Missouri Law Review

Volume 54
Issue 3 *Summer 1989*

Article 4

Summer 1989

Imputed Interest Corollary to the Constructive Transfer Doctrine: Pay the Tax or Follow the Leder, An

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AN "IMPUTED INTEREST" COROLLARY TO THE "CONSTRUCTIVE TRANSFER" DOCTRINE: PAY THE TAX OR FOLLOW THE *LEDER*?*

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I. INTRODUCTION

Society has long recognized arranging one's financial affairs to minimize tax exposure as a legitimate taxpayer prerogative.[1] Unfortunately, when the chosen technique works too well, the government is wont to respond negatively and cry, "Foul!" Sometimes the government's position deserves support even though the taxpayer has engaged in a licit transaction.[2] Other

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* Estate of Leder v. Commissioner, 89 T.C. 235 (1987), *appeal docketed sub nom.*, Leder v. Commissioner, No. 88-1125 (10th Cir. Sept. 25, 1989).

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1. In Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1963), Justice Learned Hand stated the principle, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." In addition, Chamberlain v. Commissioner, 207 F.2d 462, 468 (6th Cir. 1953) (citations omitted), stated, "The general principle is well settled that a taxpayer has the legal right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits; and that the taxpayer's motive to avoid taxation will not establish liability if the transaction does not do so without it."

2. Approving certain activities could undermine the efficacy of a particular statutory provision. *See, e.g.*, United States v. Estate of Grace, 395 U.S. 316 (1969) (applying the reciprocal trust doctrine to force tax accounting under section 811(c)(1)(B) of the Internal Revenue Code of 1939—current version of I.R.C. § 2036 (1982 & Supp. 1987)—despite the fact the decedent never actually engaged in the actions required by a plain reading of the statute); Gregory v. Helvering, 293 U.S. 465 (1935) (applying I.R.C. § 112(g), (i) (1928) to the seemingly non-taxable reorganization of a corporation for the purpose of causing income tax accounting on the transaction); United States v. Allen, 293 F.2d 916 (10th Cir.), *cert. denied*, 368 U.S. 944 (1961) (requiring gross estate inclusion of property originally subject to

times, it is the taxpayers who, having worked properly within established parameters, deserve approbation of their actions. The clash of these interests is particularly noticeable in the estate tax arena,[3] principally because the levy is a one time charge.[4] With a transaction designed to achieve a given tax effect, the attendant revenue loss may never be recovered.[5]

Nowhere is the estate tax problem more acute than when life insurance purchased by the decedent is owned by someone other than the deceased-insured. In these situations, the government has successfully raised a "constructive transfer" theory[6] under section 2035 of the Internal Revenue Code[7] to include insurance policies in the decedent's gross estate,[8] even though

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life estate pursuant to I.R.C. § 811 (c)(1)(B)(ii) (1939)—current version at I.R.C. § 2036 (1982 & Supp. 1987)—even though the taxable interest was sold for adequate consideration prior to death). Approval could also undermine the revenue collection system itself. *See, e.g.*, Lucas v. Earl, 281 U.S. 111 (1930) (ruling that anticipatory assignments of income would not be given tax effect, thereby preventing the entire revenue system from possibly being undermined by extensive taxpayer use of such arrangements).

3. I.R.C. §§ 2001-2663 (1982 & Supp. 1987).

4. Although the estate tax is a tax unto itself, it is part of an overall transfer tax system which also includes the gift tax (I.R.C. §§ 2501-2600 (1982 & Supp. 1987)) and the generation-skipping transfer tax (I.R.C. §§ 2601-3100 (1982)). There are interrelationships between the estate tax and the other transfer taxes, but none of these impact on the incidence of the estate tax, which is fixed by death. Whereas taxpayers may make transfers that dictate the filing of more than one gift tax return or accompanying generation skipping tax schedules, there is but one estate tax return to be filed and one final accounting to be had.

5. Although other taxes have fixed taxable periods, there is some interplay among the periods themselves. For example, income taxes are annual charges, but there are carrybacks to prior years and carryovers into future years generated in one tax year that can impact actual liabilities in other tax periods. *See, e.g.*, I.R.C. § 172 (1982 & Supp. 1987). Although prior gift tax transactions can impact the ultimate estate tax liability, the estate tax liability becomes immutable once it is established. *See* I.R.C. § 2001(b) (1982).

6. This term means those situations in which an insured permits another to procure an insurance policy on the insured's life. The insured either directly or indirectly furnishes the consideration for the policy.

7. I.R.C. § 2035 (1988). Section 2035 of the Internal Revenue Code is the so-called "contemplation of death" or "three year-transfer" provision. It was designed to prevent dissipation of the estate tax base through transfers made near the end of one's life, but currently applies only to a few limited situations such as life insurance transfers. *See infra* notes 26-55 and accompanying text for a detailed discussion of section 2035.

8. The starting point for computing the estate tax is the "gross estate," a wealth transfer analog to gross income I.R.C. § 61 (1982 & Supp. 1987). Section 2031(a) provides, "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." I.R.C. § 2031(a) (1988). Sections 2033 to 2042 and section 2044 identify specific assets which are to be included in the gross estate. I.R.C. §§ 2033-2042, 2044 (1982 & Supp. 1987) (amended 1987). Sections 2043, 2045 and 2046 provide other rules which impact directly on the gross estate computation. *See* I.R.C. §§ 2043, 2045,

the deceased-insureds never possessed any technical taxable powers[9] over the policy. Recently, in *Estate of Leder v. Commissioner,*[10] the Tax Court concluded that "constructive transfers" of life insurance no longer required the strict scrutiny they were previously given. The constructive transfer doctrine, while perhaps still alive,[11] was deemed to be meaningless as far as the application of section 2035 to life insurance transfers was concerned. The court noted that constructive transfers of life insurance fail the new "transferred interest" test[12] of section 2035 and, therefore, avoid estate taxation.

It is uncertain whether this surprising taxpayer victory will withstand further judicial or congressional review. Consequently, a refocus on whether the constructive transfer doctrine still has an estate tax role for transfers of life insurance and, if so, how important it is seems warranted. More importantly, the inquiry should determine whether constructive transfers move along "imputed interests." Indeed, it may be necessary to recognize an "imputed interest" corollary to ensure the proper application of section 2035 to "constructive transfers" of life insurance policies.

II. The Estate Tax Treatment of Life Insurance: an Overview

Life insurance proceeds are directly included in a decedent's gross estate in a number of ways. The first two are mandated by the primary insurance

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9. Section 2042 provides the test for the inclusion of insurance payable upon a decedent's death. I.R.C. § 2042 (1988). *See infra* notes 13-15 and accompanying text for a discussion of section 2042 and the "taxable powers."

10. 89 T.C. 235 (1987) (*Leder*—now on appeal to the 10th Circuit—has recently been followed by Estate of Headrick v. Commissioner, 93 T.C. 18 (1989)). A decedent established an irrevocable intervivos trust with a bank as trustee. The trust agreement drafted by the decedent authorized, but did not require the bank to invest the trust principal in life insurance policies. The bank exercised independent discretion in acquiring a whole life insurance policy on the decedent's life. The decedent contributed cash annually to the trust in amounts sufficient to meet the trust's cumulative monthly premium obligations. The decedent died within three years of the trust's purchase of the policy. The court held that the decedent never possessed 'incidents of ownership' in the life insurance policy within the meaning of I.R.C. section 2042. *Id.*

11. *See id.* The *Leder* court stated, "We hold that the proceeds from the policy are not includable in the gross estate where the decedent did not possess at the time of his death, or at any time in the three years preceding his death, any of the incidents of ownership in the policy . . . . In so holding, *we do not reach the issue of whether there was a transfer within the meaning of section 2035(a).*" 89 T.C. at 238 (emphasis added). While *Leder* did not reach the transfer issue, it is clear it could have only found one under a constructive transfer theory. *See infra* notes 84-144 and accompanying text.

12. 89 T.C. at 242-44. Section 2035(d)(2) requires inclusion of insurance proceeds only if a transfer of an interest in the policy occurred within three years of a decedent's death, which, if retained, would have had to have been included in the gross estate. I.R.C. § 2035(d)(2) (1982). *See infra* notes 49-55 and accompanying text.

inclusion provision, section 2042.[13] Inclusion results if the proceeds are payable to the executor of the estate[14] or if the decedent died seized of any "incident of ownership."[15] Although not entirely free of interpretation

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13. I.R.C. § 2042 (1982). Section 2042 provides:

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

(1) Receivable by the executor - To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.

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

Id.

14. *Id.* § 2042(1). Section 20.2042-1(b) of the Treasury Regulations provide that the estate does not have to be specifically named as a beneficiary under the policy. *See* Treas. Reg. § 20.2042-1(b) (as amended in 1988). If the proceeds are payable to another beneficiary who is subject to a legally binding obligation to pay taxes, debts or other charges enforceable against the estate, the amount of the proceeds required to satisfy the obligation are includable in the gross estate. *Id.* The regulation also provides that proceeds are deemed to be receivable for the benefit of the estate if the policy was purchased for the benefit of another person "as collateral security for a loan or other accommodation." *Id.*

15. I.R.C. § 2042(2) (1986). Pursuant to section 2042, proceeds of life insurance policies to which a decedent possessed any of the "incidents of ownership" are included in the gross estate. *Id.* The section defines "incident of ownership" to include reversionary interests exceeding five percent of the value of the policy immediately preceding the death of the decedent. *Id.* Treasury Regulation 2042-1(c)(2) expands this definition by providing that the term refers to "the right of the insured or his estate to the economic benefits of the policy." Treas. Reg. § 20.2042-1(c)(2) (as amended 1988). Under the regulation, the definition includes the power to change the beneficiary, to surrender, cancel, assign or revoke the policy, to obtain a loan against the surrender value of the policy and to pledge the policy for a loan. *Id.*

Subsection (4) of the regulation provides that a decedent retains an "incident of ownership" in a policy insuring his life, which is held in trust, if the decedent "has the power (as trustee or otherwise) to change the beneficial ownership in the

problems, these two avenues of inclusion have been fairly well litigated and offer few surprises for the decedent's executor.

A third route for the estate taxation of life insurance is an indirect one. Life insurance proceeds can be brought into the tax base as a part of some asset which itself is included in the gross estate. Business interests, like closely held corporations or partnerships, are illustrative. It is quite common for these types of business entities to own life insurance on their owners.[16] Proceeds of such a policy which are paid to the entity itself upon an owner's death are factored into the valuation of the business.[17] These amounts are exposed to estate taxation to the extent the value of the corresponding business interest, otherwise includable in the gross estate, is increased.[18] Indirect taxation of the proceeds becomes a direct inclusion under section 2042 when one can show that ownership of the business entity is equivalent to personal ownership of the life insurance policies.[19]

Yet another route for gross estate inclusion of life insurance proceeds is through one of the transfer sections, namely, I.R.C. sections 2035-2038. It is quite unlikely, however, that either section 2036 or 2038 would cause *direct* inclusion of the life insurance policy itself in the gross estate. An outright transfer of a policy subject to the retention of a section 2036 or section 2038 power would trigger section 2042 since the retained power would be a taxable "incident of ownership." Thus, the need to go beyond the primary inclusion section would be obviated.

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policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust." Treas. Reg. § 20.2042-1(c)(2) (as amended 1988).

16. *See generally* R. GAEDEKE & D. TOOTELIAN, SMALL BUSINESS MANAGEMENT 178-79 (1980); C. WILLIAMS & R. HEINS, RISK MANAGEMENT AND INSURANCE 473-74 (4th ed. 1981).

17. *See* Newell v. Commissioner, 66 F.2d 102 (7th Cir. 1933); Estate of Huntsman v. Commissioner, 66 T.C. 861 (1976); Rev. Rul. 82-85, 1982-1 C.B. 137.

18. *See* I.R.C. § 2033 (1982). It includes in the gross estate property owned by the decedent at death. Business interests are such property and are, therefore, includable. Thus, to the extent insurance proceeds increase the value of the property included in the gross estate, they are taxed. *See id.*

19. Treasury Regulation 20.2042-1(c)(6) provides that where a corporation owns and is the beneficiary of an insurance policy on the life of a sole or controlling stockholder, the corporation's incidents of ownership are not attributed to the decedent, and therefore, the proceeds are not directly includable in his gross estate. Treas. Reg. § 20.2042-1(c)(6) (as amended in 1988). For this portion of the regulation to apply, the decedent must have possessed, at the time of his death, more than 50 percent of the total combined voting power of the corporation. *Id.* However, under Treasury Regulation section 20.2031-2(f), the proceeds of such policies shall be considered in setting the value of the decedent's stock which is included in the gross estate. Treas. Reg. § 20.2031-2(f) (as amended in 1988). *See* Estate of Levy v. Commissioner, 70 T.C. 873 (1978); Rev. Rul. 82-141, 1982-2 C.B. 209.

These two transfer sections are necessary for inclusion purposes, however, if the policy is transferred to a third party or entity (usually a trust) that possesses all of the incidents of ownership. If this occurs, the retained control over the transferee-owner becomes crucial to gross estate inclusion. In the more common trust setting, if a settlor retains too much control over the trust, then the value of the trust, including any insurance proceeds, will be includable in the decedent's gross estate under sections 2036,[20] 2038,[21] or both.[22] Here, however, it is the retained taxable control over the ownership held by another coupled with the transfer of the policy, not just the transfer itself, which creates the tax exposure. For either sections 2036 or 2038 to apply, both a transfer and the concomitant retention of a taxable power are required. Additionally, to the extent an insured transfers a policy and retains a reversionary interest therein, the interest retained can constitute an incident of ownership under section 2042,[23] as well as a possible taxable interest under section 2037.[24] Again, to the extent I.R.C.

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20. *See* Kasishke v. United States, 426 F.2d 429 (10th Cir. 1970); Estate of Resch v. Commissioner, 20 T.C. 171 (1953) (applying I.R.C. § 811(c)(1)(B) (1939)—current version at I.R.C. § 2036 (1982 & Supp. 1987)).

21. *See* Marshall v. United States, 338 F. Supp. 1321 (D. Md. 1971).

