A REEXAMINATION OF INTERNAL REVENUE CODE
SECTION 2042 AS APPLIED TO CALIFORNIA
COMMUNITY PROPERTY LAWS

Section 2042 of the Internal Revenue Code of 1954 requires the inclusion of the proceeds of life insurance policies in the estate of the insured, even though the proceeds are receivable by a beneficiary other than the insured's executor, provided the insured "possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person." The regulations to the Code have provided a guide for determining whether the decedent possessed the requisite incidents of ownership. They read in part:

The term "incidents of ownership" is not limited in its meaning to ownership in the technical legal sense. Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. Similarly, the term includes a power to change the beneficiary reserved to a corporation of which the decedent is sole stockholder.

If the policy on the life of the insured is considered his separate property, all the proceeds are included in the insured's gross estate at his death if the requirements of section 2042 are met. If the same policy is considered entirely community property, only one-half of the policy—the insured spouse's community interest—is included in the

1 Int. Rev. Code of 1954, § 2042. This section further provides:
"The value of the gross estate shall include the value of all property—
(1) Receivable by the executor.—To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.
(2) Receivable by other beneficiaries.—To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent 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. For purposes of the preceding sentence, 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. . . ."


3 Treas. Reg. § 20.2042-1(c) (2) (1958). In the committee reports of the Seventy-seventh Congress (1942) the situations embodied in the present regulations were described as examples of incidents of ownership. H.R. Rep. No. 2338, 77th Cong., 2d Sess. 162-63 (1942); S. Rep. No. 1631, 77th Cong., 2d Sess. 234-35 (1942). Case law also supported the regulation's list of examples. For a listing of cases, see C. Lownes & R. Kramer, Federal Estate and Gift Taxes 280 n.34 (2d ed. 1962).

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insured's gross estate. In the normal situation the net estate tax is the same in both instances because the marital deduction may be used for policies that are separate property, but not for community policies. The rationale of the decision of the Internal Revenue Service and the courts to include only one-half of community policies in the insured's gross estate, however, is subject to criticism in the light of recent decisions and the express language of section 2042.

The regulations mention both a "power" and a "right" in regard to incidents of ownership, but the two words are not synonymous. Generally, the word "power" refers to the insured's ability to exercise legally an incident of ownership according to the terms of the insurance contract. A "right" refers to the insured's ability to affect the economic benefits of the policy without incurring legal liability once the power is exercised. Therefore, the distinction between a power and a right to exercise an incident of ownership is a first step toward the classification of the respective interests of the husband and wife in a community policy. This classification is necessary in order to determine whether the rationale of the decision to tax only one-half the proceeds of community policies is correct. It is the premise of this note that if the decedent-insured has a power to exercise an incident of ownership his estate will include the value of the policy regardless of the fact that he may not have a corresponding right.

Recent decisions in separate property jurisdictions have interpreted section 2042 in terms of the "powers" and "rights" possessed by the insured in the policies. Often, however, the courts have not distinguished between a power and a right and the two words have been used interchangeably. It is not necessary to draw this distinction when the insured possessed both a "power" and a "right" to exercise incidents of ownership since if both are present the courts have held that the entire life insurance proceeds are to be included in the gross estate of the insured.

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4 See United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7, 11 (1st Cir. 1966); Estate of Fruehauf, 50 T.C. 915, 925 (1968). The words "power" and "right" as used in this comment do not correspond with Hohfeldian terminology as expressed in W. Hohfeld, Fundamental Legal Conceptions (1923).


7 E.g., United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7 (1st Cir. 1966); Estate of Fruehauf, 50 T.C. 915 (1968).

8 See, e.g., Commissioner v. Estate of Noel, 380 U.S. 678, 683-84 (1965); Farwell v. United States, 243 F.2d 373, 377 (7th Cir. 1957).

“power” nor a “right” to exercise an incident of ownership his estate would not be taxed under section 2042,10 unless the insured possessed a reversionary interest that exceeded five percent of the value of the policy immediately before his death.11 It is possible, however, to possess a “power” without a corresponding “right.”12

This approach of examining the insured’s interest—incidents of ownership—in the policy in terms of “powers” and “rights” may affect estate taxation of community life insurance policies. In order to determine the effect of viewing incidents of ownership in terms of “powers” and “rights” upon life insurance taxation in California it is necessary first to determine the type of interests possessed by each spouse under the applicable state law and the resulting estate tax consequences of that determination.

Ownership of Community Life Insurance Policies in California

The entire proceeds of a non-community policy would be included in the decedent-insured’s gross estate13 because of the interests created by the insurance contract unless the insured irrevocably assigned the policy or gave away all the incidents of ownership before his death14 but not in contemplation of it.15 Although depending upon the insured’s contract with the insurance company, it is likely that he, as the insured or the named owner of the policy, will have both the power and the right to exercise the incidents of ownership in the entire policy.16

In California, life insurance policies purchased from community funds are ordinarily community property.17 If part of the premiums are paid from community funds and part from separate funds, own-

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10 See, e.g., First Nat’l Bank v. United States, 358 F.2d 625 (5th Cir. 1966); Estate of Crosley, 47 T.C. 310 (1966).
11 INT. REV. CODE OF 1954, § 2042 (2).
12 E.g., United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7 (1st Cir. 1966); Estate of Fruehauf, 50 T.C. 915 (1968).
14 E.g., Estate of Crosley, 47 T.C. 310 (1966); see Commissioner v. Estate of Noel, 380 U.S. 678, 684 (1966). A contract between the insured and others providing for the direction of the proceeds of the policy may effectively deprive the insured of the “power” to change the beneficiaries. First Nat’l Bank v. United States, 358 F.2d 625 (5th Cir. 1966).
15 INT. REV. CODE OF 1954, § 2035.
16 See, e.g., Freedman v. United States, 382 F.2d 742, 743-44 (5th Cir. 1967).
ership is divided proportionately.\textsuperscript{18} If a husband takes out an insurance policy on his life and pays all the premiums with community funds, the wife owns a vested one-half interest in the policy.\textsuperscript{19} However, since the husband is given the power to manage all the community assets,\textsuperscript{20} the wife's interest in the policy during the existence of the community is imperfect.

