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Policy Facts and Incidents of Ownership Under Estate Tax Section 2042(2): The Legacy of Rhode Island Hospital Trust

Richard L. Haight*

I. THE NATURE OF THE ISSUE

A. Introduction

Consider the Federal Estate Tax consequences to the late Mr. Smith resulting from the existence of an insurance policy on his life. Mr. Smith took out the policy several years prior to his death. The insurance company complied with the contract provisions when Mr. Smith died, paying the full $500,000 proceeds to the beneficiaries whom he had named.

Since the proceeds were not payable to Mr. Smith's estate, his executrix might be tempted to believe that they are not subject to the Estate Tax as part of the estate. However, the $500,000 must be included in Mr. Smith's gross estate for Estate Tax purposes if Mr. Smith possessed at death an "incident of ownership" in the insurance policy.

It is fairly clear that, in order to determine whether Mr. Smith had an incident of ownership in the policy, the provisions of the insurance contract (sometimes called the "policy terms") should be examined. However, since 1966, when United States v. Rhode Is-

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1. The provisions of the Federal Estate Tax are found in Subtitle B of the Internal Revenue Code of 1986. Unless otherwise indicated, all section references in this article will be to the Internal Revenue Code of 1986, as amended.

2. The quoted term appears in Section 2042(2) in the Estate Tax portion of the Internal Revenue Code. See infra note 9. For the purposes of this article, it is assumed that the proceeds of the insurance policy are not payable to the decedent's estate (i.e., to the decedent's "executor"), a fact which would warrant includability in the gross estate under Section 2042(1). See infra n.8.

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land Hosp. Trust Co.\textsuperscript{3} (hereinafter \textit{RIHT})\textsuperscript{4} was decided by the Court of Appeals for the First Circuit, there has been some confusion in the decided cases as to whether, and to what extent, factors beyond the policy terms are pertinent to this inquiry. Some cases have treated \textit{RIHT} as authority for viewing the policy terms alone as determinative; other cases have not regarded \textit{RIHT} as requiring so narrow a focus and have considered the impact of various factors outside of the insurance contract provisions; and still other cases have ignored \textit{RIHT} completely.

As a consequence, Mr. Smith's executrix will find that the question of whether the decedent had an incident of ownership in the $500,000 policy is not necessarily one which lends itself to easy resolution.

The purpose of this article is to examine the current state of the law in this area\textsuperscript{5} and to suggest a rational approach for dealing with this issue in the future.

\section*{B. Incidents of Ownership}

It is difficult to comprehend the full import of the \textit{RIHT} case without having a basic understanding of what the concept of incidents of ownership entails.

The incidents of ownership test, first applied in a life insurance context by the Supreme Court in 1929,\textsuperscript{6} was formally made a part of the Estate Tax statute in 1942.\textsuperscript{7} Under Section 2042(2), in the current version of the Internal Revenue Code, life insurance proceeds (paid to someone other than the decedent's personal representative)\textsuperscript{8} are included in the insured's gross estate if they are

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3. 355 F.2d 7 (1st Cir. 1966).
4. For ease of discussion, the 1966 \textit{Rhode Island Hosp. Trust Co.} case is referred to in this article as "RIHT."
8. Under Section 2042(1) of the current Internal Revenue Code, insurance proceeds which are "receivable by the executor as insurance under policies on the life of the decedent" are included in the decedent's gross estate without regard to an incidents of ownership test. Section 2042(2) applies when the proceeds under a policy on the decedent's life are not "receivable" by the decedent's personal representative.
payable under a policy "with respect to which the decedent [insured] possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person." The purpose of the test is to prevent avoidance of the application of the Estate Tax by an insured who has made an inter vivos disposition of a life insurance policy, but nonetheless has retained until death some of the benefits of ownership in the policy.

Aside from one example appearing in Section 2042(2), itself, the Code does not define the term "incident of ownership." Examples of incidents of ownership were described in the relevant committee reports and now appear in the regulations.

9. Emphasis added. The pertinent provision in current Section 2042, as enacted in 1954, reads as follows:

The value of the gross estate shall include the value of all property —

(2) RECEIVABLE BY OTHER BENEFICIARIES.—To the extent of the amount receivable by all other beneficiaries [than the executor] 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 "incidents of ownership" includes a reversionary interest....

10. Estate of Rockwell v. Comm'r, 779 F.2d 931, 933 (3rd Cir. 1985); Estate of Connelly v. United States, 551 F.2d 545, 551 (3rd Cir. 1977).

11. Section 2042(2) describes a reversionary interest in the policy as an incident of ownership. See in this regard Section 20.2042-1(c)(3), Estate Tax Regs., and Rev. Rul. 117, 1979-1 C.B. 305.


13. Section 20.2042-1(c)(2), Estate Tax Regs. The following sentence used to follow the paragraph quoted in the text: "Similarly, the term includes the power to change the beneficiary reserved to a corporation of which the decedent is the sole stockholder." Amendments were made to the regulations under Section 2042 (see T.D. 7312, April 26, 1974, and TD 7623, May 14, 1979). The sentence following the paragraph quoted in the text now reads as follows: "See subparagraph (6) of this paragraph for rules relating to the circumstances under which the incidents of ownership held by a corporation are attributable to a decedent through his stock ownership." Section 20.2042-1(c)(6), Estate Tax Regs., which now provides the corporate attribution rules, reads, in part, as follows:

[1] If the decedent is the controlling stockholder in a corporation, and the corporation owns a life insurance policy on his life, the proceeds of which are payable to the decedent's spouse, the incidents of ownership held by the corporation will be attributed to the decedent through his stock ownership, and the proceeds will be included in his gross estate under section 2042. . . . For purposes of this subparagraph, the decedent will not be deemed to be the controlling stockholder of a corporation unless, at the time of his death, he owned stock possessing more than 50 percent of the total combined voting power of the corporation.

This provision of the regulations also states that there will be no attribution to a decedent/shareholder of incidents in a corporation-owned policy "to the extent the proceeds of the policy are payable to the corporation." This exception reflects the wide use of life insurance in funding corporate buy-sell arrangements.
[The 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. 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.]

The listing of incidents in Section 2042(2) and in the accompanying regulations does not purport to be exhaustive. Moreover, the court decisions dealing with this topic have acknowledged that “it is not possible to draw a clear line with respect to this issue.” It has been pointed out more than once that “[t]he very phrase ‘incidents of ownership’ connotes something partial, minor, or even fractional in scope.” As a result, “it is not the number of powers possessed that is the determining factor. Rather it is the existence of even a ‘fractional’ power not the ‘probability’ of its exercise that controls.”

Given the broad parameters of this statutory term, courts have viewed limited, insubstantial, or nominal rights as constituting incidents of ownership. For example, it has been held that a decedent’s mere right to consent to (or veto) the exercise of a power held by another is an incident of ownership because there is no significant difference under Section 2042(2) between the power to make changes and the power to bar changes. On the other hand, it has been held that an incident of ownership does not exist when a decedent has a mere expectancy in policy proceeds, or when

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14. See paragraphs (1) through (6) of Section 20.2042-1(c), Estate Tax Regs., for the complete regulatory discussion of the term. Some additional aspects of these provisions will be dealt with below.

15. Estate of Smead v. Comm’r, 78 T.C. 413, 47-48 (1982). In Smead, the court stated that the failure of the committee reports or the regulations to list a particular right or power as an example of an incident of ownership “is not determinative.” 78 T.C. at 48.


17. RIHT, 355 F.2d at 10. These sentences have often been quoted in subsequent opinions.

18. Schwager, 64 T.C. at 791. Rev. Rul. 129, 1979-1 C.B. 206, presents an interesting example of a “fractional” power. In that ruling, the decedent had the right to obtain a loan against the surrender value of the policy on his life, such right being limited to the amount of the premiums that had been paid. This right was held by the Internal Revenue Service to be an incident of ownership, sufficient to warrant the inclusion in the decedent’s gross estate of the entire policy proceeds.

19. Schwager, 64 T.C. at 791. The Court stated that “it is the power and not the substantiality of the power that we must look to.” Id.

20. Estate of Margrave v. Comm’r, 618 F.2d 34 (8th Cir. 1980). In that case, the decedent’s ability to designate the beneficiary of a trust to which the proceeds of the policy were payable, was held to be a mere power over an expectancy in view of the powers held by the
any action by a decedent to affect a policy would constitute an actionable breach of contract.\textsuperscript{21}

Incidents of ownership are frequently described as rights to a life insurance policy's "economic benefits." This feature is emphasized in the regulations under Section 2042(2), which provide that "the term has reference to the right of the insured or his estate to the economic benefits from the policy."\textsuperscript{22}

From this language it would appear that there are two underlying requirements which must be satisfied if a right in an insurance policy is to constitute an incident of ownership: First, the right must relate to an economic benefit; second, the economic benefit must inure to the decedent or to the decedent's estate.\textsuperscript{23}

However, as to this second regulatory requirement, the Internal Revenue Service has taken the position that it is not necessary under Section 2042(2) for the decedent to benefit personally as long as the decedent has control over who does benefit. Often, but not always,\textsuperscript{24} the IRS will support this seemingly contradictory position by citing a companion regulatory provision which concludes that a decedent has an incident in a policy held in trust if the decedent's spouse over the policy, and the court concluded that includability under Section 2042(2) was therefore not warranted. The court of appeals affirmed the Tax Court on this issue, 71 T.C. 13 (1979). The Tax Court opinion is discussed in K. Eliasberg, Estate of Robert B. Margrave and the Estate Taxation of Life Insurance—Incidents of Ownership Revisited, INSURANCE LAW JOURNAL (#679, August 1979) at 443.

\textsuperscript{21.} See Estate of Bartlett v. Comm'r, 54 T.C. 1590, 1597-98 (1970), wherein the court held that a mere "ability" to affect a life insurance policy, without the legal "right" to do so, was not an incident of ownership. Thus, in Bartlett, the decedent's ability to cash in an insurance policy on his life was not considered an incident of ownership when such an action would have been in breach of the decedent's trust agreement and a fraud upon the trustee. The Bartlett case is discussed below in connection with Example 3.1.

\textsuperscript{22.} Section 20.2042-1(c)(2), Estate Tax Regs. Note that this sentence is introduced with the phrase, "generally speaking," and one must wonder whether it is the position of the Treasury that it may be possible to have an incident of ownership in a policy if the right or power possessed by the decedent does not bear a relationship to any economic benefit flowing from the policy. The weight of the cases is against such a proposition. See note 26, infra.

\textsuperscript{23.} The emphasis given by the regulations to economic benefit seems to go beyond the congressional mandate, as that mandate is disclosed by the committee reports. Estate of Connelly v. United States, 551 F.2d 545, 547 n.7 (3rd Cir. 1977).

\textsuperscript{24.} See Rev. Rul. 70, 1975-1 C.B. 301. In Morton v. United States, discussed below in connection with Example 1.1, the Government argued that, if the decedent by virtue of his retained rights in a policy on his life, could effect the transfer of the policy proceeds, he had an incident of ownership even though there was no possibility of personal economic benefit. Because the court concluded that the decedent had assigned all of his rights in the policy, the court stated that it was unnecessary to decide "whether retention by him of incidental powers which could not possibly occasion him economic benefit might be sufficient 'incidents of ownership' to bring the proceeds of the policy within Section 2042(2)." 457 F.2d at 753, n.4.
cedent "has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust." The courts have taken varying positions as to whether this language eliminates any requirement for the decedent (or the decedent’s estate) to have a direct, personal benefit from the policy.

In this article, it is assumed in most instances that, if the power under discussion was actually held by a decedent at death, it was an incident of ownership under Section 2042(2). While not all of the referenced court opinions are careful in defining the question before them, the focus in the article is primarily on whether an acknowledged incident of ownership is in fact possessed by a decedent. Under Section 2042(2), do we resolve this question by looking just to the policy terms, or are other factors relevant in making this determination?

C. The Leading Cases

1. Rhode Island Hospital Trust

In RIHT, the father of D had purchased an insurance policy on the life of D when D was 18. The proceeds were payable to D’s


26. While a thorough analysis of these cases is beyond the scope of this article, the reader’s attention is directed to the discussion of this point and the authorities cited in Estate of Connelly v. United States, 551 F.2d at 547, 551-552, and Estate of Rockwell v. Comm’r, 779 F.2d 931, 934-935 (3rd Cir. 1985). See also RIHT, 355 F.2d at 11. In Rockwell, several insurance policies on the decedent’s life were held in an irrevocable trust. The decedent was not the trustee, but he had the power to veto any assignment of the policies by the trustee if the assignee did not have an insurable interest in the decedent’s life. The court held that the decedent was unable to exercise his limited retained power for his own economic benefit and that he, therefore, did not have any incident of ownership in the policies. In so holding, the court stated (779 F.2d at 937): “Congress’ purpose in requiring the inclusion of policies in a gross estate when the decedent retains incidents of ownership is to prevent taxpayers from enjoying property without paying tax on it. Rockwell [decedent], by his retained power neither enjoyed the benefits nor exerted ownership of life insurance policies.” Compare the result in Rockwell with the result in Revenue Ruling 75-70. In Estate of Bloch v. Comm’r, 78 T.C. 850, 862-864 (1982), the decedent pledged a policy insuring his life as collateral for a personal loan. The policy was part of the corpus of a trust of which the decedent was the trustee. The decedent’s use of the policy for his personal economic benefit was viewed by the court as an actionable breach of his fiduciary duty. Thus, despite the economic benefit inuring to the decedent, the court held that he possessed no incidents of ownership in the policy under Section 2042(2).

