COMMENTS

FEDERAL ESTATE TAX: PREMIUM PAYMENTS MADE IN CONTEMPLATION OF DEATH. GORMAN v. UNITED STATES, AN ANGRY REBUTTAL TO REVENUE RULING 67-463.

The millions of dollars in proceeds which annually pass to estates and beneficiaries under life insurance policies on the life of the decedent, have long been considered a prime source for federal estate taxes. The nature of the life insurance contract, however, with its numerous ownership and dispositive options, has complicated and often frustrated effective assertion of the tax.

The continuing controversy attending the inclusion of policy proceeds in the decedent's gross estate was recently accentuated by *Gorman v. United States*.[1] Although the decision only encompasses a very limited problem, its ramifications are broad, especially for the estate planner. The problem encountered by the *Gorman* court was basically this: what portion of the proceeds of a life insurance policy in which the decedent had no incidents of ownership at death, yet continued to pay premiums until that time, are taxable to his estate? Certainly no less important than the resolution of this question was the *Gorman* court's feeling that Revenue Ruling 67-463[2] was a flagrant overassertion of authority by the Internal Revenue Service. The controversial ruling reads:

> A decedent, within three years of death and in contemplation of death, paid the premiums on a policy of insurance on his life. He had transferred the incidents of ownership in the policy to his wife more than three years prior to his death. *Held*, such payment was a transfer of an interest in the policy measured by the proportion the amount of premiums so paid bears to the total amount of premiums paid. Accordingly, the value of the proportionate part of the amount receivable as insurance that is attributable to those premiums paid by the decedent within three years of death is includable in his gross estate under section 2035 of the Internal Revenue Code of 1954. This conclusion is also applicable where the wife originally applied for the insurance.

Rejecting the Ruling's premise that premiums paid in contemplation of death are transmuted into proceeds on a pro rata basis, the *Gorman* court held that only the dollar amount of the premiums so paid by the insured non-owner are includable in his gross estate.

---

1 288 F. Supp. 225 (E.D. Mich. 1968).
2 1967 INT. REV. BULL. No. 52, at 15.

Before examining the *Gorman* rationale, an attempt will be made to place the problem in perspective by briefly surveying the development of two pertinent current Code sections; section 2042 (Proceeds of Life Insurance)[3] and section 2035 (Transactions in Contemplation of Death).[4] Some tangential considerations raised by the ruling and the *Gorman* holding also will be approached. Likewise, the community property aspect of the problem will be considered. One preliminary caveat is in order. It is not within the scope of this note to propose alternative estate plans in light of *Gorman* and the revenue ruling.

SECTION 2042: PROCEEDS OF LIFE INSURANCE

The current Code section applicable to the proceeds of life insurance,[5] although innocuous enough on its face, has had an amazingly tortuous history.[6] Although from 1918[7] to 1942 the wording of the provision remained unchanged (only the Code section designation changed),[8] there was little reprieve from the flow of contradictory Treasury regulations interpreting it. The origin of this confusion can be traced to the inconsistent application of two independent taxing standards, the "incidents of ownership" test and the "premium payment" test. From time to time the Service used one or the other of these tests, or both, to assure the includability of proceeds.[9] In looking to the courts for guidance through this regulatory maze, one only finds more confusion. It is clear, however, that an understanding and appreciation of the principles behind section 2042 is impossible without at least a perusal of some of the major decisions and developments throughout its history.

As noted, prior to 1942 the life insurance proceeds provision remained unchanged:

> [T]he 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—
>
> . . . .
>
> (f) To the extent of the amount receivable by the executor as

---

[3] INT. REV. CODE of 1954, § 2042.
[4] INT. REV. CODE of 1954, § 2035.
[5] INT. REV. CODE of 1954, § 2042.
[6] *See* A. CASNER, ESTATE PLANNING 322 (3d ed. 1961); 4 J. RABKIN & M. JOHNSON, 1968 FEDERAL INCOME, GIFT AND ESTATE TAXATION § 61.04; Kimbrell, *Planning Insurance Transactions to Avoid Transfers in Contemplation of Death*, 36 U.M.K.C. L. REV. 1 (1968); Oppenheimer, *Proceeds of Life Insurance Policies Under the Federal Estate Tax*, 43 HARV. L. REV. 724 (1930); Paul, *Life Insurance and the Federal Estate Tax*, 52 HARV. L. REV. 1037 (1939).
[7] Revenue Act of 1918, ch. 18, § 402(f), 40 Stat. 1057 [hereinafter cited as Revenue Act of 1918]. Prior acts merely exempted insurance proceeds from the income tax. *See* Revenue Act of 1916, ch. 463, § 4, 39 Stat. 756.
[8] Revenue Act of 1918; Revenue Act of 1921, ch. 136, § 402(f), 42 Stat. 227; Revenue Act of 1924, ch. 234, § 302(g), 43 Stat. 253; Revenue Act of 1926, ch. 27, § 302(g), 44 Stat. 9.
[9] *See* RABKIN & JOHNSON, *supra* note 6, at § 61.04(2).

> insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life.[10]

Under this section, the courts early developed a test which excluded the death proceeds from the gross estate where it could be shown at the time of death that the deceased had no "incidents of ownership" in the policy. If the test was applicable, there was no need to consider the $40,000 exemption, since the entire amount of the proceeds "receivable by all other beneficiaries" was then considered as not being within the scope of the provision.[11]

In *Lewellyn v. Frick*,[12] Mr. Justice Holmes, speaking for the Court, relied on what even then must have been a tired maxim when he quoted that " 'laws are not to be considered as applying to cases which arose before their passage.' "[13] The Court reasoned that since all of Mr. Frick's 11 policies were issued before the passage of the 1918 Revenue Act,[14] the proceeds were not includable in the computation of his estate tax.[15] On the facts recited in *Frick* it is possible to conclude that all the incidents of ownership in all the politices were divested before the passage of the 1918 Act, but a close reading of the lower court opinion[16] shows this was not the case. In effect, the Supreme Court skirted the "incidents of ownership" issue with the application of a simple rule of statutory construction. Although *Frick* only indirectly bore on the issue of "incidents of ownership,"[17] it was the precursor of the flood of litigation that would ensue.

