Washington and Lee Law Review

Volume 32 | Issue 4 Article 16

Fall 9-1-1975

V. Life Insurance Proceeds Under § 2042

the matter of trustees and powers of appointment.[40]

It would seem, therefore, that unless a trustee who has a power of appointment is limited in the exercise of that power by either an ascertainable standard, a state statute as in New York, or by the existence of co-holders of the power with substantial adverse interest, the proceeds subject to that power will be taxable to the trustee's estate. Thus, statutory and regulatory provisions must be strictly adhered to or the risk of undesirable tax consequences can greatly increase for the often unsuspecting holder of the power of appointment.

V. LIFE INSURANCE PROCEEDS UNDER § 2042

The taxation of life insurance proceeds to the gross estate of an insured decedent is provided for in § 2042 of the Internal Revenue Code of 1954.[1] The provision is important because life insurance proceeds are often the greatest asset of an estate and are used in the planning of both large and small estates.[2] Under § 2042, life insurance[3] is taxable to an insured decedent's estate to the extent of the amount receivable by the executor and the amount receivable by all

[40] *See* Miller v. United States, 387 F.2d 866 (3d Cir. 1968); Strite v. McGinnes, 330 F.2d 234 (3d Cir.), *cert. denied*, 379 U.S. 836, *rehearing denied*, 379 U.S. 910 (1964).

[1] INT. REV. CODE OF 1954, § 2042.

[2] J. TRACHTMAN, ESTATE PLANNING 88 (rev. ed. 1968). The prevalence of life insurance is reflected by the fact that Americans were covered by $1,628 billion of life insurance in 1972. The trend in the past indicates continued growth in the amount of life insurance and the number of people insured in the future. *See* INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 1973 at 8, 11 (1973).

[3] The provisions of § 2042 fail to include any definition of "life insurance." The absence of a definition is important in connection with § 2039 concerning annuities because § 2039 specifically excludes life insurance from taxation under that section. It is possible that benefits received under a non-qualified plan could be considered life insurance, yet if the decedent possessed no incidents of ownership in the benefits then the proceeds might not be taxed under § 2042. *Cf.* All v. McCobb, 321 F.2d 633 (2d Cir. 1963). Judicial decisions have stated that "life insurance" includes accidental death benefits, annuity and life insurance combinations, group insurance, health insurance, death benefits in addition to retirement benefits, stock exchange benefits, and war risk insurance among others. There are also many benefits normally considered insurance that are not "life insurance" within the meaning of § 2042. *See* C. LOWNDES, R. KRAMER, AND J. MCCORD, FEDERAL ESTATE AND GIFT TAXES § 13.12 (3d ed. 1974). One treasury regulation gives a very broad and unhelpful definition of "life insurance." Treas. Reg. § 20.2042-1(a)(1) (1958), *as amended*, T.D. 7312, 39 F.R. 14948 (1974).

other beneficiaries if the decedent possessed "incidents of ownership" in the insurance policies under which the other beneficiaries received payment.[4] The term "incidents of ownership" has proven troublesome since its inception in the Code.[5] Among the 1974 decisions and rulings concerning § 2042,[6] were a series of cases that illustrate the different estate tax results caused by the common law or community property laws of the decedent's domicile.

A. Common Law Property States and § 2042

In *Terriberry v. United States*[7] an interpretation of the meaning of "incidents of ownership" was offered in regard to certain fiduciary powers possessed by an insured decedent over his own life insurance policies.

[4] *See* note 1 *supra*; C. LOWNDES, *supra* note 3, at §§ 13.5 and 13.6; 1 H. HARRIS, HANDLING FEDERAL ESTATE AND GIFT TAXES §§ 66, 70, and 71 (J. Rasch rev. ed. 1972); J. TRACHTMAN, *supra* note 2, at 89-90; 2 J. MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION §§ 17.07 and 17.08 (1959, Supp. 1974); 2 R. RICE, FAMILY TAX PLANNING Ch. 19, §§ 21-22 (1974).

