CORPORATE CONTROL AS AN INCIDENT OF OWNERSHIP UNDER SECTION 2042 OF THE INTERNAL REVENUE CODE

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A problem of mounting concern in the estate planning field involves the estate tax consequences of ownership of a life insurance policy by a close corporation when the insured has a controlling interest in that corporation. The problem potentially affects the utility of many "key-man" insurance policies taken out by corporations to sustain their financial health if their principal shareholder and key corporate officer should die prematurely.[1] Previously, it had been regarded as certain that corporate ownership of the policy would generally preclude inclusion of the insurance proceeds in the insured decedent's estate under section 2042(2) unless the decedent was the sole shareholder of the corporation.[2] Stimulated by a recent government victory in a district court case and a recent revenue ruling,[3] however, many practitioners are now concerned about

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1. It is assumed in this article that the corporation owns the insurance policies and has named itself beneficiary. If someone other than the corporation were named beneficiary, such as the insured's wife, the discussion would have some application, but a variety of collateral issues would be raised which are beyond the scope of this article. These include such problems as the taxability of the premium payments to the insured; the consequences triggered by the insured's death; the effects on earnings and profits; and the corporate purpose of such an arrangement. Many of these problems are discussed in Goldstein, *Tax Aspects of Corporate Business Use of Life Insurance*, 18 TAX L. REV. 133 (1963).

2. Inclusion of the insurance directly in the insured decedent's estate would be warranted despite corporate ownership of the insurance if the insured were the corporation's sole shareholder. Treas. Reg. § 20.2042-1(c)(2) (1958). Inclusion of the insurance in the insured's gross estate might also be warranted on other grounds in the appropriate circumstances, especially under section 2035 if the insured-decedent transferred ownership of the policy to the corporation in contemplation of death. This article will not attempt to consider such problems.

All citations of section numbers are to the *Internal Revenue Code of 1954*, as amended by the Tax Reform Act of 1969 and the Revenue Act of 1971, unless otherwise indicated. Hereinafter the *Internal Revenue Code of 1954* will be referred to as I.R.C.

3. Cockrill v. O'Hara, 302 F. Supp. 1365 (M.D. Tenn. 1969); Rev. Rul. 71-463, 1971 INT. REV. BULL. No. 42, at 25. *See* Simmons, *How to Handle the IRS's 71-463 Attack on Corporate Owned Life Insurance*, 36 J. TAX. 142 (1972).

the sanctity of this conclusion.[4] Several estate representatives have reported that revenue agents have taken adverse positions on the question.[5]

This article accordingly will set forth the basic legal background of the problem, attempt to define the appropriate scope and effect of the rule involved, and consider techniques for minimizing its impact.

THE BASIC LEGAL BACKGROUND

Section 2042(2) requires insurance on the life of a decedent, receivable by beneficiaries other than the insured's estate to be included in his gross estate if the decedent "possessed at his death any of the incidents of ownership, exercisable alone or in conjunction with any other person."[6] The phrase "incidents of ownership" is not defined in the statute but the regulations offer some guidance.[7] They indicate that the quoted phrase generally "has reference to the right of the insured or his estate to the economic benefits of the policy."[8] Illustrative of such benefits are the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, and to pledge the policy for a loan against the surrender value of the policy.[9] The crucial language then follows: "Similarly, the term includes a power to change the beneficiary reserved to a corporation of which the decedent is sole stockholder."[10] This sentence, standing by itself, appears anomalous since the tax law normally views a corporation and its shareholders as distinct and separate entities.[11] The anomaly, however, is in fact supported by the

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4. *See, e.g.*, Dopheide, *Assigning Group Life Insurance: How Can the Current Problems be Overcome?*, 34 J. TAX. 220 (1971); Eliasberg, *Life Insurance: Recent Estate Tax Developments*, 48 TAXES 399 (1970); Simmons, *"Incidents of Ownership"—Some Haunting Reminders*, 57 A.B.A.J. 815 (1971).

5. This writer has had a substantial number of conversations with attorneys, accountants and insurance agents on this subject. In addition, he has been the recipient of many written inquiries concerning the validity of Revenue Ruling 71-463 and its ramifications. Several other attorneys in this field have reported similar interest.

As this issue went to press John Chapoton, the Treasury's tax legislative counsel, expressed his personal opinion that Revenue Ruling 71-463 should be revoked. He further stated that the Service is presently reviewing the ruling. The Wall Street Journal, Feb. 23, 1972, at 1, col. 6.

6. INTERNAL REVENUE CODE of 1954 § 2042(2) [hereinafter cited as I.R.C.; see note 2 *supra*] provides that the value of the gross estate shall include the value of all property:

> To the extent of the amount receivable by . . . 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. . . .

7. *See* Treas. Reg. § 20.2042-1 (1958).

8. *Id.* § 20.2042-1(c)(2).

9. *Id.* Several recent cases have defined "incidents of ownership" somewhat narrowly. *See* Estate of James H. Lumpkin, Jr., 56 T.C. No. 63 (July 19, 1971); Estate of Howard Infante, 29 CCH TAX CT. MEM. 903 (1970); Morton v. United States, 322 F. Supp. 1139 (S.D.W. Va. 1971).

10. Treas. Reg. § 20.2042-1(c)(2) (1958). This portion of the regulation will hereinafter be referred to as the sole stockholder rule.

11. *E.g.*, National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949); Mo-

legislative history.[12] Accordingly, it must be assumed that the sole stockholder regulation is valid.

This validity was affirmed by *Cockrill v. O'Hara.*[13] The taxpayer was president and sole stockholder of a corporation that owned an insurance policy on his life. The corporation possessed all the incidents of ownership of the policy and had paid all the premiums on it. The court granted the government's motion for summary judgment, recognizing that the case was squarely within the sole stockholder regulation. Further, the court accepted the government's argument that the taxpayer possessed personal incidents of ownership "in conjunction with" the corporation.

No other court has held that an insured has any incident of ownership in a life insurance policy merely because the policy was owned by a corporation which was solely owned by the insured. Moreover, no court has held that the insured had an incident of ownership where the insured merely controlled the policy-owning corporation.[14] The Court of Claims decision in *Landorf v. United States*[15] does provide insight into

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line Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Burnet v. Commonwealth Improvement Co., 287 U.S. 415 (1932).

12. Both the House and Senate Committee reports to section 404 of the 1942 Revenue Act, which was the initial codification of the sole stockholder rule, contain identical language treating incidents of ownership possessed by wholly-owned corporations as if possessed directly by the insured. Thus H.R. REP. No. 2333, 77th Cong., 2d Sess. 163 (1942), 1942-2 CUM. BULL. 372, 491; and S. REP. No. 1631, 77th Cong., 2d Sess. 235 (1942), 1942-2 CUM. BULL. 504, 677, provide as follows:

> Incidents of ownership are not confined to those possessed by the decedent in a technical legal sense. For example, a power to change the beneficiary reserved to a corporation of which the decedent is sole stockholder is an incident of ownership in the decedent.