The decedent-insured in the case of a community policy enjoys a more preferred status than does his counterpart with a non-community policy due to the effect of community property laws upon the taxability of the proceeds of the policy.\textsuperscript{21} According to the regulations, regard must be given to state law in determining taxability under section 2042.\textsuperscript{22} The courts, in justifying the inclusion of only one-half the proceeds of the community policy in the gross estate of the insured, have relied upon the fact that state law gives the wife a vested interest in the policy; the powers of management that the husband possesses in the policy are not enough, however, to subject the entire proceeds of the policy to taxation under section 2042.\textsuperscript{23}

\begin{itemize}
  \item \textsuperscript{18} Estate of Sears, 182 Cal. App. 2d 525, 530, 6 Cal. Rptr. 148, 152 (1960); Modern Woodmen of America v. Gray, 113 Cal. App. 729, 733-34, 299 P. 754, 755 (1931).
  \item \textsuperscript{19} CAL. CIV. CODE § 161a. "The respective interests of the husband and wife in community property during the continuance of the marriage relation are present, existing and equal interests under the management and control of the husband . . . ." \textit{Id.} See Estate of Mendenhall, 182 Cal. App. 2d 441, 445, 6 Cal. Rptr. 45, 48 (1960). The remainder of this note will deal exclusively with situations in which it is assumed that premiums were paid entirely from community funds.
  \item \textsuperscript{20} CAL. CIV. CODE § 172. "The husband has the management and control of the community personal property, with like absolute power of disposition, other than testamentary, as he has of his separate estate; \textit{provided}, however, that he can not make a gift of such community personal property, or dispose of the same without a valuable consideration . . . without the written consent of the wife." \textit{Id.}
  \item \textsuperscript{21} \textit{E.g.}, Commissioner v. Chase Manhattan Bank, 259 F.2d 231 (5th Cir.), \textit{cert. denied}, 359 U.S. 913 (1959); see Thurman, \textit{supra} note 17, at 256; cf. Treas. Reg. § 20.2042-1(b) (2), -(c) (5) (1958). However, it is possible to be at a disadvantage in a community property state with regard to insurance policies. For example, in Freedman v. United States, 382 F.2d 742 (5th Cir. 1967), a husband was the named owner of an insurance policy on his wife's life. All of the premiums were paid from community funds. According to the terms of the contract only the owner, if one was named in the policy, could exercise any of the incidents of ownership. The court stated that there was insufficient evidence to establish that the wife intended to make her husband the absolute owner of the policy rather than the agent of the community. Noting that the result would have been different if the policy were separate property, the court included one-half of the proceeds in her gross estate.
  \item \textsuperscript{22} Treas. Reg. § 20.2042-1 (c) (5) (1958).
  \item \textsuperscript{23} Commissioner v. Chase Manhattan Bank, 259 F.2d 231 (5th Cir. 1958), \textit{cert. denied}, 359 U.S. 913 (1959). "If the decision of the Tax Court is upheld, consistency would require that the entire proceeds of insurance policies be included in a husband's estate, notwithstanding his ownership of only half of
The Nature of the Interests Possessed by the Husband and Wife in Terms of Powers and Rights

Since, in California, the wife has a vested one-half interest in a community insurance policy, it would seem she also owns the "powers" and "rights" with respect to her interest. Thus, the husband in a community property state does not in fact possess entirely the powers and rights to which he is entitled under the terms of the insurance contract. Nevertheless, since California has given the husband the power of management and control over community funds, he does hold the wife's powers and rights as her agent. The scope of the agency is limited by California law in two respects: (1) During the husband's life the wife can set aside a gratuitous assignment of the policy to a third party or an irrevocable naming of a beneficiary other than herself if she did not give her written permission; and (2) After the husband's death the wife can recover one-half of the proceeds of the policy if her husband revocably named someone other than herself as the beneficiary and if she did not give her written permission.

These two limitations on the scope of the agency relationship warrant examination. By the first limitation, the wife or her estate has the ability to void her spouse's action. If the wife or her estate elects to void her spouse's actions, the policy remains a community asset in California, federal law is now clear that only one-half of the proceeds will be included in the gross estate, the decedent being the true owner under state law of no more than that portion, even where the policy purports to vest in him all of the power enumerated in the Regulations. There have been no cases in the Ninth Circuit that have considered the question since the incidents of ownership test became embodied in section 2042 as a criterion of taxation. This is because the Commissioner has not attempted to tax the entire proceeds of California community policies. See Scott v. Commissioner, 374 F.2d 154, 157 (9th Cir. 1967).

27 E.g., Britton v. Hammell, 4 Cal. 2d 690, 52 P.2d 221 (1935) (real estate); Lynn v. Herman, 72 Cal. App. 2d 614, 165 P.2d 54 (1946) (automobile); see Thurman, supra note 17 at 260-61.
California law is clear, however, that the wife has merely the ability to invalidate the gift and that the husband's act is not a complete nullity. If the wife or her estate fails to void the gift she will be deemed to have made a taxable gift of her interest to the named beneficiary.

By the second limitation, if the husband revocably names someone other than his wife as the beneficiary of the policy, the wife cannot void her spouse's action during his life because the beneficiary has a mere expectancy and there is nothing to void. After the husband dies, however, the wife may elect to void the gift to the named beneficiary as to one-half of the proceeds. As was the result above, if the wife elects not to void the gift she will be deemed to have made a taxable gift to the named beneficiary. Also, the husband's act is not a nullity merely because the wife possesses the ability to invalidate part of the attempted gift.

The above discussion indicates that the agency relationship between husband and wife created by California law and continuing during the existence of the community, has limited the wife's actual control over her interest in the economic benefits of the policy to her ability to void only two actions of her spouse. All the other incidents of ownership, except one, can be exercised by the husband without any recourse by his wife. Thus, the husband can pledge the policy for a community venture, assign it for consideration, obtain a loan

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29 E.g., Britton v. Hammell, 4 Cal. 2d 690, 52 P.2d 221 (1935) (real estate); Lynn v. Herman, 72 Cal. App. 2d 614, 165 P.2d 54 (1946) (automobile); see Thurman, supra note 17 at 160-61.
33 Estate of Mendenhall, 182 Cal. App. 2d 441, 445, 5 Cal. Rptr. 45, 48 (1960). As to the method of voiding the gift to the named beneficiary, "[the wife] could, of course, give notice to the insurance company of her community claim, thereby preventing payment of her half interest to a third party, but she could not disturb the policy during the husband's lifetime." Id. at 446, 6 Cal. Rptr. at 48. But if an insurance company has paid the proceeds to the beneficiary in accordance with the terms of the policy, before any notification from the wife, the company is fully discharged from all claims under the policy. See CAL. INS. CODE § 10172. If the wife failed to give notice she could proceed against the named beneficiary. Thurman, supra note 17, at 251.
34 Commissioner v. Chase Manhattan Bank, 259 F.2d 231, 254 (5th Cir. 1958), cert. denied, 359 U.S. 913 (1959); cf. Thurman, supra note 17 at 251.
against its surrender value, or surrender or cancel the policy. The husband possesses all these powers and rights as the manager of the community, and when the community is separated into the husband's and wife's respective interests, the husband holds these powers and rights as to one-half of the policy in his own right and to one-half as his wife's agent.

The exception to this coexistence of powers and rights in the husband regards his use of the property as collateral for his separate debts and obligations. He may use the policy for this purpose, but if so used the wife has a cause of action against her husband's estate. Therefore, the husband possesses a power, but not a corresponding right, as to this incident of ownership.