[5] *See* C. LOWNDES, *supra* note 3, at § 13.7; 1 H. HARRIS, *supra* note 4, at § 72, J. TRACHTMAN, *supra* note 4; J. MERTENS, *supra* note 4, at § 17.10; R. RICE, *supra* note 4, at Ch. 19 § 25. The term "incidents of ownership" is not defined in § 2042. Treasury regulations attempt to provide examples of the nature of incidents of ownership. Treas. Reg. § 20.2042-1(c)(1)-(6) (1958), *as amended*, T.D. 7312, 39 F.R. 14948 (1974). The latest addition to the regulations concerning incidents of ownership appeared in 1974 as Treas. Reg. § 20.2042-1(c)(6). This regulation concerns estate taxation of corporate owned life insurance where the insured decedent was the sole or controlling stockholder. The regulation implements two basic changes. First, not only will incidents of ownership be imputed to a sole stockholder of a corporation which holds an insurance policy on the stockholder's life but also now such incidents of ownership will be attributed to a majority shareholder. The latter provision was earlier included in Rev. Rul 463, 1971-2 CUM. BULL. 333 but because of criticism was withdrawn by Rev. Rul. 167, 1972-1 CUM. BULL. 307 to allow further study. Treas. Reg. § 20.2042-1(c)(6) replaces the majority shareholder provision into the regulations. Second, the regulation restricts the thrust of the first change to situations where the proceeds are not payable to the corporation. Thus, if the proceeds are payable to the corporation, even where the proceeds are moving through the corporation to a third party, the incidents of ownership reserved to the corporation are not to be attributed the sole or controlling shareholder. Treas. Reg. § 20.2042-1(c)(6) (1958), *as amended*, T.D. 7312, 39 F.R. 14948 (1974); *see* C. LOWNDES, *supra* note 5, at 333.

[6] Other relatively important decisions handed down in 1974 concerned the relationship of § 2042 and the community property laws of certain states. *See* Kern v. United States, notes 52-68 and accompanying text *infra*; Saia v. Commissioner, note 55 *infra*. An important addition to the regulations concerning incidents of ownership in regard to sole and majority stockholders of a corporation which owns life insurance policies on those stockholders was also given in 1974. *See* note 5 *supra* in regard to Treas. Reg. § 20.2042-(1)(c)(6) *as amended*, T.D. 7312, 39 F.R. 14948 (1974).

[7] 74-2 U.S. Tax Cas. ¶ 13,002 at 85,759 (M.D. Fla. 1974).

In *Terriberry*, the wife of the insured decedent had created a trust composed of seven life insurance policies that she owned on the life of her husband. According to certain provisions of Florida law it was necessary to have co-trustees for such a trust to be valid. Therefore, she made herself and her husband co-trustees. The trust was revocable and her husband was appointed co-trustee solely to ensure that the trust was valid under Florida law. In an attempt to remove all incidents of ownership from the husband, the trust included provisions stating that ownership of the policies would not vest in the husband individually, but only in his fiduciary capacity; that the husband was expressly prohibited from exercising any incidents of ownership in his individual capacity; and that the husband was prohibited from any exercise of control over the trust. However, the trust also provided that upon surrender or maturity of the insurance contracts either co-trustee could elect a settlement option based upon the life of either the grantor or her husband, but the husband could so only to the extent that ownership did not vest in him. Finally, the grantor-wife reserved for herself the absolute right to revoke or amend the trust at any time and to remove any trustee. These provisions were all in effect at the time of decedent's death.[8]

The district court concluded that the insured decedent as co-trustee of the insurance trust did not possess sufficient incidents of ownership to have the policies' proceeds included in his gross estate for taxation purposes.[9] The decision in *Terriberry* is in apparent conflict with its own court of appeals' holding in *Estate of Lumpkin v. Commissioner*,[10] the recent decision in *Rose v. United States*,[11] and a treasury regulation directly on point.[12] Nonetheless, the court refuted

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[8] Terriberry v. United States, *supra* note 7 at 85759-60.

[9] *Id.* at 85762-63.

[10] 474 F.2d 1092 (5th Cir. 1973).

[11] 74-1 U.S. Tax Cas. ¶ 12,965, at 84,313 (E.D. La. 1973).

[12] Treas. Reg. 20.2042-1(c)(2) and (4) (1958), states that:

> (2) For purposes of this paragraph, the term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. 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. . . .
>
> (4) 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 cited authorities using the reasoning of the Second Circuit's holdings in *Estate of Skifter v. Commissioner*[13] and the Sixth Circuit's holding in *Estate of Fruehauf v. Commissioner*.[14] Due to the holdings in these latter two cases and the particular facts in *Terriberry*, the court held the proceeds to be nonincludable in decedent's gross estate.

The Commissioner relied principally upon Treasury Regulation § 20.2042-1(c)(2) and (4) and the *Rose* decision to support the argument for inclusion of the insurance proceeds in decedent's gross estate.[15] Incidents of ownership is defined in subsection (2) as generally the right of the insured to the economic benefits of the insurance policies and includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, or to revoke an assignment.[16] Furthermore, under subsection (4) incidents of ownership includes the power as a trustee, alone or in conjunction with another, "to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust."[17] The insured decedent in *Terriberry* possessed none of the enumerated powers in subsection (2) that would have given him economic benefit in the policies. He merely possessed, as trustee, the power to elect a settlement option upon surrender or maturity of the policies but only to the extent ownership did not vest in him. However, this settlement option concerned the time that enjoyment of the proceeds of the policy would occur, and the option could be made operative by the decedent's action either alone or in conjunction with the co-trustee grantor.[18]

> the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust. Moreover, assuming the decedent created the trust, such a power may result in the inclusion in the decedent's gross estate under section 2036 or 2038 of other property transferred by the decedent to the trust if, for example, the decedent has the power to surrender the insurance policy and if the income otherwise used to pay premiums on the policy would become currently payable to a beneficiary of the trust in the event that the policy were surrendered.

