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# LIFE INSURANCE AND FEDERAL TAXES

*Daniel Candee Knickerbocker, Jr.†*

We all remember a few dates. We all have a vague idea that something important happened in 1066 or 1492 or 1776, that after the events of each of those years the world was somehow different. The world of the "tax wallah"<sup>1</sup> is more circumscribed. To him the years to remember are 1913, 1916, 1939, and 1954. The first of these brought the federal income tax; the second the estate tax; the third the internal revenue codification; and the fourth its first major attempt at reform.

I was not on hand for the 1913 and 1916 ceremonies and was too busy being a college undergraduate when 1939 rolled around. But by 1954 I was up to my ears in the practice of tax law and remember the legislative events of that year as a somewhat extended—but very merry—*Walpurgisnacht*.

The Internal Revenue Code of 1954 had its genesis in the cry for reform. As the years had passed our tax rates had gone steadily upward, the attempts to avoid their impact had become increasingly tortuous, the lawyer-invented loopholes required correspondingly larger and more complicated plugs, and more and more congressional time was spent in enacting "technical amendments"<sup>2</sup>—special provisions designed to give relief in hard cases. All of this inevitably bred demands for simplification and equity, and the result was the 984-page statute which became law on August 16, 1954.

To the sponsors of this document its birth was cause for dancing in the streets. Not only had there been a logical rearrangement and more understandable rewording of the tax law, there had been substantive changes made as well whose purpose was

to remove inequities, to end harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment.<sup>2</sup>

The reformers,<sup>3</sup> on the other hand, found the new code nothing but a source of pain. The attempt at simplification they found only partially successful.<sup>4</sup> As for the removal of inequities, they could not even bring

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† See Contributors' Section, Masthead, p. 449, for biographical data.

<sup>1</sup> The generic description of lawyers who practice enough tax law to enable them to discuss its problems in terms of section numbers of the Internal Revenue Code. There are less of them around today than there were prior to August 16, 1954.

<sup>2</sup> H.R. Rep. No. 1337, 83d Cong., 2d Sess. 1 (1954).

<sup>3</sup> This word must not be understood in any pejorative sense. It is used here as a shorthand identification for all those who think there should be a general overhaul of the tax law, a class that includes with equal hospitality both the AFL-CIO and the NAM, Norris Darrell and Stanley Surrey.

<sup>4</sup> Cf. Darrell, "Internal Revenue Code of 1954—A Striking Example of the Legislative Process in Action," 7 U. So. Calif. Tax Inst. 1, 29-32 (1955); Slowinski, "The Internal Revenue Code of 1954: A General Consideration," 40 A.B.A.J. 1037, 1039 (1954).

themselves to admit there had been an attempt. "There is general agreement," wrote Randolph Paul a year later, "that something strenuous needs to be done. . . . This process of erosion and patchwork amendment must stop somewhere . . . ."<sup>5</sup>

And so the cry for reform continues to be heard, to grow in volume, and it may be that 1958—or 1959—or perhaps 1960—will be another year to add to the tax man's list of memorable dates. We might as well face it. Another great revision, perhaps the greatest of all, is in the making.

The purpose of this paper is not to test the question of the need for reform. Rather, I would like here to consider one of the areas in which reform is said to be necessary and to attempt an analysis of such arguments as well as the obstacles to change. The general subject is life insurance which, we are told, enjoys a peculiarly favored position.

## I

It was Mr. Justice Cardozo who observed that "in the thought of many" the purchase of life insurance is "a pressing social duty."<sup>6</sup> Whatever the motive, during 1956 (the last year for which figures are now available) Americans purchased more than \$55,000,000,000 in life insurance coverage and at the end of that year were insured to the tune of \$412,630,000,000.<sup>7</sup> These are good round figures and suggest that, as a nation, we believe in life insurance. Some of our belief doubtless stems from the way in which this form of investment is sheltered from the tax laws.