In the landmark case, *Chase National Bank v. United States*,[18] the deceased procured three life policies naming his wife as beneficiary, but he reserved the right to change the beneficiary of each. The right was exercised on one of the policies,[19] and the deceased paid all the premiums up to his death. The Court noted that section 402(f) of the Revenue Act of 1921,[20] a predecessor of section 2042, imposed a tax on the *transfer* of a decedent's estate at his death.[21] Where, as in this case, "[u]ntil the moment of death the decedent retained a legal interest in the

---

10 Revenue Act of 1918.
11 *See* RABKIN & JOHNSON, *supra* note 6, at §§ 61.04, 61.04(2).
12 268 U.S. 238 (1925), *aff'g* 298 F. 803 (W.D. Pa. 1924).
13 268 U.S. at 252.
14 Revenue Act of 1918.
15 Later acts contained specific provisions giving retroactive effect to those subsections taxing insurance proceeds. *E.g.*, Revenue Act of 1924, ch. 234, § 302 (h), 43 Stat. 253.
16 Frick v. Lewellyn, 298 F. 803 (W.D. Pa. 1924).
17 For further development of the "incidents of ownership" retroactivity aspect of the problem see Bingham v. United States, 296 U.S. 211 (1935); Heiner v. Grandin, 44 F.2d 141 (3d Cir. 1930).
18 278 U.S. 327 (1929).
19 *Id.*, reporter's note at 333.
20 Revenue Act of 1921, ch. 136, § 402(f), 42 Stat. 227.
21 Chase Nat'l Bank v. United States, 278 U.S. 327, 334 (1929).

policies which gave him the power of disposition of them and their proceeds as completely as if he were himself the beneficiary of them."[22] The transfer did not occur until death, and therefore, was taxable. Not only did *Chase* firmly establish the constitutionality of the life insurance proceeds taxing provision,[23] but it also affirmed the "incidents of ownership" theory—that where the deceased does not retain any interest, power or right under the policy,[24] as where it has been assigned,[25] an inter vivos transfer of ownership has taken place, leaving nothing to be transferred and taxed at death.[26]

Frequently changing Treasury regulations interpreting the critical phrase "taken out by the decedent upon his own life"[27] reflected the seemingly unending confusion and controversy that attended the evolution of section 2042. The earliest regulations, adopting a premium payment test, ruled these words meant that for estate tax purposes, the decedent would be deemed to have taken out a policy to the extent that he or someone else other than a beneficiary paid the premiums.[28] A 1934 regulation[29] employed both the ownership and premium test in reaching insurance proceeds. Some courts, however, relying on the reasoning of *Walker v. United States*,[30] continued to exclude life insurance proceeds in a prorated amount to the extent the beneficiary had paid the premiums, even where the insured retained significant incidents of ownership.[31] The *Walker* court noted that other decisions intimated that the payment of premiums by the beneficiary had always been a controlling consideration for both Congress and the courts.[32] Further, to the extent that the 1934

---

[22] *Id.*

[23] The Court determined that the estate tax on insurance was not violative of art. I, §§ 2 & 9 of the Constitution as being a direct and unapportioned levy on property. Further, the method of fixing and securing the tax was determined not to be so arbitrary and capricious as to violate the fifth amendment.

[24] For a list of incidents of ownership that have been held taxable see RABKIN & JOHNSON, *supra* note 6, at § 61.05. A noninclusive list of the incidents of ownership under the 1954 Code can be found in Treas. Reg. § 20.2042-1(c), T.D. 6296, 1958-2 CUM. BULL. 432.

[25] Paul, *supra* note 6, at 1039 n.3.

[26] *See* Flick's Estate v. Commissioner, 166 F.2d 733 (5th Cir. 1948); Commissioner v. Sharp, 91 F.2d 804 (3d Cir. 1937); Pennsylvania Co. v. Commissioner, 79 F.2d 295 (3d Cir. 1935); Anna Rosenstock, 41 B.T.A. 635 (1940); Old Point Nat'l Bank, 39 B.T.A. 343 (1939); May Billings, 35 B.T.A. 1147 (1937); Edith Huggard Sharp, 33 B.T.A. 290 (1935); Parker v. Commissioner, 30 B.T.A. 342 (1934), *aff'd*, 84 F.2d 838 (8th Cir. 1936). *Cf.* Reinecke v. Northern Trust Co., 278 U.S. 339 (1929); Saltonstall v. Saltonstall, 276 U.S. 260 (1928). *See also* Levy's Estate v. Commissioner, 65 F.2d 412 (2d Cir. 1933); Louise C. Moore, 33 B.T.A. 108 (1935) H.T. Cook, 23 B.T.A. 335, *aff'd*, 66 F.2d 995 (3d Cir. 1933).

[27] Revenue Act of 1918.

[28] Fraenkel, *Federal Taxation of Life Insurance Policies*, 5 BROOKLYN L. REV. 140, 144-45 (1936).

[29] Treas Reg. 80 Arts. 25, 27 (1934).

[30] 83 F.2d 103 (8th Cir. 1936).

[31] Helvering v. Reybine, 83 F.2d 215 (2d Cir. 1936); Estate of John Gain, Sr. v. Commissioner, 43 B.T.A. 1133 (1941); Old Colony Trust Co. v. Commissioner, 39 B.T.A. 871 (1939). *Cf.* Nelson v. Commissioner, 101 F.2d 568 (8th Cir. 1939).

[32] 83 F.2d at 109, *citing* Chase Nat'l Bank v. United States, 278 U.S. 327 (1929).

regulations incorporating the "incidents of ownership" test conflicted with the long-standing premium payment test, the ownership test would fall, since Congress impliedly sanctioned the premium test by reenacting the life insurance section without change while it remained in the regulations.[33]

The Revenue Act of 1942[34] brought substantial change to the life insurance section. Not only did the new Act dispense with the $40,000 exemption for proceeds payable to named beneficiaries, but the proceeds of a life insurance policy could be included in the estate if (1) the proceeds were payable to the deceased's representative,[35] (2) the deceased had retained any of the incidents of ownership during his life,[36] or (3) the insured paid the premiums either directly or indirectly.[37] The life insurance contract was thus accorded the harshest treatment in the history of estate tax. For example, in 1945 a taxpayer made a down payment on an automobile and paid the first premium of an insurance policy on his own life. If that taxpayer irrevocably transferred both of these items to his son in 1946, but continued to pay the installment payments and premiums until his death in 1950, the proceeds of the policy but not the value of the automobile would be included in the deceased's gross estate. Such discriminatory treatment of life insurance was recognized by Congress[38] and resulted in the elimination of the premium payment test from the 1954 Code.[39]

SECTION 2035: TRANSACTIONS IN CONTEMPLATION OF DEATH

The development of current Code section 2035 is similarly fraught with many illogical pitfalls such that, even to the present, any attempted generalization of the meaning of "in contemplation of death" would be useless. A detailed examination of section 2035's progress is not within

---

[33] In 1937, the incidents of ownership standard was clearly the only test retained by the Treasury. Treas. Reg. 80 Art. 25, T.D. 4729, 1937-1 CUM. BULL. 284. In 1941, there was a reversion to the premium payment test. T.D. 5032, 1941-1 CUM. BULL. 427.