The Scope of Section 2042

In order to determine the scope of inclusion under section 2042 it is necessary to examine its criteria for inclusion which are embodied in three important phrases—"incidents of ownership," "possessed" by the decedent, and "either alone or in conjunction with any other person."

"Incidents of Ownership"

A comprehensive definition of "incidents of ownership" is not given in the statute. A broad definition is given by Commissioner v. Chase Manhattan Bank, in which the court states: "[I]ncidents of ownership of ... a policy are all the rights except the right to the proceeds." The regulations are helpful in determining what are the incidents of ownership of an insurance policy, and it is there stated:

"[T]he term "incidents of ownership" is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking the term has reference to the right of the insured or his estate to the economic benefits of the policy. ..."

In United States v. Rhode Island Hospital Trust Company, the court explained that the phrase "incidents of ownership" includes situations other than merely "the right of the insured or his estate to

87 Id. If the husband obtains a loan against the cash surrender value of the policy or surrenders the policy, the money he receives is community property. See also Treas. Reg. § 20.2042-1(c)(5) (1958).
93 Id. at 245.
95 355 F.2d 7 (1st Cir. 1966).
the economic benefits of the policy.” The court held:

First, it is clear that the reference to ownership in the “technical legal sense” is not abandoned and supplanted by reference to “economic benefits”. Second, the regulation goes on to list illustrative powers referred to by Congress in its reports. All of these are powers which may or may not enrich decedent’s estate, but which can affect the transfer of the policy proceeds.46

In Estate of Fruehauf,47 the majority of the court agreed with the Rhode Island Hospital Trust Company pronouncement and stated that “the phrase has always been defined as a right affecting the beneficial enjoyment of the insurance proceeds by beneficiaries . . .”48

Thus, an incident of ownership definitely exists if the insured could benefit himself or his estate economically by the exercise of the power. Additionally, if the Rhode Island Hospital Trust Company case and the majority in the Fruehauf case are correct, an incident of ownership exists if the insured merely could affect “the transfer of the policy proceeds.”49

40 Id. at 11, quoting in part Treas. Reg. § 20.2042-1(c) (2) (1958).
47 50 T.C. 915 (1968).
48 Id. at 924. The concurring opinion seems to agree with the regulation’s definition. Id. at 926. Compare these definitions of incidents of ownership with C. Lowndes & R. Kramer, Federal Estate & Gift Taxes 273 (2d ed. 1962): “[I]ncidents of ownership mean any power over an insurance policy which amounts to substantial ownership of the policy . . . .”

49 The distinction will become apparent with a few examples similar to the facts in Estate of Fruehauf, 50 T.C. 915 (1968). Assume an irrevocable trust has been created which includes life insurance policies irrevocably assigned to it. Before the assignment, the beneficiary had been irrevocably named. The trust was funded and had sufficient assets to pay the premiums on the policies as they became due. Also assume that a named person was to receive income for life from the trust and a different person would receive the corpus when the life beneficiary died. The beneficiary of the policies was not the beneficiary of the corpus of the trust.

If the insured was a trustee, consider the following two examples: (1.) The insured was the life beneficiary of the trust. (2.) Someone other than the insured was the life beneficiary of the trust.

In the first example the insured could have economically benefited himself, by surrendering or cashing in the policies. He then would have received a greater amount of income during his life because the cash surrender value would be added to the corpus of the trust.

In the second example the insured could not have economically benefited himself, but could have affected the transfer of the policy proceeds by surrendering, pledging or cancelling the policy.

See also Lowndes, Tax Consequences of Limitations Upon the Exercise of Powers, 1966 Duke L.J. 959. “[I]f W insured H’s life and gave H power to change the beneficiaries under the policy with the stipulation that H could not make himself or his estate a beneficiary, the proceeds of the insurance would be taxable to H’s estate under Section 2042.” Id. at 961 n.4.

In giving all the incidents of ownership to a trust, the insured could state in the trust instrument that the trustees could only name the beneficiary from
"Possessed"

If at his death the insured "possessed" an incident of ownership, his estate will be taxed even though he did not have possession of the policy, or did not pay any of the premiums, or was under a contractual obligation to transfer the policy to a trust. The estate of the insured will also be taxed if the insured possessed an incident of ownership even though the beneficiary (a corporation) paid the premiums, used the policy as collateral for a business loan and carried it on the corporate books as an asset of the corporation. It is this concept of "possession" that courts have had difficulty defining, and the cases must be examined for the individual instances of "possession" considered therein.

In Prichard v. United States, a life insurance policy was taken out in the community property state of Texas. The wife of the insured was named as the owner and beneficiary, but this action was taken with the "understanding, agreement, and arrangement" that the policy would be pledged as collateral for a community loan. As a result of this agreement, the insured received an economic benefit from the pledge and the court held he therefore possessed an incident of ownership at his death. The court concluded that for this reason one-half of the proceeds of the policy should be included in the husband's gross estate.

In Commissioner v. Estate of Noel, a wife bought two flight insurance policies on the life of her husband, who subsequently died in the crash of the plane. Even though the husband did not have possession of the policies during the flight and did not have the ability to exercise any incidents of ownership while on the plane, the Supreme Court allowed the inclusion of the proceeds of the policies in his gross estate. The decision was based upon the decedent's power to exercise the incidents of ownership granted by the terms of the insurance contract.

State tax liability for policies "with respect to which the decedent possessed at his death any of the incidents of ownership" depends on a limited class of people, and still avoid section 2042. Estate of Crosley, 47 T.C. 310 (1966). Fried v. Granger, 105 F. Supp. 564 (W.D. Pa. 1952), aff'd per curiam, 202 F.2d 150 (3d Cir. 1953). Id.

Estate of Piggott v. Commissioner, 340 F.2d 829 (6th Cir. 1965).
397 F.2d 60 (5th Cir. 1968).
Id. The husband possessed incidents of ownership at all times. The court raised the question whether the husband would have been taxed if he had held no incidents of ownership in the policy but the wife had assigned it as collateral for a community debt. Unfortunately, the court found this question unnecessary to answer in order to determine the case before them. Id. at 64.

a general, legal power to exercise ownership, without regard to the owner’s ability to exercise it at a particular moment.\textsuperscript{57}

In \textit{United States v. Rhode Island Hospital Trust Company},\textsuperscript{58} a father took out insurance on the life of his son. The father kept the policy in his possession and paid the premiums, but the son held the incidents of ownership according to the terms of the contract. In reply to the argument that the son had only a power to exercise incidents of ownership and not a right to do so, the court made it clear that a power, even without a corresponding right, is adequate to constitute possession of incidents of ownership.

