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# Taxation -- Estate Tax -- The Life Estate with a Power of Disposition and the Life Insurance Settlement Option: Candidates for the Marital Deduction

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## NOTES

### TAXATION — ESTATE TAX — THE LIFE ESTATE WITH A POWER OF DISPOSITION AND THE LIFE INSURANCE SETTLEMENT OPTION: CANDIDATES FOR THE MARITAL DEDUCTION.

#### I. Introduction

The life estate with a power of disposition and the life insurance option are two types of devisable interests which have been especially troublesome to the estate planner seeking qualification under the marital deduction. In the field of estate planning and taxation, where the rigid letter of the law is enforced—sometimes to the detriment of the spirit—it is not surprising that the drafter is frequently in dispute with the taxing authorities. Case law and Treasury Regulations are the two most reliable guides in interpreting the statute and determining what drafting language will be successful. In that respect recent developments concerning both the life estate and the life insurance option make it advisable to take another look at the tax consequences of these interests. First, however, it is necessary to consider the background of the life estate, the insurance option, and the taxing statute in order to establish a common basis for discussion.

The life estate with a power of disposition as a means of testamentary disposition of property is popular. An example of a power of disposition or invasion would be: "Residuary estate to my wife for the term of her natural life with full power to use, enjoy, sell, or dispose of the income and principal thereof as she in her uncontrolled discretion may choose, remainder, if any, to. . ."<sup>1</sup>

Often the testator desires to leave his property to his wife so that she may use it in any manner that she sees fit; but at the same time, he does not want to appear callous in completely excluding his children. In such a case, the life estate with a power of disposition seems to be what he is looking for. If the testator's attorney agrees, then the tax aspects of the disposition should be investigated.<sup>2</sup>

The life insurance settlement option is really a species of the life estate with a power of disposition. The chief difference is that the corpus of the life estate is the proceeds of a life insurance policy rather than some other property. Under the settlement options, the proceeds of the policy are not immediately paid out, but are: (1) held at interest; (2) distributed in periodic installments over a fixed number of years; or (3) distributed in the form of a life annuity to a stated beneficiary.<sup>3</sup> In any case, the surviving spouse is given a life interest with power to invade the

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1 A similar estate was contested and found not to qualify in *Pipe v. Commissioner*, 241 F.2d 210 (2d Cir. 1957), cert. denied 355 U.S. 814 (1957). A more limited example is a life estate with power to consume such as: "to my wife for life, with the power in my wife to dispose of the property and to use the proceeds as she deems necessary for her support and maintenance, remainder to . . ."

2 The life estate with a power of disposition may be a two-edged sword. Among its advantages are:

- (1) It provides a fluctuating income to enable the surviving spouse to meet hardships.
- (2) It makes possible a protection of the property against swindlers by imposing a condition that the sale of the property be for full consideration.
- (3) It can be used to discourage remarriage.
- (4) It has a possible economic advantage over trusts if the corpus is less than \$25,000.

On the other hand, its disadvantages are:

- (1) The remaindermen can be completely cut out.
- (2) The protective restrictions cloud the title to the corpus.
- (3) It is difficult to trace the corpus through the hands of the spouse in determining the remaindermen's share.
- (4) It has proved to be unusually litigious.

For a discussion of the estate generally, see Note, 32 NOTRE DAME LAWYER 141 (1956).

3 Waldo, *Utmost Care Is Needed in Qualifying Insurance for the Marital Deduction*, 13 J. TAXATION 280 (1960).

principal as she wills, remainder, if any, to a third party. While the settlement option, as has been pointed out, is merely a form of the life estate, it contains several peculiar, crucial tax problems which will be discussed later.

This brief outline of the nature of the interests should provide a sufficient framework upon which to found a discussion of their tax consequences. The drafter must constantly recognize, however, that there are many important property and estate planning aspects to be investigated in creating the testamentary instrument. Some of these aspects may outweigh the tax advantages. Tax planning has been defined as "the obtaining of whatever tax economies are consistent with overall human objectives of estate planning."<sup>4</sup> With this in mind, the next step is to look to the statutory provisions to which he must strictly adhere.

