Estate Tax Impact of Life Insurance Required by Divorce

Life insurance owned by a decedent in connection with a divorce could be includable in (with or without an offsetting deduction) or excludable from the estate.

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Life insurance often assumes an important role in a marital settlement agreement or divorce decree. One party may be required to maintain for life a policy insuring himself or herself that names the former spouse as beneficiary. Alternatively, the party may be required to keep life insurance in force as security for alimony or other payments to the former spouse. Depending on the structure of the obligation to maintain insurance, the policy proceeds may be subject to tax in the insured's estate for federal estate tax purposes.

The extent to which life insurance proceeds required to be maintained pursuant to a divorce are taxable in the estate of the insured is determined by an analysis of both the state law that governs the obligation and federal laws of taxation. This article discusses the steps to consider in order to anticipate the federal estate tax treatment of that insurance policy and obligation.

Includability in gross estate

Section 2042(2) provides that a life insurance policy is includable in a decedent's gross estate to the extent that the decedent possessed incidents of ownership over that policy, exercisable alone or in conjunction with another. Additionally, Section 2036(a) provides that the value of a decedent's gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), under which the decedent retains for life the right to the income from that property. Moreover, Section 2035(a) causes inclusion in a decedent's estate of the value of life insurance and certain other property that the decedent transferred during the three years prior to the decedent's death if such property would have been included in the decedent's gross estate if the property had been retained by the decedent on the date of death.

Decedent holds no incidents of ownership. As is apparent from the plain language of Section 2042(2), a policy of insurance generally is not includable in the decedent's gross estate if the decedent did not possess any incidents of ownership over the policy at the time of death. However, even if the decedent retains the economic benefits of a policy of insurance on his or her life[1] which would amount to incidents of ownership, a state court ruling in connection with divorce that requires a decedent to maintain insurance may effectively negate the decedent's ownership for purposes of federal estate taxation.

For example, assume that under a property settlement agreement, a decedent agreed to carry life insur-

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ance upon his or her life in a certain sum, naming the former spouse as the beneficiary. The decedent was also required to pay all premiums on that insurance, and could not change the beneficiary of the insurance policy. The result may be that, for all practical purposes, the decedent was stripped of his or her rights to revoke the policy, change the beneficiary, surrender the policy, or borrow against it. Such restraints, the Tax Court has held, result in the decedent possessing no incidents of ownership in the insurance at the time of death other than possibly a reversionary interest.[2]

Similarly, the IRS has ruled on a situation involving a property settlement agreement that required the decedent to maintain in force certain policies of insurance on his life payable to the decedent's former spouse as an annuity upon his death. The agreement further provided that it would not be effective unless approved by the divorce court. The IRS determined that the former spouse acquired an absolute interest in the annuity payments provided by the insurance, so the decedent had no incidents of ownership. As a result, the insurance proceeds were not includable in the decedent's gross estate.[3]

Thus, constraints imposed on an insured's authority over a policy of insurance can cause the insured to lose substantial rights over that policy and so effectively nullify what otherwise might appear to be incidents of ownership. As a result, the policy proceeds may not be includable in the decedent's gross estate.[4]

Decedent holds incidents of ownership. Inclusion of the insurance proceeds in the gross estate under Section 2042(2) will occur if the insured holds incidents of ownership over the policy. If the insured has the power to receive insurance benefits or change their disposition, the proceeds will be included in the insured's estate at death. "[T]he term 'incidents of ownership' is not limited in its meaning to ownership of the policy in the technical legal sense.... [I]t includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy...."[5] But even without any currently exercisable rights in the policy, the proceeds may be includable.

If a possibility exists that a policy of insurance or its proceeds may return to the decedent or to the decedent's estate, or if the insurance proceeds may become subject to a power of disposition by the decedent, the decedent holds a reversionary interest. If the value of that reversionary interest immediately before the decedent's death exceeds 5% of the value of the policy, the decedent will be deemed to have incidents of ownership in that policy or the proceeds.[6]

As explained in Reg. 20.2042-1(c)(3), determining whether the value of a decedent's reversionary interest immediately before the decedent's death exceeds 5% of the value of the policy involves following Regs. 20.3037-1(c)(3) and (c)(4), and also involves consideration of incidents of ownership held by individuals other than the decedent. Specifically, Reg. 20.3037-1(c)(3) provides that the value of the reversionary interest is to be ascertained using recognized valuation principles for valuing future or conditional interests in property for estate tax purposes, and must be computed as of the moment immediately before the decedent's death but without regard to the fact of death. Reg. 20.2037-1(c)(4) instructs that the value of the reversionary interest is to be compared with the value of the transferred property.

