Denver Law Review

Volume 25 | Issue 4 Article 2

June 2021

Life Insurance - A Frozen Asset

Charles C. Nicola

Recommended Citation
Charles C. Nicola, Life Insurance - A Frozen Asset, 25 Dicta 80 (1948).

Life Insurance—A Frozen Asset

By CHARLES C. NICOLA
of the Denver Bar

Only a few can afford to die. In the past decade death has been transformed from its historic role as the advent of the better life into a taxable event of overwhelming magnitude and dismal consequences. Acceptance of the proposition that one must pay as he goes—and pay handsomely—has precipitated a shift in emphasis among problems of estate planning. The protection of the estate from the impact of federal taxation has emerged as a factor of principal concern to prospective decedents and their advisers.

The problem customarily involves two considerations—the minimization of taxes and the provision of funds for their payment. The irrevocable living trust is the most favored device for accomplishing this dual objective. By depleting the gross taxable estate through *inter vivos* gifts, this plan travels the only broad avenue which remains open for minimization of estate tax; and if the trust is properly constructed, the availability of the corpus thereof for payment of the settlor's death taxes may be retained without subjecting such funds to inclusion in the settlor's gross estate. The trust offers the additional feature of excluding the corpus thereof from the income beneficiary's taxable estate, thus eliminating a "second" estate tax on the same property.

But great care must be given to the terms of the trust and to the type of property to be placed in trust if maximum tax benefits are to be derived.

If the corpus of the trust is to be excluded from the settlor's gross estate, close attention must be paid to the following fundamentals:

1. The trust must be irrevocable. If the settlor reserves the right to alter, amend, revoke, or terminate the trust, its corpus will be swept into his gross estate by operation of Section 811(d) of the Internal Revenue Code.
2. The transfer in trust must not be made in contemplation of death, or the corpus thereof will be includible in the settlor's gross estate under Section 811(c).
3. The transfer in trust must not be intended to take effect in possession or enjoyment at or after the settlor's death, or the corpus thereof will be includible under another provision of Section 811(c). Under the rule of the Hallock case [1] the transfer in trust will be regarded as one intended to take effect at the settlor's death if he reserves a possibility of reverter in the corpus.
4. The settlor must not reserve certain rights over and benefits from trust property, as particularly set out in Section 811(c). Broadly

[1] Helvering v. Hallock, 309 U. S. 106.

speaking, this includes a reservation for the settlor's life of the right to receive the income from the trust or the right to designate the persons who are to receive the income.

The foregoing are the prerequisites of a valid irrevocable gift in trust. Each must be satisfied if the corpus of the trust is to be removed sufficiently from the dominion and control of the settlor so that it will not be regarded as his at his death and thus includible in his taxable estate. To intend that the transfer possess these qualities is, of course, not enough. The successful creation of such a trust depends upon the draftsman's familiarity with the law of federal taxation and with the frequently changing meanings ascribed to these terms which are subject to constant redefinition by regulations and court and board decisions.

It has been asserted that notwithstanding the fact that the settlor has parted absolutely and forever with the property comprising the trust, he may set up the trust in such a manner that the assets thereof may be used by the executor of his estate to pay death taxes. It has also been represented that this can be accomplished without subjecting the assets of the trust to inclusion in the settlor's taxable estate. This result is achieved customarily by including among the broad powers of management and investment given to the trustee, the power to lend funds to or purchase property from the executor of the estate of the settlor upon such terms as the trustee, in his sole discretion, shall deem appropriate. The trustee is thus in a position to rescue from the estate of the settlor at a fair price, assets of the estate which otherwise might have to be sold in the open market at substantial loss for the purpose of raising funds in a short time for the payment of death taxes. Without this provision, the settlor is obliged to retain in his personal estate relatively unproductive liquid assets of sufficient value to pay the taxes which accrue at his death. With this provision he may dispose of them safely during his lifetime, seizing the tax advantages which attend the depletion of his estate, but retaining the use of those funds for the same purpose to which they would have been put had he kept them in his taxable estate.