27. In this article, the letter D (for “decedent”) will be used to refer to the person on whose life there is a policy of insurance (the “insured”) and who, at death, arguably possessed an incident of ownership in that policy, resulting in the inclusion of the policy proceeds in his or her gross estate under Estate Tax Section 2042(2).
father and mother. The father kept the policy in his safe deposit box and paid all of the premiums.

It was clearly understood by D and his father that the father was the effective owner of the policy and that D would never benefit from it. Nevertheless, under the contract of insurance, D was granted various powers, including the rights to change beneficiaries, to assign the policy, and to borrow on the policy.\(^2\)

Pursuant to his understanding with his father, D never exercised any of these powers, at least for his own benefit. When his mother died, his father told him to change the beneficiary designation to make the father the primary beneficiary, and D complied. D did not otherwise exercise any of the powers granted to him by the policy. At D's death, the proceeds of the insurance policy were paid to the father.

In its opinion, the court acknowledged that the father was the instigator, premium payer, and primary beneficiary of the policy and, pursuant to his understanding with D, had full control over the policy. Notwithstanding these facts, the court held that the proceeds of the policy were includable in D's gross estate under Section 2042(2).

In reaching this conclusion, the court pointed out that the case presented two kinds of facts—"intent facts" and "policy facts." The "intent facts" were those facts which related to the conduct and understanding of D and his father, showing that the father was regarded as the owner of the policy. The "policy facts" were those facts revealed by the insurance contract, showing that D had various substantive rights and powers.\(^2\)

The court held that the intent facts were not relevant and that, in view of the policy facts, the case fell squarely within the ambit of Section 2042(2). The Court pointed out that when Congress added the "incidents of ownership" language in 1942, Congress intended the term to cover the mere existence of a power in an insurance policy. Congress believed includability was warranted even where a decedent's interest in a policy was "partial, minor, or even

\(^{28}\) See RIHT, 355 F.2d at 9, wherein the court listed various "rights, privileges, or powers accorded to the decedent." The Court also pointed out that D had an additional negative power in view of the fact that D's signature was necessary if the father wanted to change the beneficiaries, to surrender the policy for its cash value, or to do other things with reference to the policy. The Court felt that even such a negative power in D would be "incident of ownership," it being irrelevant under the express provisions of Section 2042(2) that it was exercisable "in conjunction with [another] person." \textit{Id.} at 11.

\(^{29}\) \textit{Id.} at 8. For a list of D's rights and powers under the insurance contract, see \textit{Id.} at 9.
fractional in its scope."

It was not essential for D to have had control over the economic benefits, according to the court; all that was necessary for includability was that D be able to "affect the transfer of policy proceeds." Here, D could do so even, in some instances, without having actual possession of the policy.

The court concluded it was irrelevant that an understanding existed between D and his father that D would not exercise any of the powers granted to D under the policy. The critical question for includability under Section 2042(2) was what rights and powers did D actually possess under the policy facts.

2. Estate of Noel

In RIHT, the Court of Appeals placed heavy reliance on a then recent decision of the United States Supreme Court, Commissioner v. Estate of Noel. In Noel, D, about to board an airplane, applied for two policies of insurance on his life. D’s spouse (S), who accompanied D to the airport, paid for the policies. D told the clerk that the policies were S’s, and the clerk gave the documentation to S. A few hours later, D was killed when the plane on which he was traveling crashed.

Among other things, the contracts of insurance gave D the right to change the beneficiaries and to assign the policies. The taxpayer argued before the Supreme Court that D did not have any incidents of ownership in the policies. Three alternative reasons were given:

(a) S purchased the policies, and, as owner, S possessed all incidents of ownership.
(b) Assuming that D owned the policies, D gave the policies to S, and D could therefore not exercise the powers granted to him by the policy terms.
(c) Assuming that D retained the powers granted to D by the policy terms, D was unable to exercise them while D was on the airplane—up to the moment of death.

The Supreme Court held that the proceeds of the policies were includable in D’s gross estate under Section 2042(2). The Court

30. Id. at 10.
31. Id. at 11.
32. Id.
responded to the taxpayer’s arguments as follows:

As to arguments (a) and (b): Regardless of whether S purchased the policies or was given the policies by D, the policy terms gave D, and not S, the power to assign the policies and to change the beneficiaries. These terms rebutted the claims that S became the complete owner of the policy and that S’s ownership precluded the existence of any rights in D. D held the powers granted to D under the insurance contracts up to the moment of death.34

As to argument (c): While it is true that, as a practical matter, D could not exercise his retained powers once D had boarded the airplane and that, therefore, the powers were not exercisable by D at the moment of death, Congress did not intend to have Estate Tax liability determined “by an individual’s fluctuating, day-by-day, hour-by-hour capacity to dispose of property which he owns.”35 The term “incidents of ownership” means “a general, legal power to exercise ownership, without regard to the owner’s ability to exercise it at a particular moment.”36

In RIHT, the Court of Appeals relied heavily on Noel to support its conclusion that policy facts are determinative on the question of includability under Section 2042(2)—even in situations where a person other than the decedent can be viewed as owning the policy. The Court of Appeals also gave considerable weight to the conclusion in Noel that it is of no importance that a decedent might not be able, as a practical matter, to exercise at death the powers granted by the insurance contract. In this respect, the Court of Appeals apparently believed the decedent in Noel and the decedent in RIHT were similarly situated — D in Noel could not exercise the powers because D was in an airplane at the moment of death; D in RIHT could not exercise the powers because of the understanding that D’s father was the owner of the policy.

While Noel does provide support for the RIHT conclusion that policy facts predominate heavily in this area of the law, nothing in Noel provides direct support for the proposition, articulated in

34. Noel, 380 U.S. at 683. The Supreme Court also pointed out:

Nothing we have said is to be taken as meaning that a policyholder is without power to divest himself of all incidents of ownership over his insurance policies by a proper gift or assignment, so as to bar its inclusion in his gross estate under Sec. 2042(2).

What we do hold is that no such transfer was made of the policies here involved. Id. at 684.

35. Id. Note also that Section 2042(2) refers to incidents of ownership “which the decedent possessed at his death.” [Emphasis added.]

36. Id.
RIHT, that the so-called intent facts are basically not relevant on the issue of includability under Section 2042(2).

D. Examining the Post-RIHT Cases

This article analyzes Section 2042(2) cases decided subsequent to RIHT to study the extent to which RIHT has affected the process of ascertaining the existence of incidents of ownership. Since its issuance in 1966, RIHT has been widely cited in cases in which the terms of the insurance contract have conflicted with other facts, thereby creating an issue as to whether the decedent possessed the requisite incidents of ownership under Section 2042(2). While some courts have resolved this issue without reference to RIHT, others have placed heavy reliance on the case and, in some instances, have rigidly applied the predominance of the policy facts principle. In this latter group are cases which seem to have adopted the view that this RIHT principle is to be applied virtually without regard to other elements present in the case. These cases can arguably stand for the proposition that, under RIHT, the policy facts are solely determinative of the question of whether the decedent possessed incidents of ownership. Most cases, however, have placed limitations on application of the RIHT principle.

A review of the post-RIHT cases in this area suggests that most of the courts have based their decisions on an analysis of two groups of factors. For convenience of discussion, these factors are referred to in this article as the “policy factors” and the “outside factors,” defined as follows: Policy Factors: The provisions of the life insurance policy, i.e., the terms of the contract of insurance, as they appear in the application for insurance and in the policy document, including endorsements thereto, as well as in any written amendments and assignments of the policy which are filed with and accepted by the insurance company. Outside Factors: Matters which bear some relationship to the insurance policy, but which are not apparent from an examination of the language of the insurance contract, i.e., matters pertaining to the insurance policy which are extrinsic to the policy factors.

37. The court in RIHT stated that there was at least one occasion when intent facts could have relevance. RIHT, 355 F.2d at 13. See the General Comments, below, for Examples 5.1 and 5.2.

38. See, e.g., Puchner v. United States, discussed below in connection with Example 3.1. See also Kearns v. United States, and Nance v. United States, discussed in connection with Example 4.1. In some cases, Noel is also cited as supportive of the predominance of the policy facts principle.
It is clear from the vast majority of the post-RIHT cases that policy factors alone are not always determinative on the question of whether a decedent had an incident of ownership in a life insurance policy and that a consideration of certain outside factors is at times essential to a resolution of the issue of includability under Section 2042(2).

There are two general categories of post-RIHT cases which present the policy factors vs. outside factors issue. They are referred to in this article as “term deletion cases” and “term addition cases,” defined as follows: Term Deletion Cases: Cases in which the taxpayer takes the position that outside factors have the effect of deleting terms from the insurance contract, *i.e.*, cases in which the taxpayer contends that, although the policy factors indicate that the decedent had an incident of ownership in the insurance policy, the outside factors establish that the decedent did not have such a right or power. Term Addition Cases: Cases in which the Internal Revenue Service takes the position that outside factors have the effect of adding terms to the insurance contract, *i.e.*, cases in which the IRS contends that, although the policy factors indicate that the decedent did not have an incident of ownership in the insurance policy, the outside factors establish that the decedent did have such a right or power.

### E. Outside Factors in General

As will be seen from the discussion of the cases in this article, there is no certainty in any given case that a court is going to find that a particular outside factor is relevant in determining whether a decedent had incidents of ownership in an insurance policy. However, certain outside factors have been dealt with by the courts, and they merit particular attention.

One of the more important outside factors to be examined in a Section 2042(2) case is the applicable local law. The manner in which state law construes the terms of a life insurance policy, or otherwise bears upon the rights granted by the policy, is frequently pertinent to the determination of whether a decedent held an incident of ownership. It is possible in a given case for the state law to contradict what appears to be the plain language of the insurance contract. Those Section 2042(2) cases which address the effect of local law, present the following question:

**QUESTION:** Is there a local case or statutory provision which, when applied to the terms of the insurance policy, would regard the decedent as possessing (or, alternatively, not possessing) a particular right or power?
In this regard, it is also possible for a Section 2042(2) case to present the following question:

**QUESTION:** Is there a court order bearing on the insurance policy which effectively grants an incident of ownership to the decedent (or, alternatively, takes an incident of ownership away from the decedent)?

Another outside factor relates to the existence of formal and informal arrangements between the decedent and a third party and to the effect that these agreements or understandings have under local law. Those Section 2042(2) cases which address the effect of such “side” arrangements, usually present one of the following questions:

**QUESTION:** Has the decedent formally assigned an incident of ownership to a third party (or, alternatively, has a third party formally assigned an incident of ownership to the decedent)?

**QUESTION:** Have the decedent and a third party made some informal arrangement whereby a particular right or power granted by the policy to the decedent is exercisable only by the third party (or, alternatively, have they made an informal arrangement whereby a particular right or power granted by the policy to the third party is exercisable by the decedent)?

The question of subjective intent may be relevant in resolving some of these questions, particularly the last question above, and intent is therefore another outside factor which can have a bearing on incidents of ownership.\(^{39}\) Intent is also a pertinent consideration in those Section 2042(2) cases which present the following question:

**QUESTION:** Is a particular incident of ownership granted to the decedent merely because of an error made by the insurance company, *i.e.*, is the existence of that right or power in the policy clearly contrary to an understanding reached by the decedent and the insurance company? (In the alternative, is a particular incident of ownership not granted to the decedent merely because of an error made by the insurance company, *i.e.*, is the existence of such a right or power in the policy clearly consistent with an understanding reached by the decedent and the insurance company?)

An examination of cases presenting these questions follows in Part II.

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39. As a consequence, the following additional question may become relevant, notwithstanding the *RIHT* rule: Is a particular incident of ownership which is granted by the policy terms to the decedent consistent with (or, alternatively, contrary to) the decedent's subjective intent?
II. OUTSIDE FACTORS UNDER THE POST-RIHT CASES

A. Introduction

The following is a discussion of significant post-RIHT cases in which it was argued by either the taxpayer or the Government that, in determining whether the decedent had incidents of ownership under Section 2042(2), the outside factors should predominate over the policy factors.

For ease of analysis, the cases are divided into five broad categories, determined by reference to the nature of the outside factors under consideration. These outside factors are (1) local law, (2) court orders, (3) formal "side" arrangements, (4) informal "side" arrangements, and (5) insurance company errors.

The discussion of each of these five outside factors is preceded by two simple examples showing the nature of the issue presented by the subsequent cases in both the term deletion and term addition contexts. In each of the examples, it is to be assumed that (1) when the decedent died, an insurance company paid out proceeds on a policy insuring the life of the decedent,40 and (2) the Internal Revenue Service has taken the position that the proceeds of that policy are includable in the decedent's gross estate under Section 2042(2).41

B. The Effect of Local Law

1. Examples

**EXAMPLE 1.1.: TERM DELETION CASE**

*Policy Factors:* The policy terms state that, at death, D had the right to change the beneficiaries on the policy. *Outside Factors:* Under the statutory or case law of the state, D did not have that right at death.

**EXAMPLE 1.2: TERM ADDITION CASE**

*Policy Factors:* The policy terms do not give D the right to change the beneficiaries on the policy. *Outside Factors:* Under the statutory or case law of the state, D did have that right at death.