The existence of such powers in the decedent is to be distinguished from such rights as may have existed in decedent’s father or duties owed the father by decedent. \textit{It is therefore, no answer that decedent’s father might have proceeded against him at law or in equity.} The company made it clear in the contract that it bore no responsibility for the validity of an assignment, that it could pay a beneficiary without recourse, and that it was under no obligation to see to the carrying out of any trust. It even made it clear that a beneficiary need only write to the home office to receive payment. Should a third party—for example, an innocent creditor who had given valuable consideration to decedent—receive the proceeds of the policy, the proceeds of a loan on the policy, or the cash value, it could not be said that the transaction between decedent and such third person would in all such cases be nugatory. For decedent had some powers—perhaps not rights, but powers—which could, if exercised alone or in conjunction with another, affect the disposition of some or all of the proceeds of the policy.\textsuperscript{59}

The court also pointed out that the power to exercise incidents of ownership held by the decedent was impregnable from attack by evidence of the intentions of the father and decedent as to who was to possess that power.\textsuperscript{60} This should be the result unless a mistake was made by the agent who drafted the contract, so that it did not reflect the original intent of the parties as expressed to the agent.\textsuperscript{61}

In justifying its “power” rationale the court said:

While decisions against the estate of a passive but power-possessing decedent may often conflict with the honest intentions and understanding of premium-paying beneficiaries and insureds, the alternative of abandoning the insistence of the governing nature of the contract, in most cases, is less desirable. The drawing of a useful line would be impossible; there would be a much wider range of varying decisions on similar facts; and there would be an invitation to unprincipled estate manipulation. As a government counsel has pointed out, there could always be a formally executed side agreement under which the insured clearly surrenders to the beneficiary all his rights to the policy, such agreement to be brought to light only in the event of the decedent’s dying before the beneficiary.\textsuperscript{62}

\textsuperscript{57} Id. at 684 (emphasis added).
\textsuperscript{58} 355 F.2d 7 (1st Cir. 1966).
\textsuperscript{59} Id. at 11 (emphasis added).
\textsuperscript{60} Id. at 12.
\textsuperscript{61} National Metropolitan Bank v. United States, 87 F. Supp. 773 (Ct. Cl. 1950); Estate of Fuchs, 47 T.C. 199 (1966); see United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7, 13 (1st Cir. 1966).
\textsuperscript{62} 355 F.2d at 13.
Estate of Fruehauf⁶⁸ went further than the Rhode Island Hospital Trust Company case and held that an insured possessed incidents of ownership if he held a power in a fiduciary capacity over an insurance policy on his life. In the Fruehauf case Vera Fruehauf was the sole owner of several insurance policies on the life of her husband. All the powers and rights with respect to the policies were possessed by Vera while she was alive. She predeceased her husband and bequeathed the insurance policies to a testamentary trust that was to be established by the executors of her estate. According to the provisions of the trust the husband was to receive the trust income for life, and the remainder, free of the trust, was to go to the then surviving issue of Vera Fruehauf per stirpes. The husband was one of three named trustees who were given broad powers to exercise the incidents of ownership over the policies including the power to surrender them. A further provision of the trust instrument was that the husband could receive a portion of the corpus of the trust, but only as much as would be determined by the other two trustees.

The trust was never established, but when the husband died the court included all the proceeds of the policies in his gross estate. To the argument that the insured had no right to the economic benefits of the policies the court stated: "The right of the insured or his estate to the economic benefits of the policy is merely one of the several incidents of ownership."⁶⁴ To the contention that a fiduciary who held incidents of ownership did not "possess" them, it held:

> It would frustrate the manifest purpose of the statute if inclusion or exclusion of the insurance proceeds in the decedent's estate is made to depend on the capacity in which decedent held powers over the policies rather than the extent of such powers held by decedent.⁶⁵

Thus, the insured "possesses" an incident of ownership for purposes of section 2042 if he has the legal power to exercise an incident of ownership, regardless of the rights of others in the policy and regardless of other extrinsic circumstances such as the lack of possession of the policy, the inability to use the power at a particular moment, or the capacity in which the power is held.

"Alone or In Conjunction with Any Other Person"

The meaning of "alone" is self-evident, and has not been particularly important in this context, but the phrase "in conjunction with any other person" has posed significant interpretative problems. If the insured could participate in decisions with others in exercising incidents of ownership he will possess an incident of ownership.⁶⁶ These problems can be explained best by examining a few representative cases.

In Estate of Selznick,⁶⁷ the decedent-insured was permitted to

⁶³ 50 T.C. 915 (1968).
⁶⁴ Id. at 919.
⁶⁵ Id. at 925.
⁶⁶ E.g., Estate of Fruehauf, 50 T.C. 915 (1968).
⁶⁷ 15 T.C. 716 (1950), aff'd per curiam, 195 F.2d 735 (9th Cir. 1952).
cancel insurance policies held in trust if he first obtained the written consent of the trustees. The court held that the proceeds of the policy were to be included in the gross estate of the insured.\(^{68}\)

In *Hall v. Wheeler*,\(^{69}\) the court said that the decedent-insured possessed during his life an incident of ownership even if the approval of the decedent’s employing company-beneficiary was required in order to exercise it.\(^{70}\) The insured had this ability subject to a veto by another, and this qualified as an incident of ownership. In *Estate of Goldstein v. United States*,\(^{71}\) only the irrevocably named beneficiary had the capacity, with the written consent of the insured, to exercise any incidents of ownership. Although the insured could not himself exercise any of the incidents of ownership and possessed only an ability to veto, the court held that the insured possessed an incident of ownership in conjunction with another person.\(^{72}\)

In *Commissioner v. Estate of Karagheusian*,\(^{73}\) the court gave the following explanation of the phrase:

> It makes no difference whether under the trust instrument the decedent may initiate changes or whether he must merely consent to them. . . . If the decedent acting with others can effectively change the beneficiary of the policy, he possesses an incident of ownership.\(^{74}\)

Thus, the phrase “in conjunction with any other person” includes situations in which the insured possesses only the ability to veto attempts by others to exercise incidents of ownership, where a third party has the ability to veto attempts to exercise incidents of ownership by the insured, or where the insured could participate in decisions with others in exercising incidents of ownership. In all of the above cases the insured’s policies will be included in his gross estate.

**Section 2042 as Applied to Community Policies in California**

**Rationale for Inclusion of Entire Community Policy**

In the *Rhode Island Hospital Trust Company*\(^{75}\) case the court found that “[w]hat [Congress] was attempting to reach in Section 2042 . . . was the power to dispose of property . . . .”\(^{76}\) In *Commissioner v. Chase Manhattan Bank*,\(^{77}\) the Fifth Circuit, deciding an estate taxation question involving Texas community property, ex-

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\(^{68}\) Id.


\(^{70}\) Id.


\(^{72}\) Id.

\(^{73}\) 233 F.2d 197 (2d Cir. 1956).

