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Income Tax--Liability of a Life Insurance Beneficiary for Unpaid Income Taxes of the Insured

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Recent Cases

INCOME TAX—LIABILITY OF A LIFE INSURANCE BENEFICIARY FOR UNPAID INCOME TAXES OF THE INSURED

The Supreme Court in two recent cases has clarified the liability of a life insurance beneficiary for the unpaid income taxes of the insured, a subject about which the decisions of the lower federal courts had been in great conflict. However, in doing so, it produced apparently opposite results in two similar fact situations.

Dr. Milton J. Stern died a resident of Lexington, Kentucky, on June 12, 1949. Nearly six years after his death, the Tax Court held that Dr. Stern was liable for an income tax deficiency of $32,777.51 for the years 1944 through 1947. Dr. Stern's widow had received $47,282.02 as beneficiary of life insurance policies held by him. Dr. Stern had retained the right to change the beneficiary and to draw the cash surrender value of each policy until his death when the cash surrender value had been $27,259.68. Because the assets of the estate were insufficient to meet the tax liability, the Commissioner proceeded against Mrs. Stern as transferee of the property of the taxpayer under section 311(a)(1) of the Internal Revenue Code of 1939.[1] The respondent petitioned the Tax Court for redetermination of the liability assessed against her. The Tax Court held she was liable for the full amount of the deficiencies out of the life insurance proceeds. The Court of Appeals, Sixth Circuit, reversed, holding that the respondent was not liable even for the amount of the cash surrender value.[2] On certiorari to the Supreme Court, *Held*: affirmed, with Justices Black, Warren, and Whittaker dissenting. Without finding it necessary to determine whether the petitioner was a transferee within the meaning of section 311, the Court held that the existence and extent of the beneficiary's liability under the transferee provision for an income tax deficiency assessed against the insured after his death was governed by local state law. Under applicable Kentucky statute,[3] the widow was not liable to her husband's creditors and

[1] Now Int. Rev. Code of 1954, § 6901 (a) (1) (A) (i).

[2] Stern v. Commissioner, 242 F. 2d 322 (6th Cir. 1957).

[3] Ky. Rev. Stat. § 297.150 (1948), now Ky. Rev. Stat. § 304.691 (1) & (2) (1959), which provides:

> (1) When a policy of insurance is effected by any person on his own life or on another life in favor of some person other than himself having an insurable interest therein, the lawful beneficiary thereof, other than the person effecting the insurance or his legal representatives, shall be entitled

hence not liable to the federal government, in the absence of any finding that the insured had paid the premiums with the intent to defraud his creditors, or that he was insolvent at any time prior to his death. *Commissioner v. Stern,* 357 U.S. 39 (1958).[4]

Herman Bess died a resident of New Jersey in 1950. His wife was the beneficiary of eight insurance policies on his life from which she received $63,576.95 in proceeds. The cash surrender value of these policies at the death of the insured was $3,362.53. In seven of the policies Bess had retained the right to change the beneficiary and to draw or borrow against the cash surrender value, while in the eighth he had reserved only the right to change the beneficiary. None of the premium payments were made in fraud of creditors. At the time of his death, Bess owed federal income taxes for 1945 through 1949. Prior thereto, notice and demand were made upon him for payment of the deficiencies he acknowledged as owing for 1945 and 1946. No payment on the amount owing for 1946 was made by him in his lifetime or by his estate after his death. The government brought this action to recover in equity from his beneficiary the entire amount of taxes owed by the insured at the time of his death—$8,874.57. The District Court entered judgment for the government for the total tax unpaid,[5] but the Court of Appeals, Third Circuit, reduced the judgment to the amount of the cash surrender values, which was less than the tax deficiency for 1946.[6] On certiorari to the Supreme Court, *Held:* affirmed, with Justices Harlan and Burton dissenting. The Court held that, under applicable state law, the cash surrender value constituted "property" of the insured, to which a federal tax lien attached under section 3670 of the Internal Revenue Code of 1939[7] prior to his death. Such a lien was not extinguished by the death of the insured but followed his "property" when it was transferred to the beneficiary as part of the proceeds. *United States v. Bess,* 357 U.S. 51 (1958).[8]

> to its proceeds against the creditors and representatives of the person effecting the same.
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> (2) Subject to the statute of limitations, the amount of any premiums for such insurance paid in fraud of creditors, with interest thereon, shall inure to their benefit from the proceeds of the policy. . . .

