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Bruce Wolk*

I. INTRODUCTION

Congress has intentionally exempted employee death benefits payable under qualified retirement plans from the federal estate and gift taxes. In addition, a narrow but significant class of unqualified death benefits has also managed to escape taxation. The benefits in question are pure death benefits over which the employee has no power to change the designated beneficiary. A death benefit is pure if it provides no payments during the employee's life. Although the Internal Revenue

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1. I.R.C. § 2039(c). The exclusion applies only if the benefits are payable to beneficiaries other than the employee's estate, and other than in a lump sum. Even lump sum payments may qualify if the recipient irrevocably elects not to make use of the extremely favorable ten-year averaging of lump sum payments for income tax purposes. I.R.C. § 2039(f). The exclusion does not apply to the extent the benefits are attributable to employee contributions.

The types of benefits which qualify for exclusion are set forth in paragraphs (1)-(4) of § 2039(c). These include the typical pension and profit sharing plans which meet the requirements of I.R.C. § 401 and thereby receive highly favorable income tax treatment.

2. I.R.C. § 2517.


The Treasury Department recommended repeal of I.R.C. §§ 2039(c) and 2517 as part of its general reform proposals for a unified transfer tax in 1969. HOUSE COMM. ON WAYS AND MEANS, 91ST CONG., 1ST SESS., UNITED STATES TREASURY DEPARTMENT TAX REFORM STUDIES AND PROPOSALS 363-64 (Comm. Print 1969).


5. A typical benefit provides that upon the death of the employee a specified sum, frequently linked to the employee's salary, is to be paid to a named beneficiary, often the employee's spouse. The payment might be in a lump sum or payable over some period of time.
Service has sought to fit the pure death benefit under almost every section of the Internal Revenue Code defining the gross estate for federal estate tax purposes, these attempts have met with only limited success. The exclusion of pure death benefits from the employee's estate opens a significant loophole in the Code's transfer tax provisions. The Service has recently attempted to reach these benefits under the gift tax. These efforts, although ingenious, remain stopgap measures. A comprehensive rethinking of the treatment of employee death benefits is clearly in order.

This Article initially discusses the attempts to apply the Code's estate tax sections to the pure death benefit, concluding that section 2038 can be interpreted to reach such benefits and that judicial decisions to the contrary are incorrect. Because the courts are reluctant to construe section 2038 to reach pure death benefits, the Article examines the various ways in which these benefits could be taxed as gifts. The Article notes that a number of courts have strongly hinted at the possible applicability of the gift tax. In addition, a recent ruling by the Service provides for the taxation of such benefits as gifts. The Article asserts, however, that this ruling is an inappropriate application of the gift tax. The Article concludes that, in the absence of an appropriate response by the Service or the judiciary, statutory changes may be necessary. Congress should amend section 2039 of the Code to remove the retained interest requirement, thereby bringing pure death benefits within the employee's gross estate.

II. ESTATE TAX ASPECTS

A. THE LIMITED SCOPE OF SECTION 2039

The death benefit must be pure—contain no lifetime benefit—if it is to escape estate taxation under section 2039(a). 6

6. Hereinafter referred to in the text as "the Code" or by section number only.
9. E.g., Estate of Porter v. Commissioner, 442 F.2d 915, 919 (1st Cir. 1971) ("The benefits were, in effect, a gift from Porter to his wife."); Estate of Tully v. United States, 528 F.2d 1401, 1404 (Ct. Cl. 1976) ("Tully in substance, if not in form, made a gift of a part of his future earnings to his wife.").
12. I.R.C. § 2039(a):
   (a) General.—The gross estate shall include the value of an annuity or
This section includes in the gross estate the value of an annuity or other payment receivable by any beneficiary surviving the decedent under any form of contract or agreement, but only if under such contract or agreement an annuity or other payment was payable to the decedent, or would in the future be payable to the decedent during his or her lifetime.\(^1\) Section 2039 was intended to require inclusion of the value of a survivor's rights in a joint and survivor annuity or similar benefit without resort to the uncertain applicability of the other more general estate tax provisions.\(^2\) By including a retained lifetime interest requirement\(^3\) in section 2039, however, Congress chose to deal only with the general problem of joint annuities and "not with the whole gamut of arrangements under which an employee, his employer, or both may create benefits for the employee's survivors."\(^4\)

Recognizing that some kind of lifetime payment or benefit was an essential prerequisite to applying section 2039, the Service has sought to find such payments outside the typical context of a joint and survivor annuity. An employer and employee could seemingly avoid the literal application of section 2039 by entering into two separate contracts, one for a pure

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\(^1\) The annuity or other payment is included in the gross estate only in proportion to that part of the purchase price contributed by the decedent, but for this purpose, a contribution by the decedent's employer (other than under qualified plans or other qualified retirement arrangements; see note 1 supra) is considered to be a contribution by the decedent "if made by reason of employment." I.R.C. § 2039(b).


\(^3\) Prior to the enactment of I.R.C. § 2039 in 1954, the value of the survivor's rights in a joint annuity purchased by the deceased annuitant was included in the decedent's gross estate, but the courts had differed as to the reasons. Compare Commissioner v. Clise, 122 F.2d 998, 1003 (9th Cir. 1941), cert. denied, 315 U.S. 821 (1942) (purchase of a joint and survivor annuity is a transfer with a retained life interest taxable under the predecessor of section 2036) with Commissioner v. Wilder's Estate, 118 F.2d 281, 283 (5th Cir.), cert. denied, 314 U.S. 634 (1941) (survivor's benefit is a transfer intended to take effect at death).

\(^4\) I.R.C. § 2036(a) (transfers with retained life estate).

\(^5\) Estate of Schelberg v. Commissioner, 612 F.2d 25, 30 (2d Cir. 1979).
death benefit, and another for retirement or other lifetime benefits. The Treasury Regulations, however, foreclose this apparent opportunity by providing that the term “contract or agreement” includes “any combination of arrangements, understandings or plans arising by reason of the decedent’s employment.”\(^\text{17}\) The courts have accepted this interpretation.\(^\text{18}\)

In *Estate of Fusz v. Commissioner*,\(^\text{19}\) the Commissioner took the position that the deceased employee’s salary itself constituted an “other payment”\(^\text{20}\) sufficient to bring section 2039 into play. Had this view been upheld, all pure death benefits would have been subject to the estate tax under section 2039. The Tax Court, however, rejected this approach and held that the phrase “other payment” is “qualitatively limited to post-employment benefits which, at the very least, are paid or payable during the decedent’s lifetime.”\(^\text{21}\) Since the Commissioner has now acquiesced in *Fusz*,\(^\text{22}\) it is clear that a pure employee death benefit, taken by itself, will not be reached by section 2039.

Although the treatment of salary is now settled,\(^\text{23}\) disability benefits have generated some controversy. In *Estate of Bahen*...

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\(^{18}\) See Gray v. United States, 410 F.2d 1094, 1105 (3d Cir. 1969); All v. McCobb, 321 F.2d 633, 636 (2d Cir. 1963); *Estate of Bahen v. United States*, 305 F.2d 827, 830 (Ct. Cl. 1962); *Estate of Beal v. Commissioner*, 47 T.C. 269, 274 (1966).


\(^{20}\) I.R.C. § 2039(a).

\(^{21}\) 46 T.C. at 218 (emphasis added). The Commissioner did not argue that another estate tax provision might be applicable and the Tax Court declined to express an opinion with respect to any Internal Revenue Code section other than § 2039. *Id.* at 215 n.2.

In *Estate of Bahen v. United States*, 305 F.2d 827 (Ct. Cl. 1962), the government also argued that a decedent’s regular salary was an “other payment.” The court disagreed, noting that “[s]ince employees normally receive salary or wages, defendant’s interpretation would effectively obliterate, for almost all employees, the express requirement in Section 2039 of an annuity or other payment” to the decedent. If Congress had intended that strange result, it would certainly have mentioned or referred to it.” *Id.* at 834.

\(^{22}\) 1967-2 C.B. 2.

\(^{23}\) There does remain a problem, however, of distinguishing between “salary” and “post employment benefits.” A contract with an executive which provides for lifetime payments in return for his or her consulting services might well be a disguised retirement annuity. In such cases, the test appears to be whether the services to be rendered are nominal or pro forma. *Compare Kramer v. United States*, 406 F.2d 1363, 1366-67 (Ct. Cl. 1969) (substantial services could have been required) *with Hetson v. United States*, 209 Ct. Cl. 691, 692 (1976) (“salary” would be payable regardless of amount of time devoted to the business and ability of employee to perform services) and *Silberman v. United States*, 333 F. Supp. 1120, 1126 (W.D. Pa. 1971) (“salary” payable even if employee totally incapacitated).
an employer had agreed to pay a death benefit to specified beneficiaries in monthly installments. If, however, the employee became totally disabled prior to retirement, the payments would be made to the employee; any amounts unpaid at the employee's death would be paid to the specified beneficiaries. The employee died while still employed. The Court of Claims held that the decedent's interest in future disability benefits, even though contingent, was a sufficient lifetime benefit to meet the requirement of section 2039. Nevertheless, not every disability benefit plan will result in the inclusion of a death benefit plan under section 2039. In Revenue Ruling 77-183 the Service took the position that wage continuation benefits payable under a short-term (maximum of fifty-two weeks) sickness and accident income plan were in the nature of salary and not an "annuity or other payment" for purposes of section 2039.

The Service's concession in Revenue Ruling 77-183 may have triggered some judicial rethinking of the disability benefit issue. Recently, in Estate of Schelberg v. Commissioner, the Second Circuit seriously questioned the holding in Bahen. The decedent in Schelberg, an employee of IBM, was covered by a number of employee benefit plans. Among these were a survivor's income benefit, a qualified pension plan, a short-term disability plan nearly identical to the one described in Revenue Ruling 77-183, and a long-term disability plan. At the time of his death, the employee was not receiving benefits under any of these plans. The Commissioner sought to include the survivor's income benefit in the deceased employee's gross estate under section 2039 on the theory that the decedent's contingent right to long-term disability benefits constituted an "annuity or other payment." The Tax Court, relying on Bahen, sustained the Commissioner's position, but the Second Circuit reversed.

The Second Circuit could find no principled distinction between short-term and long-term disability benefits. Carefully reviewing the legislative history of section 2039, the court con-

24. 305 F.2d 827 (Ct. Cl. 1962).
25. Id. at 831.
27. I.R.C. § 2039.
29. 612 F.2d 25 (2d Cir. 1979), rev'd 70 T.C. 690 (1978).
31. 612 F.2d at 34.
32. Id. at 31.
cluded that in framing the lifetime benefit condition in section 2039, "[C]ongress was not going beyond benefits the employee was sure to get as a result of his prior employment if he lived long enough." Schelberg does not indicate whether the result would have been different if the decedent were actually receiving disability payments at the time of his death. The opinion does, however, reveal a judicial reluctance to extend the reach of section 2039 beyond arrangements that more or less resemble the classic joint and survivor annuity.

Although in applying section 2039 the Service has been aggressive in finding the presence of some kind of lifetime benefit, in Revenue Ruling 76-380 the Service has made a curious and enormously significant concession. Relying primarily on some parenthetical language in the regulations, the Commissioner concluded that a qualified retirement plan would not be considered together with a non-qualified death benefit plan in determining the applicability of section 2039. The statute itself provides only that death benefits receivable by a beneficiary pursuant to a qualified plan are excludable from the gross estate. This provision hardly seems to preclude treating qualified retirement benefits and non-qualified death benefits as one agreement for purposes of section 2039.

Revenue Ruling 76-380 permits an employer to set up a non-qualified death benefit for a select group of employees that will not be included in a deceased employee's gross estate under section 2039, even though the employee may also have been entitled to qualified retirement benefits. Many employees would not be content to have only death benefits paid to survivors while retaining no retirement benefits, even when they know that the death benefits would escape section 2039. An exception might be the owner of a close corporation who expects to work until death.

33. Id.
34. 1976-2 C.B. 270.
37. See I.R.C. § 2039(c).
38. The Second Circuit has noted that the language of § 2039(c) "does not seem to lead inexorably" to the conclusion of Revenue Ruling 76-380. Estate of Schelberg v. United States, 612 F.2d 25, 29 n.7 (2d Cir. 1979).
39. 1976-2 C.B. 270. From an employer's point of view, one drawback of qualified pension plans is that the benefits are not permitted to discriminate in favor of employees who are officers, shareholders, or highly compensated. I.R.C. § 401(a)(4). For a general discussion of the requirements of qualified plans, see M. Canan, Qualified Retirement Plans (1977).
40. An exception might be the owner of a close corporation who expects to work until death.
Service's remarkable concession, therefore, makes the use of pure death benefit plans even more viable.

Although one can quarrel over the precise scope of the retained interest requirement of section 2039—over how pure the death benefit must be—a death-benefit-only plan is apparently outside the reach of 2039. Any attempt to include such benefits under section 2039 would more properly be directed to Congress than the courts.\textsuperscript{41} The inapplicability of section 2039, however, does not resolve the issue of the estate taxation of pure death benefits. In enacting section 2039, Congress did not intend to make it the exclusive statutory provision for taxing employee death benefits;\textsuperscript{42} pure death benefits may be subject to estate taxation under one or more of the other estate tax provisions.

B. Section 2033

The Service has sometimes argued that employee death benefits are equivalent to property owned by the employee and therefore are includable in the gross estate under section 2033,\textsuperscript{43} but this argument usually fails to impress the courts. Courts base their rejection of the Service's position on a number of theories, depending to some extent on the nature of the particular death benefit before the court. For example, if the employer retains the right to revoke or modify the benefit at any time prior to the employee's death, the courts regard the employee's interest in the benefit as something less than property.\textsuperscript{44} Nevertheless, the mere possibility of revocation\textsuperscript{45} or for-
feiture of an interest does not compel the conclusion that no property interest exists. Moreover, if the employee's death forecloses revocation or forfeiture, what was perhaps a mere expectancy undeniably becomes a property interest of obvious value. Since courts must identify and value interests under section 2033 at the moment of the decedent's death, the possibility that the death benefit plan might be revoked prior to death cannot by itself render section 2033 inapplicable.

Plans under which the death benefit remains discretionary with the employer, even after the death of the employee, present a different problem. The courts and the Service have concluded that because such plans do not create enforceable rights to the death benefit, they represent a mere expectancy and not property under section 2033. Although this result has a certain logical appeal, it ignores the reality of the restraints imposed on employers both by the marketplace for skilled employees and by the need to enhance productivity by maintaining good employee relations. As a practical matter, the employer's ability to withhold the benefit is largely irrelevant since, for readily apparent business reasons, it would be foolish to do so. Thus, what is technically an expectancy may have substantial value. One court has held that unenforceability is not "conclusive" of the includability issue, but rather is "important principally as an indication of the likelihood that the agreements will be honored in fact." This kind of wealth, generated as it is by the lifetime efforts of the decedent, should certainly be within the reach of the estate tax.

