EMPLOYEE BENEFITS AND FEDERAL ESTATE AND GIFT TAXES*

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INTRODUCTION

The taxation of employee benefits has long plagued the federal tax system. Prior to enactment of the 1954 Code, efforts to solve the problems caused by the nature of such benefits, so far as the estate and gift taxes were concerned, had been, in large part, unsuccessful. In the 1954 Code, Congress for the first time attempted to deal with these problems by enacting section 2039, which purports to provide a fair and equitable method of imposing an estate tax upon employee benefits. It is the thesis of this article that:

1. Section 2039 is a badly drafted provision which, by following too closely the traditional and technical concepts of property law as developed by the courts for section 2036 (a reserved life interest), fails to solve many of the difficulties encountered under the 1939 Code in taxing employee benefits.

2. The modifications made in the 1954 Code in other sections, notably (a) the elimination of the premium payment test in section 2042 for the taxation of insurance payable to beneficiaries other than the insured's estate, and (b) the return in section 2037 to the requirement that decedent have a reversionary interest before a transfer dependent upon survivorship is taxable, will lead to arbitrary, unfair, and harsh results so far as taxation of employee benefits is concerned.

3. The exemptions under sections 2039(c) and 2517 for all employee benefits under qualified plans, so far as they are noncontributory, is unwarranted and, taken together with the weaknesses of the 1954 Code pointed out in (1) and (2) above, probably will cause more employee benefits to escape taxation under the 1954 Code than escaped the 1939 Code, as well as result in unfair discrimination and tax traps for the unwary. Moreover, there is every indication that, as so often

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happens, Congress will find it impossible, both politically and logically, to refrain from granting the sweeping exemptions of sections 2039(c) and 2517 to more and more employee benefits.

These are harsh words. They call for exacting and scholarly proof to support their allegations. I believe there is such proof.

I

THE 1939 CODE

A. Types of Benefits

For the most part, we can concentrate upon the federal estate tax. Obviously, from the standpoint of the estate tax, we can limit our discussion to those benefits which (1) are payable to someone other than the employee, and (2) continue after, or are transferred or take effect at the death of the employee—in other words, death benefits, rather than purely inter vivos pension, profit-sharing, deferred compensation, and stock option plans of which the sole beneficiary is the employee during his life.

By and large, it is employee annuity plans, where the annuity is purchased by the employer or by contributions of the employer and employee for the employee and some other beneficiary, which form the background for section 2039.¹ To understand the ineptness of the language of section 2039, we must look at the problems encountered in taxing annuities under the 1939 Code.

We deal here only with commercial annuities—that is, those paid the annuitant as a result of a bona fide business transaction. An example is where the annuity was purchased from a commercial annuity company. We are not concerned with the headaches of the so called intrafamily

¹H.R. REP. NO. 1337, 83d Cong., 2d Sess. 90 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 123 (1954). See, on this problem in general, Meisenholder, *Taxation of Annuity Contracts Under Estate and Inheritance Taxes*, 39 MICH. L. REV. 856 (1941); Murphy, *The Survivorship Annuity: Estate Tax Kaleidoscope*, 1 HOW. L.J. 1 (1955); Bittker, *Estate and Gift Taxation Under the 1954 Code: The Principal Changes*, 29 TUL. L. REV. 453, 469-72 (1955); Note, 6 STAN. L. REV. 473 (1954); Note, *Estate Taxation of Employee Death Benefits*, 66 YALE L.J. 1217 (1957); Note, *Estate Taxation of Contract Rights Subject to Conditions Precedent*, 67 YALE L.J. 467 (1958); Note, 48 COLUM. L. REV. 393 (1948); Pincus, *Estate Taxation of Annuities and Other Payments*, 44 VA. L. REV. 857 (1958); Moses, *How Estate Tax Regulations Affect Estate Planning for Pension and Profit Sharing Interests*, 97 TRUSTS & ESTATES 616 (1958); Bilder, *Death Benefits Paid Under an Express Contract*, 34 TAXES 529 (1956); Winton, *Two Estate Planning Devices: Life Insurance Trusts; Employees Death Benefits*, 7 J. TAXATION 52 (1957).

annuities, where sons or daughters promise to pay fathers a lifetime income when the parents transfer property outright to their children.²

There are, roughly, three general types of commercial annuities. One is the straight life annuity in which the payments last only for the life of the beneficiary and cease completely at his death. If the beneficiary is the employee, obviously there can be no estate tax, since the value of the annuity ends at his death. If the beneficiary is the employee's wife, widow, or other relative or beneficiary and the payments are made by the employer or by reason of monies paid by the employer alone or by the employer and employee to a trust or commercial annuity company, estate tax problems will arise.

A second type is the refund or retirement annuity, where, if the beneficiary dies before a stipulated amount has been paid him, someone else designated by him usually will receive a stipulated amount, representing a refund with interest of the original consideration not yet repaid the annuitant. Retirement annuities are similar to refund ones. The annuity payments are deferred and do not begin until a date subsequent to the time of purchase—usually the time of retirement. If the primary beneficiary dies before retirement, all premiums paid are refunded with interest to someone designated by him. In both refund and retirement annuities, estate tax problems arise if the primary beneficiary is the employee and he dies before retirement or before receiving back the cost of the annuity.

A third type of annuity is the joint and last survivor, or survivorship or longer life. In the first, the annuity payments are made to two beneficiaries for their joint lives and then to the survivor for his life; in the second, to beneficiary *A* for his life, and at his death, to beneficiary *B*, if alive, for the life of the latter. If one of the joint annuitants, or *A*, is the employee, again estate tax questions are present if the employee dies before the other beneficiary.

B. Estate Taxation of Nonemployee Commercial Refund or Survivorship Annuities

Before taking up the treatment of these annuities when they form part of an employee benefit plan, it is necessary to have a brief glance at the treatment under the 1939 Code of commercial, nonemployee annuities.

Strangely enough, the Treasury and the courts, in spite of the absence of any specific provisions in the Code purporting to tax annuities,

² See LOWNDES & KRAMER, *FEDERAL ESTATE AND GIFT TAXES* 151, 869-72 (1956).

found little difficulty in imposing an estate tax on annuity death benefits if they did not involve employee benefit plans and were paid by commercial companies engaged regularly in the sale and payment of annuities.³ This was true regardless of the type of annuity involved.

If the payments or refunds after the prime annuitant's death were made to his estate, obviously they were included in his gross estate under section 811(a) as property he owned at his death.⁴ If he named a beneficiary to receive the refund or payments after death, but retained until death the power to change the beneficiary, section 811(d) could easily be applied to include the refund or payments in his gross estate.⁵ Section 811(f) might also apply here if the annuitant reserved power until death to appoint the postdeath payments to his creditors or his estate. Since only a general power was taxable under section 811(f) and since the definition of a general power included only those where the holder could appoint to himself, his creditors, his estate, or the creditors of his estate, obviously section 811(d) would reach almost all cases covered by section 811(f) (when the power was a reserved one, as it would be if the annuitant was the purchaser of the annuity), as well as many not covered by section 811(f) (when power was reserved to change the beneficiary only among a class excluding the annuitant's creditors or his estate). Section 811(f)⁶ might reach a case where the decedent reserved no rights to change the beneficiary, but had the right to assign the benefits for value (and thus appoint them to himself or his creditors)—a right perhaps not covered by section 811(d).

Annuities were not taxable under section 811(g), because the Supreme Court held that only insurance was taxable under this section

³ See note 1 *supra*.

⁴ *Cf.* Equitable Trust Co. of N.Y., 31 B.T.A. 329 (1934), *rev'd on other grounds*, 82 F.2d 157 (2d Cir.), *cert. denied*, 299 U.S. 552 (1936); Millard v. Maloney, 121 F.2d 257 (3d Cir.), *cert. denied*, 314 U.S. 636 (1941); Theodore F. MacManus, 8 T.C. 330 (1947), *aff'd*, 172 F.2d 697 (6th Cir.), *cert. denied*, 337 U.S. 938 (1949); Wishard v. United States, 143 F.2d 704 (7th Cir. 1944); Kernochan v. United States, 29 F. Supp. 860 (Ct. Cl. 1939), *cert. denied*, 309 U.S. 675 (1940); Arthur W. Davis, P-H TCM ¶ 52,238; Leonard B. McKitterick, 42 B.T.A. 130 (1940); Stuart Wilson, 42 B.T.A. 1196 (1940).

⁵ *Cf.* Guaranty Trust Co. of New York, 16 B.T.A. 314 (1929); Adeline F. Davis, 27 T.C. 378 (1956); Old Colony Trust Co. v. Commissioner, 102 F.2d 380 (1st Cir. 1939); Commissioner v. Erickson, 74 F.2d 327 (1st Cir. 1934); Stuart Wilson, 42 B.T.A. 1196 (1940). *But cf.* Harriot R. Schultz, 38 B.T.A. 59 (1938).

⁶ *Cf.* G.C.M. 27242, 1952-1 CUM. BULL. 160; Eugene F. Saxton, 12 T.C. 569, 574 (1949); Charles B. Wolf, 29 T.C. 441 (1957); Adeline F. Davis, 27 T.C. 378 (1956). *But cf.* Harriot R. Schultz, 38 B.T.A. 59 (1938).

and that it was essential for there to be a risk-shifting or risk-distribution element in order to have insurance—elements absent from an ordinary annuity contract.⁷

The most difficult question arose when the primary annuitant, during his life, irrevocably designated a beneficiary for the refund or survivor or joint annuity. If the designation were made in contemplation of death and within three years of the annuitant's death, the value of the refund or survivor annuity would seem to be taxable under section 811(c)(1)(A),⁸ if the requirement for such treatment is a testamentary motive only, and not a consciousness of nearing death.⁹ Oddly enough, although such designation seems at least as much in contemplation of death as the designation of an insurance beneficiary¹⁰ (for the survivor-annuitant can get little, often not even cash surrender or loan values, before the primary annuitant's death), there are very few cases imposing a tax under this section. If the annuity were purchased not by a lump sum payment, but rather by a series of annual premium payments, the question would arise as to how much, if any, of the refund or survivorship annuity would be included if the irrevocable

⁷ *Helvering v. Le Gierse*, 312 U.S. 531 (1941); *Tyler v. Helvering*, 312 U.S. 657 (1941); *Keller v. Commissioner*, 312 U.S. 543 (1941); *Goldstone v. United States*, 325 U.S. 687 (1945); *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958); *Knight v. Finnegan*, 74 F. Supp. 900 (E.D. Mo. 1947); *W. J. O'Shea*, 47 B.T.A. 646 (1942); *Stuart Wilson*, 42 B.T.A. 1196 (1940); *Kernochan v. United States*, 29 F. Supp. 860 (Ct. Cl. 1939), *cert. denied*, 309 U.S. 675 (1940). *But cf.* *Commissioner v. Treganowan*, 183 F.2d 288 (2d Cir.), *cert. denied*, 340 U.S. 853 (1950); *W. E. Edmonds*, 16 T.C. 110 (1951); *B. L. Snyder*, P-H TCM ¶ 45,320. A survivorship annuity is clearly not insurance—there is no shifting of the risk of the primary annuitant's premature death to others. It is designed to return the premiums paid, with interest, to the annuitants during the duration of their joint lives; but if both die prematurely, then unlike life insurance, the amount paid the beneficiaries will be less than the premiums paid, and the unreturned portion is kept by the company itself for the benefit of other annuitants. Annuities reward long-lived persons; true insurance rewards those who die prematurely.

⁸ *Cf.* *Updike v. Commissioner*, 88 F.2d 807 (8th Cir.), *cert. denied*, 301 U.S. 708 (1937); *United States v. Tonkin*, 150 F.2d 531 (3d Cir.), *cert. denied*, 326 U.S. 771 (1945); *C. B. Schwartz*, 9 T.C. 229 (1947). *But cf.* *Hariot R. Schultz*, 38 B.T.A. 59 (1938).

⁹ See LOWNDES & KRAMER, *op. cit. supra* note 2, at 67-71.

¹⁰ *Cf.* *Davidson v. Commissioner*, 158 F.2d 239 (10th Cir. 1946); *Diamond v. Commissioner*, 159 F.2d 672 (2d Cir. 1947); *Slifka v. Johnson*, 161 F.2d 467 (2d Cir.), *cert. denied*, 332 U.S. 758 (1947); *Vanderlip v. Commissioner*, 155 F.2d 152 (2d Cir.), *cert. denied*, 329 U.S. 728 (1946); *Sloan v. Commissioner*, 168 F.2d 470 (2d Cir. 1948); *Garrett v. Commissioner*, 180 F.2d 955 (2d Cir. 1950). *But cf.* *Cronin v. Commissioner*, 164 F.2d 561 (6th Cir. 1947); *Flick v. Commissioner*, 166 F.2d 733 (5th Cir. 1948); *Aaron v. Commissioner*, 224 F.2d 314 (3d Cir. 1955).

designation were made more than three years before death, but the primary annuitant paid premiums within three years of his death. Would only that portion of the postdeath payments representing the payments within three years of death be included? How would that portion be determined—by the exact amount of annuity premiums paid during the three-year period, or by a portion of the value of the annuity equal to that proportion of the premiums attributable to payments within the three-year period? Or the total value of the annuity, on the theory no annuity would have been paid if no payments had been made in the final three years? Or by the difference between the annuity payable at the end of three years and either that payable at the start of the three-year period or the cash surrender value then? The analogy to life insurance at once comes to mind,¹¹ but the question is unsettled in the case of life insurance, and also the analogy is not a complete one—the survivor-annuitant often has no power to obtain cash surrender or loan values.

The courts, in fact, did include in a decedent's gross estate the value at his death of the refund or survivorship annuity, even when he had made an irrevocable transfer during his life of his postdeath benefits by designation of a beneficiary other than his estate. The courts were uncertain on two points: (1) which section of the 1939 Code sustained a tax in these cases; and (2) how the survivor benefits were to be valued.

One theory was that section 811(c)(1)(B) applied because the annuitant had retained a life interest. Actually, of course, he had not, strictly speaking, done anything of the kind. He had either purchased two annuities, one for himself and one (deferred) for the survivor starting at his death, or had purchased one annuity with a certain sum guaranteed payable, the unpaid amount of which at his death was refunded to the beneficiary. He did not buy one annuity which he enjoyed during his life and which went to the survivor at the buyer's death. Yet the courts, with little trouble, applied the technical property concepts of section 811(c)(1)(B) here to impose a tax.¹²

¹¹ Cf. *Liebmann v. Hassett*, 50 F. Supp. 537 (D. Mass. 1943), *aff'd on this issue*, 148 F.2d 247 (1st Cir. 1945) (part of insurance proceeds proportionate to those premiums not paid in contemplation of death is to be excluded).

¹² *Forster v. Sauber*, 249 F.2d 379 (7th Cir. 1957); *Commissioner v. Clise*, 122 F.2d 998 (9th Cir. 1941), *cert. denied*, 315 U.S. 821 (1942); *Commissioner v. Wilder*, 118 F.2d 281 (5th Cir.), *cert. denied*, 314 U.S. 634 (1941); *Mearkle v. Commissioner*, 129 F.2d 386 (3d Cir. 1942); Rev. Rul. 302, 1955-1 CUM. BULL. 446; Rev. Rul. 682, 1955-2 CUM. BULL. 601; *Grant v. Smyth*, 123 F. Supp. 771 (N.D. Cal. 1954), *aff'd per curiam*, 226 F.2d 407 (9th Cir. 1955). Cf. *William L. Nevin*,

As an alternative, the tax¹³ might be imposed under section 811(c)(1)(C), and (c)(2) or (c)(3). Until the Technical Changes Act of 1949, this theory, again, did considerable violence to the language of the statute, as construed by the Court. So long as a reversionary interest in the grantor was required to tax a transfer taking effect at his death,¹⁴ it was a pure fiction to find any reversion in the primary annuitant. His interest does not alter in the least, whether he outlived or predeceased the survivor annuitant. His interest did not in any way return to him if he outlived the other beneficiary. However, when the 1949 Technical Changes Act¹⁵ eliminated the requirement of any reversionary interest in the grantor if his death and the transfer occurred after October 7, 1949, and imposed a tax if the beneficiary could obtain enjoyment of his interest only by surviving the grantor, there was a firm basis under section 811(c)(3) for taxing survivorship and refund annuities if the beneficiary was irrevocably designated after October 7, 1949.

