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## Estate Tax — Simultaneous Death — Problem of Valuing Decedent's Ownership Interest in Life Insurance Policy

Where a person who is both the absolute owner<sup>1</sup> and primary beneficiary of a life insurance policy and the insured die simultaneously, a question arises in determining the value of the policy for federal estate tax purposes. Executors generally contend that the interpolated terminal reserve value is the proper amount to be included in the deceased owner's gross estate.<sup>2</sup> However, the Commissioner seeks to have included an amount equal to the full proceeds actually paid under the policy.

Decisions rendered in cases involving these facts have differed.<sup>3</sup> In *Estate of Chown*<sup>4</sup> the tax court held that an amount equal to the entire proceeds of the policy is includable in the owner's gross estate.<sup>5</sup> However, in *Old Kent Bank & Trust Co. v. United States*<sup>6</sup> a Michigan district court held that the owner's interest is includable in his gross estate at a zero valuation.<sup>7</sup>

### I. STATUTORY ESTATE TAX PRINCIPLES

The federal estate tax is calculated as a certain percentage of the decedent's "gross estate." Section 2031 of the Internal Revenue Code of 1954<sup>8</sup> provides that the "gross estate" of a decedent is the value of all his property at the time of his death. This section must, however, be read in conjunction with section 2033,<sup>9</sup> which provides that the property is valued to the extent of the ownership interest in that property at the time of death. These two sections relate to all property but make no specific reference to life insurance.

Valuation of life insurance is specifically provided for in section 2042,<sup>10</sup> but its application is limited to determining the amount includable in the gross estate of the insured. Under this section, if the insured dies possessed of the incidents of ownership or his estate is the beneficiary of the policy, the entire proceeds payable to the beneficiary are included in the insured's

<sup>1</sup> Ownership of an insurance policy is determined by possession of the incidents of ownership. An absolute owner is one who possesses all of the following incidents of ownership: the right to surrender, cancel, or pledge the policy; the right to borrow on the policy; the right to change the beneficiary; and any equity of redemption on a pledge policy. W. CASEY, *IBP-ESTATE PLANNING* § 16,403.3 (1969).

<sup>2</sup> "This is not the cash surrender value; it is the reserve which the insurance company enters on its books against its liability on the contracts. The word 'interpolated' simply indicates adjustment of the reserve to the specific date in question." *Commissioner v. Edwards*, 135 F.2d 574, 576 (7th Cir. 1943).

<sup>3</sup> In each of the cases discussed in this Note, the wife was the absolute owner and primary beneficiary of an insurance policy on the life of her husband. Both husband and wife died simultaneously in a plane crash and the proceeds of the policy were paid to their children as contingent beneficiaries. The facts given, however, represent merely the operative facts of the cases involved. While minor differences do exist in the cases, they cannot be used to distinguish the conflicting decisions.

<sup>4</sup> 51 T.C. 140 (1968).

<sup>5</sup> Only one month after the *Chown* decision, the tax court decided *Estate of Wien v. Commissioner*, 51 T.C. 287 (1968), a case in which the facts were substantially the same. This decision, which cited *Chown* as authority, reached an identical conclusion.

<sup>6</sup> 292 F. Supp. 48 (W.D. Mich. 1968).

<sup>7</sup> This case was decided during the period of time between the *Chown* and *Wien* decisions.

<sup>8</sup> INT. REV. CODE OF 1954, § 2031.

<sup>9</sup> INT. REV. CODE OF 1954, § 2033.

<sup>10</sup> INT. REV. CODE OF 1954, § 2042.

gross estate.<sup>11</sup> Even though section 2042 is the only section that makes a specific reference to valuation of life insurance, this does not mean that the interest of an owner who is not the insured is not taxable. Section 2033 has been interpreted as requiring inclusion of any ownership interest in the policy by a person other than the insured in that person's gross estate.<sup>12</sup> In such a situation the amount includable in the owner's estate is the value of the policy at his death, rather than the amount of proceeds actually paid under the policy.<sup>13</sup> It should be noted that the estate tax, to be constitutional, must be a tax on a *transfer* rather than a direct, unapportioned tax on property.<sup>14</sup> Even though termination of the policy owner's power to exercise the incidents of ownership may not appear to be the type of "transfer" necessary, it has been held that termination of the power of the decedent owner to change beneficiaries is the legitimate subject of a transfer tax.<sup>15</sup>

