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Estate Taxation - Life Insurance - Inclusion in Gross Estate If Purchased by a Trust with Money Given It by Decedent in Contemplation of Death - Detroit Bank and Trust Co. v. U.S.

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ESTATE TAXATION—Life Insurance—Inclusion in Gross Estate if Purchased by a Trust with Money Given It by Decedent in Contemplation of Death. Detroit Bank and Trust Co. v. U.S., 467 F.2d 964 (6th Cir. 1972).

On April 9, 1964, Fred W. Ritter, in apparent good health, entered into a trust agreement with the Detroit Bank and Trust Co. He transferred $9,600 to the bank as trustee, naming his children as beneficiaries. The trust acquired $100,000 of insurance on Ritter's life. The trust was irrevocable and beyond Ritter's control except that he could continue to make contributions to the trust for the payment of future premiums on the insurance policy. Ritter died six months later on October 6, 1964. The parties stipulated that the $9,600 paid to the trust was presumed to have been given in contemplation of death under Section 2035 of the Internal Revenue Code.[1] The dispute in this case centered on the amount to be included in the decedent's gross estate for estate tax purposes. The federal district court held that only the amount of the premiums paid in contemplation of death should be included.[2] The Sixth Circuit Court of Appeals reversed and held that a gift of money, made in contemplation of death, used to pay the premiums on an insurance policy acquired within three years of death, was to be valued, for federal estate tax purposes, in terms of the proceeds at death rather than the amount of the premiums paid.[3]

The first federal estate tax statute completely omitted life insurance from its provisions.[4] This meant that the proceeds from a life insurance policy were included in decedent's gross estate only if they were paid to the estate itself, instead of to some designated benificiary. People could avoid paying estate taxes by converting their estate assets into life insurance policies payable to specific beneficiaries. In fact, insurance companies "openly urged persons of wealth to take out additional insurance payable to specific beneficiaries for the

1. INT. REV. CODE of 1954, § 2035.
2. For a discussion of this unreported case see *New Danger for Payment of Premiums by Insured,* 38 J. TAXATION 7 (1973).
3. Detroit Bank and Trust Company v. United States, 467 F.2d 964 (6th Cir. 1972).
4. INT. REV. CODE of 1916.

reason that such insurance would not be included in the gross estate.'"[5]

In 1918, Congress moved to stop this mode of tax avoidance.[6] They redefnied gross income to include amounts received by the estate or by the beneficiaries under policies "taken out by the decedent" upon his own life.[7] Because of its ambiguity, the phrase "taken out by the decedent" produced nothing but confusion. The Treasury Department added to this chaos by issuing regulation after regulation which reconstrued the meaning of the phrase.[8]

Congress finally intervened in 1939 by eliminating the words "taken out by the decedent." In their place, Congress enacted legislation which provided that proceeds payable to designated beneficiaries would be included in the decedent's gross estate if the decedent had either (1) paid the premiums on the policy directly or indirectly,[9] or (2) possessed incidents of ownership in the policy at the time of his death.[10] These enactments became known as the "premiums paid" test and as the "incidents of ownership" test.

Under the premiums paid test, insurance proceeds purchased with assets directly or indirectly coming from the decedent, would have been included in his gross estate in the proportion that the amount of the premiums paid by the decedent bore to the total premiums paid.[11] For example, if a decedent paid directly or indirectly $20,000 out of $25,000 total premiums on a $100,000 insurance policy, $80,000 of the proceeds would be included in his estate. Yet, the interpretation of what constituted an indirect payment of premiums by the decedent became the subject of litigation with differing results. At times an unrestricted gift of money used by the donee to pay the premiums on a policy covering the donor's life constituted indirect payments, at other times it did not.[12]

5. H.R. REP. NO. 767, 65th Cong., 2d Sess. 22 (1918).
6. John Hancock Mutual Life Insurance Company v. Helvering, 128 F.2d 745 (D.C. Cir. 1942).
7. INT. REV. CODE of 1918, § 402(f).
8. Eisenstein, *Estate Taxes and the Higher Learning of the Supreme Court,* 3 TAX L. REV. 395, 513-36 (1948).
9. INT. REV. CODE of 1939, § 811(g)(2).
10. *Id.*
11. H.R. REP. No. 2333, 77th Cong., 2d Sess. 57 (1942).
12. Estate of Showers v. Commissioner, 14 T.C. 902 (1950); Estate of Selling v. Commissioner, 24 T.C. 191 (1955).