The nature of the shelter is simply stated. Generally speaking, neither the current earnings on savings invested in life insurance nor the proceeds payable upon the death of the insured are subjected to income tax.<sup>8</sup>

And if the insured effectively manages to divest himself of all the "incidents of ownership" in his policies before he dies, no part of the proceeds payable to beneficiaries other than his estate will be subjected to the federal estate tax.<sup>9</sup>

<sup>5</sup> Paul, "Erosion of the Tax Base and Rate Structure," in *Federal Tax Policy for Economic Growth and Stability* 297, 307 (1955) (hereinafter cited as *Federal Tax Policy*). For other criticisms see *Federal Tax Policy*, supra; Surrey, "The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted," 70 *Harv. L. Rev.* 1145 (1957); DeWind, "A Technical Appraisal of the Internal Revenue Code of 1954," 8 *Nat'l Tax J.* 40 (1955). Finally there is the admission both in Congress and at the Treasury that the tax law is still in need of reform. See H.R. 41 and 4203 and S. 769, 85th Cong., 1st Sess. (1957), which would establish a "Hoover-type" commission "to study and investigate the fundamental tax policy and the tax structure of the Federal Government." See also *N.Y. World Telegram and Sun*, Jan. 20, 1958, p. 5, col. 1.

<sup>6</sup> *Burnet v. Wells*, 289 U.S. 670, 681 (1933).

<sup>7</sup> 1958 *World Almanac* 760.

<sup>8</sup> *Int. Rev. Code of 1954*, § 101. This is an over-simplified statement of the income tax rule but is believed sufficient for present purposes. The best available summary of the complete rule appears in Casner, "The Internal Revenue Code of 1954: Estate Planning," 68 *Harv. L. Rev.* 222, 244-50 (1954).

<sup>9</sup> *Int. Rev. Code of 1954*, § 2042.

These are the principles. Now, what are the reasons for changing them?

## II

Each life insurance premium is designed to cover three things: the cost of current insurance, the company's expenses of administration, and savings. As the policy ages, its value (payable upon surrender or available as loan collateral) increases by the amount saved plus the interest earned thereon. By the time an ordinary "whole life" policy has been in force about fifteen years the amount of each annual increase in value is just about equal to the premium paid. Similarly, when the insured finally dies the proceeds paid his beneficiary consist of three elements. These are a return of his savings, the interest earned on them to the date of his death, and an amount equal to the difference between the face of the policy and the sum of savings and interest which is the pure insurance item.<sup>10</sup> The two things the reformers want to subject to income tax are the current interest earnings on savings and that part of the death proceeds constituting pure insurance. As a palliative for the outraged feelings of policyholders, however, it is also urged that a new deduction be allowed for that part of the premiums used to buy current insurance protection. The interest earnings would be taxed and the premium deduction would be allowed to the insured; the pure insurance part of the proceeds would be taxed to their recipients, the beneficiaries.<sup>11</sup>

The general exemption for life insurance proceeds has been part of the statute, almost without modification, since 1913.<sup>12</sup> The abbreviated legislative history of that faraway day suggests two possible reasons for the rule, namely, Congress' usual tender regard for widows, and a vague sense that the item in question was like a legacy which no one ever intended to be considered as income.<sup>13</sup>

More recently, spokesmen for the life insurance companies have inferred another congressional motive, a belief in the social desirability of life insurance.<sup>14</sup> Such a belief has never been officially expressed.

It is possible, of course, that the Constitution itself might stand in the way of an income tax on life insurance proceeds. They simply may not constitute "income" within the meaning of the sixteenth amendment.

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<sup>10</sup> This analysis is lifted in its entirety from Vickrey, "Insurance Under the Federal Income Tax," 52 Yale L.J. 554, 560 (1943).

<sup>11</sup> Vickrey, *supra* note 10, at 561-63. Randolph Paul urged the taxation of no more than the interest element—apparently on a current basis—to the insured. Paul, "Erosion of the Tax Base and Rate Structure," in Federal Tax Policy 297, 301 (1955).

<sup>12</sup> Tariff Act of 1913, § II. B, 38 Stat. 167.