22. *See* Estate of Sulovich v. Commissioner, 587 F.2d 845 (6th Cir. 1978) (holding that the decedent-settlor, by controlling the beneficiary's access to the funds, had retained sufficient control over the trust savings accounts to require their inclusion in the gross estate under I.R.C. §§ 2036, 2038 (1954)—current version at I.R.C. §§ 2036, 2038 (1982 & Supp. 1987)); Estate of Craft v. Commissioner, 68 T.C. 249 (1977), *aff'd*, 608 F.2d 240 (5th Cir. 1979) (per curiam) (ruling that the decedent-settlor's retention of the power to add beneficiaries and to change beneficial interests in the trust was sufficient to cause the trust assets be taxed under I.R.C. §§ 2036, 2038 (1954)—current version at I.R.C. §§ 2036, 2038 (1982 & Supp. 1987)); Estate of O'Connor v. Commissioner, 54 T.C. 969 (1970) (ruling that the settlor-trustee's retention of power to distribute trust income or to add it to the principal rendered trust assets taxable under I.R.C. §§ 2036, 2038 (1954)—current version at I.R.C. §§ 2036, 2038 (1982 & Supp. 1987)).

23. Treasury Regulation 20.2042-1(c)(3) defines "reversionary interest" to include "a possibility that the policy or its proceeds may return to the decedent or his estate and a possibility that the policy or its proceeds may become subject to a power of disposition by him." Treas. Reg. § 20.2042-1(c)(3) (as amended in 1988). To determine whether the value of a reversionary interest exceeds five percent of the value of the policy immediately before the death of the decedent, "there must be specifically taken into consideration any incidents of ownership held by others immediately before the decedent's death which would affect the value of the reversionary interest. *Id.* If, at that time, some other person was the sole holder of the power to obtain the cash surrender value of the policy or if the decedent might receive the policy or its proceeds through the estate of another person, the decedent would not have a reversionary interest in the policy in excess of five percent.

24. I.R.C. § 2037(a)(2) (1988). Section 2037 is designed to force inclusion in the gross estate property which the decedent has transferred but has: (1) conditioned the recipient's enjoyment or possession of the property upon his surviving the decedent, and (2) has retained a reversionary interest in the property where

section 2037 must be relied upon for inclusion purposes, the transfer coupled with the taxable retained interest is necessary.

Section 2035, however, triggers estate tax accounting purely upon the transfer itself.[25] There is no need for a corresponding retention of taxable control. For this reason, it is the most potent of the indirect transfer tax inclusion sections as applied to the gross estate inclusion of life insurance.

III. I.R.C. SECTION 2035

A. Historical Review

A historical review of section 2035 is a micro-analysis of one of the major problems associated with administering the estate tax proper: tax liability avoidance through tax base reduction. Although the provision has undergone numerous specific changes since its inception,[26] from a broader perspective one can identify three phases of its metamorphosis. Phase I was a subjective inclusion era, Phase II a strict inclusion era, and Phase III, generally, an exclusion era. Despite its historical interest[27]—indeed, the common reference to the section 2035 transfers as "gifts in contemplation of death" sprang from its early versions[28]—Phase I and its presumption

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the reversion's value exceeds five percent of the transferred property's value. I.R.C. § 2037(a)(1)-(2) (1986).

Treasury Regulation 20.2037-1(c)(2) defines "reversionary interest" to include "a possibility that property transferred by the decedent may return to him or his estate and a possibility that property transferred by the decedent may become subject to a power of disposition by him." Treas. Reg. § 20.2037-1(c)(2) (as amended in 1988). The term includes "an interest arising either by the express terms of the instrument of transfer or by operation of law," but does not include rights to income only nor the "possibility that the decedent during his lifetime might have received back an interest in transferred property by inheritance through the estate of another person." *Id.*

25. *See, e.g.*, Estate of Porter v. Commissioner, 442 F.2d 915 (1st Cir. 1971).

26. The original version first appeared in Revenue Act of 1916, ch. 463, § 202(b), 39 Stat. 756.

27. For a brief history of the section, see C. LOWNDES, R. KRAMER & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES 68-71 (3d ed. 1974); Comment, *Transfers in Contemplation of Death—The Golden Anniversary of Chaos*, 11 VILL. L. REV. 814 (1966).

28. *See, e.g.*, Revenue Act of 1916, *supra* note 26. Section 202(b) of the Revenue Act of 1916 provided:

> [T]hat the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated:
>
> . . . .
>
> (b) To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has created a

of includability for certain gifts[29] currently is of little import. Phase II, however, has retained its vitality for certain transfers of life insurance and, consequently, merits review.

When the estate and gift tax structure was revamped by the Tax Reform Act of 1976,[30] section 2035 underwent a sweeping change which ushered in Phase II.[31] Taxpayers no longer have the opportunity to raise defenses against application of the section to overcome the statutory presumption.[32]

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trust, in contemplation of . . . death . . . . Any transfer of a material part of his property in the nature of a final disposition or distribution thereof, made by the decedent within two years prior to his death without such consideration, shall, unless shown to the contrary, be deemed to have been *made in contemplation of death* within the meaning of this title. . . .

Id. (emphasis added).

29. The original "contemplation of death" provision presumed transfers of "material parts of [decedent's] property" occurring within two years of death to have been made in contemplation of death unless there was a showing to the contrary. *See id.* The donor-decedent's motivation for making the gift was the pivotal test for includability. United States v. Wells, 283 U.S. 102, 115-19 (1931). Each case warranted a *sui generis* review. Herbert Kahn v. Commissioner, 4 B.T.A. 1289 (1926). The burden was clearly on the estate to overcome the presumption. *See* Wickwire v. Reinecke, 275 U.S. 101, 105 (1927).

In an effort to thwart a perceived manipulation of the statute resulting in a loss of revenue and to eliminate unfair results, Congress replaced the rebuttable presumption with an irrebutable presumption for certain gifts. *See* Revenue Act of 1926, ch. 27, § 302(c), 44 Stat. 9; H.R. 1, 69th Cong., 1st Sess. (1925). Shortly after its enactment, the provision was ruled unconstitutional. Heiner v. Donnan, 285 U.S. 312 (1932). Congress then returned to the two year rebuttable presumption. Revenue Act of 1932, ch. 20, § 803(a), 47 Stat. 169 (1932). Phase I ended with the establishment of a rebuttable presumption that *all* transfers made within three years of death were made in contemplation of death and, therefore, were part of the decedents' gross estate. Revenue Act of 1950, ch. 994, § 501, 64 Stat. 906.

30. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 172 [hereinafter TRA 1976].

31. Section 2001(d)(1) of TRA 1976 amended section 2035 of the Internal Revenue Code to provide in pertinent part:

> Adjustments for gifts made within 3 years of decedent's death
>
> (a) Inclusion of gifts made by decedent. Except as provided in subsection (b), 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, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

I.R.C. § 2035(a) (1976).

The act also provided an exception for small gifts and added the "subsection (c) gross-up" rule for forcing an estate tax accounting for gift taxes paid within three years of the donor-decedent's death. *See* TRA 1976, *supra* note 30.

32. In Phase I, executors often successfully rebutted the statutory presumption and were able to exclude the value of the property transferred within three years of the decedent's death from estate taxation. The cases are legion in number and any attempt to cite them all would be pointless. For citations to taxpayer victories in proving different motives, see C. LOWNDES, R. KRAMER & J. MCCORD, *supra* note 27, §§ 5.5-5.12.

Instead, all transfers made within three years of death were included in the gross estate. The new rule did not create an uproar comparable to that accompanying the original "contemplation of death" statute[33] because of the way in which the revised section interacted with the new transfer tax structure that had been put into place.[34] The new uniform transfer tax system was designed to treat inter vivos and testamentary transfers substantially the same for tax purposes.[35] Even though some benefits for inter vivos gifts survived,[36] the overall effect of the system was to treat all transfers, whenever made, equally. In theory, therefore, it made little difference whether the transfer was made part of the overall transfer tax base as a gift or as part of the gross estate.

A major exception to the equal treatment of transfer rule was the value of the property ultimately subjected to the tax. By including transfers made within three years of death in the estate tax base as part of the gross estate, all post-transfer appreciation was captured and added to the tax base.[37] Ordinarily, the Internal Revenue Code would not have exposed

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33. The original "contemplation of death" provision, Revenue Act of 1916, ch. 463, § 202(b), 39 Stat. 756, was eventually challenged on constitutional grounds but found valid. *See* Milliken v. United States, 283 U.S. 15 (1931).

34. TRA 1976 integrated the estate and gift taxes into a single unified transfer tax system with a common rate schedule. *See* I.R.C. § 2001(c) (1976). *See also* I.R.C. § 2502(a) (1976) (directing the use of the schedule for gift tax computations). In addition, TRA 1976 created a unified credit. *See* I.R.C. §§ 2010, 2505 (1976). Thus, in theory it made little difference whether the transfer was taxed as a gift or as part of the gross estate. *See infra* note 36 for a different conclusion. For a discussion of the constitutionality of the automatic inclusion rule, see Peat, *The Constitutionality of New Section 2035: Is There Any Room for Doubt?*, 33 TAX L. REV. 287 (1978); Note, 19 B.C.L. REV. 577, 580-84 (1978).

35. *See* R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION § 1.02(1) (5th ed. 1983).

36. Only taxable gifts, not otherwise included in the gross estate, were brought back into the tentative estate tax base. Thus, transfers excluded from gift tax accounting entirely, such as annual gifts of $10,000 or less, were also excused from the final transfer tax accounting. *See, e.g.*, I.R.C. § 2503(b) (1988). Also, the post-transfer appreciation of and income from gifts escape estate taxation since taxable gifts are included in the tentative estate tax base at their value on the date the gift was made. *See* I.R.C. § 2001(b)(1)(B) (1988). Finally, to the extent a gift generates a gift tax liability which is not recaptured under section 2035(c), one can capture an additional overall transfer tax savings. For a full discussion of transfer tax benefits associated with gift giving, see Morris, *The Tax Posture of Gifts in Estate Planning: Dinosaur or Dynasty?*, 64 NEB. L. REV. 25, 51-55 (1985).

37. This is the result of the section 2031 date of death valuation, or if operative, section 2032 alternate valuation estate tax accounting versus the date of gift accounting for taxable gifts not otherwise made a part of the gross estate. *See infra* note 62 for discussion of I.R.C. § 2032 (1982 & Supp. 1987).

It is worth noting that when a decline in value occurs, the system operates in reverse. This result is a logical consequence of looking to the date of death values instead of the date of gift values for estate tax inclusion purposes. For example, if the gift property had a date of gift value of $4x and a date of death

this growth to taxation. A gift not otherwise included in the gross estate became part of the estate tax base at its gift tax value.[38]

Despite its apparent simplicity, Phase II was not without its interpretative difficulties. Congress carved out a notable exception to the strict inclusion rule for gifts that did not require a concomitant filing of a gift tax return.[39] In practical terms, gifts equal to, or under, the annual exclusion amount (then $3,000, now $10,000)[40] did not have to be pulled back into the gross estate under section 2035. Indeed, such gifts were never subjected to a transfer tax at all.[41] This rule applied regardless of the gifted property's value at the time of the donor's death.

Taxpayers sought to use the "small gift" exception to exclude the full annual exclusion amount or some appropriately computed percent of the gift's date of death value for all transfers made within three years of death. They ultimately discovered that the section excused only transfers at or below the annual exclusion amount at the time of the gift.[42] Life insurance policies, assets with usually small gift tax values that blossomed into large estate tax amounts were, nevertheless, easily fit into the exception. Subsequently, Congress closed the escape hatch by specifically excluding gifts of life insurance from the operation of the "small gift" exception.[43] Thus, Phase II moved on, with little difficulty, through its relatively short-lived existence.

When Congress reexamined the estate tax in 1981,[44] it drastically changed

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value of $3x, only the $3x value is includable in the tentative tax base, notwithstanding the fact that the donor-decedent transferred $4x of value. One might recover any gift tax paid on the higher amount through the mechanics of the estate tax computation. *See* I.R.C. § 2001(b)(2) (1988).

38. *See* I.R.C. § 2001(b)(2) (1988).

39. I.R.C. § 2035(b)(1) (1954), as *amended by* TRA 1976, *supra* note 30, § 2001(a)(5).

40. *See* I.R.C. § 2503(b) (1982 & Supp. 1987). Prior to 1982, the annual exclusion amount was $3,000. *See* I.R.C. § 2503(b) (1954), as *amended by* TRA 1976, *supra* note 30.

41. Not only did these transfers escape gift taxation, but they escaped estate taxation as well. Other inter vivos transfers were added to the tentative estate tax base as adjusted taxable gifts. These transfers by definition were not taxable gifts and, therefore, not adjusted taxable gifts. *See* I.R.C. §§ 2503(a), 2001(b)(2) (1982 & Supp. 1987). Consequently, they never generated any adverse estate tax exposure.

42. *See* Estate of Ceppi v. Commissioner, 698 F.2d 17 (1st Cir.), *cert. denied*, 462 U.S. 1120 (1983).

43. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 702(f)(1), 92 Stat. 2930. The Revenue Act of 1978 amended section 2035(b)(2) by adding the following sentence: "Paragraph (2) shall not apply to any transfer with respect to a life insurance policy." *Id.*

44. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981) [hereinafter ERTA 1981] significantly changed the application of the estate and gift taxes by, *inter alia*, increasing the unified credit and restricting the marital deduction. For a general discussion of the impact of ERTA, see PRACTICING LAW INSTITUTE, ESTATE AND GIFT TAX AFTER ERTA (M. Weinberger ed. 1982).

the role of section 2035.[45] At that time, Congress took the exact opposite tack it had taken a few years earlier and decided that transfers made within three years of death, except in some limited instances,[46] should not be

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45. *See* ERTA 1981, *supra* note 44, §§ 403(b)(3)(B), 424(a). Sections 403(b)(3)(B) and 424(a) changed section 2035 to read as follows:

(a) Inclusion of gifts made by decedent.—Except as provided in subsection (b), 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, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

(b) Exceptions.—Subsection (a) shall not apply -

(1) to any bona fide sale for an adequate and full consideration for money or money's worth, and

(2) to any gift to a donee made during a calendar year if the decedent was not required by section 6019 (other than by reason of section 6019(a)(2)) to file any gift tax return for such year with respect to gifts to such donee. Paragraph (2) shall not apply to any transfer with respect to a life insurance policy.