The IRS has ruled that insurance proceeds required by a divorce decree to be paid directly to a decedent's former spouse upon the decedent's death were includable in the decedent's gross estate because of the possibility that the proceeds might return to the decedent or the decedent's estate or be subject to the decedent's power of disposition if the former spouse died or remarried prior to the decedent's death. That possibility amounted to a reversion, and the value of the reversion, the IRS held, exceeded 5% of the value of the policies immediately before the decedent's death.[7] Thus, according to the IRS, the full value of the insurance proceeds were properly included in the decedent's gross estate even though the proceeds were paid directly to the former spouse and never became part of the decedent's probate estate.

Even if it appears that a divorce decree has effectively divested a decedent of obvious incidents of ownership, it is important to consider whether at the time of death the decedent held a reversionary interest in the policy and, if so, to ascertain the value of that reversion as it may cause estate tax inclusion of the insurance proceeds.

Decedent's bona fide sale. Inclusion of the insurance proceeds in

1 Reg. 20.2042-1(c)(2).
2 Estate of Bowers, 23 TC 911 (1955).
3 Rev. Rul. 54-29, 1954-1 CB 186.
4 The Tax Court in Bowers, *supra* note 2, did, however, find that a portion of the insurance proceeds were includable in the decedent's gross estate as a result of his payment of premiums on the policies.
5 Reg. 20.2042-1(c)(2).
6 Reg. 20.2042-1(c)(3).
7 Rev. Rul. 76-113, 1976-1 CB 276.
8 TAM 9826002.
9 Section 2035(d).
10 48 F.3d 838, 75 AFTR2d 95-1356 (CA-4, 1995).
11 Rev. Rul. 76-113, 1976-1 CB 276.

the decedent's estate may also occur pursuant to Section 2036(a), which creates broad inclusion of assets in a decedent's gross estate. However, a notable exception exists for sales made bona fide for an adequate and full consideration in money or money's worth.

If the insured has the power to receive insurance benefits or change their disposition, the proceeds will be included in the insured's estate at death.

In connection with his divorce, a decedent established a trust to secure the decedent's obligations under the divorce decree. The trust held stock and a policy of insurance on the decedent's life, with trust income distributable to the decedent provided payments to the spouse were made as required under the terms of their stipulation. If the decedent predeceased the spouse, the spouse's benefits were to be paid from the trust, and if the spouse predeceased the decedent, the trust assets would benefit the decedent. The trust was found to be established as a property settlement, not a relinquishment by the spouse of any support rights. That relinquishment was not consideration to the decedent in money or money's worth. Consequently, the decedent was deemed to have received no consideration for the transfer, the exception under Section 2036(a) was not fulfilled, and the full value of the trust was includable in the decedent's gross estate.[8]

Transfer within three years of death. If a decedent transfers a policy of insurance within three years of death, the value of that policy may be included in the decedent's estate for estate tax purposes under Section 2035(a), as a transfer presumed to be in contemplation of death. However, if that transfer is a bona fide sale for an adequate and full consideration in money or money's worth, Section 2035(a) will not apply, and the value of the transferred property will not be includable in the decedent's gross estate.[9]

In *Estate of Waters*,[10] after years of negotiations between the decedent and his spouse in connection with their divorce, but before a property agreement was finalized, the decedent transferred a policy of insurance on his life to his spouse in response to the spouse's request for the financial security that the insurance would provide to her. The spouse did not give or relinquish any entitlement to any property or other assets in exchange for the insurance. When the couple's property agreement was later finalized, that policy of insurance was not referenced in the agreement. Finding that the decedent's transfer of the insurance reflected no bargained-for exchange that might allow the transfer to be characterized as supported by consideration, the court concluded that because the decedent died within three years of the transfer to the spouse, that insurance policy was subject to the general rule of includability of Section 2035(a).

Type of deduction

If the proceeds of an insurance policy which the decedent is required under state law to maintain as a result of a divorce are included in the decedent's gross estate, an offsetting deduction may be available.

The deduction generally takes one of two forms under Section 2053(a). That section provides, in pertinent part:

> [T]he value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—
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> …
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> (3) for claims against the estate; and
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> (4) for … any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such … indebtedness, is included in the value of the gross estate,
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> as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered."

Claim against decedent's estate. Reg. 20.2053-4(a) provides, in pertinent part, "a claim against a decedent's estate must represent a personal obligation of the decedent existing at the time of the decedent's death.… [T]he amounts that may be deducted as claims against a decedent's estate are limited to the amounts of bona fide claims that are enforceable against the decedent's estate (and are not unenforceable when paid)…."