Id.

[13] 468 F.2d 699 (2d Cir. 1972).

[14] 427 F.2d 80 (6th Cir. 1970).

[15] Terriberry v. United States, *supra* note 7 at 85761. *See* notes 11 & 12 and accompanying text *supra*.

[16] Treas. Reg. 20.2042-1(c)(2) (1958), *as amended* T.D. 7312, 39 F.R. 14948 (1974).

[17] Treas. Reg. 20.2042-1(c)(4) (1958), *as amended* T.D. 7312, 39 F.R. 14948 (1974); *see* note 12 *supra*.

[18] *See* note 8 and accompanying text *supra*.

Upon a literal reading of subsection (4), it would appear that the insured decedent possessed incidents of ownership because of his power as trustee, either alone or in conjunction with another, to change the time of enjoyment of the insurance proceeds in the trust. Therefore, the value of the insurance proceeds at decedent's death were arguably taxable under § 2042(2).[19]

In support of this contention, the Commissioner relied upon *Rose*. The district court found the proceeds of life insurance policies in a trust to be includable in the insured decedent's estate because of his trustee powers. The decedent was sole trustee of an irrevocable trust with the power to change beneficiaries, to surrender or cancel the policies, to borrow on the policies, to convert the policies, and to distribute the income of the trust when the beneficiaries attained a prescribed age.[20] As in *Terriberry*, the trust powers were not retained by the insured decedent as settlor of a trust but rather the powers as trustee were given to him. The court in *Rose* held the proceeds includable because the term incidents of ownership connotes "something partial, minor, even fractional in its scope. It speaks more of possibility than of probability."[21] Under this broad test the powers that decedent possessed as trustee were deemed incidents of ownership in the life insurance policy trust and the fact that decedent was given the powers as trustee rather than having reserved them to himself was deemed irrelevant for § 2042 purposes.[22] In reaching this result the *Rose* court apparently considered as very persuasive authority *Estate of Lumpkin v. Commissioner*.[23] In *Lumpkin*, the Fifth Circuit held the proceeds of an employer-procured insurance policy to be includable in the employee decedent's gross estate because the decedent possessed the right to alter the time of insurance payments. Since the court in *Lumpkin* had reasoned that mere possession of the powers constituted incidents of ownership sufficient for inclusion of the proceeds, the district court in *Rose* held that the manner of possession of the powers, whether by retention or receipt, was irrelevant.[24]

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[19] Terriberry v. United States, *supra* note 7 at 8859-3.

[20] Rose v. United States, *supra* note 11 at 84,314.

[21] *Id.*

[22] *See* note 24 *infra*.

[23] 474 F.2d 1092 (5th Cir. 1973).

[24] Estate of Lumpkin v. Commissioner, 474 F.2d at 1097. The issue of whether the insured decedent possessed powers, bordering on incidents of ownership, over the insurance policies, or more specifically over the trust in which the policies are being held, as the result of a retention or a receipt of the powers is important to the various decisions in question. In *Lumpkin*, the Fifth Circuit argued that it was the intent of Congress to treat insurance under § 2042 in the same manner as other property is

The court in *Terriberry* rejected these arguments offered by the government and supported by *Rose*.[25] The court countered the gov-

treated under the remaining estate tax sections of the Internal Revenue Code of 1954. *Id.; see* S. REP. No. 1622, 83d Cong., 2d Sess. 472 (1954). The court stated that the power to alter the time and manner of enjoyment of property is generally subject to taxation under § 2036 and § 2038. To support this statement, the Fifth Circuit referred to Lober v. United States, 346 U.S. 335 (1953) and United States v. O'Malley, 383 U.S. 627 (1966). 474 F.2d at 1096. However, these Supreme Court decisions concerned respectively the *retained* right to alter a trust, making the trust taxable to trustee decedent's estate under the predecessor of § 2038, and the *retained* right to designate the beneficiary who would enjoy the benefits of the insurance proceeds, making the trust taxable to the trustee decedent's estate under § 2036. Lober v. United States, 341 U.S. at 337; United States v. O'Malley, 383 U.S. at 634. The court in *Lumpkin* stated in regard to the inclusion of the proceeds in the non-trustee decedent's estate that § 2042 was different from § 2036 and § 2038 in that the latter required an incomplete transfer of property, the retention of an interest in the property, while § 2042 required mere possession of an interest without regard to whether a transfer occurred. 474 F.2d at 1097. Thus despite the strong argument that the courts in both *Lumpkin* and *Rose* make in support of the similarity between § 2042 and §§ 2036 and 2038, the courts found a large disparity between them. Under § 2042, the courts argued an insured decedent could either have retained or received the powers that are tantamount to incidents of ownership whereas under § 2036 and § 2038 such powers could be taxable only if retained. These courts seek equality in the treatment of the property but argue inequality in the final analysis. This disparity between acknowledged Congressional purpose and the courts' interpretation, along with the added feature of fiduciary limitations on the exercise of such powers by a trustee, indicates why the *Rose* and *Lumpkin* cases had no effect on the outcome of the *Terriberry* case. *See* notes 25-48 accompanying text *infra*.