[34] Revenue Act of 1942, ch. 619, § 404, 56 Stat. 798.

[35] RABKIN & JOHNSON, *supra* note 6, at § 61.04(1); *see* CASNER, *supra* note 6, at 322.

[36] *E.g.*, Chase Nat'l Bank v. United States, 278 U.S. 327 (1929).

[37] RABKIN & JOHNSON, *supra* note 6, at § 61.04(1),(2).

[38] *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 316-17 (1954).

[39] INT. REV. CODE of 1954 § 2042 reads in part:

> 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 the 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 . . . .

the scope of this note, but a brief survey of past developments and decisions will hopefully illuminate what the position of the Service is today.

The 1916 Code contained a provision which created a rebuttable presumption that any property transferred by the decedent two years prior to his death was made in contemplation of death and was therefore taxable.[40] Each subsequent revision of the Code has had a comparable but not identical provision. For instance, in 1926 the rebuttable presumption was made conclusive,[41] but the Supreme Court in *Heiner v. Donnan*[42] held such a provision unconstitutional. The impossibility of showing a life motive for making an inter vivos transfer of property within two years of the donor's death was found so arbitrary and unreasonable as to be violative of the due process clause of the 5th amendment.[43]

The significance of having an opportunity to prove a life motive in the presumptive statutory period is well illustrated by *United States v. Wells*,[44] the major case dealing with the term "in contemplation of death." There, the donor's inter vivos scheme of disbursing large portions of his fortune to his children to ascertain their ability to manage funds was continued up until his death. In order to determine whether these advancements made within the two years preceding death were made "in contemplation of death," the Court generalized:

> There is no escape from the necessity of carefully scrutinizing the circumstances of each case to detect the *dominant* motive of the donor in the light of his bodily and mental condition, and thus give effect to the manifest purpose of the statute.[45] (emphasis added).

More specifically, the Court noted that the term "in contemplation of death" did not necessarily mean in "contemplation of *imminent* death."[46] Further, the motive for distribution had to be of a nature which would lead to testamentary acts.[47] Despite the donor's failing health, evidence indicated he had confidence in his recovery and the Court found the

---

[40] Revenue Act of 1916, ch. 463, § 202(b), 39 Stat. 756. *See* Pavenstedt, *Taxation of Transfers in Contemplation of Death: A Proposal for Abolition*, 54 YALE L.J. 70 (1944).

[41] Revenue Act of 1926, ch. 27, § 302(c), 44 Stat. 9 read in part:

> Where within two years prior to his death but after the enactment of this Act and without such a consideration the decedent has made a transfer or transfers, by trust or otherwise, of any of his property, or an interest therein, not admitted or shown to have been made in contemplation of or intended to take effect in possession or enjoyment at or after his death, and the value or aggregate value, at the time of such death, of the property or interest so transferred to any one person is in excess of $5,000, then, to the extent of such excess, such transfer or transfers shall be deemed and held to have been made in contemplation of death within the meaning of the title . . . .

[42] 285 U.S. 312 (1932).

[43] *Cf.* Schlesinger v. Wisconsin, 270 U.S. 230 (1926). The rebuttable presumption was, however, reinstated in later Revenue Acts.

[44] 283 U.S. 102 (1931).

[45] *Id.* at 119.

[46] *Id.* at 117.

[47] *Id.*

dominant or compelling motive of the giving to be a continuation of the lifelong practice of testing his children's managerial abilities.

To conclude that *Wells* ended the difficulties attending interpretation of the phrase "in contemplation of death" and automatically resulted in a tremendous advantage to the taxpayer, is to seriously underestimate the resourcefulness of the Internal Revenue Service. It followed from *Wells* that as long as the dominant motive of the donor was a living one, then even if one of the purposes of the inter vivos transfer was to evade the estate tax, the property so transferred was not taxable. The Treasury retaliated with an amendment to the regulations which considerably frustrated the advantages of *Wells*. It read in part:

> A transfer in contemplation of death is a disposition of property prompted by the thought of death (though it need not be solely so prompted). A transfer is prompted by the thought of death if it is made with the purpose of avoiding the tax, or as a substitute for a testamentary disposition of the property, or for any other motive associated with death . . . .[48]

This change in the regulations has been severely criticized as being completely unjustified in view of the *Wells* "dominant motive" reasoning,[49] yet the regulation remains almost unchanged today.[50] Nevertheless, the Supreme Court has recognized that only where the tax saving motive is the dominant factor influencing the transfer, will the tax automatically attach. Thus, in situations where motives are mixed, *Wells'* reasoning is still valid.[51]

REVENUE RULING 67-463

Independent application of either section 2042 or section 2035 to a factual situation where the deceased non-owner paid premiums in contemplation of death, produces inconclusive results as to the taxability of the policy proceeds. Section 2042, as indicated, no longer contains a premium payment test, and section 2035 is, at first glance, inapplicable because the policy was either never owned by the deceased or his ownership was transferred inter vivos before the presumptive period. The regulations do provide for the case where the deceased transferred all

---

[48] T.D. 4966, 1940 CUM. BULL. 220, *amending* Treas. Reg. 80, Art. 16.

[49] Pavenstedt, *supra* note 40, at 74.

[50] Treas. Reg. § 20-2035-1(c), T.D. 6296, 1958-2 CUM. BULL. 432 reads in part: A transfer 'in contemplation of death' is a disposition of property prompted by the thought of death (although it need not be solely so prompted). A transfer is prompted by the thought of death if (1) made with a purpose of avoiding death taxes, (2) made as a substitute for a testamentary disposition of the property, or (3) made for any other motive associated with death . . . .

[51] Allen v. Trust Co., 326 U.S. 630 (1946); *see* RABKIN & JOHNSON, *supra* note 6, at § 52.03(6).

In 1950 the presumptive period was increased to three years (Revenue Act of 1950, ch. 994, § 501, 64 Stat. 906) and remains three years to date.

rights in the policy in contemplation of death,[52] but this is substantively different from the case where only the premiums are paid by the non-owner in contemplation of death.