As to valuation for a survivorship annuity, at least three theories were suggested: (1) the cost of purchasing a single premium life annuity at the death of the primary annuitant for the survivor, based upon the age of the survivor at the former's death;¹⁶ (2) the value of the survivor's annuity, calculated actuarially upon the basis of the survivor's age at the death of the primary annuitant, using the Treasury's factors and life expectancy tables;¹⁷ and (3) the difference at the date of death between the cost of a joint and survivor annuity at the primary annui-

11 T.C. 59 (1948); *United States Trust Co. v. Higgins*, 56 F. Supp. 997 (S.D.N.Y. 1942); *J. M. Goetchius*, 17 T.C. 495 (1951); *Judson C. Welliver*, 8 T.C. 165 (1947); *Stewart v. United States*, 116 F. Supp. 752 (D. Minn. 1953). *But cf. Pruyn v. Commissioner*, 184 F.2d 971 (2d Cir. 1950); *W. F. Hofford*, 4 T.C. 542, 790 (1945).

¹³ See the cases in note 12 *supra*, and also *M. H. Hughes*, 44 B.T.A. 1196 (1941), *overruled in Edward E. Bradley*, 1 T.C. 518 (1943), *aff'd*, 140 F.2d 87 (2d Cir. 1944); *Rev. Rul. 158, 1953-2 CUM. BULL. 259. But cf. Pruyn v. Commissioner*, 184 F.2d 971 (2d Cir. 1950).

¹⁴ *Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929); *Helvering v. Hallock*, 309 U.S. 106 (1940).

¹⁵ 63 Stat. 894 (1949).

¹⁶ *Rev. Rul. 302, 1955-1 CUM. BULL. 446; Mearkle v. Commissioner*, 120 F.2d 386, 388 (3d Cir. 1942); *Christiernin v. Manning*, 138 F. Supp. 923 (D.N.J. 1956); *John L. Walker*, 8 T.C. 1107 (1947); *Judson C. Welliver*, 8 T.C. 165, 172 (1947). *Cf. Goodman v. Granger*, 243 F.2d 264 (3d Cir.), *cert. denied*, 355 U.S. 835 (1957).

¹⁷ *Grant v. Smyth*, 123 F. Supp. 771 (N.D. Cal. 1954), *aff'd per curiam*, 226 F.2d 407 (9th Cir. 1955); *Goodman v. Granger*, 243 F.2d 264 (3d Cir.), *cert. denied*, 355 U.S. 835 (1957).

tant's death (based on the ages of the two beneficiaries at that time) and the cost at his death of a single life annuity with no survivorship feature for the deceased, based on his age at his death.¹⁸

C. Estate Taxation of Employee Survivorship or Refund Annuities

Oddly enough, without acknowledging any inconsistency, the courts, in part led astray by some premature decisions and questionable policies of the Treasury, often excluded from the gross estate the identical annuities under employee benefit plans which they included if *non-employee* benefits were involved. There were at last three reasons for this quite different attitude.

1. *The Expectancy Argument*

First of all, the courts argued that the employee had only an expectancy at most and lacked the kind of property interest which had to be the subject of a transfer under section 811(c) and (d) in order to be included in the gross estate.¹⁹ For one thing, the employee himself could often end all his rights and those of the beneficiary simply by quitting his job or terminating his employment or getting himself fired for misconduct. This argument is obviously weak (except when a gift tax is in question)—after all, a decedent frequently has it in his power

¹⁸ Cf. Frederick J. Twogood, 15 T.C. 989, 992 (1950), *aff'd*, 194 F.2d 627 (2d Cir. 1952); William J. Higgs, 12 T.C. 280, 283 (1949); *rev'd on other grounds*, 184 F.2d 427, 428 n. 1 (3d Cir. 1950).

¹⁹ Dimock v. Corwin, 19 F. Supp. 56 (E.D.N.Y. 1937), *aff'd on other grounds*, 99 F.2d 799 (2d Cir. 1938), 306 U.S. 363 (1939); Libbey v. United States, 147 F. Supp. 383 (N.D. Cal. 1956); Molter v. United States, 146 F. Supp. 497 (E.D.N.Y. 1956); Hanner v. Glenn, 111 F. Supp. 52 (W.D. Ky. 1953), *aff'd per curiam*, 212 F.2d 483 (6th Cir. 1954); Albert L. Salt, 17 T.C. 92 (1951); William S. Miller, 14 T.C. 657 (1950); Eugene F. Saxton, 12 T.C. 569 (1949); M. Hadden Howell, 15 T.C. 224 (1950); Emil L. Stake, 11 T.C. 817 (1948). Cf. John C. Morrow, 19 T.C. 1068 (1953); Frederick C. Kirchner, 46 B.T.A. 578 (1942); Illinois Merchants Trust Co., 12 B.T.A. 818 (1928). *But cf.* Goodman v. Granger, 243 F.2d 264 (3d Cir.), *cert. denied*, 355 U.S. 835 (1957); Adeline F. Davis, 27 T.C. 378 (1956); Rev. Rul. 260, 1953-2 CUM. BULL. 262; Rev. Rul. 158, 1955-2 CUM. BULL. 259; Rev. Rul. 438, 1955-2 CUM. BULL. 601; Albert B. King, 20 T.C. 930 (1953); and note 20 *infra*. The forfeiture should be regarded as a condition subsequent—the employee has vested rights, subject to divestment if a certain condition occurs before his death. Of course, if the condition occurs before death and destroys the death benefit, there should be no tax. Commissioner v. Rosser, 64 F.2d 631 (3d Cir. 1933); Davis v. United States, 27 F. Supp. 698 (S.D.N.Y. 1939). Death benefits of a purely voluntary nature—without even a forfeitable right—were not taxed. John C. Morrow, 19 T.C. 1068 (1953); Jack Messing, P-H TCM ¶ 48,150; United States Trust Co., 9 B.T.A. 514 (1927); Rev. Rul. 581, 1955-2 CUM. BULL. 381. *But cf.* Raphael A. Casilear, P-H TCM ¶ 45,328.

by inter vivos acts to eliminate property interests otherwise includible in his gross estate—he may invest all his assets in a nonrefundable annuity solely on his life, transfer all or part of them to charity, etc. The mere fact that the decedent had power to terminate the beneficiary's interest seems no reason for not including that interest in the decedent's gross estate if, in fact, it has not been terminated prior to his death.²⁰ More difficult was the fact that quite frequently the rights of the employee and the beneficiary were terminable by the employer—either under certain specified conditions²¹ or even at will. Originally, the Treasury, in a decision issued perhaps before the widespread growth of employee benefit plans was foreseen, ruled that such forfeitable benefits were not taxable because they were mere expectancies and not vested interests.²² When the Treasury later changed its position,²³ it found the courts often of a contrary opinion.²⁴

This attitude seems to ignore the hard, practical realities of the market place and modern employment conditions. Many employee benefit plans are the result of tough collective bargaining between employer and employees. Any unilateral revocation of benefits by employers, even if justified by the terms of the contract, absent a major economic catastrophe, would probably be fought tooth and nail by the unions and employees. Moreover, we are not dealing here with estates of the rank and file—even today, only a small fraction of executives are apt to leave taxable estates of more than \$60,000 (or \$120,000 if full advantage of the marital deduction is taken). Competition for this type of executive talent is keen; fringe-benefit plans are a key ingredient in most schemes of executive compensation. Any company which, even if within its legal rights, began to revoke such benefits for

²⁰ In *Charles B. Wolf*, 29 T.C. 441 (1957), the Tax Court held decedent possessed enforceable vested rights, even if they were subject to forfeiture if he terminated his employment or was discharged for cause. *Id.* at 447. To the same effect, *Eli L. Garber*, P-H TCM ¶ 58,121; Rev. Rul. 307, INT. REV. BULL. 1958-25, at 16. Cf. *Adeline F. Davis*, 27 T.C. 378 (1956); *Albert B. King*, 20 T.C. 930 (1953); *Goodman v. Granger*, 243 F.2d 264 (3d Cir.), *cert. denied*, 355 U.S. 835 (1957); *Christiernin v. Manning*, 138 F. Supp. 923 (D.N.J. 1956).

²¹ The usual conditions of forfeiture are: (1) continuity of services until death or retirement, whichever is earlier; (2) noncompetition with the employer; (3) continuity of service after retirement in an advisory or consultative capacity.

²² G.C.M. 17817, 1937-1 CUM. BULL. 281.

²³ G.C.M. 27242, 1952-1 CUM. BULL. 160. Cf. Rev. Rul. 158, 1953-2 CUM. BULL. 259; Rev. Rul. 260, 1953-2 CUM. BULL. 262. *But cf.* Rev. Rul. 581, 1955-2 CUM. BULL. 381.

²⁴ See note 19 *supra*.

its executives would soon find itself unable to secure the talent it needed, as word would quickly get around that this company was not one that could be relied upon to fulfill its commitments. This is especially true because often the forfeiture clauses are designed chiefly for one or both of the following purposes: (1) as window dressing for income tax purposes to insure nontaxability of the benefits as deferred compensation to the employee until after retirement; and (2) as a club to prevent the employee from voluntarily quitting and going to work for a competitor.

Whatever the economic merits or faults of forfeitable rights—and one could make a powerful argument, I believe, that their use to freeze one of our greatest assets, creative executive talent, is far worse for the health of our economy than any freezing of capital by a capital gains tax—it is certainly true that to make an estate tax depend upon such factors is unsound and unfair. True, it is possible that an employer, out of sheer generosity, may voluntarily pay a benefit to an employee or his widow. But in fact, employers, meaning corporations, are not usually motivated by generosity, particularly when the employee is not the crippled night watchman but a vice president in charge of sales or production. Payments are made for past, present, or future services—they are paid because the employee worked for the company; and if they are, in fact, made as a result of his services, that should be enough to make them a taxable interest, irrespective of vesting. Actually, the employee's rights vest when he enters the plan, but are subject to divestment before death.

2. The Lack of a Taxable Transfer

A second argument was that even if the benefit was an interest subject to the estate tax, there had been no transfer of it by the decedent which could be the subject of a tax. Sometimes this argument is really based upon the reasoning that if the employee has only an expectancy, he has nothing he can transfer to anyone. But in part this argument rested upon the fact that under many benefit plans there is no transfer by the decedent, because the employee cannot designate the beneficiary—the payments are made to certain beneficiaries in certain classes designated by the employer, irrespective of the actual wishes of the employee. The transfer is made by the employer, not by the employee. Here, the Treasury itself, even today, follows a similar line of reasoning. Thus, it has ruled Social Security benefits payable to persons other than the decedent's estate are not taxable, because the beneficiaries are fixed by law

and cannot be altered by the employee.²⁵ So, too, it ruled workmen's compensation payments²⁶ paid directly to persons designated by statute, and payments made to satisfy a wrongful death claim where the statute gave decedent no interest in the right of action during his life but vested it in his executor or administrator for his intestate successors,²⁷ not taxable. This reasoning in the case of employee benefits,²⁸ again, seems to ignore realities.

The employee's services are the cause of the transfer of the benefit by the employer to the beneficiary. If the beneficiary is the company, of course, the employee's estate should not be taxed upon the benefits—they are not made on his behalf as part of his compensation. But if, as is true in all these cases, they are made to the natural objects of the employee's bounty, his surviving spouse, children, kin, or heirs, we shut our eyes to economic truth if we say these payments are not transferred by him. Again, we must recall we are dealing here, under the estate tax, with employees in the higher echelons—executives who in today's competitive market for talent can and will find other employers if the beneficiary designations are not to their liking, or who will successfully persuade the company itself to alter policies to meet their wishes. Often, one suspects, the exclusive power of designation conferred on the company is given with full consent of the executive employees, who wish it done in this way for tax or other reasons. As a practical matter, the death benefits are paid to the beneficiaries on behalf of the employee, as part of his compensation for his work. The employee is the economic source of the benefits, the transfer is made because of his services. By accepting employment, knowing that benefits will be paid according to the plan, the employee has designated the beneficiaries.

Further confusion often arose because many plans stipulated certain beneficiaries, but allowed the employee to alter the beneficiaries by exer-

²⁵ Rev. Rul. 87, 1955-1 CUM. BULL. 112; E.T. 18, 1940-2 CUM. BULL. 285. Cf. Rev. Rul. 581, 1955-2 CUM. BULL. 381; E.T. 10, 1937-2 CUM. BULL. 469 (benefits taxable if payable to decedent's estate).

²⁶ Rev. Rul. 637, 1956-2 CUM. BULL. 600 (workmen's compensation award paid directly to dependents is excluded from estate tax). Cf. Rev. Rul. 54, 1957-1 CUM. BULL. 298.

²⁷ Rev. Rul. 19, 1954-1 CUM. BULL. 179. Would the result differ if the decedent had the right of action which survived for his heirs?

²⁸ William S. Miller, 14 T.C. 657 (1950); Glenn v. Hanner, 212 F.2d 483 (6th Cir. 1954), *affirming per curiam*, 111 F. Supp. 52 (W.D. Ky. 1953); Eugene F. Saxton, 12 T.C. 569 (1949); Libbey v. United States, 147 F. Supp. 383 (N.D. Cal. 1956). But cf. Adeline F. Davis, 27 T.C. 378 (1956); William L. Nevin, 11 T.C. 59 (1948); Paul G. Leoni, P-H TCM ¶48,213.

cising certain options prior to retirement or death. If the employee did not exercise the option,²⁹ there seemed to be a feeling that the mere existence of the unexercised power should not cause taxability—an erroneous concept, for such a power results in a tax under sections 2036, 2038, and 2041 (if a post-1942 general power). Moreover, by exercising the option to take a reduced monthly payment for himself while alive to obtain a survivor annuity for the beneficiary, the employee, in effect, transfers part of his life annuity to the survivor.

More difficult to answer were the arguments that if the employee himself made an irrevocable designation of a beneficiary there was no basis for taxing the transfer under the estate tax and the 1939 Code. He had not retained a life interest;³⁰ he had not retained a reversionary interest in making a transfer conditioned on survivorship.³¹ The courts so held, without any attempt to reconcile this result with the opposite results reached for identical nonemployee annuities, although it would seem that either both types were taxable transfers here, or neither. In the case of designations after October 7, 1949, it is difficult to see why employee annuities were not taxable as transfers taking effect at death. No reversionary interest was required, and the survivor's rights were certainly conditioned on surviving the grantor. The Treasury finally adopted this position under the 1939 Code for all transfers after October 7, 1949.³²

3. Valuation Difficulties

Finally, in an amazing approach, reminiscent of the medieval reason-

²⁹ *Exercise* of the option was held to be a transfer. *Adeline F. Davis*, 27 T.C. 378 (1958); *William J. O'Shea*, 47 B.T.A. 646 (1942); *Stuart Wilson*, 42 B.T.A. 1196 (1940); *Kernochan v. United States*, 29 F. Supp. 860 (Ct. Cl. 1939), *cert. denied*, 309 U.S. 675 (1940).

³⁰ *Commissioner v. Twogood*, 194 F.2d 627 (2d Cir. 1952); *Higgs v. Commissioner*, 184 F.2d 427 (3d Cir. 1950); *W. F. Hofford*, 4 T.C. 542, 790 (1945); *Herrick v. United States*, 108 F. Supp. 20 (E.D.N.Y. 1952); *Isidor M. Stettenheim*, P-H TCM ¶ 55,158; Rev. Rul. 158, 1953-2 CUM. BULL. 259. *Cf. Cowles v. United States*, 152 F.2d 212 (2d Cir. 1945); *Pruyn v. Commissioner*, 184 F.2d 971 (2d Cir. 1950). *But cf. Rev. Rul. 260, 1953-2 CUM. BULL. 262.*

³¹ *Ibid.*

³² Rev. Rul. 158, 1953-2 CUM. BULL. 259. The Treasury in this ruling stated it would not attempt to tax employee survivorship annuities involving transfers prior to October 7, 1949, because the 1949 Technical Changes Act required a reversionary interest in such cases of a transfer taking effect at death. *But cf. Rev. Rul. 260, 1953-2 CUM. BULL. 262*, finding a reversionary interest in a pre-October 7, 1949, benefit. The same ruling (158) stated, however, that nonemployee annuities involving pre-October 7, 1949, transfers would be taxed. It is equally hard to find any reversionary interest for these.

ing about the number of angels able to sit upon the point of a needle, some courts became hopelessly confused over the valuation problem. If, the argument ran, the survivor's benefits are forfeitable until the employee dies, either because of the employee's power of voluntary termination of employment or because the employer can revoke them for some reason, how and when do you value these rights? If valued just before death, they are so contingent as to be either worthless or incapable of any valuation. Do you value them, instead, at the moment of death, or the moment after death?³³ Viewed from this standpoint, there is little hope of reaching a fair solution.