<sup>13</sup> 50 Cong. Rec. 508, 1239 (1913).

<sup>14</sup> Brunstrom, "The Life Insurance, Endowment and Annuity Features of the 1954 Code," 32 Taxes 866, 868 (1954); Hearings on H.R. 7378 Before the Senate Committee on Finance, 77th Cong., 2d Sess., at 1303, 1950, 1972 (1942).

The Supreme Court has never passed upon this point and in the only case before it in which the constitutional argument was made the justices were able to avoid a decision by finding the statutory exemption applicable.<sup>15</sup> Without embarking upon the detailed analysis required for such a determination, I am inclined to believe a constitutional objection would fail. The beneficiary's receipt of proceeds seems to meet all the tests of economic gain and realization that lie at the root of the income concept.<sup>16</sup>

It may, however, be somewhat more difficult to include current interest accretions to life insurance savings as income. Indeed, our foremost authority on the nature of income has flatly stated that such an inclusion "runs counter to our general philosophy that income shall not be taxed until it comes to hand, actually or constructively" and "lies beyond any current application of the doctrine of constructive receipt."<sup>17</sup> One may question this view and there is at least one ruling that holds a very similar form of income taxable.<sup>18</sup> But the constitutional objection to a tax at this level takes on more weight when what we desire to call income has not been reduced to possession.

A system of information returns would probably make the collection of tax from both insured and beneficiary relatively easy. Nevertheless, we cannot be certain that present methods of writing and carrying insurance would be continued if the tax rules were changed. The American imagination, always most fertile when applied to the avoidance of rules that seem illogical or unfair, may be depended upon to find new methods for doing old things. And perhaps the mere burden of exceedingly complex computations would bring down the proposed system. Its proponents confess to some such worry.<sup>19</sup>

Finally, there is the policy question. Even if Congress has not yet admitted its belief in insurance it may well do so in the future. The argument of social desirability is not wholly implausible and one can hardly foretell the result if our legislators are ever again subjected to the vehemence of that agent from Cowley, Wyoming, who once told them that any proposal to tax life insurance is dangerous, that

to in any way, directly or indirectly, discourage the purchase of legal

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<sup>15</sup> *United States v. Supplee-Biddle Hardware Co.*, 265 U.S. 189 (1924).

<sup>16</sup> Cf. Magill, *Taxable Income* 450-51 (rev. ed. 1945). Paul, "Life Insurance, Annuities and the Income Tax," in *Studies in Federal Taxation*, Third Series 351, 355 (1940), suggests that perhaps life insurance proceeds payable to individual (as opposed to corporate) beneficiaries are not income in the constitutional sense.

<sup>17</sup> Magill, "The Impact of Income Tax Leakages—A Postscript to Randolph Paul," 12 *Tax L. Rev.* 1, 10 (1956).

<sup>18</sup> *I.T.* 3907, 1948-1 *Cun. Bull.* 46 (interest credited to building and loan share accounts).

<sup>19</sup> Vickrey, "Insurance Under the Federal Income Tax," 52 *Yale L.J.* 554, 564-65 (1943).

reserve life insurance . . . is only to dignify and encourage indolence and irresponsibility throughout our land.<sup>20</sup>

But even if you object to subsidizing a particular form of savings you may still question the need for taxing a form of income (if it is income) so universally enjoyed. It is possible, as Roswell Magill has suggested, that enough of our people own life insurance so that "this tax leakage does not really derange the equity of the tax system."<sup>21</sup>

### III

The favoritism supposed to be accorded life insurance by the estate tax law is more subtle. Under the present statute, as under all prior law since the first enactment of a federal estate tax in 1916,<sup>22</sup> life insurance proceeds payable at the death of the insured to his estate are wholly taxable. But if such proceeds are payable to some other beneficiary they are includible in the gross estate only if at the time of his death the insured "possessed . . . any of the incidents of ownership, exercisable either alone or in conjunction with any other person" in the policies.<sup>23</sup>

This is not to say, of course, that insurance proceeds payable to named beneficiaries will never be includible in the insured's gross estate. There may, as is pointed out below, be other sections of the statute that encompass them. But they will not be included merely because they are insurance and this is true even though the insured paid all or some portion of the premiums.

