a renewable one year term policy may be viewed as consideration for the insurer's obligation to renew the policy in year #20, even though the policy has been renewed 19 times during that period. This same analysis applies if there is a convertibility right in the

On the basis of these aspects of the renewable term policy, the estate can argue that the only transfer occurs outside of the presumptive period; that the bare renewal of the policy should not be considered a purchase and constructive transfer of the policy. Nevertheless, even though substantial rights may be contracted for outside of the three year period, a court relying on the expansive reading of transfer provided in *Bel*[68] and *Detroit Bank* could still conclude that the re-

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policy. *See* Beadles, *Contracts—Term Insurance*, in LIFE AND HEALTH INSURANCE HANDBOOK 55, 57 (D. Gregg & V. Lucas ed. 1973). An approximation of the additional consideration paid for the renewal right can be made by comparing the *gross* premiums paid on various policies issued by one insurance company. At age 30 the annual premium per $1,000.00 of coverage on a five year non-renewable and non-convertible term policy is $3.08. If a convertibility right is added, the premium become $3.39. If the policy is also made renewable, the premium increases to $4.00. At age 40, the respective premiums are $4.95, $5.44 and $5.94.

[68] The language used by the Commissioner in Rev. Rul. 71-497 and the analysis of the Fifth Circuit in *Bel* is of little help in determining whether a renewal of a renewable term policy within the three year presumptive period can be a "transfer." Both tended to view the purchase and therefore the transfer of a policy bought by an insured who designates another as owner of that policy, in absolute terms. Either all of the rights under the policy arise in the three year period of the presumption and § 2035 could apply or none of them arise within that period and § 2035 does not apply. This approach is illustrated by the court's comparison of the facts in Estate of Inez Coleman, 52 T.C. 921 (1969), with the facts before them:

> In *Coleman* the premium payments were made on a policy that was brought into existence more than three years prior to the decedent's death. Thus, the original contractual rights and ownership of the policy in *Coleman* were created outside the presumptive period, and, as the Tax Court noted, those premiums paid in contemplation of death served only to keep "the economic substance of that ownership alive." In the instant case, however, the premium paid by the decedent less than one year prior to his death engendered the entire right, title and interest which the decedent's children had in the accidental death policy. Essentially, every stick in the bundle of rights constituting the policy and its proceeds had its genesis within three years of the decedent's death.

452 F.2d at 690. The court based its analysis on when the rights under the policy were created in relation to the three year period. If the rights under a renewable term policy originally taken out and transferred prior to the three year period but renewed within the period arise both within and outside of the presumptive period, then the above language can be read to bar the use of § 2035 since all of the rights under the policy do not have their "genesis within three years of the decedent's death." Too much reliance on the passage quoted above would probably be misplaced, however, as the court was distinguishing cases and not setting up a test. The Commissioner may well assert that the courts have barred the use of § 2035 to the government only when *all* of the rights making up the policy on which the proceeds were paid arose outside of the three year period, as in *Coleman* and First Nat'l Bank v. United States, 423 F.2d 1286 (5th Cir. 1970).

newal of a renewable term policy with the insured's funds is a transfer of that policy under § 2035. The probability of a court so deciding is likely enough to advise heavily against the purchase of a short term renewable term policy until the question has been conclusively decided by the courts. Therefore, other forms of renewable term policies must be examined.

If the insured purchases a five year renewable term policy and immediately transfers it into trust, § 2035 cannot be invoked against the proceeds if the insured lives for three years after the original acquisition of the policy or its renewal. This view was explicitly recognized by the Commissioner in Rev. Rul. 71-497.[69] The problem under a five year policy is that the proceeds are exposed to the application of § 2035 for three years out of every five. The situation is improved with a renewable ten year term policy, and improved even more under a renewable 20 year term policy. If the latter policy is originally taken out at age 30 and the insurer permits coverage until age 70, then only one renewal is required. The insured's estate is vulnerable to § 2035 for only six years, three years at age 30, and three at age 50. If the insured lives through those periods, then § 2035 cannot apply to any proceeds paid on the policy. As safe as the renewable 20 year term policy appears to be, it is still desirable to avoid the second three year period of vulnerability if possible.