(c) Inclusion of gift tax on certain gifts made during 3 years before decedent's death. - The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the 3-year period ending on the date of the decedent's death.

(d) Decedents dying after 1981. —

(1) In general.—Except as otherwise provided in this subsection, subsection (a) shall not apply to the estate of a decedent dying after December 31, 1981.

(2) Exceptions for certain transfers—paragraph (1) of this subsection and paragraph (2) of subsection (b) shall not apply to a transfer of an interest in property which is included in the value of the gross estate under section 2036, 2037, 2038, or 2042 would have been included under any of such sections if such interest had been retained by the decedent.

(3) 3-year rule retained for certain purposes.—Paragraph (1) shall not apply for purposes of —

(A) section 303(b) (relating to distributions in redemption of stock to pay death taxes),

(B) section 2032A (relating to special valuation of certain farm, etc., real property),

(C) section 6166 (relating to extension of time for payment of estate tax where estate consists largely of interest in closely held business), and

(D) subchapter C of chapter 64 (relating to lien for taxes).

Id. Subsequently, powers of appointment (covered by section 2041) were eliminated from subsection (d)(2) treatment. Technical Corrections Act of 1982, Pub. L. No. 97-488, § 104(d)(2)(B), 96 Stat. 2635.

46. Section 2035(d)(2), I.R.C. § 2035(d)(2) (1981), serves a dual function. It provides that certain transfers which are includable in the gross estate under other transfer sections are not excused from taxation under subsection (d)(1) because they were made within three years of death. *Id.* Subsection (d)(2) also prevents transfers of otherwise taxable interests, which occur within the proscribed period, from escaping inclusion in the gross estate.

pulled back into the gross estate.[47] In general, fully completed gifts were to be added to the estate tax base in the normal course of tax accounting at their gift tax values and not be taxed through the gross estate with the potential for higher valuation.[48] Consequently, in the current Phase III exclusion era of section 2035, the problems of the past phases seem to have "gone by the boards." Unfortunately, some problems still linger, and a significant one concerns life insurance.

Section 2035 still requires gross estate inclusion for any life insurance policy transferred within three years of death if the policy would have been included in the gross estate under section 2042 had the decedent not made the transfer.[49] The statute provides for this result in a rather circumlocutory way. The Phase II inclusion provision—subsection (a)[50]—is generally made inapplicable by the Phase III exclusion provision—subsection (d)(1).[51] But, subsection (d)(2)[52] specifically excepts application of the (d)(1) general rule for transfers of property interests which would have been included under, *inter alia*,[53] section 2042 had the taxpayers retained the interest until death. Moreover, once subsection (a) applies, a transfer of life insurance made within three years of death becomes includable in the gross estate regardless of its gift value date because the "small gift" exception remains inapplicable to life insurance transfers. Even if the exception could be applied, subsection (d)(2) specifically *excepts* the exception.[54] All in all, this is a very convoluted method for ensuring that the full proceeds, not just the gift tax value of life insurance, are subjected to transfer estate taxation if the policy, or an interest therein, is transferred within three years of death by the insured-decedent.

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47. *See* ERTA 1981, *supra* note 44, § 424(a). Notwithstanding the benefit accorded completed gifts themselves, section 2035(c), which forces the recapture of any gift tax paid on gifts made within three years of death, remained unchanged.

48. *See supra* notes 35-36 and accompanying text for a discussion of the impact of estate tax versus gift tax valuation for transfer tax purposes.

49. *See* I.R.C. § 2035(d)(2) (1982 & Supp. 1987). Section 2035(d)(2) specifically refers to interests taxable under section 2042, the life insurance inclusion section.

50. I.R.C. § 2035(a) (Supp. 1987). Section 2035(a) was never repealed. Instead, section 2035(d)(1) makes it inapplicable to the estates of decedent's dying after December 31, 1981, except for certain interests enumerated in subsection (d)(2). *See* I.R.C. § 2035(d)(1) (1981). *See supra* note 45.

51. I.R.C. § 2035(d)(1) (1981). *See supra* note 45.

52. *Id.* § 2035(d)(2) (1981).

53. Section 2035(d)(2), I.R.C. § 2035(d)(2) (1981), also included transfers of interests otherwise includable under sections 2036, 2037 and 2038, I.R.C. §§ 2036-2038 (1982 & Supp. 1987). *See id.* § 2035(d)(2). Transfers of interests taxable under section 2041 were originally included in this group, but were subsequently excused from the application of section 2035(d)(2). *See id.*

54. I.R.C. § 2035(d)(2) (1981). The statutory direction is clear; any interest that would be included in the gross estate under section 2042 is made subject to section 2035(a) by section 2035(d)(2).

The result, if not the route, is clear. "Transfers" of certain "interests" are given Phase II inclusion treatment in the Phase III exclusion era. Still, the statute leaves some questions unanswered. Specifically, what are "transfers" and "interests" for purposes of the section? And, are or should constructive transfers of life insurance be subject to the non-exclusionary rule that an otherwise "plain reading"[55] of the statute would indicate, as held by *Leder*?

B. Life Insurance Transfers: Some Specifics

It was well settled that proceeds from a life insurance policy transferred by a decedent prior to his death were excludable from the gross estate.[56] Nevertheless, it was essential that the decedent not retain *any* "incident of ownership" in the policy in order to avoid adverse estate tax exposure.[57] But, as already discussed, the government could seek inclusion of proceeds of transferred life insurance policies under section 2035. Given its legislative purpose[58] and the nature of the asset, the application of the section to gifts of life insurance, surprisingly, did not generate the number of gross estate inclusions during Phase I as one might have expected.[59]

Throughout most of its history, section 2035 only applied to transfers made within a certain time period prior to the transferor's death.[60] With hindsight, this requirement was easily determined mechanically. The vexing

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55. The *Leder* court stated:

> The plain language of section 2035(d)(2) requires as a threshold issue that there be an interest in property under the terms of the sections it lists (e.g., sec. 2042). It requires that the decedent transfer an interest in property included in the gross estate or an interest that would have been included if the decedent had retained such an interest. The decedent must have had at some time such an interest in property, or else there is nothing for him to retain or transfer and section 2035(d)(2) cannot apply.

89 T.C. 235, 239 (1987).

56. Treas. Reg. § 20.2042-1(c) (1988).

57. I.R.C. § 2042 will force inclusion of insurance proceeds even if the decedent was possessed of only one incident of ownership. Sec. Reg. § 20.2042-1(C). Thus, it is essential that all such incidents be transferred away prior to death in order to avoid subjecting the proceeds to estate taxation.

58. The provision was always viewed as a protection against estate tax base dissipation through end-of-life gift-giving. As noted by the Supreme Court in *Milliken v. United States*, 283 U.S. 15, 23 (1931), "Underlying the present statute is the policy of taxing such gifts equally with testamentary dispositions, for which they may be substituted, and the *prevention of the evasion of estate taxes* by gifts made before, but in contemplation of, death." *Id.* (emphasis added).

59. Pavenstedt, *The Limitation of Taxation of Transfers in Contemplation of Death by the Revenue Act 1950*, 49 MICH. L. REV. 839, 840-41 (1951).

60. Early versions of the provision permitted scrutiny of all gifts, whenever made, for "contemplation of death" purposes. In the final stage of Phase I, in all of Phase II and presently in Phase III, however, the provision looks only to gifts made within three years of donor's death. *See supra* notes 28 and 29.

issues were whether a transfer had been made at all, and if so, of what? Other times, even after a taxable transfer was found, the section lent itself to different interpretations of the proper value for inclusion in the gross estate. A review of these two issues and how they interrelate with the basic statutory requirements for the section will bring the current problems associated with transferring life insurance and including it under section 2035 into better focus.

Looking at the valuation problem first, section 2035, like all estate tax inclusion sections, is keyed to section 2031, the gross estate definition section.[61] The general rule is that the gross estate is valued at the decedent's date of death.[62] When dealing with a taxable section 2035 transfer, the question becomes what is to be valued at the time of death—the specific asset itself that was transferred or the quantum of interests resulting from the transfer?

If a donee receives property and retains it up until the decedent's death, it is quite simple to posit that the asset's date of death value, itself, is includable in the gross estate if section 2035 applies. On the other hand, what if the donee sells the gifted property and reinvests the proceeds in another asset? Now what is the proper value captured by section 2035? Is it the new asset's date of death value, or should one look back to the original asset transferred by the donor-decedent and value it at the donor's death, even though it is no longer owned by the donee? The government, through its regulations,[63] has long insisted that one must look to the thing itself that was transferred and value it as of the decedent's death. This position was sustained in *Humphrey's Estate v. Commissioner*.[64] There, after specifically referring to the Treasury Regulations, the court posited that the purpose of the statutory provision was to reach "the same tax result as if the decedent had kept [the transferred property] till [sic] he died instead of transferring it."[65] Thus, the court concluded that the asset itself was to be valued at the date of death irrespective of any changes

61. Section 2031, I.R.C. § 2031 (1982), defines the gross estate as follows: "(a) General.—The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."

62. *Id.* Section 2032, I.R.C. § 2032 (1982 & Supp. 1987), provides an elective alternative valuation rule. It is designed to prevent unfair results which may arise from forcing a tax accounting based upon a "one-day freeze" of assets. Thus, executors may choose date of death values or the alternate valuation values (sale or disposition values within six months of death and, for assets not disposed of, their value at six months from death). Application of the provision would never change the valuation of cash, and, thus, life insurance proceeds payable upon the decedent's death are unaffected. *Id.*

63. *See* Treas. Reg. 105 § 81.15 (19xx) (interpreting I.R.C. § 811 (1939)).

64. 162 F.2d 1 (5th Cir.), *cert. denied*, 332 U.S. 817 (1947).

65. *Id.* at 2.

in its form or subsequent investment that may have occurred from the time of gift to the time of death.

Humphrey's Estate involved a cash gift which, after being invested by the donee, resulted in a partial loss of capital at the time of the donor's death. In Revenue Ruling 72-282,[66] the donee received stock, subsequently sold it, and used the proceeds utilized to procure a different investment. Applying the rationale and language of *Humphrey's Estate*,[67] the ruling concluded that the original stock's date of death value was the appropriate includable amount. The ruling specifically noted that any increase (and implicitly, decrease) in value resulting from the donee's actions is not to be taken into account for the purposes of valuing section 2035 interests.[68]

With life insurance, the application of an apparently easy "date of death" valuation rule has a significant impact on estate taxation. Life insurance, unlike most other assets, is designed to have its full value realized at death and tends to be of only minimal value during life.[69] Therefore, valuing it at the transferor-insured's death provides maximum tax exposure to the estate. Perhaps ensuring full value taxation is the very reason that section 2035 includes a special rule for transfers of life insurance.[70]

Taxpayers have met with little success in their efforts to reduce the estate tax valuations of life insurance transfers. When less than full value of the policy proceeds has been included, the results flowed from the favorable resolution of "donee consideration"-type claims raised by estates rather than from pure valuation arguments. *Estate of Haas*[71] and *Estate of Silverman v. Commissioner*[72] are illustrative.

In *Haas*, the decedent died shortly after having taken actions deemed a constructive transfer of life insurance within the purview of section 2035. To determine the proper amount to be included in the gross estate, the court first looked to the relevant local community property law. After doing so, it determined that a constructive transfer was paid for from community property funds, one-half of which was attributable to each spouse. The court concluded that since only one-half of the funds belonged

66. Rev. Rul. 72-282, 1972-1 C.B. 306.

67. The revenue ruling stated, "Where the donee has dissipated the property so that there is nothing left as of the date of the transferor's death, the amount includable is not what actually exists but rather the present value of the property originally transferred." Id. at 307 (citing *Humphrey's Estate*, 162 F.2d at 2).

68. *Id.*

69. Although traditionally this was the case, a variety of new insurance products have recently emerged which are designed to provide benefits while the owner is still alive. These products usually depend on the tax-free internal growth to provide benefits accorded life insurance policies. The tax treatment of these products has received criticism, and stricter regulation is imposed.

70. *See* I.R.C. § 2035(b) (1982).

71. 51 T.C.M. (CCH) 453 (1986).

72. 521 F.2d 574 (2d Cir. 1975).

to the decedent, he could have transferred only a corresponding fraction of the policy. The balance of the policy was the surviving spouse's property from the outset of the transaction, and, therefore, could not be viewed as a transfer by the decedent to her. Since only one-half of the policy was transferred by the decedent, only one-half of the proceeds were properly included in his gross estate.[73]

In *Silverman*, the decedent transferred insurance to his children who paid all of the post-transfers to support the policy from their own funds. The transfer was made within three years of the decedent's death, and the government sought inclusion of the policy proceeds in the decedent's gross estate under section 2035. The estate contended that the beneficiaries should be credited with their contributions toward the maintenance of the policy and that only the portion of the proceeds attributable to the decedent's premium payments should be included in the gross estate. The court concurred with the taxpayer analogizing the situation to any other one in which contributions made by donees to property subsequently included in the donor's gross estate ought to be credited to the donees and not be taxed in the estate. Thus, by applying the section 2035 contribution rule,[74] the court excluded a percentage of the proceeds attributable to the donees' premium payments from the gross estate.[75]

In *Silverman*, the premiums paid by the decedent within three years of death on the policies included in the gross estate were not considered separate section 2035 transfers.[76] To include both the premiums and the corresponding proceeds gives the appearance of taxing the same transfer twice.[77] Generally, however, if a policy is transferred beyond the statutorily proscribed period, the proceeds themselves are not capturable as a section 2035 asset, but any premium payments made within the measuring period are includable in the gross estate under section 2035.[78] One might query why, when the donee pays premiums, an aliquot share of the proceeds are attributable to any such payments, but when the donor makes premium payments on a policy transferred beyond the statutory period, the only assets captured by section 2035 are the actual premiums paid?