The fact is that some interests are valued at or after death—sometimes because death increases the value of the asset, as in the case of the proceeds of insurance on decedent's life, and sometimes because death obliterates all value of the asset to the estate, as in the case of a life estate (not a reserved one) enjoyed by decedent or a straight life annuity. Frequently, the value created by, or depending upon, or obliterated by decedent's death is fully taken into account. Is not the same true here? Decedent's death is what generates the value of the interest enjoyed by the beneficiary, an interest created by decedent's work for his employer. The forfeiture conditions are often paper ones, designed mainly to defer income taxation for the employee. If, in fact, there has been no forfeiture prior to the employee's death, the value of the interest passing to the beneficiary is scarcely debatable if death actually makes the right to the benefit vest irrevocably in the surviving beneficiary. A different problem arises if the beneficiary's rights are forfeitable even after the employee's death—this contingency affects the *value* of the rights, but not the fact of their inclusion in his gross estate.

D. Estate Taxation of Employee Benefits Other Than Annuities

Two more points about the 1939 Code merit consideration. If the employee benefits were actually insurance, rather than an annuity, there was perhaps no difficulty in taxing them after 1942 under section 811(g), which had adopted the premium-payment test. Even if the employee gave up all incidents of ownership in the insurance long prior to his death, he obviously paid the premiums for the insurance, even if the employer bore the entire cost of the premiums.³⁴ The employer paid

³³ Cf. *Goodman v. Granger*, 243 F.2d 264 (3d Cir.), *cert. denied*, 355 U.S. 835 (1957) (value after, not before death; reversing a contrary holding of the district court); *Christiernin v. Manning*, 138 F. Supp. 923 (D.N.J. 1956) (same).

³⁴ Cf. *Yuengling v. Commissioner*, 69 F.2d 971 (3d Cir. 1934); *Brown v. Commissioner*, 95 F.2d 184 (6th Cir. 1938), *cert. denied*, 305 U.S. 644 (1938); *George*

the premiums because the employee worked for him. Thus, employee benefits in the nature of insurance, even under a noncontributory plan, were included in the employee's gross estate, unless viewed as a mere expectancy because forfeitable, or unless there was no transfer because the employee lacked power to designate the beneficiary.

Second, what if the benefits were neither insurance nor a refund or survivor's annuity, but simply a pure death benefit, paid solely after the employee's death, with no payments of any kind to the employee himself? Here again, at least after the 1949 Technical Changes Act, if the beneficiary was irrevocably designated after October 7, 1949, the benefits, if conditioned on the beneficiary's surviving the employee, would appear to be taxable,³⁵ unless they were forfeitable ones, or unless perhaps the employee could not designate the beneficiaries.

Thus, under the 1939 Code, the major gap in the estate taxation of employee benefits was where an irrevocable designation of a beneficiary for a refund or survivor annuity was made at least three years before decedent's death, or where the death benefits were forfeitable and not vested or were subject to a condition precedent other than survivorship which had not occurred prior to the employee's death, or where the employee had no direct power to designate the postdeath beneficiary.

II

THE 1954 CODE

A. Section 2039

Section 2039, of course, is not limited to employee benefits. It applies to all types of joint and survivorship annuities, such as are purchased by an individual directly from a commercial company.³⁶ Our discussion of section 2039, however, will focus mainly on employee bene-

M. Adams, 18 B.T.A. 381 (1929). This was true of group insurance also. *Commercial Nat'l Bank & Trust Co. of N.Y. v. Johnson*, 123 F. Supp. 728 (S.D.N.Y. 1954); Eugene F. Saxton, 12 T.C. 569 (1949); *First Nat'l Bank & Trust Co. of Minneapolis*, 39 B.T.A. 134 (1939); J. C. Welliver, 8 T.C. 165 (1947). *But cf.* J. C. Morrow, 19 T.C. 1068 (1953).

³⁵ See note 32 *supra*.

³⁶ The Committee Reports actually devote 3 of their 5 examples to the effect of section 2039 on nonemployee annuities. Ex. 1 is a survivorship annuity; ex. 2 is a joint and last survivor annuity; ex. 5 is a refund annuity. H.R. REP. NO. 1337, 83d Cong., 2d Sess. A314-15 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 470 (1954). The Regulations also give an example of a nonemployee annuity: Treas. Reg. § 20.2039-1(b)(2) ex. (1) (1958). See also Treas. Reg. § 20.2039-1(c) ex. (1) (1958) (joint and last survivor nonemployee annuity).

fits, since it was the difficulty in taxing these benefits under the 1939 Code which supposedly led to the enactment of section 2039.³⁷

The first thing that strikes one when reading section 2039³⁸ is that it is clearly patterned after section 2036—the language is almost an exact parallel. The chief differences are: (1) no “transfer” is required under section 2039; and (2) no “property” is referred to as in section 2036. Perhaps the fact that nonemployee annuities had been successfully taxed under the similar section of the 1939 Code induced the drafters of section 2039 to model it along these lines. Whatever the reason, this was a most unfortunate decision, it seems to me.

1. *The Expectancy Argument: The Employee's Interest*

Let us see how section 2039 deals with the three troublesome problems that arose under the 1939 Code. First, there is the expectancy argument when the benefits are forfeitable and not vested. Section 2039 makes no effort to face the problem squarely—indeed, it uses ambiguous language on this point. Section 2039 stipulates that there is no tax unless under a contract or agreement made subsequent to March 3, 1931, either (1) the annuity or other payment “was payable” to the employee, or (2) the employee “possessed the right to receive such annuity or payment,” in both instances for his life, or for any period not ascertainable without reference to his death, or for a period which does not in fact end before his death.

a. *The meaning of “was payable.”* What is meant by the phrase “was payable”? Is it enough that the employee at death is actually receiving payments? What if the payments may be terminated at any time prior to his death by the employer for stipulated reasons or no reason at all?

The statute is silent. The Treasury Regulations,³⁹ in a valiant effort to fill the gap, take the position that the phrase “was payable”

³⁷ See note 1 *supra*.

³⁸ Section 2039(a) reads: “The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement entered into after March 3, 1931 (other than as insurance under policies on the life of the decedent), if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another 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.”

³⁹ Treas. Reg. § 20.2039-1(b)(1) (1958) states that an annuity “was payable” if, “at the time of his death, the decedent was in fact receiving an annuity or other payment, whether or not he had an enforceable right to have payments continued.”

includes any case where, at death, the employee was in fact receiving payments from the benefit plan, even if his rights might be forfeited either by his own acts or by unilateral action by the employer, and even if he had no enforceable right to have the payments continue. This is certainly a reasonable interpretation of this phrase,⁴⁰ but will the courts agree? The phrase could be construed to demand an enforceable right. Why did not the draftsmen foresee this problem, or at least see to it that the Committee Reports contained a flat statement on this question?

In one example in the Regulations,⁴¹ the plan gave the employee and his wife a survivorship annuity upon his retirement at sixty. During his life all benefits were forfeitable, but after his death the widow's annuity was forfeitable only for remarriage. The employee died at sixty-one, while receiving the annuity after retirement. The value of his widow's annuity is taxed under section 2039. The fact that benefits were forfeitable during his life is irrelevant since he was receiving payments then under the plan. In valuing the widow's annuity, the forfeiture for remarriage may be taken into account (how, the Regulations carefully do *not* say).

May payments of his regular salary to the employee satisfy this requirement for actual receipt of a "payment" at death? We do not know, although an example in the Committee Reports⁴² may cover this situation. There is "a contract or agreement entered into by the decedent and his employer under which at decedent's death, prior to retirement or prior to the expiration of a stated period of time, an annuity or other payment was payable to a designated beneficiary if surviving the decedent." The Committee Reports assert this annuity payable to the beneficiary is included in decedent's gross estate. The

⁴⁰ The Committee Reports in several places and examples use the phrase "was receiving" in referring to payments to the employee—indicating this is synonymous with "was payable." H.R. REP. NO. 1337, 83d Cong., 2d Sess. A314-15, exs. 1-3, 5 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 470, exs. 1-3, 5 (1954).

The Treasury's interpretation would cover such cases as William S. Miller, 14 T.C. 657 (1950), and M. Hadden Howell, 15 T.C. 224 (1950), where the benefits were not taxed under the 1939 Code either because, when the employee retired before the retirement age stipulated by the plan, the employer "voluntarily" paid the employee until he died the usual (or a reduced) retirement annuity, or because the benefits being paid the employee when he died after retirement were subject to forfeiture by the employer. Cf. decisions in note 20 *supra*, following the opposite point of view to these two cases, even under the 1939 Code.

⁴¹ Treas. Reg. § 20.2039-1(b)(2) ex. (2) (1958).

⁴² H.R. REP. NO. 1337, 83d Cong., 2d Sess. A315, ex. 4 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 470, ex. 4 (1954).

example fails to indicate whether before retirement the employee had any right of any kind to receive after retirement an annuity or payment for himself, if still alive then, or if he had any right, if he ended his employment otherwise than by death before retirement, to any payment such as a refund of his contributions, if any. If he did not have any such rights, the only basis for finding any payment to him would be the salary he was receiving when he died (the salary, of course, would be a payment he was receiving at death, so forfeitability for it would be irrelevant).

b. *The meaning of "possessed the right."* What is meant by "possessed the right" to receive payments if the employee is not in fact receiving payments at his death?⁴³ Must he have a legally enforceable right to the payments? The statute speaks of payments under "any form of contract or agreement"—does this mean a legally enforceable one? What if the right is a conditional one—must the condition have occurred prior to his death? What if the right is forfeitable by the employer—is it sufficient then? Must the right be a vested one? The statute and the Committee Reports are silent. The Regulations state⁴⁴ that purely voluntary benefit payments are not within section 2039 unless the employer has consistently made such payments in all cases irrespective of the lack of any legal rights thereto. But payments pursuant to any sort of plan, arrangement, or understanding are sufficient.⁴⁵ Again, the rights need not be vested always—they can be forfeitable or subject to conditions precedent. However, the Regulations⁴⁶ assert that the employee must ordinarily have immediately prior to death a legally enforceable right to future (not necessarily present) payments; but a legally enforceable right includes⁴⁷ a forfeitable one if prior to death the employee has complied with all his contractual obligations

⁴³ The Committee Reports' examples, *supra* note 40, speak of "entitled to receive" in lieu of "possessed the right."

⁴⁴ Treas. Reg. § 20.2039-1(b)(2) ex. (3) (1958).

⁴⁵ Treas. Reg. § 20.2039-1(b)(1) (1958) states contract or agreement means "any arrangement, understanding, or plan, or any combination of arrangements, understandings or plans arising by reason of the decedent's employment."

⁴⁶ Treas. Reg. § 20.2039-1(b)(1) (1958) states the employee possesses the right to receive an annuity "if, immediately before his death, the decedent had an enforceable right to receive payments at some time in the future, whether or not, at the time of his death, he had a present right to receive payments."

⁴⁷ Treas. Reg. § 20.2039-1(b)(1) (1958) states the employee has an enforceable right to receive payments in the future "so long as he had complied with his obligations under the contract or agreement up to the time of his death."

and there has been no forfeiture. A condition is no bar if it occurs before or immediately after death.

Thus, in an example in the Regulations,⁴⁸ the employee and his wife were to receive a survivorship annuity upon his retirement at sixty. If he died before sixty, his widow would receive a lump sum payment, but if he left the employer's service before sixty for any reason except death, he would forfeit all rights under the plan. If he dies at forty-nine, before retirement while in service, the lump sum paid his widow is taxed under section 2039. He had an enforceable right to receive payments—the annuity—when he died. It is irrelevant that he would forfeit the right for certain acts if, in fact, he had fulfilled all his obligations under the contract until his death.⁴⁹

In another example in the Regulations,⁵⁰ the employer agreed to provide the employee upon retirement at sixty with a survivor annuity for the employee and his wife. No benefits at all were payable if the employee died before retirement. The employee died at fifty-nine, but the employer paid a smaller annuity to his widow. Section 2039 does not apply, because the employer had "no obligation" to pay the annuity, so payment was not made under any contract or agreement, unless the employer consistently paid annuities under similar circumstances, when the annuity is considered as being paid under a contract or agreement.⁵¹

Why should taxability under section 2039 depend upon the employee's having any sort of inter vivos right to the benefits? Payments are made because of his work, they are part of his compensation,

⁴⁸ Treas. Reg. § 20.2039-1(b)(2) ex. (3) (1958).

⁴⁹ Although it actually is ambiguous at best, one example in the Committee Reports may be read as enforcing the Treasury's position. The example (text *supra* at note 42) relates to payment of an annuity to the beneficiary when the employee dies before retirement. The example fails to indicate: (1) if the employee had a right of any kind (other than to his salary) to any payments, present or future, for himself at the time he died; and (2) whether his right to such payments was conditional or forfeitable—quite possibly by contract or unjust enrichment he would be entitled at least to a refund of all premiums paid with interest if he quit his job before retirement. If his salary is viewed as the payment to him required by the statute, it, of course, is being received by him when he dies, so forfeiture is irrelevant.

⁵⁰ Treas. Reg. § 20.2039-1(b)(2) ex. (4) (1958). Cf. *Emil L. Stake*, 11 T.C. 817 (1948). Here the employer "voluntarily" paid the survivor an annuity when the employee died prior to retirement, so there was no legal right to the annuity. It was not taxed under the 1939 Code.

⁵¹ But cf. *Albert L. Salt*, 17 T.C. 92 (1951) ("voluntary" benefits not taxed under 1939 Code despite fact no eligible beneficiary was denied benefits during entire 15 years plan had operated).

whether or not he has any kind of right to them, legal or otherwise, during his life. To a large extent, therefore, section 2039 perpetuates the forfeiture-expectancy problems which proved so troublesome under the 1939 Code, unless the Treasury Regulations survive judicial review.

c. *The required period.* It is not enough for the employee to have the right to receive payments, or to be receiving payments, unless the payments are to be made for his life, or for a period not ascertainable without reference to his death, or for a period which does not in fact end before his death. If the employee is actually still receiving payments (including salary if it is deemed the payment the statute requires) at the time of his death, clearly the period of the payments is one which did not in fact end before his death. What if the payments were to be made for only a stipulated period, substantially shorter than the employee's life expectancy when the payments began, but he died before expiration of the period? Since payments are not ordinarily begun until retirement, there seems little chance that this will ever occur, but the 1939 Code Regulations for a reserved life interest did indicate such a case would not fall within the statutory period.⁵² The 1954 Code Regulations⁵³ for section 2036, however, omit this qualification.

As under section 2036,⁵⁴ it is not clear whether the period refers to the duration of the right, or the time during which the payments are to be made, or both. The statutory language would seem to refer to the right's period rather than the period for the payment, but a fair interpretation would also require that if the payments are scheduled to begin in the future, they are reached by section 2039 only if the payment's termination is fixed by reference to the time of decedent's death.

If a right to receive payments is involved, it may be exercisable either by the employee alone or in conjunction with anyone else, including presumably one with a substantial adverse interest.⁵⁵

d. *The nature of the payments.* The Regulations⁵⁶ also state that the annuity or other payment to either the employee or the beneficiary includes equal or unequal payments, periodic or sporadic, lump sum or multiple payments, as well as conditional or unconditional ones.

If decedent at death possesses only a right to receive a lump sum pay-

⁵² Treas. Reg. 105, § 81.18 (1942).

⁵³ Treas. Reg. § 20.2036-1(b)(1) (1958).

⁵⁴ See LOWNDES & KRAMER, *op. cit. supra* note 2, at 163-66.

⁵⁵ Cf. *Helvering v. City Bank Farmers Trust Co.*, 296 U.S. 85 (1935); Treas. Reg. § 20.2036-1(b)(3)(i) (1958).

⁵⁶ Treas. Reg. § 20.2039-1(b)(1) (1958).

ment, can this be deemed a payment for his life or for the other required statutory periods? Examples and statements in Committee Reports⁵⁷ specifically refer to the inclusion of a "payment," as does the language of section 2039. The Proposed Regulations⁵⁸ seemed to take a contrary view, but the Final Regulations⁵⁹ specifically require inclusion here if the lump sum has not been paid prior to decedent's death. This seems correct—the lump sum is payable for a period which does not in fact end before his death. So also, a lump sum payment to a beneficiary, unless insurance, seems within section 2039, since there is no requirement that the beneficiary's benefits be for any stipulated period, such as for life, etc.,⁶⁰ as in the case of the employee's.