Understandably, the Internal Revenue Service could not indefinitely tolerate the excludability of all death proceeds in the case where a non-owner paid premiums in contemplation of death without making some attempt to attach at least a part of them. The case of *Lamade v. Brownell*[53] must have appeared foreboding to the Service. The *Lamade* court was largely concerned with whether the deceased husband had retained any incidents of ownership in a policy that had been reissued and assigned long before his death. Once it was established that no meaningful ownership rights were retained, the premiums paid in contemplation of death by the deceased were deemed to have been made by way of a gift, and no part of the proceeds entered his gross estate.[54]

Arguably, some kind of transfer does occur when a non-owner pays premiums in contemplation of death. The character and effect of such a transfer was the subject of *Revenue Ruling* 67-463.[55] Although the reaction to the ruling has been generally critical,[56] its application was not tested in the courts until *Gorman v. United States.*[57]

THE RATIONALE OF GORMAN V. UNITED STATES

Judge Kaess, in *Gorman*, did not hesitate to mount a vigorous and lucid attack against *Revenue Ruling* 67-463. The deceased had taken out a $50,000 five-year term life policy naming his wife *owner* and *beneficiary*.[58] For lack of evidence to the contrary, it was assumed that the deceased paid the $403.00 first-year premium.[59] Approximately 9 months after issuance, the insured died. The Commissioner, relying on

---

[52] Treas. Reg. § 20.2042-1(a)(2), T.D. 6296, 1958-2 CUM. BULL. 432 reads in part:

> Proceeds of life insurance which are not includible in the gross estate under section 2042 may, depending upon the facts of the particular case, be includible under some other section . . . . For example, if the decedent possessed incidents of ownership in an insurance policy on his life but gratuitously transferred all rights in the policy in contemplation of death, the proceeds would be includible under section 2035 . . . .

[53] 245 F. Supp. 691 (M.D. Pa. 1965).

[54] *Id.* at 697.

[55] 1967 INT. REV. BULL. No. 52, at 15.

[56] *See* Kimbrell, *Planning Insurance Transactions to Avoid Transfers in Contemplation of Death*, 36 U.M.K.C.L. REV. 1 (1968), (especially n.60 at 24); 46 N.C.L. REV. 989 (1968); 3 U. SAN FRAN. L. REV. 116 (1968). *But see* 14 N.Y.L.F. 198 (1968).

[57] 288 F. Supp. 225 (E.D. Mich. 1968).

[58] An identical policy designating the deceased's business as life owner was previously issued. The tax consequences of that policy and its proceeds were not mentioned in the case.

[59] The stipulation of facts contained no designation or agreement as to who paid the premium in question. For the purpose of considering the plaintiff-executrix's motion for summary judgment, the court presumed it was paid by the deceased. 288 F. Supp. at 226, 236.

the ruling, included the entire amount of the death proceeds in the taxable estate since the proportional amount of the premiums the deceased paid was 100% of the total amount of the premiums paid.

The *Gorman* court first assailed the attempt to tax the entire $50,000 proceeds on the basis of premiums paid by the decedent in contemplation of death as a back-door attempt to reintroduce the premium payment test. After discussing the legislative history of § 2042 and § 2035, the court in no uncertain terms concluded:

> Payment of premium test being specifically deleted may not be incorporated through administrative tactics. This court will not legislate, nor shall the Service, in an area specifically reserved to Congress. The fact that a tax break in estate planning may arise from the deletion of the premium payment test is no reason to argue that the benefit should not inure to the taxpayer.[60]

After methodically denying the applicability of the *Revenue Ruling* by distinguishing its precedent with the facts at hand, the court examined various property transfer theories and the nature of the insurance contract to conclude that only the dollar amount of the premiums was to be taxed as the quantum transferred in contemplation of death.

To buttress the ruling's position that "a premium payment is a gift of insurance protection, a transfer in the interest in the policy which is transmuted at death into the proceeds of the policy,"[61] the Service advanced several authorities.[62] The *Gorman* court, like several critics of the ruling in the past,[63] encountered little difficulty in distinguishing these cases on their facts from the *Gorman* situation. One warning should be proffered at this point. With the almost infinite variety of ownership possibilities and benefits a life insurance policy offers, distinguishing cases on the facts is a relatively easy task. It is not enough, however, to rely on factual peculiarities without relating them to a conceptual scheme which embodies all facets of the insurance contract, *i.e.*, the transfer of ownership, the relation of premiums paid to ownership, and ownership itself. Further, the scheme must have some relevance to the actualities of human conduct and motive. It was to such a theory the *Revenue Ruling* and supporting authority were directed and to which the *Gorman* court so adroitly countered.

The Service relied heavily on *Chase National Bank v. United States*[64] for the proposition that the premiums paid by a deceased in contemplation of death result in a prorated amount of the proceeds being included in his taxable estate. More particularly, the Service, by quoting

---

60 288 F. Supp. at 230.
61 1967 INT. REV. BULL. No. 52, at 16.
62 *Id.* at 16-17.
63 46 N.C.L. REV. 989 (1968); 3 U. SAN FRAN. L. REV. 116 (1968).
64 278 U.S. 327 (1929).

a portion of *Chase*,[65] inferentially argued as follows: The Supreme Court in *Chase* liberally construed the word "transfer" in the predecessor of section 2035. A premium payment by a non-owner is, in effect, an indirect transfer of property made with testamentary motives and comes within section 2035's meaning of "transfer." The payment of premiums, then, effectuates a transfer of policy proceeds.

Chase, as we have noted, was concerned with "incidents of ownership," the specific question being whether the deceased, by reserving the right to change a beneficiary, retained any incidents of ownership in the policy. The payment of premiums by the deceased could not, by any reasonable analysis, be considered an operative fact in that case. As the court in *Gorman* noted, "the court never considered the relationship of premiums with proceeds."[66]

The case of *Lehman v. Commissioner*[67] was likewise advanced as authority for the ruling's position. It is very difficult to ascertain how this case in any way relates to the facts in Gorman. In *Lehman* two brothers executed reciprocal or "crossed" trust agreements which, in effect, gave one brother's property to the other and that other's heirs and vice versa. Again, for estate tax purposes there was a question of ownership. The court determined that to the extent each brother could invade the corpus of the trust created in his favor, he would be deemed owner and estate tax liability would attach proportionately upon his death. The reciprocity supplied the consideration which made each brother the donor of the trust created in his favor.[68] There was no question of a transfer made in contemplation of death and the pro rata formula used in *Lehman* was directly related to the amount of the corpus the donor could reach, obviously a different situation than the premium-proceeds relationship of an insurance contract.