The examples present the question of whether the relevant pro-

40. It is important under Section 2042(2) that the decedent be the person whose life is insured under the policy at issue. If the decedent owns at death a policy insuring the life of another person, Section 2042(2) does not apply to that policy. Includability of the value of the policy in the gross estate in that circumstance comes under the purview of another Estate tax provision, e.g., Section 2033. See Section 20.2042-1(a)(2), Estate Tax Regs.

41. In the examples and the cases, the letter "D" is used to refer to the insured decedent (see n.27, supra), the letter "S" is used to refer to the decedent's spouse, and the Letter "X" is used to refer to an unrelated third party.
visions of State law can be more important than the terms of the insurance policy. This question can be broken down into two parts: If the policy terms grant the decedent an incident of ownership, but local law eliminates or nullifies that right or power, does Section 2042(2) apply? If the policy terms do not grant the decedent an incident of ownership but local law does grant the decedent an incident, does Section 2042(2) apply?

2. Term Deletion Cases

In Morton v. United States,42 D applied for and was issued a life insurance policy on D's life. D never considered himself the owner of the policy intending it to provide financial security for D's spouse (S). D never paid any of the premiums. (They were paid by others, including S.) Under the terms of the policy, D, as the insured, had various incidents of ownership. D executed an endorsement in which he made an irrevocable designation of the beneficiaries43 and the mode of settlement. This action left D with certain incidents of ownership under the policy terms. The policy factors showed that D still had (1) the right to assign, (2) the right to surrender for cash surrender value, and (3) the right to obtain loans.

The court examined the outside factors and held that, regardless of the policy factors, D did not have an incident of ownership in the policy. The court looked to state law which provided that D's irrevocable designation of S as the policy beneficiary made S a third party beneficiary to a contract with enforceable rights. In this respect, the court regarded the case as distinguishable from RIHT. Given the local law provisions, the court concluded that it was impossible for D to exercise the retained incidents of ownership in any manner that would control the disposition of the proceeds or in any other way produce an economic benefit to D or D's estate. The court stated: "We hold that where an insured has never paid a premium and has never for any purpose treated the property as his own that his irrevocable designation of beneficiaries and mode of payment of proceeds is an effective assignment of all of his incidents of ownership in the policy."44

43. The primary beneficiaries under the endorsement were D's spouse and children. Id. at 752, n.2.
44. Id. at 755. Presumably, the quoted conclusion by the court is based on the law of the state (West Virginia) involved in the case. However, the opinion may suggest to some readers that the court is adopting a rule of general application in Section 2042(2) cases.
The Internal Revenue Service also argued that even if D had no independent power, he still had the power under the policy terms to act "in conjunction with" the beneficiaries in exercising incidents of ownership. The court held that, given the fact that S had paid premiums and was irrevocably designated as beneficiary, under the applicable State law the incidents of ownership were exercisable by S alone. The court stated:

It is not necessary to ignore the policy facts in order to recognize that with respect to premium derived options it is clear that the decedent never considered the policy his, and had the question come up, that all parties would have doubtless agreed that the decedent’s wife should be entitled to exercise these options.

In sum, the court held that even though D was granted incidents of ownership by the policy factors, D would not be regarded as possessing any incident of ownership in the policy when the outside factors show that under local law D did not have the power to exercise those incidents.

_Estate of Carlstrom v. Commissioner_ shows another application of this principle in a term deletion setting. In that case, D was the president of (and ultimately controlled) a family corporation which had committed to pay the premiums on an insurance policy on D’s life. D’s spouse (S) applied for the policy and signed the application as the purchaser. D signed the application as the insured. Shortly after the policy was issued, the insurance company...
was sent a document requesting that the policy be amended. The
document sought (1) to have the corporation named as the owner
of the policy, but without the right to change the beneficiary, and
(2) to designate irrevocably the corporation and S as the benefi-
ciaries under the policy. The document was executed by D in his
capacity as the insured and as corporate president. It was not
signed by S, who was not even aware of its existence.

Both D and the insurance company apparently believed that the
policy, as originally issued, gave D the power to amend the policy.
When D died three years later, the insurance company treated
the amendment as part of the policy terms and paid the proceeds to
the corporation and to S.

The policy factors in *Carlstrom* are shown in the terms of the
original insurance contract as modified by the amendment. Relying
on these policy factors, the Internal Revenue Service wanted to in-
clude the proceeds in D's gross estate under Section 2042(2). The
position of the IRS was that the policy factors showed that the
corporation was the owner and, since D owned over 70% of the
corporate stock at death, the corporation’s incidents of ownership
should be attributed to D.\(^5\)

The Tax Court disagreed that the corporation had incidents of
ownership in the policy. The court based its decision on the
outside factors, specifically the provisions of State law bearing on
amendments to insurance policies. The court pointed out that S
was the owner of the policy under local law and that only S could
have made a proper amendment. Accordingly, the amendment
made by D was not valid.\(^6\) As a result, at D's death, the corpora-

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\(^5\) The attribution of corporate incidents of ownership to controlling or sole share-
holders is covered in Section 20.2042-1(c)(6), Estate Tax Regs. See n. 13, *supra*, and the
accompanying text. Note that the regulations provide that “the corporation's incidents of
ownership will not be attributed to the decedent through this stock ownership to the extent
the proceeds of the policy are payable to the corporation . . . [or to] a third party for a valid
business purpose . . . .” In *Carlstrom*, the IRS sought to include in D's gross estate only the
portion of the proceeds paid to W. See also Rev. Rul. 145, 1982-I C.B. 213.

Technically, perhaps, a decedent's stock holdings in a corporation can be viewed as an
outside factor. However, for purposes of this article, a decedent who can control the deci-
sions of a corporation is regarded as possessing the incidents of ownership held by the cor-
poration under the policy factors. The practical situation of such a decedent is generally not
significantly distinguishable from that of a decedent who possesses the incidents directly;
absent evidence to the contrary, the imposition of the corporate entity in this context is a
minimal inhibition of the decedent's ability to exercise the relevant powers. Moreover, it is
possible to argue that includability is warranted under Section 2042(2) because the decedent
is able to exercise the incidents of ownership “in conjunction with” the corporation. See

\(^6\) In Bintliff v. United States, 462 F.2d 403, 407 (5th Cir. 1972), although D's spouse
tion held no incidents of ownership which could be attributed to D. All such incidents were held by S, therefore the proceeds were not includable in D's gross estate under Section 2042(2).

The Tax Court in *Carlstrom* did not regard the policy factors in that case as determinative. However, since the *Carlstrom* opinion makes no mention of the RIHT case, the court was not compelled to point out any distinguishing elements.

3. **Term Addition Cases**

In *Estate of Meyer* v. Commissioner, the Tax Court again made no reference to RIHT in reaching the conclusion that outside factors were to control over policy factors. In *Meyer*, a term addition case, the application for the policy on D's life designated D's spouse (S) as the owner of the policy, and S signed the application as purchaser. The policy designated S as the owner. Thus, the policy factors indicated that D had no incidents of ownership in the policy. Nevertheless, the IRS argued and the court agreed that one half of the proceeds was includable in D's gross estate under Section 2042(2).

The court relied on the provisions of the local community property law (outside factors) in holding that, notwithstanding the language on the application (policy factors), D held a one-half community interest in the policy and its proceeds.

*Meyer* is a term addition case because the court's opinion gives D a 50% ownership interest which the policy terms, standing alone, do not appear to grant to D. The language of the insurance contract has been affected by the application of state law.

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(S) held all incidents of ownership, D was required by a bank to co-sign the assignment of the insurance policy as security for a loan to D and S. The court pointed out that D's co-signing was superfluous and did not operate to grant D an incident of ownership. Cf. *Estate of Goodwyn* v. Comm'r, par. 73, 153 T.C.M. (P-H) (1973) at 736-737.

53. It is interesting to observe that the insurance company in *Carlstrom* dealt with the amendment as though it were valid and made the distribution of proceeds in accordance with its requirements. 76 T.C. at 145. The Tax Court's determination of the realities for tax purposes (that the amendment was invalid) is clearly at odds with what actually occurred. Generally, courts try to avoid this type of result; see, on a related point, the discussion in connection with Examples 5.1 and 5.2 of *Fuchs v. Commissioner*.


55. The State's community property law provided that the payment of insurance premiums with community funds made the insurance policy community property. *Id.* at 43. *Cf.* *Scott v. Commissioner*, 374 F.2d 154 (9th Cir. 1967).

56. In one respect, *Meyer* may appear to be a term deletion case in that the court's opinion affects the policy terms by taking away from S, 50% of the interest granted to S by
Freedman v. United States, 57 and Daubert v. United States, 58 are factually similar to Meyer and are additional examples of term addition cases in which the terms of a life insurance policy (showing that only D's spouse had incidents of ownership) are affected by the local community property law. In Freedman and Daubert, as in Meyer, the court held that one half of the policy proceeds was includable in D's gross estate under Section 2042(2).59

Still other examples of cases factually similar to Meyer, are Catalano v. United States, 60 Kern v. United States 61 (as it relates to the second insurance policy considered therein), 62 and Madsen v. Commissioner. 63 In Catalano, Kern, 64 and Madsen, 66 the outside factors (local community property law) were regarded by the courts as having the potential to dominate the policy factors (policy terms which showed that only D's spouse had incidents of ownership). 67

57. 382 F.2d 742 (5th Cir. 1967).
59. To a similar effect, see Rev. Rul. 228, 1967-2 C.B. 331.
60. 429 F.2d 1058 (5th Cir. 1969).
61. 491 F.2d 436 (9th Cir. 1974).
62. The second policy in Kern is designated as “Policy No. 505389,” issued on March 3, 1965, by Northern Life in the amount of $10,000. Id. at 438.
63. 659 F.2d 897 (9th Cir. 1981).
64. In Catalano, the court examined State community property law and concluded that D was granted no incidents of ownership under local law. To a similar effect, see Estate of Saia v. Comm'r, 61 T.C. 515 (1974).
65. As to the second policy considered in Kern, the court reached no final decision regarding ownership because of the need to consider the impact of an additional State statute on remand. Kern, 491 F.2d at 439-440.
66. In Madsen, an issue of local law was certified by the Court of Appeals to the State supreme court. The opinion of the State supreme court, 97 Wn.2d 792 (1982) (unofficially reported at 82-2 USTC par. 13, 495), led the Ninth Circuit Court of Appeals to conclude that the outside factors (local community property law) gave D incidents of ownership in the policy. The subsequent opinion of the court of appeals in Madsen is reported at 690 F.2d 164 (9th Cir. 1982).
67. As to the first policy considered in Kern (designated “Policy No. 467-750,” issued on January 15, 1958, by Northern Life in the amount of $20,000), a somewhat different issue was presented. There was a typed endorsement to the first policy, part of the policy terms, which in very explicit language (much stronger and clearer than the language appearing in the second policy) declared that D's spouse was to have all incidents of ownership and that D was to have none. The court, in this instance, regarded the policy factors to be controlling when construed in the light of the applicable state law. Therefore, as to the first policy, Kern is not a term deletion or a term addition case. D was held to have no incidents of ownership in the first policy, and it was not includable in D's gross estate under Section
Not all attempts by the Internal Revenue Service to prove incidents of ownership by reference to local law have been successful. In *Estate of Crosley v. Commissioner*,68 D, who was insured under various life insurance policies, established an irrevocable trust to which he transferred all of his incidents of ownership in the policies. Formal assignments for each of the policies were filed with the respective insurance companies on forms provided by the companies. Thus, the policy factors showed that D held no incidents of ownership at his death. The IRS argued that the local trust law (outside factors) showed the trust to be a sham or to have terminated and that D, therefore, retained the incidents of ownership at death. The court examined the applicable State law and the evidence before it and concluded that D held no incidents of ownership once the policies were assigned.

A similar result was reached in *Estate of Gorby v. Commissioner*.69 In that case, D was the insured under two life insurance policies. In order to transfer all of his incidents of ownership in the policies to his spouse, D executed assignment documents which were provided by, and subsequently filed with, the insurance companies. Thus, as in *Crosley*, the policy factors showed that D held no incidents of ownership at his death. The IRS argued that, when the provisions of State law (outside factors) were applied to the policy terms, D's assignments were invalidated and D, therefore, died possessing incidents of ownership. The court examined the local statutory and case law and held that the policy terms permitted the assignments and that D had divested himself of all incidents of ownership.

In *Parson v. United States*,70 when D applied for a life insurance policy, he designated his spouse as the one who was to possess all of the incidents of ownership. Once more, the policy factors showed that D held no incidents of ownership at his death. But the IRS argued that, under the provisions of the State community property law (outside factors), D possessed one half of the incidents of ownership at death, notwithstanding the policy terms.

2042(2). *Kern*, 491 F.2d at 438-439.
68. 47 T.C. 310 (1966).
70. 460 F.2d 228 (5th Cir. 1972). Only Issue I is dealt with in the Text. *Id.* at 228-32. In Issue II the policy terms showed that D was the owner of 14 policies on his life which were obtained by D prior to moving with his spouse into a community property state. The court applied the State community property law in holding that D held all incidents of ownership in the policies. *Id.* at 232-34.
shown by the application. The court disagreed, concluding that, when the policy factors were examined under the applicable local law, D held no incidents in the policy, having validly assigned them to his spouse.\footnote{Accord: Bintliff v. United States, 329 F. Supp. 1356 (E.D. Tex. 1971), aff'd. as to this point, 462 F.2d 403 (5th Cir. 1972); Estate of McKee v. Comm'r, par. 78, 108 T.C.M. (P-H) (1978). See also, supra note 64.}

In none of the term addition cases considered in connection with Example 1.2 does the court's opinion cite \textit{RIHT} or discuss the "policy matters vs. outside matters" issue.