2. *The Contract or Agreement*

Section 2039 applies only when benefits are payable under a contract entered into after March 3, 1931, the same effective date as for reservation of a life interest under section 2036. What if amendments to a pre-1931 plan are made at a later date? If the amendments were substantial, the contract might then be considered a post-1931 one. No doubt an annuity contract is entered into when it is taken out, even if the contract calls for annual or periodical payments of premiums. What if the rights of the employee are not vested, are forfeitable at the will of the employer, a mere expectancy—would the date the contract was entered into be deferred until the rights vested or matured? It would seem not. Also, although section 2039 refers to March 3, 1931, it actually uses the language not of the Joint Resolution of March 3, 1931, but of the June 6, 1932 Act in defining the period for which the employee must receive or have a right to receive an annuity and also in imposing a tax when the right is shared by the employee with

⁵⁷ All the 5 examples in the Committee Reports refer to an annuity or other stipulated "payment" (in the singular). H.R. REP. NO. 1337, 83d Cong., 2d Sess. A314-15 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 470 (1954). In fact, the Senate revised the House Bill "so as to make it clear that the provisions of this section apply not only to cases where an annuity was payable to a decedent but also to contracts or agreements under which a lump-sum payment was payable to the decedent or the decedent possessed the right to receive such a lump-sum payment in lieu of an annuity." *Ibid.*

⁵⁸ Proposed Treas. Reg. § 20.2039-1(b) ex. (5), 21 Fed. Reg. 7850 (1956).

⁵⁹ Treas. Reg. § 20.2039-1(b)(2) ex. (5) (1958). This is the same example as given in the Proposed Regulations, *supra* note 58.

⁶⁰ Treas. Reg. §§ 20.2039-1(b)(2) exs. (1), (3), (5); 20.2039-2(b) ex. (2) (1958). The Committee Reports state the payment to the beneficiary may be in a "lump sum." H.R. REP. NO. 1337, 83d Cong., 2d Sess. A315 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 470 (1954).

someone else. Two of these changes made in the 1931 Act by the 1932 Act are not retroactive, including the taxing of a right possessed by a decedent in conjunction with⁶¹ any other person. If an employee irrevocably designated a beneficiary for a benefit prior to June 6, 1932 and after March 3, 1931, reserving the right to revoke with the beneficiary's consent, it would seem that this would be taxable under section 2039, despite the contrary result in the case of a reserved life interest under section 2036.

What if the same employer has several plans covering the same employees? Section 2039(a)⁶² plainly states that the amounts receivable by the beneficiary must be paid under the same contract or agreement as gives the employee a right to receive payments or under which the employee is receiving payments. The Regulations, however, state that a contract or agreement includes "any combination of arrangements, understandings or plans arising by reason of the decedent's employment."⁶³ In an example in the Regulations,⁶⁴ an employer has set up at different times two plans, each of which is separately administered. One plan gives the employee, at retirement at sixty, a life annuity only. The other plan gives the beneficiary, at the employee's death, a similar annuity. The beneficiary's annuity is included in the employee's gross estate when he dies, because the two plans are considered as one contract or agreement. If the plans are considered separately, nothing will be taxed at the employee's death under the first, since his pension ends then. Nothing will be taxed under the second at his death under section 2039, since he has no inter vivos right of any kind (unless he is receiving salary payments perhaps) to any benefit under it.

There is one exception. When some of the same employer's plans are qualified ones under the income tax and others are not, the benefits of all qualified plans are considered separately from those of the unqualified plans. This, of course, is necessary in order to apply the special rules for qualified plan benefits contained in section 2039(c).⁶⁵

The benefits of the beneficiary are receivable under a contract even if they are fixed by an option or election exercised or exercisable by the

⁶¹ See LOWNDES & KRAMER, *op. cit. supra* note 2, at 131-35.

⁶² Section 2039(a) speaks of the annuity receivable by the beneficiary under "any form of contract or agreement" and of the right of the decedent to receive the annuity "under such contract or agreement."

⁶³ Treas. Reg. § 20.2039-1(b)(1) (1958).

⁶⁴ Treas. Reg. § 20.2039-1(b)(2) ex. (6) (1958).

⁶⁵ Treas. Reg. §§ 20.2039-1(b)(2) ex. (6); 20.2039-2(b) ex. (1) (1958).

employee, rather than directly by the contract.⁶⁶ Nor need the annuity or payment to the beneficiary be identical in form or amount to that payable to the employee.⁶⁷

3. *The Transfer Problem*

What about the "transfer" questions? Does section 2039 answer them? The Treasury apparently still follows the policy that under other sections of the Code there is no transfer by the decedent and, therefore, no tax if he has no control over the beneficiaries, as in the case of Social Security benefits. Will the Treasury apply this rule to section 2039? Apparently not, for the Regulations⁶⁸ explicitly state that section 2039 applies even if the beneficiaries are beyond the power of the employee to designate. This view seems sound. As the Regulations⁶⁹ assert in an example, the fact that the employee has no power to choose or change the beneficiary is immaterial. Nothing in the language of section 2039 requires any transfer by the employee, so certainly it would seem that his lack of power to name or change beneficiaries is not a *sine qua non* for taxability under the section. In fact, this is perhaps the main difference between section 2036 and section 2039; so a contrary interpretation will in fact almost entirely nullify much of what section 2039 does accomplish beyond what the 1939 Code did.

4. *The Valuation Problem*

Does section 2039 solve the valuation problem? The statutory language is clear on this point, referring in section 2039(a) to the inclusion in decedent's gross estate of the "value" of the "annuity or other payment receivable by any beneficiary." There is also a statement in the Committee Reports that the benefit is to be valued on the basis of the "value at the decedent's death of the annuity or other payment receivable by the survivor."⁷⁰ These statements seem to emphasize

⁶⁶ H.R. REP. NO. 1337, 83d Cong., 2d Sess. A315, ex. 3 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 470, ex. 3 (1954).

⁶⁷ *Ibid.*

⁶⁸ Treas. Reg. § 20.2039-1(b)(2) ex. (2) (1958) states: "Nor is it important that the decedent had no right to choose the surviving beneficiary." This example is given in the text, *supra* at note 41, and here the employee, it is specified, had no right originally to designate or ever to change the beneficiary (his wife) designated by the employer. Cf. notes 28 and 29 *supra*.

⁶⁹ *Ibid.*

⁷⁰ H.R. REP. NO. 1337, 83d Cong., 2d Sess. A315 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 470 (1954).

the value of what the beneficiary will, in fact, receive at or immediately after the employee's death. The Regulations,⁷¹ in the case of a benefit forfeitable by employee or employer prior to the employee's death under which payments are being made to the employee at his death, assert that this element of forfeiture is irrelevant in valuing the annuity. It is ignored unless the benefits, after the employee's death, are still subject to forfeiture by some act (as remarriage) of the beneficiary, which may affect valuation of the benefits. Valuation should, therefore, be made immediately after death, giving effect to the occurrence of the death. If the benefit is conditional even after the employee's death, the condition merely affects the value. Also, valuation would apparently be made on the basis of the cost of a commercial annuity for the survivor's life immediately after the employee's death (or the value of such an annuity based upon the Treasury's factors and life expectancy tables if the cost of a commercial annuity is not ascertainable for any reason). Valuation would not be made on the basis of the difference in cost just before the employee's death of a survivorship annuity and a single life annuity for the employee.

5. *The Survivorship Requirement*

Another problem is, what about benefits not dependent on survivorship? Suppose the employee designated *W* as the prime beneficiary with a power to appoint by deed or will a secondary beneficiary if she did not survive him, and in default of any appointment by her, to her estate. Actually, of course, she still must survive him to enjoy *possession* of the benefit; but on the other hand, she has full ownership and control even if she does not survive him. Section 2039 simply refers to payments receivable by a beneficiary "by reason of surviving" the employee. Does this mean actual possession or enjoyment, or legal title and power to control the benefit? It would seem that possession or enjoyment should be the test here, but the statute and the Regulations are silent on this point. Under the 1949 Technical Changes Act, in the case of transfers after October 7, 1949, a similar view was taken, but the statutory language here is clear on this point and expressly refers to "possession or enjoyment" which is obtained through ownership. The same is true of section 2037. What about a transfer conditioned on survivorship or some other event, whichever occurs first? If decedent dies before the other event occurs, will section 2039 apply?

⁷¹ Treas. Reg. § 20.2039-1(b)(2) ex. (2) (1958). See text at note 41 *supra*.

B. Taxation Under Other Sections of the 1954 Code

The provisions of section 2039, according to the Committee Reports, do not bar application of the other sections of the Code relating to the estate tax.⁷² Thus, if in the case of death before retirement, the contributions of the employee are refunded to his estate, the refund is taxable under section 2033 as property owned by the decedent.

Of course, if section 2039 applies, there is no need to worry whether the benefit is taxable under another section of the Code, such as sections 2036 or 2037. However, two points should be noted about the 1954 Code. First, under section 2037, unlike the case of transfers made after October 7, 1949 under the 1949 Technical Changes Act which were conditioned upon survivorship, the rule of *Reinecke v. Northern Trust Company*⁷³ is restored, and where the employee dies after August 16, 1954, no benefit can be included in his gross estate unless he has retained a reversionary interest therein worth more than five per cent of the property immediately before his death. This means, of course, that few if any employee death benefits are taxable under section 2037—for if a joint and survivor or refund annuity is involved, the employee, as the courts held under the 1939 Code, usually has no true reversionary interest. If a pure death benefit is involved, there is clearly no reversionary interest. Second, section 2039 specifically is inapplicable to any benefits in the nature of insurance. These are taxable only under section 2042, or possibly other sections of the Code, such as a transfer in contemplation of death under section 2035.

1. Insurance and Section 2042

How does one determine if a death benefit is insurance? The Code is silent; no doubt the decisive factor is that enunciated by decisions of the Supreme Court under the 1939 Code—insurance demands an element of *risk*.⁷⁴ The Treasury Regulations, in attempting to apply this principle, have adopted an apparently harsh and arbitrary all-or-nothing test. According to the Regulations,⁷⁵ so long as there is the least element of risk involved, the entire benefit is insurance. Thus, in an example of the Regulations,⁷⁶ the employer purchased an insurance contract to provide the employee and his wife with \$100 a month upon

⁷² H.R. REP. NO. 1337, 83d Cong., 2d Sess. A316 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 472 (1954); Treas. Reg. § 20.2039-1(a) (1958).

⁷³ 278 U.S. 339 (1929).

⁷⁴ See *supra* note 7.

⁷⁵ Treas. Reg. § 20.2039-1(d) (1958).

⁷⁶ Treas. Reg. § 20.2039-1(d) (1958).

retirement at sixty-five. If the employee died before sixty-five, \$20,000 was payable to his widow. The reserve value would equal \$20,000 at retirement. If death occurred before retirement—even if only a few days—the entire \$20,000 is regarded as insurance. If death occurs after retirement, the benefits are not insurance and are taxed under section 2039, not section 2042. Thus, if the benefit is a \$20,000 endowment policy, so long as the reserve under the policy is less than its death benefit value at the insured's death—\$20,000—the proceeds are insurance, taxable under section 2042, not section 2039. But once the reserve equals or exceeds \$20,000, then the entire benefit is not insurance. Would not a fairer test be to apportion the benefit between the reserve of the policy and the face value? If the reserve equals \$15,000 on a policy for \$20,000, then \$5,000 is insurance and the rest is not. However, under the Treasury rule, the relation of the reserve value of the policy to the death benefit is the decisive factor—the contract is all insurance until the reserve equals the death benefit, and thereafter it is not.

The Regulations also lay down two additional supplementary rules. First, if the death benefit can never exceed the total premiums paid plus interest, there is no insurance⁷⁷ element ever. Second, a combination annuity contract and insurance policy is not insurance once it has matured before the insured's death.⁷⁸

The probable justification for the Treasury's test for the estate tax is the practical difficulty involved in administering a different one, such as that suggested above, particularly if applied to self-funded plans where adequate actuarial and reserve computations may be lacking. The other approach suggested herein—apportioning the benefits between the reserve and the risk element of the policy—is, in fact, taken under the income tax, where only the amount at risk is treated as insurance.⁷⁹ Such a method may not be suitable for the estate tax unless only regular insurance policies are excluded from section 2039, and self-funded benefits are not considered insurance at all.

The importance of this test lies in the fact that taxability under section 2039 is based upon a wholly different standard than under section

⁷⁷ Treas. Reg. § 20.2039-1(d) (1958).

⁷⁸ *Ibid.*

⁷⁹ Treas. Reg. § 1.402(a)-1(a)(3), (4) (1956). Cf. *Altschuler v. United States*, 169 F. Supp. 456 (W.D. Mo. 1958), where in an estate tax case under the 1939 Code, the court refused to segregate the reserve and risk portions of an employee death benefit, but treated the entire benefit as insurance, taxable under § 811(g).

2042. Under section 2042, the test for taxability of insurance proceeds of a policy on decedent's life payable to beneficiaries other than his estate is incidents of ownership—does he have any at the time of death? Under the 1954 Code, the decedent may have paid all premiums without incurring any taxability under section 2042. Under section 2039, however, incidents of ownership are not decisive—it is immaterial that the employee gives the beneficiary all incidents of ownership irrevocably long before his death, for the test is payment of premiums—the employee is taxable in any event to the extent he has contributed directly or through his employer's contributions (apart from the exemption of section 2039(c)) for the cost of the benefit. If the benefits fall under section 2039, the employee may keep complete control of them until death, without incurring added estate tax liability. In fact, he may incur a gift tax if he irrevocably gives the benefits up before death.

Does such a distinction make any sense—have any economic or social justification? Why should insurance benefits be taxed one way and noninsurance benefits another? Is not this a purely arbitrary difference? As far as the beneficiary is concerned, his rights are exactly the same, whether the benefits are or are not insurance—he receives the same amount when the employee dies. Should not all benefits, whether insurance or not, be taxed the same way and be subject to section 2039? For example, suppose an employer has a self-administered plan for a nonqualified pension and death benefit program. If the pension and survivor benefits are wholly self-administered and funded, the survivor benefits may be subject to section 2039. If the pension is self-administered, however, but the survivor benefits are obtained through purchase of insurance, the policy being vested in the trustees who deliver it to the beneficiary at the insured employee's death, section 2039 will not apply at all if the benefits are insurance, nor will section 2042 apply since the insured has no incidents of ownership.

a. Self-funding and nonfunded insurance plans. If the employer uses a self-funding plan instead of buying contract policies from a regular insurance company, it may be very difficult, if not impossible, to apply the test of the Regulations or any other test to determine if insurance or noninsurance benefits are involved. Professional insurers will maintain the technical computations necessary to ascertain the terminal reserve, used by the Regulations as the test. Self-funding plans are not apt to keep such records. Courts deciding cases prior to the 1954 Code often had great difficulty in ruling whether employee death bene-

fits were insurance or not when regular policies of insurance companies were not used to fund the plan.⁸⁰ Yet, it is clearly unfair to tax self-funded insurance benefits under section 2039 rather than section 2042, and if no terminal reserve is present, other tests should be used. For example, pure death benefits should be presumed insurance. Benefits paid prior to retirement might be presumed to be insurance, but not those paid after retirement.

The Regulations and Committee Reports are ambiguous on this important point. All the examples in the Regulations showing the application of section 2039 to employee benefits involve *self-funded* plans, which may give rise to a negative implication that benefits of such plans cannot be classified as insurance.⁸¹ The only examples given of an insurance benefit are ones where the employer purchased a policy from a regular company.⁸² These examples stress the terminal reserve. An example in the Committee Reports⁸³ is ambiguous.

In the case of unfunded plans, it would seem virtually impossible to determine that any benefits are insurance, because of the complete absence of mathematical calculations and reserves of the type needed.

2. *Self-Funded and Unfunded Benefits, Not Insurance*

It is uncertain if unfunded benefits would even fall under section 2039, even if they are in the form of a joint or survivor annuity, because ordinarily there would be no "contributions" made by either the employee or the employer for any unfunded benefits—the employer merely

⁸⁰ Compare cases finding insurance: *Commissioner v. Treganowan*, 183 F.2d 288 (2d Cir.), *cert. denied*, 340 U.S. 853 (1950); *Kernochan v. United States*, 29 F. Supp. 860 (Ct. Cl. 1939), *cert. denied*, 309 U.S. 675 (1940) (year's salary paid widow); *B. L. Snyder, P-H TCM ¶45,320*; *W. E. Edmonds*, 16 T.C. 110 (1951); *with* contrary decisions: *Stuart Wilson*, 42 B.T.A. 1196 (1940); *William J. O'Shea*, 47 B.T.A. 646 (1942); *Knight v. Finnegan*, 74 F. Supp. 900 (E.D. Mo. 1947). Cf. *John C. Morrow*, 19 T.C. 1068 (1953); *Central Bank & Hanover Trust Co.*, 40 B.T.A. 268 (1939); *Illinois Merchants Trust Co.*, 12 B.T.A. 818, 820 (1928); *Dimock v. Corwin*, 19 F. Supp. 56 (E.D.N.Y. 1937), *aff'd*, 99 F.2d 799 (2d Cir. 1938), 306 U.S. 363 (1939).