46. See Estate of King v. Commissioner, 20 T.C. 930, 935 (1953); Rev. Rul. 65-217, 1965-2 C.B. 214, 216 (decedent's conditional right to benefits, which becomes the unconditional right of his estate upon his death, is property included under I.R.C. § 2033).


48. See Kramer, supra note 3, at 349-50.

49. Estate of Porter v. Commissioner, 442 F.2d 915, 918-19 (1st Cir. 1971).

50. In First Victoria Nat'l Bank v. United States, 620 F.2d 1096 (5th Cir. 1980), the court rejected a claim that a certain interest ("rice acreage history") was not property under I.R.C. § 2033 and stated:

Possible revocability is not a destroyer. "Ifs," "maybes," modifiers, and contingencies might negate the concept of property, but we must be certain that the analysis is a pragmatic one, not a theoretical one. So
The revocable or unenforceable nature of certain employee death benefits has not, however, been the only source of judicial reluctance to include such benefits under section 2033. Courts have also refused to apply section 2033 even if the benefit could not be withdrawn by the employer.52 Some courts theorize that the deceased employee had no right to any payments and therefore had no section 2033 interest.53 Under this view, the beneficiary holds the property right. Other courts accept the possibility that the decedent may have had a property interest in his or her employment agreement, but hold that such interest terminates at death, placing the decedent's interest, like a life estate, beyond the reach of section 2033.54 The clearest example of this approach is the Tax Court's decision in Estate of Wadewitz v. Commissioner.55

In Wadewitz, the decedent had entered into a contract with his employer whereby the decedent would receive monthly payments for a fifteen year term following his retirement or the termination of his employment. If the decedent died prior to the end of the fifteen year period, the remaining payments were to be made to named beneficiaries. The decedent died while still employed. Viewing the decedent's interest under the contract as an interest separate from that of the beneficiaries, the court held that death terminated the decedent's interest and caused the remainder interest of the beneficiaries to long as an interest is not chimerical, it should fall within the broad reach of the taxing statute.

Id. at 1104.


55. 39 T.C. 925 (1963), aff'd on other grounds, 339 F.2d 980 (7th Cir. 1964).
become "fixed."56

The Tax Court's analysis in Wadewitz provides a satisfactory interpretation of section 2033. The key principle is that section 2033 does not reach property interests which terminate at death. In this context, the Tax Court suggests that an interest terminates when it is not transferable through the decedent's estate either by will or intestacy.57 Thus, the contract in Wadewitz created two separate interests, both of which were contingent. One belonged to the decedent and the other belonged to the beneficiaries as third party beneficiaries under the contract. Because the beneficiaries did not derive their interest from the decedent's estate, the interest was outside the scope of 2033.58

In a small number of cases, however, the Government has successfully included employee death benefits under section 2033 or its predecessor in the 1939 Code, section 811(a).59 In each case the decedents themselves had a right to payments during their lifetimes and thus the death benefits would today be reached by section 2039.60 The cases can be divided into two classes, depending on whether the death benefit was payable to the decedent's estate or to other beneficiaries. Those cases which concern death benefits payable to the deceased employee's estate61 are not contrary to the Wadewitz interpretation of section 2033. A right to have payments made to one's estate is an interest held by the decedent during his or her life that becomes the right of the estate at death, just as any typical property interest of a decedent becomes the property of his or her estate.62

56. 39 T.C. at 935.
57. Id.
58. Their interest is, however, included under I.R.C. § 2039 because the deceased employee had a right to payments during his lifetime.
60. See note 12 supra and accompanying text.
62. The employee death benefit can be analogized to A's interest in a trust that is to pay the income to B for A's life, remainder to A's estate. Although A could not possess any income or corpus during A's life, it is hardly a forced reading of I.R.C. § 2033 to view A as possessing a right at death that could be transmitted and is therefore an interest embraced by section 2033. Commentators have differed on whether section 2033 reaches a remainder interest passing to the estate of the life tenant. Compare S. Surrey, W. Warren, P. McDaniel & H. Gutman, supra note 3, at 105 (yes) with R. Stephens, G. Maxfield, & S. Lind, Federal Estate and Gift Taxation § 4.05[6] n.65 (4th ed. 1978) (no). In Second Nat'l Bank of Danville v. Dallmon, 209 F.2d 321 (7th Cir. 1954), the court
The more troublesome cases are those that have applied section 2033 or its predecessors to benefits payable to a beneficiary other than the deceased employee's estate. Thus several courts have concluded that if an employee becomes entitled to accrued benefits in an employer-funded qualified retirement trust, and has the right to designate the beneficiaries of that part of the account which remains unpaid at death, the decedent's control over the benefit renders it includable under section 811(a) of the 1939 Code. The leading case, Garber v. Commissioner, expresses the broad rationale that "death benefits derived from funds which represent deferred compensation to the decedent, or granted under plans which explicitly gave the decedent direct contractual rights in the funds," are included under section 811(a) of the 1939 Code.

Any employee death benefit can obviously be viewed as "deferred compensation." Later cases, however, have limited the reach of this doctrine to situations in which the decedents retain the right to receive payments from the fund until the time of their death. Garber therefore provides scant authority for the inclusion of a pure death benefit under section refused to include such an interest under the predecessor of section 2033, but the Service does not appear to have abandoned its claim that section 2033 applies. See Keeter v. United States, 461 F.2d 714, 719 n.3 (5th Cir. 1972).

Even if section 2033 would not reach such an interest, it would seem that the ability to dispose of one's estate by will should constitute a general power of appointment over the benefit, which would cause the benefit to be taxed under I.R.C. § 2041. The Danville court rejected this result, but the Service announced it would not follow Danville, Rev. Rul. 55-277, 1955-1 C.B. 456, 457, and the Service's position was upheld in Keeter.

63. See Rosenberg v. United States, 309 F.2d 724, 727 (7th Cir. 1962); Estate of Garber v. Commissioner, 271 F.2d 97, 104 (3d Cir. 1959). The only significant difference between the two cases is that in Rosenberg installment payments of the accrued benefit had commenced during the decedent's life, while in Garber the decedent had elected to leave the benefit in the trust. In both cases, the decedents could have named their estates as the beneficiary. See also Estate of Wolf v. Commissioner, 29 T.C. 441 (1957), rev'd on other grounds, 264 F.2d 82 (3d Cir. 1959) (reaching the same result as Rosenberg and Garber although the employee could have forfeited all benefits merely by leaving the job).

In Eichstedt v. United States, 354 F. Supp. 484 (N.D. Cal. 1972), the court took the same approach to an unfunded benefit. The decedent was an insurance salesman who had an agreement with his employer that if he died, as he did, before retirement, his widow was to receive for a period of up to three years from his death one-half of the renewal commissions that he would have received had he lived. The court concluded that the renewal commissions were includable in the decedent's gross estate under I.R.C. § 2033. Id. at 490.

64. 271 F.2d 97 (3d Cir. 1959).

65. Id. at 101.

To so include the pure death benefit would produce a profoundly novel definition of the terms "property" and "interest . . . of the decedent" as used in section 2033. Short of this strained construction, the courts cannot properly include pure death benefits in the deceased employee's gross estate under section 2033.

C. THE LIFETIME TRANSFER SECTIONS

The federal estate tax reaches more than just the property owned by a decedent. Congress has provided in sections 2035 through 2038 that certain lifetime transfers of property are sufficiently testamentary to justify subjecting the property to estate taxation. This section of the Article examines the applicability of these Code sections to the pure death benefit.

67. The courts applying I.R.C. § 2033 to employee death benefits have succumbed to the temptation, not wholly unreasonable, of viewing the right to have payments made to oneself, coupled with the right to have the payments made to one's beneficiaries if one dies, as equivalent to ownership of the payments. Although the courts have warmly embraced the concept of substantial ownership for income tax purposes, see Helvering v. Clifford, 309 U.S. 331, 335 (1940) (construing section 22(a) of the Revenue Act of 1934), courts have been reluctant to read section 2033 as broadly as section 61. See generally Stephens, The Clifford Shadow Over the Federal Estate Tax, 4 GA. L. Rev. 233 (1970). Thus the Supreme Court has held that section 2033 does not reach a life estate in property or a testamentary general power of appointment over property, even if both are held together. Helvering v. Safe Deposit & Trust Co., 316 U.S. 56, 66 (1942) (construing section 302(a) of the Revenue Act of 1926, now I.R.C. § 2033). A life interest in a trust, coupled with a general power to withdraw the corpus for one's own use, was similarly held not includable under the predecessor of section 2033, despite the Government's claim that the decedent was in substance the owner of the property. See Estate of Royce v. Commissioner, 46 B.T.A. 1090, 1093 (1942).

68. I.R.C. § 2033.

69. A right to the payment of money would be an interest of the decedent in property even though the decedent could never receive the money while alive, nor could the decedent's estate receive the money after his death. One cannot attribute to Congress such a strained use of language, especially in light of the Supreme Court's conclusion that section 2033 does not reach a general power of appointment. See note 67 supra.


71. I.R.C. § 2036 is not discussed because section 2036 does not play a significant role in the taxation of pure death benefits. Section 2036(a) provides:

(a) General Rule.—The value of the gross estate shall include the value of all property to the extent of any interest therein or which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or
In order to include an interest in property in the gross estate, the lifetime transfer provisions all require that the decedent have "made a transfer" of the "property" interest.\textsuperscript{72} The lack of any obvious transfer of property by the employee has troubled some of the courts that have considered the application of these provisions to employee death benefits. In cases in which a decedent purchased a joint and survivor annuity, the courts have had little difficulty in concluding that a "transfer" occurred.\textsuperscript{73} The courts disagree on the tax consequence if the employer purchased or provided the benefit. Some courts have refused to find a transfer if the benefit was voluntarily created,\textsuperscript{74} discretionary,\textsuperscript{75} or forfeitable.\textsuperscript{76} A transfer has been found, however, where the decedent qualified for an annuity but elected to receive a reduced annuity to provide his spouse with a survivor's annuity.\textsuperscript{77} Finally, if the decedent procured a

\begin{itemize}
\item\textsuperscript{72} L.R.C. §§ 2035(a), 2036(a), 2037(a), 2038(a)(1)-(2). There is nothing in the statute, regulations, or legislative history to suggest a different standard of interpretation for the term "transfer" as is used in the various inter vivos transfer provisions. Estate of Kopperman v. Commissioner, 37 T.C.M. (CCH) 1849-24 (1978). \textit{But see} Harris v. United States, 72-1 U.S. Tax. Cas. (CCH) ¶ 12,845 (C.D. Cal. 1972).
\item\textsuperscript{73} Estate of Mearkle v. Commissioner, 129 F.2d 386, 388 (3d Cir. 1942); Commissioner v. Clise, 122 F.2d 998, 1004 (9th Cir. 1941), \textit{cert. denied}, 315 U.S. 821 (1942); Commissioner v. Wilder's Estate, 118 F.2d 281, 283 (5th Cir.), \textit{cert. denied}, 314 U.S. 634 (1941).
\item\textsuperscript{74} Provident Trust Co. v. United States, 170 F. Supp. 74, 77 (E.D. Pa. 1959); Hanner v. Glenn, 111 F. Supp. 52, 58 (W.D. Ky. 1953); Estate of Saxton v. Commissioner, 12 T.C. 569, 575 (1949). In Libbey v. United States, 147 F. Supp. 383 (N.D. Cal. 1956), the court reached the same result without discussion of the "voluntary" versus "contractual" distinction, although the facts indicate that the plan was probably "voluntary." \textit{Id.} at 384.
\item\textsuperscript{75} Estate of Miller v. Commissioner, 14 T.C. 657, 664-65 (1950).
\item\textsuperscript{76} Estate of Stake v. Commissioner, 11 T.C. 817, 825 (1948).
\item\textsuperscript{77} \textit{See} Davis v. Commissioner, 27 T.C. 378, 381 (1956); Estate of Twogood v. Commissioner, 15 T.C. 989, 997 (1950), \textit{aff'd on other grounds}, 194 F.2d 1627 (2d Cir. 1952); Estate of Higgs v. Commissioner, 12 T.C. 280, 283 (1949), \textit{rev'd on
survivor's benefit from the employer in return for the performance of services during the course of employment, a substantial body of authority provides that the transfer requirement is satisfied.\textsuperscript{78}

A leading case applying the "transfer" requirement to an employee death benefit is \textit{Estate of Porter v. Commissioner}.\textsuperscript{79} Bernard Porter was employed by three corporations that he and his two brothers owned. The day before Bernard underwent surgery, he entered into identical agreements with each of the corporations to provide death benefits to his wife or children if he should die while employed by the corporations. Bernard died less than three weeks later. The Tax Court concluded, and the Court of Appeals agreed, that for the purposes of section 2035 Bernard "made a transfer of property by entering into the agreements."\textsuperscript{80}

\textsuperscript{other grounds}, 184 F.2d 427 (3d Cir. 1950). \textit{But see} Libbey v. United States, 147 F. Supp. 383 (N.D. Cal. 1956).

In Estate of Howell v. Commissioner, 15 T.C. 224 (1950), a similar election was found not to constitute a transfer when, at the time of election, the decedent's right to the annuity payments was not yet "vested," but was contingent on his remaining living and in the employ of his employer for five more years. In the court's view, the decedent had no property right that could be transferred. \textit{Id.} at 231.


The Service has also adopted this view. \textit{See} Rev. Rul. 78-15, 1978-1 C.B. 239; Rev. Rul. 76-304, 1976-2 C.B. 269. This approach is actually a corollary of a more general rule that a "transfer" occurs whenever the decedent provides consideration to a third party in exchange for the death benefit. \textit{See} Estate of Fried v. Commissioner, 445 F.2d 979, 984 (2d Cir. 1971), \textit{cert. denied}, 404 U.S. 1016 (1972) (transfer of partnership assets to corporation in return for death benefits); \textit{Estate of Nevin v. Commissioner}, 11 T.C. 59, 65 (1948) (agreement to retire from a position that decedent could not have been forced to retire from in return for death benefits).

79. 54 T.C. 1066 (1970), \textit{aff'd}, 442 F.2d 915 (1st Cir. 1971).

To support this conclusion, both courts relied on the language contained in the Supreme Court decision in *Chase National Bank v. United States.*\(^81\) In what was essentially dictum,\(^82\) the Court stated that the word “transfer” in the estate tax statute was not to be construed so narrowly as to encompass only the passing of property directly from the decedent to the transferee.\(^83\) Rather, the court noted, “transfer” also includes “the transfer of property procured through expenditures by the decedent with the purpose, effected at his death, of having it pass to another.”\(^84\)

*Chase* stands for the principle that a decedent who furnishes the consideration for the payment by another to a beneficiary upon the decedent’s death has made a “transfer” of “property” for estate tax purposes.\(^85\) The courts nevertheless display a certain amount of confusion in applying this seemingly self-evident principle to employee death benefits. An example outside the employment context is therefore useful.