4. \textit{General Comments}

Regardless of whether these opinions discuss \textit{RIHT} and regardless of whether they have the effect of deleting or adding policy terms, they nevertheless provide authority for the proposition that, notwithstanding the policy factors rule set out in \textit{RIHT}, such factors do not always control the result under Section 2042(2). At least one outside factor—the provisions of State law—can override the policy factors. This is a position articulated with some consistency, albeit not universally, in various Section 2042(2) cases decided after (as well as before) \textit{RIHT}.

It seems reasonable to conclude that a decedent can have incidents of ownership in a life insurance policy only if such rights exist when the insurance contract is construed under the applicable provisions of State law. The principle is certainly not foreign to the Federal tax law in general\footnote{See, generally, Estate of Bosch v. Comm'r, 387 U.S. 456 (1957).} or to the Estate Tax statute in particular.\footnote{See, e.g., Estate Tax Section 2033, and Sections 20.2041-2(e), 20.2056(b)-l(g), Ex. (8), and 20.2042-l(c)(5), Estate Tax Regs.} Specifically, with respect to Section 2042, the regulations provide that, "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."\footnote{Section 20-2042-l(c)(5), Estate Tax Regs. Dawson v. Comm'r, 57 T.C. 837 (1972), aff'd. in unpublished order, 480 F.2d 917 (3rd Cir. 1973).} The Tax Court elaborated on this principle in \textit{Watson v. Commissioner},\footnote{Par. 77,268 T.C.M. (P-H) (1977) at 1088. Similarly, in \textit{Estate of Gorby v. Comm'r}, discussed in connection with Example 1.2, the Tax Court stated: "While Federal law determines whether the decedent's rights under the policies require the insurance proceeds to be included in his gross estate, we must look to the applicable State law to ascertain the nature of decedent's rights under the policy." Gorby, 53 T.C. at 85. This generally accepted rule finds its roots in a Supreme Court opinion which predates the current version of the statute: Lang v. Comm'r, 304 U.S. 264 (1938).}
although the question [of] whether incidents of ownership found to be possessed by the decedent are sufficient to bring section 2042 into play is a question of Federal law, the question of what, if any, incidents of ownership the decedent had, and his legal power in respect thereof, ultimately depends upon an analysis of the facts in light of the applicable state law.

Nothing in the RIHT opinion suggests that the court of appeals intended to modify this accepted principle. It seems fairly clear, from an analysis of the cases subsequent to RIHT, that the courts have not been hesitant to conclude that policy factors do give way to the provisions of local law when there is a conflict between the two. Thus, in Examples 1.1 and 1.2, it follows that the outside factors would operate to negate the policy factors, notwithstanding the general rule enunciated in RIHT. The result is that, at death, D would not have the incident of ownership in the term deletion case (Example 1.1) and would have the incident of ownership in the term addition case (Example 1.2).

One point becomes apparent when one analyzes the cases bearing on Examples 1.1 and 1.2. In a term deletion case (in which outside factors eliminate the decedent's incidents), the IRS is likely to argue that the policy factors are not controlling, and in a term addition case (in which outside factors increase the decedent's incidents), the IRS is likely to argue that the outside factors are controlling. The matter of how this inconsistent IRS approach squares with the RIHT rationale is dealt with below.

76 The IRS thinking on this point was disclosed when the IRS made its arguments in Infante v. Comm'r, as discussed below in connection with Example 3.2.

C. The Effect of Court Orders

1. Examples

Example 2.1: TERM DELETION CASE

76. The IRS thinking on this point was disclosed when the IRS made its arguments in Infante v. Comm'r, as discussed below in connection with Example 3.2.
Policy Factors: The policy terms state that, at death, D had the right to change the beneficiaries on the policy.
Outside Factors: Pursuant to the order of a state court, D did not have that right at death.

Example 2.2: Term Addition Case
Policy Factors: The policy terms do not give D the right to change the beneficiaries on the policy.
Outside Factors: Pursuant to the order of a state court, D did have that right at death.

The examples present the question of whether the provisions of a court order can be more important than the terms of the insurance policy. This question can be broken down into two parts: If the policy terms grant the decedent an incident of ownership but a court order eliminates or nullifies that right or power, does Section 2042(2) apply? If the policy terms do not grant the decedent an incident of ownership, but a court order does grant the decedent an incident, does Section 2042(2) apply?

These examples contemplate a situation where a state court order affecting the decedent eliminates or grants rights in an insurance policy on the decedent’s life, and the court order thereby effectively deletes terms from or adds terms to the insurance contract. Logically, the rule to be applied here should not differ from the rule that was applied in connection with Examples 1.1 and 1.2.

2. Term Deletion Cases

In Beauregard v. Commissioner, the policy on D’s life gave D the right to designate and change the beneficiaries. However, under a divorce settlement agreement which was incorporated into a court decree, D was required to maintain his minor children as the beneficiaries. D died during the children’s minority, and therefore, at the time of D’s death, the court order operated to preclude D from exercising the right which had been granted to him by the policy terms.

The Tax Court held that the policy factors (the terms of the insurance contract) were overridden by the outside factors (the court decree which was binding on D). The outside factors showed that the right to change beneficiaries, granted to D by the policy terms, was not an incident of ownership.

The Internal Revenue Service pointed to another incident of

77. 74 T.C. 603 (1980).
ownership granted to D by the policy terms—the right to decide upon the settlement options—and the IRS argued that this was also an incident which warranted includability in D’s estate. Here again, the court concluded that a policy factor was overridden by an outside factor. In this instance, the outside factor was a provision of state law, pursuant to which the guardian of the beneficiaries could have required a lump sum payment to the beneficiaries, notwithstanding any settlement option selected by D. The court concluded that this legal right of the guardian under local law effectively divested D of this incident of ownership. In this respect, Beauregard is similar to the Carlstrom decision.

In view of the fact that, under the Tax Court’s analysis, D did not have at death an incident of ownership in the life insurance policy, the court held that the proceeds were not includable in D’s gross estate under Section 2042(2). Significantly, the court observed that the rights granted D by the policy “fall squarely within the term ‘incidents of ownership’,” and the court noted that, under RIHT, the policy facts should predominate. However, the opinion states that “both parties . . . appear to proceed upon the tacit assumption that a strict application of the so-called ‘policy facts’ doctrine is here inappropriate and we accordingly accept the case in this posture and reach our decision on this basis.”

3. Term Addition Cases

No decided cases have been found which deal with a court order in the context of Example 2.2. See the General Comments which follow.

4. General Comments

In reaching its conclusion that D had an incident of ownership in the policy, notwithstanding the policy terms, the court in Beauregard appears to have been somewhat concerned with the seeming inconsistency of its holding with the “predominance of policy facts” principle articulated in RIHT. To avoid any conflict with RIHT, the court said that is was accepting the case in the posture

78. Id. at 607.
79. Id. note 2. In this footnote, the court acknowledged the status of RIHT as “a leading case in this area” and suggested that the cases which follow policy facts “do so on the basis that the express language of the policy prevails over the unenforceable intentions of the parties.”
80. Id. See, in this regard, the General Comments which follow.
in which the parties seemed to have presented it \textit{i.e.}, that it was not appropriate to apply the \textit{RIHT} doctrine.

The Tax Court in \textit{Beauregard} appears to suggest that the \textit{RIHT} case would require a court order to be ignored when that order is incompatible the terms of a life insurance policy. Perhaps that is true under one reading of the case, but, for the reasons discussed in connection with the first examples, it would appear that the Court of Appeals in \textit{RIHT} did not intend its policy facts principle to be applied in the \textit{Beauregard} setting.

Actually, the result reached by the Tax Court is fully compatible with the result reached in Examples 1.1 and 1.2. In those examples, we saw a generally recognized exception to the policy facts approach in cases where applicable local law speaks directly to the incidents of ownership issue. The local law to be applied in a given case can be found in the statutory law of the State, in the decisions of the supreme court of the State, and, indeed, in the decision (and orders) of the lower courts of the State. As a result, the issue presented in Examples 2.1 and 2.2 is, essentially, a more specialized manifestation of the issue presented in Examples 1.1 and 1.2.\textsuperscript{81}

For an exception to \textit{RIHT} to be available on these facts, the law applied by the local court must, of necessity, be consistent with the law of the State as reflected in the opinions of the Supreme Court of the State,\textsuperscript{82} and the local court's order must be binding on the decedent.\textsuperscript{83} Both of these elements were present in \textit{Beauregard}, and the case was, therefore, properly decided.

In the Examples 2.1 and 2.2, it follows that the outside factors would operate to negate the policy factors, notwithstanding the general rule in \textit{RIHT}. This means that, at death, \textit{D} would not pos-

\textsuperscript{81} The Tax Court in \textit{Beauregard} in fact discussed cases falling within the ambit of Example 1.1, although the court did not expressly view those cases as presenting an exception to the \textit{RIHT} rationale.

\textsuperscript{82} Estate of Bosch v. Comm'r, 387 U.S. 456 (1967). The \textit{Bosch} case was cited and applied by the Tax Court in \textit{Beauregard}. In \textit{Bosch}, the Supreme Court stated:

\[\text{\textit{When the application of a federal statute is involved, the decision of a state trial court as to an underlying issue of state law should \textit{a fortiori} not be controlling. This is but an application of the rule of \textit{Erie R. Co. v. Tompkins, supra}, where state law as announced by the highest court of the State is to be followed. This is not a diversity case but the same principle may be applied for the same reasons, viz., the underlying substantive rule involved is based on state law and the State's highest court is the best authority on its own law. If there be no decision by that court then federal authorities must apply what they find to be the state law after giving \textit{proper regard} to relevant rulings of other courts of the State.}\]

\textit{Id.} at 465.

\textsuperscript{83} \textit{Cf. Rev. Rul. 142, 1973-1 C.B. 405. See Beauregard, 74 T.C. at 605.}
sess the incident of ownership in the term deletion case (Example 2.1) and would possess the incident of ownership in the term addition case (Example 2.2).

While no cases have been found dealing with a court order in a term addition context (Example 2.2), it would seem that the approach taken in *Beauregard* should appropriately be applied here as well. Thus, a state court order which gives D an incident of ownership in a policy should warrant includability in D's gross estate under Section 2042(2), even though the policy language makes no mention of D or of D's possession of that incident. This would generally be the result when a binding court order establishes legal rights which, under the law of the jurisdiction, clearly takes precedence over any contrary provisions in an insurance contract.

**D. The Effect of Formal "Side" Arrangements**

1. **Examples**

**EXAMPLE 3.1: TERM DELETION CASE**  
*Policy Factors:* The policy terms state that, at death, D had the right to change the beneficiaries on the policy.  
*Outside Factors:* Pursuant to a written agreement between D and X, D assigned his right to X.

**EXAMPLE 3.2: TERM ADDITION CASE**  
*Policy Factors:* The policy terms do not give D the right to change the beneficiaries on the policy; rather they give that right to X.  
*Outside Factors:* Pursuant to a written agreement between D and X, X assigned the right to D so that, at D's death, D had the right to change the beneficiaries on the policy.

The examples present the question of whether the provisions of a written agreement between the decedent and a third party can be more important than the terms of the insurance policy. This question can be broken down into two parts: If the policy terms grant the decedent an incident of ownership, and the decedent, in a written instrument, has assigned that right or power to a third party, does Section 2042(2) apply? If the policy terms do not grant the decedent an incident ownership, and a third party, in a written instrument, has assigned an incident of ownership to the decedent, does Section 2042(2) apply?

These examples envision the existence of a formal "side" arrangement, such as written agreement to which the insurance company is not a party, which impacts upon the rights which the decedent has at death in the life insurance policy.
2. Term Deletion Cases

In *First National Bank of Birmingham v. United States*, D was one of four corporate shareholders who entered into a buy-sell agreement related to the disposition of their shares of stock. To fund this agreement, the four shareholders obtained policies of insurance on their respective lives. Under the terms of the insurance contract, each shareholder had the right to designate the beneficiaries of $20,000 of proceeds. Pursuant to the terms of a separate written agreement, each shareholder named the other three shareholders as the beneficiaries of $15,000 of proceeds ($5,000 to each of the three others).

At D's death, the IRS claimed that the $15,000 of proceeds payable to the other three shareholders was includable in D's gross estate under Section 2042(2). The IRS looked to the policy factors which showed that D had the power to designate the beneficiaries under the terms of the insurance contract.

The Court of Appeals for the Fifth Circuit, without citing *RIHT*, held that D did not at death have any incidents of ownership for Section 2042(2) purposes. The court based its opinion on the outside factors, specifically the contract signed by the shareholders regarding the designation of beneficiaries. The IRS argued that, under the policy terms, D had the right to change the beneficiaries up to the moment of death and that there was nothing in the side agreement to bind D not to exercise that power. The Court disagreed, pointing out that when the side agreement was construed under State law, D was indeed bound not to change the beneficiary. Because D's surrender of the right was enforceable under local law, D was precluded from exercising that incident of ownership at death.