When a decedent was required under the terms of a decree of divorce to name the decedent's former spouse as primary beneficiary of certain policies of insurance and to maintain those policies until the death or remarriage of the former spouse, and the decedent did so, the IRS ruled that the decedent fully complied with the decree such that no obligation survived death. Consequently, no deduction was permitted under Section 2053(a)(3) because no enforceable claim could be made by the former spouse.[11]

In making that ruling, the IRS distinguished those facts from a situation in which a divorce decree required a decedent to provide the former spouse with a specific sum of money and the decedent ensured that payment by means of life insurance. In that situation, the IRS recognized that the decedent's payment of the required amount would be a personal obligation. If the insurance company was unable to satisfy the obligation, it would be payable from the decedent's estate. Accordingly, the IRS acknowledged that payment to the former spouse would be deductible under Section 2053(a)(3).

Debt against insurance proceeds. Although the IRS in Rev. Rul. 76-113[12] disallowed a deduction to the decedent's estate under Section 2053(a)(3) because no enforceable claim could be made against the decedent's estate, the IRS found that the decedent's obligation to the former spouse was a debt against property (the insurance proceeds) that was included in the decedent's estate. Thus, the IRS permitted a deduction under Section 2053(a)(4) for the value of the insurance proceeds.[13]

The Tax Court has explained, "under the provisions of a property settlement agreement incident to a divorce, an indebtedness might arise under state law against a decedent's estate for the amount of life insurance he was required to keep in force, had he not kept such life insurance in force. If such an obligation exists under state law, it represents an indebtedness within the meaning of section 2053(a)(4) with respect to property included in the gross estate where the proceeds of the life insurance policy actually maintained by the decedent have been included in the estate."[14]

Similarly, for insurance that the decedent is required to maintain for the benefit of a child, the IRS has ruled that "the support order created the decedent's obligation to maintain the insurance policies in question for the support of the child in the event of the decedent's death before the child attained majority age.... [¶] Accordingly, the decedent's estate is entitled to a deduction under section 2053(a)(4)."[15]

Availability of deduction

Whether a deduction is founded on a claim against the decedent's estate, or upon debt against insurance proceeds that are includable in the decedent's estate, in either case, if the decedent's obligation to maintain the insurance is founded on a property settlement agreement then, in determining whether a deduction will be available to the decedent's estate for the insurance proceeds payable to another, it is necessary to examine that property settlement agreement. Only if the agreement was contracted in a bona fide manner and supported by adequate and full consideration in money or money's worth will a deduction be available.

Settlement agreement supported by adequate and full consideration. In evaluating whether a property settlement agreement that gives rise to the claim or the debt satisfies the bona fide and adequate consideration requirements, the following issues should be considered:

Relinquishment of marital rights in property. A relinquishment or promised relinquishment of marital rights in the decedent's property is not the type of consideration necessary to support a deduction. Section 2043(b)(1) clearly states, "[f]or purposes of this chapter, a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration in 'money or money's worth.'"

Transfers that satisfy Section 2516. Section 2043(b)(2) provides, in pertinent part, "a transfer of property which satisfies the requirements of paragraph (1) of section 2516 (relating to certain property settlements) shall be considered to be made for an adequate and full consideration in money or money's worth."

Section 2516, in turn, states, "[w]here husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within the 3-year period beginning on the date 1 year before such agreement is entered into (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to such agreement—(1) to either spouse in settlement of his or her marital or property rights, or (2) to provide a reasonable allowance for the support of issue of the marriage during minority, shall be deemed to be transfers made for a full and adequate consideration in money or money's worth."

Section 2516 originally applied only to the gift tax, but Section 2043(b) was amended in 1984 to add Section 2043(b)(2) and so extend Section 2516 to the estate tax.

Therefore, if a transfer between the parties in connection with a property settlement agreement meets the requirements of Section 2516 for gift tax purposes, that transfer will also meet the requirements of Section 2043(b)(2) for estate tax purposes. This means that the transfer will be deemed to be made for an adequate and full consideration in money or money's worth.

Release of support rights. Although a relinquishment or promised relinquishment of marital rights in the decedent's property expressly is not consideration which supports a deduction

[12] *Id.*
[13] Rev. Rul. 76-113, *supra* note 7.
[14] Estate of DeVos, TCM 1975-216.
[15] TAM 8128005.
[16] Estate of Glen, 45 TC 323 (1966).
[17] Estate of Meyer, 110 F.2d 367, 24 AFTR 503 (CA-2, 1940).
[18] Rev. Rul. 71-67, 1971-1 CB 414.
[19] Estate of McKeon, 25 TC 697 (1956).
[20] 78 TC 1172 (1982).
[21] Estate of Gray, 440 F. Supp. 684, 40 AFTR2d 77-6260 (DC Calif., 1977).
[22] GCM 37397 (1/30/1978).