Assume that X pays Y $100 in return for Y’s promise to pay Z, at X’s death, $100 plus compound interest at six percent. X has certainly transferred the $100; furthermore, this transfer is clearly to Y. This transfer, however, also creates a property interest in Z, namely the contractual right to the $100 plus interest that pursuant to *Chase* is property “of which the decedent has . . . made a transfer.”\(^86\) Thus one or more of the lifetime transfer sections could reach the claim to the $100 plus interest, provided that the other requirements, apart from a “transfer” of “property,” are met.\(^87\)

Assume that instead of $100 plus interest, Y, being a person who enjoys gambling, promises to pay Z $150 at X’s death. Af-

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\(^{81}\) See notes 93-105 infra and accompanying text.

\(^{82}\) In *Chase,* the decedent had purchased life insurance and made his wife the beneficiary. The decedent’s executor argued that the statute that subjected insurance proceeds to estate taxation was unconstitutional since it was an unapportioned direct tax on property rather than a tax on the “transfer” of property by the decedent. In the executor’s view, there was nothing to which a transfer or privilege tax could apply, since the beneficiary’s interest in the policy was not transferred from the decedent, but rather from the insurer. The Supreme Court upheld the tax. *Id.*

\(^{83}\) *Id.* at 337.

\(^{84}\) *Id.*

\(^{85}\) Numerous other decisions have also adopted this interpretation. See note 78 supra.

\(^{86}\) *Id.* at 337.

ter examining X's health and consulting actuarial tables, Y determines that on the average, paying $150 will cost as much as paying $100 plus interest. If X dies early, Y loses the gamble, but if X lives well beyond his life expectancy, Y stands to make a profit. Y's promise is, of course, the functional equivalent of a life insurance contract. The risk component present in this hypothetical seems irrelevant to the application of the Chase principle. The nature of the property interest transferred differs from that in the first hypothetical, but it nonetheless is "property" of which the decedent has made a "transfer."

Now consider the second hypothetical in an employment context. Assume that X is employed by Y and that X and Y agree that for X's services during the year X will be paid $5,000 and that Y will pay Z $150 at X's death. In substance this is no different from an agreement by Y to pay X $5,100 and a simultaneous agreement by X to pay Y $100 in return for Y's payment of $150 to Z at X's death. The Tax Court in Porter expressly adopted this view. As a matter of tax policy, the two arrangements are indistinguishable. Thus once one accepts the existence of a "transfer" of "property" in the case of a purchase for cash, it is but a short and logical step to conclude that in the case of other consideration, such as services, the result should be the same.

Some early cases refused to apply the Chase principle to death benefits unilaterally established by the employer. These courts reasoned that the decedent could not have made or procured a transfer of property unless the death benefit had been specifically bargained for. This argument ignores, however, the reality of the employer-employee relationship. These ostensibly voluntary benefits are certainly part of the employment contract; the employer's total compensation package constitutes an offer by the employer that the employee accepts by working. The employer establishes fringe benefits, including death benefits, in order to recruit and retain employees. The goal of the employer is to motivate employees, not to bestow gifts out of some deep affection for the employee's relatives. Whether the employee had an opportunity to bargain over the

89. E.g., Estate of Saxton v. Commissioner, 12 T.C. 569, 575-76 (1949). See also the cases cited in note 74 supra.
90. 54 T.C. at 1070.
91. See Restatement of Contracts §§ 12, 29 (1932).
precise structure of his compensation plan is irrelevant. The death benefit is a reward for the employee's services, and as such it is properly treated as indirectly transferred by the employee.\(^9\)

1. **Section 2035**

Before the enactment of the Economic Recovery Tax Act of 1981,\(^93\) property interests transferred by a decedent within three years of death without adequate consideration were included in the decedent's gross estate under section 2035(a).\(^94\) The original purpose of section 2035 was to prevent estate tax avoidance by means of lifetime gifts shortly before death.\(^95\) The unification of the estate and gift taxes under the Tax Reform Act of 1976\(^96\) reduced the significance of section 2035(a) to a great extent.\(^97\) Under the unified transfer tax system, the effect of section 2035(a) was to subject post-gift appreciation to transfer taxation. Congress has now determined that the taxation of such appreciation is generally unnecessary.\(^98\)

By enacting new section 2035(d)(1),\(^99\) Congress has made section 2035(a) inapplicable to the estates of decedents dying after December 31, 1981. Important exceptions remain, however. For example, under new section 2035(d)(2),\(^100\) section 2035(a) remains applicable "to a transfer of an interest in prop-

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\(^9\) This position finds support in the income tax treatment of fringe benefits; payments by an employer to relatives of the employee, such as tuition payments for children, are considered taxable income to the employee, even if the employee did not bargain for the benefit. See, e.g., Grant-Jacoby v. Commissioner, 73 T.C. 700, 708 (1980). See also Armantrout v. Commissioner, 67 T.C. 996 (1977), aff'd per curiam, 570 F.2d 210 (7th Cir. 1978); Blum, *The Educational Benefit Trust as a Lesson in Taxation*, 56 TAXES 600 (1978).


\(^94\) I.R.C. § 2035(a) provides:

(a) Inclusion of Gifts Made by Decedent—Except as provided in subsection (b), the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

\(^95\) See Garber v. Commissioner, 271 F.2d 97, 101 (3d Cir. 1959).


\(^97\) The 1976 Act also amended I.R.C. § 2035 to provide that any gift taxes paid on gifts made by a decedent after 1976, and within three years of death, are to be included in the decedent's gross estate. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a)(5), 90 Stat. 1525.


property which is included in the value of the gross estate under sections 2036, 2037, 2038, 2041, or 2042 or would have been included under any of such sections if such interest had been retained by the decedent. Gifts of life insurance, in particular, continue to be covered by sections 2035(a) and 2042. Thus, if one year prior to death a decedent transferred all of the incidents of ownership in a life insurance policy, the entire amount of the proceeds would be included in the decedent’s gross estate.

Although prior to the 1981 Act, section 2035 would have included in the gross estate any pure death benefit created within three years of the decedent’s death, the 1981 Act appears to have changed this result. Pure death benefits may now be outside the scope of taxation under section 2035. Under a literal reading of section 2035(d), an employer and employee can contractually establish a pure death benefit payable to

101. Id.
102. See I.R.C. § 2042.

103. See S. Rep. No. 144, 97th Cong., 1st Sess. 139 (1981). The 1981 Act provides another exception to the general repeal of I.R.C. § 2035(a). Under section 2035(d)(3), section 2035(a) continues to apply for purposes of determining the estate’s eligibility for favorable redemption, see section 303(b), valuation, see section 2032A, and deferral provisions, see section 6166. These additional exceptions were motivated by congressional concern about the possibility of taxpayers using deathbed transfers to obtain tax benefits for the beneficiaries, or the estate, that would otherwise be unavailable.


105. None of the Internal Revenue Code sections enumerated in I.R.C. § 2035(d)(2) expressly deals with employee death benefits. The omission of section 2039 is particularly striking. Suppose an employer provides a joint and survivor annuity to an employee and the employee’s spouse. One year before his death, the employee assigns all of his interest in the annuity to his spouse. The surviving spouse’s annuity would not be included in the decedent’s gross estate under section 2039 since the decedent had no lifetime benefit at the time of his death. Prior to the 1981 Act, it was generally assumed that section 2035 would apply in this situation, thus causing the value of the annuity to be included in the decedent’s gross estate, even though a literal reading of section 2035 could lead to a contrary result. See C. LOUNDES, R. KRAMER, & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES 91-95 (3d ed. 1974). By omitting section 2039 from the special rule of section 2035(d)(2), Congress may have created an important pre-mortem planning device. Employees receiving non-qualified annuities (or entitled to receive non-qualified annuities in the future) who discover they are terminally ill might be able to remove the survivor’s annuity from their gross estate merely by assigning their own annuity. The Commissioner might challenge this result by resurrecting the arguments, made before the enactment of section 2039 in 1954, that section 2036 also reaches joint annuities. See note 14 supra.
some beneficiary and have this benefit excluded from the employee's gross estate.

a. The Life Insurance Exception

As noted above, Congress excepted life insurance from the general repeal of section 2035(a). If the insured assigned all rights in an insurance policy within three years of death, the courts will include the proceeds in the insured's gross estate under section 2035(a).

From the beneficiary's point of view, an employer-provided pure death benefit and an employer-provided life insurance policy are nearly indistinguishable. The only significant difference is that the promise of the employer has replaced the promise of an insurance company. The question therefore arises whether a pure death benefit is a life insurance policy for estate tax purposes.

In the leading case of Helvering v. Le Gierse, the Supreme Court held that the essential feature of a life insurance contract is "risk-shifting and risk-distributing." Moreover, the requisite risk-shifting is not limited to contracts issued by an insurance company. Thus, for example, if a stock exchange assesses its members to fund death benefits for the families of deceased members, the courts find a sufficient shift-

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106. See note 102 supra and accompanying text.
107. The statute reaches this result as follows: section 2042 includes in the gross estate of a decedent the proceeds of life insurance policies on the life of the decedent if the proceeds are payable to the decedent's estate or if the decedent possessed at his death "any of the incidents of ownership, exercisable either alone or in conjunction with any other person." I.R.C. § 2042. Thus if a decedent had retained a life insurance policy, instead of transferring it before his death, it would have been included in his gross estate under section 2042. Therefore I.R.C. § 2035(d)(2) makes section 2035(d)(1) inapplicable to the transfer. Since section 2035(d)(1) is inapplicable, section 2035(a) continues to apply.
109. But see note 206 infra.
110. This difference can, of course, be important if the employer is financially unstable. Cf. In re Penn Cent. Transp. Co., 484 F.2d 1300 (3d Cir. 1973), cert. denied, 415 U.S. 951 (1974) (employees with vested rights to deferred compensation awarded approximately one-fourth of benefit in settlement with the bankruptcy trustee).
111. 312 U.S. 531 (1941).
112. Id. at 539.
ing of the risk of loss to justify the characterization of the arrangement as life insurance.\footnote{113}

In \emph{All v. McCobb},\footnote{114} however, an unfunded employee death benefit plan was held not to constitute a life insurance policy under section 2039. Given the absence of any premiums or reserves, the court could find no "gamble" with the decedent nor any undertaking to "distribute among a larger group of employees, on the basis of actuarial data from which the appropriate size of a terminal reserve could be computed, the risk of the premature death of a single employee."\footnote{115} The court distinguished a mere "promise to pay a sum certain to a named beneficiary upon the death of a retired employee" from a life insurance policy.\footnote{116}

Although \emph{All v. McCobb} supports the proposition that a pure death benefit is not a life insurance policy,\footnote{117} the court's analysis is subject to criticism. The pure death benefit is not functionally distinguishable from term life insurance.\footnote{118} The death benefit, like any other employee benefit, is a substitute for salary, and the employee in effect pays a premium to the employer by accepting the benefit in lieu of cash. The employer makes a gamble just like a life insurance company; an employee who dies prematurely is overcompensated, but an employee who works for many years and then retires is undercompensated. Also, to the extent the employer has more than one employee, the employer can spread the risk to produce, in effect, an annual actuarial cost for providing the benefit. This cost is paid by the services of each employee covered under the death benefit plan.

Moreover, both the pure death benefit and employer-provided life insurance present similar tax avoidance problems.\footnote{119}

\footnote{113}{See Commissioner v. Tregonowan, 183 F.2d 288, 292 (2d Cir. 1950), cert. denied, 340 U.S. 853 (1950); Estate of Moyer v. Commissioner, 32 T.C. 515, 527 (1959); Estate of Edmunds v. Commissioner, 16 T.C. 110, 118 (1951); cf. Ross v. Odom, 401 F.2d 464, 473 (5th Cir. 1968) (operation of state survivor's benefit plan was based on actuarial computations and involved sufficient risk-shifting to constitute life insurance).

\footnote{114}{321 F.2d 633 (2d Cir. 1963).

\footnote{115}{Id. at 637.

\footnote{116}{Id.


\footnote{118}{For an excellent discussion of this issue, see Comment, \emph{Estate Taxation of Employee Death Benefits}, 66 YALE L.J. 1217, 1237 (1957).

\footnote{119}{The legislative history is strangely silent as to Congress's reason for enacting the life insurance exception, or any of the other exceptions contained}
If section 2035(d)(2) does not include transfers of pure death benefits, artificial distinctions between similarly situated taxpayers may result. An employee who is covered under a $200,000 group term life insurance policy is in essentially the same economic position as an employee covered under an employer-provided $200,000 pure death benefit plan. If both assign the rights to their benefits to their respective spouses and both are killed in automobile accidents the next day, there is no logical reason to distinguish between the two benefits for federal estate tax purposes.

b. The Timing of the Transfer

Section 2035(a) continues to apply to employee death benefits for decedents who die before 1982. Section 2035(a) also determines the estate's eligibility for favorable redemption, valuation, and deferral provisions. Furthermore, if the Service succeeds in arguing that employee death benefits are life insurance, section 2035(a) may apply to decedents dying in future years. The exact timing of the transfer of an employee death benefit therefore remains significant.

Although the courts generally conclude that the transfer of an employee death benefit occurs when the employee enters into a contract with the employer, the analysis by these courts is deficient. One significant difficulty with this approach, the so-called continuum approach, involves the proper treatment of contract modifications. Consider the example of a one year contract. Assume that each year the employer and em-
ployee negotiate a contract for the coming year. In some years they have included various forms of death benefits, and in others they have not. In the last five years, they have consistently agreed to a $25,000 benefit. If the employee dies during the current year, can it realistically be said that the beneficiary's right to the $25,000 was transferred five years ago? The proper view is that the beneficiary had a right in prior years, but that right became valueless when the year ended. The beneficiary's present right to the $25,000 originated at the earliest in the current year.

An employment-at-will contract is analytically equivalent to successive one-year contracts. In a manner analogous to the negotiation of an annual employment contract, the employer's compensation offer is accepted by working that day. Because the employer and employee are free to renegotiate the employee's compensation, the beneficiary's rights arise out of the current agreement. The equivalence of the old and new benefit packages is irrelevant. In effect, the "transfer" of the right occurs continually during the term of employment.

Nevertheless, the courts do not regard a mere continuation of a death benefit provision in a new contract as a new transfer. Not surprisingly, if a new contract was signed within three years of death, taxpayers have sought to bring their situation within this rule. In Porter, the death benefit agreement replaced a prior agreement entered into nine years earlier. The Tax Court rejected the estate's continuation argument, noting three factors: the later agreement provided for a larger benefit, payable over a longer time period; the prior agreements were formally cancelled; and the later agreement added a clause that the agreement could not be modified or terminated without the consent of both parties. The Court of Appeals attached little significance to the last two factors, describing them as purely "formal considerations;" even without a "no termination" clause, in the court's view, the agreement could still be modified by a subsequent agreement. But the Court of Appeals agreed that the creation of a "more liberal provision" made the

123. See Restatement of Contracts §§ 12, 29 (1932).
125. 54 T.C. at 1077.
126. 442 F.2d at 920 n.9.
127. Id.
new agreement a transfer in contemplation of death.\textsuperscript{128}

As a factual matter it is not clear that the new benefit was more liberal,\textsuperscript{129} but even if it were, why should the entire benefit be treated as a new transfer? Under the continuum approach, it would seem that only the additional benefit should be considered transferred by the new agreement, since the prior benefit remains in effect.\textsuperscript{130} In addition, it may often be difficult to determine whether a modified benefit is to be treated as a new transfer. For example, does a change in the payment from a lump sum to two installments thirty days apart result in a new transfer?