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73. *Haas*, 51 T.C.M. (CCH) at 455 (1986).

74. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 35, at § 4.07(2)(d); Treas. Reg. § 20.2035-1(e) (1988).

75. *Silverman*, 521 F.2d at 577-78.

76. *Id.* at 576.

77. Safeguards exist against multiple taxation of the same transfer. Section 2012 allows a credit for gift taxes paid on gifts made after 1977 which are included in the gross estate under one of the estate tax sections. I.R.C. § 2012 (1982). Section 2001(b) allows a similar result for all gifts made after December 31, 1976. I.R.C. § 2001(b) (Supp. 1987). The credit for these latter transfers is necessary because all taxable gifts not made part of the gross estate are nonetheless added to the tentative estate tax base.

78. *See, e.g.*, Bintliff v. United States, 462 F.2d 403 (5th Cir. 1972); Estate of Coleman, 52 T.C. 921 (1969).

Although valuation problems can usually be solved without much difficulty even when life insurance proceeds are concerned, the issue of whether or not a transfer has been made does not always lend itself to such easy resolution. In many cases, it is easy to identify the transfer necessary for the purposes of section 2035. Generally, any time an already existing policy is given to another, the transfer will be apparent. Taxpayers have attempted, however, to avoid "transferring" the policy by utilizing a simple procedure. The policy is actually taken out by the beneficiary, and the premiums to support the policy are furnished, either directly or indirectly, by the decedent during his or her life. One could argue then that 1) section 2042 is inapplicable because the decedent did not possess any incidents of ownership in the policy at death, and 2) section 2035 is inapplicable for want of a transfer. The government, quick to realize the ease with which a taxpayer could avoid the application of the statute,[79] focused attention on the effect of the decedent's application for insurance coupled with the furnishing of premium payments, and concluded that those acts taken together constituted a transfer. Ultimately, the courts were quite hospitable to the government's argument,[80] and, by recognizing these "constructive transfers," paved the way for estate taxation of these transactions, but only in Phases I and II. During these two phases, only a transfer of some unidentified or nonspecific interest in the property was required in order for section 2035 or one of its predecessors to apply.[81] Phase III, however, requires the transfer of an interest otherwise taxable under section 2042(a) before life insurance can be brought into the gross estate under the authority of section 2035.[82]

The current section 2035-life insurance transfer embroglio centers on whether constructive transfers of policies are still susceptible to gross estate inclusion. The more narrow question is exactly what, if anything, has the decedent transferred when the policy is applied for and always owned by another. If it can be shown that the decedent either 1) has not made a transfer of a verbotten interest in the policy, or 2) possessed no incidents of ownership in the policy at his death, then there is no basis for including any of the proceeds in the gross estate.[83] That is the teaching of *Leder*. If, however, the decedent transferred an otherwise "taxable interest in the policy" (whatever this phrase is ultimately defined to mean) within the three year period preceding death, then inclusion of the proceeds under

79. *See infra* notes 84, 89-92 and accompanying text.

80. After some early judicial hostility (*see infra* notes 93-96, 99-110 and accompanying text), the courts eventually approved this analysis and adopted the "constructive transfer" doctrine. *See, infra* notes 112-30 and accompanying text.

81. *See* Estate of Porter, 442 F.2d 915 (1st Cir. 1971). This case is discussed *infra* notes 158-61 and accompanying text.

82. *See* I.R.C. § 2035(d)(2) (1988).

83. *See supra* notes 13-25 and accompanying text.

section 2035 seems warranted. In these instances, there is direct authority for inclusion under section 2035(d)(2), which carves out specific exceptions to the rule excluding transfers made within three years of death from the gross estate.

It is undisputed that if a decedent had any "section 2042(a) interest" in the policy and transferred it away within three years of death, the proceeds of the life insurance policy would be includable in the gross estate. But, if the decedent never had such an interest in the policy, it follows there was no "interest" that could have been given away. Therefore, the "section 2035(d)(2)" rule would not apply. So goes the argument for excluding policies taken out by another on the life of the premium-paying deceased-insured. An argument accepted by the *Leder* court, without going to the perhaps more pressing underlying questions, is whether an "incident of ownership" is an interest in the policy.

What is the wisdom of adopting this interpretation of the tax rule? Did Congress really intend to leave such an easily accessible escape hatch? Is the constructive transfer theory sufficiently elastic to include an "imputed interest" corollary? The analysis starts innocently enough, but quickly moves into the treacherous waters of trying to determine the underlying nature of "transfers" themselves for estate and gift tax purposes.

C. The Constructive Transfer Doctrine

If a decedent transferred money to a donee, proper application of section 2035 would require inclusion of only that dollar amount in the decedent's gross estate, irrespective of what the donee subsequently did with the money. Merely because a donee applied the funds to the purchase of an insurance policy on the donor's life, instead of some other asset, should ordinarily leave the rule unaltered. The government was unhappy with the result. Specifically, if the donee used the gifted money to support an insurance policy on the donor-decedent, payable at the latter's death, the government thought that the corresponding proceeds, not just the value of the premium payments themselves made within the statutorily proscribed period, ought to be captured by section 2035. This theory began a long, hard fought battle over the proper application of the "contemplation of death" section to life insurance transfers.

The first meaningful skirmishes came in Revenue Ruling 67-463[84] and a trio of subsequent cases. All were reported within a relatively small time of each other and involved Phase I-type section 2035 transfers. Additionally, each relied upon *Chase National Bank v. United States*[85] as authority for finding the requisite transfer for application of section 2035. Thus, *Chase* serves as a logical first step in tracing the trail up to *Leder*.

84. Rev. Rul. 67-463, 1967-2 C.B. 327.
85. 278 U.S. 327 (1929).

In *Chase*, the decedent purchased insurance policies reserving the right to change the beneficiary designation. The government sought to include the policy proceeds in the gross estate pursuant to an early Phase I version of section 2035. The decedent's estate challenged the constitutionality of the provision and of the tax itself and argued in the alternative that the decedent had not made a transfer to which the tax could attach. After dismissing the constitutional issues raised by the estate,[86] the Court similarly disposed of the taxpayer's other claim by finding that there was a "transfer" to which the tax could attach.[87] The critical aspect of *Chase* is how it conceptualized "transfer" for transfer tax purposes. The Court recognized that "transfer" is not limited to a direct movement of a property right from donor to donee, but includes indirect transfers whereby the donor is the source of a transaction that results in the donee's receipt of a benefit.[88] This broad view of "transfer" is the key that opens the door for "constructive transfers" to enter the section 2035 field of activity.

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86. The taxpayer argued that the tax was "a direct tax on property void because not apportioned," or alternatively unconstitutional because the arbitrary and capricious method of collection violated the 5th Amendment. *Id.* at 333-34. The Court had little difficulty in dismissing these claims and upholding the statute as a tax on the privilege of transferring property rather than on the property itself. *Id.* at 334.

87. *Chase*, 278 U.S. at 335, 338.

88. *Id.* at 337-38. Regarding this point, the Court stated:

> Obviously the word "transfer" in the statute, or the privilege which may constitutionally be taxed, cannot be taken in such a restricted sense as to refer only to the passing of particular items of property directly from the decedent to the transferee. It must, we think, at least include the transfer of property procured through expenditures by the decedent with the purpose, effected at his death, of having it pass to another. Section 402(c) taxes transfers made in contemplation of death. It would not, we assume, be seriously argued that its provisions could be evaded by the purchase by a decedent from a third person of property, a savings bank book for example, and its delivery by the seller directly to the intended beneficiary on the purchaser's death, or that the measure of the tax would be the cost and not the value or proceeds at the time of death.
>
> The plaintiff points to no requirement, constitutional or statutory, that the termination of the power of disposition of property by death whereby the transfer of property is completed, which we have said is here the subject of the tax, must be preceded by a transfer directly from the decedent to the recipient of his bounty, of the property subject to the power. And we see no necessity to debate the question whether the policies themselves were so transferred, for we think the power to tax the privilege of transfer at death cannot be controlled by the mere choice of the formalities which may attend the donor's bestowal of benefits on another at death, or of the particular methods by which his purpose is effected, so long as he retains control over those benefits with power to direct their future enjoyment until his death. . . .

Id. at 337-38.

The government relied heavily on *Chase* in promulgating Revenue Ruling 67-463.[89] The ruling addressed the specific issue of whether any portion of the proceeds of an insurance policy transferred by the decedent more than three years prior to his death were includable in his gross estate merely because he continued to make the premium payments on the policy up until his death. The ruling also examined the situation when a spouse was the original applicant for and owner of the policy, but all premium payments were made by the insured-decedent up until his death.[90] The ruling distinguished a gift of cash from a gift of a premium payment proper, analogizing the latter to a gift of specific property. The ruling stated, "[U]nlike the unrestricted gift of money, a premium payment is a gift of insurance protection, a *transfer of an interest in the policy* which is transmitted at death into the proceeds of the policy."[91] Since section 2035 requires the value of the actual property transferred to be included in the gross estate, the ruling concluded that the proceeds corresponding to the property interest in the policy that was transferred, and not the dollars used to pay the premium, were properly subject to estate tax exposure. Accordingly, the proportion of the proceeds attributable to the premium payments made in contemplation of death, as it bears to the total premium payments made to support the policy from its inception, are properly includable in the gross estate.

The ruling also summarily concluded, without any amplification, that the same tax consequences result even though someone other than the insured had originally applied for the policy.[92] The message was clear; proper application of *Chase* makes each premium payment a transfer of a corresponding interest in the insurance policy itself.

The revenue ruling received a sharp rebuke in *Gorman v. United States*,[93] a case involving the acquisition of an insurance policy in the name of the insured by another within three years of the insured's death. The court criticized the ruling's attempt to apply a variation of the "premium payment" test to a section 2035 transfer.[94] The "premium payment" test was a method for taxing life insurance under section 2042, by then long since replaced by the "incidents of ownership" test.[95] In giving *Chase* an extremely narrow reading,[96] the court held that when a premium is paid by someone for a policy on the life of another without any obligation to do so, only

89. *See* Rev. Rul. 67-463, 1967-2 C.B. 328.
90. *Id.* at 329.
91. *Id.* at 328 (emphasis added).
92. *Id.* at 230.
93. 288 F. Supp. 225 (E.D. Mich. 1968).
94. *Id.* at 225.
95. *Id.*
96. The court concluded that *Chase* was essentially a case concerning the constitutionality of the tax statute itself and not one which "considered the relationship of premiums with proceeds." *Id.* at 228-29.

the value of the premium itself is the subject of the transfer. In turn, only the dollar value of the premium, and not a corresponding portion of the proceeds, is capturable by section 2035.

On facts similar to *Gorman*, the district court in *First National Bank of Midland v. United States*[97] included a portion of an insurance policy's proceeds in the decedent's gross estate based upon premiums made in contemplation of death.[98] Offering no rationale of its own, the court merely cited Revenue Ruling 67-463 as its authority for the rule that premiums paid in contemplation of death require an estate tax accounting for an aliquot share of proceeds attributable to those premiums.

The third case, *Estate of Coleman v. Commissioner*,[99] became the most notable of the group. In *Coleman*, the decedent's children purchased a life insurance policy on the decedent's life. The record indicates that the children owned the policy from its inception and that the decedent never possessed nor transferred any of the incidents of ownership in it. The decedent, however, made all of the premium payments on the policy. The parties agreed that a portion of the premiums paid within three years of death were section 2035 transfers.[100]

Using a *Gorman*-type theory, the estate claimed that only the value of the premiums themselves should be included in the gross estate under section 2035. It was argued that when Congress abolished the premium payment test under section 2042, it was a clear indication that premium payments should never be viewed as a basis for including life insurance proceeds in the gross estate. The court rejected this argument and questioned whether it was appropriate to borrow the legislative history of section 2042 and apply it to section 2035.[101]

The court did not, however, concur with the government's reliance on Revenue Ruling 67-463 as a basis for including a percentage of the proceeds attributable to the premiums made "in contemplation of death."[102] In rejecting the application of the ruling to the case, the court sought to determine what actually had been transferred and looked to two section 2036 cases[103] which had dealt with the issue of premium transfers as a

97. 69-1 U.S. Tax Cas. (CCH) § 12,574 (W.D. Tex. 1968).

98. *Id.* The decedent and his wife had, eight years prior to his death, arranged for their daughters to be owners of insurance policies on the decedent's life. All premium payments came from community property funds, therefore, the court concluded that only one-half of the premiums were properly attributable to the decedent as a transfer made by him. The court deemed the last three premiums to have been made in contemplation of death. Thus, three-sixteenths (one-half of three-eighths) of the proceeds were included in the gross estate. *Id.*

99. 52 T.C. 921 (1969).

100. *Id.* at 922.

101. *Id.* at 922-23.

102. *Id.* at 923.

103. Goodnow v. United States, 302 F.2d 516 (Ct. Cl. 1962); Estate of Pyle, 313 F.2d 328 (3d Cir. 1963).

basis for including proceeds in the decedent's estate. Both courts found that transfers of premium payments did not constitute a transfer of the proceeds themselves. Based on these holdings and *Gorman*, the *Coleman* court concluded that only the premium payments themselves and not the corresponding face value of the insurance should be included in the decedent's gross estate.[104]

The majority's position was strongly criticized in three separate dissenting opinions. All three in one way or another criticized the majority's reading of the *Chase* definition of "transfer," but differed from one another primarily on the particular part of the majority's position each sought to attack.[105] The first focused on the fact that money was never given to the donees but was actually paid directly to the insurance company for insurance coverage.[106] This led to the conclusion that the fruit of that coverage was the section 2035 asset transferred.[107] The second questioned whether one could actually claim that the donees had purchased the policy and concluded that, in reality, the decedent was the true owner of the policy from the inception of the transaction.[108] Once established as owner, the usual rules of valuing section 2035 assets with reference to the decedent's contribution for them led to the inclusion of a proportionate value of the policy proceeds supported by the premiums made "in contemplation of death."[109] The last dissent followed the same path and sought to place the substance of the

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104. *Id.* at 924.