A contrary result was reached by the district court in *Puchner v. United States*. In that case, D and D's fiance (S) executed a binding pre-nuptial agreement, pursuant to which D agreed to transfer a life insurance policy to an irrevocable trust established

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84. 358 F.2d 625 (5th Cir. 1966). *Birmingham* was decided more than two months after the decision in *RIHT*. See note 86, infra.

85. The remaining $5,000 out of the $20,000 total proceeds was payable to D's estate and was, therefore, includable under Estate Tax Section 2042(1). This point was not at issue in *Birmingham*.

86. *RIHT* was decided on January 11, 1966. *Birmingham* was decided on March 29, 1966.

by D and S.88 Under the terms of the policy, D was both the owner and the insured. At D's death, D had taken no action to effect that transfer, nor had D designated the trust as the beneficiary of the proceeds. D had designated S as the beneficiary. When S was paid by the insurance company shortly after D's death, S turned the proceeds over to the trust.

The IRS argued that the policy factors were controlling and that includability was warranted under Section 2042(2). The court agreed that the proceeds of the policy were includable in D's gross estate. In reaching this conclusion, the court relied on the terms of the insurance contract, showing that D remained the owner of the policy, able to exercise all incidents of ownership up to his date of death. The court concluded that D held the incidents in the policy notwithstanding the side agreement. Surprisingly, the court gave no consideration at all to the ramifications of the contractual obligation between D and S under local law. The court simply cited RIHT as authority for its decision on this point.

A decision aligned closely to Birmingham was achieved by the Tax Court in Estate of Bartlett v. Commissioner,89 in which the court relied on both Birmingham and RIHT to support its conclusion that the proceeds of life insurance policies were not included in D's gross estate under Section 2042(2).

In Bartlett, a term deletion case, D owned several insurance policies on his own life. D established an irrevocable and unamendable trust, assigning in the written trust agreement all of his incidents of ownership in the policies to the trustee. Although the policy terms required the insurance company to be notified of the assignments, D did not provide such notification.

The IRS argued includability based on the terms of the insurance policy which showed that D, and not the trustee, held the incidents of ownership. D would have to suffer the consequences of not taking the formal step of notifying the insurance company. The court disagreed with the IRS and relied on outside factors to support its holding. The assignment, held the court, was binding under local law. The failure to notify the insurance company meant only that the insurance company was not bound, and not

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88. At one point in the opinion, the court said that D "agreed to make the Trust the beneficiary" of the life insurance policy. Id. at 707. At another point in the opinion, the court said that D "agreed to contribute New York Life Insurance Policy No. 17703423 of which he was the owner and the insured as an asset of the Trust."Id. at 709. [Emphasis added.]

89. 54 T.C. 1590 (1970).
that the assignments themselves were not valid. The court stated that while D might technically have had the ability to exercise incidents of ownership, such action would have been a breach of the trust agreement under state law and a fraud on the trustee. A mere "ability" to affect an insurance policy is not tantamount to a "right" to do so, the court observed, and only a "right" can fit the definition of an incident of ownership. 90

Given the outside factors in this case—the binding side agreement with the trustee and the ramifications of that agreement under local law 91—the Tax Court concluded that the policy factors should not control.

3. Term Addition Cases

Among the term addition cases in this category is Estate of Infante v. Commissioner, 92 wherein two partners, D and E, purchased life insurance to carry out the partnership agreement’s buyout plan. D became the owner and the beneficiary of a policy insuring E’s life, and E became the owner and the beneficiary of a policy insuring D’s life. Under the terms of the policies, all incidents of ownership were held by the respective owners, and not by the insureds.

The primary outside factor in this case was the partnership agreement, which provided, inter alia, that E could not change the beneficiary (E) of the policy insuring D’s life without the consent of D. 93 The Internal Revenue Service argued that the partnership agreement thus served to give D an incident of ownership insuring

90. In this analysis, the Tax Court differs with the following statement appearing in the RIHT opinion: “For the 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.” RIHT, 365 F.2d at 11. Moreover, the court of appeals in RIHT did not consider it significant that D might have owed a duty to his father or that the father might have had an action against D. See note 132, infra.

91. In Bartlett, the Tax Court rejected the argument of the IRS that local law can be consulted in a Section 2042(2) case for only for the limited purpose of interpreting the provisions appearing on the face of the policy. The IRS had contended that it was inappropriate to examine state law to determine if the assignment was effective notwithstanding the language in the insurance contract. The court stated that this argument by the IRS was an inappropriate extension of the “policy facts” cases and was inconsistent with the Government’s own regulations—Section 20.2042-1(c)(5), Estate Tax Regs. “Local law,” observed the Tax Court, “is commonly omitted from the face of the policy. And local law may require that external provisions be added to the policy.” Bartlett, 54 T.C. at 1598.

92. Par. 70,206 P-H Memo TC (1970)

93. Allowing a change of beneficiary would defeat the buyout plan. The purpose of having the proceeds payable to E was to provide E with the resources to purchase D’s partnership interest at D’s death.
D’s life—the right to consent to a change of beneficiary—and the proceeds were, therefore, includable in D’s gross estate at his death under Section 2042(2). In effect, the IRS took the position that outside factors added a term to the provisions of the insurance contract, giving D an incident of ownership.

In making this argument, the IRS was aware that it was departing from the RIHT principle that the policy factors should control. Here, the Government was asserting that an outside factor, the terms of the partnership agreement, should be dispositive.

The IRS tried to rationalize its departure from RIHT by drawing a distinction between (1) cases in which life insurance policies confer incidents of ownership on a decedent, and collateral documents or agreements purport to negate those incidents (these would be examples of “term deletion cases,” as that term is used in this article), and (2) cases in which life insurance policies confer no incidents of ownership on a decedent, and collateral documents or agreements purport to grant such incidents to the decedent (these would be examples of “term addition cases,” as that term is used in this article).

The IRS took the position in Infante that the RIHT rationale was applicable only in the term deletion cases and that the Government could, therefore, look beyond the policy factors in term addition cases such as the instant one. The Tax Court refused to accept this purported distinction between the term deletion and term addition cases. The Court cited various pre-RIHT term addition cases to support its view that collateral agreements and documents could not create incidents of ownership not otherwise granted by an insurance policy.

The Tax Court applied the RIHT principle in Infante and held that the partnership agreement did not serve to confer an incident of ownership on D. The court stated:

The decedent was given a single incident of ownership (the veto power) by a collateral contract (the partnership agreement) for the sole purpose of insuring that the proceeds of the policy would be available in accordance with the agreement between the partners and the survivor should purchase the interest of the deceased partner. This does not impinge upon the policy it-

94. Comm'r v. Karagheusian's Estate, 233 F.2d 197 (2nd Cir. 1956); Comm'r v. Treganowan, 183 F.2d 288 (2nd Cir. 1950); Altshuler v. United States, 169 F.Supp. 456 (W.D. Mo. 1958); and Bank of New York v. United States, 115 F.Supp. 375, 385 (D.C. N.Y. 1953). The court went to great lengths to show how the Bank of New York case supported the proposition that side agreements cannot confer incidents of ownership. In fact, as the court admits, the incident of ownership in that case was conferred exclusively by a trust agreement, and the court’s attempt to distinguish the case seems strained.
self... [R]estrictions of the type utilized in this case, which are included in the partnership agreement to insure that funds are available for the purchase of a deceased partner's interest, should not form a basis for the inclusion of the policy in the estate of the decedent where the decedent does not otherwise possess any "incidents of ownership" under the policy itself. ... Even assuming that the policy and the partnership agreement must be read together, and recognizing that the decedent’s veto power constitutes an "incident of ownership,"... to include the proceeds of the insurance in the estate of the insured in this instance would be an unwarranted extension of the statute.95

On this basis, the Tax Court concluded that the proceeds of the policy insuring D's life should not be included in D's Gross estate under Section 2042(2).

In Estate of Thompson v. Commissioner,96 the Tax Court, did not cite Infante97 and appears to take an opposite approach. The life insurance policy in Thompson was purchased by a corporation which, under the policy terms, held all incidents of ownership. The corporation named itself beneficiary and paid all of the premiums. The critical outside factor in Thompson was a separate contract entered into by the corporation and D, pursuant to which the corporation agreed to pay a portion of the proceeds of the policy (the portion in excess of the cash surrender value at D's death) to beneficiaries designated by D. D established an irrevocable trust, and the corporation arranged to have the designated portion of the proceeds paid to the trust.

The Internal Revenue Service again chose to emphasize the

95. Infante, Par. 70,206 T.C.M. (P-H) at 995. The Tax Court also attempted to develop an "economic benefits" theory, pointing out that, under the partnership agreement, each partner "gave up any right to control the flow of economic benefits for any purpose other than the one specified in the agreement." Id. [Emphasis added]. In fact, the economic benefit to D under the partnership agreement was arguably substantial since the agreement contemplated that the proceeds of the insurance policy would be used to purchase D's partnership interest at his death.


97. Estate of Infante was a "memorandum" opinion of the Tax Court. Such opinions are not published by the Government in the official Tax Court reports. ("Memorandum" opinions of the Tax Court are made available to the tax bar by commercial publishers.) The Tax Court tends to assign "memorandum" status to essentially factual cases involving the application of clearly established legal principles. "Memorandum" opinions, therefore, generally (although not always) involve cases which break no new legal ground. As a consequence, such cases rarely are cited by the Tax Court as legal precedent in its subsequent cases. (Even in cases where they are mentioned with approval, they are seldom relied on as dispositive authority; any references to such opinions are usually discreetly tucked away in a footnote.) Similarly, the Tax Court does not always feel compelled to explain away or distinguish a prior "memorandum" opinion whose conclusions (or, indeed, legal premises) are at variance with the case at bar.
outside factors, contending that D's right under the contract to designate the beneficiary of a portion of the proceeds was an incident of ownership in an insurance policy on D's life.98 The Tax Court agreed with the IRS and held that includability was warranted under Section 2042(2).

The Tax Court acknowledged the general rule articulated in RIHT that policy factors should govern the result in cases of this nature. But the court pointed out that there could be exceptions to this general rule. These exceptions would arise in the "rare circumstances" in which "evidence to the effect that 'policy facts' do not conform to the intent of the parties thereunder ('intent facts') overcome[s] the heavy presumption in favor of 'policy facts.'"99

The court added that

the legal relationships established by the policy may be altered by an extrinsic, enforceable contract executed by those parties who have contractible rights in the policy [footnote reference to Estate of Bartlett]. However, such extrinsic contract will not be respected for tax purposes unless (1) the existence and provisions of the contract overcome the heavy predominance of policy facts and (2) the contract is valid and enforceable under state law.100

The court observed that the contract between D and the corporation did not provide that, once D made a beneficiary designation, D's choice of beneficiary was irrevocable, and the court concluded that D held the right to change the beneficiary up to the moment of his death, as required by Section 2042(2).

Arguing against includability, D's estate contended that the irrevocable trust was a third party beneficiary which could deprive D of legally exercising his right to change the beneficiary under the policy, with the result that D did not have that power at death. However, after examining the applicable state law, the Tax Court held that the trust held only an expectancy in the proceeds and was not a third party beneficiary with enforceable rights.101

98. Although the corporation was wholly owned by D, the IRS does not appear to have argued that the incidents of ownership held by the corporation should be attributed to D. See generally n. 51, supra, and the related text.

99. Thompson, Par. 81,200 T.C.M. (P-H) at 644. Moreover, the court pointed out that "'[f]or the same reasons that 'intent facts' rarely predominate over 'policy facts,' extrinsic contracts and the provisions thereunder will be respected for tax purposes only if established by a heavy predominance of the evidence.'" Id. at 644, n.3. The court adopted this standard to deal with the concerns expressed by the Court of Appeals in RIHT relating to the evidentiary problems that would flow from adopting a rule which looked to the decedent's intentions ("intent facts"). Id.

100. Thompson, Par. 81,200 T.M.C. (P-H) at 644.

The clear thrust of the Tax Court's opinion in Thompson is that, in an appropriate term addition case, an outside factor showing "intent facts," such as a side agreement, can override policy factors for the purposes of Section 2042(2).

This theme was continued by the Tax Court in Estate of Tomerlin v. Commissioner, a case with facts fairly similar to those of Thompson. A corporation purchased a life insurance policy on the life of D and paid all premiums. Under the terms of the policy, the corporation had all incidents of ownership. The corporation named itself and D's children as the beneficiaries. Under a separate written agreement, the corporation and D agreed that D was to have the right to designate the beneficiaries under the policy, as well as certain other rights respecting the policy.

The court held that D had incidents of ownership in the policy at his death and that Section 2042(2) applied. D's estate had argued that only policy factors should be considered in making the determination of includability and, since D was nowhere mentioned in the policy, D should not be viewed as having an incident of ownership. In rejecting this argument, the court noted the similarity of the instant case to Thompson and concluded it was permissible to examine the side agreement between D and the corporation to determine what rights respecting the insurance policy were granted to D by that contract.

While Tomerlin is another term addition case holding that outside factors can control over policy factors, the opinion at no point cites RIHT or discusses the evidentiary standards deemed important in the Thompson opinion.