These problems display the basic inadequacy of the continuum theory and suggest a plausible alternative—the continuous transfer theory. Because the existence of the death benefit depends on the employee's daily performance of services, the death benefit should itself be viewed as transferred on a daily basis. Today's benefit owes its entire existence to today's transfer of consideration by the employee and the current agreement between employer and employee. The existence of an identical agreement, or for that matter a totally different agreement, accompanied by consideration five years earlier is irrelevant to the current benefit. Under the continuous transfer approach, every pure death benefit is transferred within three years of death.\textsuperscript{131}

\textsuperscript{128} 442 F.2d at 920. Neither court deciding \textit{Porter} clarifies whether the continuation rule relates to the timing of the transfer or to the contemplation of death requirement. Before the Tax Reform Act of 1976, I.R.C. § 2035 required both a transfer within three years of death and a transfer in contemplation of death. In a later case the Tax Court indicated that the continuation argument relates to when the transfer actually occurred. \textit{See} Estate of Kopperman v. Commissioner, 37 T.C.M. (CCH) 1849-24, 1849-29 (1978).

\textsuperscript{129} While the new benefit provided for a somewhat larger total payment, it stretched out the payments over a ten year period. Under the prior agreement all payments would be made within three years. Using the six percent discount factor required by the regulations, \textit{see} Treas. Reg. § 20.2031-10(f) (1970), the present value of the prior benefit for estate tax purposes might well exceed the present value of the new benefit.

\textsuperscript{130} For example, assume that a $25,000 death benefit had been in effect for five years, but one year before the employee's death the employer agreed to raise the benefit to $50,000. Under the continuum approach, a right to the second $25,000 benefit was arguably transferred within three years of death, but the right to the first $25,000 was transferred at an earlier date.

\textsuperscript{131} The case for the continuous transfer theory is somewhat weaker if the pure death benefit cannot be modified without the beneficiary's consent. This kind of benefit is probably rare, but it is possible to arrange. \textit{See} note 157 \textit{infra}. Under such an arrangement, the employee does not continually transfer the right to benefit, but merely maintains a previously transferred right now owned by someone else. The underlying rationale of I.R.C. § 2035—to prevent the decedent from diminishing the gross estate by making transfers close to death—
The possibility of describing a section 2035 transfer under either the continuum theory or the continuous transfer theory is not limited to the employer-provided death benefit. A choice between the two theories must also be made in connection with employer-provided group term life insurance, a benefit strikingly similar to the pure death benefit. The Service's present position, announced in Revenue Ruling 71-497 and supported in a number of cases, is that the proceeds of life insurance policies assigned more than three years before the insured's death are not includable under section 2035, even if the insured continues to pay the premiums. Neither the Service's rulings nor the cases dealing with assignments more than three years provides support for this characterization. The deceased employee could not have acquired the death benefit, at least not without the beneficiary's consent. The employee could only maintain the beneficiary's right by furnishing the consideration represented by his services. Thus, the cost of purchasing the benefit from the employer, rather than the cost of the benefit itself, is continuously transferred within three years of death. This cost in theory amounts to the additional salary the employer would have been willing to pay in lieu of providing the death benefit plan, and equals the employer's actuarially determined cost of providing the benefit.

The argument that, in the case of the non-modifiable death benefit, the employee is merely maintaining a previously transferred right is weakened, however, by the beneficiary's inability to maintain the benefit if the employee fails to do so. Thus the employee is doing more than merely substituting his consideration for that of the beneficiary; the employee, and the employee alone, by continuing to work and thereby furnishing the necessary consideration, enables the beneficiary to receive the benefit. But this argument addresses I.R.C. § 2038 rather than section 2035. See text accompanying notes 148-56 infra. Under section 2035, the issue is whether a transfer within three years of death diminishes the decedent's gross estate by the amount of the benefit.

132. See notes 109-10 supra and accompanying text.
134. See, e.g., Estate of Silverman v. Commissioner, 521 F.2d 574, 576 (2d Cir. 1975); First Nat'l Bank of Oregon v. United States, 488 F.2d 575, 578 n.3 (9th Cir. 1973); Detroit Bank & Trust Co. v. United States, 467 F.2d 964, 966 (6th Cir. 1972).
135. In 1967, the Service took the position that the payment of premiums by the insured, made within three years of death on policies previously transferred, was a transfer of an interest in the policy itself, measured by the proportion of the premiums paid within the three year period to the total premiums paid. Rev. Rul. 67-463, 1967-2 C.B. 327. This same proportion of the insurance proceeds was included in the insured's gross estate under I.R.C. § 2035. In essence, the Service viewed the premium payment much like an improvement to property previously transferred. The courts uniformly rejected this approach. See, e.g., First Nat'l Bank of Midland v. United States, 423 F.2d 1280, 1288 (5th Cir. 1970); Estate of Coleman v. Commissioner, 52 T.C. 921, 923-24 (1969). See also Kahn & Waggoner, supra note 108, at 951. The courts reasoned that the premium payment merely maintained rights belonging to others, rights that "were thus neither transferred nor transferrable by the decedent" within three years of death. First Nat'l Bank of Midland v. United States, 423 F.2d at 1288. After its failure to win judicial support, the Service revoked its 1967 ruling and announced its current policy in Rev. Rul. 71-497, 1971-2 C.B. 329.
before death considered, however, assignments of group term life insurance.

Revenue Ruling 71-497 also considered the transfer of a one-year term policy purchased by a decedent nine months before death. When the decedent purchased the policy, he designated his children as the owners and beneficiaries of the policy. Relying on language in Chase,¹³⁶ the ruling held that all of the proceeds were includable in the insured's gross estate under section 2035. This position was sustained in Bel v. United States.¹³⁷ In Bel, the decedent had purchased, for four successive years, a one-year accidental death policy on his own life and made his three children the owners. The insured died less than ten months after the last purchase. The Fifth Circuit held that the last purchase constituted a "transfer" of the accidental death policy within the meaning of section 2035 and the proceeds were therefore included in the decedent's gross estate.¹³⁸

The Bel court's holding implies that although the children's right to the policy proceeds existed for more than three years before the insured's death, it was not a continuously existing right. The purchases instead represented a series of separate annual "transfers" of the right. At the end of each one-year term, an old right expired and a new right was created, notwithstanding the absence of any lapse or modification in coverage.

The assignment of group-term life insurance can similarly be characterized as the legal basis for a series of separate annual transfers of policy rights at each renewal of the policy by the employer.¹³⁹ If the employer is not contractually obligated to maintain the group insurance contract, the yearly decision by the employer to renew the group contract seems analogous to the yearly decision by the insured in Bel to purchase a new one-year policy. The crucial factor in both situations is the inability of the assignee of the policy to continue the policy. Absent the right of continuation, the assignee has a right that annually expires.¹⁴⁰

¹³⁶. See text accompanying notes 81-84 supra.
¹³⁷. 452 F.2d 683 (5th Cir. 1971), cert. denied, 406 U.S. 919 (1972).
¹³⁸. Id. at 692.
¹³⁹. But in a recent IRS Technical Advice Memorandum, the Service held, without any serious discussion, that the yearly renewal of a group term policy by an employer was not a "new transfer of insurance coverage under section 2035." LTR 8034017, National Office Technical Advice Memorandum, May 9, 1980, reprinted in IRS Letter Ruling No. 183, Sept. 3, 1980 (CCH).
¹⁴⁰. If, however, the assignee has the right of continuation, the employer's premium payments would constitute a maintenance expense of a continuously existing right rather than the transfer of a new property right. Commentators
An employer's decision to change insurance carriers of existing term policies illustrates an additional defect in the Service's continuum theory as set forth in Revenue Ruling 71-497. Assume an employer has provided a group term life insurance policy to its employees, and that an employee assigns all rights under the policy to his or her spouse more than three years before his or her death. Under the general rule of Revenue Ruling 71-497, the proceeds of the policy are not included in the insured's gross estate because the transfer took place more than three years before death. But suppose within three years of the employee's death, the employer terminates its then current insurance arrangement and obtains a similar arrangement with a different insurer, and the insured assigns the new policy to the spouse. Are the policy proceeds includable in the insured's gross estate as a transfer within three years of death under section 2035?

On these facts, the Service initially held in Revenue Ruling 79-231 that the proceeds were includable under section 2035, notwithstanding the decedent's previous assignment of the rights under any arrangement for life insurance coverage provided by the employer. Without citing any direct authority, the Service announced the general theory that a binding promise to transfer property becomes a transfer for section 2035 purposes at the time the promise becomes "enforceable and susceptible of valuation." The Service reasoned that the assignment of future policies was not effective as a present transfer of any rights, but rather was a contract to assign that could become enforceable if and when a new policy were

have recently recognized the crucial role played by the right of continuation component of a life insurance policy in applying I.R.C. § 2035 to policy assignments. See Kahn & Waggoner, supra note 108, at 977. Although Professors Kahn and Waggoner do not discuss the special problem of group life insurance, they do accept the notion that life insurance coverage can be treated as "a continuum and not as a collection of a number of contractual arrangements" only if the right of continuation component has been assigned. Id. at 979.

141. 1979-2 C.B. 323.

142. Id. at 324. As indirect authority for this rule, the Service first noted the existence of a parallel rule for gift tax purposes. Id. In a number of rulings, the Service has held that a binding promise to transfer property is subject to a gift tax on the date the promise to make the future transfer becomes enforceable and susceptible of valuation, rather than when the promise is made or when actual transfer of ownership occurs. See Rev. Rul. 75-71, 1975-1 C.B. 309; Rev. Rul. 69-347, 1969-1 C.B. 227; Rev. Rul. 69-346, 1969-1 C.B. 227. Without any further elaboration, the Service concluded that the same rule applies with equal force to I.R.C. § 2035, "since the estate and gift tax provisions are in pari materia and must be construed together." Rev. Rul. 79-231, 1979-2 C.B. 323, 324. The purported gift tax rule is itself somewhat questionable. See notes 216-27 infra and accompanying text.
acquired.\textsuperscript{143} Revenue Ruling 79-231 threatened to disrupt the estate plans of numerous employees who had transferred their group term insurance policies in an effort to reduce their taxable estates. A decision by an employer to select a new insurance company, perhaps to achieve premium reductions or improvements in service, would start the three-year clock running anew. The Service subsequently revoked the ruling in Revenue Ruling 80-298.\textsuperscript{144}

In Revenue Ruling 80-289, the Service did not retreat from any of the general theories it had put forth in the prior ruling; indeed, it reiterated its view that the original assignment of the policy "was not technically effective as a present transfer of the decedent's rights"\textsuperscript{145} in future policies. Nevertheless, the ruling concluded with the Service's statement that because the new group term life insurance arrangement was "identical in all relevant aspects to the previous arrangement," the date of the original assignment should control.\textsuperscript{146}

Revenue Ruling 80-289 represents an adoption by the Service of the continuum theory in the group term life insurance context. This approach raises the same problems as in the case of the pure death benefit discussed above.\textsuperscript{147} For example, how much change in the policy will be tolerated before the new policy constitutes a new transfer? Is a change in the policy benefit from two times annual salary to three times annual salary a new transfer? If so, is it a transfer of just the excess benefits, or of the whole value of the policy?

The continuous transfer model, on the other hand, provides a sounder analytical basis for applying section 2035 to group term life insurance. Moreover, the Service is obviously uncomfortable, as evidenced by its revocation of Revenue Ruling 79-231, with drawing a distinction between the renewal of an existing group term policy and the purchase of a new identical policy. Although the Service's discomfort is wholly justified, the relief provided by Revenue Ruling 80-289 is inappropriate. The better view finds even the renewal of a policy by the employer a transfer under section 2035. At the end of a group life insurance policy's term, the employer has the option of renewing the existing policy, discontinuing the policy and substi-

\textsuperscript{143} Rev. Rul. 79-231, 1979-2 C.B. at 324.
\textsuperscript{144} 1980-2 C.B. 270.
\textsuperscript{145} Id.
\textsuperscript{146} Id.
\textsuperscript{147} See text accompanying note 130 \textit{supra}.
tuting another, or discontinuing the policy and making no substitution. The selection of the course of action is in essence a renegotiation of the employee's contract. As in the case of the pure death benefit, the assignee of the life insurance policy has merely a right that periodically expires, rather than a right continuously in existence.

2. **Section 2038**

Section 2038(a)(1)\(^{148}\) includes in a decedent's gross estate any property interest transferred by the decedent, but which remains, at the date of the decedent's death, subject to the decedent's power, either alone or in conjunction with any other person, to alter, amend, revoke, or terminate the enjoyment of the property interest. It is now well established that the transfer requirement of section 2038(a)(1) is satisfied if an employer provides a death benefit in return for an employee's services.\(^{149}\) The more troublesome issue has been the degree of power a deceased employee must have retained over the benefit in order to bring it within the reach of section 2038(a)(1).

Although an employee's power to change the beneficiary of the death benefit clearly triggers section 2038(a)(1),\(^{150}\) an employee may also be able to indirectly affect the beneficiary's interest in the benefit without expressly retaining the right to alter the beneficiary. For example, the employee always retains the power to "terminate" the enjoyment of the death benefit by leaving his or her job. The courts, however, have rejected the Commissioner's attempts to include such a power under the ambit of section 2038(a)(1).\(^{152}\) Other indirect con-

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148. I.R.C. § 2038(a)(1) provides:

(a) In General.—The value of the gross estate shall include the value of all property—(1) Transfers after June 22, 1936.—To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.


151. I.R.C. § 2038(a)(1).

152. See Estate of Tully v. United States, 528 F.2d 1401, 1405 (Ct. Cl. 1976);
trols over death benefits, such as the power to divorce one's spouse, where the death benefit is payable to the spouse, or the power to accept a lower salary, where the death benefit is pegged to the salary, have been held not to be section 2038(a)(1) powers.\textsuperscript{153}

The courts are warranted in excepting these last two powers from the scope of section 2038. Changing a spouse or having children are acts of independent significance that are unlikely to be undertaken for purposes of transfer tax manipulation.\textsuperscript{154} At least one commentator has joined the Commissioner in suggesting that changing employment is in the same category.\textsuperscript{155} There is, however, a significant distinction for transfer tax purposes between a decision to work and a decision to marry or procreate. The act of working is an act of wealth creation. The pure death benefit is a part of the compensation package and represents a deliberate incentive to exercise the power in question, namely to continue employment. Although it is not the only such incentive, the relative level of incentive is not the significant factor. An individual works for compensation, and the decision to work or not to work represents control over the entire compensation package. Furthermore, the death benefit might be a significant factor in the decision to continue employment if, for instance, the employee has become uninsurable. Thus, the conclusion is incorrect that the power to terminate a death benefit by changing jobs falls outside the scope of section 2038(a)(1).\textsuperscript{156}

\begin{footnotes}


\item[154] Estate of Tully v. United States, 528 F.2d 1401, 1405-06 (Ct. Cl. 1976).