4 Commented upon in 44 A.B.A.J. 885 (1958), 44 Cornell L.Q. 278 (1959), 8 De Paul L. Rev. 131 (1958), 57 Mich. L. Rev. 285 (1958), 31 Rocky Mt. L. Rev. 108 (1958) and 14 Tax L. Rev. 137 (1958).

5 United States v. Bess, 134 F. Supp. 467 (D.N.J. 1955).

6 United States v. Bess, 243 F. 2d 675 (3d Cir. 1957).

7 Now Int. Rev. Code of 1954, § 6321, which provides:

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

8 Commented upon in 44 A.B.A.J. 886 (1958), 44 Cornell L.Q. 278 (1959),

In reaching its decision in the *Stern* case, the Court had to find: (1) that there was no federal statute which defined the substantive liability of life insurance beneficiaries for the unpaid income taxes of the insured; and (2) that there had been no expression of congressional preference for a uniform system of liability to be based on federal decisional law. On the basis of the legislative history of its predecessor—section 280 of the Revenue Act of 1926—the Court concluded that section 311 of the 1939 Code neither created nor defined the substantive liability of a transferee but merely provided a new procedure by which the Government might collect taxes. After a perusal of House and Senate reports, the Court was satisfied that the design of this section was to enable the government to collect a tax deficiency from the transferee in the same manner as from the taxpayer himself, without in any way changing the extent of the transferee's liability under existing law. Since Congress, when it passed the predecessor to section 311, must have been aware that the prevailing practice was to use state statutes in determining liability, and since it must have known that, by reason of varying definitions of liability under these statutes, this practice resulted in an absence of uniformity, the court in the *Stern* case reasoned that, by disclaiming any intention to define or change existing liability, Congress had disavowed any desire for uniformity of liability among states.[9]

As the federal courts must now apply state decisional law in diversity cases brought by private creditors within the larger field of creditor's rights, the Court felt that, in the absence of any manifest desire by Congress for uniform liability, any attempt to formulate a body of federal decisional law for the small field of federal tax cases would be "episodic." Moreover, they considered such an effort unjustified in light of a "flexible body of pertinent state law being continuously adapted to changing circumstances affecting all creditors."[10] Therefore, "until Congress speaks to the contrary, the *existence* and *extent* of liability should be determined by state law.[11] (Emphasis added).

The dissenting Justices in the *Stern* case took the position that, in the absence of the plainest congressional mandate to the contrary,

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8 De Paul L. Rev. 131 (1958); 31 Rocky Mt. L. Rev. 108 (1958); 14 Tax L. Rev. 137 (1958).

[9] Moreover, as the Court pointed out, uniformity is not *always* the federal policy. Under § 70 (e) of the Bankruptcy Act, 30 Stat. 565 (1898), as amended, 11 U.S.C. § 110 (1952) state law is applied to determine what property of the bankrupt has been transferred in fraud of creditors, so that what is a good transfer in one jurisdiction might not be so in another.

[10] 357 U.S. at 45.

[11] Ibid.

liability for federal taxes should be determined by uniform principles of federal law. In their opinion, the legislative history of section 280 of the Revenue Act of 1926 fell far short of a congressional direction that the tax liability of a transferee be determined by state law. To them, uniformity in the imposition and collection of federal taxes was extremely desirable. They would hold, therefore, "as a matter of federal law, that where a transferee receives property from a taxpayer who is left with insufficient assets to pay his federal taxes, the transferee is liable for those taxes to the extent he has not given fair consideration for the property received."[12] The dissenters agreed with the majority decision in the *Bess* case that the cash surrender values of the policies were property of the insured which passed to the beneficiary upon the insured's death. On this basis, they would have held that the beneficiary was responsible for the unpaid taxes of the insured to the extent of the cash surrender value just prior to his death.