Prior to 1942 the law was in considerable confusion as to what circumstances required the inclusion of life insurance in a decedent's gross estate. *See* Howard, *The Estate Tax Impact of Paying Life Insurance Premiums in Contemplation of Death*, 5 A.B.A. FORUM 97, 116 (1970) (Appendix I). Accordingly, in that year Congress provided a dual basis of inclusion for insurance on a decedent's life, based either on the retention of incidents of ownership or the payment of premiums by the decedent. Int. Rev. Code of 1939, § 811(g)(2), *as amended*, Revenue Act of 1942, ch. 619, § 404, 56 Stat. 798. When the premium payment test was eliminated by the 1954 Code, the "incidents of ownership" test stood as the sole basis for inclusion under the insurance code section when proceeds were payable to a person other than the decedent's executor or administrator. No change in the meaning of "incidents of ownership" was suggested in the following Committee Reports, H.R. REP. No. 1337, 83d Cong., 2d Sess. 91 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 124 (1942).

13. 302 F. Supp. 1365 (M.D. Tenn. 1969).

14. There are several older cases in which the court implicitly held that corporate control was not a basis for inclusion. In each, the decedent did in fact have corporate control and the corporation owned policies on the insured's life but it did not consider whether this might be grounds for inclusion of the insurance proceeds. *See* Annie S. Kennedy, 4 B.T.A. 330 (1926). *See also* Newell v. Commissioner, 66 F.2d 102 (7th Cir. 1933); Estate of S.A. Scherer, 1940 P-H B.T.A. MEM. DEC. ¶ 40,530. These cases, however, arose at a time when the elusive phrase "policies taken out by the decedent upon his own life" was the critical test. As indicated in note 12 *supra*, there was sufficient confusion as to what warranted inclusion without the introduction of a relatively sophisticated concept such as corporate control.

15. 408 F.2d 461 (Ct. Cl. 1969).

the meaning of corporate control in the event such a test is to be applied. The decedent was president and owner of 50 percent of the voting stock of a corporation which secured a group term life insurance policy on the lives of its employees, including the decedent. An unrelated party owned the other 50 percent of the voting stock. Two years before his death the decedent assigned his beneficial rights in the policy to his wife. The court found that the assignment was not made in contemplation of death, that it was effective under the New York insurance law and that the decedent's right to terminate employment was not an incident of ownership.

The government further contended that the decedent and the other owner of the voting stock could have used their corporate control to cancel or substantially reduce the coverage of the group insurance contract, that the decedent alone had the power to veto any corporate cancellation and that as corporate president he had the power to cancel the policy. The court rejected these arguments on the basis that the potential for concerted action between the decedent and other unrelated shareholders was not the type of incidents of ownership contemplated by Congress. The controlling factor influencing the court seemed to be that these arguments, carried to their logical extreme, would require a recognition of incidents of ownership irrespective of the extent of an individual shareholder-employee's control over corporate activities. That some type of dominant corporate control position is necessary is evident from the following statement by the court:

> This may not be the case, however, if the corporation is wholly owned or if it is proved that a particular stockholder has control over a sufficient number of other stockholders to effect a cancellation at his will. Of prime importance is the fact that there is no proof that this is the situation in our case. [The government] has not proved that decedent could have caused the corporation to act at his will. The mere fact of stock ownership is insufficient. We conclude that decedent did not have this alleged incident of ownership.[16]

The decedent's powers as corporate president were not dealt with specifically. The court did note parenthetically that the exercise of corporate power might sometimes be wrongful. It was apparently content, however, that in the situation before it the decedent did not have unilateral control despite his stockholdings and corporate office.[17]

Revenue Ruling 71-463 presents the issue squarely within the con-

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16. *Id.* at 471.

17. A similar conclusion was reached where a partnership owned policies on the insured's life and the Service attempted to attribute ownership incidents to the decedent by virtue of his partnership interest. The decedent, however, was only a 50-percent partner and the court brushed aside the Service's suggestion that the partnership was the decedent's alter ego. Estate of Frank H. Knipp, 25 T.C. 153, 166-69 (1955), *acquiesced in (result only)*, 1959-1 CUM. BULL. 4, *aff'd on other grounds*, 244 F.2d 436 (4th Cir. 1957);, *cert. denied*, 355 U.S. 827 (1957). *See also* Estate of George H. Atkins, 2 T.C. 332 (1943).

text of majority corporate ownership.[18] The insured was president and 75 percent owner of the corporation's only class of stock. Upon the insured's death, the proceeds of a corporate-owned life insurance policy were paid to the corporation. The corporate bylaws provided that a majority vote of the shareholders elected each officer and director. Likewise, under the bylaws and the law of the state of incorporation, a majority of the corporate shareholders could dissolve the corporation at any time provided they acted in good faith. The Service asserted that the sole stockholder regulation is exemplary rather than exclusionary, stating:

> [I]t is not the only situation in which a decedent's ownership of stock will include control of incidents of ownership possessed by a corporation. To the contrary, the regulation is applicable in circumstances where the insured decedent, or his estate, could exercise voting control of the corporation despite the combined votes of all of the other stockholders.[19]

Proceeding from this premise, the Service ruled that the proceeds were includable in the insured's gross estate because he possessed incidents of ownership. Since he could dissolve the corporation, he could effectuate the cancellation or distribution of the insurance policy. Further, since he could elect the corporate officers and directors, he could exercise the other incidents of ownership as if he were the named owner of the policy but without the necessity of acquiring the policy itself.

The Service did observe that although the proceeds were includable in the insured's gross estate, the insurance should not be reflected in the value of the decedent's 75 per cent interest in the corporation for inclusion under section 2033 or any other section of the Code. No reference was made to *Cockrill, Landorf* or any other decided case. Moreover, the failure of the Service to consider any of the collateral effects of its ruling casts considerable doubt upon its propriety.[20]

The foregoing authorities comprise the basic legal framework for the corporate control problem. Clearly they do not fully define the scope of any rule which would regard corporate control as an incident of ownership. The boundaries of such a rule must be gauged by reference to the corporate field of law which is inseparably linked to the problem.

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18. 1971 INT. REV. BULL. No. 42, at 25.
19. *Id.*
20. Consider, for example, the determination of the basis of the decedent's stock. It is unclear whether inclusion of life insurance proceeds under the ruling's section 2042 rationale dictates that such proceeds be excluded from the basis of decedent's stock. It seems arguable that the transferee's basis of the stock should be stepped-up under section 1014 by the amount of the inclusion under section 2042. Still another alternative would be to assign to the stock a basis equivalent to its fair market value at the date of decedent's death or alternative valuation date as the case may be. While the last alternative seems to be the most reasonable, the question is unanswered. Such uncertainty significantly undermines the utility of the ruling. Equally important questions remain with respect to sections 303 (redemption of estate's interest) and 6166 (estate's payment of federal estate tax burden in installments).

THE SCOPE OF THE REGULATION'S RULE

As noted, the regulations under section 2042 specifically indicate that an ownership incident of a corporation of which the decedent is sole stockholder is per se an ownership incident of the decedent.[21] The absence of more explicit guidance in the regulations raises numerous questions if the decedent possesses something less than absolute ownership of a corporation. A threshold inquiry must be made to ascertain the minimum stock ownership which will activate the recognition of an incident of ownership. Stock ownership by persons related to the decedent may also have a bearing upon his control over the corporation.