\item[155] See Rev. Rul. 80-255, 1980-2 C.B. 272 (trust provision including settlor's afterborn and after-adopted children as beneficiaries is not equivalent to settlor's retention of power to alter beneficial interests within the meaning of I.R.C. §§ 2038(a)(1) and 2036(a)(2)).


\item[157] Employer-provided life insurance which terminates if the employee ceases employment raises a similar issue. Although the Service has not argued this position under I.R.C. § 2038, it did at one time assert that the power to terminate the policy by terminating employment was an "incident of ownership" under I.R.C. § 2042(2). Rev. Rul. 69-54, 1969-1 C.B. 221, 222. After the Court of Claims rejected this position, see Landorf v. United States, 469 F.2d 461, 469 (Ct. Cl. 1973), the Service acknowledged that "[a]n insured's power to cancel his insurance coverage by terminating his employment is a collateral consequence of the power that every employee has to terminate his employment", and therefore was not an incident of ownership in the policy. Rev. Rul. 72-307, 1972-1 C.B.
The power to renegotiate the terms of the death benefit presents a somewhat different issue. The employer and the employee might have expressly reserved such a power, or it might exist as a matter of local contract law. It is well established that section 2038 reaches powers held by a decedent which are exercisable only in conjunction with another person, whether or not the other person has an adverse interest in the

307, 308, modifying Situation 1 in Rev. Rul. 69-54, 1969-1 C.B. 221, 222. The Service's current position is unfortunate for the reasons noted in the accompanying text.

157. A death benefit cannot be modified without the consent of the beneficiary if the agreement creating the benefit so provides. See Restatement (Second) of Contracts § 142(1) (Tent. Drafts Nos. 1-7, 1973). The more difficult problem is whether an agreement that is silent as to the right of the employer and employee to modify the death benefit nevertheless creates an obligation to pay the death benefit that cannot be varied without the beneficiary's consent. Under the original Restatement the duty of a promisor to a third party beneficiary cannot be affected by any agreement between the promisee and the promisor, unless the power to do so is reserved. Restatement of Contracts § 142 (1932). Under the Restatement (Second), in the absence of a term precluding modification, the promisor and promisee retain the power to modify the duty by subsequent agreement. Restatement (Second) of Contracts § 142(2) (Tent. Drafts Nos. 1-7, 1973). The power to modify, however, "terminates when the beneficiary, before he receives notification of the discharge or modification, materially changes his position in justifiable reliance on the promise, or brings suit on it, or manifests assent to it at the request of the promisor or promisee." Id. § 142(3). The Restatement (Second) appears to represent the majority rule. See Spates v. Spates, 267 Md. 72, 78, 296 A.2d 581, 584 (1972).

Rhodes v. Rhodes, 266 S.W.2d 790 (Ky. 1953), apparently is the only case to consider the issue of the power to modify an employee death benefit. In Rhodes, an employment contract provided for annuity payments to the son of an employee if the employee died while employed and before reaching age 65. The employee divorced, remarried, and entered into a new employment contract in which his new wife was named the beneficiary of the annuity instead of the son. The court held that since the right to rescind the contract was not reserved in the contract, the employer and employee had no power to alter the rights of the son after the son had accepted the contract. Id. at 792-93. Because the son was an infant, his assent was presumed. Id. at 792.

The result in Rhodes is questionable. The comments to the Restatement (Second) suggest that "[t]he true test rests not on fictitious assent but on the manifested intention of the original parties; other circumstances, such as the fact that the consideration for the promise is executory, may rebut the inference that the beneficiary's right is irrevocable." Restatement (Second) of Contracts § 142, Comment d (Tent. Drafts Nos. 1-7, 1973). Some cases have expressly held that a beneficiary's rights under an executory contract can be modified, even if the beneficiary is an infant. See, e.g., Lehman v. Stout, 261 Minn. 384, 392-94, 112 N.W.2d 649, 646-47 (1961). Although Lehman did not involve a death benefit, its approach is directly contrary to Rhodes. The contract in Rhodes was executory, since the employee had to be employed at the time of his death in order for the employer to be obligated to pay the benefit. It should be noted that the Restatement (Second) includes illustrations in its comments based on both the Rhodes and Lehman cases, without attempting to reconcile them. Compare Restatement (Second) of Contracts § 142, Comment d, illustration 3 (Tent. Drafts Nos. 1-7, 1973) with id. illustration 4.
property.\textsuperscript{158} It would seem, therefore, that a power of negotiation, whether arising under a contract or implied by law, is sufficient to require inclusion of the death benefit under section 2038(a)(1). In \textit{Estate of Tully v. United States},\textsuperscript{159} however, the Court of Claims held that Congress did not intend section 2038(a)(1) to extend to the mere possibility that an employer and employee might modify the contractual death benefit.\textsuperscript{160}

The decedent in \textit{Tully} owned half the stock of a closely held corporation. Decedent entered into a contract with the corporation whereby his wife was to receive as a death benefit an amount equal to double her husband's salary for the year immediately preceding his death. The contract was later amended to limit the maximum amount of the death benefit. The original agreement did not include an expressly reserved right to modify the death benefit,\textsuperscript{161} and as the court noted, Tully's stock ownership was insufficient to compel modification of the agreement.\textsuperscript{162} The court therefore concluded that Tully possessed merely "powers of persuasion"\textsuperscript{163} that fell short of the power contemplated by section 2038(a)(1), and that the death benefit was accordingly excluded from the gross estate.

This conclusion is incorrect for two reasons. First, the court's argument that section 2038(a)(1) does not extend to "powers of persuasion" is unconvincing. The court apparently viewed the power to renegotiate as an incidental power. But, unlike the incidental powers noted above,\textsuperscript{164} an employee can use this power to directly affect the beneficiary's interest; the employee, for example, could agree with the employer to change the beneficiary from the employee's spouse to the employee's children. This power is no more speculative than a power held by a grantor of a trust to change the remainderman with the consent of the trustee, and should be within the reach of section 2038(a)(1).\textsuperscript{165} The employee's power is even less

\begin{footnotes}
\item[159] 528 F.2d 1401 (Ct. Cl. 1976). A similar result was reached in \textit{Kramer v. United States}, 406 F.2d 1363, 1369 (Ct. Cl. 1969).
\item[160] 528 F.2d at 1405.
\item[161] \textit{Id.} at 1404.
\item[162] \textit{Id.}
\item[163] \textit{Id.} (emphasis omitted).
\item[164] See text accompanying note 153 \textit{supra}.
\item[165] Nevertheless, in the typical trust situation, a mere power of persuasion is not an I.R.C. § 2038 power. Thus, a grantor of a trust who has granted dispositive powers to a sole trustee does not jointly hold the power merely because he might persuade the trustee to act in a certain way. A contrary result would render every irrevocable trust subject to section 2038 and is clearly beyond
\end{footnotes}
speculative, since a trustee may have no incentive to accommodate the grantor, but an employer usually has every incentive to accommodate an employee, especially when it costs the employer nothing.

The court also reasoned that if the mere possibility of bilateral contract modification were within the reach of section 2038(a)(1), "it would sweep all employee death benefit plans into the gross estates of employees." This conclusion is incorrect, since there are some benefits that cannot be revoked or modified without the consent of the beneficiary. Moreover, even assuming that section 2038 would reach the majority of pure death benefits, the court does not explain why this result would contravene tax policy. Indeed, tax policy suggests that a pure death benefit which can be bargained away in the renegotiation of an employee's fringe benefit package is still within the control of the employee, and represents a substitute for a testamentary transfer.

A recent Tax Court case has further called into question the Tully court's interpretation of section 2038. In Estate of Siegel v. Commissioner, the Tax Court held that an expressly reserved power of bilateral contract modification justifies inclusion of the pure death benefit under section 2038(a)(1). The Tax Court purported to distinguish Tully on Congress's intent. But if the grantor and the trustee share the dispositive power, section 2038 cannot be avoided. Similarly, if the employer and employee by agreement may alter the beneficiary's rights under the death benefit agreement, section 2038 should also be applicable.

166. 528 F.2d at 1405.
167. See note 157 supra. It might be argued that even in the case of the "irrevocable" death benefit, the beneficiary could consent to a modification and thus the employee retains an I.R.C. § 2038 power to modify held in conjunction with the employer and the beneficiary. This argument is properly foreclosed by the holding in Helvering v. Helmolz, 296 U.S. 93 (1935), that a grantor's power under local trust law to revoke a trust only with the consent of all the beneficiaries was outside the scope of the predecessor to section 2038(a)(1). The Treasury Regulations now embody the Helmolz rule that "section 2038 does not apply . . . (2) If the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law. . . ." Treas. Reg. § 20.2038-1(a) (1958). This rule is correct, since a contrary rule would make section 2038 applicable to almost all irrevocable trusts, a result certainly beyond Congress's intent. This kind of power is simply too incidental to warrant including the subject property in the decedent's gross estate.
168. 74 T.C. 613 (1980).
169. In Siegel, the employee entered into an employment agreement with the employer that provided for the continuation, for a limited period of time, of the employee's salary to his children in the event of the employee's death. The agreement contained the following statement: "No right or interest is hereby granted to the children of SIEGEL except as set forth herein and such rights or
the basis that the case did not involve an express reservation of a power to modify.\textsuperscript{170} The estate maintained, however, that \textit{Tully} was nevertheless on point because, under local contract law, the parties to a contract may always renegotiate the terms of their contract, and the reserved power added nothing to the rights already possessed by the employee.\textsuperscript{171}

The Tax Court rebutted this argument by examining the common law power of employer and employee to modify the beneficiaries' rights in the absence of an expressly reserved right to do so. Finding no controlling state law on point, the court looked to the original \textit{Restatement of Contracts} and \textit{Restatement (Second) of Contracts} for assistance.\textsuperscript{172} Under section 142 of the original \textit{Restatement},\textsuperscript{173} a third party donee beneficiary acquires an indefeasible right to performance of the contract unless the power to modify the contract is expressly reserved in specific terms.\textsuperscript{174} Under section 142 of the \textit{Restatement (Second)},\textsuperscript{175} the rule is more limited. In the absence of an agreement precluding variation of a duty to a beneficiary, the promisor and promisee retain the power to discharge or modify the duty by a subsequent agreement until the beneficiary materially changes his or her position in justifiable reliance on the promise, brings suit on it, or manifests assent at the request of the promisor or promisee.\textsuperscript{176} The Tax Court concluded that, whichever rule is applied, by expressly reserving the power to modify the rights of the beneficiaries, the employer and employee had greater rights than they possessed under local law.\textsuperscript{177}

\textit{Siegel} correctly concluded that an expressly reserved right of modification is a section 2038 power. By distinguishing \textit{Tully}, \textit{Siegel} might also be read to imply that if the employer and employee had not expressly reserved the right to modify the death benefit, then any rights to modify arising under local law would not be sufficient to include the benefit under section 2038. This

\begin{quote}
interests are subject to any modification of this agreement by the mutual consent of \textit{SIEGEL} and the \textit{CORPORATION}.' \textit{Id.} at 616.
\end{quote}

\textsuperscript{170} \textit{Id.} at 627. \textit{See also} Kramer \textit{v. United States}, 406 F.2d 1363 (Ct. Cl. 1969).

\textsuperscript{171} 74 T.C. at 627.

\textsuperscript{172} 74 T.C. at 629.

\textsuperscript{173} \textit{RESTATEMENT OF CONTRACTS} § 142 (1932).

\textsuperscript{174} \textit{See note 157 supra.}

\textsuperscript{175} \textit{RESTATEMENT (SECOND) OF CONTRACTS} § 142 (Tent. Drafts Nos. 1-7, 1973). \textit{See note 157 supra.}

\textsuperscript{176} \textit{Id.}

\textsuperscript{177} 74 T.C. at 629.
implication is incorrect and contrary to authority.\textsuperscript{178} Because an employer and employee could clearly create a duty to a beneficiary that could not be varied without the beneficiary's consent,\textsuperscript{179} it is irrelevant whether they fail to do so by expressly reserving the power to modify or rely on a state law rule. The crucial point about both expressly reserved and common law rights of contract modification is that the employee retains sufficient control over the transferred property to warrant inclusion under section 2038.\textsuperscript{180} Properly understood, \textit{Siegel} supports the extension of the scope of section 2038(a)(1) to reach any death benefit over which the employee, in conjunction with the employer, retains a right of modification, regardless of whether that right is express or implied by law.

\textit{Siegel} therefore provides the Service with new ammunition in its protracted struggle to subject nonqualified employee death benefits to transfer taxation. Whether other courts will follow or even extend the reach of \textit{Siegel} is uncertain, but the opinion is a first step toward judicial recognition that the reasoning in \textit{Tully} is flawed.

3. \textit{Section 2037}

The Service has successfully relied upon section 2037\textsuperscript{181} to

\textsuperscript{178} The Tax Court itself has held that a grantor's power to revoke a trust suffices to require inclusion under I.R.C. § 2038, even though the contract contains no express reservation of such a power by the grantor and the power arises solely by operation of state law. \textit{See} Estate of Casey v. Commissioner, 55 T.C. 737, 743 (1971); Estate of Davis v. Commissioner, 51 T.C. 361, 368 (1968). In addition, other estate tax provisions have been held to reach interests or powers retained by operation of law. \textit{See} Estate of Spiegel v. Commissioner, 335 U.S. 701 (1949) (interpreting section 811 of the Internal Revenue Code of 1939). In Estate of Wyly v. Commissioner, 610 F.2d 1282 (5th Cir. 1980), \textit{rev'd}, Estate of Castleberry v. Commissioner, 68 T.C. 682 (1977), the majority of the Fifth Circuit panel attempted to distinguish \textit{Spiegel} as its reasoning would be applied to I.R.C. § 2036, at least where the retained interest was "created solely by operation of law as the unavoidable result of what was in form and within the intention of the parties the most complete conveyance possible . . . ." \textit{Id.} at 1294. Judge Roney dissented from this portion of the opinion, however, noting that "the tax consequences should be the same whether [the] interest was retained by the express provisions of [the] donative instruments, or arose by operation of law . . . ." \textit{Id.} at 1296 (Roney, J., concurring in part and dissenting in part). For a criticism of \textit{Wyly}, see Dodge, \textit{supra} note 155, at 38.

\textsuperscript{179} \textit{See} note 157 \textit{supra}.

\textsuperscript{180} Section 2038 provides even stronger textual support for this position than the other estate provisions since it expressly includes a power to change enjoyment "without regard to when or from what source the decedent acquired such power." I.R.C. § 2038(a)(1).