[25] The court in *Terriberry* seemed to find that because the insured decedent was a co-trustee instead of a sole trustee that fewer palpable incidents of ownership existed in the decedent in *Terriberry* than in the decedent in *Rose*. Terriberry v. United States, at 85762. This distinction alone is clearly refuted by § 2042(2) and Treas. Reg. § 20.2042-1(c)(4) which both state that incidents of ownership can exist when exercisable either alone or in conjunction with another person. *See* note 12 *supra*. A second questionable basis for the decision in *Terriberry* was a distinction based on the fact that the trust in *Terriberry* was revocable whereas the trust in *Rose* was irrevocable. The court stated that because the settlor wife could revoke the trust at any time in her sole discretion that the trust would be includable in her estate under § 2038. The inference seemed to be that since the wife's taxable estate would include the value of the trust because of her right to revoke the trust, the decedent possessed no incidents of ownership to make the value of the trust taxable to his estate. *Id.* Again, by itself this argument lacks merit because there is no indication that sections of the estate tax law are meant to be exclusive. In fact the indication is just the opposite. Several sections of the Code might make property subject to estate tax. *See* C. LOWNDES, *supra* note 4, at § 13.1.

There is no reason why such proceeds could not be taxable to successive estates, first to the insured decedent's estate under § 2042 and then to the settlor wife's estate under § 2038 when she died. If the insured decedent possessed incidents of ownership at his death and his wife still retained the right to revoke the trust at her death, the ernment's reliance on Treasury Regulation § 20.2042-1(c)(2) and (4) by citing cases which purportedly limited the scope of that regulation. The limitations countenanced the special nature of a trustee and the trustee's fiduciary obligations. In *Estate of Fruehauf v. Commissioner*,[26] the Sixth Circuit confronted a similar factual situation to that of *Terriberry*.[27] The court of appeals overruled a Tax Court decision[28] which established a rule of per se inclusion of insurance proceeds over which decedent possessed powers in a fiduciary capacity. In *Fruehauf*, the court of appeals stated that where a decedent held powers over policies solely as a transferee in a fiduciary capacity with no beneficial interest in the policies, the policies were not includable in decedent's estate because the powers could not be construed as a "substitute for testamentary disposition" by the decedent.[29]

The rule in *Fruehauf* contains two separate concepts which when combined prevent inclusion of the proceeds in decedent's gross estate for taxation purposes. The first is that the decedent must hold the policies in a fiduciary capacity with no beneficial interest in the policies. It is well established that a trustee is held to the highest degree of responsibility and cannot use his position to benefit himself in his individual capacity.[30] Therefore, unless the terms of the trust authorize the insured decedent as trustee to exceed his normal fiduciary

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value of the trust at the time of their respective deaths would be includable in their respective gross estates. It may be inferred that the court offered these arguments as part of an attempt to show less control by, and thereby fewer incidents of ownership in, the insured decedent. However, they are subject to improper interpretation and should be carefully dealt with in the proper context. The court offered more tenable bases upon which to reach its decision. *See* notes 26-48 and accompany text *infra*.

[26] 427 F.2d 80 (6th Cir. 1970).

[27] In *Fruehauf*, the insured decedent was co-trustee of a trust composed of six insurance policies on his life applied for, paid for, and owned by his wife. The trust provided that the husband was to receive income from the trust for his life, but was specifically excluded from taking part in decisions setting the lifetime remittances that he was to receive. The insured decedent was not precluded however from deciding with other trustees when the insurance policies should be surrendered for cash value, used as collateral for loans, and set aside for premium payments. 427 F.2d at 82.

[28] Estate of Harry R. Fruehauf, 50 T.C. 915 (1968).

[29] 427 F.2d at 84. The Sixth Circuit cited prior decisions of the Tax Court itself which held that even when decedent himself bought the policies and transferred them to a trust, while retaining powers in a fiduciary capacity, that the policies were not includable in decedent's gross estate because of the absence of sufficient incidents of ownership. *Id.*; *see* Estate of Bert L. Fuchs, 47 T.C. 199, 204 (1966); Estate of Newcomb Carlton, 34 T.C. 988, 996 (1960), *rev'd on other grounds*, 298 F.2d 415 (2d Cir. 1962).