The rule above stated is one of the major substantive changes in the tax law effected by the 1954 Code. Under the earlier law the payment of premiums alone had been sufficient to require taxation.<sup>24</sup> But this, it was thought, involved an unjustified discrimination against a particular form of property.<sup>25</sup> In the words of the Ways and Means Committee report, "no other property is subject to estate tax where the decedent initially purchased it and then long before his death gave away all rights to the property."<sup>26</sup>

On its face this argument makes sense. If I do surrender all the rights I have under an insurance policy—the right to cash it in, the right to borrow against it, the right to change the beneficiary—how can there be

<sup>20</sup> Testimony of Grant Taggart, Hearings on Revenue Revision of 1942 Before the House Committee on Ways and Means, 77th Cong., 2d Sess. 2384-85 (1942).

<sup>21</sup> Magill, "The Impact of Income Tax Leakages—A Postscript to Randolph Paul," 12 Tax L. Rev. 1, 11 (1956).

<sup>22</sup> Revenue Act of 1916, § 201, 39 Stat. 777.

<sup>23</sup> Int. Rev. Code of 1954, § 2042(2).

<sup>24</sup> Int. Rev. Code of 1939, § 811(g), as amended by Revenue Act of 1942, § 404, 56 Stat. 944-45. The checkered history of life insurance under the federal estate tax prior to 1942 is recounted in 1 Paul, *Federal Estate and Gift Taxation* 485-516 (1942).

<sup>25</sup> S. Rep. No. 1622, 83d Cong., 2d Sess. 124 (1954).

<sup>26</sup> H.R. Rep. No. 1337, 83d Cong., 2d Sess. 91 (1954).

any ground for including its proceeds in my estate and levying a tax on them? What does my continued payment of premiums have to do with it? I made a gift of the policy and I am making a gift of each premium.

But to the reformers the new law "opened the door for substantial tax avoidance."<sup>27</sup> It is no excuse, they say, to point to the estate tax treatment of other property, for

life insurance is not like other property. It is inherently testamentary in nature. It is designed, in effect, to serve as a will, regardless of its investment features.<sup>28</sup>

With all respect for the authors of these words it must be suggested that they have engaged in mere labelling. The words "inherently testamentary," of course, can mean whatever you like. If, however, we consider them descriptive of any property disposition which provides for events that may or will occur after the death of the donor, they obviously are not confined in their application to life insurance.

Recurrent throughout the reformers' thought on the subject of life insurance are two basic themes. The first is a determination that life insurance agents must not be allowed to benefit from the provisions of federal tax law. There is constant reference to the fact that these deep-dyed traitors are "openly" urging people to buy insurance and save taxes.<sup>29</sup> Somehow this is more reprehensible than the similar conduct of dealers in real estate, municipal bonds or oil investments. I must confess that I don't understand the distinction.

But what really bothers the reformers is money. They find it impossible to forget the enormous disparity between the face amount of an insurance policy and the amount of the first premium. Louis Eisenstein has given us the example of a forty-year-old man who could provide a \$900,000 life insurance estate for his wife and three children at no cost either to himself or his beneficiaries in either gift or estate taxes.<sup>30</sup>

The reformers have a case, of course, only if this well-fixed husband fails to live out his life expectancy. If he were to pay into a trust each year the same amount of money he paid in premiums, his wife and children might end up with even more money just as free of tax.<sup>31</sup>

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<sup>27</sup> Lowndes & Kramer, *Federal Estate and Gift Taxes* 280 (1956). The words quoted are, of course, those used by all of us whenever referring to a provision of law of which we disapprove, but in this context they are Messrs. Lowndes' and Kramer's very own.

<sup>28</sup> H.R. Rep. No. 1337, 83d Cong., 2d Sess. B14 (1954) (minority views).