The marital deduction first appeared in the Internal Revenue Code in 1948. Its declared purpose is to make the federal estate tax burden more equitable for common law property states.<sup>5</sup> Formerly the residents of community property states received a tax advantage since, in such jurisdictions, each spouse possesses an undivided one-half interest in fee in the community property. In order to equalize the tax burden, it was necessary to allow a deduction, of an amount equal to one-half the value of the decedent's adjusted gross estate, to be subtracted from the value of all property passing from the decedent to his surviving spouse.<sup>6</sup>

Since the only purpose in allowing the marital deduction is to neutralize the advantage of the community property states, it follows that only interests equivalent to community property interests passing to the surviving spouse should be allowed the deduction. In keeping with this theory, section 2056(b)<sup>7</sup> provides that no marital deduction is allowed with respect to certain property interests known as terminable interests. Terminable interests have been defined as interests "which will terminate or fail on the lapse of time or on the occurrence or the failure to occur of some contingency."<sup>8</sup> Such terminable interests, *e.g.*, life estates, are not the equivalent of the estate which passes tax-free in community property states and should not be allowed the deduction.

There are, however, three exceptions to the terminable interest rule. They are: (1) A deduction is allowed if the only condition under which the interest will terminate is the death of the surviving spouse within six months after the decedent's death and the condition does not occur.<sup>9</sup> (2) A deduction is allowed if a life interest in property passes to the surviving spouse (whether in trust or not) and the spouse is entitled to all the income from all or a specific portion of the property, *coupled* with a power in her to appoint her entire interest in the property.<sup>10</sup> (3) A deduction is allowed if the interest in property passing to the surviving spouse consists of proceeds held by an insurer under the terms of a life insurance contract, provided she complies with certain conditions.<sup>11</sup> The first exception is beyond the scope of this discussion, but the second and third exceptions are the life estate with a power of disposition and the insurance settlement option respectively.

The federal tax regulations list five conditions for the allowance of the deduction to the life estate and five conditions for the allowance to the insurance option. The conditions which must be met by the life estate are:<sup>12</sup> (1) The surviving spouse must be entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from

4 Lawthers, *Basic Planning Principles in Qualifying Life Insurance for the Marital Deduction*, 37 TAXES 723 (1959).

5 S. REP. NO. 1013, 80th Cong., 2d Sess. 16, pt. 2 (1948).

6 INT. REV. CODE OF 1954, § 2056(c)(1).

7 INT. REV. CODE OF 1954, § 2056(b)(1).

8 Treas. Reg. § 20.2056(b)-1(b) (1960).

9 INT. REV. CODE OF 1954, § 2056(b)(3).

10 INT. REV. CODE OF 1954, § 2056(b)(5).

11 INT. REV. CODE OF 1954, § 2056(b)(6).

12 Treas. Reg. § 20.2056(b)-5(a) (1960).

the entire interest. (2) The income must be payable annually or at more frequent intervals. (3) The surviving spouse must have the power to appoint the entire interest or the specific portion to either herself or to her estate. (4) The power must be exercisable by the surviving spouse alone, and in all events. (5) The interest must not be subject to a power in another person to appoint to any person other than the surviving spouse. Correspondingly, the conditions to be met by the insurance settlement option are:<sup>13</sup> (1) The proceeds of the policy must be held by the insurer subject to an agreement either to pay the entire proceeds or a specific portion thereof in installments or to pay interest thereon, and the payments during the life of the spouse must be made only to her. (2) The installments or interest must be payable annually or at more frequent intervals, commencing not later than 13 months after the decedent's death. (3) The surviving spouse must have the power to appoint the amounts so held by the insurer to either herself or her estate. (4) The power must be exercisable by the surviving spouse alone and in all events. (5) The amounts payable under such contract must not be subject to a power in another person to appoint to any person other than the surviving spouse.