[30] 427 F.2d at 86. *See* G. G. BOGERT AND G. T. BOGERT, TRUSTS AND TRUSTEES § 129 (2d ed. 1965); 2 A. SCOTT, THE LAW OF TRUSTS § 170.23 (3d ed. 1967).

responsibility and thereby benefit himself as an individual,[31] the value of the policies should not be included in the insured decedent's estate simply because of his control over the policies. The court in *Terriberry* pointed to the denial of such extraordinary powers to the insured decedent in that case.[32] As the court in *Terriberry* stated, *Fruehauf* limited the scope of Treasury Regulation § 20.2042-(1)(c)(2).[33] The economic benefit of the policies to the insured decedent, which results in the policies' inclusion in decedent's gross estate, does not arise for the decedent in the limited role of trustee with its normal fiduciary restraints.[34]

The second important part of the *Fruehauf* non-inclusion rationale is that in conjunction with being a trustee the insured decedent should be the recipient of his powers as trustee.[35] The court in *Terriberry* peremptorily referred to this second element of the *Fruehauf* holding in an apparent refutation of the government's reliance on Treasury Regulation § 20.2042-1(c)(4) and *Rose v. United States*.[36] Since the insured decedent in *Terriberry* did not reserve the powers as trustee in himself but received the powers by designation from his wife, the court stated that the policies were not includable in decedent's estate.[37] The underlying rationale for the second element of the *Fruehauf* case, as used by the *Terriberry* court, is more clearly explained in *Estate of Skifter v. Commissioner*.[38]

In *Skifter*, the Second Circuit confronted facts similar to the situation in *Terriberry*. Decedent's wife created a life insurance trust with the insured decedent as trustee. As trustee, the decedent possessed broad powers to sell, mortgage, or invest the proceeds from the trust.[39] The government contended that under Treasury Regulation § 20.2042-1(c)(4) decedent possessed incidents of ownership in the policies because of his powers as trustee.[40] Despite the fact that these powers were greater than those possessed by the decedent in

[31] 427 F.2d at 86; *see* 2 A. Scott, *supra* note 30, at § 170.9.

[32] Terriberry v. United States, *supra* note 7, at 85761.

[33] *Id.*

[34] *See* notes 8 and 12, and accompanying text *supra*, specifically in reference to Treas. REg. § 20.2042-1(c)(2).

[35] 427 F.2d at 86; *see* note 29 and accompanying text *supra*.

[36] Terriberry v. United States, *supra* note 7, at 85761. *See* notes 12 & 15-24 and accompanying text *supra* as to the government's argument for inclusion of the policies in decedent's gross estate because of Treas. Reg. § 20.2042-2(c)(4) and Rose v. United States.

[37] Terriberry v. United States, *supra* note 7, at 857.61.

[38] 468 F.2d 699 (2d Cir. 1972).

[39] *Id.* at 701.

[40] For text of Treas. Reg. § 20.2042-1(c)(4), see note 12 *supra*.

Terriberry,[41] the court of appeals in *Skifter* held the policies to be non-includable in the insured decedent's estate. The court stated that as to trustees subsection (4) applied only to powers reserved by, not to powers granted to, the decedent.[42]

To support this conclusion, the Second Circuit referred to § 2036 and § 2038 of the Code. As the courts in *Lumpkin* and *Rose* similarly stated, the *Skifter* court reasoned that Congress intended insurance to be treated under § 2042 like other property under other sections of the Code. Therefore, reliance was placed upon § 2036 and § 2038 for a source of analogous reasoning to determine whether the policies' value at decedent's death should be included in his estate.[43] Unlike the *Lumpkin* and *Rose* decisions, however, the Second Circuit by way of the analogy found the decedent's estate not to be burdened with the policies.[44] The *Skifter* court held that since § 2036 and § 2038 applied only to retained powers that, therefore, § 2042 similarly required the trustee powers to be retained by the insured decedent in order to have taxable incidents of ownership. The distinction between retention of powers and devolution of powers, has "considerable substance."[45] By reserving powers as trustee the taxpayer selects the powers that he wishes to reserve to implement his scheme of testamentary disposition. On the other hand, where the powers have been delegated, the trustee cannot be sure what powers he will possess unless there is some underlying agreement with the settlor-beneficiary. Thus, it is difficult to construe the arrangement in *Skifter* or *Fruehauf* as a substitute for testamentary disposition by the insured decedent.[46]

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[41] *See* note 8 and accompanying text *supra*.

[42] 468 F.2d at 705.