While retaining the incidents of ownership test, the 1954 Code eliminated the premiums paid test.[13] Under Section 2042 of this Code, the insured could pay the premiums himself yet keep the proceeds of the policy out of his estate by placing the incidents of ownership in someone else.[14] In 1957, the Treasury Department attempted to reintroduce a modified form of the premium payment test into the Code. This attempt was rejected by Congress.[15] The Department then decided to do administratively what it could not do legislatively. It revived the premium payment test with Revenue Ruling 67-463.[16] However, this ruling was in connection with Section 2035 of the 1954 Code which deals with transactions in contemplation of death and not with Section 2042 which deals with the inclusion of life insurance in the decedent's estate. This premium payment test was identical to the 1939 Code test except for the three year limitation set forth by the contemplation of death provisions.

According to Revenue Ruling 67-643, the amount of proceeds, included in the decedent's gross estate, was to be determined by the ratio that premium payments, made during the three years prior to death, had to the total amount of premiums paid.[17] For example, if the proceeds of the policy were $100,000 and twelve equal annual premium payments had been made, three of them during the three years immediately preceding the decedent's death, ¼ of the proceeds, or $25,000 would be included in his gross estate.

In 1968, a district court in Michigan became the first court to hear a case involving this revenue ruling. In *Gorman v. United States*,[18] the deceased had taken out an insurance policy naming his wife as beneficiary and owner. He died nine months later after paying all of the premiums on the policy. The court concluded that Revenue Ruling 67-643 was unfounded in either statute or case law and that any reliance placed upon this ruling should be rejected.[19] Only the amount

13. INT. REV. CODE of 1954, § 2042.
14. BITTKER & STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 1227 (4th ed. 1972).
15. H.R. REP. No. 8381, 85th Cong., 1st Sess. 56 (1957).
16. Rev. Rul. 67-463, 1967-2 CUM. BULL. 327.
17. *Id.* at 329.
18. 288 F. Supp. 225 (S.D. Mich. 1968).
19. *Id.* at 228.

of the premium payments made in contemplation of death were included in the estate.

A year later, the tax court heard its first case concerning the revenue ruling. In *Estate of Inez Coleman*,[20] the decedent's children had taken out and at all times had owned a policy on the decedent's life. The decedent paid the premiums on the policy and died over three years after the policy had been purchased. The court held against the revenue ruling and included only the premiums paid in contemplation of death in the decedent's estate.[21] After this, the Fifth Circuit became the first circuit court to hear the issue. In *First National Bank of Midland, Texas*,[22] an insurance company issued a policy to the beneficiary-owner on the life of the decedent. The decedent paid the premiums dying eight years after the policy was issued. Once again, this court ruled that only the premiums paid in contemplation of death were includable in the decedent's gross estate.[23]

Subsequent to these cases, a federal district court in Michigan first heard the case under consideration.[24] Following the *Gorman* decision, this court ruled that only the premiums paid in contemplation of death were to be included in the gross estate. Upon appeal, however, the circuit court noted that two things had occurred between the time the lower court had heard this case and the time the appeal had been brought.[25]

First of all the Treasury Department had revoked Revenue Ruling 67-463 replacing it with Revenue Ruling 71-497.[26] Under this new revenue ruling, the Department acquiesced in the *Coleman* and *Midland* decisions. It said that the proceeds of any policy on the decedent's life would not be included in his gross estate if the policy had been owned by another person for at least three years prior to the decedent's death.[27]

20. 52 T.C. 921 (1969).
21. *Id.* at 924.
22. First National Bank of Midland, Texas v. United States, 423 F.2d 1286 (5th Cir. 1970).
23. *Id.* at 1289.
24. *New Danger for Payment of Premiums by Insured*, *supra* note 2.
25. Detroit Bank and Trust Company v. United States, *supra* note 3, at 967.
26. Rev. Rul. 71-497, 1971-2 CUM. BULL. 329.
27. *Id.* at 330.