A logical starting point is to analyze the ramifications of the resolution of these questions. If corporate control is not regarded as an incident of ownership, it is clear, for example, that in measuring the value of the decedent-insured's stock, the full value of the corporate-owned insurance proceeds is to be taken into account, not merely the cash or replacement value immediately before death.[22] Hence, if the insured is the sole shareholder and the stock is to be valued simply by determining the corporation's net assets, no difference in his gross estate results whether additional insurance proceeds or additional stock value is taken into account as long as the proceeds are not included in both estate schedules.

Normally, however, stock is not valued simply by determining net asset values.[23] Ordinarily, earning power is a more critical factor and there are generally a host of other variables which may be considered.[24] Thus, if the value of a share of stock is determined to be principally a function of earning power, the presence of insurance proceeds payable to the corporation may not significantly affect its value. If the value of the stock is discounted because it is owned in a large block, the proceeds may not increase stock value on a directly proportional basis. Hence, frequently a greater inclusion would be required under section 2042 than would be warranted by including additional stock value under section 2033. Moreover, if the insured is not a 100 percent stockholder, the inclusion under section 2033 would probably not be equal to an inclusion premised on section 2042 even if valuation were determined strictly on a net asset basis. It seems fair to say that in the usual corporate control

21. Treas. Reg. § 20.2042-1(c)(2) (1958).

22. *See* Annie S. Kennedy, 4 B.T.A. 330 (1926). *See also* Newell v. Commissioner, 66 F.2d 102 (7th Cir. 1933); Rev. Rul. 59-60, § 4.02(b), 1959-1 CUM. BULL. 237, 239, *modified on another point*, Rev. Rul. 65-193, 1965-2 CUM. BULL. 370.

23. *See* Treas. Reg. § 20.2031-2 (1958).

24. To mention but a few, these include sales reasonably proximate to the date of death; the presence of goodwill; the economic outlook in a particular industry; the company's position in the industry and the caliber of its management; the value of securities in a similar line of business; the degree of control represented by the block of stock to be valued; the difficulties in selling a large block of stock; and the effect on the business of the loss of a key-man.

situation, avoiding inclusion under section 2042 will tend to materially diminish the amount of estate tax attributable to the insurance proceeds.[25]

Accordingly, the application of section 2042 within the corporate control context is an essential determination which may have significant estate tax consequences. To effectively deal with this problem, consideration must be given to the meaning of "corporate control" as influenced by attribution of ownership, analogous attacks directed at corporate control and the indirect possession of incidents of ownership.

Attribution in Federal Estate and Gift Taxation

The significance of corporate control as a measure of economic power is a familiar concept in federal tax law. In the income tax area, there are numerous intances of divergent consequences to a transaction depending on the presence or absence of such control. Frequently, attribution principles treat one person as owning property actually owned by another for the purpose of applying a given statutory test. Perhaps the most prominent example of a detailed attribution structure is section 318(a), which provides rules affecting many corporate distributions and adjustment transactions.[26]

While Revenue Ruling 71-463 deals with the problem whether an insured is deemed to possess the ownership incidents of a life insurance policy under section 2042, the attribution concept the ruling seeks to establish is clearly derived from the income tax law. In importing such a concept, the ruling almost completely ignores three extremely cogent factors, giving them minimal discussion.

First, attribution principles are neither statutorily sanctioned nor commonly recognized judicially in the estate and gift tax area. Further, even in the income tax area where attribution rules abound and control is often accorded considerable significance, the normal rule is to respect the corporate entity, even if solely owned. Finally, the Service disregarded the difficulty in fashioning a definition of control, the many variations possi-

25. Under Treas. Reg. § 20.2042-1(a)(3) (1958), there would generally not appear to be any basis for including a percentage of the proceeds less than 100 percent once section 2042(2) of the Code is found applicable. Of course, in a community property state where the stock is owned by the marital community, generally only half the proceeds would be included in the insured's estate. *See* Treas. Reg. § 20.2042-1(c)(5) (1958); Rev. Rul. 48, 1953-1 CUM. BULL. 392.

26. Note I.R.C. § 318(a)(2)(C), where attribution from a corporation to a taxpayer depends on owning 50 percent or more of the value of the corporation's stock. There are numerous other examples where corporate control yields distinctive consequences. These include, for example, sections 267(b) and 267(c), dealing with the disallowance of losses, expenses and interest in transactions between related parties; section 351(a), dealing with transfers to 80 percent controlled corporations; section 544(a), dealing with the application of personal holding company rules; section 958(b), dealing with the definition of controlled foreign corporations; section 1239(a)(2), relating to gains from sales of depreciable property between an individual and a greater than 80 percent controlled corporation; and section 4946(a), defining disqualified persons for purposes of private foundation status.

ble and the fact that such definitions are usually congressionally determined. An analysis of these factors is essential to an evaluation of the ruling's propriety and likelihood for expansive application.

The presence of attribution in the estate and gift tax area is relatively rare. For example, insurance owned by the decedent's wife on the life of the decedent normally will not be included in the decedent's gross estate, assuming the insured owns no incident of ownership and has made no transfer to her in connection with the policy in contemplation of death.[27] For this purpose it makes no difference how much influence the decedent has over his wife through love or affection.[28] Of course, even in the estate tax area sham titles or nominee arrangements will not affect the tax consequences that flow from the realities of ownership.[29] If the decedent has in fact indirectly or surreptitiously retained ownership rights, his estate will be taxed accordingly, despite an apparent divestiture of such rights.[30]

There is no statutory parallel, however, in the estate and gift tax area to the income tax attribution principles. In fact, the sole stockholder regulation under section 2042 is the only example of such a phenomenon in the estate and gift tax regulations. The studied absence of such attribution principles in this area strongly suggests that applications of such a doctrine should be carefully limited.

A review of the analogous treatment of the corporate entity in the income tax area reinforces this conclusion since the general rule is to respect the corporate entity irrespective of sole stockholder ownership.[31] Equally significant are several cases which have specifically held that the payment of premiums by a corporation on a policy of which it was both

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27. *See, e.g.*, Landorf v. United States, 408 F.2d 461 (Ct. Cl. 1969); Gorman v. United States, 288 F. Supp. 225 (E.D. Mich. 1968); Estate of Max J. Gorby, 53 T.C. 80 (1969), *acquiesced in*, 1970-1 CUM. BULL. xvi (1970); Rev. Rul. 69-54, 1969-1 CUM. BULL. 221.

28. *See* Anna Ball Kneeland, 34 B.T.A. 816 (1936). *See also* Kramer v. United States, 406 F.2d 1363 (Ct. Cl. 1969).

29. *See, e.g.*, Estate of Saul A. Levine, 27 CCH TAX CT. MEM. 284 (1968); Estate of Albert Rand, 28 T.C. 1002 (1957); Agnes McCue, Transferee, 5 CCH TAX CT. MEM. 141 (1946); Estate of Philip McRae, 30 B.T.A. 1087 (1934).

30. *See, e.g.*, Estate of Skinner v. United States, 316 F.2d 517 (3rd Cir. 1963); Estate of McNichol v. Commissioner, 265 F.2d 667 (3d Cir.), *cert. denied*, 361 U.S. 829 (1959); Greene v. United States, 237 F.2d 848 (7th Cir. 1956).