(unless it comes within Section 2516), a release of support rights has been held to be adequate and full consideration in money or money's worth. Indeed, the Tax Court has stated, "to the extent that a settlement agreement pursuant to divorce involves the wife's relinquishment of support rights, there is consideration received for the transfer of property to the wife under the agreement."[16]

This distinction between marital rights and support rights draws a rather fine line, because a right to support has been treated as a "marital right in property" under Section 2043(b).[17] Nevertheless, the IRS has not followed that reasoning of the Second Circuit but has recognized support rights as the basis for adequate consideration.[18]

Therefore, in ascertaining what was negotiated by the parties in reaching a property settlement agreement, it may be necessary to review the nature of the rights exchanged to determine whether they are in the nature of dower or curtesy, support rights, or other "marital rights."

Contracted bona fide for adequate and full consideration. Even if a property settlement agreement is found to be supported by adequate and full consideration in money or money's worth, a deduction against the decedent's estate for insurance proceeds included in the estate still may not be available. In order to be deductible, those insurance proceeds must be shown to have been bargained for in the decedent's exchange with the former spouse. This "bargained for" element is an important part of the analysis. Section 2053(c)(1)(A) requires that "[t]he deduction allowed by this section ... shall, when founded on a promise or agreement, be limited to the extent that they were contracted bona fide and for an adequate and full consideration in money or money's worth...." Proof of being "contracted bona fide" is necessary even if the transfer satisfies Section 2516 or is otherwise found to have been made for adequate and full consideration in money or money's worth. Section 2053(c)(1)(A) limits a deduction to the extent that the claim against the decedent's estate or the debt was so contracted.

This applies not only to life insurance that the decedent is obliged to maintain for the benefit of the former spouse, but also to insurance that the decedent is obliged to maintain for the benefit of the decedent's children. The Tax Court has held that property transferred by a decedent in release of an obligation to support children was done for consideration in money or money's worth.[19]

How does one show that a decedent's obligation was contracted bona fide for adequate and full consideration in money or money's worth? The executor of the decedent's estate should collect information sufficient to prove that under the state law governing the decedent's divorce, the value of the insurance proceeds received by the decedent's former spouse was bargained for in exchange for the rights released. The Tax Court in *Estate of Satz*[20] denied a deduction for insurance proceeds included in the decedent's estate on the basis that "[t]here is no evidence of the value of the couple's marital assets, of Ruth's and decedent's income following the divorce, or of Ruth's, decedent's, and the children's expenses. In short, the record in this case ... lacks any evidence from which we can value the postponed support rights or, in fact, determine the existence of any uncompensated support rights."

Stated simply, "[t]o determine whether [husband]'s promise to maintain the life insurance policy with [wife] as beneficiary was supported by full and adequate consideration, the value of what [husband] received must be measured against the value of what [wife] transferred."[21]

Insurance maintained for children. A general counsel memoranda considered whether proceeds of life insurance payable to a decedent's minor children pursuant to a divorce decree were deductible from the decedent's gross estate under Section 2053. Because generally a parent is liable for the support of a minor child only during the parent's lifetime, to the extent that a divorce decree requires insurance to be maintained for the benefit of the children after the decedent's death, the decree may be inconsistent with state law. If that is the case, the Service can disregard the decree.[22] But even if the divorce decree is consistent with state law, a deduction may nevertheless be disallowed. As the General Counsel explained:

> It is firmly established in judicial authority that the ... rationale is limited to adjudications of marital or property rights between spouses and does not apply to provisions to third parties such as children. ... [W]e believe it is essentially because children often are not directly involved in divorce proceedings, and even if they are involved, their interests are properly limited to custody and support rights. While divorce courts may provide for property interests in children beyond support rights, such provisions are an incidental part of the divorce proceedings and are not interests to which the children have any recognizable legal claim, and are very often in reality testamentary dispositions.

Merely because life insurance is payable to the children pursuant to the court decree does not necessarily make the proceeds deductible for federal estate tax purposes. "[E]ven if the divorce decree was in accordance with state law requiring the decedent to provide for a transfer of property to the decedent's [minor] children at death, the maintenance of the life insurance policy was a testamentary disposition since it was neither in satisfaction of a legal duty to support the children nor contracted for a full and adequate consideration."[23]

Stated another way, "the children's claims are founded upon a promise or agreement [by the decedent to provide for the children] and there must be adequate consideration for an estate to claim a section 2053 deduction."