[43] Section 2036 includes in the gross estate of a decedent any property subject to decedent's retention of a life estate in the making of a transfer of such property. Section 2038 includes in decedent's gross estate any property transferred by the decedent over which the decedent retains a right to revoke the transfer. INT. REV. CODE OF 1954, §§ 2036 and 2038.

[44] *See* note 24 and accompanying text *supra* for analysis of the intent of Congress by the Fifth Circuit in *Lumpkin*.

[45] 468 F.2d at 703; see note 24 *supra*.

[46] *Id.* at 703-04. The court in *Skifter* acknowledged that the wording in § 2038, "(without regard to when or from what source the decedent acquired such power)," tended to support the government's position. However, the court stated that no court ever held those words to apply to a "power other than one that the decedent created at the time of the transfer in someone else and that later devolved upon him before his death." *Id.* at 704. The court opined that the words added to § 2038 above were meant only to restrict the holding of the Supreme Court in White v. Poor, 296 U.S. 98 (1935). There the decedent created an inter vivos trust, conferred power on the trustee

In *Terriberry*, the reasoning of the *Skifter* case was applied in a similar manner. The wife of the decedent was the settlor-beneficiary of the life insurance trust and designated the insured decedent as trustee with strictly limited powers.[47] The decedent, therefore, was granted the powers as trustee by the settlor-wife and did not retain the powers himself. Nor were any extraordinary powers granted to decedent as trustee so as to allow accrual of economic benefits to himself. In fact, the powers were very limited. By this reasoning, the court in *Terriberry* chose not to follow the rationale of *Rose* in its reliance upon subsections (2) and (4) of regulation § 20.2042-1(c) to include the policies' value in decedent's gross estate.[48] Indeed, unlike *Rose*, the court reasoned that *Lumpkin* was inapposite because the decedent in that case held his powers in a non-fiduciary capacity and was, therefore, free to exercise those powers as his personal desires might dictate.[49]

The ruling in *Terriberry* outlines several steps to avoid taxation of insurance proceeds to the insured decedent's estate when the decedent is trustee of a life insurance trust. The insured must receive his powers as trustee from a settlor other than himself. Moreover, the powers given to the insured must not permit him to benefit himself or his estate. A safer course, however, would be to avoid designating the insured as trustee of the insurance trust all together. The latter step would prevent the need for difficult interpretation by the courts as to the sufficiency of incidents of ownership in the life insurance policies. This would eliminate the uncertainty of taxation, provided no other incidents of ownership exist. However, the *Terriberry* decision must be recognized as attesting to a significant distinction between powers by reservation and powers by grant in a trustee under the incidents of ownership test of § 2042.

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to terminate the trust, and subsequently decedent was appointed trustee. The court in *Skifter* stated that the above addition to § 2038 applied only to the factual situation of White v. Poor. 468 F.2d at 704.

[47] As stated previously, the trustee powers of the insured decedent in *Terriberry* were of more limited scope than those of the decedent in *Skifter*. *See* notes 8 & 41 and accompanying text *supra*.

[48] It should be noted that the limitation placed upon Treas. Reg. § 20.2042-2(c)(4) by the decisions in *Terriberry*, *Skifter*, and *Fruehauf* is not an unusual procedure. Since the Second Circuit specifically referred to the absence of sound support for taxing a decedent under § 2042 where he is a trustee by grant, not by reservation, the court could find that it was not bound by the regulation. *See* Smith v. Commissioner, 332 F.2d 671, 673 (9th Cir. 1964); 2 R. RICE, *supra* note 4, at 804 (Supp. Sept. 1974).

[49] Terriberry v. United States, *supra* note 7 at 85761.

B. *Community Property States and § 2042*

The treatment of life insurance proceeds under § 2042 in community property states[50] is largely controlled by local community property law.[51] Although practitioners in common law states may doubt the need to be familiar with the different treatment accorded estate taxation of life insurance in the community property states, the increasing geographical mobility in society will often confront the practitioner with such estate planning problems.[52] Therefore, the rule limiting federal estate taxation according to the substantive law of community property states is of importance to practitioners throughout the country.

In 1974, the Ninth Circuit considered the procedures necessary to implement transmutation of community life insurance into the separate property of only one spouse.[53] The court's decision in *Kern v. United States*[54] dealt with an application of Washington state law to an attempted removal of life insurance proceeds from a decedent spouse's estate.

The wife of the insured decedent as applicant, and the decedent as the proposed insured, signed an application for an insurance policy. The application included a standard provision that the proposed insured agree that the policies applied for would be under the exclusive control and disposition of the applicant. The policy issued on this application upon payments from community funds contained a typed endorsement stating that the applicant was sole owner of the policy and that neither the proposed insured nor his estate "shall have any interest in the policy." Subsequently, another policy was issued in the same manner but contained no typed provision excluding the

[50] There are eight community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. *See* J. DUKEMINIER AND S. JOHNSON, FAMILY WEALTH TRANSACTIONS: WILLS, TRUSTS, FUTURE INTERESTS, AND ESTATE PLANNING. 494 (1972) [hereinafter DUKEMINIER].