\(^{74}\) Id. at 199.

\(^{75}\) 355 F.2d 7 (1st Cir. 1966).

\(^{76}\) Id. at 10 (emphasis by the court).

\(^{77}\) 259 F.2d 231 (5th Cir. 1958), cert. denied, 359 U.S. 913 (1959).
pressed the purpose of the statute as follows:

"We think it plain that [section 2042] imposes a death tax, not upon the proceeds of insurance policies, the property of the estate, nor upon the proceeds of insurance policies which but for the gift of the beneficiary would be owned by decedent, but upon the cessation ... of the control he had over the policies, [as agent of the community] so that his death vested in the beneficiary a settled right which she did not have before."78

The "power to dispose of property," which the Rhode Island Hospital Trust Company case referred to and the "control over the policies," which the Chase Manhattan Bank case referred to, are both interpretations of the word "possesses" as it is used in the statute. There is no substantial difference between these two interpretations; the difficulty is in the explanation of Chase Manhattan Bank as to the control or power over the policy as it applied to community property. That explanation is as follows:

In a community property state where insurance on the husband's life is purchased with community funds, payable revocably to a third person beneficiary, the husband's right to change the beneficiary and all other control over the property are held as agent of the community. The bundle of rights in the policy is owned by the community. Something happens to this bundle when the insured dies, thereby terminating his control over the property and bringing the community to an end. What happens is, that the community's property interests in the policy-rights are transformed into the beneficiary's right to the proceeds. It is a shift in control and a shift of beneficial interest. This is the transfer that is taxed.79

The problem lies in the court's statement that "the bundle of rights in the policy is owned by the community," and that the husband's "control" over the property is as agent of the community. Although this statement is true, it alone does not resolve the question of taxability under section 2042. Section 2042 is designed to tax only interests of the insured. Since the community consists of two persons, i.e., the husband and the wife, only one of them can be the insured to whom the statute is meant to apply. Thus, the statute requires an investigation into the nature of the community and a determination of exactly what incidents of ownership were possessed by the insured at the time of his death.

If under California law the wife possessed an equal one-half interest in the policy and there were no other qualifications, there would be no question that she would possess the incidents of ownership as to her one-half. However, California does add a qualification, i.e., the power of management that the husband possesses over community assets. For the purpose of section 2042, the husband's power of management makes him an agent for his wife's interest in the community.80 Therefore, giving regard to California law, whether

78 Id. at 255, quoting Newman v. Commissioner, 75 F.2d 449, 450 (5th Cir. 1935).
79 259 F.2d at 255.
the agency gives the husband any incidents of ownership over all the policy becomes a question of fact.

For the purposes of section 2042, it is not essential to determine what incidents of ownership the uninsured spouse possessed, but only what the insured spouse possessed. California law may have given the wife an absolute ability to devise a one-half interest in the policy, but at the critical time of the insured's death he does possess some incidents of ownership over the entire community policy which could have been used to affect the economic benefits of the policy.

If the husband has a power to exercise an incident of ownership in the policy his interest will be within the contemplation of the term "possesses." Since the capacity in which an incident of ownership is held is not crucial to taxation under section 2042, the fact that the husband in California holds such powers merely as an agent of his wife is not determinative. The primary question is whether the interest the husband-insured possesses in the community insurance policy is an incident of ownership.

Section 2042 requires only the possession of one incident of ownership to include the policy in the decedent's estate. If the position is accepted that in order to come within the statute an incident of ownership need only be an interest that can affect "the transfer of the policy proceeds," it is obvious that in California the husband possesses this incident. He can surrender, pledge, or cancel the policy. If an incident of ownership must be one that can affect the economic benefit of the insured or his estate, the California husband possesses this type as well. One example of the "affect the economic benefit of the insured or his estate" type incident of ownership is the power or capacity the husband possesses in his own right and as the agent of his wife to cancel the policy. By this action the insured could destroy the beneficiary's right to the proceeds and also the possibility that the wife would receive one-half of the proceeds of that particular asset against the named beneficiary. If the policy were cancelled, the insured would obtain an economic benefit by not having to pay the premiums from either his separate funds or from community funds. A second example of the "affect the economic benefit of the insured or his estate" type incident of ownership is the power of the husband to assign the policy or to name irrevocably a third person as the beneficiary of the policy if the wife does not contest the action. The wife could veto the action of her husband, but the husband would determine the beneficiary of the policy, in conjunction with his wife, if she failed to use her veto power. Together, therefore, the husband and the wife do possess such an incident of ownership. A third example of such an incident of ownership is the husband's power to pledge the policy as collateral for his separate debts and obligations. The husband does not have the right to pledge the policy in the above manner, but he does have the power. The wife has a right of action against the estate of the decedent, but a
power without a corresponding right is still sufficient to include the policy in the decedent's gross estate.

Ownership Versus Incidents of Ownership

In *Freedman v. United States*,⁸¹ a case involving taxation of community property in Texas, the court said: "Section 2042 prescribes ownership as the test [of inclusion of proceeds in the gross estate of the insured] ..."⁸² In *Scott v. Commissioner*,⁸³ the court agreed in stating: "In substance, at least in community property cases, both the Commissioner and the courts have limited the effect of the incidents of ownership to the interest in the policy that belongs to the decedent."⁸⁴

These two statements are repugnant to the expressed language of the statute. The statute mentions incidents of ownership as the test and not ownership per se. It is contended that ownership is not meant to be the test of inclusion because the possession of only one incident of ownership will cause the entire proceeds of the policy to be included in the gross estate of the insured. The court, in *United States v. Rhode Island Hospital Trust Company*,⁸⁵ expressed this concept succinctly:

> In the provision which was the predecessor of Section 2042, [Congress] was not trying to tax the extent of the interest of the decedent. ... What it was attempting to reach in Section 2042 ... was the power to dispose of property ... Power can be and is exercised by one possessed of less than complete legal and equitable title. The very phrase "incidents of ownership" connotes something partial, minor, or even fractional in its scope. It speaks more of possibility than of probability.⁸⁶

Thus, even though under California law the wife is the legal owner of part of the policy or has an equal interest in the policy, it still remains to be determined whether her husband as the community manager possessed any of the incidents of ownership over the entire policy exercisable either alone or in conjunction with her which would include the entire amount of the proceeds in the decedent's estate.⁸⁷ The conclusion is inescapable that if the courts gave effect to the California law providing that the husband is the manager of the community funds, they would necessarily be forced to include in his gross estate the entire proceeds of the policy.

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⁸¹ 382 F.2d 742 (5th Cir. 1967).
⁸² Id. at 748.
⁸³ 374 F.2d 154 (9th Cir. 1967).
⁸⁴ Id. at 157.
⁸⁵ 355 F.2d 7 (1st Cir. 1966).
⁸⁶ Id. at 10 (emphasis by the court).
History of the Incidents of Ownership Test of Section 2042

In order to determine whether the courts should adopt the reasoning of the preceding discussion—that California law dictates inclusion of the entire community policy in the husband’s gross estate under section 2042—it is necessary to review the history of federal estate taxation of life insurance.

