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PRORATION OF FEDERAL ESTATE TAX AMONG LIFE INSURANCE BENEFICIARIES

BY

EDWARD N. POLISHER*

The Federal Estate Tax is levied upon the value of the net estate, irrespective of the relationship of the beneficiary to the decedent: Section 811, Internal Revenue Code. The net estate is arrived at by deducting from the gross estate the allowable deductions and the applicable exemptions under the Federal Estate Tax statute: Section 812, Internal Revenue Code.

By the provisions of the Federal Estate tax statute, as amended by section 404 (a) of the Revenue Act of 1942, the proceeds of life insurance policies taken out by the insured are includible in the decedent's gross estate to the extent that—

(a) They are receivable by the executor; or are

(b) Receivable by all other beneficiaries in the proportions that—

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1. The premiums or other consideration paid for the insurance, directly or indirectly by the decedent, bear to the total premiums paid, or
2. With respect to which the decedent possessed any incident of ownership in the policy at his death: Polisher, Estate Planning and Estate Tax Saving, P. 50.

This inclusion of life insurance proceeds in the gross estate applies to the estates of all decedents dying after October 21, 1942. The previously allowed exemption for life insurance in the amount of $40,000 no longer obtains.

The tax is imposed at increasing, graduated rates applicable to various brackets of net estate valuation as to which the specific rates are levied. The larger the net estate, the higher are the rates of tax attained and the greater the amount of the total taxes.

The duty to pay the tax is imposed primarily upon the executor of the decedent's estate: Section 822 (b), Internal Revenue Code. The amount of such taxes is often increased by the value of property includible in the gross estate under the provisions of the Federal Estate tax statute, even though such property may never come into the executor's possession for estate administration purposes. A common illustration of such property is the proceeds of life insurance policies payable to named beneficiaries in force upon the decedent's life at the time of his death. In many instances, a substantial part of the increase in the Federal Estate tax is due directly to the inclusion of such life insurance proceeds in the decedent's gross estate for Federal Estate tax.

Prior to the enactment of estate tax apportionment statutes, the Federal Estate tax was treated as part of the expenses incident to the administration of the estate. In the absence of a testamentary direction to impose the tax upon the beneficiaries of the estate, such portion of the Federal Estate tax, attributable to property transferred to them at death, the tax would fall upon the decedent's residuary estate: Polisher, Estate Planning and Estate Tax Saving, P. 205. From experience in such matters, the residuary estate usually is intended for the enjoyment of beneficiaries who are the nearest next of kin of the decedent. Hence, a gross injustice may be perpetrated upon those for whom the decedent would naturally wish to provide the greatest measure of security after his death by their being obliged to absorb this tax burden.

To avoid the possibility of such an inequitable situation, the Federal Estate tax statute confers upon the executor the right to enforce reimbursement from the beneficiaries of life insurance proceeds on the decedent's life for that proportion of the tax which the proceeds received by the beneficiaries bears to the net estate of the decedent and the amount of the exemption allowed in computing of the net estate for Federal Estate Tax. Under the statute, the executor's right of reimbursement is not enforceable in those cases where the decedent in his Will

directs otherwise—that is, provides that all Federal Estate tax is to be paid out of the assets in his general estate: Section 826 (c) Internal Revenue Code, as amended by Revenue Act of 1942. In such an event, the beneficiaries under life insurance policies are freed of any burden of Federal Estate tax unless the assets in the general estate are insufficient to pay it. Were this latter situation to arise, the beneficiaries would become personally liable as transferees of the proceeds for the proportionate share of the estate taxes to the extent of such proceeds received: Section 827 (b), Internal Revenue Code.

It has been accepted generally, that the executor's right of reimbursement and the proceedings to enforce it are within the jurisdiction of the probate court of the state which controls the administration of the decedent's estate. The Federal Government is not concerned with the method of withdrawing funds from a decedent's estate to pay such taxes: Riggs vs. del Drago, 317 U. S. 95 (1942).

To implement the executor's right of reimbursement several states have enacted local laws prescribing the conditions and the procedure by which recovery should be had by the executor of the estate from those to whom property of the decedent was transferred at death which added to the burden of the Federal Estate tax. The effect of these statutes is to reverse the prior rule and to create a presumption that the testator intended the beneficiaries to share the tax pro rata, unless he directed otherwise in his Will. Among such states are Arkansas, California, Florida, Pennsylvania and New York. Most states, however, make no such provision and the common law rule in such states prevails: CCH—Federal Estate Tax Service, Par. 3729.18.