\textsuperscript{181} I.R.C. § 2037(a) provides:

(a) General Rule.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the
include pure death benefits in the estate of a deceased employee, but its reach can easily be avoided. Under section 2037, property transferred during life by a decedent will be included in the decedent's gross estate if possession or enjoyment of the property, through ownership of the transferred interest, can be obtained only by surviving the decedent and the decedent has retained a reversionary interest in the property that immediately before the decedent's death exceeds five percent of the property's value. As in the case of the other lifetime transfer provisions, the courts properly view the making of a contract with the employer as a transfer of a property interest to the beneficiary.

Since the pure death benefit will be paid only if and when the employee dies, the survivorship requirement of section 2037 is automatically satisfied. By drafting the agreement so that the deceased employee does not possess any reversionary interest in the benefit, however, the arrangement can avoid the reversion requirement of section 2037. The drafter could accomplish this result by making the death benefit payable to various classes of the employee's relatives, such as a spouse, children, or issue, while providing that if no beneficiaries survived the benefit would not be paid. Since neither the employee or the employee's estate could receive the payments, section 2037 would not apply.

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184. Careless drafting can be fatal to any attempt to avoid I.R.C. § 2037. In Estate of Bogley v. United States, 514 F.2d 1027, 1039 (Ct. Cl. 1975), the corporate resolution establishing the death benefit provided that "the surviving widow or estate is to receive two years' salary ...." The question the court had to face was whose estate, the widow's or the employee's, would be entitled to the death benefit had the widow not survived. If it were the widow's estate, section 2037 would not have applied for lack of a reversionary interest in the
III. GIFT TAX ASPECTS

The Service has devoted much effort in attempts to include the pure death benefit in the deceased employee's gross estate, but as noted above, these efforts have generally been unsuccessful. The cases, however, have established that, for estate tax purposes, a transfer by an employee can take place if, in consideration of an employee's services, the employer agrees to pay a death benefit. \(^{18}\) Several courts have actually referred to the transfer as a gift. \(^{186}\) The gift tax issue thus arises naturally from the estate tax treatment of such benefits.

A number of troublesome issues of valuation and timing arise in determining the application of the gift tax to pure death benefits. As a preliminary matter, it seems clear that there is no completed gift if the employee has the power to alter the beneficiary designation once it is made. \(^ {187}\) As noted above, however, such a power would result in the inclusion of the benefit in the employee's gross estate under section 2038. \(^ {188}\) On the other hand, if an employee has an unqualified right to receive an annuity, but elects to take a reduced annuity in return for a death benefit payable to an irrevocably designated beneficiary, the regulations provide that the employee makes a completed gift at the time the election and designation become irrevocable. \(^ {189}\)

A number of factors may cause the typical pure death benefit to fall somewhere between these two extremes. The benefit may be subject to forfeiture should the employee leave employment; \(^ {190}\) the amount of the benefit may be variable, such as amounts tied to the employee's salary at death; the benefit may be payable only to certain qualifying beneficiaries and if there are none, no benefit is payable; \(^ {191}\) or, finally, the benefit may be modified or discontinued through renegotiation of the employee's benefit package.

decedent. The court concluded that it was the employee's estate, and included the benefit in the employee's gross estate. \textit{Id.}\n
185. \textit{See} note 78 \textit{supra}.
186. \textit{See}, \textit{e.g.}, note 9 \textit{supra}.
188. \textit{See} note 150 \textit{supra} and accompanying text.
190. \textit{See} text accompanying notes 117-18 \textit{supra}.
191. An example would be a benefit payable only to an employee's surviving spouse. If the employee is not married, no benefit would be payable.
It is possible to construct at least three general theories for the gift taxation of the pure death benefit: the single gift at creation theory; the continuous gift theory; and the completed gift at death theory. The remainder of this section discusses these possibilities.

A. SINGLE GIFT AT CREATION

The beneficiary's right to the pure death benefit can be characterized as a single gift occurring at the time the contract creating the benefit is made. This characterization is consistent with the courts' conclusion that the relevant transfer for estate tax purposes takes place at that time. Nevertheless, it is well established that a gift is not complete for gift tax purposes if the transferor retains a power to alter the disposition of the property, and the employee's ability to terminate the benefit by ceasing employment would seem to render the gift incomplete in any meaningful sense. Moreover, the gift is also incomplete if the employee and employer acting together can modify or terminate the benefit.

Even if the beneficiary's right to receive the pure death benefit were treated as a taxable gift, the characterization of the death benefit as a single transfer would cause it to be grossly undervalued, because at the time the contract creating the benefit is made the gift has only nominal value. Obviously no market exists for such benefits, and any purely actua-

192. See Estate of Porter v. Commissioner, 442 F.2d 915, 919 (1st Cir. 1971); Estate of Kopperman v. Commissioner, 37 T.C.M. (CCH) 1849-24, -30 (1978). See also Estate of Tully v. United States, 528 F.2d 1401, 1404 (Ct. Cl. 1976). For a criticism of this approach, see notes 123-30 supra and accompanying text.


194. The argument that the gift of the pure death benefit is incomplete parallels the discussion above concerning IRC. § 2038. See notes 148-80 supra and accompanying text. There it was asserted that the power to terminate the benefit by ceasing employment and the power to renegotiate the benefit were both sufficient to trigger the applicability of section 2038 to the death benefit. Since the courts, with the exception of Siegel v. Commissioner, 74 T.C. 613 (1980), have rejected this interpretation of the term "power" in section 2038, see notes 158-80 supra and accompanying text, such powers may also be found insufficient to prevent the gift from being complete for gift tax purposes.

195. Although the employee acting alone may not be able to change the benefit, for gift tax purposes a donor possesses a power of modification or reversion if it is exercisable in conjunction with any person not having a "substantial adverse interest" in the transferred property. See Treas. Reg. § 25.2511-2(e) (1958). See also Camp v. Commissioner, 195 F.2d 999 (1st Cir. 1952). An employer has no adverse financial interest in the selection of a new beneficiary and certainly would not be adverse to eliminating the death benefit entirely.

196. See text accompanying note 191 supra.
rial value would have to be heavily discounted under any reasonable application of the general willing buyer-willing seller\textsuperscript{197} standard of valuation. The pure death benefit would virtually escape transfer taxation if this approach were adopted, and the courts could not be convinced to reconsider their estate tax analysis.

This result would clearly be inappropriate. The employee has negotiated a benefit that is in essence a salary substitute. Had the benefit not been created, the employee presumably would have been paid additional salary which would have enhanced his estate and been subject to taxation. The single gift at creation approach, therefore, represents an inadequate response to the gift taxation of pure death benefits.

B. CONTINUOUS GIFT

In the alternative, the pure death benefit could be regarded as a series of successive transfers in a manner analogous to the Service's treatment of term life insurance. Revenue Ruling 76-490\textsuperscript{198} expresses the Service's position on the gift tax aspects of the transfer of a group term life insurance policy. Under the facts of that ruling, an employee transferred all of his rights in an employer-provided group term policy to an irrevocable trust. The Service held that the initial transfer to the trust did not constitute a taxable gift because the employee's interest in the policy had no ascertainable value at the time of the transfer, but concluded that each premium payment made by the employer was taxable as an indirect gift by the employee to the assignee of the policy\textsuperscript{199}.

In reaching this conclusion, the Service reasoned that the initial transfer of the employee's rights in the term insurance policy lacked an ascertainable value because the employer could refuse to make further premium payments\textsuperscript{200}. The pure death benefit presents the same valuation problem since the benefit may be terminated by agreement between the employer and employee. Even if the death benefit may not be withdrawn without the consent of the beneficiary\textsuperscript{201}, the benefit still depends on the employee's continued employment, a factor that

\textsuperscript{198} 1976-2 C.B. 300.
\textsuperscript{199} Id. at 301.
\textsuperscript{200} The ruling expressly stated that the employer had no contractual obligation to the employee or the assignee to maintain the group contract. Id. at 300.
\textsuperscript{201} See note 157 supra.
is hardly more predictable than continued employer premium payments.

The second conclusion of Revenue Ruling 76-490, that taxable gifts occur as the employer pays the premiums, suggests the possibility of a similar result in connection with death benefits. The beneficiary's contractual right to the death benefits is a valuable right, functionally equivalent to life insurance. Each day the right exists the beneficiary receives an economic benefit that could be treated as a gift. The employee is in effect purchasing the benefit for the beneficiary by performing services. Although it may seem odd to view the beneficiary as re-

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202. The pure death benefit, of course, involves no premiums, but the beneficiary still receives the economic benefit of equivalent insurance coverage. One can therefore view the provision of this benefit during a given month as a transfer of an amount equal to the monthly cost of providing term insurance coverage equal to the death benefit. Cf. Treas Reg. § 1.79-3 (1979) (valuation of employer provided group term life insurance for employee's income tax purposes). The gift tax would then be assessed as of the end of each calendar year based on the number of months of coverage. Although there is little direct authority for this approach, the Court of Claims in Goldsmith v. United States, 586 F.2d 810 (Ct. Cl. 1978), held that the promise of an employer to pay a death benefit to the children of an employee constituted a current economic benefit to the employee taxable as income to the employee. The court focused on the similarity between the death benefit and life insurance:

It becomes quite clear that the promises of payment on death or disability were the familiar undertakings of a life insurance company, albeit made by a hospital. To the extent of these promises, the deferred compensation agreement provided the taxpayer with a current economic benefit as valuable as comparable promises by a life insurance company. Taxability is as plain as the taxability of an insurance premium paid by an employer, in other than a qualified pension or group plan, on a policy of which the employee is beneficiary.

Id. at 821. As for the valuation problem, the court concluded that the value of the economic benefits "is in principle easily accomplished with evidence of the cost of comparable commercial insurance." Id. at 822. The case did not deal with the estate or gift tax consequences of the agreement, but if the beneficiary designation were irrevocable, it would seem that the economic benefit was transferred to the beneficiary and subject to gift tax by analogy to an assigned life insurance policy.

Whether other courts will follow Goldsmith, even as to the income tax issue, is unclear. The agreement between the employer and the employee in Goldsmith had some unique aspects. The parties expressly agreed to reduce the employee's salary by an amount equivalent to the employer's cost of providing the death benefits (as well as retirement benefits provided by the agreement). In addition, the employer actually funded the agreement by purchasing a life insurance endowment policy, the premium for which exactly equaled the salary reduction. The policy was, however, payable to the employer, not the employee. Id. at 814-15.

In Centre v. Commissioner, 55 T.C. 16 (1970), the Tax Court, with little discussion, declined to hold that the employee received an annual taxable benefit. Id. at 19. In Centre the taxpayer urged earlier taxability while the Commissioner argued taxability when the insurance policy owned by the employer was assigned to the employee when he terminated employment.
ceiving anything of value, since no money is received unless the employee dies, the analysis is in principle no different than the Service's treatment of life insurance.

Equating the value of the gift of the pure death benefit to the cost of equivalent life insurance coverage is not, however, consistent with established gift tax valuation principles. The value of property for gift tax purposes is the price at which such property would change hands between a willing buyer and a willing seller. Thus, the value of the gift of a pure

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203. Rev. Rul. 76-490, 1976-2 C.B. 300, ignores, however, a subtle valuation problem. The Ruling assumes without any discussion that the value of the gift is the amount of the premium paid by the employer. This amount, however, is not necessarily equal to the economic benefit of the life insurance coverage. For example, if the employee is in bad health and uninsurable at normal rates, the value of the economic benefit of the coverage would be greater than the premiums. By contrast, if the beneficiary actually owned a life insurance policy on the employee's life and the employee paid one month's premiums, it would be inappropriate to treat the gift as anything more than a gift of the actual premiums. If the employee did not pay the premiums, the beneficiary could simply pay them and thereby obtain the enhanced benefit of the insurance coverage. Thus the employee has not transferred the value of the month's insurance coverage in excess of the premiums paid; that value was already owned by the beneficiary. The beneficiary of an assigned group term policy stands in a very different position. If the employer decides to discontinue paying the premiums, the beneficiary does not have the right to pay them and renew the policy. Therefore, the employee's payment of the premiums on the group term policy may provide the beneficiary with an economic benefit, in excess of the premiums, that would otherwise not be available.

But is this additional value properly subject to the gift tax? On the one hand, this value does not reduce the employee's potential estate tax liability. The employee is purchasing the policy with his services and, therefore, presumably forgoing additional salary equal to the employer's cost of providing the policy. Thus, the employee's wealth is reduced only by the cost of the policy, not its value. On the other hand, under present gift tax law, many transfers are taxable although there is no reduction in the wealth of the transferor at the time of the transfer. For example, assume a donor has created an irrevocable trust under which the donor reserved the right to determine whether the income would be paid to A or B. If the trust income is $10,000 and the donor directs that it be paid to A, there is a taxable gift to A of $10,000. See Treas. Reg. § 25.2511-2(f) (1958). Although the donor could not have obtained the money, the donor's retained control over the transferred property justifies this result.

Nevertheless, the administrative difficulties raised by an individualized determination of value based on the health of the employee argue against its implementation. See Kahn & Waggoner, supra note 108, at 977-78. See also Treas. Reg. § 25.2512-6 (1963). The Supreme Court, however, has indicated that the insurability of an insured may affect the gift tax value of a policy. United States v. Ryerson, 312 U.S. 260, 262 (1941). Cf. Estate of Pritchard v. Commissioner, 4 T.C. 204 (1944) (payment equal to cash surrender value of policy was not adequate and full consideration for assignment of policy where insured was terminally ill). Notwithstanding this authority, because any increase in value due to poor health does not cause a reduction in the employee's potential estate, there seems little reason not to rely on some kind of a uniform table for valuing the insurance benefit.

death benefit is equivalent to what an arm's length purchaser would continually pay to possess the right to the benefit, with the knowledge that the right might terminate at any time if the employee ceases employment or renegotiates the benefit. This value would certainly be far less than the monthly cost of equivalent term life insurance. By contrast, if the insured becomes terminally ill during the period of coverage, the policy cannot be snatched away, because the purchaser of term life insurance buys coverage for a fixed period of time, usually with the right of renewal without evidence of insurability. The value of the right to a death benefit which can be terminated at any time is therefore somewhat indeterminate.\textsuperscript{205} The value of equivalent term life insurance is, at best, a distant upper bound.\textsuperscript{206}

\textsuperscript{205} It should be emphasized that the terminability of a transferred right does not necessarily imply a continuous transfer of only minimal value. For example, assume that the employer and employee have agreed that the employer will loan the employee's spouse $50,000 interest free as long as the employee remains employed. The transaction is in substance an interest free loan to the employee followed by a similar loan from the employee to the employee's spouse. As a theoretical matter it seems clear that an interest free loan constitutes a gift, although a number of courts have rejected this view. See Johnson v. United States, 254 F. Supp. 73, 77 (N.D. Tex. 1966); Crown v. Commissioner, 67 T.C. 1060, 1062 (1977), nonacq., 1978-1 C.B. 2, aff'd, 585 F.2d 234, 240-41 (7th Cir. 1978). See generally Joyce & Del Cotto, Interest-Free Loans: The Odyssey of a Misnomer, 35 Tax L. Rev. 459, 495-99 (1980). The Service's view is that the right to use property, in this case money, is itself an interest in property, the transfer of which is subject to the gift tax. Rev. Rul. 73-61, 1973-1 C.B. 408.