With the applicable statutory provisions and administrative regulatory interpretation of the statute set out, it is possible to proceed in considering how specific estate plans have fared in the courts.

## II. *The Life Estate With a Power of Disposition*

The leading case dealing with the qualification of the life estate with a power of disposition for the marital deduction is *Pipe v. Commissioner of Internal Revenue*.<sup>14</sup> While *Pipe* was decided under the pre-1954 Code, it would not be wise to disregard it today.

The testator devised and bequeathed a life estate to his wife, "with full power to use, enjoy, sell or dispose of the income and principal thereof, . . . as she in her uncontrolled discretion may choose, . . . except that she shall have no power over the disposition of such part thereof as remains unexpended at the time of her death." The remainder of the estate, if any, was to go to certain named legatees. The first contention for the testator was that the life tenancy was the equivalent of an absolute ownership under a New York Statute<sup>15</sup> changing some life estates with the power of disposition into fee absolutes for certain purposes. This view was rejected by the court because one of the most significant elements of absolute ownership, namely, testamentary power, was absent.

The second contention in *Pipe* was that even if the bequest did not convey a fee simple, it nevertheless qualified for the marital deduction under the predecessor of subsection 2056(b)(5), as a trust coupled with the power of appointment.<sup>16</sup> The court also rejected this view. According to the Treasury Regulations, the widow must have a power to appoint the corpus to herself<sup>17</sup> as unqualified owner or to appoint the corpus as part of her estate. Clearly the wife had no testamentary power, and the court claimed that there was no unlimited power to invade free of the trust because as long as the corpus remains it will be held in trust for the remainderman. The crux of the argument seems to be that the wife, during her lifetime, could not appoint the entire corpus to herself "free of the trust" because there would be a trust imposed upon her to refrain from squandering the corpus

13 Treas. Reg. § 20.2056(b)-6(a) (1960).

14 241 F.2d 210 (2d Cir. 1957).

15 N.Y. REAL PROP. LAW § 149 (McKinney 1946).

16 Since *Pipe v. Commissioner* was decided under the 1939 Code, it was necessary to claim that the life interest was held in trust. Under the 1954 Code the life estate barren of any trust was made to qualify. The court in the present case assumed *arguendo* that the bequest created a trust.

17 It is customary in this field to speak of the surviving spouse as the wife although the same results would occur if it were the husband, of course.

to defeat the remainder. No provision was made in the will for the cessation of the remainder upon the appropriation of the corpus.<sup>18</sup>

Judge Swan, dissenting, argued that the deduction should be allowed, looking to the legislative intent, since the power of appointment in the wife would be subject to her estate tax. The judge cited the Senate Finance Committee Report, stating: "This provision is designed to allow the marital deduction for such cases where the value of the property over which the surviving spouse has a power of appointment will (if not consumed) be subject to either the estate tax or the gift tax in the case of such surviving spouse."<sup>19</sup> The "legislative intent" argument, while frequently raised, has had limited acceptance as an argument upon which decision is rested.

Looking at *Pipe* in the light of the 1954 Code, it would seem to have lost much of its vitality as a leading case. It is no longer necessary that the property pass to the surviving spouse in trust. Secondly, the statute no longer requires that the spouse be able to appoint the corpus "free of the trust." This seemed to be the phrase upon which the court declared that the wife's power of appointment during her lifetime was limited. The decision denying that the bequest was an absolute ownership under New York law still appears sound.

The Third Circuit applied very similar reasoning in *Commissioner v. Ellis*.<sup>20</sup> In this case, the widow was to receive all the income from a trust and had the right to invade the corpus in such amounts as she required. Upon her death, one-half of the corpus was to pass to her estate and one-half to decedent's children. The court rightly allowed the deduction as to the one-half portion of the unconsumed corpus which would go to the wife's estate. Under the Tax Regulations, either an unlimited power to invade during the lifetime or the power to devise is sufficient to qualify for the deduction.<sup>21</sup> As in *Pipe*, the deduction was not allowed to the one-half of the corpus which would go to the decedent's children. The court held that even though the wife could invade at her discretion, she could not appoint the children's one-half interest "free of the trust." That is to say, she could not defeat the testator's intent as to remaindermen *unless for valid purposes*. Hence, her control was not unlimited. *Ellis* was also decided under the 1939 Code.