However, the Department would not go along with the *Gorman* decision. The ruling gives the situation of a person buying an accidental death insurance policy and designating his children as both owners and beneficiaries. If he dies nine months later after paying all of the premiums, the Service would include the entire proceeds in his gross estate. In other words, if the policy is taken out less than three years prior to the insured's death, the entire proceeds will be included in his estate if he has paid the premiums on the policy. If the policy is taken out more than three years prior to his death, only the premiums paid in contemplation of death will be included.[28]

Revenue Ruling 71-497 is based solely on the 1929 case of *Chase National Bank v. United States.*[29] In this case the Supreme Court had said that the word "transfer," as it was used to value the gift made, could not be taken in a

> restricted sense as to refer only to the passing of particular items of property directly from the decedent to the transferee. It must . . . include the transfer of property procured through expenditures by the decedent with the purpose, effected at death, of having it pass to another.[30]

Thus the service reasoned that by paying the premiums on the policy, the decedent had not just made a gift of these premiums but had made a gift of insurance protection. This was a transfer of an interest in the policy which changed at death into the proceeds of the policy.[31]

Secondly, the service had won its first appellate court case covering this issue. In *Bel v. United States,* the decedent had died within one year after purchasing a policy on his life naming his children as beneficiaries and owners. He had paid all of the premiums on the policy. Relying on the *Chase National Bank* decision, the court said that there was more than mere money transferred by the decedent. He had "beamed" the policy to his children and had created in his children all of the contractual rights to the insurance bene-

28. *Id.*
29. 278 U.S. 327 (1929).
30. *Id.* at 337.
31. Rev. Rul. 71-497, *supra* note 26, at 330.

fits. Thus, in effect, he had transferred the policy and, as this transfer was in contemplation of death, all of the proceeds were includable in his gross estate.[32]

Using these two recent developments, as well as the conclusion that the omission of the premium payment test from Section 2042 did not preclude its use under Section 2035, the appellate court in *Detroit Bank and Trust Co.* held to reverse the district court.[33]

It is submitted that the court's decision should not be based upon Revenue Ruling 71-497, the nature of the gift transferred, or the purpose of Congress in enacting Sections 2042 and 2035.

At best, the reliance on Revenue Ruling 71-497 is tenuous. This Ruling is based exclusively upon the *Chase* case. *Chase* was decided in 1929 before the premium payments test had even been devised. The issue before the court was whether the estate tax could cover insurance policies taken out and owned by the decedent but payable to his wife.[34] The court was concerned with the constitutionality of the estate tax law and not with the relationship between premiums and proceeds.

Chase was used as main support for Revenue Ruling 67-463. The courts in deciding cases under this ruling noted the discrepancy in the factors underlying the *Chase* decision and in the factual situations to which the Service tried to apply it.[35] If *Chase* were decided today, the decision would be the same as it was in 1929. As the decedent had retained all of the incidents of ownership in the policy, at his death the proceeds would be included in his estate under the incidents of ownership test.[36] The relevancy of the decision in *Chase* as applied to the situation in our case is therefore highly questionable.

Under Section 2035 of the Code, gifts in contemplation of death are included in the decedent's gross estate only to the extent of the interest he has transferred.[37] It is the value of

32. 452 F.2d 683, 691 (5th Cir. 1971).
33. Detroit Bank and Trust Company v. United States, *supra* note 3, at 969.
34. Chase National Bank v. United States, *supra* note 29, at 333.
35. Gorman v. United States, *supra* note 18, at 228.
36. INT. REV. CODE of 1954, § 2042(a)(2)(A).
37. INT. REV. CODE of 1954, § 2035.

this interest that is added back into the estate. *Bel* concerned itself mainly with determining exactly what interest the decedent had transferred. The court in *Bel* held that the decedent had "beamed" the policy to the beneficiaries; that without the decedent's conception, guidance and payment, the proceeds would never have reached the beneficiaries.[38] Yet it is dubious whether a decedent can transfer what he did not own. At no time did the decedent have any incidents of ownership in the policy. He could not cancel or assign the policy. He could not borrow against it or change the beneficiary. He had absolutely no economic interest in the policy. At all times, these interests were located in the owner of the policy and not in the decedent. These interests were therefore neither transferred nor transferrable by the decedent.