31. See cases cited, note 11 *supra*. There are numerous grounds for disregarding or piercing the corporate entity in whole or in part which are not automatic but dependent on the presence of certain fact patterns. For example, under section 269 tax benefits arising out of certain acquisitions of corporate stock or other property may be disallowed if the acquisition was principally motivated by tax avoidance. Under section 482 the Commissioner may allocate income and deduction items among related entities to reflect income more clearly. Under section 1551, an additional surtax exemption may be denied if a major purpose of the transfer of property to a corporation is to secure such surtax exemption. For various judicially established doctrines, see Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Higgins v. Smith, 308 U.S. 473 (1940); Gregory v. Helvering, 293 U.S. 465 (1935). Despite the many reservations that must be made, respect for the corporate entity is the normal operating rule in the income tax area.

owner and beneficiary resulted in no taxable income to be realized by either the insured or his co-stockholder.[32] The plain import of this analogy to the income tax area is that the line between a corporation and its stockholders should not be ignored.

A factor which further militates against recognizing corporate control as an incident of ownership is the difficulty inherent in defining corporate control. More than 50 percent voting power might seem to be the appropriate test since this will tend to give the insured the decisive voice in the management of the insurance policies.[33] Of course, there are many instances where even a lesser percentage might give the insured effective control, and this suggests a more liberal rule analogous to that under section 482.[34] On the other hand, since the effect of the definition may be to include proceeds in the insured's gross estate in excess of his economic benefit in the policy, it may well be that a closer approximation of the "alter ego" concept would be required, such as 80 percent or even 95 percent in both value and voting power.

A brief review of the definitions of control in the federal income tax area indicates numerous criteria that have been enumerated by Congress to govern various transactions. For example, sections 267(b), 318(a) and 1563(c) rely on a value criterion only; section 368(c) depends on both voting power and number of shares; section 4946(a) depends on voting power alone; and section 269(a) depends either on voting power or value. Moreover, the percentage of stock ownership necessary to trigger the consequences also varies considerably. Sections 368(c) and 1239(a)(2) use an 80 percent figure; sections 269(a) and 318(a) require 50 percent or more; section 958(b)(2) requires more than 50 percent; section 4946(a)(1)(C) requires only 20 percent; and sections 267(c) and 544(a) simply attribute on a proportional basis. Finally, attribution under section 269(a) depends on the taxpayer's motives while under sections 318(a) and 1239(a)(2) the taxpayer's motives are considered irrelevant for attribution purposes.

The complexity of defining corporate control illustrated by the experience in the federal income tax area is a strong indication that it is not practical to arrive at such a definition on a case-by-case basis. Yet if a corporate control test is to be applied, it is imperative that the concept be clearly delineated because of the numerous possibilities available. Accordingly, attribution should not be attempted in the estate and gift tax area absent congressional guidance.

The attempt of Revenue Ruling 71-463 to import attribution principles into the estate tax area runs counter to the general structure of the

32. *See* Sanders v. Fox, 253 F.2d 855 (10th Cir. 1958); Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957); Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957). *See also* Rev. Rul. 59-184, 1959-1 CUM. BULL. 65.
33. *See* Rev. Rul. 71-463, 1971 INT. REV. BULL. No. 42, at 25.
34. *See* Treas. Reg. § 1.482-1(a)(3) (1968).

estate tax law. It apparently disregards the existence of the corporate entity without congressional sanction, a course that is generally not followed even in the income tax area. Finally, it assigns a definition of corporate control without any congressional guidance.

Analogous Attacks Directed at Corporate Control

In the area of estate and gift taxation neither the statute nor the regulations, except the section 2042 sole stockholder rule, provide for any kind of attribution of a close corporation's ownership to its controlling shareholder. The Service, however, has attempted to remedy this omission in rulings. In addition to Revenue Ruling 71-463,[35] Revenue Ruling 67-54,[36] arising under the retained power provisions of section 2036 dealing with *inter vivos* transfers in trust,[37] attached estate tax significance to corporate control.

The decedent's corporation had 10 shares of voting common stock and 990 shares of nonvoting common stock. The decedent transferred the 990 shares of nonvoting stock to a trust for the benefit of his children and the trust owned those shares at the date of the decedent's death. The trustee, moreover, could not sell such shares without the decedent's consent. The Service reasoned that the decedent's voting control gave him control over the corporation's dividend policy and the right to determine the extent of the income from the nonvoting stock. This was fortified by the decedent's right to prevent sale of the stock by the trust. Hence, under the regulations,[38] the decedent retained the right to designate the person or persons who would possess or enjoy the transferred property or the income therefrom. The retention of this power, exercisable as controlling shareholder, was sufficient to warrant inclusion.[39]

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35. 1971 INT. REV. BULL. No. 42, at 25.
36. 1967-1 CUM. BULL. 269.
37. Section 2036(a) provides:

> (a) General rule.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
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> (1) the possession or enjoyment of, or the right to the income from, the property, or
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> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

For an analysis of the tax consequences of retained powers under section 2036, see O'Connell, *An Irrevocable Trust with a Power to Accumulate Income or Invade Principal: Federal Tax Consequences to the Grantor,* 13 ARIZ. L. REV. 267 (1971).

38. Treas. Reg. § 20.2036-1(b)(3) (1958).
39. Treas. Reg. § 20.2036-1(b)(3) (1958) indicates that it is immaterial "in what capacity the power was exercisable by the decedent." Treas. Reg. § 20.2042-1(c)(4) (1958) is similar but not identical in this respect since its first sentence provides as follows:

> A decedent is considered to have an 'incident of ownership' in an insur-

The Service cited no case authority for its opinion but presumably its view was based on a substantial line of cases indicating that a retained *direct* power to accumulate or distribute income of a trust created by the taxpayer is within the ambit of section 2036.[40] With that power the grantor of a trust can control the beneficial enjoyment of the trust as between income beneficiary and remainderman. This ruling, however, delves into a situation where the power retained is indirect.

Even if it is a correct reflection of the law under section 2036,[41] however, the ruling is not dispositive within the section 2042 context. First, the ruling requires not only corporate control, but also a transfer of related property into a trust and the retention of a veto power over the sale of the stock by the trust. Secondly, the governing law is section 2036, not section 2042. The significance of this is that under section 2036 there must be a transfer and a retention of sufficient economic strings to warrant inclusion. Under section 2042, the insured personally need do nothing if corporate control is to be regarded as an incident of ownership since it would be sufficient that the policy is on the insured's life and that his controlled corporation owns the policy.[42]

This latter point deserves some emphasis. If section 2036 is to apply, the decedent must attempt to reduce the size of his estate by a transfer in trust for others. If the controls he retains are too broad, it may well be appropriate to conclude that his estate should not be so diminished. On the other hand, the insured under section 2042 may not be attempting an estate reduction. The corporation may simply consider it prudent to insure the decedent's life with its own resources, regardless of the amount of voting power the insured may possess. Indeed, such a decision may have been reached even before the insured acquired control. To require inclusion of the insurance proceeds under such circumstances may be to penalize hm for reasons having little connection with estate tax avoidance.