Before discussing the remaining principal cases in this area, it is necessary to mention the Technical Amendments Act of 1958.<sup>22</sup> Essentially, the amendment applies the 1954 Code retroactively to estates of decedents dying after April 1, 1948 and before August 17, 1954.

As a result of the Technical Amendments Act, the Fifth Circuit, in 1958, passed down two important decisions in which the marital deduction was allowed. In *Stallworth v. Commissioner*,<sup>23</sup> the wife was the beneficial owner, under the will, of an undivided one-half interest in the testator's estate for a term of life. In addition, she had the power to invade and dispose of the one-half interest as she saw fit. If it remained in the trust, then on the wife's death the remainder would be disposed of according to the will.

The court first rejected the contention that the life tenancy, because of the power of appointment, was the equivalent of a fee simple under Alabama law; it is only where no remainder is limited on the estate of the donee that such estate becomes an absolute fee. The court stated further that the estate did not qualify for the deduction under Section 2056(b)(5) because the wife was not entitled to all the income from the corpus of the trust and did not have power to appoint the

18 This point was an important factor in *Hoffman v. McGinnes*, 277 F.2d 598 (3d Cir. 1960), which will be taken up later.

19 S. REP. NO. 1013, 80th Cong., 2d Sess. 16, pt. 2 (1948).

20 252 F.2d 109 (3d Cir. 1958).

21 Treas. Reg. § 20.2056(b)-5(a)(4) (1960).

22 TECH. AMEND. ACT OF 1958, §93, 72 Stat. 1668. While *Commissioner v. Ellis* is dated 1958, it was decided before the Act was passed.

23 260 F.2d 760 (5th Cir. 1958).

entire corpus free of the trust.<sup>24</sup> However, on rehearing, the marital deduction was allowed to the one-half interest possessed by the surviving spouse. Under the 1954 Code, the estate or trust may consist of all the income from the entire interest or all the income from a specific portion of the entire interest with the corresponding power to appoint.<sup>25</sup>

The other case coming out of the Fifth Circuit is *McGehee v. Commissioner*.<sup>26</sup> The devise was to the husband, with "full power to dispose of the same and to use the income and corpus thereof in such a manner as he may determine, without restriction or restraint." If any of such property remained in possession of the husband on his death, then the remainder went to the testator's brothers and sisters. Again, the court determined that under the applicable local law (Florida) the life estate with a power of appointment was not enlarged to a fee. Also, there was no allowance under section 2056(b)(5) because the interest did not pass in trust. On rehearing, however, the deduction was allowed, again because of the passage of the Technical Amendments Act. Under the 1954 Code, the interest may pass "whether or not in trust."<sup>27</sup> The Commissioner argued on the basis of the *Ellis* decision that the interest here was not exercisable in all events.<sup>28</sup> The court distinguished *Ellis*<sup>29</sup> by holding that here the surviving spouse had power to dispose "without restraint," e.g., he could give the property away, while in *Ellis* the power was "as she required," which meant she could use the property only for herself. The distinction may seem small, but in this area it may be important that the drafter refrain from limits such as those set in *Ellis*. The power to make either a testamentary or inter vivos gift will eliminate many tax stumbling blocks. It should be noticed also that here the spouse was allowed, by gift, to defeat the remaindermen, an incident which did not disturb this court as much as it disturbed the *Pipe* court.<sup>30</sup>

The most recent and enlightening decision in the field of the life estate with power of invasion is *Hoffman v. McGinnes*,<sup>31</sup> in the Third Circuit. The will in *Hoffman* created a trust from which the wife was given the income for life and "the right to use and spend any or all of the principal of my said estate, if she so desires . . . and said trust shall cease as to that part of the principal so paid to her." The balance, if any, remaining in the estate upon the wife's death went to certain named remaindermen. The court first pointed out that the 1954 Code had made two significant changes. It eliminated the requirements (1) that the life estate must be devised *in trust* and (2) that the surviving spouse's right to income and power to appoint must extend to the *entire* interest. However, the court stated that the difference in the codes was of no importance in this decision.