Liebmann v. Hassett,[69] a 1945 case from the First Circuit, is perhaps the most germaine and persuasive authority advanced in support of the ruling.[70] There a husband assigned a policy to his wife within the 2 year "in contemplation of death" period then applicable, but the wife paid two premiums before the donor-husband's death. The main question presented was how and when, for estate tax purposes, was the policy to be valuated. Rejecting the theory that the cash surrender value on the date of assignment should be the measure, the court determined the decedent's property interest in the policy was to be ascertained as of the

---

[65] 1967 INT. REV. BULL. No. 52, at 16.
[66] 288 F. Supp. at 229.
[67] 109 F.2d 99 (2d Cir. 1940).
[68] *Id.* at 100.
[69] 148 F.2d 247 (1st Cir. 1945).
[70] Scott v. Commissioner, 374 F.2d 154 (9th Cir. 1967) was also advanced in support of the ruling, but discussion of it will be deferred until the community property aspect of the problem is discussed.

date of his death,[71] thus making taxable the entire maturity value of the policy. But the court, reasoning further, determined that the proportion of the insurance purchased by the last 2 premiums paid by the wife should be excluded from the gross estate.[72]

Should not the reverse be true then? That is, should not the payment of premiums by the donor in the presumptive period produce tax liability in the proportion those premiums bear to the total proceeds? The argument is not without logical appeal in view of *Liebmann*. One overriding consideration, however, cannot be ignored. The *Liebmann* case was decided under the Revenue Act of 1926 and at a time when a premium payment analysis had some relevance.[73] It will be recalled that the words "taken out by the decedent" were the touchstone of the premium payment test controversy. The *Liebmann* court very logically reasoned that no more could be assessed to the decedent's taxable estate than what he had "taken out" by way of premium payments. It is particularly significant that the words "taken out," etc., have long been eradicated from the Code and Congress has evidenced an intent to do away with the premium test altogether.

Having indirectly attacked *Revenue Ruling* 67-463 in the foregoing manner, the *Gorman* court was not hesitant in rejecting it completely. One final problem remained: What specifically is transferred when one who has no incidents of ownership pays premiums in contemplation of death? Here, the *Gorman* court advanced its logical and, for the taxpaying estate, most attractive solution to the problem.

Starting with the proposition that section 2035 basically involves *transfers* of property, an incontrovertible tenet since *Chase*, and applying various transfer theories[74] to the premium transaction, the court concluded that only the dollar amount of the premiums was transferred in contemplation of death and includable in the gross estate. By eliminating inapplicable theories, the premium payment transaction was finally placed in a traditional, well-defined "transfer" category and taxed accordingly. For instance, it is clear that a premium payment by a non-owner is not a revocable transfer. The donor cannot at his option redeem the premium during his life. The premiums, then, cannot conceivably be taxed as a revocable transfer, a category provided for by section 2038 of the Code.[75]

---

[71] 148 F.2d at 251.

[72] *Id.*

[73] *See* Revenue Act of 1926, ch. 27, § 302(g), 44 Stat. 9; T.D. 5032, 1941 CUM. BULL. 427.

[74] The court applied three legal theories of transfer discussed by Pavenstedt. The three theories are (1) the specific asset theory (2) revocable transfer theory, and (3) trust theory. 288 F. Supp. at 231 n.16.

[75] INT. REV. CODE of 1954, § 2038(a)(1), T.D. 6296, 1958-2 CUM. BULL. 432 reads:

> 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

Nor can such premiums be taxed, as assets transferred to a trust in contemplation of death. The essentials of a trust and an insurance contract are significantly different. In the case of a trust, the specific assets transferred are viewed only in terms of the trust corpus. That is, the resultant corpus, not the specific assets, is the taxable entity.[76] If a trust analogy could be applied to the insurance contract, the pro rata premiums to proceeds scheme would be the result. The crux of the *Gorman* court's overruling of *Revenue Ruling* 67-463, which is based on this transmutation principle, is illustrated in its denial of this analogy.

> On the contrary, the proceeds result from the nature of the contractual arrangement the owner of the policy has with the insurance company. This contractual right or any portion thereof is not being transferred when a premium is paid. . . . [T]he right to pay the premiums generally belongs to the owner of the policy. Thus, payment of the premium by another merely benefits the owners to the extent of the amount of the premium. The right to be able to pay premiums and by doing so also receiving the proceeds existed prior to a premium payment made on a policy which is at least three years old.[77]

One cannot help but admire the dexterity with which the *Gorman* court hurdled this critical roadblock. The nature of the insurance contract, then, is the key to the death of the pro rata scheme and *Revenue Ruling* 67-463. This reasoning warrants at least a brief analysis.

If *A*, an owner and beneficiary of a policy which insures the life of *B* had to borrow cash from *C* to pay a premium, *A* would still be entitled to all the proceeds on the death of *B*. Providing *C* had not insisted on a pro rata share in consideration of the loan, *C* would at most be entitled to a dollar amount of the premium money loaned plus interest from *A*. In no way would *C*'s act of lending transmute itself into ownership shares in the policy. Likewise, if *A* was given cash to pay the premiums by *C*, *A* would be entitled to all the proceeds. Similarly, if *B*, the insured non-owner paid the premium for *A*, his payment would in no way be transmuted into proceeds. As the *Gorman* court noted:

> Generally, the policy owner is not under a legal obligation to pay the premiums on the life insurance policy. The company, however, is bound to provide the insurance protection subject to the terms of the policy if the premiums are in fact paid and even if not paid may under certain circumstances be obligated to provide certain insurance benefits to the owner.[78]

---

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, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person . . . to alter, amend, revoke or terminate or where any such power is, relinquished in contemplation of decedent's death.

[76] 288 F. Supp. at 231.

[77] *Id.* at 233.

[78] *Id.* at 232.

It might be profitable at this point to take a closer look at the court's denial of the trust—insurance contract analogy. Aside from *Revenue Ruling* 67-463, this analogy has the most potential for reaching insurance proceeds. It is, after all, related to yet independent of the traditional premium payment test. Application of either would lead to the same result—including the proceeds in the gross estate on a prorated basis.

The *Gorman* court did not view a trust agreement as analogous to an insurance contract because "the 'appreciation' [to proceeds] of the premium payment does not result from the payment itself,"[79] but from the nature of the insurance contract which imposes an obligation on the insurer to pay a specified amount upon a given event. Presumably in a trust, the res is the accumulation of the transfers of specific assets, although not viewed so for taxation purposes.[80] This fine distinction, although deemed sufficient by the *Gorman* court, might not be recognized by the Service which could rely on such an analogy to tax proceeds, especially if *Revenue Ruling* 67-463 receives *Gorman*-like treatment from other courts. Congressional intent,[81] however, manifested by the exclusion of the premium payment test in the 1954 Code, argues against any attempted pro rata scheme to include proceeds.

Not surprisingly, the *Gorman* court determined that what was transferred in contemplation of death was the specific asset—the dollar amount of the premium. It is apparent that under this holding the menacing phrase "in contemplation of death" need no longer fatally obstruct a premium payment transaction.