The federal statute[88] that first determined estate tax consequences of life insurance policies appeared in 1918 and remained in force until 1942. It stated that the gross estate of the decedent would include policies

to the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life.[89]

The criteria for taxation under the regulations was whether the insured either directly or indirectly paid the premiums of the policy.[90] This “payment of premiums” regulation, with minor changes, remained in force until 1931. In 1931, the Treasury Department adopted the “incidents of ownership” test,[91] which continued until 1941, when a shift back to the “payment of premiums” test was made.[92]

In 1942, Congress enacted by statute both the “payment of premiums” and the “incidents of ownership” tests for determining estate tax consequences of life insurance.[93] In the same year, an insurance provision regarding community property life insurance was adopted by Congress which specifically provided for the inclusion of all the proceeds of the policy in the estate of the insured.[94] This provision was repealed by the Revenue Act of 1948, which, however, continued the alternative tests for inclusion.[95]

After 1948, for the first time, the courts had to interpret a statute, rather than a regulation, which embodied the incidents of ownership test for determining the taxation of community life insurance policies without specifically requiring the inclusion of the entire proceeds of the policy in the insured’s gross estate.

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[89] Id.

In the 1954 revision of the Internal Revenue Code, Congress abandoned the “payment of premiums” test, and the “incidents of ownership” test became the sole criterion for taxability. INT. REV. CODE OF 1954, § 2042(2).
After the repeal in 1948 of the 1942 provision taxing all the community policy proceeds, the courts,\textsuperscript{96} the regulations,\textsuperscript{97} and the commentators\textsuperscript{98} assumed that the decisions rendered during the period from 1918 to 1942, which determined the extent of inclusion of community life insurance policies in the gross estate of the decedent-insured, would be revitalized and become precedent for interpreting the relevant sections of the Revenue Act of 1948. Two such cases, decided in 1938 and 1940 respectively, frequently cited\textsuperscript{99} as establishing that only one-half of the proceeds should be included in community property states under the 1948 Act, are \textit{Lang v. Commissioner}\textsuperscript{100} and \textit{De Lappe v. Commissioner}.	extsuperscript{101} Both cases were decided under section 402 (f) of the Revenue Act of 1918.

In the \textit{Lang} case the Supreme Court was not faced with a statute that defined the test of includability in terms of "incidents of ownership" and therefore its authority for interpreting incidents of ownership is questionable. The court in \textit{Lang} did not consider the newly-formulated Regulation 80\textsuperscript{102} which expressed the incidents of ownership test for inclusion, because the regulation was not applicable when the case arose. The decision rested on an interpretation of Treasury Regulation 70,\textsuperscript{103} which was the "payment of premiums" test. In its conclusion, the Court explained why Regulation 70 did not apply to the community insurance policy:

Where children were named beneficiaries and premiums were paid from community funds the situation is not within the precise words of the Regulations; but the rather obvious reason underlying the definition of what constitutes a policy "taken out by the assured" should be respected. In the absence of a clear declaration it cannot be assumed that Congress intended insurance bought and paid for with the funds of another than the insured and not payable to the latter's estate, should be reckoned as part of such estate for the purposes of taxation.\textsuperscript{104}

In the \textit{De Lappe} case, Regulation 80\textsuperscript{105} was in effect, but the court refused to apply it. The Court observed:

It is elementary that a treasury regulation can not change the

\textsuperscript{96} E.g., Commissioner v. Chase Manhattan Bank, 259 F.2d 231 (5th Cir. 1958), cert. denied, 359 U.S. 913 (1959). "[I]n repealing the controversial provisions of the Revenue Act of 1942 and enacting the Revenue Act of 1948 Congress revitalized the pre-1942 interpretations of community property law." Id. at 252.

\textsuperscript{97} See Treas. Reg. § 20.2042-1(b) (2),(c) (5) (1958).

\textsuperscript{98} E.g., Thurman, supra note 17, at 154-56.

\textsuperscript{99} Commissioner v. Chase Manhattan Bank, 259 F.2d 231, 254 (5th Cir. 1958), cert. denied, 359 U.S. 913 (1959); see Thurman, supra note 17, 255-56 & n.91.

\textsuperscript{100} 304 U.S. 264 (1938).

\textsuperscript{101} 113 F.2d 48 (5th Cir. 1940).

\textsuperscript{102} Treas. Reg. 80, art. 27(2), T.D. 5032, 1941 CUM. BULL. 427.

\textsuperscript{103} Treas. Reg. 70, arts. 25, 28 (1926).

\textsuperscript{104} 304 U.S. at 270.

\textsuperscript{105} Treas. Reg. 80, art. 27(2), T.D. 5032, 1941-1 CUM. BULL. 427.
law but it is unnecessary to strike down Art. 25 of Regulation No. 80 for the purpose of deciding this case. The regulations follow the law except wherein it attempts to define ownership in the policy . . . . [I]ncidents of ownership are not conclusive but merely create a presumption of ownership that may be rebutted . . . . [I]ncidents of ownership could be given to an agent without his having any ownership in the policy at all. In these instances, where the premiums on a policy have been paid out of community funds the husband is acting only as an agent. . . .

. . . In computing estate taxes on the proceeds of life insurance the question to be decided is whether the decedent paid all or only part of the premiums. . . . [T]he interest of decedent in the policies at the time of his death was only one-half. Regulation 80 could not and did not change this.106

Again the court used ownership and interests and not incidents of ownership as criteria for determining inclusion. It is true, as the court stated, that if the incidents of ownership were given to an agent he would not have any ownership rights in the policy, but whether he possessed an incident of ownership as required by section 2042 in order to include the proceeds of the policy in the gross estate is an entirely different question.

Even though the Lang and De Lappe cases were not decided under a statute expressing incidents of ownership as the criterion of inclusion, Congress could have intended to revive the rationale of these decisions by the enactment of the applicable sections of the Revenue Act of 1948. Therefore, an examination of the congressional intent behind section 2042 will be helpful in understanding the scope of the incidents of ownership test.

Congressional Intent Behind Section 2042

The Senate Committee reports dealing with the Revenue Act of 1948 are helpful in determining the congressional intent of section 2042. In the reports, much attention was given to the community property amendments of 1942 which related to the sections taxing the interest owned by the decedent, but little was given to the insurance section, section 2042. One paragraph, however, does shed some light on the latter section.