24 The same phrases of the 1939 Code were crucial to the holding in *Pipe v. Commissioner*, it will be recalled.

25 INT. REV. CODE OF 1954, § 2056(b)(5).

26 260 F.2d 818 (5th Cir. 1958).

27 INT. REV. CODE OF 1954, § 2056(b)(5).

28 The powers which are also spoken of as being unqualified or unlimited more properly fit under the words of the statute "exercisable in all events."

There are many tax court cases which point out that some of the traditional standards set for the surviving spouse's invasion of the corpus will defeat the marital deduction allowance. Examples of standards making the power "not exercisable in all events" are: "comfort and maintenance," *Elwood Comer*, 31 T.C. 1193 (1959) and *E. W. Noble*, 31 T.C. 888 (1959); "happiness and well-being," *Ralph May*, 32 T.C. 386 (1959); "normal living expenses," *Thomas Tebb*, 27 T.C. 671 (1957); "deemed to be in best interest," *Harriet Evilsizor*, 27 T.C. 710 (1957); "as she pleases for her support," *Wallace Howell*, 28 T.C. 1193 (1957). In *Howell* it was held that controlling Ohio law holds such language to create a vested remainder subject to divestment and the life estate is limited to consumption for support.

29 *Commissioner v. Ellis*, 252 F.2d 109 (3d Cir. 1958).

30 *Pipe v. Commissioner*, 241 F.2d 210 (2d Cir. 1957), cert. denied 355 U.S. 814 (1957). *Boyd v. Gray*, 175 F. Supp. 57 (W.D. Ky. 1959), followed the *Stallworth* and *McGehee* decisions. There the estate was left for life to the wife to be disposed of in any way she chose but if any property was left at her death, then the remainder went to the testator's son.

31 277 F.2d 598 (3d Cir. 1960).

The district court relied on *Ellis* in denying the deduction but the circuit court distinguished *Ellis* and reversed. To begin with, ". . . [p]recedents are of little value in the construction of wills, because when used under different circumstances and with different context, the same words may express different intentions."<sup>32</sup> The court went on to distinguish *Ellis* in two material aspects. First, there was a power to invade as the spouse "required" in that case whereas here the power was as she "desired." It may be that under the applicable Pennsylvania law "required" would limit the invasion to personal uses, but under a host of Pennsylvania decisions included in the opinion, it would seem that "desired" would be interpreted as a full power of appointment including the power to make gifts as required by the Regulations.<sup>33</sup> The second distinguishing aspect was that in *Hoffman* the language stated that the "trust shall cease as to that part of the principal paid." This last phrase is the most crucial in the decision and would be appropriate for the drafter's files. The court was trying throughout the opinion to establish the testator's intent. Did he intend that the spouse have the power to invade for any reason, including giving the corpus away if she saw fit? Did he intend that the spouse should have the power to cut out his named remaindermen if she so desired for any reason she might have? The court answered yes to both questions, stating that under Pennsylvania law the marital deduction would be granted. The "trust shall cease" phrase was seized upon as indicating the *testamentary* extinguishment of the remainder interest as the corpus was used. In other words, the spouse could defeat the remainder interest for any reason or no reason. This may be important in states which impose a duty on the spouse life tenant to refrain from squandering the estate to deprive the remaindermen of their interest, as in *Pipe v. Commissioner*. At any rate, *Hoffman* provides a healthy injection of the "testamentary intent" test into the estate tax picture.