4. General Comments

Slavish adherence to the rule in RIHT when written side arrangements are involved can lead to incongruous results. For example, in the term deletion case, D's rights under an insurance policy could be formally assigned by him to a third party in a binding side agreement, and, as a practical matter, D would be precluded from exercising those rights. Still, a rigid application of RIHT leads to the conclusion that D has incidents of ownership because that is what the policy terms say. And, in the term addition case, a binding side agreement could grant to D certain rights to affect an insurance policy, and, as a practical matter, D would possess significant incidents of ownership. Nevertheless, a rigid application of

102. Thompson, Par. 86,147 T.C.M. (P-H) (1986).
RIHT leads to the conclusion that D has no such incidents because none are granted to him by the policy terms.

Looking to the decided cases for a clear exposition of the law in this area is of no avail, for the cases are not consistent. When there is a conflict between the terms of the insurance policy (policy factors) and the terms of a written agreement made by the decedent and a third party (outside factors), the applicable principles for Section 2042(2) purposes are at best confused.

In Birmingham the court held that the terms of the agreement bound D not to exercise the rights granted by the policy terms. In so holding, the court made no mention of RIHT or of the RIHT principle that policy factors should be dominant. On the other hand, the court in Puchner deferred to the RIHT principle and held that the terms of a written side agreement could not serve to negate incidents of ownership granted to D by the insurance policy.

Puchner, like Birmingham, involved a written side agreement between the decedent and a third party which was binding under local law. However, Puchner, relying on RIHT, gave great weight to the fact that the policy terms showed D to have the ability to exercise incidents at death.\(^{103}\) In contrast, Bartlett pointed out that D's mere ability to affect an insurance policy is not the same as a right to do so, and the court did not believe that RIHT required a contrary conclusion. As a result, because D was bound by a trust agreement not to exercise the powers granted by the policy, D was held in Bartlett not to possess incidents of ownership in the policy.

In Infante, the RIHT principle was acknowledged by the Tax Court in a case in which the terms of the policy gave D no incidents of ownership, but the terms of a partnership agreement did. The court concluded that the policy proceeds were not includable in D's gross estate. The court did not squarely base its decision on RIHT, preferring instead to rely on what is essentially a tax policy argument—that incidents of ownership commonly granted by business buyout agreements should not be within the scope of Section 2042(2).

However, in a case involving an agreement between D and a corporation which owned a policy on D's life—Thompson—the Tax Court held that the side agreement did give D an incident of own-

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\(^{103}\) The decedent in Birmingham also had the ability to exercise the incidents pursuant to the policy terms, but there the court did not view that fact as significant.
ership in the insurance policy. The court viewed the case as involving the application of an exception to the RIHT principle. The court believed a divergence from RIHT was necessitated by the existence of a binding contract which was valid and enforceable. The Tax Court relied on Thompson in reaching a similar result in Tomerlin (in a case which makes no reference to RIHT).

The best rule in this area would be one that avoids the incongruities that are inherent in ignoring a significant right that is granted in a binding agreement—one which is enforceable under the applicable State contract law. In the term deletion context, the contract would have to grant all of the decedent's rights to a third party. The local law must be such that, if the decedent were to exercise a power which he technically possessed under the unchanged terms of the insurance policy, that action would be an actionable breach of the contract. In the term addition context, the contract would have to grant to the decedent a right in connection with the policy which, if granted directly by the policy, would meet the definition of an incident of ownership. The right granted to the decedent must be one which can be enforced under the provisions of local law.

Applying this rule to the current examples (3.1 and 3.2) and assuming the agreement to be binding, it follows that the outside factors would operate to negate the policy factors. Therefore, in the term deletion case (Example 3.1), D would not possess an inci-

104. See, e.g., Estate of Bartlett v. Comm'r, supra, wherein the court, in concluding that D had effectively assigned his incidents of ownership in a side agreement, stated:

While the insured could possibly have cashed in some of the policies or could have exercised a second assignment with notice thereof to the insurers, any such action on his part would have constituted a breach of the trust agreement and would have amounted to fraud against the bank, as assignee and trustee.

Bartlett, 54 T.C. at 1597.

Cf. Estate of Bloch v. Comm'r, 78 T.C. 850, (1982), wherein the court stated:

When decedent used the life insurance owned by the 1946 trust as collateral for bank loans in which he had a personal interest, he acted contrary to the provisions of the trust agreement and clearly in breach of his duty as trustee of undivided loyalty to the beneficiaries.

Although decedent may have benefited from his wrongful use of the policies during his lifetime and thus enhanced the value of his estate, we do not think those benefits permit the proceeds of the policies to be included in the gross estate.

Id. at 862, 863-64.

105. E.g., see note 75, supra, and the associated quotation from Estate of Watson v. Comm'r. See, generally, Estate of Fuchs v. Comm'r, 47 T.C. 199, 204-206 (1966). See also Estate of Beauregard v. Comm'r, discussed in connection with Example 2.1, 74 T.C. at 607, n.2; Landorf v. United States, 408 F.2d 461, 466 (Ct. Cl. 1969).
dent of ownership, and, in the term addition case (Example 3.2), D would possess an incident of ownership.\textsuperscript{106}

E. The Effect of Informal “Side” Arrangements

1. Examples

\textbf{Example 4.1: TERM DELETION CASE}
\textit{Policy Factors:} The policy terms state that, at death, D had the right to change the beneficiaries on the policy.
\textit{Outside Factors:} Pursuant to an informal arrangement or understanding between D and X, that right is exercisable only by X.

\textbf{Example 4.2: TERM ADDITION CASE}
\textit{Policy Factors:} The policy terms do not give D the right to change beneficiaries on the policy; rather they give that right to X.
\textit{Outside Factors:} Pursuant to an informal arrangement or understanding between D and X, that right is exercisable by D.

The examples present the question of whether an informal arrangement or understanding between the decedent and a third party can be more important than the terms of the insurance policy. This question can be broken down into two parts: If the policy terms grant the decedent an incident of ownership but, pursuant to an informal arrangement or understanding, that right or power is exercisable only by a third party, does Section 2042(2) apply? If the policy terms do not grant the decedent an incident of owner-

\textsuperscript{106} An additional issue is raised when the “side” agreement between X and D is a trust agreement. Suppose that X owns all incidents of ownership in a policy insuring D's life. Suppose that X and D execute a written trust agreement, pursuant to which X transfers all of the incidents of ownership in the policy, along with funds for maintaining the policy, to D, to hold in trust solely for the benefit of Y (unrelated to D). It has been argued on these facts that, as a result of the agreement between X and D, D holds incidents, albeit as a fiduciary, for Section 2042(2) purposes and that the proceeds would be includable in D's gross estate at D's death. See Rev. Rul. 261, 1976-2 C.B. 276. See also note 25, supra, and the associated text.

While the IRS received some judicial support for this position, e.g., Rose v. United States, 511 F.2d 259 (5th Cir. 1975), it was largely unsuccessful in litigation, e.g., Estate of Skifter v. Comm'r, 468 F.2d 699 (2d Cir. 1972). As a result, the IRS reversed its position in Rev. Rul. 179, 1984-2 C.B. 195, giving weight to the facts that (1) the decedent had neither transferred nor retained an interest in the policy, and (2) the decedent's powers, held as a fiduciary, were not exercisable for the decedent's personal benefit. Under the rationale of many cases, the economic benefits argument alone would be sufficient to take the case out of Section 2042(2) because there would be no incident of ownership. See Part I.B., supra.

It may be possible, based on Skifter and Revenue Ruling 84-179, to develop an argument, in a non-fiduciary case presenting the issue in Example 3.2, that includability in D's gross estate is not warranted when D did not retain the power D holds. However, success in the non-fiduciary context would be doubtful, particularly in the usual situation where D is able to exercise the power for D's personal benefit. See, e.g., the Thompson and Tomerlin cases discussed in the text, accompanying notes 96 and 102, supra.
ship but, pursuant to an informal arrangement or understanding, the decedent does have an incident, does Section 2042(2) apply?

These examples are similar to Examples 3.1 and 3.2, except that the "side" arrangement here, while ostensibly impacting on the decedent's rights under the insurance policy, is not reduced to a formal writing.

2. Term Deletion Cases

Obviously, the prime example of a term deletion case in this context is the RIHT case itself, involving an understanding between D and D's father that the father held all incidents of ownership in a policy insuring D's life. The father had purchased the policy, paid all premiums, and kept the policy in his possession. D understood that he could never exercise (for his own benefit) any of the various incidents of ownership that were granted to him by the insurance contract. The court of appeals held that the policy factors controlled and that D held incidents of ownership in the policy at D's death, despite the outside factors which showed the clear understanding between D and his father. The court held that the outside factors (the "intent facts") were not relevant for purposes of Section 2042(2).

A similar result was reached by the Court of Claims in Kearns v. United States, involving two insurance policies on D's life, the terms of which granted D certain rights, including the right to change the beneficiaries. A family corporation (previously a partnership), which was the designated beneficiary under both policies, paid all premiums and carried the policies on its books as a corporate asset. The corporation was regarded by its officers and D as the owner of the policy, and the corporation assigned the policies, with D's consent, as collateral for corporate loans. On one occasion, when the business was incorporated, D changed the beneficiary designation from the partnership to the corporation. Otherwise, D's actions and statements showed that D did not consider the policies to be his property, but rather that of the corporation.

D's estate argued that D did not have incidents of ownership in the policies at D's death because he had assigned the policies to the corporation (albeit not in writing), and when D exercised incidents of ownership in the policies, he did so as a mere nominee on behalf of the corporation.

Relying primarily on the Supreme Court opinion in Estate of

107. 399 F.2d 226 (Ct. Cl. 1968).
Noel, but citing RIHT and other cases, the court held that the policy factors must control, stating that "where the decedent retains rights under the policy he possesses incidents of ownership within the meaning of section 2042(2)." The court observed that the terms of the policy, which clearly granted rights to D, showed that no assignment had been effectuated. Citing Noel, RIHT, and Puchner, the court concluded that "[t]hese cases further delineate the general rule that so-called 'policy facts' (i.e., reservation rights in the contract of insurance) are not easily rebutted by reference to 'intent facts' or external circumstances."

Much the same approach was adopted by the Tax Court in Estate of De Vos v. Commissioner, although the opinion makes no reference to RIHT. In that case, a divorce decree required D to assign two life insurance policies on D's life to D's former spouse (S), but D did not make any assignments. Instead, D merely made S the beneficiary of a third policy on D's life. The policy factors showed that D retained until death the right to change the beneficiary of the third policy. Because the outside factors showed that D had advised S that the third policy was a substitute for the policies referred to in the court order, D's estate claimed that D had effectively assigned his right to change the beneficiary in that policy to S. The opinion points to the facts that the court decree had not been modified and that S had not agreed to any substitution. After an examination of the applicable State law, the court concluded that, even if D and S had both intended to substitute the third policies for the ones referred to in the decree, they could not have done so without a securing a formal change in the provisions of the decree. As a result, the policy factors controlled, and the proceeds of the third policy were included in D's gross estate under Section 2042(2).

In Nance v. United States, the policy factors showed that D had an incident of ownership, but the outside factors showed that D and his spouse (S) had an understanding, based on the insurance company's usage and practice, which was known to both D

108. Id. at 229.
109. Puchner is discussed above in connection with Example 3.1. See supra note 87 and accompanying text.
111. Par. 75,216 T.C.M. (P-H) (1975).
112. 430 F.2d 662 (9th Cir. 1970).
and S,\(^{113}\) that S would be treated by the company as holding all incidents of ownership in the policy. The court of appeals ignored the outside factors and held that the proceeds were includable in D's gross estate under Section 2042(2). Citing Noel, the court held that the extrinsic evidence (evidence pertaining to outside factors) was irrelevant. The court did not cite RIHT, but, in holding that policy factors alone were determinative of the result in that case, the Nance opinion by implication applies the RIHT principle.

The Tax Court reached the opposite result in Estate of Barrata-Lorton v. Commissioner,\(^{114}\) a case which bears some similarity to Meyer discussed in connection with Example 1.2. As in Meyer, the court applied the State community property law and concluded, at least initially, that the insurance policy was owned 50% by each spouse.\(^{115}\) However, in Barrata-Lorton, the Tax Court examined additional outside factors and held that D had assigned D's incidents of ownership to D's spouse (S). The court considered the evidence relating to the understanding between D and S and concluded that there was an oral contract between them, and the court examined the effect of that agreement under local law. Since the outside facts showed that S held all of the incidents of ownership at D's death, the proceeds were not included in D's gross estate under Section 2042(2). The opinion makes no reference to RIHT.

In a prior case, Estate of Wilmot v. Commissioner,\(^{116}\) the tax Court had achieved a similar result, stating that, from the evidence, it was clear that D and S "intended" S to be the owner of the policy and that the outside factors showed an "implied agreement" between D and S which was "sufficient under local law" to result in the policy being S's separate property.\(^{117}\) Without citing RIHT, Wilmot held that Section 2042(2) did not apply to D.

\(^{113}\) The knowledge and understanding of D and S are shown in the opinion of the district court, unofficially reported at 21 AFTR2d 1702 (DC Ariz. 1968).

\(^{114}\) Par. 85,072 T.C.M. (P-H) (1985), afld., in an unpublished opinion, 787 F.2d 597 (9th Cir. 1986).

\(^{115}\) As was the case in Meyer, D's spouse (S) in Barrata-Lorton was designated 100% owner of the policy, but the court ignored that designation and concluded that D and S each owned 50% of the policy. To this extent, Barrata-Lorton is also an Example 1.2 case because the provisions of local law are viewed as giving D an incident of ownership not provided for in the insurance contract. But, as can be seen from the text, Barrata-Lorton takes an additional step.