[51] Treas. Reg. § 20.2042-1(b)(2) and (c)(5) (1958), *as amended* T.D. 7312, 39 F.R. 14948 (1974). This rule has been supported consistently by the courts as well. *See* Lang v. Commissioner, 304 U.S. 264, 267 (1938); Scott v. Commissioner, 374 F.2d 154, 157 (9th Cir. 1967); Monroe v. United States, 301 F. Supp. 762, 767 (E.D. Wash. 1969).

[52] *See* DUKEMINER, *supra* note 49, at 543-47.

[53] In the ensuing discussions concerning community property it is necessary to realize that the law varies from state to state in the community property system. Therefore, what may be considered as true for one community property state may not be true for another. For a basic discussion of the different treatment of life insurance proceeds by the community property states and the effect on federal estate taxation see 1 H. HARRIS, *supra.* note 4, at § 80.

[54] 491 F.2d 436 (9th Cir. 1974).

proposed insured's interest in the policy. After decedent's death, the estate tax return prepared by his estate included one half of the insurance proceeds of both policies in his gross estate apparently based upon the fact that the policies were the community property of the decedent and his wife.[55] A claim for a refund was filed thereafter seeking exclusion of all proceeds of the policies from decedent's gross estate.[56]

In the lower court's opinion,[57] the proceeds were not entitled to total exclusion since the premium payments were from a community bank account. The court concluded that the estate failed to bear the burden of overcoming the presumption that the life insurance was community property. If another instrument, stating that the property was separate and not community property, had been executed, such provision for the specific gift of the premiums would probably have vested the policies as separate property in the surviving spouse.[58] Therefore, the lower court upheld inclusion of one half of the proceeds in the insured decedent's estate.

On appeal to the Ninth Circuit, the lower court's decision was reversed. The court of appeals agreed with the lower court that there existed a strong presumption that property acquired during marriage constituted community property.[59] However, certain exceptions could

[55] To determine the amount of proceeds from life insurance to be included in a decedent's estate it is necessary to determine in each case if decedent was married at the time of the issuance of the life insurance, if the premiums were paid from community or separate funds, and the identity of the insured and the beneficiary under the policy. The various community property states apply different rules to the above determinations as to when inclusion occurs and as to what amount shall be included. *See* 1 H. HARRIS, *supra* note 4, at § 80; note 58 *infra*.

[56] 491 F.2d at 438. In another community property decision in 1974, the Tax Court followed Louisiana law in excluding all proceeds from the insured decedent's gross estate where the decedent's spouse was the apparent owner-beneficiary of the policies. As in *Kern*, the premium payments were made from community property. However, because Louisiana law treats life insurance in a class by itself, Catalano v. United States, 429 F.2d 1058 (5th Cir. 1969), the court concluded that the policies did not fall within the presumption that property was community property. Saia v. Commissioner, 61 T.C. No. 57, 2 FED. & EST. GIFT TAX REP. ¶ 8603 (Jan. 28, 1974).

[57] Kern v. United States, 72-1 U.S. Tax Cas. ¶ 12,826 (E.D. Wash. 1971).

[58] *Id.* at 84,685.

[59] 491 F.2d at 438. Part of the reason for this strong presumption lies in the codification of community property law in Washington. 26 R.C.W.A. §§ 16.010, 16.020, and 16.030 (1961). *See* United States v. Overman, 424 F.2d 1142, 1144 (9th Cir. 1970), where it is explained that the interest of each spouse in community property is an intangible asset "giving each spouse an equal, present, and vested right in the marital community with full rights of enjoyment." The "vested" interest of the surviving spouse is the amount excluded from the decedent spouse's gross estate for taxation

remove the property from inclusion in decedent's gross estate. To claim an exemption under Washington law, it is necessary to show that the receiving spouse acquired the property by gift, devise or descent. Any such exception must overcome a strong presumption in favor of community property and the burden of proof is upon the party asserting that the property is separate from the community.[60] The proof must be clear, definite, and convincing to overcome the presumption.[61]

Using the burden of proof standard, the Ninth Circuit agreed with the district court that the second policy's standard provision in the application[62] failed to show an intent to transmute the community property into the wife's separate property. The provision in printed form applied to any applicant and an insured without regard to their marital status. This provision failed to meet the requirement of clear, definite, and convincing evidence necessary to rebut the presumption.[63]

However, as to the typed provision in the first policy,[64] the court of appeals disagreed with the lower court. The agreement placed all incidents of ownership in the wife as sole owner and expressly precluded any interest in the policies by the insured or his estate. This provision together with the testimony of the wife and the insurance agency who sold the policies constituted clear, definite, and convincing evidence that the policy was intended to be the separate property of the wife.[65]

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purposes. Parson v. United States, 460 F.2d 228 (5th Cir. 1972); Scott v. Commissioner, 374 F.2d 154 (9th Cir. 1967); *see* C. LOWNDES, *supra* note 3, at 338.