105. *Coleman*, 52 T.C. at 926-28 (Tietjens, Raum, Dawson, Js., dissenting).

106. *Id.* at 926 (Tietjens, J., dissenting).

107. *Id.* In his dissent, Judge Tietjens wrote:

> As I see it the problem is really not whether there was a 'transfer' in contemplation of death. The taxpayer concedes there was such a transfer . . . . The real question is how to value that transfer. I think it should be valued at what the amounts paid as premiums purchased in the way of insurance protection and not at what was actually paid for that protection.

Id.

108. *Id.* at 927 (Raum, J., dissenting). In this dissent, Judge Raum stated, "Life insurance, like any other property, may be the subject of a gift in contemplation of death. Whatever conclusory terms or euphemisms may be used to describe the transaction, the decedent in fact purchased the life insurance for her children." *Id.*

109. *Id.* Regarding this point, Judge Raum stated:

> If the decedent, in contemplation of death, had purchased a parcel of real estate for her children, I think there would be no doubt that the value of that property . . . . would be includable in her gross estate. . . . Similarly, if she had paid only part of the purchase price in contemplation of death, the proportionate value of the property at the time of her death would be includable in her gross estate. And when all the smoke has cleared away here, that is all that remains in this case.

Id.

transaction over its form.[110] Technical ownership was downplayed, and emphasis was placed on the decedent's actions which gave her an "interest" in the policy. This interest was transferred and resulted in section 2035 tax accountability.[111]

Notwithstanding the stinging dissent, *Coleman* was subsequently followed in a taxpayer victory when *First National Bank of Midland v. United States* was heard on appeal by the Fifth Circuit.[112] The court, after identifying the case as one of first impression, followed the *Gorman* and *Coleman* rationale in holding that only the value of the premiums themselves, and not the corresponding value of the insurance proceeds attributable to those premiums, was properly includable in the decedent's gross estate under section 2035. *Midland* involved a policy taken out more than three years prior to death with ownership from inception of the policy in someone other than the deceased-insured. The court noted that the beneficiaries alone had the exclusive right to the policy proceeds from the date the policy was issued, and were under no duty themselves to allow anyone else to pay the premiums. By permitting the decedent to pay the premiums, the beneficiaries had received cash gifts which were used to maintain the policy. Thus, only the value of the premiums, and not the corresponding proceeds, were properly includable in the gross estate.[113]

After suffering defeats in *Gorman*, *Coleman*, and *Midland*, the government relented and issued Revenue Ruling 71-497[114] which revoked Revenue Ruling 67-463. The new ruling conceded that when premiums were paid by the decedent for insurance policies transferred more than three years prior to death, only the dollar value of the premiums made in contemplation of death would be included under section 2035. The ruling went on to state, however, that renewable term policies obtained within three years of death and paid for from the decedent's funds would continue to trigger estate tax accounting for the full proceeds even though someone other than the decedent was originally designated as owner. The ruling seemingly equated "purchase in the name of another" with a "transfer," a result clearly inconsistent with *Gorman* and arguably contrary to *Coleman*. Thus, it was questionable how much the government had really conceded.

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110. *Id.* at 928 (Dawson, J., dissenting). Judge Dawson stated, "It seems to me that the majority opinion fans the flickering flame of form. The legal and economic substance is indeed interred. Too much emphasis is placed on formalities." *Id.*

111. *Id.*

112. First Nat'l Bank v. United States, 423 F.2d 1286 (5th Cir. 1970).

113. The court only addressed the issue of whether any portion of the proceeds was includable in the gross estate under § 2035 and found that none was. 423 F.2d at 1289. The question of including the value of the premium payments themselves was not at issue, but clearly was capturable by § 2035. *See* Bintliff v. U.S., 462 F.2d 403, 406 (5th Cir. 1972) (citing *Midland* on this point).

114. Rev. Rul. 71-497, 1971-2 C.B. 329.

More importantly, did it make any sense to distinguish premium payments supporting renewable term policies based upon when the policy was originally obtained, or, for that matter, to distinguish renewable term coverage from other types of policies?

Although not specifically cited, the rationale underlying Revenue Ruling 71-497 was thoroughly approved in *Bel v. United States*[115] by the same court that had given taxpayers a victory in *Midland*. Consistent with the tack taken in the ruling, the court distinguished *Midland* on the facts. The original policy purchase date became the focus of attention: if acquired more than three years prior to death, *Midland* controlled; if acquired less than three years prior to death, *Midland* was inapplicable.

In *Bel*, the decedent had purchased an accidental death policy. The policy was renewable at the end of each one year term. The decedent died and the policy proceeds were paid within three years of the decedent's original application for the insurance policy. The estate argued that the policy was excludable from the gross estate on the theory that, from its inception, the decedent's children owned it exclusively. The estate offered this argument even though the decedent had 1) made the original application for the policy personally, and 2) paid for all of the premiums until the time of his death.[116]

After deciding the general applicability of section 2035, the court addressed the issue of "what" the decedent actually had transferred and, therefore, was properly includable in the gross estate. The district court, relying on *Coleman*, had held that only the premium payments made by the decedent were to be included in the decedent's gross estate.[117] The government sought inclusion of the full value of the proceeds arguing that *Coleman* was distinguishable on the facts. Specifically, it argued that *Coleman* involved the acquisition of a policy more than three years prior to the insured-decedent's death with premium payments made thereafter until death. In *Bel*, the policy itself was purchased within three years of death. Thus, if acquisition of the policy in the names of the children was deemed the "transfer," the entire policy would be the property that was the subject of a section 2035 transfer.

The court distinguished *Coleman*. Of primary importance was the timing of the original acquisition of the policy.[118] In the instant case, where the policy was acquired and all of the premium payments made within three years of the decedent's death, essentially, "every stick in the bundle of

115. 452 F.2d 683 (5th Cir. 1971), *cert. denied*, 406 U.S. 919 (1972).

116. *Id.* at 686.

117. 310 F. Supp. 1189 (W.D. La. 1970).

118. 452 F.2d at 690. One should remember that in *Coleman* the policy was taken out more than three years prior to death. *Coleman*, 52 T.C. at 921. The government sought to include both the premiums paid within three years of death and the proceeds of the policy attributable to those premiums. *Id.* at 924.

rights constituting the policy and its proceeds had its genesis" within the restricted statutory period.[119] Thus, the court concluded it was inappropriate to use the premium payments as the measure of the section 2035 interest.[120]

The court further questioned whether the district court had focused on the proper inquiry. It believed that consideration of what the decedent had "parted with" was unimportant.[121] In its interpretation of *Chase* and the definition of "transfer" for the purposes of the estate tax, the court indicated that the so-called "diversion" principal was an improper method of approaching the problem.[122] The court suggested the appropriate interpretation of "transfer" is "not limited to the passing of property directly from donor to the transferee, but encompasses a donation 'procured through expenditures by the decedent with the purpose, affected at his death, of having it passed to another.'"[123] In sum, the court believed that to sanction the practice of avoiding estate taxation when the decedent, during his life, permits beneficiaries to take the policy out on him while he still makes all the premium payments, represents a charade which operates as an effective statutory-emasculating device. The court held, to do so frustrates the statutory effort to collect tax from these transfers and prevent tax motivated estate reduction.

The court refocused its attention on what it called the "control beam of the word 'transfer.'"[124] It concluded that,

> [T]he decedent, and the decedent alone, beamed the accidental death policy at his children, for *by paying the premium he designated ownership* of the policy *and created* in his children all of the contractual *rights* of the insurance benefits. *These were acts of transfer.* The policy was not procured and ownership designated and designed by some goblin or hovering spirit.[125]

The court noted that this situation should be treated no differently than if the decedent had taken out the policy in his own name and, within three years of death, irrevocably assigned all rights of ownership to another beneficiary yet continued to pay the premiums.[126] In that instance, section 2035 would properly impose the tax. The court viewed that transaction as "functionally indistinguishable" from the situation at hand.[127]

There is little doubt that in reaching its decision, the Fifth Circuit sought to establish a rule that transfers of life insurance made within the

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119. 452 F.2d at 690.
120. *Id.*
121. *Id.*
122. *Id.*
123. *Id.* at 691 (quoting Chase Nat'l Bank v. United States, 278 U.S. 327, 337 (1929)).
124. *See id.*
125. *Id.* (emphasis added).
126. *Id.* at 692.
127. *Id.*

time frame of section 2035, no matter how disguised, are includable in the gross estate at their full proceed amount. Although the court might have been willing to accept inclusion of only the premiums paid by the decedent-insured when the policy itself was transferred beyond the three year period prior to death, it clearly rejected the *Gorman* decision as too restrictive in its interpretation of the word "transfer." With this, "constructive transfers" of life insurance entered the scene.

Two other significant cases, *Detroit Bank & Trust Co. v. United States*[128] and *First National Bank of Oregon v. United States*,[129] followed suit and taxed the proceeds of a life insurance policy taken out within three years of the decedent's death in the names of the beneficiaries and never owned by the decedent. Further proof that the *Bel* decision was to carry the day came when the Tax Court revisited the issue in *Kurihara v. Commissioner*.[130]

In *Kurihara*, the decedent established a trust and subsequently had the trustee apply for insurance on the settlor-decedent's life. The settlor signed the application and issued a check in the exact amount of the premium payable to the trustee. The trustee, in turn, endorsed the check over to the insurance company. The settlor subsequently died within three years of the transaction. The government sought inclusion of all of the policy proceeds in the gross estate under section 2035. The estate argued that the decedent had no rights in the trust. Further, he could not have transferred the insurance policy within three years of death; he never had any interest in the policy to transfer. The Tax Court reviewed the previous cases on point and concluded that *Bel* was controlling.[131] Although *Coleman* and its progeny were not specifically rejected, the court was able to distinguish them on the grounds that in those cases the policy was acquired more than three years prior to the decedent's death. In finding for the government, the court addressed two questions and answered them in a manner that required inclusion. The first was, "[D]id the payment of the initial and only premium within the proscribed three year period create the ownership right in the policy on the decedent's life?" and the second, "[D]id the decedent pay that premium?"[132]

As to the first question, following the *Bel* rationale, the court deemed the mere fact that the decedent did not formally acquire and then transfer

128. 467 F.2d 964 (6th Cir. 1972).
129. 488 F.2d 575 (9th Cir. 1973).
130. 82 T.C. 51 (1984).
131. *See id.*
132. *Id.* at 60. The court stated:
> We think it clear from the foregoing analysis that the ultimate questions in the instant case are: (1) Did the payment of the initial (and only) premium within the proscribed 3-year period create the ownership rights in the policy on the decedent's life; (2) did the decedent pay that premium? We think that both questions should be answered in the affirmative.

Id.

the policy immaterial. The "beaming" of ownership rights from the totality of the transaction was deemed critical.[133] For the second question, the court concluded that it was of little consequence whether the decedent had made the premium payment personally, directly to the insurance company, or directed it to the insurance company through an agent.[134] It was clear in *Kurihara* that the trustee under some fiduciary duty principle had no choice but to endorse over the check; therefore, he was merely acting as the decedent's agent. This, in essence, created the ownership rights in the trustee and constituted the transfer.

The court did recognize that, without the agency theory argument, it would be possible to demonstrate there was no transfer. This wrinkle was presented in *Hope v. United States.*[135] The *Hope* court recognized the distinction between buying insurance for someone on one hand, and on the other, giving that person money which was then subsequently used to purchase insurance on the donor's life. Nevertheless, it opined that, in order to avoid recognition of a transfer, some showing must be made that the use of funds for that particular purpose was not under an agency or the otherwise controlled direction of the donor.[136]

Hope can be read to stand for the proposition that the use of the insured's money to fund a life insurance policy on the insured is not, *as a matter of law*, a transfer for purposes of section 2035. Indeed, the case seems to leave room for maneuvering on the agency issue. In *Kurihara*, there was sufficient evidence for finding an agency relationship, and clearly an undertone in the opinion that such an agency would be hard to disprove in this type of case.[137] Illustrative is *Traub v. United States*,[138] where a district court, relying on *Bel*,[139] had little difficulty in concluding that the *Hope* rationale was inapplicable when the premium was from the donor-decedent's own personal funds.[140]

When the opportunity arose, however, the Tax Court was not bent on expanding *Kurihara* and confined its application to its own specific facts. In *Estate of Clay v. Commissioner*,[141] the court rejected the government's attempt to extend *Kurihara* to permit funds tracing for attributing

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133. *Id.*
134. *Id.*
135. 691 F.2d 786 (5th Cir. 1982).
136. *Id.* at 789.
137. *Kurihara*, 82 T.C. at 59.
138. 58 A.F.T.R.2d (P-H) § 148, 155 (1986).
139. The court found that the taxpayer's reliance on *Hope* was misplaced primarily because the facts of *Hope* were distinguishable, while the facts of *Bel* and *First National Bank* were directly on point. It thus stated, "This case is controlled by *Bel v. United States* and *First National Bank of Oregon*." *Id.* (citations omitted).
140. 58 A.F.T.R.2d (P-H) § 148, 155 (1986).
141. 86 T.C. 1266 (1986).

premiums to the decedent for a policy on his life taken out and paid for by his spouse. In declining to adopt the government's expansive reading of *Kurihara*, the court pointed out that it had been decided against the *Bel* backdrop and "must be understood in that context."[142] Emphasizing that the source of the premium is not determinative, the court noted that the totality of the transaction is the proper focal point of the analysis. The degree of control exercised by the decedents over the entire transactions in both *Kurihara* and *Bel* made the premium payments "transfers" of the policies. In *Clay*, the decedent was almost incidental to the play, lending little more than his spouse's use of her insurable interest in him.[143] Such cooperation did not constitute a transfer.