Two sources of authority indirectly support the *Gorman* court's conclusion that only the dollar amount of the premiums paid in contemplation of death is includable in the deceased non-owner's gross taxable estate. The regulations themselves, as the court noted,[82] suggest such a tax treatment of premiums. The Internal Revenue Service in *Revenue Ruling* 67-463 ignored the one applicable gift tax regulation. It reads:

> If the insured purchases a life insurance policy, or pays a premium on a previously issued policy, the proceeds of which are payable to a beneficiary or beneficiaries other than his estate, and with respect to which the insured retains no reversionary interest in himself or his estate and no power to revest the economic benefits in himself or his estate or to change the beneficiaries or their proportionate benefits (or if the insured relinquishes by assignment, by designation of a new beneficiary or otherwise, every such power that was retained in a previously issued policy), *the insured has made a gift of the value of the policy, or to the extent of the premium paid,* even though the right of the assignee or beneficiary to receive the

[79] *Id.* at 233.
[80] *Id.* at 231.
[81] Note 38 *supra.*
[82] 288 F. Supp. at 232.

benefits is conditioned upon his surviving the insured . . . .[83] (emphasis added).

It cannot be denied that this gift tax regulation is mute on the subject of transfers made in contemplation of death, but the fact remains that there is an unequivocal announcement that premium payments by a non-owner are to be treated as a gift—the dollar amount of the premiums being the taxable entity. When the Service reintroduced the long-buried premium-to-proceeds plan, it understandably chose not to recognize this regulation.

In *Lamade v. Brownell*,[84] the court without stating its reasons held premiums so paid to be a gift. In *Gorman* the court was more graphic in arguing for gift tax treatment.

> If premiums are paid by another in absence of any agreement, the payor is a mere donor and obtains no rights in or to the contract, its value or its proceeds and it is presumed that such payments are made on behalf of the owner. As a purely economic matter, these conclusions seem quite logical. In addition the gift tax regulations support the conclusion that this type of analysis should be applied for Federal tax purposes . . . .[85]

Certainly this approach has the advantages of tying most of the elements into a neat package. The insurance contract, its ownership, transfer and valuation can all be satisfactorily accounted for. The gift tax regulation negates any notion that a premium payment is transmuted into ownership shares of proceeds. Why should a payment made in the presumptive period warrant different treatment? The *Gorman* court did not think it should and alternatively held that the premium paid in contemplation of death was a gift which gave the decedent no interest in the policy other than the payment of that premium.[86] Except for the fact that the transfer was made in contemplation of death, the picture would be complete.

A tangential area of estate tax law lends support to a method of taxing premium payments which is not based on a pro rata premium-to-proceeds relationship. Section 2036 of the Code, another "transfer" section, includes in the decedent's gross estate those inter vivos transfers in which he retained a life estate or interest.[87] In *Goodnow v. United*

---

[83] Treas. Reg. § 25.2511-1 (h)(8), T.D. 6542, 26 C.F.R. 231 (Supp. 1967). Section 25.2512-6, T.D. 6542, 1961-1 CUM. BULL. 2 further explains how such policies are to be valued for gift tax purposes.

[84] 245 F Supp. 691, 697 (M.D. Pa. 1965).

[85] 288 F. Supp. at 232.

[86] *Id.* at 234.

[87] INT. REV. CODE of 1954, § 2036 reads in part:

> 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 for any period not ascertainable without reference to his death or for any period which does not in

States,[88] a case decided under this section, the Court of Claims determined that where a wife paid all the premiums of policies included in an insurance trust from which she would receive life income after her settlor-husband's death, there was no section 2036 transfer to the wife. Upon her death, the corpus of the trust was not includable in her gross estate. The court, although indicating that the premiums so paid could be said to have been transferred, completely negated the theory that the wife, by paying premiums, became the settlor of the trust, and, in effect the donor of the trust assets (policy proceeds).[89] As can readily be seen, the precise issue concerning what is transferred when a non-owner pays premiums is crystalized and resolved in a slightly different context. As noted before, the taxable entity consists of the trust res, not its individual assets. Where as in *Goodnow*, the husband established the res by placing the policies in an unfunded trust, it is he who is to be considered the settlor. The court noted that "speaking in terms of 'creating' the trust per se, tends to obscure the real issue and does not lead to its resolution."[90] In discussing the central issue, the court found that Mrs. Goodnow did not retain a life interest in the premiums paid, thus precluding the existence of a section 2036 transfer. *Goodnow*, which does not stand alone in proposing a lack of any pro rata relationship between premiums and proceeds,[91] is certainly valuable authority in support of the *Gorman* reasoning.

Before analyzing the ramifications of *Revenue Ruling* 67-463 in Arizona, mention should be made of several additional features of the *Gorman* case. When the policy in question was purchased, the deceased was 38 years old and, according to the medical history appended

---

fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(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.

88 302 F.2d 516 (Ct. Cl. 1962).

89 *Id.* at 520.

90 *Id.*

91 *Accord*, Nat'l City Bank v. United States, 371 F.2d 13 (6th Cir. 1966); *see* Estate of Pyle v. Commissioner, 313 F.2d 328 (3d Cir. 1963).

Savage v. United States, 220 F. Supp. 745 (E.D.N.Y. 1963), presents a very interesting combination of all theories heretofore mentioned. The deceased wife had been the owner of a life policy insuring the husband. During her life she paid the premiums and was to receive a life income from the policy after her husband's death. Upon her death the principle was included in her gross estate. The court held that under the predecessor of § 2036.

[t]he 'proceeds' were the performance of a purely contractual promise to pay upon the death of the insured; the promise, made for a certainly adequate consideration, was aleatory and not the direct exchange equivalent of the premium payments in the same sense that goods bought are the barter equivalents of the price paid for them. 220 F. Supp. at 748.

Nevertheless, the wife was deemed the owner of the policy with sufficient interest to warrant the finding of a 2036 transfer. The basis of the holding was that the wife did procure the policy. The court also noted the difference between insurance and entrusted funds.