⁸¹ Treas. Reg. §§ 20.2039-1(b)(2) exs. (2)-(6), (c) ex. (2); 20.2039-2(b) exs. (1), (2) (here, no insurance obviously, since beneficiary received only actual contributions with interest when employee died before retirement), 4; 2039-1(c)(2) (1958).

⁸² Treas. Reg. §§ 20.2039-1(d); 20.2039-2(b) ex. (3) (1958).

⁸³ The example is the one given in the text at note 42 *supra*, where at the employee's death prior to retirement, an annuity paid his widow is taxed under section 2039. The example is ambiguous, for the nature of the "annuity or other payment" to the widow is not specified. Is it mere return of contributions with interest (no insurance), or may the widow receive more than this, so insurance is present? Some decisions have found insurance in employee death benefits which were self-funded. See note 80 *supra*.

makes payments when due out of his current profits or assets. This would mean that these benefits are taxed, if at all, under some other sections of the Code, and may then entirely escape taxation—clearly an unfair discrimination against funded plan benefits.

Thus the statute and the Regulations, in referring to benefits covered by section 2039, state that it applies only to that part of employee benefits attributable to contributions by the employer and the employee. Section 2039(b)⁸⁴ refers to "any contribution" by the employer to "the purchase price" of such "contract or agreement (whether or not to an employee's trust or fund forming part of a pension, annuity, retirement, bonus, or profit sharing plan)." It can be argued that the purpose of the parenthetical phrase quoted above is to reach unfunded arrangements. Also, in an unfunded plan, it is very possible that at the employee's retirement the employer may *purchase* an annuity from a commercial company, and the price then paid would be the employer's contribution. On the other hand, if the employer, upon retirement of the employee, pays the annuity or pension directly himself, it is hard to find any purchase or contributions, as the language of the statute seems to contemplate. Nothing is being purchased, no contributions are made. Perhaps the employer could be viewed as making "contributions" in the case of such unfunded plans when the cost is borne solely by him when he actually pays the benefits—although this may seem rather to stretch the meaning of the word—or even when he simply incurs the liability, becomes subject to the obligation or debt, of making the payments. The employer then contributes the purchase price by agreeing to pay the benefits. An alternative argument would be that the employee here contributes the purchase price by his agreeing to render services to the employer, who then sells the benefit for this price to the employee. None of the examples in the Committee Reports or the Regulations refers to unfunded plans. Yet, not to tax unfunded benefits under section 2039 is illogical, unfair, and discriminatory, and contrary to the policy of the statute.

⁸⁴ Section 2039(b) states that section 2039(a) applies "only to such part of the value of the annuity or other payment receivable under such contract or agreement as is proportionate to that part of the purchase price therefor contributed by the decedent. For purposes of this section, any contribution by the decedent's employer or former employer to the purchase price of such contract or agreement (whether or not to an employee's trust or fund forming part of a pension plan, annuity, retirement, bonus or profit sharing plan) shall be considered to be contributed by the decedent if made by reason of his employment." See Treas. Reg. § 20.2039-1(c) (1958).

In fact, there even may be doubt if a self-funded plan falls under section 2039, on the ground that here, too, if the employer does not purchase contracts from a regular insurer, but pays the benefits directly, he has not made "contributions." The Regulations,⁸⁵ wisely I think, reject this idea and apply section 2039 to funded plans, as indicated by several examples. Yet, under the income tax, section 105(a) specifically taxes direct employer payments to employees under accident and health plans, so the failure of section 2039 to have such specific language may indicate a negative inference that it does not cover employer funded benefits.

3. *Other Noninsurance Benefits Not Covered by Section 2039*

Just as one finds it hard to justify the exclusion from taxability under section 2039 of insurance benefits, so it is equally hard to find justification for the exclusion from section 2039 of other noninsurance benefits. Section 2039 requires not only that the benefits arise out of the employment relation and that the beneficiary's rights depend on survivorship of the decedent employee, but also that the employee have an interest analogous either to a reversion or a life interest—he must either have a right to receive payments or be actually receiving payments for some period analogous to that required under section 2036 for a life interest. This means that pure death benefits alone are probably not taxable under section 2039. Why should this be so? The beneficiary's interest is the same, the beneficiary receives the same amount, whether the employee has any right to benefits during his life or not. The highly arbitrary nature of this requirement is well illustrated by an example based upon one in the Regulations.⁸⁶

Under an employee benefit plan, an employee is entitled to a lump sum payment equal to one-half the amount credited to his account under the plan upon reaching retirement at sixty years, and may designate beneficiaries to receive the other half at his death, after retirement; if he dies before retirement, the entire amount in his account is paid his beneficiary. Two employees, *A* and *B*, each irrevocably designate their wives and children as beneficiaries. *A* dies one day before his sixtieth birthday. Since he had a "right" at his death to the payment of one-half of his benefit, the entire lump sum payment to his beneficiary is included in his gross estate under section 2039. *B* dies one day after his sixtieth birthday. Since he no longer had any "right" to any pay-

⁸⁵ Treas. Reg. § 20.2039-1(b)(2) exs. (2)-(6), (c) ex. (2) (1958).

⁸⁶ Treas. Reg. § 20.2039-1(b)(2) ex. (5) (1958).

ment at all (having received his one-half before death) and is no longer receiving any payment, the lump sum paid his beneficiary is not taxable under section 2039. And it is hard to see how it can be taxed under any other section of the Code, unless *B*'s designation of the beneficiary was made in contemplation of death within three years of his death. *B* had no life interest, no reversion, no power over or in the benefit paid the beneficiary. Why should *B* receive such favored treatment over *A* here? Do we want to penalize *A* because he died younger than *B*—this, indeed, is a queer philosophy!

Actually, under the present Code, it would seem that all employee benefits not covered by section 2039—insurance and pure death payments—should be treated alike. The test should be that of section 2042—retention of control. For noninsurance death benefits, taxation should be based upon retention of control—if all control were divested more than three years before death there should be no tax here (since there is no lifetime benefit involved, there is no retained life interest or reversionary interest to consider). Arguments based on expectancies and lack of a transfer should be rejected as unrealistic.

Other problems arise here. Would *B*'s transfer to his beneficiary be taxable under section 2035 if he designated the beneficiary more than three years before his death, to the extent of any contributions made by *B* or his employer within three years of *B*'s death? If so, how much of the benefit would be taxed? An amount equal to the payments made during the three-year period? The proportion of the benefits equal to the ratio between all payments made for the benefit and those made within the three-year period? An amount equal to the difference between what the beneficiary would have received had *B* died three years ago and what the beneficiary did receive when *B* actually died?⁸⁷

4. *The Effect of Consideration*

Another problem may arise from the fact that section 2039, unlike the other sections of the Code except section 2042, does not exempt transfers made for a valuable consideration in money or money's worth. Suppose an employee designated *B* as beneficiary of a survivor-employee annuity upon receipt of a valuable consideration from *B*? Suppose *B* was his wife, and the designation was made as part of a written separation agreement, followed three years later by a divorce decree incorporating the agreement. Even if section 2516⁸⁸ is to be read

⁸⁷ See note 11 *supra*.

⁸⁸ This section exempts from the gift tax transfers of property between spouses pur-

into the estate tax, it would not apply here, since it requires that divorce occur within two years after execution of the separation agreement. Would the doctrine of the *Harris*⁸⁹ case apply, when section 2039 does not exempt a transfer for consideration? Arguably it should, if the principle of the *Harris* case is that a transfer pursuant to a court decree is exempt even if no consideration is present—the *Harris* case ignores consideration, as does section 2039.

Moreover, the benefit is included under section 2039 in the employee's estate only to the extent that he paid for it (either directly or through his employer's contributions). If the employee transfers his benefits for a full and adequate consideration, it would seem that the transferee should be treated as having contributed the entire purchase price for the benefits; or if the transferee furnishes some, but less than full and adequate consideration, he should be considered to have contributed part of the purchase price (in the proportion that the consideration bears to the value of the benefits at the time of the transfer).

5. *The Marital Deduction Problem*

In the case of employee benefits taxed under section 2039, if the beneficiary is a surviving spouse, will a marital deduction be allowed for the benefit, since it is included in the gross estate? Of course, the benefit must not be a terminable interest, or if it is, it must fall within one of the exceptions to the terminable interest rule. But is it an interest "passing" to the surviving spouse as required by section 2056? Section 2056(e), which defines the seven types of situations where property *passes*, does not specifically refer to section 2039 or to annuities. The only one of these seven situations which seems applicable to annuities is the fourth: an interest "transferred to" the spouse by the decedent at any time. In view of the decisions under the 1939 Code stating that there was no tax because there was no *transfer* by decedent of any interest to the beneficiary of an employee survivorship annuity,⁹⁰ it could well be argued that such annuities do not pass from decedent to the surviving spouse. It is doubtful if Congress intended this result, and the Regulations wisely state specifically that to the extent that the value of it is

suant to a written agreement made in settlement of marital or property rights or to support minor children, but only if divorce occurs within 2 years of the agreement. It is uncertain if this will be read into the estate tax. See LOWNDES & KRAMER, *op. cit. supra* note 2, at 323.

⁸⁹ *Harris v. Commissioner*, 340 U.S. 107 (1950) (transfer of property in satisfaction of marital rights pursuant to divorce decree held not a taxable gift).

⁹⁰ See note 19 *supra*.

included in decedent's gross estate, an annuity or payment to a surviving spouse subject to section 2039 is considered to have passed from the decedent so far as the marital deduction is concerned.⁹¹

6. *Transfers in Contemplation of Death*

Suppose that less than three years before his death an employee receiving payments under a survivorship annuity for himself and his wife transfers all his rights to future payments thereunder to his wife in contemplation of death. What amount will be included in his estate: only the value of what he transferred in contemplation of death—the value of his right to future payments for himself alone; or the value of what would have been included in his gross estate (her survivorship annuity) but for his transfer in contemplation of death? The Regulations are silent on this point. The same question arises when there is a release in contemplation of death of a reserved life estate, a reversionary interest, or incidents of ownership in life insurance. The Regulations⁹² indicate that in these three cases, not merely the value of the "string" (the life estate, reversionary interest, or incident of ownership), but the value of all the property taxable but for the transfer in contemplation of death of the "string" is taxable. However, unlike the situations of powers to alter or amend or of powers of appointment,⁹³ there is no express provision of the Code requiring this result. Moreover, the courts reach the opposite result under section 2040⁹⁴ when a joint owner transfers his interest and severs the tenancy in contemplation of death, taxing only the value of the transferor's "string"—his fractional share of the jointly-owned property (not the part proportional to his contribution to its acquisition, which would be taxed if there were no transfer in contemplation of death). So far as section 2039 is concerned, the

⁹¹ Treas. Reg. § 20.2056(e)-1(a)(6) (1958).

⁹² Treas. Reg. §§ 20.2035-1(b); 20.2042-1(a)(2) (1958). Cf. Rev. Rul. 324, 1956-2 CUM. BULL. 999.

⁹³ INT. REV. CODE OF 1954, §§ 2038(a), 2041(a)(1)(B), (2).

⁹⁴ *Sullivan v. Commissioner*, 175 F.2d 657 (9th Cir. 1949); *A. Carl Borner*, 25 T.C. 584 (1955); *Edward Carnall*, 25 T.C. 654 (1955). Cf. Rev. Rul. 448, INT. REV. BULL. 1957-41, at 43. The Proposed Regulations followed the rule of these decisions. Proposed Treas. Reg. § 20.2040-1(d), 21 Fed. Reg. 7879 (1956). The Final Regulations are silent on this point. Treas. Reg. § 20.2040-1 (1958). See LOWNDES & KRAMER, *op. cit. supra* note 2, at 230-34, 314-17; Lowndes, *Cutting the "Strings" on Inter Vivos Transfers in Contemplation of Death*, 43 MINN. L. REV. 57 (1958); Note, 66 YALE L.J. 140 (1956); Wright, *Transfers of Joint Property in Contemplation of Death—A Call for Immediate Statutory Revision*, 55 MICH. L. REV. 1 (1956).

tax should be based upon the interest otherwise includible in the employee's estate but for the transfer in contemplation of death.

C. The Amount Taxable Under Section 2039

All amounts of the benefits attributable to contributions by the employee are included under section 2039 (unless exempted by 2039(c)). Contributions of an employer are attributed to the employee if made by reason of his employment. The contributions of the employer include all those made by reason of employment by a present or former employer and extend to any payment offered as an inducement to employment or a continuance thereof or in lieu of additional compensation or other rights, if so understood by the employer and employee, even if not stated expressly in the contract or agreement.⁹⁵ Thus, section 2039 applies to a wholly noncontributory plan where the employer alone makes contributions to the plan. Section 2039(c), however, provides that in the case of benefits under qualified plans, the contributions of an employer are not attributed to the employee.

D. The Gift Tax

Although it would seem that an irrevocable designation of a beneficiary by the employee for a benefit would be a taxable gift, there is very little law on the point.⁹⁶ The Treasury has, in fact, ruled that such a designation is a taxable gift.⁹⁷ The real problem is that the gift tax is, as a practical matter, administratively ineffective here. In the case of the inter vivos designation of a beneficiary, unlike death with probate of the estate, it is hard for the Treasury to get information. Moreover, the valuation problem is acute. What is the value of the benefit if it is not vested, if it is subject to one or more conditions precedent until the employee dies, if it is forfeitable by either employee or employer until the former's death? Should the transfer escape the gift tax because it cannot be valued when made, or should the tax be deferred until the rights vest and can be taxed although the rights may not vest until the employee dies? The Treasury apparently does not impose a gift tax unless the employee has an "unqualified right" to the benefit,⁹⁸ deferring any tax until vesting.

Even if the designation is made of vested rights, problems remain.

⁹⁵ H.R. REP. NO. 1337, 83d Cong., 2d Sess. A315 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 471 (1954). See Treas. Reg. § 20.2034-1(c) (1958).

⁹⁶ See LOWNDES & KRAMER, *op. cit. supra* note 2, at 653-55.

⁹⁷ Treas. Reg. § 25.2511-1(h)(10) (1958). Cf. Rev. Rul. 307, INT. REV. BULL. 1958-25, at 16.

⁹⁸ *Ibid.*

Is the interest a present one, entitled to the \$3000 exclusion? The mere fact that it consists of future payments is not conclusive that it is a future interest. An irrevocable designation of a beneficiary for the proceeds of an insurance policy is a transfer of a present interest, even if the policy then has no cash surrender or loan values.⁹⁹ On the other hand, an irrevocable transfer of a remainder would be a transfer of a future interest.¹⁰⁰ Does this mean that if the benefit is insurance the exclusion is allowed, but if it is a noninsurance straight death benefit it is not? What about a joint or survivor annuity? Here, the few cases in point seem to treat the transfer as one of a future interest, unless the donee has an immediate right to the cash surrender value.¹⁰¹ What about contributions made after the designation of the beneficiary—are those made each year a taxable gift; and if so, are they present interests? Presumably they are present interests only if the transfer of the annuity itself was.¹⁰²

The truth is that even if a vested right is transferred, the present value of that right at the time of transfer may be so much less than its value at the employee's death that the gift tax is a wholly ineffective substitute for the estate tax. Taxation of subsequent contributions after the designation is difficult and unlikely. The employee benefits involved here are death benefits—seldom if ever does the beneficiary get any *inter vivos* rights of any kind worth anything.

III

THE EXPRESS TAX EXEMPTIONS FOR EMPLOYEE BENEFITS

Section 2039(c) gives an exemption from the estate tax for that part of all employee benefits not attributable to employee (as distinguished from employer) contributions under qualified plans,¹⁰³ if the bene-

⁹⁹ Treas. Reg. § 25.2503-3(a) 1958; Rev. Rul. 408, 1955-1 CUM. BULL. 113.

¹⁰⁰ *Welch v. Paine*, 120 F.2d 141 (1st Cir. 1941); *Commissioner v. Glos*, 123 F.2d 548 (7th Cir. 1941); *Rosa A. Howze*, 2 T.C. 1254 (1943); *Alma S. Hay*, 47 B.T.A. 247 (1942).

¹⁰¹ *Roberts v. Commissioner*, 143 F.2d 657 (5th Cir. 1944), *cert. denied*, 324 U.S. 841 (1945); *Clara Ream*, P-H TCM ¶43,501; *Elizabeth C. Morrow*, 2 T.C. 210 (1943).

¹⁰² *Roberts v. Commissioner*, *supra* note 101. This is the rule followed in gifts of life insurance policies. *Commissioner v. Boeing*, 123 F.2d 86 (9th Cir. 1941); *Francis P. Bolton*, 1 T.C. 717 (1943); *George B. Caudle*, P-H TCM ¶45,100; Rev. Rul. 408, 1955-1 CUM. BULL. 113.