Subsequently, in *Schnack v. Commissioner*, the Tax Court reaffirmed the position stated in *Clay*.[144] In *Schnack*, the taxpayers prevailed even though the decedent and her spouse intentionally arranged the purchase and ownership of life insurance in an effort to avoid estate taxation of the proceeds. The husband was designated as owner, beneficiary, and applicant of the policy on his wife's life. Premiums were paid from a joint bank account similar to the one at issue in *Clay*.[145]

The court noted its obligation to follow the Ninth Circuit's position, stated in *First National Bank of Oregon*, that section 2035 applies "where life insurance policies are procured at the instance [sic] of the deceased within the [statutory] period and the premiums are paid either directly or indirectly by the deceased."[146] But, relying upon *Clay*, the court concluded that the the decedent had not paid the premiums. Therefore, the facts did not meet the second prong of the Ninth Circuit's test and the proceeds were properly excludable from the decedent's gross estate.[147]

The "hope" for escaping estate tax on "constructive transfers," dashed by *Kurihara* but rekindled by *Clay* and *Schnack*, received a stiff blow when the Ninth Circuit reversed *Schnack*.[148] Relying heavily on its decision in *Oregon*, the Court reiterated its "substance over form" approach and found that the decedent had indeed made a transfer within the ambit of section 2035. The court suggested that *Clay* was either improperly decided or should be read narrowly to apply only in those instances where the deceased-insured is a passive participant and truly incidental to the transaction.[149]

These cases left one questioning the prospect of future taxpayer successes. The "constructive transfer" doctrine still applied to life insurance

142. *Id.* at 1272.
143. *Id.* at 1267-70.
144. 55 Tax Ct. Mem. Dec. (P-H) § 86,570 (1986).
145. *Id.*
146. *Id.*
147. *Id.*
148. 848 F.2d 933 (9th Cir. 1988).
149. *Id.* at 939-40.

payable on the life of the non-owner-insureds. Clever estate planning maneuvers were not going to carry the day, at least not until the Tax Court decided *Leder*.

D. Phase III

As noted earlier,[150] section 2035, although sharply curtailed in Phase III, retained its vitality for transfers of life insurance. Thus, Phase II cases defining the role of "constructive transfers" seemed still to have an important role in Phase III, at least until the *Leder* court concluded that a "plain reading" of the statute mooted the "constructive transfer" or "beaming" of life insurance issue. This result may not have surprised all, yet clearly it caught the government off-guard. Just a short time earlier, in Private Letter Ruling 85-09005,[151] the government had reasoned to an opposite result in its first Phase III interpretation of section 2035. Although private letter rulings are not citable precedent,[152] they, nevertheless, reflect government sentiment on particular tax issues. In the letter ruling, it was clear that the government saw little reason to back away from the success the "constructive transfer" doctrine had provided in Phase II. Relying on the legislative history of the statute's new version[153] and *Oregon*, the letter ruling concluded that the purchase of insurance by someone in the name of another "cannot be distinguished from the procurement of [insurance] in [one's] own name" with the immediate transfer of all ownership rights to the other person.[154] The letter ruling also found a way to overcome the obstacle of the decedent never having had the newly imposed requisite "subsection (d)(2)" interest in the policies. It resorted to legislative history that suggested life insurance retained the same treatment in Phase III as it was given in Phase II.[155] In sum, if *Oregon* applied, then section 2035(d) was not intended to alter the rule of exposing life insurance to estate tax accounting pursuant to a "constructive transfer" theory.

A first blush reading of the letter ruling leads one to conclude that the right result was reached, but a closer reading clearly shows it was probably for the wrong reasons. Section 2035(d)(2) does not, as interpreted by the letter ruling, require only a "transfer." If it did, the result would be correct. The provision, however, specifically requires the transfer of an interest in property which by itself would cause inclusion in the gross estate had such a transfer not been made. Although *Bel* and its progeny are

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150. *See supra* notes 44-54 and accompanying text.

151. Priv. Ltr. Rul. 85-09005 (Nov. 28, 1985).

152. Every private letter ruling states that it is not usable as authority and may be relied upon only by the taxpayer to whom it is addressed, citing to I.R.C. § 6110(j)(3) (1982 & Supp. 1987).

153. *See infra* notes 167-68.

154. *Id.*

155. *Id.*

perhaps still good law on whether the decedent actually made a transfer, it is questionable whether any of the opinions seriously addressed the issue of what the decedent had actually transferred that permitted the application of section 2035.[156] For section 2035(a) to have applied in either Phases I or II, only a transfer of some interest was required.[157] The transfer itself was the crucial subject of scrutiny. There was never any requirement that the transfer be of a *specific* interest in property. Seemingly, that was the teaching of *Estate of Porter v. United States.*[158]

In *Porter*, the decedent's surviving spouse received, from the decedent's employer, certain death benefits that were not otherwise includable in his gross estate unless capturable as a transfer in contemplation of death.[159] The court determined that the decedent had made a transfer of the benefits within the meaning of section 2035 and within the statutorily proscribed period. On this point it stated, "[T]he term 'transfer' 'must, we think, at least include the transfer of property procured through expenditures by the decedent with the purpose, effected at his death, of having it pass to another.'"[160] The decedent's continued employment for the company was seen as a *quid pro quo* for the company's promise to pay the benefits at the time of his death. The decedent's participation permitted him to, in effect, transfer a gift of the benefits to his wife. Even though it might have been difficult to determine the value of the gift at the time it was made, the court noted that it is unnecessary to compute that figure since the measure of the estate tax is the value of the property transferred at death.[161] It was fairly easy to determine what was payable at death. Thus, even though the decedent might not have possessed any palpable interest in the benefits, there was a transfer of the right to receive them, and that was sufficient for section 2035 to apply.

While Private Letter Ruling 85-09005 was correct in concluding there was a "transfer," it failed to distinguish between *Porter*-type transfers of non-specific property interests includable under section 2035 in Phases I and II, and transfers of certain statutorily enumerated interests, now the only gifts recaptured in the gross estate under section 2035. The letter ruling seemed content to look to the legislative history of "subsection (d)"

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156. *But see infra* notes 194-98 and accompanying text discussing conclusions reached in *Bel*, *First National Bank of Oregon*, and *Schnack*.

157. In Phases I and II, section 2035 and its predecessors required transfers of an interest within the statutorily prescribed period. *See* I.R.C. § 2035 (1982). The term "interest" was neither defined nor limited in the statute. *See id.*

158. 442 F.2d 915 (5th Cir. 1971).

159. *Id.* at 916. The court addressed the question of whether the payments could be included in the decedent's gross estate under section 2039 as an "annuity or other payment," but concluded that the section was inapplicable. *Id.*

160. *Id.* at 917 (quoting Chase Nat'l Bank v. United States, 278 U.S. 327, 337 (1929)).

161. *Id.*

and conclude that life insurance was intended to be given the same tax treatment after the 1981 amendments as it received before the changes. Ironically, the *Leder* court's scrutiny of the legislative history and the Congressional intent resulted in an interpretation directly opposite the one suggested in the letter ruling.[162]

The facts of *Leder* are quite similar to that of the letter ruling. The decedent's spouse applied for and owned, from the date of issuance, a policy on her husband's life. All of the premiums were paid for by the decedent's wholly-owned corporation and, thus, were properly attributable to him.[163] Application for, issuance of, and all premium payments with respect to the policy occurred within three years of the decedent's death. The Tax Court rejected the government's effort to include the proceeds in the decedent's gross estate under section 2035 by concluding that the section was inapplicable.[164]

In reaching its result, the court noted that the Phase III general rule excludes gifts made within three years of death from the gross estate unless overridden by subsection (d)(2). In order for (d)(2) to apply to the instant case, the decedent must have transferred a property interest taxable under section 2042 within three years of his death. The court specifically stated that "[t]he plain language of section 2035(d)(2) requires as a threshold issue that there be an interest in property under the terms of the sections it lists (e.g. sec. 2042). It requires that the decedent transfer . . . an interest that would have been included [in the gross estate] if the decedent had retained such an interest."[165] According to the court, the decedent must have, at one time, possessed one of the interests listed in the section. If such an interest was owned and then transferred within three years of death, (d)(2) would apply and the corresponding asset could be included in the gross estate.[166] Absent possession of such an interest and its transfer, the court believed Congress intended (d)(1) to provide that nothing be pulled into the gross estate under section 2035.

The government argued that such a reading of the statute was too constrained and inconsistent with the legislative history. Specific references to the Senate[167] and House[168] reports were made in an effort to demonstrate

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162. 89 T.C. 235, 238 (1987).

163. The court "assumed[d] . . . that by virtue of decedent's wholly owned corporation paying the policy premiums, the decedent [had] paid the premiums." *Id.* at 244 n.11.

164. *Leder*, 89 T.C. at 244.

165. *Id.* at 240-41.

166. *See id.* at 240 n.8.

167. The relevant Senate report from the Finance Committee, S. REP. No. 97-144, 97th Cong., 1st Sess 138-39 (1981), is as follows:

E. Estate Tax Treatment of Transfers Made Within Three Years of De-

that Congress intended to continue the special treatment accorded transfers

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cedent's Death (sec. 405 of the bill and secs. 1014 and 2035 of the Code)
Present Law

Under present law, transfers made by a decedent within three years of death are included in the decedent's gross estate without regard to whether the gifts were made in contemplation of death. A gift included in the decedent's gross estate is valued at the time of decedent's death (or alternative valuation date, if elected). However, any gift tax paid is allowed as a credit against the decedent's estate tax. In general, the net effect of these two provisions is to include in the decedent's gross estate the property's appreciation in value from the date of the gift until the date of death.

An exception to these rules applies with respect to transfers of property (other than transfers with respect to a life insurance policy) where no gift tax return was required to be filed with respect to the gift. Thus, a gift for which no gift tax return was required is generally not included in the decedent's gross estate, while a gift subject to the filing requirements is included at its appreciated value, without reduction for the amount of the gift tax annual exclusion.

Generally, where an interest is brought back into the estate, the donee's basis in such interest is its date of death fair market value, reduced by amounts claimed by the donee as deductions in computing taxable income prior to the decedent's death.

Reasons for Change

The committee generally does not believe it appropriate to tax appreciation that accrues after a gift has been made under the unified estate and gift taxes merely because the donor died within 3 years of the gift. The present rule often results in needless administrative burdens in valuing property twice. However, the committee believes that complete repeal of section 2035 for gifts other than life insurance would allow decedents to arrange their estates on their death bed in order to qualify for certain provisions which depend upon the size and make-up of the gross estate (e.g., secs. 303, 2032A and 6166). Accordingly, the committee believes that it is appropriate to include gifts made within 3 years of death at their value at the time of the gift.

. . . .

The change does not modify the valuation rules with respect to transfers of property included in a decedent's gross estate because (1) the decedent retained the beneficial enjoyment of the property during life, or the power to alter, amend, or revoke a previous lifetime transfer; (2) the property was transferred previously by the decedent but the transfer takes effect at the decedent's death; (3) the decedent possessed a power of appointment over the property; or (4) with respect to the proceeds of life insurance, the decedent possessed an incident of ownership or the proceeds are receivable by the decedent's executor. Thus, such property would still be included in the decedent's gross estate at date of death fair market value. For example, if one year prior to death, a decedent transferred all incidents of ownership in a life insurance policy to a third party, the entire amount of the proceeds would be included in the decedent's gross estate pursuant to sections 2035 and 2042.

168. The relevant House report from the Ways and Means Committee, H. R. REP. No. 97-201, 97th Cong., 1st Sess. 186-87 (1981), is as follows:

of life insurance under the pre-"subsection (d)" era. After stating its view that one must produce "unequivocal evidence of legislative purpose"[169]

G. Estate Tax Treatment of Transfers Made Within 3 Years of Decedent's Death.

. . . .

Reasons for Change

Under the law prior to the Tax Reform Act of 1976, gifts made in contemplation of death (other than gifts made more than 3 years before the decedent's death) were included in a decedent's gross estate to prevent deathbed transfers designed to avoid estate taxes. However, the prior law presumption that gifts made within 3 years of death were made in contemplation of death caused considerable litigation concerning the motives of decedents in making gifts. As a result, Congress, in 1976, eliminated the problem by requiring the inclusion of all such gifts in a decedent's estate without regard to the motives of the decedent.

Under the unified transfer tax system adopted in the Tax Reform Act of 1976, the inclusion in the gross estate of gifts made within 3 years of death generally has the effect of including only the property's post-gift appreciation in the gross estate (because the gift tax paid with respect to the transfer is allowed as a credit against the decedent's estate tax). The committee believes that inclusions of such appreciation generally is unnecessary except for gifts of life insurance and certain property included in the gross estate pursuant to certain of the so-called transfer sections (sec. 2036, 2037, 2038, 2041, and 2042). However, gifts made within 3 years of death should be included in a decedent's gross estate to determine the estate's eligibility for favorable redemption, valuation, and deferral provisions (under secs. 303, 2032A, and 6166) to preclude deathbed transfers designed to qualify that estate for such favorable treatment.

Explanation of Provision

In general, the bill provides that section 2035(a) will not be applicable to the estates of decedents dying after December 31, 1981. Thus, gifts made within 3 years of death will not be included in the decedent's gross estate, and the post-gift appreciation will not be subject to transfer taxes. Accordingly, such property will not be considered to pass from the decedent and the step-up basis rules of section 1014 will not apply.

The committee bill contains exceptions which continue the application of section 2035(a) to (1) gifts of life insurance and (2) interests in property otherwise included in the value of the gross estate pursuant to sections 2036, 2037, 2038, 2041 or 2042 (or those which would have been included under any of such sections if the interest had been retained by the decedent).

In addition, all transfers within 3 years of death (other than gifts eligible for the annual gift tax exclusion) will be included for purposes of determining the estate's qualification for special redemption, valuation, and deferral purposes (under secs. 303, 2032A, and 6166) and for purposes of determining property subject to the estate tax liens (under subchapter C of Chapter 64).

Section 2035(c), requiring the inclusion of all gift taxes paid by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and within 3 years of death, will continue to apply to all estates.