When life insurance is taxed under section 2033 to the estate of an owner who is not the insured, the amount includable in his gross estate is determined by section 20.2031-8 of the Treasury Regulations.<sup>16</sup> Under this regulation, the amount to be included in the decedent owner's gross estate can be determined by ascertaining the price for which comparable policies would be sold by the insurance company.<sup>17</sup> An alternative method provided by this regulation requires adding the interpolated terminal reserve at the time of the owner's death to the proportionate part of the last premium paid before this date which covers the period extending beyond the time of death.<sup>18</sup>

Under ordinary circumstances, valuation is determined by the selling price of comparable contracts.<sup>19</sup> Even though this valuation is expressed in terms of a sale by the insurance company, it is also stated to be the amount that a "willing buyer" would give a "willing seller" for the contract.<sup>20</sup> The alternate method,<sup>21</sup> to be used only when the price of comparable contracts cannot be ascertained, provides for using the interpolated terminal reserve as the base figure and adding a proportionate part of the last premium. This method is not to be used, however, if the approximation is not reasonably close to the full value of the policy.

Valuation of an interest in life insurance for inclusion in the decedent's estate usually does not present great difficulties. Where the owner of the policy is someone other than the insured and the owner predeceases the insured, an amount equal to the replacement value<sup>22</sup> of the policy is in-

<sup>11</sup> *Commissioner v. Noel Estate*, 380 U.S. 678 (1965).

<sup>12</sup> *United States v. Stewart*, 270 F.2d 894 (9th Cir.), *cert. denied*, 361 U.S. 960 (1959).

<sup>13</sup> *Treas. Reg. § 20.2031-8(a)(1)*, T.D. 6680, 1963-2 CUM. BULL. 417.

<sup>14</sup> *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921).

<sup>15</sup> *Chase Nat'l Bank v. United States*, 278 U.S. 327 (1929).

<sup>16</sup> *Treas. Reg. § 20.2031-8*, T.D. 6680, 1963-2 CUM. BULL. 417.

<sup>17</sup> *Treas. Reg. § 20.2031-8(a)(1)*, T.D. 6680, 1963-2 CUM. BULL. 417.

<sup>18</sup> *Treas. Reg. § 20.2031-8(a)(2)*, T.D. 6680, 1963-2 CUM. BULL. 417.

<sup>19</sup> *Treas. Reg. § 20.2031-8(a)(1)*, T.D. 6680, 1963-2 CUM. BULL. 417.

<sup>20</sup> *Goodman v. Commissioner*, 156 F.2d 218 (2d Cir. 1946).

<sup>21</sup> *Treas. Reg. § 20.2031-8(a)(2)*, T.D. 6680, 1963-2 CUM. BULL. 417.

<sup>22</sup> The replacement value is the amount it would cost on the effective date to purchase the policy from the same or another insurance company. *DuPont's Estate v. Commissioner*, 233 F.2d 210 (3d Cir.), *cert. denied*, 352 U.S. 878 (1956).

cludable in the gross estate.<sup>23</sup> If, however, the insured predeceases the owner, there is no estate tax liability upon the owner's subsequent death because the incidents of ownership are lost when the policy matures and the proceeds are paid to the beneficiary.<sup>24</sup>

## II. VALUATION IN EVENT OF SIMULTANEOUS DEATH

Where the insured and the owner of a life insurance policy die simultaneously, valuation of the policy may become difficult. This is particularly true when the owner is the primary beneficiary under the policy. Under the Uniform Simultaneous Death Act the insured is presumed to have survived the beneficiary.<sup>25</sup> Because of this presumption the owner-beneficiary is not entitled to receive the proceeds of the policy. Also, since the property of each party is disposed of as if he had survived,<sup>26</sup> the insured cannot inherit the incidents of ownership from the owner-beneficiary. Since the presumption of survivorship effects only the *distribution* of property after death, the courts have not recognized it as being pertinent in determining the value of the ownership interest at the moment of the owner's death.