<sup>29</sup> Eisenstein, "The Rise and Decline of the Estate Tax," in *Federal Tax Policy* 819, 842 (1955); H.R. Rep. No. 767, 65th Cong., 2d Sess. 22 (1918).

<sup>30</sup> Eisenstein, *supra* note 29, at 842. The annual premium in this example is \$24,000. By splitting this up into four \$6,000 segments and taking advantage of the marital deduction and the annual exclusions of both husband and wife the total premium passes free of gift tax. The same argument is made in Lowndes & Kramer, *Federal Estate and Gift Taxes* 280-81 (1956).

<sup>31</sup> The Treasury's tables in U.S. Treas. Reg. § 1.72-9 (1954), give a forty-year-old male

It is for this reason that the Treasury has indicated it would find something less than full includibility on grounds of payment of premiums an acceptable substitute for present law. The proposal to subject to estate tax only "the difference between the proceeds . . . and the reserve at the time of death or possibly cash-surrender value at the time of death"<sup>32</sup> is designed to catch up with the insured who has managed to win his gamble with the company by means of an early death.

The occasional windfall to a few beneficiaries seems scant justification for the imposition of an estate tax on insurance proceeds generally. It may, however, be the justification for subjecting some part of those proceeds to an income tax.

The best argument against restoring the premium payment test—with all its complexities—to our law is the fact that the windfalls the reformers so detest may not after all be tax-free.

The law requires inclusion in a decedent's gross estate of all property transferred by him "in contemplation of death." There is a rebuttable presumption that all transfers during the three-year period ending on the date of death were so made; transfers before that period cannot be taxed on this ground.<sup>33</sup> It seems a foregone conclusion that if the decedent has given away a life insurance policy during this three-year period the proceeds will be thrown into his taxable estate. This is not merely a question of the standard of proof required to overcome the statutory presumption. Life insurance transfers may almost be said as a matter of law to be in contemplation of death.<sup>34</sup> Moreover, if the decedent merely paid premiums during the three-year period, estate tax would probably be imposed upon that portion of the proceeds equal to the proportion borne by the payments to the total premiums paid by the decedent throughout

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a life expectancy of 33.8 years. Annual payments of \$24,000 accumulated at 3% (in tax-exempt revenue bonds, for example) will amount to \$1,385,524.24 at the end of thirty-four years. An accumulation trust the income and corpus of which are to be distributed to named beneficiaries upon the death of the grantor will clearly escape taxation in the grantor's estate by virtue of the operation of Int. Rev. Code of 1954, § 2037, if the grantor retained no interest in the trust.

<sup>32</sup> List of Substantive Unintended Benefits and Hardships and Additional Problems for the Technical Amendments Bill of 1957, Item 27 (1956). A similar suggestion had been made fifteen years earlier in Schlesinger, "Taxes and Insurance: A Suggested Solution to the Uncertain Cost of Dying," 55 Harv. L. Rev. 226 (1941). The Congressional response to the Treasury's proposal, original section 56, of the Technical Amendments Bill of 1957 (H.R. 8381), was a compromise and therefore more complicated. Essentially it would have subjected to tax only that part of the proceeds produced by the insured's premium payments during the five years immediately before his death. H.R. Rep. No. 775, 85th Cong., 1st Sess. 96 (1957). However, when the bill was called up in the House a committee amendment deleted this proposed revision of § 2042. 104 Cong. Rec. 1049-50 (daily ed., Jan. 28, 1958).

<sup>33</sup> Int. Rev. Code of 1954, § 2035.

<sup>34</sup> Cf. *Bailey v. United States*, 27 F. Supp. 617, modified, 30 F. Supp. 184 (Ct. Cl. 1939), superseded by 31 F. Supp. 778 (Ct. Cl.), cert. dismissed on stipulation, 311 U.S. 721 (1940), 25 Cornell L.Q. 605 (1940).

his life.<sup>35</sup> The result here is to tax most heavily the man who has had the greatest success in winning his gamble with the company.