[60] 491 F.2d at 439; In re Estate of Smith, 73 Wash. 2d 629, 440 P.2d 179, 181 (1968); Stokes v. McDowell, 70 Wash. 2d 694, 424 F.2d 910, 911 (1967); California-Western States Life Ins. Co. v. Jarman, 29 Wash. 2d 98, 185 P.2d 494, 496 (1947).

[61] 491 F.2d at 439; *see* State v. Miller, 32 Wash. 2d 449, 201 P.2d 136, 141 (1948) (clear and definite); in re Slocum's Estate, 83 Wash. 158, 145 P. 204, 205 (1915) (clear, certain, and convincing).

[62] *See* note 55 and accompanying text *supra*.

[63] 491 F.2d at 439.

[64] *See* note 54 and accompanying text *supra*.

[65] 491 F.2d at 439. The Ninth Circuit criticized the district court's reference to the necessity of executing a separate document in order to establish sufficient proof of an intent to designate the policies as separate property. The court of appeals stated there was no support for that position in Washington law. *Id.*; see note 58 and accompanying text *supra*. The district court listed five cases from Washington courts as support for its decision without any discussion of those cases or their specific holdings. *See* Kern v. United States, 72-1 U.S. Tax Cas. ¶ 12,826, at 84,685. Upon examination of those five cases it is apparent that none expressed a position requiring a separate document to be executed to effectuate the transmutation of community property into separate property. The nearest any case came to expressing such an opinion was in Neely v.

The holding in *Kern* promulgates an important distinction in the manner in which evidence of transmutation of community life insurance into separate property can be conclusively manifested. Reliance upon standard, printed-form provisions alone, applicable to any person, will fail to support an attempt to create separate life insurance ownership. It is apparent after *Kern* that the particular parties as a community must be referred to specifically in the provisions of an insurance contract in the course of establishing a separate interest in one of the parties. The provisions must state clearly that one spouse possess all incidents of ownership and that neither the other spouse, the insured spouse, nor his estate have any interests in the policies. In this manner, the provisions of § 2042 shall not fall unexpectedly upon the insured decedent's estate.

Lockton, 63 Wash. 2d 929, 389 P.2d 909 (1964). In that case the insured decedent attempted to make someone other than his spouse the beneficiary of a life insurance contract on his life. In judging the pre-eminence of either contract law or community property law, the court argued that in the *stated* circumstances looking to the contract of the insurance company to determine beneficiary considerations was not sound. The insurance contract's provisions required less formality and forethought to execute than a separate agreement. Therefore, because of the rationale behind community property law, to provide a simple and certain method of disposing of property to *protect* the surviving spouse's interest in the property, giving more credence to the terms of the insurance contract would defeat the basic purpose of community property law. *Id.* at 911-12. Nevertheless, where as in *Kern* the spouse *is* the beneficiary of the insurance contract and the contract simply adds a more complete disposition of benefits to that spouse, the consideration behind the *Neeley* decision for not looking at the contract's terms do not apply. There is no reason to demand a separate document when the spouses themselves deliberately seek to alter their relative positions and rights in regard to community property in favor of one spouse. Support for this position in these circumstances was expressed long ago in Succession of Desforges, 135 La. 49, 62 So. 978, 981 (1914). Therefore, the court of appeals justifiably reversed the decision of the district court and remanded the case for discussion of an issue not argued at the lower level. Kern v. United States, 491 F.2d at 439-40.

The issue for remand concerned the applicability of a Washington statute, 48 R.C.W.A. § 18.440 (1961), that states in subsection (1) that policies made payable to or for the benefit of the spouse of the insured shall, unless otherwise contrary to the provisions of the insurance policy, inure to the separate use and benefit of the spouse. The court of appeals, with apparent justification, believed that the statute's terms might serve to exclude entirely the proceeds of both insurance policies from the estate of the decedent.

The effect of a final determination that a policy's proceeds are not community property would mean their complete exclusion from decedent's estate. When under local law an assignment or other transaction results in the termination of community property or conversion into separate property, the usual federal estate taxation rules apply. *See* Catalano v. United States, 424 F.2d 1058 (5th Cir. 1969); Bintliff v. United States, 329 F. Supp. 1356 (E.D. Tex. 1971), *rev'd on other grounds*, 462 F.2d 403 (5th Cir. 1972). In this case, since the insured decedent possessed no incidents of ownership in the property aside from the now refuted community property interest, his estate would be free of taxation on the life insurance proceeds.