¹⁰³ Originally, section 2039(c)(1) referred to an annuity or other payment under an employee's trust (or a contract purchased by the trust), pension, stock bonus, or profit-sharing plan which "met the requirements of section 401(a)." Section 2039(c)(2), however, referred to a retirement annuity contract purchased by the employer (not by

ficiary is not the executor of the employee. The exemption is retroactive to December 31, 1953.

There is now a similar exemption for the gift tax under section 2517, first enacted by the Technical Amendments Act of 1958,¹⁰⁴ retroactive to December 31, 1954. It exempts from the gift tax all exercises or nonexercises of elections, options, or powers to revoke made after December 31, 1954, by employees under qualified plans whereby a benefit becomes payable to a beneficiary after or at the employee's death. The exemption does not cover the part of the benefits attributable to employee contributions. Section 2517 also expressly states that its enactment is without prejudice to the taxation or nontaxation of irrevocable transfers of these employee benefits prior to this date. It exempts a transfer made either by the exercise or nonexercise of an option or election or power to revoke.

Are these exemptions warranted as sound tax policy? In their present form, are they unfair and discriminatory? To answer the last question first, I think they are unfair.

A. Benefits Payable to the Executor

For example, why is the estate tax exemption barred if the beneficiary is the executor of the employee? What is so heinous if the executor is the beneficiary rather than some one else? Is this carried over from life insurance, where the tax law in section 2042(1) sharply distinguishes policies payable to the insured's executor and those payable to other beneficiaries, and, until 1942, gave a special exemption of \$40,000 only for the latter? But the reason for the life insurance distinction originally was doubt about the constitutional and proper way to tax life insurance proceeds—a reason which has no bearing upon the exemption under section 2039(c).

What is the meaning of "executor"? The Regulations¹⁰⁵ say it means "receivable by or for the benefit of the decedent's estate." This is sound, for it follows the rules of taxability of insurance proceeds payable to the executor under section 2042, which has been similarly interpreted for years.¹⁰⁶ This means payments to a beneficiary under a

an employees' trust) pursuant to a plan which met "the requirements of section 401(a)(3)" only. This difference was apparently a legislative oversight, and section 67 of the Technical Amendments Act of 1958, 72 Stat. 1658-59 (1958), amends section 2039(c)(2) retroactively until December 31, 1953 (the effective date of Section 2039(c)), to provide that the annuity must be purchased by the employer pursuant to a plan which meets the requirements of "section 401(a)(3), (4), (5), and (6)."

¹⁰⁴ 72 Stat. 1659 (1958). ¹⁰⁵ Treas. Reg. § 20-2039-2(b) (1958).

¹⁰⁶ See LOWNDES & KRAMER, *op. cit. supra* note 2, at 293-95.

binding legal obligation to pay debts or taxes of the estate are not exempt to the extent of the amounts of such charges.¹⁰⁷

B. Qualified Plans

Why limit the exemptions to qualified plans only? The concepts and limitations¹⁰⁸ prescribed for qualified plans arose out of *income* tax problems—the allowance of a current deduction to employers for their current contributions to employee benefit plans¹⁰⁹ and the postponement for employees of any income tax liability on the employer's current contributions until the employees have retired and actually received benefits.¹¹⁰ These issues have no relationship to the problems we have already discussed at length about imposing an estate tax on employee benefits. Will not the denial of the exemption to nonqualified plans unfairly discriminate against them? In particular, does it not make it virtually impossible for unfunded plans and for small companies which find it hard to meet the requirements for qualified plans to obtain the benefits of the exemption? If it is feared that a blanket exemption for all plans might lead to abuses, why not control the exemption by definite limitations reflecting the estate tax problems, rather than indirectly through limitations basically reflecting income tax problems?¹¹¹ The qualified

¹⁰⁷ Treas. Reg. § 20.2042-1(b)(1) (1958). Cf. M. B. Morton, 23 B.T.A. 236 (1931); Pacific Nat'l Bank of Seattle, 40 B.T.A. 128 (1939); Silas B. Mason, 43 B.T.A. 813 (1941); Waldo Rohmert, 40 B.T.A. 1319 (1939); Mathilde B. Hooper, 41 B.T.A. 114 (1940); Charles Howard Wade, 47 B.T.A. 21 (1942) (no binding obligation).

¹⁰⁸ The requirements of a qualified plan are set forth in section 401. Briefly, they include: (1) no part of the income or corpus may be used for any purpose other than the exclusive benefit of the employees and their beneficiaries; (2) the plan may not discriminate in contributions or benefits or coverage in favor of officers, shareholders, supervisors, or highly paid employees; or (3) the plan must benefit 70% of all employees (or 80% of all those eligible if 70% are eligible), excluding those not employed for a minimum period (not exceeding 5 years), or excluding certain part time or seasonal employees. A plan does not discriminate if its coverage is limited only to salaried or clerical employees, or because it takes into account Social Security benefits (or even excludes those whose wages do not exceed the maximum amounts subject to Social Security taxes). The benefits and contributions may bear a uniform relationship (for contributions or benefits) to the total compensation or regular rate of compensation of employees.

¹⁰⁹ INT. REV. CODE OF 1954, § 404.

¹¹⁰ *Id.*, § 402(a)(1), providing for deferment of tax until the benefits are "distributed or made available."

¹¹¹ The exemption now extended to benefits for nonqualified plans (*infra* note 112) covers only nonforfeitable rights, only retirement annuities, only employees of a very limited group of nonprofit organizations. It is hard to rationalize these limitations so far as the estate and gift taxes are concerned.

plan seems a crude and ill-designed tool for estate tax purposes, in its present form at least.

In fact, Congress has already recognized this and begun a process, which one can predict will undoubtedly continue, of gradually eroding and breaking down the qualified plan concept. The 1958 Technical Amendments Act¹¹² extends the gift and estate tax exemptions to certain nonqualified plan annuities for employees of certain tax-exempt non-profit organizations. It is hard to criticize the extension (since such organizations are exempt from the income tax, they have no incentive to set up qualified plans to insure a deduction for their contributions to employee plans), and yet, one wonders if this is not the opening wedge, if other special groups will not present equally appealing arguments for exempting their nonqualified plans, which Congress will find it hard to resist on logical, policy, or political grounds. An exemption, once granted to one group or interest, tends to spread to others, as evidenced by capital gains and depletion.

The plan under section 2039(c) must be qualified either when the employee's service ends (by death or otherwise) or when the plan itself ends. Under section 2517, the plan must be qualified either when the plan ends or when there is an exercise or nonexercise of an option or election by the employee so that a benefit becomes payable to the beneficiary at or after the employee's death. The benefit may arise from a retirement annuity contract purchased directly by the employer or one purchased by an employee's trust, or the benefit may be paid by the trust as part of a pension, stock bonus, or profit-sharing plan.

1. *Benefits Not Otherwise Taxable Under Section 2039*

Do the exemptions of sections 2039(c) and 2517 cover only employee benefits (under qualified plans) which are otherwise subject to tax under section 2039, or do they extend to all employee benefits under qualified plans, including insurance which is not taxed under section 2039 and pure death benefits where the employee receives no payments and has no right to payments? The language of section 2039(c) is sweeping, for it covers benefits under "the provisions of this section or of any provision of law," and would seem to cover all benefits under qualified plans. So, also, section 2517 states that the exempted type of exercise or nonexercise of an election or option "shall not be considered a transfer for purposes of this chapter." The Treasury initially in the

¹¹² 72 Stat. 1622-23 (1958).

Proposed Estate Tax Regulations¹¹³ restricted the exemption of section 2039(c) to benefits otherwise taxed under section 2039. The Final Estate Tax Regulations,¹¹⁴ which seem in accord with the statutory language, grant the exemption to all qualified plan benefits, including insurance. Thus, in an example¹¹⁵ in the Regulations, the plan, a qualified one, purchased an insurance policy with the employer's contributions to provide a survivorship annuity for the employee and his wife upon his retirement at sixty-five. If he died before retirement, as he did, the beneficiary received a lump sum payment of either \$10,000 or the reserve value of the policy, whichever was greater. The entire lump sum, even if insurance, is exempt under section 2039(c).

The exemption of section 2039(c) also applies to a single lump sum noninsurance payment under a qualified plan to a surviving beneficiary. For example,¹¹⁶ suppose under a qualified plan the employer alone made contributions, all of which were payable to the employee in a lump sum at retirement at sixty, with payment in a lump sum to his beneficiary if he died before retirement. If the employee died at fifty, the lump sum payment to the beneficiary is fully exempt under section 2039(c).

As a matter of policy, I would find it hard to justify restriction of the exemption solely to those benefits taxed by section 2039—I see no reason why such benefits should be taxed differently—either more leniently or more harshly—than benefits such as pure death benefits or insurance¹¹⁷ taxable only, if at all, under sections of the Code. Yet, this means that for employee *insurance* benefits under qualified plans, the employee may retain all incidents of ownership until death without estate tax liability.

2. *Self-Funded and Nonfunded Benefits*

Does section 2039(c) apply to self-funded benefits, since the exemption applies only "to contributions or payments made" by the em-

¹¹³ Proposed Treas. Reg. § 20.2039-2(a), 21 Fed. Reg. 7850 (1956).

¹¹⁴ Treas. Reg. § 20.2039-2(b) ex. (3) (1958).

¹¹⁵ *Ibid.*

¹¹⁶ Treas. Reg. § 20.2039-2(b) ex. (2) (1958).

¹¹⁷ True, the income tax provisions disfavor insurance in certain ways: contributions by employees to some types of nonforfeitable insurance coverage, even if part of a qualified plan, are current income to the employee. Treas. Reg. § 1.402(a)-1(a)(3) (1956). Nor will a plan qualify unless insurance benefits are "incidental." Treas. Reg. § 1.401-1(b)(1) (1956); Rev. Rul. 67, 1954-1 CUM. BULL. 149. Perhaps the argument may be made that the same approach should control for the estate tax, but this is unsound, since the income tax rule is based upon the distinction between current and deferred income—a distinction wholly inapplicable to the estate tax.

ployer under a trust or plan? Clearly, it would seem that in a self-funded plan, the employer can and does make payments or contributions to the trust or plan, even if there is no purchase of a contract from an insurance company. The Regulations so assume, quite properly.¹¹⁸

What about qualified unfunded plans—may their benefits qualify for section 2039(c)? The Regulations are silent, giving no examples involving unfunded plans. Yet, if such plans may qualify, certainly they should obtain the benefit of section 2039(c). But how would the contributions of employee and employer be separated? Would all benefits be attributed to the employee's contributions, as represented by the services he rendered? Or would all contributions be attributed to the employer, by reason of his agreement or promise or assumption of liability? Even if a plan is supposed to be noncontributory, trouble may arise unless there is a definite, unambiguous statement and agreement that all costs are borne by the employer alone—absent such a statement, mere silence might permit the inference that the employee, through his services, was also contributing. Certainly, if the plan is unfunded, there must be a clearcut spelling out of exactly what each party—employer and employee—is contributing or not contributing and at what times. Otherwise, it will be impossible to apply the exclusion of section 2039(c), because there will be no way to ascertain the amount of it, since the statutory formula cannot be used when the contributions of the employer or of the employee are uncertain or unknown and unascertainable.

Section 2517 contains similar language, and if section 2039(c) applies to self-funded plans, then certainly section 2517 does. Unfunded plans raise the same problems under section 2517 as under section 2039(c).

3. *Benefits Received From Employees*

Other distinctions, too, I find hard to defend. Thus, the Treasury takes the position that if the benefits are actually received by the employee, even constructively—while alive—then the exemption of section 2039(c) does not apply to them. For example,¹¹⁹ an employee at sixty, upon retirement, has three options under a qualified plan for his benefits. He may receive them in a lump sum, elect a survivorship annuity for himself and his wife, or leave them on deposit with the fund, receiving interest during his life and having the right to withdraw all or

¹¹⁸ Treas. Reg. § 20.2039-2(b) exs. (1), (2) (1958).

¹¹⁹ Treas. Reg. § 20.2039-2(b) ex. (4) (1958).

part of the principal at any time before his death. Principal not withdrawn will be paid to his beneficiary. If, upon retirement, he selects the third method and withdraws no principal before his death, he has "constructively" received the principal, and the exclusion of section 2039(c) does not apply, since the principal is receivable by the beneficiary from decedent, not from the plan itself.

If the employee could not withdraw principal, would the result be the same? A recent income tax ruling¹²⁰ states that an option to elect irrevocably before or at retirement to have all or part of non-forfeitable benefits otherwise paid the employee during his lifetime paid to a designated beneficiary after death will disqualify a plan, so the exemption of section 2039(c) will be lost. Why should this be true? Does it matter at all to the beneficiary whether his benefits come directly from the plan or are routed to him from the plan via the employee?

No doubt the same rule applies to the exemption under section 2517. It does not apply to any transfers not made pursuant to an election or option provided in the qualified plan of an annuity or payment provided for under the plan, and so presumably would not exempt benefits "constructively received" by an employee who thereafter transferred them to a beneficiary. Moreover, since it does not exempt any benefits receivable by a beneficiary during the employee's lifetime, it would not exempt benefits "constructively received" by the beneficiary prior to the employee's death.

C. Determination of the Amount of the Exemption Under Qualified Plans

The amount of the exclusion under section 2039(c) is determined by applying to the value of the survivor benefits at the decedent's death a fraction whose numerator is the contributions of the employer and whose denominator is the total contributions made for the benefit. If it is impossible to determine otherwise the amount of the employer's contributions and the amount of the total contributions, then the total contributions are ascertained by taking the value of the annuity or payment payable to the employee and his beneficiary when the employee's rights first mature (or when the survivor's rights first mature, if the decedent's rights never matured). From this the employee's contributions are subtracted in order to ascertain the employer's contribu-

¹²⁰ Rev. Rul. 656, 1956-2 CUM. BULL. 280.

tions. Decedent's contributions include interest accrued on amounts actually paid into the plan by him.

Thus, in an example in the Regulations,¹²¹ the qualified plan provided a survivorship annuity for the employee who died at sixty-five; upon retirement at sixty. The value of the widow's annuity was \$16,000, the value of the joint annuity at the time of retirement was \$40,000. Decedent contributed \$10,000, but the employer's contributions were not credited to accounts of individual employees. The total contributions here are \$40,000 (the value of the joint annuity when decedent retired). The employer's contributions are \$30,000 (\$40,000 minus \$10,000). The exclusion then amounts to \$12,000 $\left(\frac{30,000}{40,000} \times 16,000 = \$12,000 \right)$.

If the decedent died before retirement, there would be an exclusion of \$6,000, the total amount of the employee's contributions then being included (total contributions = \$16,000, the value of widow's annuity; $\$16,000 - 10,000 = \$6,000$, the employer's contribution; $\frac{6,000}{16,000} \times 16,000 = \$6,000$ exclusion).

The amount excluded under section 2517 for the gift tax is equal to the total value of the donee's benefit at the time of the irrevocable election multiplied by a fraction whose numerator is the contributions until then of the employer and whose denominator is the total contributions until then for the benefit. If it is impossible to determine the amount of these contributions, then, as under the estate tax, the total contributions would equal the value at the time of the transfer of the annuity or other payment payable to the employee and the beneficiary. The employer's contributions are ascertained by subtracting from this the value then of the employee's contributions until this time.

What if after the initial transfer by the exercise or nonexercise of an election or option, further contributions are made? Section 2517 is ambiguous on this point, but such contributions should be construed as covered by the exemption, as Congress undoubtedly intended, when they increase or preserve the value of the beneficiary's rights, for by making or permitting the additional contributions to be made, the employee, in effect, is exercising or not exercising a further option or election under the plan. How would the amount of the exclusion for additional

¹²¹ Treas. Reg. § 20.2039-2(c)(2) (1958). See S. REP. NO. 1622, 83d Cong., 2d Sess. 471-72 (1954).

annual contributions be determined? The statute is silent on this point. A possible method would be to exclude that portion of the increase in value of the beneficiary's rights during the year in question determined by multiplying the amount of this increase in value by a fraction whose numerator is the contributions of the employer during this year and whose denominator is the total amount of contributions during the year. Should it be impossible to determine the amount of these contributions, the total yearly contribution would equal the total increase in value during that year of the benefits payable to the beneficiary and the employee, and the employer's contributions for the year would be ascertained by subtracting from the amount of this increase in value the employee's contributions during this year.