This section, which is unchanged from the bill as passed by the House, repeals, effective with respect to estates of decedents dying after the date of enactment of this bill, section 811(g) (4) [provision including all proceeds of community policy in gross estate] of the Code, relating to community property in the case of life insurance. Since section 811(g) [defining inclusion] was completely rewritten in the Revenue Act of 1942, the repeal prospectively of section 811(g) (4) makes applicable to decedents dying after the date of enactment of this bill the rules of section 811(g) which would be applicable had paragraph (4) never been contained in section 811(g).107

Thus, it is clear that in the Revenue Act of 1948, Congress intended the incidents of ownership test to be the law, and not return to the 1918 Revenue Act under which the Lang and De Lappe cases

106 113 F.2d at 51 (emphasis added).
107 S. REP. No. 1013, 80th Cong., 2d Sess. 2 (Supp. 1948).
were decided. Consequently, new impetus was given by the 1948 Act to the incidents of ownership clause, which remained embedded in the statute rather than in a regulation.

It is also clear that Congress intended that the insured in a community property state should be taxed only on one-half of the proceeds payable to his spouse. This is substantiated by the fact that the marital deduction was given at this time to taxpayers possessed of separate property. The marital deduction was created by Congress in order to equalize taxation between residents of separate and community property states. However, it is also apparent that Congress intended to continue the incidents of ownership test and not an interest test as the criterion of taxability.

If the proceeds of the policy were not payable to the surviving spouse, no marital deduction would be available to residents of separate property states, so the entire proceeds of the policy would be taxable in the decedent’s gross estate if he retained an incident of ownership. Under the same facts in a community state, however, only one-half of the proceeds would be included in the insured’s gross estate, and thus one-half of the policy would escape estate taxation. The preferential treatment afforded residents of community property states in this situation would be measured by the difference between the estate tax on one-half of the proceeds of the policy and the gift tax paid by the surviving spouse upon the gratuitous transfer of her one-half interest. Unfortunately, it is not possible to secure a marital deduction for the insured’s estate in a separate property state when the proceeds are not payable to the surviving spouse. The difference in the tax which the community residents would pay as opposed to separate property residents in cases in which the proceeds were paid to a person other than the surviving spouse, would be small. Perhaps the best solution would be to allow a marital deduction for community property life insurance only if the proceeds are payable to the surviving spouse. Unfortunately, a statute would be required for this solution.

By the enactment of the marital deduction provision, Congress was attempting to equalize the tax burdens upon residents of separate and community property states, but in the case of life insurance it was not completely successful. If there were a change in the present interpretation of section 2042 requiring the

109 This is assuming that the gift tax would be lower than the estate tax in this situation and that the wife consented to the gift.
110 See INT. REV. CODE OF 1954, § 2056 (b) (6).
111 S. REP. No. 1013, 80th Cong., 2d Sess. 27 (1948); see Commissioner v. Chase Manhattan Bank, 259 F.2d 231 (5th Cir. 1958), cert. denied, 359 U.S. 913 (1959).
112 S. REP. No. 1013, 80th Cong., 2d Sess. 27 (1948): “It is recognized that complete equalization of the estate and gift taxes cannot be achieved because of the inherent differences between community property and non-
inclusion of all the proceeds of a community policy, where the spouse is the beneficiary it would result in a greater inequality toward residents of community property states than now exists toward residents of separate property states. Nevertheless, the expressed intent of Congress was to keep incidents of ownership as the test of inclusion for section 2042 and this intent is expressed in the statute. The question is still unanswered whether the intent of Congress as expressed in the Committee Reports—that only one-half the proceeds of a community policy should be included in the gross estate—can overcome their expression of a contrary intent—that the incidents of ownership test should govern inclusion—in the statute. The regulations have expressed the intent found in the Senate reports, but they cannot contradict the statute.¹¹⁴

If the ownership interests as defined in California existed in a separate property state, there is little doubt that the entire proceeds would be included in the gross estate of the insured. Giving consideration to California law should not necessarily produce a different result from that of a separate property state. The regulation stating that the agency does not create any incidents of ownership in the insured for the purposes of section 2042 should be carefully examined to ascertain whether it is not contrary to the expressed language of the statute.

When the Uninsured Spouse Dies First

In most California cases involving the estate tax consequences of

¹¹³ Treas. Reg. § 20.2042-1(b)(2) (1958): “If the proceeds of an insurance policy made payable to the decedent's estate are community assets under the local community property law and, as a result, one-half of the proceeds belongs to the decedent's spouse, then only one-half of the proceeds is considered to be receivable by or for the benefit of the decedent's estate.” Treas. Reg. § 20.2042-1(c)(5) (1958): “As an additional step in determining whether or not a decedent possessed any incidents of ownership in a policy or any part of a policy, regard must be given to the effect of the State or other applicable law upon the terms of the policy. For example, assume that the decedent purchased a policy of insurance on his life with funds held by him and his surviving wife as community property, designating their son as beneficiary but retaining the right to surrender the policy. Under the local law, the proceeds upon surrender would have inured to the marital community. Assuming that the policy is not surrendered... on the decedent's death, the wife's transfer of her one-half interest in the policy was not considered absolute before the decedent's death. Upon the wife's prior death, one-half of the value of the policy would have been included in her gross estate. Under these circumstances, the power of surrender possessed by the decedent as agent for his wife with respect to one-half of the policy is not, for purposes of this section, an 'incident of ownership,' and the decedent is, therefore, deemed to possess an incident of ownership in only one-half of the policy.”

¹¹⁴ See De Lappe v. Commissioner, 113 F.2d 48, 51 (5th Cir. 1940).

a community life insurance policy the insured has predeceased his spouse, but this is not always the situation. For example, in Scott v. Commissioner,116 the court was asked to determine the estate tax consequences for the estate of the insured when the insured died after his wife.

Raymond Scott purchased policies of insurance on his life, and all the premiums were considered to have been paid from community funds.117 Raymond's wife, Ruth, predeceased her husband, and her estate included one-half of the cash surrender value of the policies. The wife bequeathed the residue of her estate, which included her one-half ownership interest in the policies, to her two sons. After Ruth's death, Raymond Scott changed the beneficiary of the policies to his two sons. He continued to pay all the premiums after his wife's death.118 Two months before his death he borrowed on the policies, but did not cash the check. In valuing Raymond's estate, his executor included one-half of the proceeds of the policies plus one-half of the loan. The Commissioner assessed a deficiency which resulted in the inclusion of the entire value of the policies plus the amount of the loan, less the cash surrender value of the policies which was included in the wife's estate. The Tax Court upheld the Commissioner's view, but the court of appeals reversed and arrived at a valuation of its own.119

The court of appeals stated that although the value of the policies in the wife's estate was included only at cash surrender value, it did not follow, as the Commissioner had argued, that this was all the interest she owned in them. She also owned the bundle of rights that accompanied her one-half ownership, which she could pass to her two sons.120 Contrary to the executor's reasoning, the one-half interest which the wife passed did not automatically stay at a one-half ownership interest. After the wife died, the sons and Raymond owned the policies as tenants in common.121 But because Raymond continued to pay the premiums, he began to acquire an interest in the sons' share of the policies.122 Thus, the ownership

