Estate Tax--Payment of Premiums on a Transferred Life Insurance Policy in Contemplation of Death

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CASE COMMENTS

The change in the constitution has provided for recovery in cases where there has been no taking but where the public improvement substantially damages property. This does not mean that noise alone would be considered as a proper element of damage in West Virginia. However, if substantial damage can be shown, noise might be considered as one of many elements present which reduce the market value of the land, even in the absence of a taking.

Allowing recovery for traffic noise in one case does not warrant the conclusion that noise should be considered as an element in all condemnation cases where noise is present. Refusing to consider noise as an element would be proper in many cases, but if noise directly affects the market value of the land when grouped with other elements, then it should be considered as a proper element of damage.

Charles Quincey Gage

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In May, 1957, decedent caused a life insurance policy to be issued on his life in the face amount of $50,000, his wife to be beneficiary and life owner. The decedent did not, at any time, have the right to exercise any options or privileges in the policy or to agree with the insurance company to any change in, amendment to, or cancellation of the policy. Decedent died on March 25, 1958, and his wife did not include the proceeds of the policy in his gross estate for federal tax purposes. The Commissioner assessed a deficiency; the widow paid and sued for a refund, alleging damaging property. The Tidewater Ry. case was one of the first cases in Virginia interpreting the amendment.

There are procedural difficulties attendant when trying to sue the state. The W. VA. CONST. art. VI, § 35 provides: "The State of West Virginia shall never be made defendant in any court of law or equity." However, damages may be caused by the construction of a highway, and the State Road Commissioner may fail to assess the damages and provide compensation. In such a case, instead of suing the state, a mandamus proceeding may be brought to force the commissioner to assess damages, even in the absence of an actual taking. State ex rel. French v. Sawyers, 147 W. Va. 619, 129 S.E.2d 831 (1963). Thus, the mandamus proceeding will reach the desired result. In a mandamus proceeding the petitioner need not show that he has been damaged or the amount of damage; but he must show that there is a reasonable cause for these questions to be resolved by a judge and jury. State ex rel. Smeltzer v. Sawyers, 149 W. Va. 641, 142 S.E.2d 886 (1965).
ing that the proceeds were not taxable. The court assumed that the premiums paid on the policy were paid by the decedent. Held, for the taxpayer. The court rejected Revenue Ruling 67-463 (which held that a proportionate part of death proceeds attributable to the premiums paid by the insured is includible in his gross estate under section 2035) and said that only the amount of the premiums paid by the decedent was taxable under section 2035 of the 1954 Code. Gorman v. United States, 22 AFTR2d ¶ 147, 241 (E.D. Mich. 1968).

It appears that Congress and the Treasury have had a difficult time, over the years, in formulating an acceptable test to determine whether or not the proceeds of a life insurance policy are includible in the insured's estate. The 1918 Revenue Act used the premium payment test to decide whether the proceeds of a decedent's policy payable to a beneficiary other than an executor, should be taxed as part of the decedent's estate. Under this act it was held that the proceeds upon the insured's death should be included in his estate only to the extent that he paid, either directly or indirectly, the premiums or other considerations for the policies.

At different times the Treasury Department has taken the position that both the payment of premium test and the incidents of ownership test were to be used to determine the taxability of insurance proceeds, that the possession of incidents of ownership was the sole test of taxability and that payment of premiums was the sole test of taxability.

The last major revision of the Internal Revenue Code in 1954 made the incidents of ownership test the sole test to determine the taxability of deceased's insurance proceeds payable to others than the executor of the estate. Therefore, it is important to understand what are to be interpreted as incidents of ownership. The following, among others, have been held to be incidents of ownership of an insurance policy: the right to change the beneficiary; the right

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to obtain the cash surrender or loan value without the consent of the beneficiary;\(^6\) and the right to surrender or to cancel the policy.\(^7\)

Although the Internal Revenue Code expressly taxes proceeds from life insurance in only one section,\(^8\) it is possible that the proceeds can come within another section.\(^9\) More specifically, section 2035, concerning transactions in contemplation of death, can often be applied to life insurance proceeds.\(^10\) Relying on section 2035, the Internal Revenue Service has taken the position in Revenue Ruling 67-463\(^11\) that premium payments made by the deceased within three years of his death are transfers of an interest in the policy, and a pro rata portion of the proceeds should be included in his estate, even though he had transferred the incidents of ownership in the policy more than three years before his death.\(^12\)

The Gorman case explicitly rejected Revenue Ruling 67-463\(^13\) in holding that the IRS was attempting, through administrative tactics, to incorporate the payment of premium test, even though it


\(^8\) INT. REV. CODE of 1954, § 2035. The regulation states that any transfer of a life insurance policy in contemplation of death will make the proceeds includible in the gross estate. Treas. Reg. § 20.2035-1(c) (1958). Section 2035 provides that the gross estate will include property transferred in contemplation of death during the three years prior to death. This section also states that transfers made within a period of three years of decedent's death shall be deemed to be made in contemplation of death unless shown to the contrary.