The best term policy obtainable is, therefore, one taken out and transferred only once which remains in force for as long as the insured desires insurance coverage, much like a whole life policy. Under such a policy § 2035 could be invoked against the insured only during the three year period immediately following the initial acquisition and/or transfer of the policy into the trust. One common type of term policy which avoids the need of any renewal is the "Term to age 65 (or 70)" policy which is issued by most if not all life insurance companies. The annual premiums on this policy are level throughout the term of the policy. Unlike a renewable term policy, there should be no question that a term to 65 (or 70) policy is taken out only once by the insured. All rights under the policy arise when the policy is originally taken out, and both the Commissioner in Rev. Rul. 71-497 and the courts have explicitly refused to apply § 2035 to proceeds paid under such a policy taken out more than three years before the death of the insured.[70] If the purpose of setting up the trust is to provide for the support of the family when the husband dies prematurely, then a level premium term to 65 or 70 policy is probably the best possible

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[69] 1971-2 CUM. BULL. 329, 330.

[70] *See* note 59 *supra.*

policy to transfer to the irrevocable trust. Once the policy has been in trust for three years without maturing, § 2035 cannot be invoked by the Commissioner under any circumstances to reach the proceeds of the policy.

While extended, level premium term policies are obtainable by individuals, it appears that similar policies are not available in the group context. The estate planner, therefore, may have considerably more difficulty avoiding § 2035 when dealing with group term policies than with individual term policies. There appears to be no good reason why the insurance companies do not issue longer term group policies. Doubtless underwriters would charge more for fixed obligations for longer terms. They may also reserve the right to adjust their charges in the event of a material change in their potential liability, as where an employer carrying group insurance changes his business from that of publishing to that of blasting operations. The insured should be given at least the opportunity to pay more for more continuity.

While there are certain types of insurance that facilitate the effective use of an *inter vivos* life insurance trust, individual and group term policies and accidental death policies present one final estate planning problem worthy of note. While it is difficult to rebut the presumption of contemplation of death with regard to life insurance policies generally,[71] it is even more so when term and accidental death policies are the subject of the transfer. The courts frequently express the opinion that since these types of policies rarely confer any lifetime benefits on the donee, the only justification for their transfer must be the avoidance of estate taxes,[72] particularly as the insured grows older. While the presumption can still be rebutted[73] the task of finding a sufficient life motive is significantly more difficult. For this reason, the need for extended term insurance with as few renewals as possible becomes especially important.

In short, the low cost forms of insurance are more vulnerable to

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[71]*See* note 45 and accompanying text *supra*.

[72]*See* Berman v. United States, 487 F.2d 70 (5th Cir. 1973); Estate of Ross H. Compton, 33 CCH Tax Ct. Mem. 1453 (1974).

[73]The presumption was rebutted with regard to the assignment of a group term policy in Landorf v. United States, 408 F.2d 461 (Ct.Cl. 1969), where the decedent was in good health, the transferred policy helped the decedent's wife in her estate planning and the assignment was but one of a series of lifetime gifts by the decedent. The same result was reached in Kahn v. United States, 349 F. Supp. 806, (N.D. Ga. 1972), where the transfer of group accidental death policies were held to be caused by life motives since the insureds were young and healthy, and had not even prepared a will. The court also found the policies had *inter vivos* value since they provided coverage for loss of limb, disability, etc.

the estate tax under § 2035 than are whole life policies. Because of their nature, term policies usually do not continue in force as long as whole life policies, thereby necessitating further transfers if coverage is to be continued through an insurance trust. In addition, once a transfer is found, it is more difficult to rebut the § 2035(b) presumption. Thus, while these low cost policies are the most desirable ones to transfer into an irrevocable insurance trust, to do so successfully requires a careful appreciation of all the potential hazards.

II. *Gift Tax Aspects of the Transfer of the Policy to the Trust.*

The estate tax savings which can be achieved through the use of an irrevocable insurance trust are not obtained without some cost. In all circumstances, the gift tax sections of the Internal Revenue Code must be considered, and quite often gift taxes will have to be paid, at least on the initial transfer of the policy to the trust. The imposition of gift taxes should rarely be a deterrent, however, since the gift tax on the transfer will usually be considerably less than the estate tax which is avoided.[74] In addition, because of the various exemptions and exclusions allowed under the Code in computing the gift tax, very little gift tax may ever actually be paid. The trust will especially be worth the gift tax cost if any of the proceeds escape estate taxation in any of the succeeding beneficiaries' estates.

The gift tax question arises in two contexts. First, the original transfer of the policy from the husband to the trust is taxable as a gift.[75] The value of the gift is the replacement cost of the policy on the date of the transfer.[76] The $3,000.00 annual exclusion under § 2503(b)[77] is not available since the gift in trust will be considered as

[74] *See* Moses, *Irrevocable Life Insurance Trusts in Estate Planning,* 24 J. AM. SOC'Y. C.L.U. 44 *Oct. 1970.* The git tax rates under § 2502 are three-fourths of the estate tax rates imposed by § 2001. Because the estate tax rates are graduated, a gift tax paid in a lower bracket may reduce the bracket in which the estate tax is calculated.