If a person purchases a policy and later gives it to another, the law is clear that the interest he has transferred is the policy itself. If this transfer has been made in contemplation of death, the entire proceeds will be included in the deceased's estate.[39] However, if a person gives a gift of money, and the recipient entirely on his own purchases the policy, then the only interest the donor has transferred is the monetary gift. If this gift was made in contemplation of death, only the gift itself will be included in the deceased's estate.[40] *Detroit Bank and Trust,* falls between the two extremes of a money gift or a gift of a policy. Which situation it more closely resembles is the problem to be determined.

In this regard, it should be noted that the courts prior to *Detroit Bank and Trust* had looked to the named owner on the policy to determine initial ownership. Thus, the court in *Gorman* ignored the fact that it was the decedent himself who had filled out and signed the application for the policy and that he was required to take two physical examinations before the policy could be issued. As the wife was the named owner on the policy, she was considered to be the one who had purchased the policy irregardless of the preliminary requirements met by the husband. In other words, there was no

38. Bel v. United States, *supra* note 32, at 691.
39. Vanderlip v. Commissioner, 155 F.2d 152 (2d Cir. 1946).
40. *See* Humphrey's Estate v. Commissioner, 162 F.2d 1 (5th Cir. 1947).

transfer of a policy between a husband and wife if the wife was the named owner of the policy at the time it was issued.

If the decedent had transferred more than just the premium payment, it would seem that this something extra would also be included in his gift tax liability. Yet, the premium payment is the only amount that has been transferred for gift tax purposes. Under the gift tax regulations, if the insured pays a premium on a policy that he does not own, he has made a gift only to the extent of the premium paid.[41] There seems to be very little basis in law or reason for saying that the decedent has transferred more than the money gift.

The court in *Detroit Bank and Trust* came to the conclusion that by omitting the premium payment test from Section 2042, Congress did not intend to have it precluded from Section 2035 also. The court stated that

> it appears to us that the congressional purpose was clearly to sweep into the estate tax, gifts of insurance made in contemplation of death and to value such gifts in terms of the transfer of the proceeds at death rather than at the purchase or premium cost.[42]

However in looking at the history behind the congressional action, this statement is hard to justify.

When Congress abolished the premium payment test, by enacting Section 2042 in 1954, it forbad the inclusion of any portion of the proceeds of life insurance based upon the premiums paid. The House Ways and Means Committee justified the elimination of the premium payment test on the ground that life insurance should be treated the same as other property. They noted that other property was not included in the decedent's estate, if he had completely parted with it, simply because he had paid the consideration for it. The legislative committee explained that the payment of premiums was no longer to be a factor in determining taxability of insurance proceeds.[43] It must also be remembered that Congress removed the test from the place it most logically

41. Treas. Reg. § 25.2511-1(h)(8) (1972).
42. Detroit Bank and Trust Company v. United States, *supra* note 3, at 969.
43. H.R. REP. No. 1337, 83d Cong., 2d Sess. A136 (1954).

would go; the section covering the inclusion of life insurance proceeds in a decedent's gross estate. Further, Congress rejected attempts to introduce a modified form of the test back into the Code.

This legislative history suggests that the premium payment test should not be revived under Section 2035 to accomplish the result which Congress sought to eliminate in Section 2042.

The decision in *Detroit Bank and Trust* can not reasonably be based on Revenue Ruling 71-497, on the nature of the interest transferred, or on congressional intent. Even the court admitted this when they stated that a "technical construction" of the law would lead them to a different result.[44] The mere fact that a tax break may result from the deletion of the premium payment test does not justify a judicial closing of this loophole. This is an area of exclusive congressional jurisdiction and the courts, together with the Treasury Department, should stop encroaching upon this power.

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44. Detroit Bank and Trust Company v. United States, *supra* note 3, at 969.