Three valuations are possible for determining the amount to be included in the deceased owner's gross estate when the insured and the owner-beneficiary of a life insurance policy die simultaneously: (1) an amount equal to the full proceeds of the policy, (2) an amount equal to the interpolated terminal reserve value of the policy, and (3) no amount, the property interest being included at a zero valuation. However, the gross, and hence the taxable, estate of the owner-beneficiary includes only his property interest at the time of death,<sup>27</sup> so the proper valuation must be that which most clearly represents this interest.

Even though the presumption of the insured's survivorship precludes the owner-beneficiary from receiving the proceeds of the policy, the entire proceeds may be used for valuation purposes.<sup>28</sup> Because it is the ownership interest, rather than actual receipt of the proceeds that determines the decedent's interest,<sup>29</sup> this valuation may be accurate. The second possible valuation of the policy is the interpolated terminal reserve value.<sup>30</sup> This valua-

<sup>23</sup> Estate of Ethel M. Donaldson, 31 T.C. 729 (1959).

<sup>24</sup> The incidents of ownership cannot exist without the insurance policy. Once the policy matures, the contract is at an end and the incidents of ownership end simultaneously. Even if the owner received the proceeds as the beneficiary under the policy, the money received would be merely an asset subject to tax without dependence upon any ownership interest in a policy.

<sup>25</sup> All three states in which the decisions were rendered had adopted the Uniform Simultaneous Death Act. The section which gives the presumption of survivorship states that if the insured and the beneficiary die simultaneously, the proceeds of the policy are distributed as if the insured had survived the beneficiary. GA. CODE ANN. § 56-2426 (1960); MICH. STAT. ANN. § 720.104 (1968); ORE. REV. STAT. § 112.040 (1968).

<sup>26</sup> GA. CODE ANN. § 113-906 (1960); MICH. STAT. ANN. § 720.101 (1968); ORE. REV. STAT. § 112.010 (1968).

<sup>27</sup> INT. REV. CODE OF 1954, § 2033.

<sup>28</sup> Under Treas. Reg. § 20.2031-8(a)(1), T.D. 6680, 1963-2 CUM. BULL. 417, the fair market value of the policy can possibly be equal to the full proceed value. Estate of Chown, 51 T.C. 140 (1968).

<sup>29</sup> INT. REV. CODE OF 1954, § 2033.

<sup>30</sup> If the circumstances meet those stated in Treas. Reg. § 20.2031-8(a)(2), T.D. 6680, 1963-2 CUM. BULL. 417, it may be found, as it was in Old Kent Bank & Trust Co. v. United States, 292 F. Supp. 48 (W.D. Mich. 1968), that this is the proper valuation.

tion is especially attractive because it is the traditional figure used in determining the interest of the owner when he predeceases the insured.<sup>31</sup> Also, it may be accurate since it is the insurance company's estimate of the value of the policy at the moment of the owner-beneficiary's death. Finally, the value of the policy to the decedent owner's estate may be zero.<sup>32</sup> Since under the Uniform Simultaneous Death Act there is a presumption that the insured survives the beneficiary, it may be argued that the owner-beneficiary had no valuable property interest in the policy. This argument is persuasive because the incidents of ownership are lost at the exact instant of the owner's death.

### III. ESTATE OF CHOWN AND OLD KENT BANK & TRUST CO. V. UNITED STATES

The conflict between *Chown* and *Old Kent Bank & Trust* is the result of differing interpretations of Treasury Regulation section 20.2031-8.<sup>33</sup> The tax court in *Chown* found paragraph (a) (1) of this section applicable because the approximation under paragraph (a) (2) was not reasonably close to the full value of the policy. In reaching the decision, the tax court relied on a case that did not involve simultaneous death,<sup>34</sup> and held that the policy must be treated as fully matured upon the owner's death. The court reasoned that as the event of death drew nearer, the owner's interest increasingly approached the full proceeds value of the policy until the two amounts became equal at the moment of the simultaneous deaths. Because under this theory the value of the owner's interest was equal to the full proceeds value at the time of death, the court determined that the approximation under paragraph (a) (2) was not "reasonably close to the full value of the contract."<sup>35</sup>

Having decided that paragraph (a) (1) applied, and relying on a case not involving simultaneous death,<sup>36</sup> the tax court determined that the fair market value of the policy was equal to the full value of the proceeds, therefore, this amount was includable in the owner's gross estate. The court held that the full value of the proceeds was the fair market value because it was the price at which the policy would change hands between a "willing buyer" and a "willing seller" at the moment of death.