A limited but good discussion of the *Goodnow* and *Nat'l City Bank* cases can be found in 3 U. SAN FRAN. L. REV. 116 (1968).

to the policy application,[92] in good health. The circumstances indicate a potential for asserting a dominant living motive. If an entire policy can be said to have been transferred in the presumptive period with a living motive, premiums should be similarly treated.[93] In fact, this would appear to be the most formidable weapon in the taxpayer's meager arsenal for contesting the estate tax in such cases. There is, after all, the possibility that none of the proceeds would be included if the statutory presumption could be overcome. In *Gorman*, for reasons unexplained, the plaintiff-executrix did not sustain the burden of showing that the single premium paid by the decedent was not transferred in contemplation of death.[94]

It can be assumed that in *Gorman* when the decedent purchased the policy and designated his wife as beneficiary and owner, there was no transfer of any kind. That is, the insured did not obtain any incidents of ownership in the policy which he could have later transferred. The *Revenue Ruling* specifically mentions a transfer in ownership before the presumptive period. Whether this distinction adds to the weakness of the Commissioner's position in *Gorman* is not discussed by the court, but it is submitted that a premium paid, as in the *Gorman* situation, is more easily viewed as a gift which results in no pro rata inclusion of proceeds than where the policy was originally owned and then transferred. In the latter case the continued payment of premiums is tainted with the prior ownership, whereas, in a case such as *Gorman*, this problem does not exist.

It could be asserted that since a life policy would lapse if the premiums are not paid, each premium, in effect, keeps the policy alive. It follows that the last payment before the insured's death is the most critical one. On this basis the Internal Revenue could have ruled that since the deceased non-owner had paid the last premium, all the proceeds were taxable as being attributable to that final payment. At least one commentator has called this the harshest possible route the Service could have taken.[95] In addition, it may be possible that such an approach would present too many problems to be effective. If the donor paid two premiums within the current presumptive period and knew his health was failing rapidly, he could easily prevail upon the transferee to pay the last premium, thereby avoiding all tax on the policy. Whether this approach was too radical (basically, it amounts to an all-or-nothing premium payment test) or potentially inefficient, the Service chose not to utilize it.

---

[92] 288 F. Supp. at 243-44.

[93] For a recent discussion of how a living motive may be established and asserted see Kimbrell, *Planning Insurance Transactions to Avoid Transfers in Contemplation of Death*, 36 U.M.K.C.L. REV. 1 (1968).

[94] 288 F. Supp. at 234.

[95] 3 SAN FRAN. L. REV. 116, 117 (1968).

PAYMENTS OF PREMIUMS IN ARIZONA

It is somewhat distressing to think that the problem already discussed can become even more complicated, yet this appears to be the case in a community property state such as Arizona. The only consolation that can ben given to the practitioner who must grapple with the perplexing conglomeration of state and federal legislation and case law is to point out that an understanding of the situation may afford a client a substantial tax saving. Further, the prevalance of insurance coverage is not likely to be reduced because of community property law.

It should be clearly established at the outset that there are two distinct estate tax liabilities on an Arizona decedent's estate. There is the Arizona estate tax[96] and its federal counterpart. A certain amount of interrelation exists between the two as evidenced by the credit provisions of the respective statutes,[97] but the two levies are by no means identical. The following discussion will be directed at continuing the exploration of the federal tax ramifications of the payment of premiums, especially those made in contemplation of death.

The Federal regulations make specific reference to the role of state law in determining ownership of a policy for estate tax purposes:

> As an additional step in determining whether or not a decedent possessed any incidents of ownership in a policy or any part of a policy, regard must be given to the effect of the state or other applicable law upon the terms of the policy . . . .[98]

Another provision makes reference to the community property situation where a policy is procured with community funds.[99] Under these regulations, some kind of premium payment analysis will be required to determine what portion of the policy was paid for by community and non-community funds. Despite the very strong arguments for abolishing the premium-pro rata approach in non-community jurisdictions, local property law demands such an approach in community property states.[100] This was recognized by the Supreme Court even before the regulations contained an applicable provision. In *Lang v. Commissioner*,[101] a case

---

[96] ARIZ. REV. STAT. ANN. § 42-1501 (1956).

[97] The federal and Arizona credit provisions are found at INT. REV. CODE of 1954, § 2011 and ARIZ. REV. STAT. ANN. § 42-1514, (1956), respectively.

[98] Treas. Reg. § 20.2042-1(c)(5), T.D. 6296, 1958-2 CUM. BULL. 432.

[99] Treas. Reg. § 20.2042-1(b)(2), T.D. 6296, 1958-2 CUM. BULL. 432:

> If the proceeds of an insurance policy made payable to the decedent's estate are community assets under the local community property law and, as a result, one-half of the proceeds belongs to the decedent's spouse, then only one-half of the proceeds is considered to be receivable by or for the benefit of the decedent's estate.

[100] The definitive commentary on this subject appears to be Thurman, *Federal Estate and Gift Taxation of Community Property Life Insurance*, 9 STAN. L. REV. 239 (1957). The article makes special reference to California community property law. A general treatment of Arizona community property and insurance proceeds can be found in Thurman, *Federal Estate and Gift Taxation of Community Property*, 1 ARIZ. L. REV. 253 (1959).

[101] 304 U.S. 264 (1938).

decided under Washington community property law, the Court found that only one half of the proceeds of certain policies which insured the husband's life and were paid for exclusively from community funds were includable in his gross estate. As to the policies taken out before the marriage and paid for partially with separate funds of the husband, the total proceeds less "one-half of that portion of such total which premiums satisfied with community funds bear to all premiums paid . . .,"[102] was to be included in the gross estate. To deny some kind of pro rata analysis in these cases would be to ignore the very foundation of community ownership rights in such states.[103]

A survey of Arizona law indicates there are at least three elements to be considered in evaluating the separate and/or community property shares of policy proceeds. They are: (1) the time the policy was acquired (2) the source from which the premiums were paid (3) the kind of life insurance policy involved.

There is authority to support the conclusion that in divorce, if the policy was acquired during coverture, the wife is entitled to that portion of the proceeds which is the result of premium payments made by her half of the community funds.[104] If the policy was owned by the husband prior to the marriage and later partially purchased with premiums from the community, the policy remains his separate property, but the wife has an interest to the extent of one-half the dollar amount of the premiums paid for with community funds.[105] This later rule is based on the principle "that the community, when it advances funds to improve the separate property of one of the spouses, is entitled to reimbursement . . . ."[106]

Some very recent case law has pointed to the importance of the third element used in evaluating the community property share of policy proceeds—the kind of insurance policy involved. In *Gaethje v. Gaethje*,[107] the Arizona Court of Appeals emphasized the fact that the life insurance involved was a term policy which had no cash surrender or monetary value at any time until the death of the insured. In *Gaethje*, the deceased husband paid one premium from his separate funds during the interval between the marriage and re-marriage to his executrix-widow. The court stated:

> Upon the death of the insured, the value of a term policy purchased with community funds is measured by the proceeds of the policy, and not the premiums paid thereon . . . . Community funds paid for *all* the coverage that resulted in these

---

102 *Id.* at 268.
103 The writer will not attempt even a brief survey of Arizona community property law. For a general discussion of this topic see D. KEDDIE, COMMUNITY PROPERTY LAW IN ARIZONA (Amend. ed. 1960).
104 Blaine v. Blaine, 63 Ariz. 100, 159 P.2d 786 (1945).
105 *See* Rothman v. Rumbeck, 54 Ariz. 443, 96 P.2d 755 (1939).
106 *Id.* at 452-53, 96 P.2d at 759.
107 7 Ariz. App. 544, 441 P.2d 579 (1968).