### III. *The Life Insurance Settlement Option*

As indicated in the introductory remarks, under the settlement cases the proceeds of the policy are held by the insurer. Obviously, if there is an unqualified lump sum payment to the surviving spouse and the amount is included in the decedent's gross estate the marital deduction applies. The proceeds, if held, may be held at interest, distributed in installments, or in the form of a life annuity. If the proceeds are retained by the insurer and a life annuity is paid to the spouse, a clear example of a terminable interest is set up. If the annuity is non-refundable and terminates at the spouse's death, or if refundable and paid to her estate, or if she has a power of appointment over the installments "exercisable in all events" during her life, the terminable interest will nevertheless qualify for the deduction.<sup>34</sup> Insofar as the interest is terminable, the discussion of the life estate with a power of appointment is also pertinent here. As in the life estate, two points must be remembered: (1) If the surviving spouse has testamentary power over the proceeds, the deduction will be allowed even though she may have no inter vivos power.<sup>35</sup> (2) If the power of appointment is to be exercised by the spouse it must be "exercisable in all events." More particularly, in the option area, it is important to keep in mind that it is the state of affairs at the death of the testator that governs. For example, if the surviving spouse chooses an option after the testator's death which would not qualify, the deduction is not jeopardized. These general points must be carried into all case analysis.

The decided cases dealing with eligibility of the life insurance settlement option for the marital deduction fall generally into two distinct problem areas. One prob-

32 *In re Long's Estate*, 270 Pa. 480, 113 A. 675 (1921).

33 Treas. Reg. § 20.2056(b)-5(g)(3) (1960).

34 See generally Waldo, *supra* note 3.

35 Most insurance companies do not recognize the power to appoint proceeds by will and therefore the appointment is generally by contract under one or more options in the policy.

lem is whether the wife has a power exercisable in all events when the policy provides that if she should die before due proof of her husband's death, or before distribution, the proceeds will pass to another party. Analogous to this is the question of when administrative requirements may become significant enough to be considered a limit on the power of appointment.

The other main problem leading to litigation is whether the property in interest may be considered to be in separate portions when the option creates two interests, one of which does not qualify for the marital deduction.

*Werbe v. United States*<sup>36</sup> is the key case in the "exercisable in all events" problem area. Under the insurance option contained in that policy, the surviving spouse had the power to withdraw the proceeds in whole or in part with the following restrictions: (1) The power of withdrawal could be exercised only on the monthly interest payment days. (2) The company required a 90-day notice of intent to withdraw. (3) A limit of four withdrawals of principal per year was imposed. (4) The withdrawal had to be greater than \$50, and the balance of the principal could not be maintained at less than \$100. The policy also provided that the proceeds were to be payable on receipt of proof of death.

Looking at the provisions in the policy, the court held that the surviving spouse had only a terminable interest and her power of appointment over the proceeds was not *exercisable in all events*. The court reasoned that since the proceeds were payable on receipt of proof of death and the right of withdrawal could be exercised only on interest payment dates, the first of which came one month after the testator's death, the power to withdraw was not exercisable in all events. If Mrs. Werbe were to die while the option became operative, the proceeds would go to the remainderman.

The plaintiff introduced expert testimony by an executive of the insurer showing that the restrictions were mere administrative conveniences of the company which in no way limited the wife's power of withdrawal. The witness further testified that the wife could have withdrawn the entire proceeds immediately after her husband's death if she had so requested. To this the court replied that the language of the contract was unambiguous and needed no interpretation by experts.

Certainly the *Werbe* case makes advisable a careful second look at the present insurance option provisions by both the insured and the insurer. The case is discouraging; it ignores the realities of the situation more than does the approach of the Third Circuit in the *Hoffman* case.<sup>37</sup>

Another example of the more realistic approach of the Third Circuit is *Eggleston v. Dudley*.<sup>38</sup> There the insured had intended to change the settlement provisions of his policy so as to qualify for the marital deduction. In so doing, he produced a direct contradiction as to whether the proceeds of the policy would go to his wife's estate or to his estate in the event she died before proof of his death. The court stated that in resolving the conflict under Pennsylvania law the intent of the parties should be honored and in this case the provisions of the policy would be interpreted so as to obtain the deduction. The court also held that settlement "upon receipt of due proof of death" did not mean that the widow was not entitled to the proceeds of the policy upon the death of her husband but only that she could not receive the proceeds until then. This reasoning appears to contradict the holding in the *Werbe* case.