Divorce decree. The last consideration must be the authority of the state court overseeing the parties' divorce. Significantly, that court's authority affects whether the required maintenance of life insurance payable to the decedent's former spouse will be treated as supported by adequate and full consideration in money or money's worth.

Court authorized to vary terms of settlement agreement. If the court overseeing a divorce has authority to ignore the terms provided in the property settlement agreement or has authority to establish different allowances for the parties, and if the agreement reached by the parties is incorporated into a state court decree of divorce, then the decedent's obligations to the former spouse are founded not on the property settlement agreement, but rather on the divorce decree. This distinction is significant because if the decedent's obligation to the former spouse is founded on the divorce decree, that obligation (to the extent any assets subject to it are included in the decedent's estate) will be deductible in the decedent's estate under Section 2053 without regard for any consideration given by the former spouse.

The U.S. Supreme Court in *Harris*[24] explained, "[the agreement] would be wholly conditional upon the entry of the decree; the divorce court might or might not accept the provisions of the agreement as the measure of the respective obligations; it might indeed add to or subtract from them. The decree, not the arrangement submitted to the court, would fix the rights and obligations of the parties."

Judge Learned Hand explained the distinction this way:

> [W]e must therefore here decide whether, because the decree of divorce incorporated by reference the separation agreement, [wife]'s claim against the estate was "founded upon a promise or agreement." That question apparently first arose in 1939, and the Board of Tax Appeals held that, since the divorce court was free to disregard any allowances made in the separation agreement, the allowances were authentically its own, even in cases where it expressly accepted as proper the allowances actually agreed upon. [Citations.] At first blush the distinction may seem a little formal, but on consideration it appears to be sound. One can of course say that a divorce decree is "founded" upon the testimony of the witnesses, and in that sense the decree of the Nevada court in the case at bar was "founded" upon the separation agreement. But it is pretty clear that this is not the sense in which [predecessor to IRC section 2053] uses the word; rather it means that the legal transaction which creates the obligation is the agreement, and in that sense the allowances are not "founded" upon the agreement but upon the command of the court.[25]

Demonstrating that a decedent's obligation was founded on a decree of divorce by a court having authority to alter a couple's property settlement agreement assures an estate tax deduction for assets that are subject to that obligation and includable in the decedent's gross estate, without having to prove adequate consideration.

Court not authorized to vary terms of settlement agreement. If a divorce court does not have authority to ignore the terms provided in a property settlement agreement or to establish different allowances for the parties, and if the agreement reached by divorcing parties is incorporated into a state court decree of divorce, then the decedent's obligations to the former spouse are founded *not* on the divorce decree, but rather on the property settlement agreement. The Tax Court in *Estate of Satz* expressed it this way:

> The consideration requirement of section 2053(c)(1)(A) applies to claims "founded on a promise or agreement."
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> The sine qua non of a conclusion that a claim is founded on a decree rather than the agreement between the parties is that the decree be the operative element. [Citation.] This, in turn, depends upon whether the divorce court has the power to decree a settlement of the matter upon which the claim is based (including the power to vary the terms of the agreement between the parties)–in this case the property rights in the insurance policy. [Citations.]
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> ...
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> Under this statutory framework, it is clear that, at least insofar as the settlement of property rights is concerned, the Missouri divorce court is without power to decree a disposition of such rights or to vary the terms of an agreement between the spouses settling such rights.[26]

As discussed above, if the decedent's obligation to the former spouse is founded on a property settlement agreement, not the court's decree, and if assets subject to that obligation are included in the decedent's estate for federal estate tax purposes, then the obligation will be deductible in the

[23] Rev. Rul. 78-379, 1978 CB 238.

[24] 340 U.S. 106, 39 AFTR 1002 (1950).

[25] Maresi, 156 F.2d 929, 35 AFTR 58 (CA-2, 1946).

[26] Estate of Satz, *supra,* note 20.

decedent's estate under Section 2053 only if what the decedent received in the negotiation was contracted bona fide and for adequate and full consideration in money or money's worth.

Conclusion

When evaluating the estate of a decedent, do not forget to consider whether the decedent owned insurance on his or her life. If so, it is important to consider the context in which the decedent maintained that insurance, for if the decedent was required, pursuant to a divorce, to maintain the insurance in force, the insurance proceeds may not be includable in the decedent's gross estate or, if they are, a deduction may be available. Even if the decedent did not own insurance on his or her life at the time of death, consider if the decedent transferred such a policy prior to death, as the timing and circumstances of any such transfer could nonetheless result in the value of the policy being included in the decedent's gross estate. ■