This is the broad general outline of the terms of a trust designed to accomplish minimization of estate taxes consistent with the maintenance of funds for their payment. It should be noted parenthetically, but without discussion of the many ramifications of the problem, that substantial reductions in surtaxable net income are available to the settlor through use of such a living trust, if the settlor limits his reservation of administrative control and power of disposition to the bounds prescribed by Sections 29.22(a)—21 and 22, Regulations 111, and the income beneficiary is not one whom the settlor is legally obligated to support.[2] Such a beneficiary cannot be a financially emancipated child of the settlor. The income of the trust thus may be

[2] Section 167 I. R. C. includes in the taxable income of the settlor of a trust that part of the income of the trust which is applied or distributed for the support or maintenance of a beneficiary whom the settlor is legally obligated to support or maintain.

kept within the same family group notwithstanding the broad and almost all inclusive prohibition of the Clifford doctrine.[3]

If the transfer in trust constitutes a valid gift, it will save estate taxes and income taxes, but may subject the settlor to a gift tax. However, that is not a substantial objection to the plan. Against his potential gift tax liability, the settlor may claim a specific exemption of $30,000.00, which exemption is forever lost to him if he does not take it.[4] The value of the gift in excess of $30,000.00 is taxed at a rate which is approximately 25% less than the estate tax rate. The difference in tax is actually much greater than the percentage differential suggests, because the gift removes the corpus thereof from taxation in the highest estate tax bracket and subjects it to a tax in the lowest gift tax bracket.

So much for the terms of the trust and the tax-wise results which can be anticipated therefrom. If maximum benefits to the settlor are to be obtained, particular attention must be paid to the type of property to be placed in trust. If the property is such that can be expected to increase in value subsequent to the taxable transfer, the gift tax will be at a lower rate, in a lower bracket, and on a lower valuation. It should be property which will continue to produce after it has been transferred, unlike assets of the settlor's the earning capacity of which may depend upon the exercise of his individual skill and management, such as the settlor's business. Inasmuch as the income from the trust is not to be reserved it should be property upon which the settlor is not dependent for his support. It should be property which is reasonably liquid, for it must be capable of being reduced to cash in the open market with a minimum of loss, if it is to be used for the payment of taxes as discussed above.

Life insurance is an asset possessing all of these qualities to a marked degree and it has been sold to many people largely on the strength of its adaptability to the payment of death taxes. Insured persons have seized upon the opportunity to exclude life insurance proceeds from their taxable estates through creation of funded life insurance trusts. The transfer of policies by the insured to a trustee coupled with release of all incidents of ownership[5] pertaining to the policies and the payment of premiums by someone other than the insured subsequent to the transfer, became a well accepted plan of estate tax avoidance. The funded life insurance trust is a sound proposition, not only from the points of view of the settlor and his benefiiciaries, but from the standpoint of the public revenue. Wherever used, it provides

[3] Helvering v. Clifford, 309 U. S. 331.

[4] The $3,000.00 annual exclusion of gifts to each donee is not applicable to gifts in trust except to the extent of the interest of the income beneficiary. As to remaindermen, the gift is regarded to be one of a future interest to which the annual exclusion does not apply.

[5] Incidents of ownership include the right to change the beneficiary, to borrow against the policy, to pledge it as security, to assign, surrender or convert it.

a reserve of cash which is available immediately at death for the payment of taxes. It would seem to have been the purpose of proper legislation to have encouraged the use of life insurance in gifts, and it is surprising, therefore, that plans involving the transfer inter vivos of life insurance policies were dealt a fatal blow by the 1942 amendment to Section 811(g) of the Internal Revenue Code[6]—the section dealing with the inclusion of life insurance proceeds in the taxable estate of the insured.

This amendment is widely known for its removal of $40,000.00 specific exemption which had been made available by revenue acts in effect from 1918 to 1942, to proceeds payable to beneficiaries other than the insured's executor. But practically no discussion has been accorded the provisions of the amendment which "freezes" life insurance proceeds in the taxable estate of the insured. In effect, life insurance proceeds are no longer excludable in their entirety from the insured's gross estate unless he released all incidents of ownership prior to January 10, 1941, and has paid no premiums since. If the incidents of ownership were released before that date but the insured has paid premiums since, the proceeds are includible in his taxable estate in an amount which bears the same proportion to the total proceeds realized that the amount of premiums paid by the insured since January 10, 1941, bears to the total premiums paid. If the incidents of ownership are released at a date subsequent to January 10, 1941, the proceeds are includible in the insured's taxable estate in an amount which bears the same proportion to the total proceeds realized that the amount of premiums paid by the insured bears to the total premiums paid. If the incidents of ownership are not released prior to the death of the insured, all of the proceeds realized are includible in his taxable estate regardless of who paid the premiums and in what amount.

If properly advised, persons making application for new or additional life insurance can avoid the full fury of this legislation under some circumstances by arranging for the payment of premiums by someone else and by failing to reserve to themselves any of the various incidents of ownership. While insurance may be written on the lives of those who are uninsurable physically where its purchase is coupled with the purchase of an annuity

[6] Section 811. The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the U. S.

(g) "*Receivable by the Executor.* To the extent of the amount receivable by the executor or as insurance under policies upon the life of the decedent.