The court alluded to the importance of local law in this area in the *Eggleston* opinion. There are a number of other decisions on point which apply both to the insurance option and to the life estate when there is local law precedent. For example, in *Smith v. United States*<sup>39</sup> an estate was devised absolutely, followed by

36 273 F.2d 201 (7th Cir. 1959).

37 *Hoffman v. McGinnes*, 277 F.2d 598 (3d Cir. 1960).

38 257 F.2d 398 (3d Cir. 1958).

39 158 F. Supp. 344 (D. Colo. 1958).

a provision that if the wife should die before distribution, then the devise would lapse. The marital deduction was allowed because under Colorado law the property was absolutely vested and not vested subject to divestment.<sup>40</sup>

The second major litigious problem, that of divided proceed interests, is illustrated by *Reilly v. Commissioner*.<sup>41</sup> The policy provided for a distribution of proceeds for a period of 10 years certain and thereafter for the life of the wife. If the wife died within the 10-year period, the remaining installments were to go to remaindermen. The tax court held that "property" as used in the statute<sup>42</sup> includes all proceeds payable under the contract. The Third Circuit reversed and allowed the deduction as to that portion of the proceeds funding the contingent annuity after the 10-year period. The insurance company had set up two funds out of the total proceeds, one for the 10-year period and one for the annuity. The deduction was applied to the fund set out of the proceeds for the annuity. Looking at the statute and regulations the court stated that the word property is imprecisely defined and cannot be fit into a rigid formula. It must be interpreted in the light of the particular case circumstances. The court went on to say that there were two bundles of rights at the time of the husband's death. True, there was only one fund, but the actuary computation of the amounts needed to fund each of the two rights was practically necessary. Thus, for tax purposes, there were two funds or properties, and the deduction applied to one of them. There would have been no ultimate tax avoidance; if the wife lived to collect the annuity it would have been taxed in her estate.

In *Meyer v. United States*<sup>43</sup> the Second Circuit repudiated the *Reilly* decision. The issue as stated by the court is whether the estate is entitled to the marital deduction for a portion of the proceeds of a life insurance policy when the whole proceeds are held by the insurer under a settlement option, the terms of which provide that the spouse receive monthly payments for the remainder of her life, but if she should die within 20 years then the remainderman is to receive payments until the 20-year period is lapsed. The district court found the portion of the proceeds allocable to the funding of the contingent life annuity after the 20-year period qualified for the deduction. The Court of Appeals reversed, holding that the whole of the proceeds as held by the insurer constituted the "property" and that each fund was not a separate unit of property under the statute. The court distinguished between an interest and property as used in the Regulations<sup>44</sup> and held the two funds to be separate interests but one unit of property. The contract did not request or provide for a segregation of the proceeds; the company did it as a practical matter, and for tax purposes there was only one fund. The dissent would have followed the *Reilly* case. Language in *Reilly* also indicated the court believed that the segregation was a practical matter but made necessary by the two rights set up in the contract. Throughout the marital deduction area the Third Circuit seems to have the better and more consistent approach to the marital deduction problem. However, the conflict between the *Reilly* and *Meyer* cases was resolved in favor of the Second Circuit when the Supreme Court rendered its decision in the *Meyer* case this term.<sup>45</sup>

In the light of the foregoing analysis of the *Reilly* and *Meyer* cases, the decision of the Supreme Court appears questionable. In the majority opinion, the

40 *Accord*: *Martinson v. Wright*, 181 F. Supp. 534 (D. Idaho 1959); *Steele v. United States*, 146 F. Supp. 316 (D. Mont. 1956); *Kellar v. Kasper*, 138 F. Supp. 738 (D.S. Dak. 1956). *See also*: *Helvering v. Stuart*, 317 U.S. 154 (1942). *Contra*: *California Trust Co. v. Riddell*, 136 F. Supp. 7 (S.D. Cal. 1955).