Whereas the Court in the *Stern* case found it unnecessary to consider the extent to which the beneficiary of a life insurance policy is a transferee of any property of the insured, this was the main issue with which it was faced in the *Bess* case. In the latter case the taxpayer had been notified of his tax liability and demand for payment had been made on him prior to his death. On his neglect or refusal to pay, the amount of the tax became a lien in favor of the United States upon all property or rights to property, real or personal, belonging to him. However, in order for his beneficiary to be subject to this lien, the insured must have had some property in the policies during his lifetime, and on his death this property interest must have been transferred to the beneficiary, with lien annexed, as part of the proceeds.

The Court in *Bess* interpreted section 3670[13] as *creating* no property rights but merely attributing federally defined consequences to rights created under state law. Looking to applicable state law,[14] the Court found that, since the insured could not enjoy in any way the *proceeds* of the policy during his lifetime, he had no "property" in the proceeds (within the meaning of section 3670) to which the federal tax lien could attach. However, since the insured had the right under the policy to compel the insurer to pay him its *cash surrender value* upon cancellation, he did have "property" rights (within section 3670) in this amount. The Court therefore held that a federal

[12] Id. at 50.
[13] See note 6 supra.
[14] Middlesex County Welfare Board v. Motolinsky, 134 N. J. Eq. 323, 35 A. 2d 463 (Ch. 1944); Slurzberg v. Prudential Life Ins. Co. of America, 15 N. J. Misc. 423, 192 A. 451 (Sup. Ct. 1936).

tax lien attached to this interest of the insured during his lifetime, despite the fact that it was not subject to creditors' liens under state law.[15]

> [O]nce it has been determined that state law creates sufficient [property] interests in the insured to satisfy the requirements of § 3670, state law is inoperative to prevent the attachment of liens created by federal statutes in favor of the United States.[16]

The Court then rejected the contention that the rights of the insured in the cash surrender value expired upon his death, and that the beneficiary received the proceeds as performance by the insurer of a separate promise to pay. Instead, it reasoned that "in economic reality, the insurer pays the beneficiary the insured's 'fund' [the surplus of the paid premiums accumulated to make up the cash surrender value], plus another amount sufficient to perform the insurer's promise to pay the proceeds on the insured's death."[17] On this basis, the court held that, "for purposes of § 3670, there was a transfer of property from the insured to Mrs. Bess, and that the lien attached to the property before his death followed it into her hands."[18]

Mr. Justice Harlan, with whom Mr. Justice Burton joined, dissented in an opinion in which he criticized the court's application of the "fund" theory to determine the specific reach of a lien under section 3670. He quoted extensively from an observation of Judge Learned Hand in a similar case:[19]

> The obligations of an insurer in a policy of life insurance is made up of a number of promises, of which one is to pay the beneficiary the amount of the insurance—'the proceeds'—and another is to pay the 'surrender value' to the insured upon his demand. The performances of these promises are not only separate, but inconsistent with each other: the payment of the 'surrender value' cancels the promise to pay the 'proceeds' and the promise to pay the 'proceeds' assumes that the insured has not demanded and received the 'surrender value'.[20]

On the basis of this reasoning, Mr. Justice Harlan concluded:

> [A]lthough the cash surrender values of life insurance policies were here properly considered property of a taxpayer to which federal tax liens attached during the taxpayer's life, these values cannot be deemed to exist after the taxpayer's death. It follows that the lien terminated at the time of death. . . .[21]

Before these decisions of the Supreme Court, there existed simultaneously in the federal courts four separate and distinct positions on the income tax liability of a life insurance beneficiary.[22] (1) The

[15] N. J. Stat. §§ 17:34-28, 29 (1937).
[16] 357 U.S. at 56, 57.
[17] Id. at 59.
[18] Ibid.
[19] United States v. Behrens, 230 F. 2d 504 (2d Cir. 1956).
[20] Id. at 506.
[21] 357 U.S. at 61.
[22] Grayck, "Income Tax Transferee Liability of a Life Insurance Beneficiary," 13 Tax. L. Rev. 313, 316 (1958).