\(^{116}\) Par. 70,240 T.C.M. (P-H) (1970). Wilmot is similar to Barrata-Lorton in pertinent respects, but Barrata-Lorton makes no reference to Wilmot.

\(^{117}\) Wilmot, Par. 70,240 T.C.M. (P-H) at 1156.
Estate of Crane v. Commissioner,\textsuperscript{118} on facts similar to those of Barrata-Lorton, reaches the same result, also without making any reference to RIHT. However, the Crane opinion, while giving evidentiary weight to an agreement between D and S,\textsuperscript{119} pays more attention to the various ways in which D manifested D's intent to transfer full ownership to S.\textsuperscript{120} The court regarded an inquiry into D's intent as necessary for a determination as to whether D had assigned his rights under the applicable State community property law. Thus, in order to ascertain whether D had died possessing incidents of ownership in a policy on D's life, it was necessary for the court to examine both (1) D's statements on the application for insurance ("policy facts" under RIHT), and (2) the manifestations of D's intentions when D made that application ("intent facts" under RIHT).\textsuperscript{121}

3. Term Addition Cases

Prichard v. United States,\textsuperscript{122} is a term addition case in which a decedent was found to have an incident of ownership in an insurance policy despite the absence of any language in the insurance contract pointing to such an incident.

In Prichard, D applied for a policy of insurance on D's life, designating D's spouse (S) as the owner and beneficiary of the policy. The insurance company (GR) had required D to obtain this coverage in order for D to receive a loan from GR in connection with D's business activities. GR also required D to assign the policy, including the proceeds thereof, to GR as collateral for the loan.

The policy issued by GR stated that D, as the insured, made application for the policy and that the insured and GR "understood and agreed" that S had been designated "as the beneficiary

\textsuperscript{118} Par. 82,174 T.C.M. (P-H) (1982).
\textsuperscript{119} Id. at 744.
\textsuperscript{120} Id. at 744-755.
\textsuperscript{121} Various cases arising in community property law jurisdictions can present the issues which are considered in this article. While on the surface many of them will appear to be alike, the differences should be carefully noted. In some cases the terms of the policy, as construed under local law, will control the result for estate tax purposes. In other cases, the terms of the policy will be effectively modified by the local community property law so that, for example, both the husband and wife will be viewed as owning a policy despite the fact that the insurance application indicates that only one of them does. E.g., compare Parson v. United States with Estate of Meyer v. Comm'r, both discussed in connection with Example 1.2. In still other cases, it may be possible for the terms of the policy to be effectively modified by other outside factors, such as a court decree, a formal agreement, or an informal understanding.
\textsuperscript{122} 397 F.2d 60 (5th Cir. 1968).
to control this policy” and that S was “the sole owner of this policy and shall have the right to exercise all of the privileges, benefits, rights, and options granted to the insured of the policy,”123 including the right to assign the policy.

GR made the loan to both D and S, and both D and S signed the document which effected an absolute assignment of the policy to GR. Among other things, the written assignment made S’s right to the proceeds at D’s death subordinate to that of GR.

The Court of Appeals for the Fifth Circuit, emphasizing the substance of the transaction rather than its form, held that D had an incident of ownership in the policy when he died. The Court acknowledged that under the applicable State community property law, D had conveyed the property to S and S’s ownership of the policy was complete and sole. But the court looked to the realities of the situation and stated that “the insurance policy and the loan were indispensable parts of an integrated transaction.”124 The court believed that the evidence clearly showed that S was named as the owner “under the understanding, agreement, and arrangement that the policy must be assigned”125 in order to obtain the loan made to the community (D and S). This was the intent from the outset, according to the court, even before the decision was made to make S the owner. S’s actions were not out of donative intent, the court explained; they were for the sole purpose of carrying out the business arrangement between GR and D.

In view of the facts relative to the unwritten “understanding, agreement, and arrangement,” the court regarded D as receiving a substantial economic benefit from having the policy stand as collateral for the community debt, which was still outstanding at D’s death. The existence of the collateral helped prevent D’s personal assets from being used to pay the debt, and the court therefore regarded D as enjoying “the economic benefit of protective insulation from a potential claim.”126

The court concluded that, from the inception, D held an incident of ownership in the policy — the right to use the policy as collateral to secure an agreement by GR to make the business loan, “followed by the continuing economic benefit of the completed assignment.”127 Thus, without citing RIHT, the court concluded that the

123. Id. at 61.
124. Id. at 63.
125. Id.
126. Id. at 64.
127. Id.
outside factors should control and that includability was warranted under Section 2042(2).  

4. **General Comments**

These examples (4.1 and 4.2) deal with an informal arrangement or understanding. Such arrangements or understandings, although not manifested in a formal writing, can in fact amount to contracts, such as in the *Barrata-Lorton* case, so that the rules considered in connection with the previous examples (3.1 and 3.2) would logically be applicable. On the other hand, informal arrangements or understandings can reflect nothing more than the parties' subjective intent, such as in the *Kearns* case, and would seem to fall squarely within the *RIHT* prohibition against the utilization of "intent facts" to override "policy facts."

The question here is where to draw the line, and an examination of the cases is not particularly helpful. If one compares the *Kearns* and *Barrata-Lorton* cases, the critical point of distinction between the two cases, if any, is not readily apparent. It is not a simple matter to point to the factual circumstance in *Barrata-Lorton* which compelled the court to convert the parties' intent into an assignment of incidents of ownership, or to the missing factual element in *Kearns*, the absence of which convinced the court that no assignment had been effected.

Perhaps here, as well, the issue is whether, under the applicable provisions of State law, the decedent possessed any incidents of ownership. Did D assign or receive incidents of ownership under the controlling law? While *RIHT* could be read to preclude the utilization of any facts relating to intent in determining whether a decedent died with incidents of ownership, it would seem that where such facts have a bearing on ownership rights under State law, they should not be ignored. Recall that, in *Crane*, the court gave considerable weight to the decedent's intent, believing itself compelled to do so under the local community property law.

The *Prichard* court was not reluctant to look at facts relating to intent, and, on its face, therefore, *Prichard* seems to contradict *RIHT* directly. The Court in *Prichard* acknowledges that, under the State community property law, D had conveyed all of his inci-

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128. In view of the applicable provisions of the State community property law, the IRS took the position that only one half of the policy proceeds were includable in D's gross estate under Section 2042(2). *Prichard*, 397 F.2d at 62. See Rev. Rul. 228, 1967-1 C.B. 331, 333.
dents of ownership to S. But the court pointed, in part, to the in-
tent of D and S that the policy be used to advance D’s business
dealings and concluded that, in substance, D possessed an incident
of ownership in the policy because he received an economic benefit
from it. Perhaps the court believed there was a binding contract
between D and S under State law, but the court does not say so ex-
pressly.

Perhaps the court of appeals in Prichard was adopting a rule
that, if it is intended that a decedent is to have an economic bene-
fit from a life insurance policy and the decedent is receiving that
benefit at death, then the proceeds are includable in the decedent’s
gross estate, notwithstanding the fact that the terms of the policy
do not expressly grant ownership incidents to the decedent.129 The
court does not say it is adopting such a principle and, given the
court’s discussion of “substance over form” and its comment that
the policy was an indispensable part of an integrated transaction,
the suggested principle would seem too simplistic.130

Clearly the most satisfactory approach would be to determine
whether the decedent’s informal understanding or arrangement
produced rights which were enforceable under local law.131 This
test would have the virtues of (1) being compatible with the rule
discussed in connection with the previous examples (3.1 and 3.2),
and (2) not running afoul of the RIHT proscription against looking
to the parties’ intent. Obviously, to the extent that intent is a fac-
tor in the determination of binding and enforceable rights, it will
be impossible to avoid some conflict with RIHT under a strict
reading of that case.132 However, the RIHT principle should not be
offended where a variety of factors, and not just intent, are neces-
sary to establish rights under local law.133

129. Query whether the there possession of an economic benefit in a life insurance
policy is an incident of ownership? See supra note 26 and accompanying text.
130. The ramifications of Prichard are considered in W. Thies, CA-5, in Prichard, In-
cludes in Estate Policy Subject to Parole Agreement, 29 J. of Tax’n 86 (1968).
131. See the General Comments for Examples 3.1 and 3.2.
132. The suggested solution conflicts with the RIHT opinion in one other respect. In
discussing the question of whether D’s father might have had an action against D, the court
of appeals stated (355 F.2d at 11): “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. It is, therefore, no answer that decedent’s father might have proceed
against him in law or in equity.” As can be seen from the discussion of the various examples
in the text, most post-RIHT cases which have confronted this issue directly have not fol-
lowed RIHT as to this point.
133. See Morton v. United States, 457 F.2d at 754-55, considered in connection with
Example 1.1., Cf. Estate of Thompson v. Comm’r, considered in connection with Example
With regard to the instant examples (4.1 and 4.2), if we assume that the above rule is followed and that the outside factors show that the informal arrangement and understanding produced enforceable rights under State law, then the outside factors will prevail over the policy factors. The result is that D would not have an incident of ownership in the term deletion case (Example 4.1) and would have an incident of ownership in the term addition case (Example 4.2).

F. The Effect of Insurance Company Errors

1. Examples

**Example 5.1: TERM DELETION CASE**
*Policy Factors:* The policy terms state that, at death, D had the right to change the beneficiaries on the policy.
*Outside Factors:* D (or the applicant, if other than D) intended that D was not to have this right and so advised the insurance company.

**Example 5.2: TERM ADDITION CASE**
*Policy Factors:* The policy terms do not give D the right to change the beneficiaries on the policy.
*Outside Factors:* D (or the applicant, if other than D) intended that D was to have this right and so advised the insurance company.

The examples present the question of whether the intent of the applicant, expressed to an agent of the company issuing the policy on D's life, can be more important than the terms of the policy. This question can be broken down into two parts: If the policy terms grant the decedent an incident of ownership but the existence of that incident is contrary to the applicant's intent, does Section 2042(2) apply? If the policy terms do not grant the decedent an incident of ownership but the absence of that incident is contrary to the applicant's intent, does Section 2042(2) apply?

2. Term Deletion Cases

The leading example of this exception to the RIHT general principle is a term deletion case, *Estate of Fuchs v. Commissioner.* In that case, D and his partner understood, as part of their buy-sell agreement, that all insurance policies purchased by them on each other's lives would be owned by the respective beneficiaries. They gave specific instructions to their insurance agent in this regard, but the policies issued by the insurance company showed

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3.2, Par. 81,200 T.C.M. (P-H) at 644.
that each partner had incidents of ownership in the policy insuring his own life. The partners were unaware of this discrepancy between the policy terms and their intentions.

The Tax Court concluded that, given the insurance company's error, D held no incidents of ownership in the policy, and, as a result, the proceeds of that policy were not includable in his gross estate. The court followed a specific RIHT exception pertaining to such errors, one which is expressly set out in the RIHT opinion, itself.\(^\text{135}\) As further support for its conclusion, the court made the following observations regarding the applicable local law: (1) The partners' agreement with respect to the ownership of the insurance policies "created an informal relationship of a quasi-trust nature which obligated the partners to deal with each policy in a manner conforming to the terms of the agreement."\(^\text{136}\) (2) Had the partners been aware of the error, the policies could have been corrected by reformation to reflect their intentions and their agreement.\(^\text{137}\) (3) If D had acted to violate the terms of this agreement, his partner would have had a valid claim against decedent's estate which would have reduced the gross estate by an equivalent amount.\(^\text{138}\)

In another term deletion case, Watson v. Commissioner,\(^\text{139}\) the facts were quite similar. The Tax Court relied on RIHT and on Fuchs in reaching the conclusion that "at his death, the decedent did not have the legal power to exercise any incidents of ownership within the meaning of section 2042."\(^\text{140}\) The court also stated that it was "important that the instructions to [the insurance agent] were never countermanded and that at no time, during the existence of either policy, did [D's partner] or the decedent attempt to exercise any ownership rights, e.g., by borrowing or changing the beneficiary."\(^\text{141}\)

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135. See RIHT, 355 F.2d at 13. See the quotation, below, in the General Comments for Examples 5.1 and 5.2.
136. Fuchs, 47 T.C. at 204.
137. Fuchs, 47 T.C. at 206. The Tax Court stated that "[t]he partners' agreement prohibited decedent from using or disposing of the . . . policies as to receive economic benefit therefrom or to procure any other satisfactions which are of economic worth." [Emphasis in original]
138. Id.
140. Watson, Par. 77,268 T.C.M. (P-H) at 1089. The Tax Court did not expressly attach any significance to the term "the legal power to exercise." At other points in the opinion, the court simply states that the decedent did not possess incidents of ownership.
141. Id. at 1088. The Tax Court added: "In this respect, there is a crucial distinction from the situation which existed in United States v. Rhode Island Hospital Trust Company, supra, where the decedent was permitted to exercise the right to change the beneficiary.
The Internal Revenue Service relied on *RIHT* and *Fuchs* in Letter Ruling 8610068.¹⁴² In that ruling, D's corporate employer purchased four insurance policies on D's life. The employer was named as the beneficiary on each of the policies. Three of the policies named the employer as the owner, but the fourth policy named D as the owner. The employer paid premiums on all four of the policies and treated all four of the policies as assets of the corporation. At no time did D exercise any of the incidents of ownership granted to D by the terms of the fourth policy. The IRS observed that it was the “agreement, belief, and understanding” of all parties that D's employer, and not D, would own all four policies on D's life. The IRS concluded that D was erroneously listed as the owner of the fourth policy and, as a result, the proceeds of the policy were not includable in D's gross estate under Section 2042(2).