116 374 F.2d 154 (9th Cir. 1967).
117 Id. at 156 n.l. "In his brief before the Tax Court the Commissioner stated 'The tax consequences of any separate property payments prior to marriage * * * have been ignored on a de minimis basis.'" Id.
118 374 F.2d at 161. The sons actually paid part of the premiums but the Commissioner treated these payments as a loan and this was not challenged. The error in failing to challenge had serious estate tax consequences as can be seen from the discussion accompanying notes 121-23, infra.
119 43 T.C. 920 (1965), rev'd, 374 F.2d 154 (9th Cir. 1967).
120 374 F.2d at 159.
121 Id. at 161.
122 Id. The court used an analogy to McBride v. McBride, 11 Cal. App. 2d 521, 54 P.2d 480 (1936), where a community was dissolved by divorce. The California court held that after the divorce the parties became tenants in common as to the life insurance policy which was previously an asset of the community. Since the insured continued to pay the premiums the (former)
interest the sons possessed diminished as Raymond paid each premium. In valuing Raymond's estate the court said:

The proportionate part of the proceeds that is attributable to those premiums [paid by Raymond after his wife's death] is therefore in-
cludible in his estate. One-half of the balance of the proceeds, attributable to premiums paid during the marriage from community funds, belonged to the sons, and is to be excluded from Raymond's estate, whether that amount be larger or smaller than one-half of the cash surrender value of the policies at the time of Ruth's death.123

The first problem encountered in determining whether the Scott case is correct is the characterization of the interest in the policies which Ruth actually passed to her two sons. The court quoted a California case124 in which an uninsured spouse predeceased her husband, which held: "'the wife's interest was 'present, existing and equal' and was a vested interest and . . . she has equal testamentary power with the husband."125 Thus, it is evident that the full "bundle of rights" passed to the two sons. Consequently, the sons should have had all the powers and rights in the policy with respect to their interest in their own right without any agency relationship.

The difficulty with this appraisal is that according to the terms of the insurance contract Raymond still possessed all the incidents of ownership and the sons possessed none. The conclusion to be drawn must be that Raymond held his sons' incidents of ownership as a fiduciary in constructive trust.126

If Raymond exercised any incidents of ownership over the sons' portion of the policies without their permission it would have been a breach of his fiduciary relationship. Raymond held all the powers in the policies, but not all the rights. He may have been answerable in an action at law or in equity, but he had the ability to affect the economic benefits of the policies, and, therefore, he possessed an incident of ownership. All the proceeds of the policy should have been included in his estate.127

If either of the sons had died before the insured, his estate

wife's interest diminished. Her interest in the policy was represented by one-half of the premiums paid from community funds.

128 374 F.2d at 161.

124 Estate of Mendenhall, 182 Cal. App. 2d 441, 6 Cal. Rptr. 45 (1960).
126 If this assumption is correct, Ruth actually did not have the power to pass an absolute interest in the policy. If she had passed an absolute interest her sons would have possessed the "incidents of ownership" in their own right, regardless of what the contract said.
127 Even if it is proper in community property cases to limit the effects of the insured's incidents of ownership to the interest in the policy that belonged to him, there was no reason to apply that limitation in the Scott case. After Ruth died the policies were not held by the sons and Raymond as community property. The Commissioner might have been able to argue the point successfully, but apparently he chose not to. See 374 F.2d at 157-58.
clearly would have had to pay estate taxes on the interest that he owned at the time of his death under section 2033 of the Internal Revenue Code. The value of that interest would be determined by the cash surrender value or the replacement value of the policies; it would be limited to one-half the value of the interests of the two sons at that time. Each of the sons also would have had the testamentary power over his share, and the person who took his interest would have received this very valuable asset.

The fact that the husband paid all the premiums does not imply that he made a gift to the sons since he received adequate and full consideration, i.e., a greater interest in the policies. The same result would obtain if the sons paid the premiums.

The next issue is whether the sons had a right to insist upon paying one-half of the premiums in order to keep their one-half interest intact. It would seem that they would have such a right since they were one-half owners of the policy, and the husband did not have any powers of management after the wife died. In order to protect the insured, insurance companies might include in their contracts a provision to the effect that the insured has the right to pay the premiums if he so desires. Whether this right would be considered an incident of ownership would be for the determination of the courts.

**Estate Planning Under the Scott Decision**

To avoid question as to the party having the right to pay the premiums, either the sons or Raymond could have caused a partition of the policy into equal halves. If the insured wished to shed the incidents of ownership by making a gift in order to avoid paying taxes under section 2042, he could do so. He would incur liability to pay a gift tax, however, but only as to his share. Even if the insured continued to pay the premiums until his death he would have no interest in the policies.


129 **Int. Rev. Code of 1954, § 2512(b).**

The last three premiums paid before the insured’s death, however, would be in contemplation of death, and some estate tax would have to be paid. The Internal Revenue Service has issued a Revenue Ruling to the effect that the valuation in the latter situation is the ratio of the premiums paid in contemplation of death over the total premiums paid, times the proceeds of the policy, rather than the dollar amount of the premiums. Fortunately for estate planners and taxpayers, this ruling seems to be incorrect and one court has expressly said so.

If a life insurance policy is in any part community property and the spouse predeceases the insured and bequeathes her interest in the policy to someone other than her surviving spouse, and the parties are cooperative, the estate planner has various options to consider. First and most obvious is to have the third party pay all the premiums in order to minimize the estate taxes of the insured and to acquire a greater interest in the policy. If the insured wished to rid himself immediately of his entire interest, this could easily be done by way of a gift. It has also been suggested that the parties could ask for a partition of the policy into two separate policies with each owning their interest outright and there being no tenancy in common. Many other avenues are open to avoid the thrust of section 2042, but this subject is beyond the scope of this note.

Conclusion

Community property law affects ownership interests, and in order to determine the estate tax consequences of that determination it is necessary to give regard to applicable state laws. But the courts must give regard to all portions of California’s community property laws, including the power of management over community funds. Thus, it is necessary to examine closely the insured’s interest in order to determine whether he “possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person.”

In view of the foregoing it is apparent that if the recommendations of this note are followed, drastic changes would result in the

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field of estate taxation. However, the insured still could irrevocably assign all the incidents of ownership before his death and not in contemplation of death and avoid any estate tax consequences. He could also have his wife purchase policies on his life and have her pay the premiums from her separate funds to avoid section 2042. But unless this action is taken, or until the appropriate legislation is enacted, one-half of the proceeds of community life insurance will continue to be includible in the gross estate of the insured by the application of section 2042.

Lawrence S. Braunstein*

* Member Second Year Class