Tax Court had allowed the Commissioner to recover his claim to the full extent of the insurance proceeds.[23] (2) The Court of Appeals, Second Circuit, had rejected recovery of the full proceeds on the ground that they were not the property of the delinquent taxpayer. Moreover, after having held that the cash surrender value was his property, it had denied recovery of this amount on the ground that, under applicable state law, the beneficiary was not liable, at law or in equity, for the deceased's income taxes.[24] (3) The Court of Appeals, Third Circuit, had accepted the finding of the previous court that only the cash surrender value was the property of the taxpayer. However, it had rejected the idea that state law was applicable to determine liability, and substituting instead the general law laid down by the federal courts, it had found that there was liability on the part of the beneficiary for this amount.[25] (4) In contrast, the Court of Appeals, Sixth Circuit, had held that the beneficiary was not a transferee of the deceased taxpayer, since after the death of the taxpayer there remained no cash surrender value. Furthermore, it had declared that, even if that part of the proceeds which represented the cash surrender value constituted property of the deceased taxpayer in the hands of the beneficiary as transferee, there was no liability on the part of the beneficiary under applicable state law.[26]

By its decisions in *Stern* and *Bess*, the Supreme Court has extracted from this potpourri of opinion a set of definitive principles:

(1) In no case may the Commissioner recover from the beneficiary an amount in excess of the cash surrender value of the policy at the time of the insured's death.

(2) Where under state law the cash surrender value of a life insurance policy constitutes the exclusive property of the insured during his lifetime, the unpaid taxes may become a lien on this interest under section 6321, Internal Revenue Code of 1954, upon the taxpayer's neglect or refusal to pay after notice and demand prior to his death. The Commissioner may then apply to the tax deficiency that part of the proceeds received by the beneficiary which represents the cash surrender value at the time of the insured's death. This would be true even though the law of the domicile of the beneficiary provides that the beneficiary is entitled to the proceeds against all creditors in the absence of fraud.

A minority of states appear to take the view that the beneficiary has a vested property right in the *entire* proceeds subject to being

[23] Mary Stoumen, 27 T.C. 1014 (1957); Aura Grimes Bales, 22 T.C. 355 (1954); Christine D. Muller, 10 T.C. 678 (1948).

[24] Rowan v. Commissioner, 215 F. 2d 641 (2d Cir. 1954).

[25] United States v. Bess, 243 F. 2d 675 (3d Cir. 1957).

[26] Commissioner v. Stern, 242 F. 2d 322 (6th Cir. 1957).

divested through the exercise by the insured of certain of his retained incidents of ownership; i.e. the right to change the beneficiary or the right to give up the policy for cancellation in return for the cash surrender value.[27] Under this interpretation, the beneficiary, and not the insured, would have exclusive property rights in that part of the proceeds which represents the cash surrender value. According to the opinion in the *Bess* case, in these states there would be no property of the insured to which the tax lien could attach and it *should* follow that the beneficiary would be absolved of any liability.

Though one commentator has placed Kentucky in this minority of jurisdictions,[28] an examination of Kentucky cases indicates that this classification may be erroneous. The Kentucky Court of Appeals has repeatedly stated that where, under the terms of the policy, the insured retains the right to change the beneficiary or draw the cash surrender value, the named beneficiary does not have a vested interest therein. The rights of the one named in the policy are *conditional* only, and are subject to being defeated by the terms of the contract.[29] It has further been held that after the insured has elected to draw the cash surrender value it is subject to attachment as his property.[30] However, the court has also declared that the rights of the beneficiary vest as of the death of the insured.[31] This seems to support the contention of the dissent in the *Bess* case that, though the Government in a proper action may enforce the lien in the insured's lifetime and thereby recover the cash surrender value,[32] it cannot recover any part of the proceeds paid to the beneficiary *after* the death of the insured. The beneficiary has an exclusive property right to the *full* proceeds of the policy which, not having been previously defeated *by the terms of the contract,* either voluntarily by the insured or involuntarily by his creditors (including the Government), vests on the death of the insured and *cannot thereafter be divested.*

Due to the indefinite position of Kentucky law in this area and to the interpretation which might be given it by the federal courts, it is difficult to predict with any degree of certainty what result would

[27] Grayck, supra note 19, at 321. See also Pyle, "Liability of Life Insurance and Annuities for Unpaid Income Taxes of Living Insureds, Annuitants, and Beneficiaries," 9 Tax. L. Rev. 205, 215 (1954).