The other and rather less certain ground for including the proceeds of transferred life insurance in the decedent's estate is that he has retained a reversionary interest whose value exceeds the maximum 5% permitted by the statute.<sup>36</sup> This is the result of the clause contained (so far as I know) in all life insurance policies, a clause it seems impossible to have deleted, which provides that if all the beneficiaries named in the policy die before receiving payment of the proceeds such proceeds shall be paid to the estate of the insured. The requirement of the proposed estate tax regulations that the existence of a reversion must be determined only after taking into account "any incidents of ownership held by others immediately before the decedent's death"<sup>37</sup> will certainly afford some protection. But I cannot agree with those writers who regard the problem as completely solved.<sup>38</sup>

Needless to say, the concern over whether or not the payment of premiums should result in the inclusion of the proceeds in the insured's estate is part of a general concern lest rich men's estates escape their fair shares of tax. It has been suggested that whatever tax avoidance there may be here is the result not of loopholes in the law but rather of the fact that some people are wealthier than others. The theory is that if we don't let the rich pull parts of their estates out of the tax base by buying life insurance they'll accomplish the same results in other ways.<sup>39</sup> This is the argument made by George May in reference to the income tax—that the whole system is like a football game which is no fun unless you can break through the line and make a touchdown once in a while.<sup>40</sup> I prefer to believe our tax law is based on rather more logical principles.

Finally, for what it is worth, there is the argument that the premium payment test for taxing life insurance proceeds violates the constitutional prohibition on direct taxes without apportionment.<sup>41</sup> This was the view of the seventh circuit in the surprisingly recent case of *Kohl v. United*

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<sup>35</sup> *Liebmann v. Hassett*, 50 F. Supp. 537 (D. Mass. 1943), aff'd, 148 F.2d 247 (1st Cir. 1945).

<sup>36</sup> Under Int. Rev. Code of 1954, § 2042(2), "the term 'incident of ownership' includes a reversionary interest (whether arising by the express terms of the policy or other instrument or by operation of law) only if the value of such reversionary interest exceeded 5 percent of the value of the policy immediately before the death of the decedent."

<sup>37</sup> Proposed U.S. Treas. Reg. § 20.2042-1(c)(3) (1954).

<sup>38</sup> Cf. Lowndes & Kramer, *Federal Estate and Gift Taxes* 289 (1956).

<sup>39</sup> Munch, "Estate Tax Problems in Transfers of Life Insurance," 15 N.Y.U. Inst. Fed. Tax. 219, 226-27 (1957).

<sup>40</sup> Quoted in Paul, "Erosion of the Tax Base and Rate Structure," in *Federal Tax Policy* 297, 306 (1955).

<sup>41</sup> U.S. Const. art. I, § 9, cl. 4.

*States.*<sup>42</sup> Both the Service<sup>43</sup> and the Tax Court<sup>44</sup> have indicated their disagreement. For the reasons given at length in Messrs. Lowndes' and Kramer's admirable text I would not recommend too great reliance on the Constitution for this purpose.<sup>45</sup>

#### IV

The arguments for subjecting life insurance to more stringent tax treatment cannot be brushed aside. To allow any economic gain to escape income taxation is contrary to the spirit of our law and, unless the estate and gift taxes are merely window dressing, it is equally distressing when substantial property transfers can be made tax-free. It is no argument here to assert that no tax is imposed on other forms of income or other transfers. Wrongs do not make other wrongs right. But it is permissible to argue that before we start taxing life insurance more heavily than we do we can and should pursue the other, the more obvious, the far more expensive vehicles for tax avoidance.

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<sup>42</sup> 226 F.2d 381 (7th Cir. 1955).

<sup>43</sup> Rev. Rul. 56-250, 1956-1 Cum. Bull. 659.

<sup>44</sup> Estate of Clarence H. Loeb, 29 T.C. No. 4 (1957); Estate of Ernest J. Wile, 16 CCH Tax Ct. Mem. 929 (1957).

<sup>45</sup> Lowndes & Kramer, Federal Estate and Gift Taxes 281-88 (1956).