Even within the section 2036 context, Revenue Ruling 67-54 has not received an hospitable judicial reception. In *Yeazel v. Coyle*[43] the decedent transferred stock into a trust for four grandnieces and grand-

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ance policy on his life held in trust if, under the terms of the policy, the decedent (either alone or in conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

40. O'Malley v. United States, 383 U.S. 627 (1966); Commissioner v. Estate of Holmes, 326 U.S. 480 (1946). *See also* Joy v. United States, 404 F.2d 419 (6th Cir. 1968).

41. See discussion beginning with text accompanying note 43 *infra* which suggests that the ruling was erroneous.

42. That the insured need not retain his incident of ownership to warrant inclusion was illustrated in Commissioner v. Estate of Karagheusian, 233 F.2d 197 (2d Cir. 1956) (incident conferred); Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945) (incidents revested); Estate of Michael Collino, 25 T.C. 1026 (1956), *acquiesced in*, 1956-2 CUM. BULL. 5 (incidents conferred).

43. 21 P-H AM. FED. TAX R. 2d ¶ 1681 (N.D. Ill. 1968).

nephews. The majority of the corporate stock was transferred to the trust but the decedent retained about 40 percent of the shares. As trustee, decedent could vote the stock and sell or invest it under broad investment powers. The court refused, however, to premise any inclusion under section 2036.[44] The decedent retained no direct pecuniary benefit in the trust. If she could delay dividends, it would be only to enhance the stock values the beneficiaries would ultimately take. The court suggested the beneficiaries might even borrow on such rising stock values. Revenue Ruling 67-54 was not explicitly rejected since its facts were slightly distinguishable, but it did not persuade the court to reach a different result.

Another district court reached a similar conclusion in *Byrum v. United States*.[45] The fact pattern was similar to *Yeazel*. The powers retained included the right to vote the stock of three unlisted corporations, the power to remove the designated trustee and to appoint a corporate successor and the power to veto the sale or investment of the trust corpus. Relying largely on *Yeazel*, the district court found no basis for inclusion under section 2036. On appeal, the court of appeals considered individually the powers retained and found that no one of them required inclusion under section 2036.[46] Moreover, it found that the directors of the corporation were under a fiduciary obligation to exercise sound business judgment in declaring dividends and, therefore, could not act in bad faith in this regard. Accordingly, the court refused to adopt the approach prescribed by Revenue Ruling 67-54. The dissent felt that the powers retained cumulatively gave the decedent a degree of control within the reach of section 2036.

The Tax Court in the gift tax case of *Marjorie M. Merritt* did give the Service some ammunition for its present position.[47] Five members of a family who owned all the stock of a corporation agreed to reserve to themselves life interests in their respective shares of stock in order to assure continued family control, the remainders passing to their respective children or descendants. They also reserved the right to receive all dividends whether paid out of earnings or capital. On this record, the Tax Court found the gift to be incomplete.[48] Although the children were given

44. The stock was found to have been transferred in contemplation of death, however, and inclusion was upheld under section 2035.
45. 311 F. Supp. 892 (S.D. Ohio 1970), *aff'd*, 440 F.2d 949 (6th Cir.), *cert. granted*, 92 S. Ct. 278 (Nov. 9, 1971). *See also* Estate of Harry H. Beckwith, 55 T.C. No. 23 (Oct. 29, 1970); Estate of George H. Burr, 4 CCH TAX CT. MEM. 1054 (1945).
46. 440 F.2d 949 (6th Cir.), *cert. granted*, 92 S. Ct. 278 (Nov. 9, 1971).
47. Marjorie M. Merritt, 29 T.C. 149 (1957), *acquiesced in*, 1958-2 CUM. BULL. 6.
48. The problem of illusory gifts of corporate stock was also considered in Overton v. Commissioner, 162 F.2d 155 (2d Cir. 1947), *aff'g* 6 T.C. 304 (1946). *But cf.* Henry Pullman, 23 CCH TAX CT. MEM. 1310 (1964). There are, however, many aspects to such a problem which are not involved under section 2042. These include the application of assignment of income principles, the valuation of interests which are not easy to measure, and the gift tax concept of "completeness."

remainder interests, the donors as a group could have stripped the shares of value by causing distributions of capital to themselves. Moreover, the donors were not found to be parties adverse to one another.[49] Whatever the correctness of *Merritt* for gift tax purposes, the thrust of this argument appears to have been dealt with effectively for estate tax purposes in the *Landorf* case.[50] There, it will be recalled, the Court of Claims thought that Congress could not have reasonably intended to regard as an incident of ownership the mere ability of one stockholder to combine with others to terminate a group term insurance plan. Furthermore, in the *Merritt* case the shareholders acting as a group explicitly reserved a power to themselves that no one alone possessed as shareholder and which, indeed, would not have been so unbridled in the hands of a single majority shareholder.

Another critical deficiency of Revenue Ruling 67-54 is its failure to take into account the fiduciary obligations of a controlling shareholder with respect to corporate dividend policy. Corporate management does have broad discretion in these matters but its powers are not unlimited. Except in the sole stockholder situation, the payment of dividends must be consistent with sound corporate management and the interests of minority stockholders must be respected.[51] In other words, it is a considerable oversimplification to assume that a controlling stockholder can operate a corporation for the convenience of the beneficiaries of a trust which owns some of its stock.[52]

In any event, it is clear that there is relatively meager authority from analogous situations in the estate and gift tax area to support the view that corporate control should be regarded as a per se incident of ownership. The strongest support is the Service's holding in Revenue Ruling 67-54. As has been seen, this ruling is distinguishable from the section 2042 case; it has been coolly received by the courts; and it has failed to take account of important countervailing legal doctrines.

The Indirect Possession of Incidents of Ownership

Having examined the general role of corporate control as a basis for

49. Under Treas. Reg. § 25.2511-2(e) (1958), and predecessor regulations, a donor of property is considered to have a power sufficient to bar completion of a gift if such power is exercisable with "any person not having a substantial adverse interest." This "substantial adverse interest" concept is not used under section 2036 or 2042. It is immaterial in these contexts that any other person must acquiesce in the decedent's exercise of powers or that such person's interests are adverse to the decedent's.

50. Landorf v. United States, 408 F.2d 461 (Ct. Cl. 1969), discussed in text accompanying notes 15-17 *supra*. *See also* Estate of James H. Lumpkin, Jr., 56 T.C. No. 63 (July 19, 1971).

51. This was alluded to by the Sixth Circuit in Byrum v. United States, 440 F.2d 949 (6th Cir.), *cert. granted*, 92 S. Ct. 278 (Nov. 9, 1971). *See also* 11 W. FLETCHER, PRIVATE CORPORATIONS § 5325 (perm. ed. rev. 1971).

52. *See* text accompanying note 65 *infra*.

inclusion of assets in a decedent's gross estate, it may also be helpful to consider the extent to which incidents of ownership have otherwise been regarded as indirectly possessed.[53] If it is discovered that the courts have displayed a predilection for piercing various "shields" to find possession, the Service could more defensibly justify its extension of the sole shareholder rule. Conversely, if it appears that fairly substantial connections have not been regarded by the courts as tantamount to possession, the Service's extension of the sole shareholder rule becomes even more questionable.