"*Receivable by other beneficiaries.* To the extent of the amount receivable by all other beneficiaries as insurance under policies upon the life of the decedent (A) purchased with premiums, or other consideration, paid directly or indirectly by the decedent, in proportion that the amount so paid by the decedent bears to the total premiums paid for the insurance, or (B) 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. * * *"

and the risk is thus neutralized, insurability generally is a prerequisite, and those who are insurable are most frequently of an age at which it is unwise to release incidents of ownership. Too much of life remains ahead for such an insured to make it prudent for him to forego the right to change the beneficiary, to borrow against the policy, to pledge it as security, or to assign, surrender or convert it. And arranging for another to pay premiums must not be an easy thing for most insured persons to accomplish. It is no answer to suggest that the insured might transfer funds to his wife or to some other persons to be used by them for the payment of premiums, for the tax advanages are lost if the insured pays the premiums directly or indirectly. A House committee report interpreting this expression considers the case suggested and states that under that situation it is the legislative intent that the payments of premiums be considered to have been made by the insured, even though they are not directly traceable to the precise funds transferred by the insured. It is this prohibition against payment by the insured directly or indirectly that has knocked out the insurance trust funded with assets provided by the insured. It seems quite apparent that in the ordinary case it is not feasible for most new or additional insurance to be set up in a form which will exclude the proceeds from the insured's taxable estate.

What about insurance which has been in force for a number of years? What rearrangements of these policies may be made looking toward the exclusion of the proceeds from the insured's taxable estate? Here the situation is really very desperate. Hardly anyone has any business thinking about surrendering the incidents of ownership over his life insurance until he can predict with reasonable accuracy his own financial situation and that of his named beneficiaries over the span of years which separates him from death. Such a person is usually well advanced beyond middle age, and, in the ordinary case, he has always paid the premiums on his life insurance. Much of his insurance may be "paid up." The amended provisions of the estate tax law relating to life insurance offer no way in which he can exclude from his taxable estate more than a negligible proportion of the proceeds of his life insurance. He could release all incidents of ownership at his advanced age with some degree of security. And if he could find someone who would pay the few premiums which remain to be paid on those policies which have not already become "paid up," some of the proceeds could be excluded from his taxable estate. But the only amount of the proceeds which would not be includible would be the amount which bears the same proportion to the total proceeds realized as the amount of premiums paid by one other than the insured bears to the total premiums paid—an insignificant amount at best. If the insured's wife is a person of independent means, it might be wise for him to convert his policies into policies of "paid up" insurance. The proceeds payable on his death would be substantially reduced thereby and the loss could be compensated by additional insurance on his life taken out by his wife and paid for from her own funds. But this would be the exceptional case and does not present a serious qualification to the general statement that life insurance has been frozen in the insured's taxable estate. In the ordinary case the only way that life insurance can be made the subject of an inter vivos gift is by accepting its cash surrender value and making a gift of the proceeds. Notwithstanding significant estate tax savings, surrender normally involves a net loss so substantial that the plan is not entitled to serious consideration.

The fact is that Congress has placed a restraint upon the disposition of life insurance which is not applicable to property generally. In so doing it has precluded the use of life insurance for purposes which appear to deserve the support of intelligent legislation. The doctrine must be of most serious concern to those whose principal or sole asset is life insurance, for they are very likely to be in a position where they cannot seize the tax advantages to be obtained from making gifts because they have no other property which can be disposed of by gift. But to all who seek to cushion the impact of federal taxation and to whom the disposition of large amounts of property by gift appears to be the most practicable escape from confiscatory estate taxes, the "freezing" of life insurance in the insured's estate must present a fatal objection to its purchase in substantial amounts.

Ancient and Modern Leases

By EDWIN J. WITTELSHOFER

On the Denver bar, chairman of the Committees on Real Estate Standards of the Denver and the Colorado Bar Associations, to whom we are indebted for much of the progress which has been made in the adoption of real estate title standards, and the resulting uniformity in real estate practice in both Denver and the entire state. An address before the Denver Bar Association, March 1, 1948.

The method of leasing lands and tenements under written memoranda is one of the earliest legal practices of history. Its precise origin is shrouded in antiquity and it seems to have had early birth in all recognized legal systems.

The form and method of leasing in this country is easily traced to England where such practice was well implanted even before William, the Conqueror. While in these early days leases were not regarded with too much sanctity and were easily voided by the landlord, during the reign of Henry the VIII acts were passed which permitted tenants to maintain their rights to possession of leased property even against the landlord. These acts seem to be not only the last but almost the only benefit established by statute law for aid to the tenant.