3. **Term Addition Cases**

No decided cases have been found which deal with this *RIHT* exception in the context of Example 5.2. See the General Comments which follow.

4. **General Comments**

The examples (5.1 and 5.2) envision a situation where the terms of an insurance policy are in direct contradiction to the intentions of the decedent (or of the applicant, if other than the decedent), and that intention had been made known to the insurance company. Here, the decedent has made a specific request of the insurance company regarding incidents of ownership, and the insurance company has erred and has issued a policy which does not follow the decedent’s instructions.

If one were to adhere to the *RIHT* principle in the term deletion situation, the result would be clear. D has an incident of ownership under the contract of insurance, and D’s contrary intent does not negate the fact.¹⁴³ The proceeds would be includable in D’s gross

¹⁴² This private letter ruling, regarded by the IRS as nonprecedential, was issued on December 11, 1985.

¹⁴³ See Cockrill v. O’Hara, 302 F. Supp 1365, 1369 (M.D. Tenn. 1969), specifically the treatment of the two Equitable Life Assurance policies considered therein. The district court relied on *Noel* and *RIHT* in concluding that the “intent facts” were not relevant. It is not clear from the facts whether the decedent’s intent was ever communicated to the insur-
estate under Section 2042(2).

However, RIHT expressly provides for an exception to its policy facts rule in this context — one situation in which the “intent facts” will prevail. The Court of Appeals stated:

To the principle of the heavy predominance of the “policy facts” over the “intent facts” there must be added the caveat that, where the insurance contract itself does not reflect the instructions of the parties, as where an agent, on his own initiative, inserts a reservation of right to change a beneficiary contrary to the intentions which had been expressed to him, no incidents of ownership are thereby created. National incidents of ownership are thereby created. National Metropolitan Bank of Washington v. United States (1950), 87 F. Supp. 773, 115 Ct. Cl. 396; Schongalla v. Hickey, 2 Cir. 1945, 149 F.2d 687.144

The foregoing authorities lead to the conclusion that, notwithstanding the general rule of RIHT, intent facts (outside factors) will control over the terms of the insurance contract (policy factors) in the following factual setting: (1) a policy insuring the life of the decedent contains a provision which grants an incident of ownership to the decedent; (2) that provision is inconsistent with the decedent’s intent (or that of the applicant, if other than decedent), which intent has been made known to the insurance company, and (3) the decedent has never exercised the incident of ownership granted by the policy. In this term deletion situation, the erroneous provision will not be regarded as part of the policy terms for the purposes of Section 2042(2).

There may be some justification for adding a fourth element to the list above — that, given the error by the insurance company, the policy in fact grants no incidents of ownership to the decedent under the application of state law. While it is not clear the extent to which consistency with local law is mandatory in applying the RIHT exception, such consistency is certainly desirable in all cases involving RIHT-related questions.145 The Tax Court recognized this point in Fuchs and went out of its way to show how the result

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144. RIHT, 355 F.2d at 13.
145. This is a point that has been made throughout this article. The Estate Tax is imposed on interests in property which a decedent owns at death. Estate Tax Section 2033; Section 20.2042-1(c)(5), Estate Tax Regs. Those interests are determined by examining local law. See, e.g., note 82, supra, and the associated quotation from Watson v. Comm’r. Accordingly, it stands to reason that the Estate Tax should apply to those incidents of ownership actually possessed by a decedent under the applicable State statutory and case law. However, see the following footnote.
reached by the court was consistent with local law. The Tax Court opinion implies that the result could have been different (notwithstanding the RIHT exception) if the applicable principles of State law had indicated that D did have an incident of ownership.¹⁴⁶

With regard to Example 5.1, if we assume that the elements listed above (for the term deletion situation) are present, then the policy will be treated as though it did not contain the language creating an incident of ownership in D.

It would be an unusual case which presented this issue in the term addition setting described in Example 5.2. However, it is possible for there to be a situation in which (1) a policy issued by a life insurance company does not reflect D's (or the applicant's) intent, communicated to the insurance company, that D was to possess a particular incident of ownership, and (2) as a result of the insurance company error, the applicable State law would permit the policies to be corrected by reformation to reflect the agreement of the parties.¹⁴⁷ One might then argue, for the sake of consistency, that D should be regarded as possessing an incident of ownership in the policy. Of course, the taxpayer's response to such a contention by the IRS would be predictable.¹⁴⁸

III. APPLYING SECTION 2042(2) TODAY AND TOMORROW

A. The Current State of the Law

The $500,000 proceeds from the policy insuring Mr. Smith's life will be included if his gross estate under Section 2042(2) if Mr. Smith held at death any incident of ownership in the policy. In filling out the Estate Tax return, his executrix, Mrs. Smith, must ascertain if the decedent in fact possessed such an incident. This article has dealt with the manner in which the courts have determined whether a particular power, known to be an incident of ownership, was possessed by a decedent at death. Based on the

¹⁴⁶. Not all courts (not even the Tax Court) are always disturbed by the conceptual incongruities that are created when strict application of the RIHT case produces a tax result which is not reflective of the realities under state law. See, e.g., the discussion of the Carlstrom case, supra note 53. It should be noted that, with the addition of the fourth element, the factual setting of this issue is similar to that presented in connection with Examples 1.1 and 1.2.

¹⁴⁷. Cf. Estate of Fuchs, 47 T.C. at 206.

¹⁴⁸. The taxpayer would argue that, if the policy were not in fact reformed at D's death, D at no time actually had any ability to affect the policy. See, e.g., the discussion in the Bartlett case, 54 T.C. at 1598, concerning the ability vs. the right to exercise an incident of ownership. The IRS would then counter with the observation that the insurance policy in Fuchs was never reformed.
foregoing discussion, the most satisfactory approach for dealing with this question under the current state of the law is as follows.

The executrix must first look to the language of all of the writings constituting the contract of insurance (the policy factors).

Regardless of whether the policy factors grant the decedent a power or not, her inquiry does not stop there. The executrix must also examine the State statutory and decisional law to see if the power is dealt with by the provisions of local law. Those provisions can clearly override the policy factors, and nothing in RIHT suggests a contrary rule.

In this regard, the executrix should also seek to determine if a local court ruling or order affects the power in any manner. Binding decisions of local courts, which properly apply the law of the State, can also take precedence over the policy factors and, thereby, affect the existence of a power in the decedent.

The executrix should then inquire into the possibility of a formal "side" agreement between the decedent and a third party. This, too, can establish rights under local law, and ignoring it because it is extrinsic to the insurance contract can lead to incongruous results. This would particularly be the case when the side agreement (providing, e.g., that the decedent has assigned away an incident) is at odds with the language of the policy (providing, e.g. that the decedent possesses that incident). The better view is that the RIHT principle should not be applied to preclude an inquiry into the terms of a binding agreement entered into by the decedent and that such a contract can be determinative on the issue of whether the decedent possessed an incident of ownership.

Absent a formal "side" agreement, the executrix should look into the existence of an informal arrangement or understanding between the decedent and a third party. If the informal arrangement amounts to a contract, it can be significant for the reasons given above. On the other hand, if the outside factors show nothing more than the decedent's subjective intent, then they would appear to fall squarely within the RIHT prohibition and would be irrelevant to the Section 2042(2) inquiry. Intent, however, can be relevant when it bears on property rights under local law. The best advice for the executrix would be for her to determine whether the decedent's informal arrangement produced rights which were enforceable under local law. If that is the case, the outside factors can predominate over the policy factors.

The executrix should also examine the decedent's intent in one other respect, and here the RIHT case is instructive. The executrix
should ascertain whether there is a provision in the insurance contract, ostensibly granting the decedent an incident of ownership, which the decedent (or of the policy applicant, if other than the decedent) specifically never intended to be in the contract. If there is such a provision, the executrix should ascertain whether the contrary intent had been communicated to the insurance company (or to its agent). If so, and if the power had never been exercised by the decedent, the erroneous provision will be ignored for Section 2042(2) purposes. It would also appear arguable that a comparable approach might be availed of for the purpose of adding a provision to the policy terms. The most reasonable view would seem to be that, if it is claimed that an insurance company made an error in the policy terms, the decedent’s intent should be accorded substance for tax purposes when the circumstances would warrant reformation of the insurance contract under local law. In that event, under this RIHT exception, the outside factors should prevail.

In following this approach, the executrix must bear in mind that there is not complete agreement among the decided cases as to the one acceptable method of resolving this issue.

B. A Proposal for the Future

The mere reading of RIHT, the post-RIHT cases, and the pertinent regulations does not provide adequate guidance on the handling of Section 2042(2) cases involving the issue of whether “the decedent possessed at death” an incident of ownership. The approach discussed in the preceding section of this article is the product of analysis of various authorities and cannot be gleaned from any one source. As a consequence, it is the author’s recommendation that the Internal Revenue Service address this issue in more explicit regulations, following the method outlined above, in order to assist the taxpaying public in comprehending the statutory requirements.

The regulatory language to be adopted by the IRS could be along the following lines. The author’s suggested addition to the regulations under Section 2042(2), set out below, is divided into two parts: Part A deals with the term deletion case, and Part B deals with the term addition case.

[Part A]

**SECTION A1: General Rule.** The proceeds of an insurance policy which insures the life of a decedent shall be includable in the decedent’s gross estate when —
(a) the policy factors disclose that the decedent possessed at death a power to affect the policy; and
(b) the decedent's power is an "incident of ownership," as that term is used in Section 2042(2).

SECTION A2: Policy Factors. The term "policy factors" means the terms of the contract of insurance, as they appear in the application for insurance and in the policy document, including endorsements thereto, as well as in any written amendments and assignments of the policy which are filed with and accepted by the insurance company.

SECTION A3: Exceptions. Notwithstanding the policy factors, Section A1 shall not apply to any power which the decedent does not possess —
(a) pursuant to the provisions of local law as they apply —
(1) to the decedent,
(2) to life insurance policies in general, or
(3) to the life insurance policy at issue;
(b) pursuant to a binding order or ruling of a court having jurisdiction over the decedent or the policy;
(c) pursuant to an enforceable agreement (written or oral) to which the decedent is a party.

SECTION A4: Intent of Decedent. In determining whether any exception set out in Section A3 applies in a particular case, the intent of the decedent shall be taken into account to the extent that it is relevant under the applicable provisions of local law.

SECTION A5: Erroneously granted power.
(a) Section A3(a)(3) shall be construed to exclude from the application of Section A1: an erroneously granted power.
(b) The term "erroneously granted power" means a power described in Section A1 which —
(1) the decedent has never exercised;
(2) was included in the policy provisions despite the fact that the insurance company (or its agent) had been apprised that the power was one which the applicant for the policy never intended the decedent to possess; and
(3) would be excluded from the policy factors in a local court proceeding to reform the contract of insurance.

[Part B]

SECTION B1: General Rule. The proceeds of an insurance policy which insures the life of a decedent shall be includable in the decedent's gross estate when the decedent possesses at death an
outside power, notwithstanding the fact that the policy factors do not grant the decedent an "incidence of ownership," as that term is used in Section 2042(2).

**SECTION B2: Policy Factors.** The term "policy factors" means the terms of the contract of insurance, as they appear in the application for insurance and in the policy document, including endorsements thereto, as well as in any written amendments and assignments of the policy which are filed with and accepted by the insurance company.

**SECTION B3: Outside Power.** The term "outside power" means a power to affect the policy which —

(a) is an "incidence of ownership" as that term is used in Section 2042; and

(b) the decedent possesses —

(1) pursuant to the provisions of local law as they apply —

(i) to the decedent,

(ii) to life insurance policies in general, or

(iii) to the life insurance policy at issue;

(2) pursuant to a binding order or ruling of a court having jurisdiction over the decedent or the policy; or

(3) pursuant to an enforceable agreement (written or oral) to which the decedent is a party.

**SECTION B4: Intent of Decedent.** In determining whether Section B3(b) applies in a particular case, the intent of the decedent shall be taken into account to the extent that it is relevant under the applicable provisions of local law.

**SECTION B5:Erroneously Omitted Power.**

(a) Section B3(b)(3) shall be construed to include within the definition of outside power: an erroneously omitted power.

(b) The term "erroneously omitted power" means a power which —

(1) if possessed by a decedent, would be an "incidence of ownership," as that term is used in Section 2042(2);

(2) was omitted from the policy provisions despite the fact that the insurance company (or its agent) had been apprised that the power was one which the applicant for the policy intended the decedent to possess; and

(3) would be included in the policy factors in a local court proceeding to reform the contract of insurance.

**C. Conclusion**

The regulatory provisions recommended above are regarded by the author as setting out the most satisfactory method of resolving
the possession of incidents issue because they adopt those features of *RIHT* and the post-*RIHT* cases that are most closely attuned to the purposes of Section 2042(2) and because they avoid a tax result which is incompatible with the decedent's actual property rights under the applicable State law. It is believed that regulations of this nature are necessary under Section 2042(2) in order to avoid the problems and incongruities seen to date in some of the post-*RIHT* cases and to assist the courts in the development of a rational and consistent body of law.