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Internal Revenue - Deductions in General - Whether Insurance Proceeds Retained under a Settlemlent Option May Qualify for the Marital Deduction

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On the basis of the evidence presented, it is not likely that action by the Supreme Court will result in the abolition of loan financed insurance; the definition of "interest" for tax purposes will probably be clarified and existing statutes interpreted in a manner that can be expected to curtail the abuses of the interest-deduction factor in loan-financed annuity contracts.

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INTERNAL REVENUE—DEDUCTIONS IN GENERAL—WHETHER INSURANCE PROCEEDS RETAINED UNDER A SETTLEMENT OPTION MAY QUALIFY FOR THE MARITAL DEDUCTION—An interesting attempt to define what constitutes a terminable interest in relation to life insurance policy proceeds is to be found in the recent case of *Estate of Werbe* v. *United States.*[1] In that case certain policies of insurance on the life of the decedent provided that the proceeds of the policies, payable on receipt of proof of death, were to be retained by the insurance company which was then to make monthly payments to the decedent's widow. The policy provisions further stated that in the event the wife should not survive, or should die while the above-mentioned settlement was operative, any amount due on the proceeds was to be equally divided between the insured's sons as secondary beneficiaries. The widow was also given the right to make withdrawals in whole or in part from the proceeds retained by the insurer, but only on interest payment dates, the first of which would fall one month after the death of the insured for certain of these policies and a year later for one other, and then in amounts not smaller than a sum stipulated. Following the decedent's death, and the filing of an estate tax return, the Commissioner of Internal Revenue excluded the value of these five insurance policies in determining for estate tax purposes the amount of the marital deduction. An additional tax was paid and the taxpayer then sued for a refund of an alleged overpayment. Both the district court and the Court of Appeals for the Seventh Circuit, agreeing with the Commissioner, concluded that the widow had only a terminable rather than an absolute interest in the proceeds of the insurance policies, because the proceeds could pass to the sons for less than full consideration and also because she did not have a power of appointment exercisable in all events, so recovery of the additional tax paid was denied.

The marital deduction[2] provision was inserted in the Internal Revenue Act of 1948 to equalize tax advantages in the common law and community property states and its purpose was to permit the surviving spouse to

1 273 F. (2d) 201 (1959), affirming 178 F. Supp. 704 (1959).

2 Int. Rev. Code, Sec. 812(e).

take a portion of the deceased spouse's estate free of the burden of federal estate taxes.[3] Having been enacted to put the common law states on an equal footing with the community property states the provision would not, of course, apply to the community property states.[4] For those areas where applicable, as in the instant case, the marital deduction provision permits the withdrawal of an amount up to fifty percent of the adjusted gross estate, as computed for federal estate taxes, from taxation providing this interest in property passes to or has passed from the decedent to the surviving spouse.[5] But the deduction is restricted by the requirement that if this interest in property should, by reason of a lapse of time, because of an event or contingency, or by virtue of the non-occurrence of an event or contingency, fail to pass to and vest in the surviving spouse, the interest is then to be regarded as a terminable interest and no marital deduction is to be allowed with respect thereto.[6] The precise moment to which one must look in determining whether the interest passing to the surviving spouse is or is not terminable is the instant of the death of the decedent.[7]

It should be noted that, in the instant case, the surviving spouse had to wait until the first interest payment dates subsequent to proof of death before she could, if she should so desire, draw down the proceeds of the various insurance policies. As to certain of these policies, the first interest payment date was to be thirty days after the date of death of the decedent; as to one other, the controlling date was as long as one year after the date of death. In the light of these circumstances the court, holding that these policies represented only terminable interests, reasoned in effect that, as it was possible that the surviving spouse might die during these respective periods of time, the proceeds of the policies could pass to secondary beneficiaries for less than a full consideration. In arriving at this result, the court looked to the philosophy reflected in the case of *In re Wolf's Estate*[8] where it was indicated that the allowance of the marital deduction for federal estate tax purposes is a matter of legislative and statutory privilege rather than a matter of right, as a consequence of which a court is not required to construe the statute not to examine into the equities of the particular case.

To offset this reasoning, the petitioner had insisted that the time periods in question were introduced into the policies as mere administra-

3 Pitts v. Hamrick, 228 F. (2d) 486 (1955).
4 California Trust Co. v. Riddell, 136 F. Supp. 7 (1955).
5 See note 2, *ante*.
6 In re Reilly's Estate, 239 F. (2d) 797 (1957).
7 Shedd's Estate v. Commissioner of Internal Revenue, 237 F. (2d) 345 (1956).
8 264 F. (2d) 82 (1959).

tive conveniences for the benefit of the insurance companies and had nothing to do whatever with the surviving spouse's vested right to draw down the proceeds of the policies. In fact the director of the Estate Planning Service of one of the companies, testifying on behalf of the petitioner, offered proof that such provisions were commonly inserted into life insurance policies for the convenience of the insurers in order to minimize administrative expense and that his company would have paid the entire proceeds promptly at any time upon the request of the surviving spouse. Further interpretation was given to the meaning of the contract by testimony to the effect that had the spouse died prior to receipt of proof of death of the insured, the company would have paid the money to the beneficiary spouse's personal representative. The petitioner also relied upon a Treasury Department Regulation[9] which indicated that contracts of the kind in question were not to be disqualified merely because the surviving spouse had to comply with certain formalities in order to obtain payment.

Despite these arguments, the court chose to follow the language of the statute as written; in fact, it went beyond the particular provision to point out that, even if it was possible as a practical matter that the surviving spouse might have secured all the proceeds under certain circumstances, the surviving spouse did not have a power of appointment exercisable in all events as required by another section of the Code[10] as interpreted by the case of *Starrett* v. *Commissioner of Internal Revenue.*[11]

Whether or not the Supreme Court will uphold the strict interpretation placed on the statute by the Court of Appeals is a moot point. Certainly all estate planners are hoping the court will reverse this decision. But until that is done, the result of the decision requires that all optional settlement arrangements of life insurance policy proceeds, intended to qualify for the marital deduction, must be promptly reviewed or renunciation of wills and increased tax burdens will be likely to result from inattention thereto. If policies are not revised to provide for a lump sum payment to the surviving spouse effective upon the death of the decedent, then life insurance companies must be asked to delete the objectionable "administrative facility" clauses from their policies. As a further protective step, the surviving spouse should be given the power by the insurance contract, to appoint the payment of any unpaid proceeds remaining at his or her death to anyone he or she may see fit to designate including his or her estate.

D. J. A. HAYES, JR.

[9] Treasury Department Regulation 105, Section 81.47 A (d).
[10] Int. Rev. Code Sec. 812(g).
[11] 223 F. (2d) 163 (1955).