In undertaking this discussion, three crucial points should be borne in mind. First, the basic justification for the statutory "incidents of ownership" test is that the decedent's death results in a sufficient shift of economic benefits to warrant an inclusion.[54] Second, ownership incidents possessed by the insured in a fiduciary capacity for the benefit of others should not merit inclusion under section 2042 since the insured's creation of a trust with extensive retained powers will generally warrant inclusion under section 2036 or 2038.[55] Finally, the corporation's receipt of insurance proceeds will normally be taken into account under section 2033, at least to some extent, in measuring the value of the insured's stock interest.[56] The real question under section 2042 is whether corporate control should be a basis for including all the proceeds in the insured's gross estate even though all would not redound directly to his economic benefit.

There are several cases which arguably lend some support to the Service's attempt to extend the sole stockholder rule. Significantly, however, in these cases the decedent's power with regard to the policies was not subject to the fiduciary obligation present within the corporate control context. For example, in *Commissioner v. Estate of Karagheusian*[57] the decedent's wife was grantor and trustee of a trust which owned insurance on the decedent's life. She was authorized to alter or revoke the trust with the written consent of her daughter and the decedent. This veto power in the decedent was held to be an incident of ownership since the decedent, acting with others, could have changed the beneficiaries. The court cited the sole stockholder rule in support of its decision, observing:

> The regulation . . . indicates that 'incident of ownership' is not to be confined to ownership in any technical legal sense,

53. A few illustrations of recent cases defining the phrase "incidents of ownership" were given in note 9 *supra*. For a more complete discussion of this problem, see 2 J. MERTENS, LAW OF FEDERAL GIFT & ESTATE TAXATION, §§ 17.10-17.18 (1959).

54. *See* Chase Nat'l Bank v. United States, 278 U.S. 327 (1929), where a constitutional challenge was rebutted on this ground.

55. See text accompanying notes 41-42 *supra*.

56. See text accompanying notes 22-25 *supra*.

57. 233 F.2d 197 (2d Cir. 1956). *See also* Estate of Myron Selznick, 15 T.C. 716 (1950), *aff'd per curiam*, 195 F.2d 735 (9th Cir. 1952). *Contra*, McCobb v. All, 206 F. Supp. 901 (D. Conn. 1962), *rev'd on other grounds*, 321 F.2d 633 (2d Cir. 1963).

> and the example of indirect ownership through a corporation is analogous to the situation here. The decedent, acting with his wife and daughter, had the power at any time until his death to determine the ultimate distribution of the insurance proceeds. This power was an incident of ownership . . . and the entire proceeds of the policy were therefore includable in the decedent's gross estate. . . . To hold otherwise would be to sanction tax avoidance by means of insubstantial alterations in the forms of ownership.[58]

While the analogy to the sole stockholder regulation may have been proper in *Karagheusian,* it is much more difficult to support a holding that ownership of a life insurance policy by a corporation, the stock of which is owned by several unrelated individuals, is tantamount to ownership by the corporation's controlling shareholder. Such corporate ownership should not be regarded as indirect ownership by the controlling shareholder through the corporation.

Commissioner v. Treganowan[59] represents perhaps the broadest interpretation of incidents of ownership that any court has made. Decedent was an owner of a seat on the New York Stock Exchange. Pursuant to the rules of the exchange, he was required to maintain payments to a gratuity fund which provided certain death benefits. Recognizing that the decedent could have sold his seat on the exchange and thereby have divested his wife of the right to receive the death benefits, the court held that the decedent's ability to sell his seat was an incident of ownership.[60] Judge Learned Hand dissented on the ground that this right of sale was a relatively unimportant factor and should not have been deemed an incident of ownership.[61]

While the incident of ownership in *Treganowan* was somewhat attenuated, the decision could be justified on the basis that the decedent was in a position to enjoy the economic benefits of the policy. Contrasting the case with the corporate control situation, it is clearly distinguishable because, in the latter situation, the controlling shareholder's fiduciary duties prohibit him from enjoying any of the economic benefits of the policy.

The recent Tax Court decision in *Hector R. Skifter*[62] seems to confirm the foregoing analysis of *Karagheusian* and *Treganowan.* The insured assigned nine policies on his life to his wife more than three years prior to his death. She died first, however, and created a testamentary trust for

58. Commissioner v. Estate of Karagheusian, 233 F.2d 197, 200 (2d Cir. 1956).

59. 183 F.2d 288 (2d Cir. 1950), *cert. denied sub. nom.* Estate of Strauss v. Commissioner, 340 U.S. 853 (1950).

60. For a case of similar import, see Estate of William E. Edmonds, 16 T.C. 110 (1951). *See also* Prichard v. United States, 397 F.2d 60 (5th Cir. 1968), in which ownership of a policy by the insured's wife was held to be purely nominal.

61. Commissioner v. Treganowan, 183 F.2d 288, 293 (2d Cir. 1950), *cert. denied sub. nom.* Estate of Strauss v. Commissioner, 340 U.S. 853 (1950).

62. 56 T.C. No. 91 (Aug. 26, 1971).

their daughter, naming the insured as trustee with broad powers of acceleration on behalf of the daughter. When the insured died, the government sought to include the policy proceeds in his gross estate on the ground that his powers as trustee constituted incidents of ownership. The court refused to find that such fiduciary powers were incidents of ownership where the insured could derive none of the economic benefits of the policy personally. *Karagheusian* was distinguished on the ground that the powers retained there could have benefited the decedent.

A consideration of the foregoing authorities indicates that courts tend to view the "incidents of ownership" test in terms of an economic benefit doctrine.[63] If this concept prevails, then clearly the sole stockholder rule should not be extended to require full inclusion of the proceeds. When an insured owns 51 percent of a corporation's stock, there is no reason why any greater portion of the proceeds should be included in his gross estate. Consequently, the taxing of such proceeds should be left to section 2033 which requires an inclusion of the insured's stock, the valuation of which reflects the estate's share of the life insurance proceeds.

Moreover, the courts seem to be disinclined to impute "possession" of corporate incidents of ownership to the insured where his ownership rights are restricted.[64] In a corporate control case, apart from the sole stockholder situation, the insured's powers are not unbridled. He must exercise his powers for corporate purposes and cannot give preference to his individual benefit.[65] He occupies a fiduciary position with respect to minority shareholders,[66] and if he breaches it, he is exposed to the substantial risk of a corporate derivative suit,[67] or even of a direct action by the minority shareholders.[68] Normally the controlling shareholder

63. *See also* Estate of Fruehauf v. Commissioner, 427 F.2d 80 (6th Cir. 1970); Estate of Carlton v. Commissioner, 298 F.2d 415 (2d Cir. 1962); Edmund D. Mudge, 27 T.C. 188 (1956), *acquiesced in*, 1957-1 CUM. BULL. 4, 1957-2 CUM. BULL. 6, *withdrawn on other grounds*, 1964-1 CUM. BULL. (pt. I) 6; Estate of John C. Morrow, 19 T.C. 1068 (1953), *acquiesced in*, 1954-1 CUM. BULL. 5. In *Fruehauf*, the Sixth Circuit held that the insured's broad powers as co-trustee to manage trust-owned policies on the insured's life were sufficient to warrant inclusion under section 2042 because the insured could have used such powers to benefit himself personally. The court stated, however, that the mere holding of powers in a fiduciary capacity does not require inclusion if such powers are restricted.