[28] Grayck, supra note 19 at 321.

[29] Crice v. Illinois Life Ins. Co., 122 Ky. 572, 92 S.W. 560 (1906); Wrather v. Stacy, 26 Ky. L. Rep. 683, 82 S.W. 420 (Ct. App. 1904); Hopkins v. Hopkins' Adm'r., 92 Ky. 324, 17 S.W. 864 (1891).

[30] Cooper v. West, 173 Ky. 289, 190 S.W. 1085 (1917).

[31] Parks' Ex'rs. v. Parks, 288 Ky. 435, 156 S.W. 2d 480 (1941).

[32] 357 U.S. at 57 n. 2.

be reached should a situation similar to that presented in the *Bess* case arise in this jurisdiction. However, there is at least *some* indication that it may be possible to distinguish that decision on the basis of different state property law concepts.

(3) Where a lien for unpaid taxes has *not* been created on the property of the insured under section 6321, Internal Revenue Code of 1954, prior to his death, the *existence* and *extent* of the liability of the beneficiary as a transferee of the insured under section 6901 (a) (1) (A) (i) of the 1954 code is determined by applicable state law.

(a) If the state law provides that the beneficiary is not liable to the creditors of the insured in the absence of a showing that the premiums were paid in fraud of creditors,[33] the burden of proof is on the Commissioner to show that such intent to defraud was present. If he fails to sustain this burden, he may not recover any part of the tax deficiency from the proceeds.

(b) Even if the Commissioner is able to show fraud, the Court in the *Stern* case seems to restrict his recovery to that allowed other creditors under state law. It stated: "The Government's rights in this case are precisely those which other creditors would have under Kentucky law."[34] In Kentucky, and in many other states, the statutes allow recovery by defrauded creditors only to the extent of the "tainted" premiums; i.e., those paid in defraud of creditors or while the insured was insolvent.[35] This amount more often than not is considerably less than the cash surrender value, which the Commissioner had previously been allowed to recover in cases of insolvency or fraud.[36]

The most objectionable feature of these decisions is the non-uniform, discriminatory manner in which they provide for federal income tax liability of the life insurance beneficiary of the taxpayer. As we have seen, whether or not the beneficiary is a transferee of the insured within the rule of the *Bess* case may vary from state to state, depending on whether the particular jurisdiction regards the cash surrender value as property of the insured. Moreover, as the dissent in the *Stern* case pointed out:

> The laws of the several states are bound to vary widely with respect to the responsibility of transferees for the obligations of their transferors. Therefore, application of state law leads to the anomalous re-

[33] See Ky. Rev. Stat. § 304.691(1) & (2) (1959), quoted supra note 3.
[34] 357 U.S. at 47.
[35] See Ky. Rev. Stat. § 304.691 (2) (1959), supra note 3.
[36] In Pearlman v. Commissioner, 153 F. 2d 560 (3d Cir. 1946), insolvency of the insured *prior* to death was shown and satisfaction of the income tax liability was obtained from the proceeds of the policy to the extent of the cash surrender value.

sult that transferees will be liable for federal taxes in one state but not in another even though they stand in the same position.[37]

This anomaly is further compounded when one realizes that even within the same jurisdiction, these decisions dictate opposite results in factual situations quite similar in nature. That is, had the *Bess* case and the *Stern* case arisen in the same jurisdiction—say, Kentucky—the beneficiary *might* nevertheless have been held liable in the first instance and not liable in the second. From a *practical* standpoint, just as "taxpayers should be treated equally without regard to the fortuity of residence,"[38] so also should similar liability be placed on their life insurance beneficiaries and/or other transferees, whether or not the tax deficiency has been discovered and has become a lien on the taxpayer's property prior to his death. In the end, these decisions may do nothing more than provide a reward for diligence by the Commissioner in uncovering tax deficiencies. However, it should be kept in mind in this regard that many tax irregularities first come to light on examination of the taxpayer's estate *after* his death.