169. 89 T.C. at 240.

before the plain meaning of words in a statute can be overridden,[170] the court had little difficulty in dismissing the government's arguments with its own review and interpretation of the legislative history.[171]

The court commenced its attack on the government's pronouncement of Congressional intent by noting that the Senate Finance Report[172] cited by the government was without significance since "[the] conference agreement follow[ed] the House bill."[173] The court viewed the conference report's reliance on the House bill's "specific" rather than general terms as negating the Senate Report for the purposes of establishing intent. It further found that the House bill's specific reference to retain special treatment for life insurance,[174] was of no import since 1) Congress never enacted the exception,[175] and 2) "the specific reference to life insurance in the House report was not repeated in the Conference report."[176] Thus, the court adopted the position that Congress could have singled out life insurance transfers for continued selective section 2035 treatment, but eschewed the opportunity. Further, the court said insufficient support existed in the legislative history to uphold a statutory interpretation that would have created a result not specifically endorsed by Congress.[177]

The issue of whether the decedent had made a taxable *Bel*-type or non-taxable *Clay*-type transfer was never reached.[178] The decedent had never possessed a section 2042 taxable interest concerning the insurance and, consequently, could never have transferred one.[179] Since the Phase III version of the statute required the decedent to have made a transfer of a section 2042 taxable interest within three years of death, the court concluded that the statute could not apply.[180] Both a taxable interest and its transfer had to be present. Once it was determined that the decedent never had possessed a taxable interest in the policy, it became unnecessary to inquire whether

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170. *Id.* at 240-41 (citing Huntsberry v. Commissioner, 83 T.C. 742, 747-48 (1984)).

171. *Id.* at 241-42.

172. *See supra* note 167.

173. 89 T.C. at 241 (citing H. R. REP. No. 97-215, 97th Cong., 1st Sess. (1981), *reprinted in* 1981-2 C.B. 481, 511.

174. *See* H. R. REP. No. 97-201, *supra* note 168.

175. 89 T.C. at 242.

176. *Id.*

177. *Id.* (citing United States v. American College of Physicians, 475 U.S. 834, 846 (1986)). The court said, "Although we may resort in some circumstances to the legislative history to find Congress' intent, we are hesitant to rely on inclusive history to supply a provision *not enacted* by Congress." *Id.*

178. The court specifically noted that it was not deciding the issue of whether a transfer had occurred, which would have triggered section 2035(a) in Phases I and II. *Id.* at 244 n.12.

179. *Id.* at 244.

180. *Id.*

he had made a transfer.[181] Consequently, the proceeds were excluded from the gross estate.[182]

Shortly after *Leder* was decided, Private Letter Ruling 88-006004,[183] addressing the application of section 2035 to life insurance, was issued. Although the actual result would lead one to conclude to the contrary, it seems that in its approach to the problem the ruling tacitly accepts the *Leder* interpretation of section 2035(d)(2). The specific facts involved a transfer of insurance by a corporation to certain individuals. The controlling shareholder died within three years of the corporation's transfer of the insurance. The government reasoned that the decedent had an interest in the insurance taxable under section 2042 by virtue of her stock ownership; a position well-founded in the treasury regulations.[184] Having identified the requisite section 2042 interest, there was little difficulty in showing the transfer. Thus, subsection (d)(2) applied and forced estate tax accounting for the insurance proceeds.

No doubt the ruling was technically correct, and reached a result consistent with both the letter and the spirit of section 2035(d)(2). But perhaps of greater interest than the result itself, was the manner in which it was reached. Unlike Private Letter Ruling 85-09005, this letter ruling did not delve into legislative history in an effort to equate Phase II treatment of life insurance with its Phase III counterpart. Of course, one can argue there was no need to do so. The transaction in issue fell within a "plain reading" of the statute. Conversely, the government could have just as easily followed a Phase II-type argument employed in Private Letter Ruling 85-09005 to reach the same result. The ruling could well have rejected, or at the least, criticized *Leder*, but it did neither. Instead of making subsection (d)(2) a direct access to the "subsection (b) exception" for life insurance, the ruling analyzed the transaction in "*Leder*-esque" terms and lent credence to the view that the *Leder* rationale may have been accepted.

Because private letter rulings are not citable as precedent, it is difficult to put too much stock in what any one letter ruling holds. This is especially true if the ruling is used for what it did not state or do rather than for what it specifically held. Despite these observations, one cannot totally disregard the shift in approach taken in the ruling. A deliberate effort was made to fit the transaction into the precise wording of the statute. Was this just competent legal methodology, or was it a recognition that merely meeting a supposed spirit of the law is not sufficient for tax exposure on

181. *Id.* at 244 n. 12.

182. The decision by necessity presupposes that the decedent did not possess any incidents of ownership in the policy so as to render section 2042 inapplicable. *See id.* at 244.

183. Priv. Ltr. Rul. 88-06004 (Nov. 4, 1987).

184. *See* Treas. Reg. § 20.2042-1(c)(6) (1988).

these matters anymore? It is suggested that some language in the rulings themselves supports the latter.

In Private Letter Ruling 85-09005, the government specifically rejected the notion that a decedent must have formally possessed a section 2042-type interest in a policy as a pre-requisite to applying subsection (d)(2). The ruling seemingly concluded that a constructive transfer of life insurance satisfied the statutory test. In it, the government read the legislative history as showing Congress' intent to continue the Phase II treatment of life insurance transfers in Phase III, despite the addition of subsection (d)(2) to the statute. The *Leder* court rejected the government's reading of the legislative history, and in doing so, dismantled that argument for estate taxation of life insurance transfers.

Private Letter Ruling 88-06004 specifically requires that, in Phase III, for gifts to be included in the gross estate pursuant to section 2035, there must be a transfer of an interest that would have caused inclusion in the gross estate had the decedent retained the interest. Clearly, the letter ruling is recognizing that more than a mere "transfer" is needed to trigger subsection (d)(2). Even if the ruling is not an outright acceptance of *Leder*, undoubtedly it represents a step toward the *Leder* view. Time will tell, but it is very likely that *Leder*, if unchallenged, has started the movement that will end the reign of the "constructive transfer" doctrine in the realm of life insurance transfers.

IV. Long Live the Leder

Where to from here? Is change warranted or, for that matter, desirable? Has *Leder* made the waters of aggressive tax planning safe to enter again? Will Congress move to re-create the pre-Phase III tax treatment for all "constructive transfers" of life insurance, or will it be content to let these few transactions fall through the cracks?

Of course, if *Leder* is ultimately rejected, the substance of these questions could be mooted. At this time, that does not appear to be likely. Moreover, if the failure in Private Letter Ruling 88-006004 to criticize *Leder* is any indication, no change in direction is forthcoming. In fact, the Tax Court, citing *Leder*, has reaffirmed its view regarding its obligation to follow a plain reading of the statute.[185] Therefore, it is more likely that any movement toward a strict application of the *Bel-Kurihara* approach for these phantom transactions will come from another source.

One potential line of attack against *Leder* involves the development of an "imputed interest" corollary to the constructive transfer theory. The corollary supports a view similar, but not congruent, to the one raised in

185. *See* Segel v. Commissioner, 89 T.C. 816, 841 (1988).

Revenue Ruling 67-463.[186] In that ruling, the government tried to equate each premium payment to a corresponding proportionate interest in the policy itself. As already noted, this position was soundly rejected by the courts.[187] It is an outcome subject to challenge given that a similar argument had carried the day regarding donee contributions to life insurance that were found to be taxable pursuant to section 2035.[188] It is curious that the government did not seize upon this treatment of post-transfer donee premium payment as a corresponding interest in the policy as its theory to support the basis for Revenue Ruling 67-463. If premium payments constitute corresponding interests in the policy for contribution purposes, there may not be any compelling reason to treat them differently for inclusion purposes.[189] The point need not be pressed. The "imputed interest" corollary does not equate a premium payment with a corresponding interest in the supported policy. Rather, the corollary follows the *Bel* tack and looks to the totality of the transaction in its quest for identification and recognition of any section 2042 interest passed along by a constructive transfer. Indeed, it seems odd that the government accepted *Bel* for acknowledging "constructive transfers" but not for arguing "imputed interests." After all, how can there be a transfer, even a "constructive" one, without a concomitant interest being moved along?

One might respond that the *Porter* court found a transfer without a corresponding interest. Although perhaps not specifically identified as such, something was nonetheless transferred. The naked "right to receive" the death benefit was the interest transferred. True, the benefit was speculative and difficult to value at any time prior to the decedent's death, but this was of no import to the court.[190] The transfer of an interest, regardless

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186. *See supra* notes 84, 89-92 and accompanying text.

187. See *supra* notes 93-111 and accompanying text.

188. *See* Estate of Silverman v. Commissioner, 521 F.2d 574 (2nd Cir. 1975); Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945).

189. It seems odd that the same action paying premium can be treated as contribution for donees when making a case for exclusion of proceeds, but not as contribution by the donor when arguing for inclusion of the proceeds. Giving the donee beneficiaries their due is consistent with the treatment accorded contribution for other Section 2035 assets. This is especially true in light of the fact that they are under no obligation to continue the policy in force. But, it does not follow that donor's continued payments are any less "contributions." There does not appear to be a "compelling" reason to justify why donees' premium payments represent a corresponding percentage interest in the proceeds, while similar payments by donors represent only dollar-for-dollar gifts. Neither party is under any obligation to make the payment. The crucial test should be the effect of the payment, not its source.

190. In *Porter*, the court specifically stated that the date of death value was the only item of importance. Estate of Porter v. Commissioner, 442 F.2d 915, 919 (1st Cir. 1975). The court cited Helvering v. Hallock, 309 U.S. 106, 111 (1940): "The taxable event is a transfer *inter vivos*. But the measure of the tax is the value of the transferred property at the time when death brings it into enjoyment." *Id.*

of its date of gift value, was all that was necessary for Section 2035 to apply.[191] Surely a "right to receive" can rise to the dignity of an "interest" for estate tax purposes when other more speculative contingent interests are given that status.[192]

Although the court found a transfer of an interest in *Porter*, section 2035 no longer embraces that transaction. Now, subsection (d)(2) generates inclusion treatment only for limited types of interests, and Mrs. Porter's "right to receive" was not one of those interests. While subsection (d)(2) requires a transfer of a section 2042-type interest, it is not altogether clear exactly what that means. Must there be a transfer of a specific interest in the life insurance policy proper, or can the transfer be of something less than that to generate tax accountability? Does the statute require a transfer of the thing itself, or only of anything that, had the decedent retained it, would have caused inclusion of the proceeds under section 2042? This inquiry directs attention to "incidents of ownership," the criteria for subjecting life insurance not payable to or for the benefit of the estate to taxation under section 2042. Specifically, is an incident of ownership an "interest" in the life insurance policy embraced by subsection (d)(2)? If so, does a "constructive transfer" pass any "incident of ownership"? If answered in the affirmative, *Leder* becomes unsupportable.

What then is the interest transferred by an insured who permits someone else to apply for and own a life insurance policy on the insured's life? The insurable interest one possesses in oneself is an interest common to all life insurance purchases. Although easily identifiable, it is questionable whether the insurable interest in the policy belongs to the insured rather than the applicant whom the company permits to obtain the policy. Moreover, an insurable interest is not truly an economic benefit in the policy classifiable as an incident of ownership—the crucial test for applying section 2042.[193] Thus, in any set of circumstances, passively allowing one's own life to be insured by and for the benefit of another should not be sufficient to invoke section 2035. The requisite interest must, at the least, be of a type which would trigger tax exposure under section 2042 if the decedent had retained the interest. Whether the constructive transfer cases involve the transfer of such interests is the crucial issue.

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191. *Id.* at 917 n.2.

192. "A contingent interest belonging to a decedent at his death will be taxed to his estate under section 2033 if the contingency is something other than the decedent's survival so that he has an interest which he can transfer at death. C. LOWNDES, R. KRAMER & J. MCCORD, *supra* note 27, § 4.10.

193. *See* Estate of Beauregard v. Commissioner, 74 T.C. 603 (1980). Courts have also suggested that merely possessing the right to pay premiums, something all insureds could retain, is not an incident of ownership. *See* Gorman v. United States, 288 F. Supp. 225, 232 (E.D. Mich. 1968) (citing MacKay, *Life Insurance in the Estate Plan*, 43 B.U.L. REV. 275 (1962)).

It is difficult to identify the precise interest transferred in *Bel*. The court stated that the decedent "never formally possessed any of the incidents of ownership in the [insurance] policy," but went on to explain why the proceeds were, nonetheless the subject of the transfer.[194] Unfortunately, the court blurred the distinction between the transfer itself and the exact thing being transferred. An unsurprising result given that the thrust of the opinion sought to overcome the more difficult obstacle of demonstrating the functional equivalence of the decedent's actions to an actual transfer, than to identify the interest being transferred. There was no identification of the specific interest transferred. Instead, the court seemed at ease in allowing logic to dictate that once a transfer was found, by necessity, the decedent had to have had some kind of interest, which was all the statute required at that time. In a somewhat conclusory manner, the court ultimately determined that the decedent had in fact transferred the entire policy itself.[195]

In *First National Bank of Oregon*, the issue was framed more precisely. The court specifically inquired whether the decedent's actions in the case under review resulted in a transfer of the policy proceeds, and the answer was yes.[196] As in *Bel*, the court's analysis was geared more toward establishing the transfer itself rather than identifying the underlying interest transferred. But, the court did rule that a constructive transfer of life insurance, by necessity, must pass an interest in the policy.[197] Subsequently, in *Schnack*, the court identified the proceeds of the policy as the interest passed along by the constructive transfer.[198]

Do these opinions recognize the transfer of an interest to which section 2035(d)(2) could apply, or do constructive transfers of life insurance pass *Porter*-like rights not within the ambit of the statute? *Bel* focused on the totality of the transaction, and not on its isolated events. Thus, unsurprisingly it found a transfer of the entire policy. If taken at face value, arguably, *Bel* supports the view that constructive transfers of life insurance should be treated in Phase III as they were in Phase II. A transfer of the entire policy itself, which carries with it all of the incidents of ownership, is an interest in the policy within the plain reading of "subsection (d)(2)." Under such an analysis, *Leder* becomes unsupportable. An even tougher

194. Bel v. United States, 452 F.2d 683, 691 (5th Cir. 1971).

195. *Id.* at 692.