[75] If the insured divests himself of his incidents of ownership in a life insurance policy in order to escape § 2042, he makes a completed gift of that policy. *Cf.* Treas. Reg. § 25.2511-1(h)(8) (1958).

[76] Treas. Reg. § 25.2512-6(a) (1958), states that the value of a gift of a life insurance policy which is issued by a company regularly engaged in selling such policies is the cost of a comparable policy from that company at the time of the gift. The regulations provide other methods if the value cannot be determined through comparable policies. When a gift of a life insurance policy is made, Form 938 must be filed with the gift tax return. Where the gift of an insurance policy is not completed until the death of the insured because the transferor has retained the power to revoke the gift, then the value of the gift of the policy will be its full face value rather than the replacement cost. Goodman v. Commissioner, 156 F.2d 218 (2d Cir. 1946).

[77] INT. REV. CODE OF 1954, § 2503(b).

a gift of a future interest.[78] Nor can the husband utilize the split gift provisions of § 2513 if the wife is given a life estate in the trust, unless the remainder interest for the benefit of the children is ascertainable.[79] If the remainder interest is ascertainable, then that part of the policy representing the remainder interest can be split between the husband and wife under § 2513.[80] Finally, the husband is not allowed to take advantage of the marital deduction in § 2523,[81] since to avoid estate taxation of the trust upon his wife's death he must give her no more than a life estate in the trust. The husband can, however, apply his lifetime exemption of $30,000.00 against the transfer of the policy.[82]

The gift tax question also arises in the context of the premiums paid to sustain the policy once it is in trust. If the insured husband pays the premiums, then the full amount paid will be treated as a gift. Since there is no present interest created, the § 2503 exclusion cannot be used.[83] The gift splitting and marital deduction provisions

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[78]The annual exclusion under § 2503(b) can only be used when the gift is of a present interest. Treas. Reg. § 25.2503-3(a), (b) (1958). Usually there will be no present interest created in an unfunded irrevocable insurance trust since the trust instrument will not provide for any distribution of income or principal until the death of the insured. Treas. Reg. § 25.2503-3(c) (1958), Example (2). Even if the beneficiaries are given a present interest in the trust in the form of a present unrestricted right to the trust income, the § 2503(b) exclusion will not be allowed unless it is actually intended that income producing property will be placed in the trust, and not life insurance policies. Rev. Rul. 69-344, 1969-1 CUM. BULL. 225; Estate of Jesse S. Phillips, 12 T.C. 216 (1949).

[79]The remainder interest will not be ascertainable if the trustee is given broad powers to invade corpus for the benefit of the life tenant. Sands G. Falk, 24 CCH Tax Ct. Mem. 86 (1965). If the trustee's power to invade corpus is limited by an objective standard and it is unlikely that he will have to invade, then the remainder will be ascertainable and the remainder to the children can be split between husband and wife under § 2513. *Id.* In most cases, the insured will want to give the trustee broad powers in order to adequately protect his wife. It should be made clear in the trust instrument, however, that the wife may not serve as trustee. Otherwise, if she were the trustee under an instrument with such powers, she could be found to have retained the right to designate the beneficiaries under § 2036(a)(2), the right to alter or amend under § 2038(a)(1), or a general power of appointment under § 2041(b)(1).

[80]*See* note 79 *supra.*

[81]INT. REV. CODE OF 1954, § 2523. Section 2523 permits a deduction in computing taxable gifts of one-half the value of a gift made to the spouse. The section does not allow the deduction if the gift is of a life estate with a remainder interest in someone other than the donee spouse. § 2523(b). The section can be made to apply if the life tenant is given a general power of appointment over the trust corpus, Treas. Reg. § 25.2523(e)-1 (1958), but the trust corpus would then be taxable in the life tenant's estate under § 2041.

[82]INT. REV. CODE OF 1954, § 2521.

[83]*See* Estate of Spyros P. Skouras, 14 T.C. 523 (1950), *aff'd* 188 F.2d 831 (2d Cir. 1951).

are no more available than they were with respect to the transfer of the policy itself. However, if the wife pays the premiums out of her separate property, the gift tax situation is much improved. That part of each premium paid which sustains the wife's own interest in the trust is not considered a gift.[84] The excess of the premium paid is treated as a gift to the remainderman. For the latter to be treated as a completed gift and therefore taxable, there must be some assurance that the remainderman will indeed receive his share. If the trustee of the irrevocable trust is given broad discretionary powers to invade the corpus for the benefit of the life tenant, then the transfer to the remainderman is deemed incomplete and as a result cannot be taxed as a gift.[85] It is imagined that the husband would give these broad powers to the trustee in any event to provide the fullest possible protection for his wife. Thus if the trustee is given sufficiently broad powers and the wife pays the premiums, there may be no taxable gifts whatsoever.