Contrary to the decision in *Chown*, the district court in *Old Kent Bank & Trust* determined that paragraph (a) (2) of Treasury Regulation section 20.2031-8 applied to the situation. It relied on the fact that the contract had been in force for some time, that further premium payments were to be made, and that by the fact of simultaneous death, valuation of the contract was made difficult. The court observed that the policy was not of

<sup>31</sup> Estate of Ethel M. Donaldson, 31 T.C. 729 (1959).

<sup>32</sup> Under Treas. Reg. § 20.2031-8(a) (2), T.D. 6680, 1963-2 CUM. BULL. 417, the fair market value can possibly be zero if a willing buyer would pay nothing for the ownership interest at the time of death. *Old Kent Bank & Trust Co. v. United States*, 292 F. Supp. 48 (W.D. Mich. 1968).

<sup>33</sup> Treas. Reg. § 20.2031-8, T.D. 6680, 1963-2 CUM. BULL. 417.

<sup>34</sup> Estate of James Stuart Pritchard, 4 T.C. 204 (1944).

<sup>35</sup> Treas. Reg. § 20.2031-8(a) (2), T.D. 6680, 1963-2 CUM. BULL. 417.

<sup>36</sup> *Goodman v. Commissioner*, 156 F.2d 218 (2d Cir. 1946).

such an "unusual nature" as would make the approximation under paragraph (a) (2) "unreasonable." Having found paragraph (a) (2) applicable, however, the court determined that the valuation of the policy in the owner's estate should be zero rather than the interpolated terminal reserve value. In doing so, the court applied the "willing buyer" concept used in *Chown* even though it distinguished the case principally relied on in *Chown* to establish this concept<sup>37</sup> as being inapplicable because it did not involve simultaneous death.

The district court in *Old Kent Bank & Trust* reasoned that the incidents of ownership possessed by the owner-beneficiary were worth nothing at the instant of death because the proceeds passed to the contingent beneficiaries. Because the deaths of both the owner and the insured were imminent and the proceeds upon their deaths would go to the contingent beneficiaries, the court determined that a "willing buyer" would pay nothing for the interest transferred from the owner to his estate. The court based this determination on the fact that it is the interest transferred *at death* that is pertinent to valuation, not the value of the owner's interest *before death*. It was found that inclusion of the full proceeds in the owner's estate would not tax the interest at the time of the transfer, *i.e.*, the time of death. For this proposition, the court relied on a case holding that the tax must be on the interest transferred at the time of death if the tax is constitutional.<sup>38</sup>

#### IV. CONCLUSION

Neither case is entirely correct in its reasoning. However, the decision in *Old Kent Bank & Trust* comes nearer to actually using the valuation of the transfer at the time of death. This is true even though the court found paragraph (a) (2) of the regulations applicable and yet apparently proceeded to apply the "willing buyer" test of paragraph (a) (1) in reaching its decision.

When the deaths of the insured and the owner-beneficiary are simultaneous, a proper interpretation of paragraph (a) (1) would yield the result reached in *Old Kent Bank & Trust*. Because the deaths are simultaneous, it is realistic to say that a "willing buyer" would pay nothing for the owner's interest since at the instant of death ownership control over the policy ceases, and the proceeds are payable to the contingent beneficiaries. Thus, the fair market value of the owner-beneficiaries' interest at the *exact instant* of his death would appear to be zero.

The decision in *Chown* can be questioned because it assumes that the insured died momentarily *before* the owner. This assumption appears necessary to justify the result reached in *Chown*. Since the ownership interest must be measured at the exact instant of death, this result cannot be justified.

In cases involving facts similar to *Chown* and *Old Kent Bank & Trust* it seems that paragraph (a) (1) should be applied in the absence of cir-

<sup>37</sup> *Id.*

<sup>38</sup> *United States v. Land*, 303 F.2d 170 (5th Cir.), *cert. denied*, 371 U.S. 862 (1962).