D. Nonqualified Plan Exemptions

The *income* tax exemption for employees' annuities added by the Technical Amendments Act of 1958¹²² covers all employees of non-profit corporations within section 501(c)(3) (unless exemption is denied under sections 502, 503, and 504, relating to "feeder organizations," prohibited transactions, or unreasonable accumulations of income or improper expenditures or investments). This includes religious, educational, charitable, and scientific corporations or foundations. It covers only retirement annuities purchased by the employer and employee which are not part of a qualified plan.^{122a} In contrast with the requirements for qualified plans, the exemption is granted here only if the employee's rights are nonforfeitable except for nonpayment of future premiums.

The employee is not currently taxed¹²³ on employer contributions which do not exceed his "exclusion allowance" for the current year. The exclusion allowance is an amount equal to twenty per cent of his current taxable compensation (excluding employer contributions, whether or not included in his gross income),¹²⁴ multiplied by his total

¹²² 72 Stat. 1620-23 (1958), amending INT. REV. CODE OF 1954, § 403.

^{122a} The mere fact that a person is entitled to qualified plan exclusions does not prevent his obtaining these nonqualified plan exclusions, if he is covered by two plans, one qualified and one not, of the same employer, or by two such plans of two different employers. See H.R. REP. NO. 262, 85th Cong., 1st Sess. 62 (1958); S. REP. NO. 1983, 85th Cong., 2d Sess. 147-48 (1958).

¹²³ When a previously forfeitable contract becomes nonforfeitable, the value of the contract at the time of the change is included in the employee's gross income to the extent that it is attributable to amounts contributed by the employer *after* the calendar year 1957. This applies to *all* organizations exempt under section 501(a) or 521(a) (farm cooperatives). 72 Stat. 1622 (1958).

¹²⁴ If previously forfeitable rights become nonforfeitable, then all amounts then

number of years of service with the employer, less all employer contributions excluded from his gross income in prior years.

Current compensation includes only the salary received from the tax-exempt employer and is restricted to amounts included in gross income, except that exclusions for sick pay under section 105(d) and for earned foreign income under section 911 are disregarded. In addition, all employer contributions are excluded from gross income for this purpose only, whether otherwise subject to exclusion under this section or not. It includes compensation for the most recent period, which is a full year of service ending no later than the close of the employee's taxable year. Thus, an exclusion allowance for 1960 may be based on 1958 compensation if that is the last taxable year when the employee received salary from the employer, as in a terminal-funding arrangement.

For example, if a full-time college teacher receives an annual salary of \$10,000 his first year of employment, his exclusion allowance for the year is \$2,000 ($.20 \times \$10,000$). Thus, any contributions by the college (but not contributions which are made by him as deductions from his salary) to a vested retirement annuity not in excess of \$2,000 are not included in his gross income under the income tax. If he worked four years, his exclusion allowance would total \$8,000. Of course, for income tax purposes, if the college contributed \$6,000 in the first three years of employment, his exclusion allowance the fourth year would equal only \$2,000 ($\$10,000 \text{ salary} \times .20 = \$2,000 \times 4 \text{ years service} = \$8,000$, minus \$6,000 representing amounts of employer contributions excluded in three prior years = \$2,000).¹²⁵

Part-time employees are covered by special rules in ascertaining the exclusion allowance. Until their total employment on a part-time basis equals at least one year, their period of service is one year. Thereafter, the period of service is the exact time (in years and fractions thereof) they have worked (5 years on $\frac{1}{2}$ time basis equals $2\frac{1}{2}$ years service). Their total compensation is figured on the basis of all salary actually

included in the employee's gross income because of this fact (see note 123 *supra*) are treated as employer contributions made at the time of the change, so far as ascertaining the employee's compensation for purposes of computing his compensation for the exclusion allowance for that year is concerned, whether or not they are otherwise excludable under this section. This means all such amounts are excluded then in computing the employee's current compensation for the exclusion allowance. 72 Stat. 1620-21 (1958).

¹²⁵ See H.R. REP. NO. 262, 85th Cong., 1st Sess. 65 (1957); S. REP. NO. 1983, 85th Cong., 2d Sess. 151-52 (1958).

paid them in the most recent periods of part-time service which actually equal full-time for one year (or actual salary if they have not worked the equivalent of full-time for one year). Thus, salary is aggregated from recent periods until the total of the periods equals a full year of full-time service. So, if a part-time employee has worked one year only on a half-time basis at a total salary of \$7,500, his exclusion allowance is \$1,500 ($.20 \times \$7,500$). If he works two years on this basis, his exclusion allowance equals \$3,000 ($\$15,000 \times .20$). If he works three years on the same scale, his allowance is \$4,500 ($\$15,000 \times .20 \times 1\frac{1}{2}$) (assuming no employer contributions are excluded in the prior years).¹²⁶

The estate and gift tax exemptions¹²⁷ apply only to contributions by an employer for a retirement annuity contract purchased by the employer for an employee to the extent that the employer's contributions were excludible from current income under the income tax. The estate and gift tax exemptions are more limited than the income tax one, however, for they cover only employees of organizations within section 503(b)(1)(2) and (3) (unless exemption is denied under sections 502-504). This includes only: (1) a religious organization (not a trust); (2) an educational organization with a regular faculty, curriculum, and student body in attendance; and (3) an organization which normally receives a substantial part of its income (excluding income received in performing its charitable or educational functions) from the federal or state government or a division thereof or from contributions, direct or indirect, from the general public.¹²⁸

¹²⁶ See H.R. REP. NO. 262, *supra* note 125, at 64; S. REP. NO. 1983, *supra* note 125, at 150-51. T.D. 6335, INT. REV. BULL. 1958-49, at 33, 37-39, sets forth temporary rules 18.1-5 relating to part-time employees.

¹²⁷ 72 Stat. 1622-23 (1958).

¹²⁸ The income tax exemption, for employee death benefits not in excess of \$5000, of section 101(b)(1)(2) is also extended to these annuity contract benefits of employees of these same organizations. 72 Stat. 1622 (1958). The exemption here is the lesser of either \$5000 or an amount computed as follows: that proportion of the total death benefits (deducting the employee's contributions and the employer's contributions in excess of the exclusion allowance) otherwise included in gross income represented by a fraction whose numerator is the amount of the contributions of the employer (for the benefits) excludible from gross income under section 403 (the exclusion allowance) and whose denominator is the total contributions of the employer. Thus, if the employer contributed \$6000, the excludible amounts totaled \$4000, the decedent contributed \$1,000, and the death benefit totaled \$10,000, the exclusion would total $\$4667 \left(\frac{4000}{6000} \times [10,000 - 1000 - 2000] \right)$ or 7000 = 4667). See the example in S. REP. NO. 1983, *supra* note 125, at 153. There is ambiguity as to how the exclusion allowance is to be computed here. See text *infra* at 385.

Since the employee's rights must be vested and nonforfeitable, many of the problems posed by qualified plan benefits are absent here.

1. *Exclusion Allowance Problems*

For estate and gift tax purposes, the exclusion allowance is apparently to be figured in the same way as for the income tax. There are some ambiguities here, however. For income tax purposes, the exclusion is computed annually for each taxable year on the basis of 20 per cent of current salary, times years of service, less amounts excluded in prior years from gross income. The statute, in referring to the exclusion of section 2039(c), covers employer contributions "to the extent excludible under section 403(b)." Section 2517 requires inclusion of employer contributions "to the extent not excludible from gross income under section 403(b)." Since these amendments to section 403(b) apply only to taxable years after December 31, 1957, does this mean the estate and gift tax exclusion covers only employer contributions made thereafter? Such contributions actually were excluded from gross *income* under the income tax prior to 1958, so there is no income tax problem here. Or will the estate and gift tax exclusion be computed by applying the formula of section 403(b) separately to employer contributions in each year, even if made prior to 1958? Or, will the solution be to apply the income tax formula upon the basis of the last year of service of the employee, with or without deduction for prior exclusions?

For example, suppose an employee has worked for five years before he dies before retirement on January 1, 1961. His annual salary (full time) was \$8,000 in 1956-58, and \$10,000 thereafter. The employer contributed \$1,600 for the first three years, and \$2,000 thereafter to purchase the annuity. Is his estate tax exclusion (1) \$5,600—that is, 20 per cent for each year subsequent to 1957; or (2) \$8,800—that is, 20 per cent of each year's salary since 1955, when he started work; or (3) \$10,000—that is, 20 per cent of \$10,000 x 5, his total years of service; or (4) \$3,200—that is, the exclusion allowance for 1960 only (20 per cent of \$10,000 x 5, minus \$6,800)? The second method seems the fairest. The Senate Committee Report is ambiguous, but it several times, in regard to the exclusion for the estate and gift taxes, refers to "the 20 per cent rule," showing perhaps that the exclusion is to be so calculated for the gift and estate taxes as to result in an exclusion similar to that for the income tax, a slight indication perhaps that the second or third method is to be used rather than the first or fourth.¹²⁹

¹²⁹ S. REP. NO. 1983, 85th Cong., 2d Sess. 38-39 (1958).

For annuities under nonqualified plans, the exclusion under section 2039 and section 2517 is based upon the total amount of the employer's contributions or the exclusion allowance, whichever is less. The exclusion amount is the value of the benefit multiplied by a fraction whose numerator is the lesser of the contributions of the employer or of the exclusion allowance, and whose denominator is the total contributions. Thus, if in a noncontributory plan the employer contributed \$27,000, and the exclusion allowance was \$24,000, and the beneficiary received at the employee's death an annuity valued then at \$9,000, only \$1,000 of this value would be included in his gross estate $\left(\frac{24,000}{27,000} \times 9,000 = \$8,000 \text{ excluded}\right)$. If the employee contributed \$8,000, the employer \$32,000, the exclusion allowance was \$30,000, and the annuity's value was \$48,000 when the employee died, the amount taxable would be \$12,000 $\left(\frac{30,000}{40,000} \times 48,000 = \$36,000 \text{ excluded}\right)$.

One problem that may arise is to distinguish employer from employee contributions in certain cases. Suppose an employee is paid \$10,000 a year by a hospital, and the hospital has been contributing \$1000 a year to purchase him a retirement annuity. The employee in 1959 agrees with the hospital either that: (1) in lieu of a salary increase of \$1000 to which he is now entitled, the hospital will contribute \$2000 a year to the annuity's purchase; or (2) the hospital will contribute \$1800 a year to the annuity's purchase, the employee's salary being reduced to \$9000. Under the 1954 Act, prior to the 1958 Act, the Treasury's rules¹³⁰ about employer contributions for the purchase of retirement annuities for employees under the nonqualified plans of certain tax-exempt employers were that the contributions were taxed as current income to the employee unless the annuity's purchase was "merely a supplement to past or current compensation." In applying these tests, the Treasury took the position that in the above two examples, the additional contributions of \$1000 or \$800 by the employer were taxed as current income to the employee.¹³¹ But the Senate Committee Report¹³² on the 1958 Act specifically states that the "committee intends the objective 20 per cent rule [exclusion allowance] . . . as a complete substitute" for these former rules. The only exception is that where an employee, with respect to "an amount already earned," takes a re-

¹³⁰ Rev. Rul. 267, 1954-2 CUM. BULL. 58; Treas. Reg. § 1.403(a)-1(a)(3) (1956). Cf. Rev. Rul. 181, 1953-2 CUM. BULL. 111.

¹³¹ *Ibid.*

¹³² S. REP. NO. 1983, 85th Cong., 2d Sess. 36 (1958).

duced amount as salary and accepts an annuity instead, he has "constructively received" the full amount already earned and converted part of it into an annuity, so he is currently taxed on the entire amount. Otherwise, the Committee Report emphasizes that it was desired to delete these former Treasury rules here because "they favor new employees at the expense of existing employees, who apparently cannot change their terms of employment to conform with those of the new employees." If the Committee's views are correct, then under the 1958 Act in the examples stated above, the employer's increased contributions would not be currently taxable to the employee.

E. Use of the Exemption in Tax Planning for Estates

Like all exemptions, this one for estate and gift taxes is already the subject of special schemes of estate planners to use it to obtain tax reductions. Whether the Treasury can bar the door to all of them is far from certain. The examples below are excellent illustrations.

The exemptions of sections 2039(c) and 2517, of course, apply only to benefits received by beneficiaries at or after the employee's death—any payments to him or them during his lifetime are not exempt. It would be very desirable if the plan, therefore, gave as much flexibility and choice as possible to the employee during his lifetime as to how much of the benefits he desired to have paid to himself while alive, and how much he left at or after death for beneficiaries. If he irrevocably allocates too much for postdeath beneficiaries, he may have to stint himself for lack of funds while alive. If he allocates more than he needs to himself while alive, the unspent surplus will be included in his gross estate at death. To meet this need, how about a plan which gives the employee discretion to elect, until retirement, irrevocably to have part or all of the benefits paid to the beneficiary after his death, including even nonforeitable benefits otherwise payable to the employee during his life? This is certainly attractive. The Treasury has attempted to block the idea, at least in this form, by ruling¹³³ that a pension, stock bonus, or profit-sharing plan may not be a qualified one if it contains such a provision.

Another enticing idea is to have two separate plans for employee benefits. One plan will provide for a life annuity or pension for the employee on retirement at sixty. At death, of course, nothing will be taxed to his estate for this pension, which then ends. The other plan will provide for death benefits only in the form of a similar

¹³³ See note 120 *supra*.

annuity for his widow at his death. At death, these benefits cannot be taxed under section 2039 because the employee at no time had a right to any payments or received any payments (unless receiving salary is considered receiving payments) from this plan. Nor, if he irrevocably designated the beneficiaries before death, would it be taxed under any other section of the 1954 Code, unless the designation was made in contemplation of death. Again, the Treasury has bravely stepped forth and in the Regulations¹³⁴ asserted that the two plans, even if created at different times, and even if separately administered, will be treated as a single plan, so that the death benefits will be taxable under section 2039, because the employee has, in fact, received payments under one plan which provides death benefits. The Treasury asserts that all rights arising by reason of employment by one employer for a given employee and his beneficiaries are treated as arising under one plan, except that if some plans are qualified and others not, the two types of plans are treated separately—the exemptions for the qualified plans will not apply to the nonqualified ones.¹³⁵ If the one plan had been created long before the other, would the same result be possible under the present Code, especially if the employer could show a solid business reason for having two plans? The language of section 2039 plainly indicates that normally the payments to the employee and the beneficiary must arise under the *same* contract, but two formally separate instruments arising out of one transaction or related to the same subject may be a single contract.¹³⁶

Another delightful and possibly entirely legal plan proposes to combine the use of a life estate, which escapes a tax upon the second and perhaps third generation, with the exemptions of sections 2039(c) and 2517, which remove the tax for the first generation. Truly the ultimate! To accomplish this, the employee would irrevocably designate as beneficiary of all death benefits a trustee of an inter vivos trust. The trustee would pay the income from the trust to the widow or children for their lives, with remainder to children or grandchildren. The trust could be revocable or irrevocable, for if the benefits were paid under a qualified plan, they should be exempt from gift and estate taxes to the extent that the plan is a noncontributory one. Payment to a trustee

¹³⁴ Treas. Reg. § 20.2039-1(b)(1), (2) ex. (6) (1958).

¹³⁵ *Ibid.*; Treas. Reg. § 20.2039-2(b) ex. (2) (1958).

¹³⁶ INT. REV. CODE OF 1954, § 2039(a), speaks of the annuity receivable by any beneficiary under "any form of contract or agreement" and of the right of the decedent to receive the annuity "under such contract or agreement."

of the inter vivos trust is not payment to or for the benefit of the employee's estate—at least so the courts have ruled in other situations.¹³⁷ To be entirely safe, the executor and trustee should be two different persons. At the death of the life tenant, there will be no tax, because our Code has never, unlike other death tax systems, imposed a tax upon a man simply because he possessed only a life interest in property (unless he originally owned the fee and reserved the life estate when transferring the remainder). Perhaps the Treasury can block this scheme by ruling a plan is not qualified if it permits transfer of benefits to a trust instead of outright to a beneficiary.

If a trust is used, provision can, of course, be made through use of special nontaxable powers of appointment to give the life tenant part or all of the principal. She may be given: (1) a power of invasion of principal limited by a fixed ascertainable standard, such as for her health or support or to maintain her accustomed standard of living;¹³⁸ or (2) a noncumulative power to invade corpus annually for \$5,000 or for an amount not in excess of five per cent of the value of the corpus at the end of each year, whichever is greater.¹³⁹ Also, the trustee may be given a power to pay her any amount of corpus it sees fit.¹⁴⁰ In addition, the life beneficiary may be given a power to appoint the remainder by deed or will to anyone except herself, her creditors, her estate, or the creditors of her estate.¹⁴¹

IV

A PROPOSED AMENDMENT

It is difficult to see how section 2039 by itself accomplishes too much so far as removing the uncertainties that existed under the 1954 Code regarding the taxation of employee benefits. The Treasury, by

¹³⁷ Cf. cases dealing with insurance payable to a testamentary trustee as not being payment to the executor under section 2042. *Proutt v. Commissioner*, 125 F.2d 591 (6th Cir. 1942); *Commissioner v. Jones*, 62 F.2d 496 (6th Cir. 1932); *Webster v. Commissioner*, 120 F.2d 514 (5th Cir. 1941); *United States v. First Nat'l Bank & Trust Co. of Minneapolis*, 133 F.2d 886 (8th Cir. 1943); *Boston Safe Deposit & Trust Co. v. Commissioner*, 100 F.2d 266 (1st Cir. 1938).