64. See authorities cited and discussion at note 63 *supra*.

65. *See* Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), *cert. denied*, 316 U.S. 675 (1942); Wheeler v. Abilene Nat'l Bank Bldg. Co., 159 F. 391 (8th Cir. 1908); Berle, *"Control" in Corporate Law*, 58 COLUM. L. REV. 1212 (1958).

66. *See* Pepper v. Litton, 308 U.S. 295 (1939); Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939); Southern Pacific Co. v. Bogert, 250 U.S. 483 (1919); Note, *Fiduciary Duties of Majority or Controlling Shareholders*, 44 IOWA L. REV. 734 (1959).

67. *See* Goldstein v. Groesbeck, 142 F.2d 422 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148 (1919). *See generally* 13 W. FLETCHER, PRIVATE CORPORATIONS §§ 5939-5960 (perm. ed. rev. 1970).

68. *See* Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); Porter v. Healy, 244 Pa. 427, 91 A. 428 (1914).

will also be an officer or director of the corporation where his duties are perhaps even more sharply circumscribed.[69]

Also relevant are the cases which have refused to regard the decedent as possessing incidents of ownership of policies subject to contractual duties to others.[70] For example, in *First National Bank v. United States*[71] the Fifth Circuit found that the policy involved was subject to the provisions of a binding cross-purchase agreement between the stockholders. The effect of that agreement was to contractually eliminate the insured's right under the policy to change the beneficiary and all other incidents of ownership. Hence, no inclusion of the insurance under section 2042 was found to be warranted.[72] Cases such as these not only reinforce the economic benefit test, but also illustrate that policies held under a specific set of legal duties for one purpose are not to be included merely because the insured technically possessed powers which he might have exercised in violation of those duties.

Accordingly, it appears that even if the possession of incidents of ownership extends beyond the economic benefit concept, it still remains difficult to link the corporation's incidents to its controlling shareholder. The controlling shareholder has responsibilities both to the corporation and to the minority shareholders not unlike those of a trustee to the beneficiaries. While the basic purpose of most trusts is perhaps to enhance some individual's estate plan, the basic purpose of most corporations is to conduct a business. The controlling shareholder in making a decision with respect to the corporation's insurance policies must generally consider the effect of his decision on such factors as the corporation's competitive position, its relations with creditors, the morale of its employees, and the attitudes of its customers and suppliers. Thus the controlling shareholder's fiduciary obligations in the context of most business enterprises would seem quite analogous to the contractual duty cases.[73]

In this light, consideration should be given to the provision in the regulations that the phrase "incidents of ownership" is "not limited in its meaning to the ownership of the policy in the technical legal sense."[74]

69. *See, e.g.*, Bates v. Dresser, 251 U.S. 524 (1920); Bowerman v. Hamner, 250 U.S. 504 (1919); Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918); Union Ice Co. v. Hulton, 291 Pa. 416, 140 A. 514 (1928).

70. *See, e.g.*, First Nat'l Bank v. United States, 358 F.2d 625 (5th Cir. 1966); Estate of Sidney F. Bartlett, 54 T.C. 1590 (1970); Estate of Howard Infante, 29 CCH TAX. CT. MEM. 903 (1970); Estate of Bert L. Fuchs, 47 T.C. 199 (1966); Estate of Harry W. Hahn, Jr., 38 B.T.A. 3 (1938).

71. 358 F.2d 625 (5th Cir. 1966).

72. There are cases where inclusion has been held warranted because the estate failed to show that the decedent's incidents of ownership were in fact limited by such a contractual duty. *See, e.g.*, United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7 (1st Cir. 1966); Estate of Piggott v. Commissioner, 340 F.2d 829 (6th Cir. 1965); Hall v. Wheeler, 174 F. Supp. 418 (D. Me. 1959); Kearns v. United States, 399 F.2d 226 (Ct. Cl. 1968).

73. See cases cited in note 70 *supra*.

74. Treas. Reg. § 20.2042-1(c)(2) (1958). *See also* S. REP. No. 1631, 77th Cong., 2d Sess. 235 (1942).

Enough has been adduced to show that a controlled corporation's ownership is hardly a technical legal alternate. Sham corporations, nominee arrangements and revocable trusts are illustrations of what the regulations encompass. On the other hand, the existence of a bona fide corporation is not to be taken lightly in the context of an estate tax law which has scrupulously avoided the application of mechanical attribution rules to controlling shareholders.

CONCLUSION AND PLANNING CONSIDERATIONS

On the basis of the preceding analysis, the sole stockholder rule and the decision in *Cockrill v. O'Hara* should be narrowly interpreted.[75] Revenue Ruling 71-463[76] is, therefore, incorrect. At most, an extension should be warranted only if the interests of other shareholders could be dismissed as de minimis or if the other shareholders could be regarded as mere nominees. Indeed, wherever the potential danger of a stockholder derivative suit is real, the extension of the sole stockholder rule would appear to be erroneous, notwithstanding the issuance of Revenue Ruling 71-463.[77]

To summarize, there are several highly persuasive reasons for avoiding any material extension of the sole stockholder rule. In over 50 years of estate tax administration, there had been no case, regulation or ruling which attributed corporate ownership incidents to stockholders who had less than 100 percent ownership of a corporation. Further, attribution principles are not widely used in the estate tax area. Such rules should not be formulated without congressional sanction. If the Service's view were to prevail, corporate control of insurance on a decedent's life would be a basis for inclusion while family control of insurance would not be. Likewise, the absence of a basis for defining corporate control, the applicable percentage of ownership, and the necessity for a tax-avoidance motive are matters that should not be cavalierly resolved by administrative fiat.

Perhaps the most glaring oversight in the Service's position stems from the apparent assumption that corporate control is the legal equivalent of unfettered power. In fact, the controlling shareholder of a corporation, even if he is not a director or officer, occupies a position with respect to minority shareholders akin to that of a fiduciary. Such control cannot

75. Cockrill v. O'Hara, 302 F. Supp. 1365 (M.D. Tenn. 1969), discussed in the text accompanying note 13 *supra*.

76. 1971 INT. REV. BULL. No. 42, at 25. This ruling is described in the text accompanying note 18 *supra*.

77. *See also* I.R.C. § 1504(d), where the consolidated return privilege is extended to American corporations owning 100 percent of the stock of Canadian or Mexican corporations organized and maintained to meet local law requirements as to title and operation of property. The ownership, which may be "direct or indirect," must be 100 percent—"*exclusive of directors' qualifying shares*". (Emphasis added.)

be used to prefer his own testamentary plans at corporate expense. Normally the controlling shareholder tends to exercise his power as a director or officer. As such, his duties to all shareholders are even more pronounced.

Quite apart from these fiduciary duties, however, most close corporations are business entities. Accordingly, as a general matter the disposition and management of insurance policies is a matter of business judgment in terms of business operations. To contend as does Revenue Ruling 71-463 that the power to dissolve a corporation is the kind of power contemplated by section 2042 is to indulge in a simplistic and overreaching fiction. Similarly, the controlling shareholder's general management powers are ordinarily exercised in a business context. It is an erroneous premise to assume that the insured's personal testamentary considerations would control such decisions and it would be unfortunate if a rule of law were constructed on that premise.