\(^9\) May Billings, 35 B.T.A. 1147 (1937); Estate of F. A. Vanderlip, 3 T.C. 358 (1944).

\(^10\) Id. The Revenue Ruling cited Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945) as one of the authorities for its conclusion. In this case, decedent transferred a policy to his wife and died two years later after she had paid two premiums. The court held that even though assets transferred in contemplation of death must be taxed at their value at the date of death, the portion of the proceeds attributable to the two premiums paid by the wife should not be included in the estate. The Service also cited Chase Nat'l Bank v. United States, 278 U.S. 327 (1929), as holding that the word "transfer" in the predecessor of INT. REV. CODE of 1954, §2035 must include the transfer of property procured through expenditures by the decedent with the purpose, effected at his death, of having it pass to another.

\(^11\) 1967 INT. REV. BULL. No. 52, at 15.

\(^12\) Id. The Revenue Ruling cited Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945) as one of the authorities for its conclusion. In this case, decedent transferred a policy to his wife and died two years later after she had paid two premiums. The court held that even though assets transferred in contemplation of death must be taxed at their value at the date of death, the portion of the proceeds attributable to the two premiums paid by the wife should not be included in the estate. The Service also cited Chase Nat'l Bank v. United States, 278 U.S. 327 (1929), as holding that the word "transfer" in the predecessor of INT. REV. CODE of 1954, §2035 must include the transfer of property procured through expenditures by the decedent with the purpose, effected at his death, of having it pass to another.

\(^13\) 1967 INT. REV. BULL. No. 52, at 15. The Gorman case noted that the Liebmann case should not be regarded as authority for the Service's position in the revenue ruling, 1967 INT. REV. BULL. No. 52, at 15. Liebmann relied on section 302(g) of the 1926 Revenue Act to equate the payment of premiums by the decedent's wife to an addition or improvement made by her to the property transferred in an amount equal to a pro rata amount of the proceeds. Section 302(g) and the regulations promulgated thereunder use the payment of premium test, and since this test is not contained in the
had been specifically left out of the 1954 Code. The court stated that it would "not legislate, nor shall the Service, in an area specifically reserved to Congress." The court concluded that what is transferred when a premium is paid is only the dollar amount of the premium.

It should be noted that the Commissioner in *Gorman* did not appear to concentrate on the point that the insured died only one year after the policy was taken out. It seems that the commissioner could have argued that, although the insured never technically possessed any of the incidents of ownership, he, in substance, purchased and subsequently transferred the policy to his wife. Since this purchase was made within three years of his death, it could have reasonably been argued that this amounted to a transfer of the policy itself under section 2035 of the Code.

*Gorman* has again opened the question of what should be included in an insured's estate under section 2035 when he possesses no incidents of ownership in a policy on his life, but has continued to pay the premiums on the policy. The case rejected the Service's attempt to apply the premium payment test, which was left out of the 1954 Code and held that only the amount of premiums paid by the insured within three years of his death are to be included in his estate.

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**Gift Tax—Gift to Minor Qualifying for Section 2503 Exclusion**

In 1962 the Crummeys established an irrevocable trust for the benefit of their four children, three of whom were minors. The terms of the trust provided for accumulation of the trust income, except for distributions to a needy beneficiary, until each minor reached the age of twenty-one. From age twenty-one to thirty-five all income was to be distributed to the beneficiaries and from age thirty-five on, the trustee was to control distribution of both in-

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1954 Code, the *Liebmann* case is not authority for the proposition that payment of premiums transfers an interest in the policy. The *Gorman* case also holds that the *Chase Nat'l Bank* case "did not demonstrate that transfer occurs with the payment of each premium, in fact it was not even considered by the court... The court never considered the relationship of premiums with proceeds." *Gorman* v. United States, 22 AFTR2d ¶ 147,241, at 147,990.42 (E.D. Mich. 1968).


15 *Id.* at 147,990.46-47.