196. The court stated, "It is not disputed that the premiums were paid and the policies procured in contemplation of death. The sole issue on appeal is whether the property interest transferred was the proceeds of the policies . . . , or only the premiums advanced . . . ." First Nat'l Bank of Oregon v. United Sates, 488 F.2d 575, 576 (9th Cir. 1973).

197. *Id.* at 577. Regarding this point, the court said, "Thus where a policy is both procured at the behest of the decedent within the statutory period and where all the premiums are paid by the deceased in contemplation of death, the gift must necessarily be one of the property interest in the policy. *Id.*

198. Estate of Schnack v. Commissioner, 848 F.2d 933, 936 (9th Cir. 1988).

question arises if a constructive transfer passes something less than what was suggested by *Bel.*

Leder could arguably be consistent with *Oregon* and *Schnack* if these decisions are read to mean that the interest in the proceeds conveyed by a constructive transfer is a *Porter*-type right and not an interest in the policy. Most probably, this position would prove difficult to defend. In *Porter*, the right to receive proceeds was supported only by the decedent's continued employment. Estate tax accountability could not be found under sections 2036, 2037, 2038 or 2042 (the sections specifically creating the subsection (d)(2) exclusions) for such a transaction, therefore, the decedent could not have transferred an interest to which subsection (d)(2) would apply. If the right to proceeds in an insurance policy is not an interest in the policy, then a similar argument can be fashioned. But will this proposition pass tax muster? Arguably, the nexus between the proceeds and the underlying policy is too strong to be entirely ignored, foreclosing the conclusion that proceeds are not an interest in the policy itself.

Even if one could successfully divorce the proceeds from the underlying policy and avoid the former from being considered a subsection (d)(2) "interest" *proper* in the latter, escaping the grasp of section 2035 is not assured. It is submitted that the "interest" contemplated by subsection (d)(2) is not a true property interest *per se*, but embraces all rights, powers and other indicia of control over property which results in estate tax accountability under the sections specifically enumerated in subsection (d)(2). Thus, for the purposes of applying section 2042, "incidents of ownership" are the relevant indicia of control. Following this approach puts life insurance on equal footing with other types of property subject to estate taxation (a goal set by Congress when it introduced the "incidents of ownership" test),[199] and harmonizes the overall application and effect of subsection (d)(2).

To support this point, consider the impact of subsection (d)(2) on the following transaction. Decedent transfers property to donee reserving in himself a life estate. If the decedent retains that interest until death, there is no question that the property is includable in the gross estate under section 2036. What is the result if the decedent divests himself of the life estate prior to death? Section 2035(d)(2) indicates that if the decedent's transfer of the final "string" occurs more than 3 years prior to death there is no estate tax inclusion of the property, but if transferred within three years of death the property is included in the gross estate. This follows from the wording in the statute that requires tax accountability for a transfer within 3 years of death of a property interest that "would have been included under [section 2036] if such interest had been retained

199. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 35, §§ 4.14(g)(b), 4.14(9)(b).

by the decedent."[200] As noted above, had the decedent retained the life estate until death, the property would be included in his gross estate. The statute clearly fits the transaction into the (d)(2) exception and creates tax exposure—or does it? In order for (d)(2) to apply the decedent must have transferred an "interest in property." Is a life estate such an interest?

Section 2036 specifically identifies "possession," "enjoyment," and "rights" in and over transferred property as its triggering mechanisms. While any of these could rise to the level of a recognizable, enforceable property interest, that is not necessary for the section to apply. The regulations make it quite clear that mere understandings, express or implied, can be the source of the taxable right.[201] The regulations also use the disjunctive "or" when referring to the triggering mechanisms,[202] permitting one to conclude that a difference between a taxable right over transferred property and a taxable interest retained in transferred property is recognized. Does this mean that Congress intended to have subsection (d)(2) apply to section 2036 transfers only when a section 2036-type taxable "interest" is relinquished or transferred within 3 years of death, but not when a section 2036-type taxing "right" is similarly disposed of? Assuredly not! If one of the purposes of section 2035 is to prevent property (otherwise subject to section 2036) controlled until (or close to) death from escaping proper tax accounting, it would make no sense to excuse some section 2036 transfers but not others. The better view of the subsection (d)(2) meaning of "interest" is to consider it as the "taxing interest" as defined in the enumerated sections themselves, rather than as a true property interest.

Applying this rationale to life insurance leads one to conclude that if a decedent transferred an incident of ownership within three years of death, that event alone should force estate tax accounting for the corresponding policy. Interestingly, the regulations can be read to support this view.[203] Moreover, it has been suggested that failure to recognize "incidents of ownership" as the appropriate subsection (d)(2) interests would make a "mockery" of the estate tax treatment of life insurance in general.[204]

If incidents of ownership are the triggering interests for subjecting life insurance transfers to section 2035 treatment, then it has to be determined

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200. I.R.C. § 2035(d)(2).

201. Treas. Reg. § 20.2036-1(a) (1988).

202. *Id.*

203. *See* Treas. Reg. § 20.2042-1(c)(1) (1988). It permits the exclusion of proceeds from the gross estate if the decedent neither possessed any incidents of ownership at death nor transferred "them in contemplation of death. . . ." *Id.* The message is clear: a transfer of an incident of ownership is a transfer of an interest for the purposes of section 2035. Although interpreting the Phase II provision, the Phase III version contains nothing to indicate that this perception of an "incident of ownership" as an "interest" has changed. A sound argument is difficult to fashion to the effect that an "incident of ownership" was an "interest" in property for the purposes of subsection (a), but not for subsection (d)(2).

204. R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 35, § 4.14(6)(b).

whether an interest in proceeds passed by a constructive transfer is an incident of ownership in the policy. One must conclude that it is. Incidents of ownership are conceptually tied to the economic benefits of the policy which, according to Congress, represents the requisite control for taking life insurance.[205] What greater benefit could exist than the right to receive or decide who receives the fruit of the policy—its proceeds?[206]

The transfer of proceeds incident to a constructive transfer is identical to the designation of beneficiaries under a group term[207] or split-dollar[208] insurance plan. In both of these situations, if the decedent possessed only the right to designate the recipient of the proceeds, an incident of ownership in the policy, and corresponding estate tax accountability under section 2042, has been found.[209] If the analogy holds, there can be little doubt that an interest in the proceeds is an incident of ownership in the underlying policy.

Leder correctly notes that a decedent must have owned an interest in an insurance policy transferred within three years of death in order for section 2035 to pull the proceeds of the policy into the decedent's gross estate. The *Leder* court then concluded that the decedent never had such an interest, and therefore section 2035 did not apply. It is submitted, however, that a "constructive transferor" of life insurance does possess and pass the requisite interest—an "imputed" one. Therefore, under a proper interpretation of section 2035, constructive transfers of life insurance within 3 years of death are still includable in the decedent-transferor's gross

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205. Treasury Regulation 20.2042-1(c)(2) specifically states that "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." Treas. Reg. § 20.2042-1(c)(2) (1988).

206. It has been said that the capacity to affect the disposition of the proceeds is central to taxability. Estate of Smead v. Commissioner, 78 T.C. 43, 48 (1982).

207. A group term insurance plan usually provides insurance coverage for individual plan members through a master policy. The individuals have no control over the master policy but do, in most instances, have power of disposition over the proceeds covering themselves. *See* Treas. Reg. § 20.2042-1(c)(6) (1988).

208. A split dollar insurance plan confers upon the payor of the premium (usually an employer) ownership in the underlying policy and a right to proceeds in an amount either equal to the premiums paid until the insured's death or the cash value of the policy. The insured is usually an employee who has power of disposition over the proceeds. *See* Treas. Reg. § 20.2042-1(c)(6) (1988).

209. In both group term and split dollar plans, the insured's right to control the proceeds is an "incident of ownership" forcing estate tax accounting for the proceeds pursuant to section 2042. Treas. Reg. § 20.2042-1(c)(6) (1988); *cf.* Landorf v. United States, 408 F.2d 461 (Ct. Cl. 1969); Schwager v. Commissioner, 64 T.C. 781 (1975). *See generally* Treas. Reg. § 20.2042-1(c)(2) (1988).

estate. The imputed interest is either of the entire policy, as suggested by *Bel*, or, at the least, of an incident of ownership in the policy. It is suggested that "incidents of ownership" should be considered the proper measuring sticks for determining the requisite subsection (d)(2) interest because they are the taxing mechanism for life insurance pursuant to section 2042.

Concededly, life insurance is included in the gross estate under other sections without reference to "incidents of ownership." For example, when seeking to include a policy owned by a decedent on the life of another, the policy is treated under section 2033 like any other asset.[210] But that section clearly operates independently of section 2042. It makes little, if any, tax sense to have the "incidents of ownership" test control the taxation of insurance under section 2042 proper, but abandon that approach when direct reference to section 2042 is made elsewhere in the statute. By treating an incident of ownership as the subsection (d)(2) interest and then imputing its existence to the transferor prior to a constructive transfer of an insurance policy, the purpose of the section is preserved; life insurance is accorded equal treatment with other property, and sound tax policy is advanced. Indeed, treating an incident of ownership as an interest in the policy itself for all transfer tax purposes might well prove to be a prudent position to take.

It is curious that the Tax Court had no difficulty in looking to the entirety of the transaction when it found constructive transfers in Phase II *Bel*-type cases, but was only able to focus on technicalities and a narrow reading of the statute in Phase III. Both phases require the pre-transfer existence of an interest before the section in each respective era could be applied. Why was the interest readily recognizable in Phase II but not Phase III? The *Leder* court was content to read the Phase III statute literally: there must be a pre-existing interest before the subsection (d)(2) exception can apply. Absent the pre-existing interest, there was no need to determine whether or not a transfer was made. But in the constructive transfer setting, it is the recognition of the transfer itself that is first essential to the possible discovery of an interest. Why the court was willing to resort to this sleight-of-hand in Phase III after having rejected it in Phase II is a mystery.

The *Leder* court may have been trying to distinguish the pre-requisite of the more abstract interest needed in Phase II from the concretely defined one required in Phase III. But, given the conclusions drawn in *Bel* and *Oregon*, the distinction appears illusory. The reality is that courts recognizing constructive transfers also admit to the existence of imputed interests, for

210. Estate of Du Pont v. Commissioner, 233 F.2d 210 (3rd Cir.), *cert. denied*, 352 U.S. 878 (1956); Estate of Donaldson v. Commissioner, 31 T.C. 729 (1959).

without the latter there cannot be the former. The line drawn by *Leder* is unjustifiable.

Concededly, not every instance when a decedent lends his or her name to an insurance application will or should result in estate tax accounting. The truly passive participant is insulated from section 2035 taxation for want of a constructive transfer. But, in those instances where the "constructive transfer" doctrine could be applied, there seems to be no logical reason to restrict its use in Phase III. Even-handed statutory interpretation would seem to dictate that if the courts may look beyond the technicalities of the transaction to "construct" a transfer, the same effort should be made in order to "impute" the interest that was the subject of such a transfer. Indeed, without an imputed interest, there is nothing for the constructive transfer to transmit. Should it turn out that the "imputed interest" is not a section 2042 "incident of ownership," so be it; the transaction escapes taxation based upon a proper interpretation of the statute. It is suggested, however, that constructive transfers pass along imputed interests which are properly classifiable as incidents of ownership under section 2042 and, in turn, as subsection (d)(2) interests. The consequence of this realization is a rejection of *Leder*'s limited reading of section 2035(d) and identical tax treatment in Phase III for "constructive transfers" as was given in Phase II.

If imputed interests continue to go unrecognized by the courts, Congress will have to act if it is dissatisfied with *Leder*. A simple remedy lies in a rewording of subsection (d)(2) or extending the subsection (b) "exception to the exception" for life insurance to the entire section. Before any such move is made, however, a determination of the desired result should be contemplated. Are *Leder*-type transactions the kind of taxpayer activities Congress wants to sanction? Should there be approved "maneuvers" by which the form will overshadow the substance and permit otherwise taxable events to fall through the cracks in the statute? If so, is this one of the maneuvers?

It is suggested that a review of the legislative history of section 2035 reveals *Leder* to be contrary to the purpose and intent of the section which was designed to prevent dissipation of the estate tax base. Indeed, this rationale was used to establish the constructive transfer doctrine for life insurance in the first place. Even after the change to Phase III exclusion, the sense of Congress seemed to be to permit post-transfer appreciation to escape estate taxation primarily because the value of the gift itself was already in the overall tax calculus.[211] In essence, it was a determination

211. By operation of section 2001(b), an estate tax is computed first on the tentative tax base—an amount comprised of the gross estate plus all adjusted taxable gifts not otherwise included in the gross estate. I.R.C. § 2001(b) (1986). Thus, all gifts are either tax-accounted-for during life, or at death by effectively pushing the estate into higher marginal tax brackets.

that complete divestment of ownership ought not to go unrecognized. Yet, Congress was cognizant that life insurance by its very nature is so death-oriented, appreciation-laden, that it ought to be singled out for special treatment; and it was. Did this view change or is the statute as presently worded an unfortunate result of sloppy drafting procedures? Perhaps if section 2035 had been rewritten in its entirety, rather than having been subject to piecemeal revision, a clearer picture of the true Congressional intent would have come into focus. But wondering what "might have been" must now take a back seat to "what should be." If *Leder* survives review, Congress must determine whether it is satisfied with I.R.C. section 2035 in its present form and whether the section now capably serves its intended purpose.

V. CONCLUSION

In deciding *Leder*, the Tax Court handed tax planners an opportunity for passing on substantial wealth estate tax free. In doing so, the court took a step away from its usual "substance over form" posture and gave the tax statute a literal interpretation. Although the approach is not totally without precedent, in this particular instance, it was perhaps surprising given the inhospitable treatment constructive transfers of life insurance had received in the recent past. The onus is now on the defenders of the federal treasury to assess whether the *Leder* result can be countenanced. Serious consideration ought to be given to the recognition of an imputed interest corollary to the constructive transfer doctrine so that these types of activities do not escape proper tax accounting. Regardless, in the near future, it should become known whether taxpayers will be forced to continue paying the tax or whether they can safely follow this *Leder*.