An analysis of the cases dealing with the indirect possession of incidents of ownership shows that the courts have tended to stress the economic benefit concept and to recognize the import of fiduciary limits on an insured's powers. Thus, powers possessed or even retained in an investment or administrative capacity have generally not been regarded as incidents of ownership and ostensible powers subject to contractual duties to others have not generally warranted inclusion by the insured. Likewise, it would appear that the insured should not be obliged to include proceeds which do not redound to the benefit of his estate or beneficiaries. This seems justifiable since an inclusion is required under section 2033, which as a general matter adequately reflects the insured's interest in the proceeds by reference to his stock interest.

In light of these considerations substantial planning to avoid the impact of an extension of the sole stockholder rule is probably not warranted generally. Even in the clear sole stockholder situation, it will often be sufficiently comforting to realize that a double inclusion is not likely.[78] Where an extension of the sole-stockholder rule would significantly increase the estate tax burden, given due regard for the marital deduction,[79] there are, of course, various courses of action that might be taken. Possibly the insured's wife or children can be given 5 percent or 10 percent of the decedent's voting stock without incurring an inordinate gift tax, although this technique may not always be advisable.[80] Special considera-

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78. *See* Estate of John T.H. Mitchell, 37 B.T.A. 1 (1938), *acquiesced in*, 1939-1 CUM. BULL. 23. *See also* Estate of Edward Doerken, 46 B.T.A. 809 (1942) (parties agreed to principle), *acquiesced in*, 1942-1 CUM. BULL. 5; Estate of G.C. Ealy, 10 CCH TAX CT. MEM. 431 (1951).

79. Where as a result of any increased inclusions the marital deduction under section 2056 is proportionately increased, each extra dollar of inclusion will increase the taxable estate by only fifty cents.

80. For some purposes a gift program may be disadvantageous. For example, if a redemption is planned under section 303, it is important for the decedent's

tion should be given if the insured's health is poor and the gift is apt to be regarded as made in contemplation of death under section 2035.[81]

If the insured controls the corporation by virtue of a stock interest of 51 percent, or even of 79 percent, his best course may be to merely recognize that litigation may be likely if the Service persists in asserting the position adopted in Revenue Ruling 71-463. Ordinarily he will not want to relinquish his control—and the ruling does not appear to warrant his doing so. Moreover, there would not appear to be any meaningful distinction between these percentages.

If the insured's voting control is between 80 percent and 95 percent, his litigation risk may be heightened although the insured's estate should still have a strong chance to prevail. Despite the significant arguments opposed to inclusion in such circumstances, some courts may reach a different result in the face of this degree of control. Accordingly, in such circumstances it may be appropriate to attempt to minimize the risks. Besides gifts, the insured may wish to consider sales of stock by either himself or the corporation, or employee benefit plans that include acquisitions of the corporate stock. In many instances, however, this may risk the introduction of discordant elements which might undermine the harmony of a family enterprise.

Consideration might also be given to the possibility of fitting the corporate-owned insurance into the context of a stock redemption agreement. If there is more than one shareholder, this might entail securing an insurance policy on the life of each. In addition, provision is normally made under such an agreement for buying the stock of the deceased shareholder at his death, leaving the surviving shareholders with the entire remaining equity in the corporation. This kind of arrangement, therefore, may not always be in accord with the needs of either the corportion or the controlling stockholder.[82]

Another possibility would be to have the controlling shareholder waive his right to direct the management of the corporate-owned insurance, as either director, officer or shareholder. If this is done merely by a

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stock to equal in value more than 35 percent of his gross estate or more than 50 percent of his taxable estate. I.R.C. § 303(b)(2). Likewise, if the federal estate tax is to be paid in installments under I.R.C. § 6166(a), these percentages must also be obtained. If preferred stock subject to section 306 is involved, the gift may constitute a taxable disposition under section 306(a).

81. The prospect of such a result, even if likely, may not always be sufficient to negative such a gift plan. If a gift tax is paid with respect to stock included in the gross estate, a credit may be claimed for that tax subject to the limitations of section 2012. Moreover, the estate will also be reduced by the amount of money used to pay the tax or by the amount of gift tax liability owed to the government.

82. For a detailed discussion of buy-sell agreements in general, and stock redemption agreements in particular, see Kahn, *Mandatory Buy-Out Agreements For Stock of Closely Held Corporations*, 68 MICH. L. REV. 1 (1969). For an analysis of the consequences and ramifications of stock redemptions, see Howard, *Tax Aspects of Redemptions*, in 1 BUSINESS ACQUISITIONS: PLANNING & PRACTICE, c.19 (Pract. Law Inst. 1971).

director or shareholder resolution, presumably it would be revocable in the same manner and still subject to the controlling shareholder's control. Likewise, an amendment of the bylaws or charter may be subject to the same weakness if the controlling shareholder has sufficient power under state law to subsequently void such amendments. Furthermore, if the controlling shareholder can liquidate the corporation solely by virtue of his own stock interest, such a power alone would probably be sufficient to be subject to challenge by the Service.

Such a wavier might have better prospects if done for a consideration, such as the execution of a similar waiver by other shareholders upon whose lives the corporation also carries insurance. If the controlling shareholder cannot himself liquidate the corporation, this might be acceptable to the Service. One basic difficulty with any waiver agreement, however, is that it could unduly restrict corporate flexibility. For example, if the corporation needed to borrow on a policy with such an agreement in existence, the stubbornness or unavailability of insignificant stockholders could prove awkward.

There are perhaps some instances where the insurance policies might be usefully distributed as a dividend to the insured or sold for a fair consideration to the insured or his family.[83] This would, of course, frustrate the purpose of the key-man insurance, which is to help the corporation withstand the financial costs of losing its dominant spirit. But where, for example, the insured's sons seem able to assume the helm, key-man protection may become less critical. Once freed from corporate control, the insurance may be incorporated into any gift program the insured wishes to conduct. Insurance is often a desirable gift from the tax viewpoint because the replacement value subject to gift tax is often considerably less than the face amount of the policy which would otherwise be included in the insured's gross estate.[84]

In perspective, the Service's attempt to extend the sole stockholder rule should not be permitted to discourage the use of key-man insurance, nor should it induce hasty actions designed to circumvent its application. The products of such hasty designs might long outlive the ruling. It would seem prudent to await judicial reaction to the ruling before taking steps that might otherwise be undesirable.

A careful examination into the merits of the issue shows that the

83. If an insurance policy is sold directly to the insured's wife, for example, the insured's death could result in a substantial income tax to her under section 101(a)(2) as a transfer for value. Accordingly, it is often preferable to sell the policy to the insured whose purchase is protected by an exception to the transfer-for-value rules under section 101(a)(2)(B). If the insured later gives the policy to his wife, she will also be protected under section 101(a)(2)(A). Thus, the transfer would be accomplished with only a gift tax being incurred.

84. *See* Treas. Reg. § 25.2512-6 (1958), for the rules for valuing life insurance policies for gift tax purposes.

roots underlying the position of the Service are rather shallow. Indeed, the relevant terrain surrounding the problem inclines strongly to a limited role for the anomalous rule contained in the regulations, which deals only with the sole stockholder situations. Tax practitioners should not overlook Revenue Ruling 71-463, but neither should they drastically alter estate plans to circumvent a Service position which is so much at odds with relevant legal authority.