It may also be possible to avoid any gift taxes on the payment of premiums by having the remainderman under the trust pay that part of each premium which represents his interest in the trust. Thus, once the children reach their majority they can begin to help the wife pay the premiums. If the trustee under the trust instrument is given broad discretionary powers, then their share could only be roughly estimated. It would seem that under such an arrangement the Commissioner could raise no complaint if a good faith effort was made. Perhaps the wife and children could take turns paying the premiums with the payor making it clear that he is paying the premiums for all of the beneficiaries. Again, the Commissioner would be hard pressed to challenge this arrangement unless he could show that one of those paying the premiums was paying more than his share. This would be extremely difficult to do where the trustee is given broad powers over the income and corpus of the trust.

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[84] Commissioner v. Berger, 201 F.2d 171 (2d Cir. 1953).

[85] *See* Rev. Rul. 62-13, 1962-1 Cum. Bull. 181, 182 which provides in pertinent part:

> [i]t is held that where property is transferred to a trust under the terms of which the trustee is given very broad discretionary powers over the distribution to the grantor of income and corpus, and where, even though the value of the property transferred is large in amount, under the circumstances there appears to be no assurance at the time of creating the trust that anything of value will be paid to a beneficiary . . . other than the grantor, such transfer constitutes, for purposes of the Federal gift tax statute, an incomplete transfer and, hence, does not result in a taxable gift.

See Estate of Christianna K. Gramm, 17 T.C. 1063 (1951).

In short, the possible gift tax consequences of a gift of life insurance should never be a deterrent to the establishment of an irrevocable life insurance trust. In many situations, no gift tax will ever have to be paid. Even if a taxable gift is made, the lifetime $30,000.00 exemption[86] can be applied against the original gift of the policy and/or subsequent premiums paid to sustain it. Even if gift taxes must be paid, they will be substantially less than the estate tax savings achieved through the use of the trust.[87]

III. *Conclusion.*

There are several ways that the transfer of group and individual term life insurance policies and accidental death policies into an irrevocable insurance trust can fail in its primary purpose of avoiding the estate tax on the proceeds in the estate of the insured and perhaps in the estate of some of the beneficiaries. Nevertheless, if handled carefully, a substantial estate tax savings can usually be achieved at both levels. There is nothing to lose by setting up the trust, since at most, § 2035 or § 2042 will require that the proceeds be included in the insured's gross estate: the same tax result as if no transfer had been attempted. As with the drafting of any trust instrument, care must be taken to avoid triggering any other sections of the estate tax code or the Rule against Perpetuities. Moreover, even if the transfer of the policies into the trust successfully avoids § 2042, other details must be carefully planned to deal with § 2035. The best type of term policy to transfer to the trust must be decided upon, as well as who is to purchase the policy and/or pay the premiums needed to sustain it. These determinations will in turn depend on who is best able to take on the obligation to pay, and what persons need an interest in the trust. Gift tax considerations will be a factor throughout.

Of course, the specific estate plan decided upon will depend on the particular circumstances of each case. In most contexts, however, the safest approach will probably be to have the husband purchase a level premium term policy for as long a period as he can obtain, immediately transfer it into trust, and cease paying any further premiums. Unlike the situation where he continues to pay the premiums, if the insured survives the transfer by three years neither the proceeds nor any premiums paid can be included in his gross estate

[86] INT. REV. CODE OF 1954, § 2521.

[87] Any gift taxes paid on a gift which is later found to have been made in contemplation of death under § 2035 can be credited against the federal estate tax. INT. REV. CODE OF 1954, § 2012.

under § 2035. In addition, since the wife has made no transfer of the policy, she can pay the premiums on the policy and still be given a life estate in the trust without fear of triggering § 2036.

The estate planner's task in this area of irrevocable life insurance trusts could be made much easier if the insurance companies would design both individual and group term policies and accidental death policies with cases such as *Bel* and *Detroit Bank* in mind. As this article has pointed out, the fault in not facilitating lifetime transfers which will remove term life and accident insurance from estate taxation does not lie with Congress, the IRS, or the majority of the fifty states; it lies with insurance companies which, despite their policy of service to their clients, continue to sell contracts which increase the risk of taxation as a transfer in contemplation of death.