¹³⁸ INT. REV. CODE OF 1954, § 2041(b)(1)(A). Treas. Reg. § 20.2041-1(c)(2) (1958).

¹³⁹ INT. REV. CODE OF 1954, § 2041(b)(2). Treas. Reg. § 20.2041-3(d)(3) (1958).

¹⁴⁰ This would not be a taxable power, since the trustee could only exercise it in favor of the life tenant, not in favor of the trustee himself.

¹⁴¹ INT. REV. CODE OF 1954, § 2041(b)(1). Treas. Reg. § 20.2041-1(c)(b) (1958).

its Regulations, has done its best, with all too little assistance from the language of section 2039, to cope with these questions. Whether the courts will uphold the Treasury remains to be seen. What little section 2039 does do toward making the taxation of such benefits more probable seems more than counterbalanced by (1) the changes in sections 2037 and 2042, which will, to a large extent, make nontaxable such benefits, as insurance and pure death benefits, which cannot be taxed under section 2039; and (2) the exemption of sections 2039(c) and 2517 for qualified plan benefits and certain nonqualified plan benefits.

Instead of attempting to model section 2039 after the retained life estate concept of section 2036, it seems to me the section should have provided that all payments made either to the decedent's estate or to any beneficiary whose possession or enjoyment depends upon the beneficiary surviving the decedent should be included in his gross estate to the extent that they are attributable to any employment relationship that decedent had either at his death or at any previous time, except to the extent, if any, that the beneficiary had furnished valuable consideration in money or money's worth to the decedent for the payment of such benefits. The employment relationship alone warrants an estate tax, for it is the source and motivation for payment of benefits to the beneficiary. Moreover, the benefits should be valued immediately after death, giving effect to the occurrence of the death. What are the possible objections to this type of provision?

A. Constitutionality .

First, would it be constitutional, if decedent had irrevocably designated the beneficiary long before his death? I believe so. The argument could be made that then there is no transfer at the time of death. This is true, but the Supreme Court has several times in the last two decades sustained an estate tax upon an inter vivos transfer, provided that such a tax is a reasonable method to prevent avoidance of the estate tax.¹⁴² The Court views the tax not as one upon the property itself, but as one upon an inter vivos transfer with payment postponed until the transferor's death. The reasonableness of the tax here seems

¹⁴² *Helvering v. City Bank Farmers Trust Co.*, 296 U.S. 85 (1935); *Helvering v. Bullard*, 303 U.S. 297 (1938). The tax here is very similar to the premium payment test for proceeds of insurance. Cf. *Clarence H. Loeb*, 29 T.C. 22 (1957), *aff'd per curiam*, 261 F.2d 232 (2d Cir. 1958); *Schwarz v. United States*, 170 F. Supp. 2 (E.D. La. 1959). See *LOWNDES & KRAMER, op. cit. supra* note 2, at 281-86. *But cf. Heiner v. Donnan*, 285 U.S. 312 (1932); *Kohl v. United States*, 226 F.2d 381 (7th Cir. 1955).

clear: A gift tax, as already noted, is ineffective for several reasons. The benefits involved are, almost entirely, not of any use or value to the beneficiary until the transferor's death.

What about the argument that there is no transfer of anything by the decedent? The answer is obvious—viewed in terms of practical economics there is a transfer by decedent, just as if decedent paid money to a commercial annuity company in return for payment by it of certain benefits after his death to a surviving beneficiary. In this case, if the plan is noncontributory, the employee's payment is made, not by money, but by services rendered to his employer, and because of such services, the employer pays, or arranges for the payment of, the benefits to the surviving beneficiary. The elements of forfeiture, the fact the payments are voluntary, the fact the employee may not choose or change the beneficiaries, are all beside the point—any payments made to the beneficiary are made because of services rendered by the employee to the employer. It is these services which generate any transfers to the beneficiary by the employer or others.

Would such a tax be unconstitutional if it applied retroactively to irrevocable designations made prior to the date of enactment? Again, there is no absolute ban upon a retroactive tax if it is reasonable and fair. The nature of employee benefits is such that I believe the Court could uphold a retroactive tax, particularly in the light of the uncertainty that existed about taxation of such benefits under the 1939 Code.¹⁴³

B. Fairness

Granting the constitutionality of the proposal, would it be fair, is it wise? As a general principle, I think it is justifiable. Death benefits for employees are as much a part of their estate and their wealth and their fortune which they pass on to their kin, heirs, and loved ones as any other form of real or personal tangible or intangible property. If the benefits may be enjoyed or possessed only at the employee's death, is not his death the event which passes them on to his family? Unlike other forms of property, these benefits are of little or no value to anyone prior to his death—often, they even lack cash surrender or loan

¹⁴³ The chief obstacle to a retroactive tax is *Nichols v. Coolidge*, 274 U.S. 531 (1927). Cf. *Blodgett v. Holden*, 275 U.S. 142 (1927); *Kohl v. United States*, 226 F.2d 381 (7th Cir. 1955); *Untermeyer v. Anderson*, 276 U.S. 440 (1928). The *Coolidge* case seems contrary to later decisions. *Binney v. Long*, 299 U.S. 280 (1936); *United States v. Jacobs*, 306 U.S. 363 (1939). See LOWNDES & KRAMER, *op. cit. supra* note 2, at 20-25, 286-88.

value, may not even give any "vested" interest to anyone. In any event, death greatly increases the value of the interest to the beneficiary, as well as giving him actual possession or enjoyment of it.

Would such a provision, however, be inconsistent with other policies of the 1954 Code? Would it not unfairly discriminate against employee benefits, tax them more severely than any other form of property, tax some interests only if they were employee benefits, but not if the same interests were not employee benefits? This is by no means an easy question to answer.

1. *Life Insurance Problems*

For example, if life insurance is an employee benefit it would be taxed here even if the insured employee gave up irrevocably all incidents of ownership long before his death, on the ground that he had paid in effect premiums for the policy. Yet, if the same insurance were not an employee benefit, but the employee took it out himself and paid the premiums himself, there would be no tax under section 2042 if he irrevocably gave up all incidents of ownership, and, apart from the possible effect of section 2035 if the premium payments within three years of death were made in contemplation of death, there would be no tax under any other section of the Code. Is it fair, then, to discriminate against employee benefits, to restore the premium-payment test for employee benefit life insurance, but not for other life insurance?

There are two possible answers. One can say that all insurance should be subject to the premium payment test, and this would constitute the first step in the right direction towards re-enactment of the premium payment test by Congress.¹⁴⁴ Second, one can, I believe, justify a different treatment for employee benefit insurance than for other insurance. This type of insurance is a form of compensation for the employee—it is not simply a private investment by him to protect himself and his family; it is part of his salary and his wages, and should be taxed like them rather than insurance. Why should we give special treatment to that part of the employee's compensation paid here in the form of insurance instead of an annuity or other type of death benefit? Is this fair to those employees whose benefits are noninsurance? Second, the fact that this insurance is compensation means that it offers far greater possibilities for tax avoidance than insurance taken out directly and privately by individuals. The rapid and phenomenal growth of employee benefit plans is no secret. To prevent widespread erosion of

¹⁴⁴ H.R. REP. NO. 1337, 83d Cong., 2d Sess. B14-15 (1954) (minority report).

the tax base, is not taxation of employee insurance benefits essential, desirable, and sound? Also, employee insurance benefits often differ from those under private individual insurance coverage. A beneficiary under an individual nonemployee policy has vested rights, often of considerable value—rights for cash surrender and loan values, for dividends. Beneficiaries of employee life insurance plans often may have no vested rights at all for long periods of time or even until the employee's retirement or death—they may have no rights to cash surrender or loan values or to cash dividends. Finally, so far as employee benefits are concerned, the distinction between insurance and uninsured benefits is often meaningless, because the insurance is usually a funding device—a method to accumulate the funds needed for the employer to pay the benefits. The benefits are identical whether funded by insurance or by other means (a self-administered trust), or even if unfunded—the formal purchase of an insurance policy should have no effect on taxation of the benefits. Insurance in the traditional sense differs sharply from insurance to fund employee benefits.

2. *Benefits Payable Only at Death*

What about the taxation of employee benefits which are not insurance? If these are pure death benefits, with no lifetime payments or rights to lifetime payments in the employee, is it unfair discrimination to tax the death benefits to his estate? Under section 2036, there is no tax unless the grantor retains a life interest; under section 2037, at present there is no tax on a transfer conditioned on survivorship, such as an employee death benefit, unless the grantor has a reversionary interest of more than mere nominal value. Why tax an employee benefit conditioned on survivorship when there is no reversion, and not a non-employee interest of the exact same kind? Is this unfair discrimination against the employee benefit? I think not.

One can, again, argue that, as under the 1949 Technical Changes Act, all transfers conditioned on survivorship should be taxed even if there is no reversionary interest, and taxation by Congress of such employee benefits is simply the first step in the right direction. But the very nature of employee benefits is a special reason for taxing them differently than other transfers conditioned on survivorship—the same reasons as for insurance: employee benefits are compensation, salary; their wide-scale use causes a substantial disappearance of the base for the estate tax; and the rights of beneficiaries are often far less substantial when not vested than the rights of beneficiaries of nonemployee benefits conditioned on survivorship.

C. Policy: The Exemptions

What about the argument that because of our strong social and economic policy in favor of old age security, employee benefit programs should be fostered and given preferential tax treatment, if anything, rather than being taxed more severely than similar nonemployee benefits? This argument merits close examination, particularly in connection with the exemptions of sections 2039(c) and 2517, which are a concrete, and I believe, erroneous and misconceived reflection of it.

Even if these exemptions extended, without discrimination, to all employee benefits, would they be warranted? One contention possible is that the estate and gift tax exemptions are merely a continuation of the special income tax privileges given similar benefits. This argument simply does not stand up under scrutiny. The reasons for the income tax treatment—to allow current deductions for employers for their current contributions, to defer income tax liability for employees on employer contributions until retirement or receipt of benefits—are irrelevant under the estate tax. Employers have no estate tax problems or liability. Employees face no estate tax liability until death, when their income ceases and the beneficiaries actually receive payments. Already our tax laws discriminate against the self-employed who cannot set up employee benefit plans for themselves or their dependents. Why sharpen this discrimination by increasing the tax favor already bestowed upon those not in business for themselves? Why should the estate tax exemption be restricted to employee benefits alone—why should it not extend to private commercial joint or survivorship or refund annuities, private insurance, as well?

The argument may then be made that our society has a special interest in encouraging the development of private plans in industry for old age security, and this policy is the real heart of these exemptions. These plans in effect relieve the taxpayers of the burden of supporting the indigent aged in our population.

In the first place, this argument tends to overlook the fact that under the estate and gift taxes, unlike the income tax, the beneficiaries of sections 2039(c) and 2517 are not the great masses of wage and salaried employees. The present rates and low exemptions and limited deductions for salaried employees under the income tax at least insure that the income tax favors and dispensations for employee benefits are of value not simply to a few relatively high paid employees and executives, but to large numbers of persons on a modest wage or salary, to

whom retirement benefits mean the difference between indigence, and self-support and modest financial independence. Not so under the estate tax. Few, indeed, are the run-of-the-mill low or middle-income wage earners who will in any way benefit from the section 2039(c) and section 2517 exemptions. This is because the estate tax exemption is of no use unless the decedent had at least a taxable estate (after all deductions and credits) of \$60,000. Where, as is so often the case, the recipient of the employee benefit is the surviving spouse, then the full use of the marital deduction means the estate must usually exceed \$120,000 before the section 2039(c) exemption will be of the slightest use. Where a man leaves an estate of \$120,000, it is hard to imagine that estate taxation of his retirement benefits will put his widow upon public or private relief. How many employees under qualified plans will have a taxable estate in excess of \$120,000? The answer plainly is only a small minority at best. So, too, the lifetime exemption under the gift tax is \$30,000, not counting the marital deduction or annual exclusion.

In practical operation, then, the exemptions of sections 2039(c) and 2517 are basically for high-salaried corporate executives, already the recipients of many tax advantages for stock options and profit-sharing and deferred compensation under the present income tax laws.¹⁴⁵ Such advantages for this group under the income tax laws are usually defended on the ground that without these unique favors, the stiff income tax rates on the higher brackets will deprive them of all incentive to use their abilities to the utmost to produce more and better things for society, because they can retain so little of any further salary increases once their salary puts them into a high-income tax bracket. The validity of this theory has been sharply challenged—assertions in support of it are made daily, actual evidence in support of it is hard to come by and scanty, if not entirely lacking or even contradictory.¹⁴⁶ Even if the assertion is true, is there any reason for believing that these favored few

¹⁴⁵ See H.R. REP. NO. 1337, 83d Cong., 2d Sess. B18 (1954) (minority report).

¹⁴⁶ See Break, *Income Taxes and Incentives to Work: An Empirical Study*, 47 AM. ECON. REV. 529 (1957); Davidson, *Income Taxes and Incentive: The Doctor's Viewpoint*, 6 NAT'L TAX J. 293 (1953); papers by Long, Schulman, Driscoll, Greenewalt, and Break in Joint Committee on the Economic Report, *Federal Tax Policy for Economic Growth and Stability*, 84th Cong., 1st Sess. 153-99 (1955), and their testimony in *Hearings Before the Subcommittee on Tax Policy of the Joint Committee on the Economic Report*, 84th Cong., 1st Sess. 132-64 (1955); Royal Commission on the Taxation of Profits and Income, *Second Report*, CMD. NO. 9015, 13-15, 24, 26, 31-33, 45, and app. I (1954); Kramer, *The "Uneasy Case" in Jurisprudence*, 44 VA. L. REV. 379 (1958).

need an additional incentive by receiving a special exemption under the gift and estate taxes? Is there any reason to believe that the estate and gift tax exemptions will spur them to greater efforts, or that the present gift and estate tax structure, with its widely gaping loopholes for the sophisticated taxpayer and his estate planner, is actually holding down the creative activity of the corporate executive? Not the slightest—indeed, all the evidence is quite the contrary.¹⁴⁷ Why, then, give this special group another tax exemption? Moreover, like all special exemptions, we can be sure that other groups, too, will soon demand it. The self-employed artist, writer, professional man, businessman with high potential earnings—what justification is there for not giving him a similar estate and gift tax exemption?

Perhaps the present rates of the estate and gift taxes in the upper brackets are too high. Perhaps the present \$60,000 exemption is too low; perhaps the present generous deductions are still too scanty. If so, is not the fair way to reduce the rates, for all of us, not simply a special favored elite group of taxpayers? In addition, many otherwise privileged assets, such as municipal, state,¹⁴⁸ and federal government bonds,¹⁴⁹ National Service Life Insurance,¹⁵⁰ War Risk Insurance,¹⁵¹ which serve key social purposes, have been subjected to estate and gift taxes.

The exemptions of sections 2039(c) and 2517, in effect, revive the special type of exemption once reserved for life insurance, when, prior to the 1942 Act, such proceeds on the insured's life, if not payable to his estate, were totally exempt from the tax in an amount up to \$40,000, over and above all other exemptions. Sections 2039(c) and 2517 grant a like exemption, for both estate and gift taxes, unlimited in amount, for all benefits, insurance or otherwise, of qualified employee benefit plans, payable to beneficiaries other than the employee's estate, to the extent that the plans are noncontributory. I fail to see the need or justification, in policy or law, for such an exemption today. I fear that, like similar exemptions, it will gradually be extended to more and more groups and benefits, thus continually eroding the already shrunken bases of the gift and estate taxes.

¹⁴⁷ See Smith, *The Fifty-Million-Dollar Man*, *Fortune*, Nov. 1957, pp. 176, 234, 238.

¹⁴⁸ *Greiner v. Lewellyn*, 258 U.S. 384 (1922).

¹⁴⁹ *Treas. Reg.* §§ 20.2033-1(a) (1958); 25.2511-1(a) (1958).

¹⁵⁰ *Rev. Rul.* 622, 1955-2 *CUM. BULL.* 385; *Rev. Rul.* 603, 1956-2 *CUM. BULL.* 601.

¹⁵¹ *United States Trust Co. v. Helvering*, 307 U.S. 57 (1939).