41 239 F.2d 797 (3d Cir. 1957).

42 INT. REV. CODE OF 1954 § 2056(b)(6). "In the case of an interest in property passing . . ."

43 275 F.2d 83 (2d Cir. 1959), *cert. granted* 361 U.S. 929 (1960).

44 Treas. Reg. § 20.2056(b)-6 (1960).

45 *Meyer v. United States* 81 S. Ct. 210 (Nov. 21, 1960). This decision was handed down

Court adopted the reasoning of the Second Circuit, while the three dissenters approved of the reasoning of the Third Circuit as expressed in the *Reilly* decision.

From a practical viewpoint, the drafter of insurance settlement provisions will take notice of the fact that the Court held open the possibility of providing, in the contract, for the segregation of the funds necessary to pay the contingent life annuity. This should prove to be a worthwhile tip in view of the fact that the Court held that there were two interests under the contract, but only one property right. A direct order to the insurer to segregate the funds would probably be held to create two rights and thus, in cases such as *Meyer*, to qualify for the marital deduction.

#### IV. Conclusion

From the foregoing analysis, it is readily apparent that the law concerning the applicability of the marital deduction to the life insurance option and the life estate with a power of disposition is in a confused state. As indicated, the Third Circuit seems to be applying the law most consistently, following the legislative intent. Needless to say, however, this is of little comfort to the estate planner or tax counsel who is in another jurisdiction.

It may be desirable to reiterate some of the most basic principles to bear in mind when working in this area. The most important concept to remember is stated in the Regulations:

A power is not considered to be a power exercisable for a limited purpose only. . . . Likewise, if there are any restrictions either *by the terms of the instrument or under applicable local law*, on the exercise of a power to consume property . . . for the benefit of the spouse, the power is not exercisable *in all events*. Thus, if a power is exercisable only for the spouse's support, or only for her limited use, the power is not exercisable in all events.<sup>46</sup>

The Regulations go on to say that the spouse must have unrestricted power, including the power to dispose of the property by gift. Of course, if the spouse has power to dispose by will, her lifetime power may be restricted. Unfortunately for the testator, the classic standards for invasion of the corpus used in the life estate, which may make it attractive to him (*e.g.*, comfort, support, maintenance, so long as she does not remarry, etc.) will keep the estate from qualifying for the deduction. Thus, while this paper is concerned only with the tax consequences, the drafter will often have to weigh the human and tax aspects in drafting the testamentary instrument.

Looking to the insurance option, some hints for the insurer were provided by the cases which denied deduction. For example, from the language in the *Werbe* case two possible solutions would seem to be: (1) give the widow an unqualified power to exercise her withdrawal privilege but give the company a right to delay payment until the next interest day; (2) give her the power to direct the proceeds to her estate. Either would qualify, regardless of lifetime restrictions.<sup>47</sup>

Likewise, the *Meyer* case indicates the possibility of providing in the contract for the segregation of the funds needed to pay for the contingent life annuity. The Supreme Court decision did not eliminate the *Meyer* problem.

Other than the above suggestions, the only safe course is to incorporate in the instrument the exact phrases that have been determined to be correct by the particular jurisdiction involved. In the future it may be that the approach of the Third Circuit will gain wider judicial adoption or be accorded favor by the Tax Regulations and the prosecuting division of the Treasury Department.

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after this Note was substantially completed: the comments herein are primarily in terms of the Court of Appeals decision. See 29 U.S.L. WEEK 4041 (U.S. Nov. 22, 1960).

<sup>46</sup> Treas. Reg. § 20.2056(b)-5(g)(3) (1960) (emphasis added).

<sup>47</sup> Waldo, *supra* note 3.