An interest-free demand loan cannot be valued at the time the loan is made, however, because the borrower received the right to use money for an indefinite period. The Service therefore concluded that the value of the gift should be calculated at the end of each calendar quarter, based upon the value of the use of the money during the calendar quarter, reasoning that a gift is not completed unless and until the transfer becomes susceptible of valuation. Id. at 409. The donor's power to revoke the loan provides an alternate rationale. Complete transfers take place only as the donee is allowed the use of the money. The employee can deprive the spouse of the right to the money by either terminating employment or renegotiating with the employer.

The continuous gift of the interest free loan can be valued by reference to what an arm's length borrower would continually pay for the use of the money, knowing that it might have to be returned at any time. Since demand loans are not uncommon, a suitable value should be ascertainable. The value would presumably fluctuate, just as the interest rate on demand loans fluctuates.

\textsuperscript{206} Although this analysis appears to question the validity of the Service's position in Rev. Rul. 76-490, 1976-2 C.B. 300, regarding the taxability of employer-paid group life insurance premiums, this is not necessarily so. The majority of states require that group term policies permit an employee to convert to an individual policy within thirty-one days of termination of employment. See, e.g., CAL. INS. CODE § 10209(b) (West 1972); Mich. Comp. Laws § 500.4438 (1967). See also Fed. Est. & Gift Tax Rep. CCH ¶ 7020.051 (1977). Thus the employee cannot deprive the beneficiary of the right to continue the insurance coverage merely by terminating employment. When the employer pays the
This conclusion is consistent with the view that the employee has purchased the contractual promise of the death benefit from the employer.\textsuperscript{207} By analogy, if an employee purchased a term life insurance policy, the mere existence of the policy would confer only a minimal economic benefit on the beneficiary because the employee might choose to discontinue the coverage at some future date. Moreover, although the beneficiary realizes some minimal economic benefit so long as the policy continues in force, there has never been any attempt to subject this continuing benefit to gift taxation. If the courts and the Service are correct in concluding that the beneficiary receives only a minimal economic benefit, what are the premiums buying? The answer, of course, is that they are purchasing an economic benefit for the owner of the policy. The parallel between the life insurance policy and the death benefit would be precise if the employee retained the right to alter the beneficiary. The mere power, if it exists, to renegotiate the death benefit, and the dependence of the benefit on the continuing performance of services by the employee, justify analogous treatment. The retained control amounts, in effect, to a retention of the economic benefits.

Thus, if one views the pure death benefit as a continuous series of gifts, the rights transferred to the beneficiary are like the rights of a beneficiary named in a policy owned by another under which the beneficiary could be changed at any time. The value of such rights, although probably greater than zero, is difficult to ascertain, and certainly less than the value of commercial term insurance. Gift taxation, therefore, does not provide a satisfactory alternative to taxation of the full amount of the benefit under the estate tax. Apart from statutory change, however, if the courts reject the Service's completed gift at death monthly premium, the beneficiary receives at least one month's coverage, whether or not the employer decides to make premium payments in the future.

If the employer could cancel the policy at any time during the month, even after the month's premiums were paid, the beneficiary's rights would be far more fragile, and would raise the same valuation problem as the employee death benefit. In some states, however, group-term policies must also provide a limited right to convert the policy into an individual policy if the employer terminates the group policy. Generally, such a conversion right applies only to employees who have been covered for five or more years and the right is limited to the lesser of the decrease in group-term insurance coverage, taking into account new policies purchased by the employer, or $2,000. See, e.g., N.Y. INS. LAW § 181(e) (McKinney 1980 Supp.); PA. STAT. ANN. tit. 40, § 532.6 (Purdon 1971). To the extent the conversion right exists, the approach of Revenue Ruling 76-490 is appropriate since the premium payments are in effect maintaining a right to continue the policy which is possessed by the beneficiary.

\textsuperscript{207} See text accompanying note 88 \textit{supra}.
the continuous gift theory may be the only means available to subject the pure death benefit to wealth transfer taxation. In such event, the Service should consider issuing a table setting forth a presumed monthly value for each $1,000 of pure death benefit.

If the Service adopts the continuous gift theory, the availability of the $10,000 annual per donee gift exclusion will be crucial. In order to qualify for the annual exclusion, the death benefit must not constitute a "future interest." According to the Service, a future interest does not include "such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future." Even term life insurance, which provides no current benefits such as a cash surrender value, is viewed as a present interest. A pure death benefit bears some resemblance to term life insurance and certainly qualifies as a contract right.

Nevertheless, the Service has taken the position that the election by an employee to take a reduced annuity in return for a survivor annuity payable to a designated beneficiary is a gift of a future interest. Since the payments under a survivor annuity commence upon the death of the employee, from the beneficiary's viewpoint, it is similar to a life insurance policy. The beneficiary of a survivor annuity, however, differs from the owner of a life insurance policy in one important respect. If the beneficiary dies before the employee, the right to a survivor annuity disappears, but a life insurance policy remains and becomes a part of the beneficiary's estate. In this respect a pure death benefit which is payable to the beneficiary's estate if the

208. See notes 216-24 infra and accompanying text.
209. Effective for transfers made after December 31, 1981, section 2503(b) provides an annual exclusion from the gift tax of $10,000 per donee for gifts of present interests. I.R.C. § 2503(b), as amended by, 1981 Act, Pub. L. No. 97-34, § 441(a), 95 Stat. 172. Prior to the 1981 Act, the exclusion was only $3,000.
210. I.R.C. § 2503(b). A future interest is one which is "limited to commence in use, possession, or enjoyment at some future date or time." Treas. Reg. § 25.2503-3(a) (1958). Congress disqualified future interests from the $10,000 annual exclusion because of the difficulty of valuing such interests and determining the identity of the ultimate donees. S. REP. No. 665, 72d Cong., 1st Sess. 41 (1932), reprinted in 1939-1, pt. 2, C.B. 496, 526. The fact that a donee may have vested rights, see Fondren v. Commissioner, 324 U.S. 18, 20 (1945), in the property or even an interest which can be sold, see Schuhmacher v. Commissioner, 8 T.C. 453, 462-64 (1947), acq. 1947-1 C.B. 4, Howze v. Commissioner, 2 T.C. 1254, 1256-57 (1943), is not sufficient to create a present interest.
beneficiary dies before the employee, more closely resembles the life insurance policy than the survivor annuity. Such a benefit may well qualify as a present interest. Many death benefit plans, however, provide for contingent beneficiaries if the primary beneficiary is deceased, or eliminate the benefit payment entirely if all the named beneficiaries are deceased. Since under such an arrangement every beneficiary's right to the death benefit is contingent on surviving the employee, it would seem that no donee of such a death benefit has a present interest. Contingent beneficiaries may therefore present an obstacle to qualifying the transfer of the death benefit as a present interest for purposes of obtaining the annual exclusion.

C. COMPLETED GIFT AT DEATH

The practical difficulties of prospective or periodic valuation lead to the consideration of a third approach to the gift taxation of pure death benefits—treat the gift as incomplete until it becomes susceptible of valuation. Thus, the pure death benefit would become a completed gift at the instant the employee dies. Since the estate and gift taxes are now unified, on the surface this approach seems to have the same tax effect as including the benefit in the gross estate. Perhaps for this reason, the Service recently adopted this theory in Revenue Ruling 81-31.

The death benefit involved in Revenue Ruling 81-31 was paradigmatic of the type of plan held immune from estate taxa-
tion. An employee, D, entered into an employment contract with D's employer corporation. In consideration of future services to be rendered by D, the corporation agreed to pay a death benefit to D's surviving spouse if D were employed by the corporation at D's death. The death benefit was to be equal to twice D's annual salary at the date of D's death. D had no right to change the beneficiary, nor was any amount payable to D's estate in the event D's spouse predeceased D. The benefit was not funded in any manner and was created more than three years before D's death. The Service concluded that D made a transfer to D's surviving spouse that became a completed gift for gift tax purposes in the calendar quarter in which D died, "at which time the amount of the gift first became susceptible of valuation." 217

Although this approach represents a reasonable response to the failure of the courts to subject the pure death benefit to estate taxation, it finds little support in the case law and improperly merges the two quite different concepts of valuation and completion. Language in some cases certainly suggests that the timing of the taxability of a gift may depend on when its value becomes ascertainable, 218 but these assertions are dicta because the courts concluded that valuation was possible. 219 Another court has stated forthrightly that the fact that the value of a transferred interest is "speculative, uncertain and contingent upon future developments" is "immaterial" to the timing issue. 220 Although the Supreme Court has never dealt directly with the issue, it seems to have assumed that the difficulty of valuing a remote property interest does not preclude its taxation as a gift. 221

Notwithstanding this authority, the Service supported its


218. See, e.g., Rosenthal v. Commissioner, 205 F.2d 505, 509 (2d Cir. 1953); Harris v. Commissioner, 178 F.2d 861, 865 (2d Cir. 1949), rev'd on other grounds, 340 U.S. 106 (1950).

219. Rosenthal v. Commissioner, 205 F.2d at 509; Harris v. Commissioner, 178 F.2d at 865.

220. Galt v. Commissioner, 216 F.2d 41, 50 (7th Cir. 1954).

221. See Smith v. Shaughnessy, 318 U.S. 176, 180 (1943):

[T]he taxpayer contends that no realistic value can be placed on the contingent remainder and that it therefore should not be classed as a gift. . . . We cannot accept any suggestion that the complexity of a property interest created by a trust can serve to defeat a tax. . . . The language of the gift tax statute . . . is broad enough to include property, however conceptual or contingent.
conclusion in Revenue Ruling 81-31 by analogizing the pure
death benefit to the property arrangement involved in an ear-
lier ruling, Revenue Ruling 69-346. That ruling involved an
enforceable agreement between a husband and wife that stipu-
lated that if he made provisions for her comfort in a trust to be
created under his will, she would transfer her one-half interest
in their community property to the trust after his death. The
ruling concluded that at the time of the agreement it was not
determinable whether the wife had made a gift and, if so, of
what value. Applying the open valuation theory, the Service
concluded that the wife had not made a taxable gift until her
husband's death, because the gift could not be valued before
that event.

The Service correctly observed that both the pure death
benefit in Revenue Ruling 81-31 and the wife's promise in Reve-
nue Ruling 69-346 had no readily ascertainable value when they
first became enforceable. There was, however, no need to
reach the valuation issue, because in both situations the donor
retained sufficient dominion and control to render the transfer
incomplete for gift tax purposes. The wife could determine the
extent of her community property by manipulating her invest-
ments and expenditures. Similarly, the employee in the pure
death benefit case could destroy the beneficiary's interest by
terminating his or her employment or by agreeing with the em-
ployer to terminate the benefit.

The crucial distinction the Service missed between the
facts of Revenue Ruling 69-346 and the pure death benefit is
that in the former the donor is still alive when the gift becomes
complete. Although a completed lifetime transfer of a property
interest certainly comes within the scope of the gift tax, a
transfer which becomes complete by reason of the death of the
donor seems beyond its reach. The gift tax regulations, more-
over, concede this point. Section 25.2511-2(f) of the regula-
tions regards "[t]he relinquishment or termination of a power
to change the beneficiaries of transferred property, occurring
otherwise than by the death of the donor (the statute being con-
fined to transfers by living donors), . . . as the event that com-
pletes the gift and causes the tax to apply." The Service, in
Revenue Ruling 81-31, has created a highly artificial distinction

223. Id.
224. Id.
226. Id. (emphasis added).
between two forms of incomplete gifts. In the Service's view, a gift that becomes complete at the donor's death, because the donor's retained powers have terminated, is not subject to the gift tax, but a gift that becomes complete at the donor's death, because it can then for the first time be valued, is taxable. Nothing in the gift tax statute supports such a distinction.  

Whether the open valuation concept in general is an appropriate part of the gift tax law is a complex issue well beyond the scope of this Article. The question of its applicability to the pure death benefit would be irrelevant were such benefits subject to the estate tax. But because current judicial thinking incorrectly places such benefits beyond the reach of the estate tax, Revenue Ruling 81-31 represents an expedient solution to a striking deficiency in the current tax system. If upheld by the courts, it would largely eliminate a significant loophole that now allows taxpayers to transfer substantial amounts of wealth free of any estate or gift tax.

Revenue Ruling 81-31 does not, however, produce transfer tax consequences identical to those obtained by the inclusion of the benefit in the deceased employee's gross estate. For example, the Service conceded that such gifts represent transfers of a present interest, and thus qualify for the $10,000 annual exclusion. Therefore, unlike the result under the estate tax, if the first $10,000 of every death benefit is characterized as a gift, it will escape transfer taxation.

Subjecting the pure death benefit to gift taxation, rather than estate taxation, will affect the operation of numerous statutory provisions which depend on a determination of a decedent's gross or taxable estate. For example, under section 6166 an executor may elect to defer for up to five years the payment of the estate tax attributable to a closely held business, and thereafter pay the tax in up to ten annual install-

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227. Under I.R.C. § 2501(a)(1), the gift tax is imposed "on the transfer of property by gift."
228. For a particularly thoughtful and lucid discussion of the open valuation problem, see Macris, Open Valuation and the Completed Transfer: A Problem Area in Federal Gift Taxation, 34 Tax L. Rev. 273 (1979).
229. See notes 19-22 supra and accompanying text.
231. These include, among others, I.R.C. § 303 (distribution in redemption of stock to pay death taxes), I.R.C. § 2032A (special valuation of qualified real property), § 6166 (extension of time for payment of estate tax where estate consists largely of an interest in a closely held business), and § 6501(e)(2) (statute of limitations on assessment of estate tax).
ments. To qualify for this deferral, the value of the closely held business must exceed thirty-five percent of the adjusted gross estate. By treating the death benefit as a gift, the gross estate is reduced, and the estate more easily qualifies for the special benefit of section 6166.

In addition, gift taxation under Revenue Ruling 81-31 creates a number of administrative irritations for the executor, who in some situations must prepare and file a timely gift tax return and pay the gift tax on a date much earlier than the due date for the estate tax. The source of funds used for payment of the tax may also depend on whether the tax is a gift or an estate tax. Many states have adopted apportionment statutes that, in the absence of a contrary manifestation of intent, require payment of the death taxes out of the various assets in proportion to the death taxes generated by such assets. Because these statutes probably do not apply to gift taxes, the residuary beneficiary might bear a disproportionate share of the transfer taxes in relation to the recipient of the pure death benefit.