> particular proceeds. The fact that the husband's separate estate paid a premium for a risk long since expired without loss should not give his separate estate any vested interest in these proceeds.[108]

This rationale was followed in another court of appeals decision, *Lock v. Lock*.[109] Both *Gaethje and Lock* emphasize the importance of the type of insurance being taxed.

It might be asked why the *Gorman* court did not consider the type of policy involved, for that policy also was a term policy. In *Gorman*, a non-community property situation, the deceased husband was not the owner of the policy. There simply was no issue as to life ownership of the policy. He paid premiums in contemplation of death and the Internal Revenue Service tried to tax the proceeds in a pro rata share to those premiums. In *Gaethje* and *Lock* ownership of the policy was *the* issue. The payment of one premium from separate or community funds for a long-expired risk gave no ownership rights. The type of insurance was the critical factor in the Arizona cases, whereas, it was not in *Gorman*.

In *Revenue Ruling* 67-463, the Service advanced the community property case of *Scott v. Commissioner*[110] to support its position in community property states. A close reading of this case is not required to reveal its weakness as authority. In *Scott* the wife-beneficiary predeceased the owner-husband. The policy was purchased with California community property funds. The wife's one-half interest in the policy was bequeathed to her sons and one-half of the cash surrender value of the policy at her death was included in her gross estate. Later, upon the husband's death, the Internal Revenue Service attempted to include the total proceeds of the policy less the amount included in the wife's estate in his estate. The Ninth Circuit, however, interpreting California community property law, held that the cash surrender value at the date of the wife's death was not a proper basis for determining the wife's community interest in the policy.[111] Rather, a pro rata premium to proceeds scheme for the life of the policy considering community and non-community contributions was to be the measure. Nowhere did the question of premiums paid in contemplation of death appear. This was simply an application of California community property law to determine community property interest in the policy. As previously noted, such an analysis is indispensable in a community property situation.

---

[108] *Id.* at 550.
[109] 8 Ariz. App. 138, 444 P.2d 163 (1968).
[110] 374 F.2d 154 (9th Cir. 1967).
[111] A policy of life insurance is a bundle of rights, of which the right (if any) to surrender the policy and receive the cash surrender value is but one. The California cases, by repeated holdings and dicta, make it clear that the wife's community interest, like that of the husband, is in the contract, the entire bundle of rights, not in just one or more of those rights . . . . *Id.* at 159.

A recent district court case originating in Arizona is directly in point and illustrates the effect of state law on the particular question of premiums paid in contemplation of death. In *Nance v. United States*,[112] a decision barren of facts, precedent and ratio decidendi, the district court apparently completely ignored *Revenue Ruling* 67-463 in a situation where it was applicable. Two policies were taken out on the life of the husband, the wife being stipulated as life-owner and beneficiary of each. The husband died less than three years later. In the findings of fact, the court noted that the premiums which paid for the policies were a gift from the marital community to the wife, thereby being converted into her sole and separate property. Further, this gift was not made in contemplation of death, the rebuttable presumption having been overcome. As an alternative finding, the court found that even if the funds supplied were community funds and paid in contemplation of death, the marital community would be entitled to only the amount of the premiums and not any share of the proceeds. It is to this additional and alternative finding that our attention must be directed.

Presumably the marital community would be entitled to only the amount of the premiums paid because under Arizona law the community is entitled to be reimbursed for enhancing the value of one of the spouse's separate property.[113] When the policies were taken out, the wife was designated and vested with full ownership rights under the contracts. This strongly evidenced the intent of the parties as to ownership of the policies; the payment of premiums from community funds only enhanced their value. What is interesting, is that the court in alternatively allowing a transfer in contemplation of death, did not even allude to *Revenue Ruling* 67-463 which was published more than three months earlier. Had a pro rata formula per the ruling been applied, the conclusion would have presumably stated that the community was entitled to a share of the proceeds.

To more fully illustrate the effect of the "in contemplation of death" provision of section 2035 on a situation where a non-term life policy is completely or partially purchased with community funds in Arizona, take the more common case where the *community* is deemed to be the owner of the policy. The mere fact that premiums are paid in the presumptive period with community funds only strengthens the express or implied intent of the parties that the policy belongs to the community—one-half to the husband and one-half to the wife. If the husband is the insured and dies first, half of the proceeds are includable in his gross estat by reason of the ownership test under section 2042, without regard to the section 2035 provision. If the husband transferred ownership of a community policy on his life to the wife within three years of death,

[112] 68-1 U.S. Tax Cas. ¶ 12,529 (D. Ariz. 1968).
[113] Note 106 *supra*.

evidencing an intent that she hold the policy as her sole and separate property, yet the husband paid premiums through the presumptive period with community funds, his estate, under section 2035, would be charged with one-half of the dollar amount of the premiums so paid in the presumptive period. His gross estate would also include a pro rata amount of the proceeds attributable to his one-half community property interest which was accumulated during the community ownership period.

In summary, it can be stated that *Revenue Ruling* 67-463 has more limited applicability in a community property state such as Arizona. This does not mean to say that a section 2035 "in contemplation of death" analysis is not warranted in those circumstances where a transfer is made in the presumptive period. State community property law, however, in prescribing or denying ownership rights in policy proceeds in effect determines the quantum to be taxed.

CONCLUSION

It seems quite apparent that by quasi-judicial fiat the Internal Revenue Service has attempted to reintroduce a limited premium payment test to "in contemplation of death" situations where the insured non-owner has paid some or all the premiums on a policy. If the *Gorman* court's reaction is to become typical, the Service will have failed in this attempt. Not only does the historical development of the pertinent Code sections preclude a reintroduction of the test, but as the *Gorman* court illustrated, the insurance contract does not lend itself to such treatment. In *Gorman* the court gave ample indication that its temper and reserve were tested to the limits by what it considered unjustified treatment of the taxpayer by the Service. One can only speculate that this mood is indicative of that of other courts.

For community property states, including Arizona, the ruling has a more limited significance. Community property law dominates any discussion of ownership. The ruling would have application if the rebuttable presumption of community ownership is overcome and it is deemed that the policy insuring one spouse is the separate property of the other, and, further, the spouse paying the premiums does so with his separate funds in contemplation of death.

Carmine Brogna