Of course, the way is always open for Congress to impose a uniform system of transferee liability which would remove once and for all any inequities created by these decisions. However, should the Court, in the absence of any direct legislation in this area, ever reconsider its position, either of two alternative solutions would achieve a more equitable and more consistent result.

(1) By following the dissent in the *Bess* case, the Court might hold that the tax lien which had attached to the cash surrender value *prior* to the death of the taxpayer was extinguished thereby and was not enforceable against any part of the proceeds. This would at least place life insurance beneficiaries on a fairly equal footing, at the expense of the Government. However, it would not prevent non-uniform liability from being imposed on *other* transferees under section 6901 through application of the rule of the *Stern* case to them. The subsequent case of *United States v. Ott*[39] provides a good illustration of this situation. Action was brought by the Government to recover from the widow-beneficiary the guaranteed cash refunds of annuity policies purchased by or on behalf of the deceased tax debtor during his lifetime. The Government claimed these proceeds on the theory that, since the purchaser owed income taxes at the time of his death, the widow was a transferee without consideration of the benefits of the policies under section 311 (a) (1) of the 1939 Code, and held them as trustee for the benefit of the

[37] 357 U.S. at 47, 48.
[38] Id. at 49.
[39] 166 F. Supp. 13 (E.D. Mich. 1958).

creditors of the deceased (including the Government). The court first held that, under the rule of the *Stern* case, the limits of the Government's right to recover in *any* action initiated against a transferee under section 311 are established by state law. Since the Michigan statute[40] specifically provided that, in the absence of fraud, proceeds from contracts of annuity are exempt from the claims of creditors of the purchaser, where payable to someone other than the debtor, the court concluded as a matter of law that the Government was barred from any recovery of the proceeds of the annuity contracts.

(2) The Court could impose a uniform system of transferee liability based on the reasoning of the dissent in the *Stern* case. This would insure that the result of the *Ott* case would not be reached in other similar cases. Since all claims of the Federal Government have long received preferred treatment over the claims of ordinary creditors,[41] and since enforcement and collection of the Federal income tax is a matter of peculiarly national concern, the Court would have both precedent and policy behind it should it adopt this solution.

John T. Bondurant

REAL PROPERTY—JOINT TENANCY—COMMENT—EFFECT ON RIGHTS OF MORTGAGEE AND SURVIVING JOINT TENANT OF MORTGAGE EXECUTED BY DECEASED JOINT TENANT

Appellant and her now deceased husband owned real property in fee simple as joint tenants with right of survivorship. The deceased husband, without the consent or knowledge of his wife, executed a mortgage upon the property to the respondents. The state commenced an action to condemn the property, alleging that the appellant owned the property and respondents were the mortgagees thereof. Appellant answered that she was the sole owner of the property and that respondents had no right, title, or interest therein. Respon-

40 Mich. Comp. Laws § 522.24 (1948).

41 Rev. Stat. § 3466 (1875), 31 U.S.C. § 191 (1952), provides:

> Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied. . . .

Unpaid taxes have been held to constitute "debts due to the United States" within the meaning of this section and are entitled to be first satisfied in case of the taxpayer's insolvency. Massachusetts v. United States, 333 U.S. 611 (1948). However, under § 64 (a) (4) of the Bankruptcy Act, 30 Stat. 563 (1898), as amended, 11 U.S.C. § 104 (a) (4) (1952), the United States has only a fourth priority in bankruptcy for its unsecured tax claims, along with other unsecured tax claimants; moreover, by virtue of § 64(a) (5) of the same Act, 30 Stat. 563 (1898), as amended, 11 U.S.C. § 104 (a) (5) (1952), it has only a fifth priority for unsecured non-tax claims.