Revenue Ruling 81-31 may also produce unwarranted income tax effects. Whether the death benefit is treated as a taxable gift or included in the gross estate, for income tax purposes the first $5,000 is tax free under section 101(b) and the remainder is includable in the gross income of the beneficiary as income in respect of a decedent (IRD) within the meaning of section 691(a). Although the recipient of IRD is generally entitled to an income tax deduction for the amount of the estate tax attributable to the IRD, if the death benefit is treated as a gift, it is not included in the gross estate and the IRD deduction is lost. If the death benefit is large enough to

233. Id.
235. See, e.g., CAL. PROB. CODE § 970 (Deering 1974).
236. I.R.C. § 101(b).
238. I.R.C. § 691(c).
239. For example, assume the employee dies in 1982 with a $200,000 death benefit payable to a child and a taxable estate of $1,000,000. Under Rev. Rul. 81-31, 1981-4 I.R.B. 30, the death benefit would produce a taxable gift of $190,000, after allowance for the annual exclusion. See I.R.C. § 2503(b). Assuming the deceased employee had made no prior taxable gifts, no gift tax would be paya-
actually generate the payment of gift taxes, the gift taxes would in effect be deductible by the beneficiary for income tax purposes since the death benefit would have a basis in the hands of the beneficiary equal to the gift taxes paid.\textsuperscript{2}\textsuperscript{4}\textsuperscript{0} This deduction, however, will generally be less than the IRD deduction that would be available if the death benefit were included in the gross estate. No tax policy justifies such difference in treatment; the double taxation problem underlying the enactment of the IRD deduction\textsuperscript{2}\textsuperscript{4}\textsuperscript{1} is present whether the benefit is taxed as a gift or as a part of the gross estate.

In summary, Revenue Ruling 81-31 is not the proper solution to the pure death benefit problem. It is an inappropriate application of the gift tax to a transfer that, because of its inherently testamentary nature, is more naturally the object of the estate tax.

\section*{IV. STATUTORY REFORM}

The pure death benefit is undoubtedly a proper subject of wealth transfer taxation. The payment to the beneficiary is wealth generated by the decedent’s labor, which in principle is no different than the wealth created by the decedent’s wages in the form of savings and investments. Although there is no direct cash purchase, the benefit is furnished in exchange for the services of the employee. Whether the employee can select or alter the beneficiaries of the death benefit is not relevant to the issue of whether the employee has made a transfer; the benefit is part of the employee’s compensation package, and since it derives solely from the services of the employee, it is appropria-
ate to treat the employee as the transferor.\textsuperscript{242}

Having concluded that there is a transfer, one must determine the appropriate time to tax it. If a beneficiary's enjoyment of the property remains subject to the control of the transferor, the property should be taxed upon death as part of the estate since the transfer is inherently testamentary. Even if an employee had no express control over the death benefit, the beneficiaries do not receive anything of substantial value prior to the employee's death that would warrant the imposition of only a gift tax. Although the pure death benefit with an irrevocably named beneficiary is theoretically subject to the gift tax, either at its creation or continuously over its existence, gift tax valuation alone is an inadequate measure of the value of the transfer. Not only is the valuation problem extremely difficult, but the employee's ability to terminate the benefit by ceasing employment represents an inherent control over the benefit that justifies the treatment of any transfer as incomplete until death.

This Article has suggested that the courts could properly interpret section 2038 to include the pure death benefit in a deceased employee's gross estate.\textsuperscript{243} Their failure to do so emphasizes the need for statutory reform. The simplest solution would be the amendment of section 2039(a) to remove the retained interest requirement.\textsuperscript{244} Although such an amendment would include any contractual pure death benefit in the employee's gross estate, the includability of unenforceable benefits—benefits which remain discretionary with the employer even after the death of the employee—would remain unresolved. Although the regulations to section 2039(a) indicate that such discretionary plans may be includable in the gross estate,\textsuperscript{245} the courts have divided over this issue.\textsuperscript{246} In amend-

\begin{footnotes}

\textsuperscript{242} See notes 89-92 supra and accompany text.
\textsuperscript{243} See notes 168-80 supra and accompanying text.
\textsuperscript{244} Substantially similar proposals have frequently been made. See ALL, FEDERAL ESTATE AND GIFT TAXATION, RECOMMENDATIONS AND REPORTER'S STUDIES 44, 46 (1969); G. COOPER, A VOLUNTARY TAX? 97 (1979); Dodge, Substantial Ownership and Substance Versus Form: Proposals for the Unification of Federal Estate and Gift Taxes and for the Taxation of Generation-Skipping Transfers, 1976 U. ILL. L. F. 657, 701-02; Kramer, supra note 3, at 389.
\textsuperscript{245} In order to reach a death benefit under section 2039, the benefit must be receivable under "any form of contract or agreement." Treas. Reg. § 20.2039-1(b)(1) (1958). The Regulations interpret this term to include "any arrangement, understanding, or plan," id., and provide an example that holds that a consistent practice by the employer of paying benefits is sufficient. Treas. Reg. § 20.2039-1(b)(2), ex. 4 (1958).
\textsuperscript{246} Compare Estate of Barr v. Commissioner, 40 T.C. 227, 237 (1963), acq. in
ing section 2039(a), therefore, Congress should specify that the discretionary nature of the death benefit does not preclude its inclusion in the employee's gross estate.\textsuperscript{247}

The inclusion of unenforceable benefits in the gross estate, however, raises a potentially serious valuation problem. An enforceable promise by an employer to pay $1,000 per month for three years is certainly worth something more than a similar

\textit{result only}, 1978-1 C.B. 1 (not includable) \textit{with} Neely v. United States, 613 F.2d 802, 808 (Ct. Cl. 1980) (includeable). In \textit{Barr}, the Tax Court stated that Congress intended that the requirement of a "contract or agreement" meant an enforceable arrangement; the mere consistency of payment was insufficient. 40 T.C. at 235-36. \textit{Neely}, however, refused to limit section 2039(a) to enforceable agreements. 613 F.2d at 808. \textit{Neely} justifiably criticized the statements of the \textit{Barr} court as mere dictum, since the employer involved in fact had not always paid death benefits. \textit{id.} at 807 n.13.

\textit{Barr} and \textit{Neely} involved two common, but dramatically different, factual situations. In \textit{Barr}, the decedent was employed by a publicly held corporation in which he had no significant interest. The lack of enforceability of the death benefit was largely irrelevant because the economic self-interest of the employer would compel the payment, barring unusual circumstances. In \textit{Neely}, the decedent owned 51 percent of the stock of the employer, his wife owned 20 percent, and the remainder was owned by their two daughters and their spouses. The death benefit was payable to the wife. As the court in \textit{Neely} put it, "any requirement of enforceability here would be an empty formality." 613 F.2d at 807. Given the control by the beneficiary and her familial relationship to the other shareholders, the possibility that the benefit would not be paid, other than through a voluntary renunciation, was remote.

It might be argued that the death benefit in \textit{Neely} was not a transfer by the decedent, but instead was an indirect transfer by the other family members to the widow. Long-standing Treasury regulations provide that a transfer by a corporation of money or assets to a stockholder in exchange for less than adequate and full consideration is a gift from the other stockholders to the extent the transfer exceeds the donee's own interest in such transfer. Treas. Reg. § 25.2511-1(h)(1) (1958). But it is also well established that a "transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)" does not constitute a gift. Commissioner v. Wemyss, 324 U.S. 303, 306 (1945); \textit{see} Treas. Reg. § 25.2512-8 (1958). Thus, although the death benefit is unenforceable, if it would be a reasonable business practice to pay it, the payment will be considered to be made for adequate and full consideration. A significant issue might still be whether the payment would have been made absent the family relationship. If the death benefit was just another component of the fringe benefit package provided to the employee by the employer, and the package was appropriate, given the nature of the business and the employee's position in the company, the payment to the beneficiary will probably not be treated as a gift. Under the facts in \textit{Barr}, the payment of the death benefit would certainly not be considered to be a gift by the thousands of shareholders of the employer.

\textit{247}. An employer who sets up a technically discretionary plan will likely adhere to its terms. An employer simply cannot afford to disrupt the expectations of the highly compensated executives who are the typical recipients of pure death benefit plans. \textit{See} notes 48-51 \textit{supra} and accompanying text. Given the sophistication of such employees and the care with which their benefit packages are fashioned, one suspects that in many instances the benefit has been made discretionary precisely to avoid federal estate taxation.
unenforceable promise. Nonetheless, if the employer has consistently paid the benefits, the value of the possible future payment is clearly greater than zero, since a willing buyer would pay something to a willing seller for the right to receive any payments which are actually made. A reasonable approach toward the valuation of such benefits would be to compute the value of the benefit assuming it were enforceable, then discount that amount by the probability of nonpayment. The contingent nature of an unenforceable employee death benefit is not a justification for excluding it from the reach of the estate tax, since the need to value contingent interests is an unfortunate but frequent feature of the present estate tax system.

As a corollary to subjecting the pure death benefit to estate taxation, Congress should treat the irrevocable designation of a beneficiary and the continued existence of the pure death benefit as an incomplete gift for gift tax purposes. Although the beneficiary has received a current economic benefit of non-zero value, its precise value is indeterminate, and as a practical matter the beneficiary could not sell the right to the benefit. The benefit is also not a direct substitute for an expense the beneficiary would otherwise reasonably have incurred, such as conventional insurance coverage, since the benefit is terminable if

248. See, e.g., Estate of Salt v. Commissioner, 17 T.C. 92, 97 (1951) (death benefits paid to all qualified beneficiaries for fifteen year period according to the plan).

249. The accepted definition of "value" for estate tax purposes is the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b) (1958).

250. In some cases, the death benefit will be paid before the estate tax is due. For example, in Estate of Salt v. Commissioner, 17 T.C. 92 (1951), the payments under one of the plans involved were completed within two months of the employee's death. Id. at 97. The amount of the payment is not determinative of the valuation question; the courts have consistently held that contingent claims are to be valued at the applicable valuation date, without regard to what is ultimately received. See, e.g., Duffield v. United States, 136 F. Supp. 944, 947 (E.D. Pa. 1955); Mullkin v. Magruder, 55 F. Supp. 895, 903 (D. Md. 1944), aff'd on other grounds, 149 F.2d 593 (4th Cir. 1945); Estate of Curry v. Commissioner, 74 T.C. 540, 551 (1980). Cf. American Nat'l Bank & Trust Co. v. United States, 594 F.2d 1141 (7th Cir. 1979) (value of contested life insurance claim is the value of the claim at the date of death, and not the amount of the claim ultimately recovered).

251. This particular problem would be eliminated under an accessions tax system. See generally Andrew, The Accession Tax Proposal, 22 Tax L. Rev. 589 (1967). In many ways, the accessions tax is more consistent with the equitable principles underlying both income and wealth transfer taxation. See Steuerle, Equity and the Taxation of Wealth Transfers, OTA Paper 39, U.S. Treas. Dep't, June 1980.

252. See note 131 supra and accompanying text.
the employee leaves employment or if the benefit is renegotiated.\textsuperscript{253} There is therefore little risk that estate taxation alone will undervalue the total effective wealth transfer.\textsuperscript{254}

This statutory scheme, however, results in a transfer tax treatment of pure death benefits diametrically opposite to the treatment of employer-provided life insurance. If the employee assigns the policy, the employer's premium payments are treated as gifts by the employee to the assignee,\textsuperscript{255} and the proceeds are not includable in the employee's gross estate.\textsuperscript{256} Such profound differences in treatment are difficult to justify, given the essential functional and economic similarities between the two benefits.\textsuperscript{257} Congress should therefore subject the assigned group term life insurance policy to estate taxation.\textsuperscript{258} This result could be achieved by amending Section 2042 to provide that any incidents of ownership held by an employer in a policy of life insurance\textsuperscript{259} on an employee will be attributed to the employee, unless the policy is payable to the em-

\textsuperscript{253}. See note 156 supra and accompanying text.

\textsuperscript{254}. To see the possibility of undervaluation, assume that the beneficiary is entitled to a $200,000 death benefit if the employee dies, and that the beneficiary is able to sell his or her rights to a speculator for $1,000 per year. If the employee works for ten years and then moves to another employer, the beneficiary has been enriched by $10,000. Yet nothing would be included in the deceased employee's gross estate since the benefit no longer existed.

\textsuperscript{255}. See note 199 supra and accompanying text.

\textsuperscript{256}. See notes 133-35 supra and accompanying text.

\textsuperscript{257}. See notes 109-10 supra and accompanying text. In support of the present treatment of life insurance, one could point to the ability of the assignee in most cases to continue the life insurance coverage, albeit in a different form, even if the employee terminates employment. Yet the fact remains that the employer controls the existence of the policy; it is a renegotiable part of the employee benefit package. So long as the insurance benefit remains linked to the decedent's compensation scheme, it is legitimate to view the transfer of the policy as incomplete for estate tax purposes.

\textsuperscript{258}. Apart from its theoretical propriety, subjecting the assigned group term life insurance policy to estate taxation would protect the transfer tax base from significant erosion due to the underreporting of the taxable gifts connected with the employer's premium payments. The practical difficulties of auditing the large number of relatively small periodic transfers are extreme, especially given the existence of the $10,000 annual exclusion, and there is undoubtedly significant leakage. Unless the annual premium payments exceeded $10,000, one cannot easily determine whether the decedent had any obligation to file a gift tax return. The Service would have to inquire into the existence of other gifts to the assignee, such as birthday presents, vacations, and the like, in order to ascertain whether the $10,000 limit had been exceeded.

\textsuperscript{259}. Although this Article has focused on group term insurance, the amendments should also apply to the more esoteric employer provided insurance vehicles, such as split-dollar insurance, retired lives reserve insurance, and group permanent insurance, which are also widely regarded as transfer tax avoidance devices.
ployer or is otherwise not intended to be compensation. In addition, a provision should be added to the gift tax statute that would exempt the premium payments from treatment as a transfer for gift tax purposes. As in the case of the employee death benefit, there is little risk of transfer tax avoidance.

V. CONCLUSION

The judicial treatment of the pure death benefit under the estate tax has been inadequate. Contrary to the decided cases, the typical pure death benefit is properly includable in a deceased employee's gross estate under quite reasonable interpretations of the Code and its underlying policy. Recognizing that the current law has created a significant loophole, the Service has recently attempted to circumvent these decisions by ruling that the pure death benefit is subject to the gift tax when the employee dies. The doctrinal support for this approach is weak, and the use of the gift tax in this manner is inappropriate. Whether the courts will sustain the Service's position is therefore quite uncertain. Some support exists for treating the pure death benefit as a continuous series of gifts analogous to the gift of premiums on group life insurance, but difficult questions arise regarding the appropriate valuation.

Since the Supreme Court has never ruled on the estate or gift taxation of pure death benefits, it may be possible to persuade the courts, along the lines advanced in this Article, that the estate tax does indeed reach the pure death benefit. If this is unsuccessful, section 2039 should be amended to eliminate the lifetime benefit requirement. This amendment would effectively include the pure death benefit in a deceased employee's gross estate.

260. This latter limitation would cover situations in which an employer takes out life insurance on a key employee and makes the employer's spouse the beneficiary. There is no compensatory purpose and it would be inappropriate to treat the payment of the proceeds as a testamentary transfer by the employee.

261. See note 254 supra and accompanying text.