Perhaps the most usual type of property includible in the decedent's gross estate for Federal Estate tax purposes which is received directly by the intended beneficiaries and which by-passes the executor is the proceeds of life insurance policies in force upon the decedent's life at death. Where these proceeds are made payable at death to the beneficiaries in a lump sum, there is no problem of reimbursement by the executor of the estate, if the decedent failed to relieve such proceeds from payment of their share of Federal Estate tax by an appropriate direction in his Will.

However, all life insurance policies contain settlement options exercisable by the insured in his lifetime under which the proceeds may be made payable to the beneficiaries in stated installments of interest and principal, spread over a period of time, sometimes as long as the lives of two generations. Where the proceeds are committed by the insured for payment under such options, the difficulty arises as to how the executor shall collect his reimbursement for Federal Estate tax. Shall the Court direct the insurance company which holds the funds to deduct forthwith the total amount of the share of such tax applicable to the life insurance proceeds and pay it over to the executor who paid the tax? In such case, what is to happen to the settlement agreement between the insured and the

insurance company wich stipulated for a certain number of payments of fixed amounts over a stated period? Shall the amounts of the respective payments be reduced, since the total proceeds have been reduced by the payment of the estate tax? Or shall the amount of the payments remain constant but the number of such payments be diminished?

The other alternative is to refuse to deplete the insurance proceeds by an immediate lump sum reimbursement to the executor for the share of Federal Estate tax due the estate and relegate him to the position of a "hat in hand" creditor who must await satisfaction of his just claim by attachment or sequestration of the stated installments receivable by the beneficiaries as and when they are paid to them under the provisions of the settlement arranged by the insured-decedent in his lifetime.

Both positions have been taken by the announced decisions of the State Courts. An unfortunate divergence of authority exists. We should like to examine and comment upon both views as reflected by the decisions handed down by the exponents of each.

For the purpose of convenience only, we shall refer to one view as the New York rule. It holds that the proportionate share of the Federal Estate tax for which the insurance proceeds are liable for reimbursement to the executor shall be paid first to the executor by the insurance companies and the amount of such reimbursement shall be deducted forthwith from the total of the future payments to the beneficiaries under the policies and the installments readjusted actuarially upon the insured's death: In re Scott's Estate, 286 NYS 138 (1936); 249 App. Div. 542, 293 NYS 126, affirmed sub nomine; In re Central Hanover Bank & Trust Co., affirmed, per curiam 274 N. Y. 538, 10 NE 538 (1937); Certiorari denied under name Northwestern Mutual Life Insurance Co. vs. Central Hanover Bank & Trust Co. 302 U. S. 721 (1937).

The theory of the Court's well reasoned opinion is that the estate tax is a tax upon the property of the decedent and is payable out of corpus; that the practical enforcement of a sovereign right to collect the estate tax cannot be impeded by voluntary arrangements made by the decedent in his lifetime prescribing the manner in which the property shall be enjoyed by his beneficiaries. Such provisions embodied in a contract with the insurance company for the payment of the proceeds in installments are subject to the unexpressed agreement of the parties that the sovereign should have its lawfully imposed tax. Where the executor paid the tax out of the estate funds, he is subrogated by operation of the apportionment statute to the position of the sovereign whose claim he has paid; and, consequently, he has the right to enforce against the insurance companies the same claims which the sovereign might have enforced had the tax not been paid.

Opposing this doctrine, is what we shall term the Pennsylvania rule. Upon substantially the same state of facts, and under a statute similar to that enacted in New York, the Supreme Court of Pennsylvania held (reversing the lower court, 93 Pitts. 9) that apportionment may not be enforced against insurance companies to compel payment of the beneficiaries' proportionate share of Federal Estate tax, applicable to the life insurance proceeds and paid by the executor. Its construction of the wording of the Pennsylvania Apportionment Act of July 2, 1937, P. L. 2762, 20 PS, Par, 844, compelled the conclusion that insurance companies are not "persons interested in the estate" as defined in the statute and are not proper parties to proration proceedings within the purview of the statute. The Court relegates the executor to his rights of attachment and sequestration of the beneficiaries' payments in satisfaction of his liability but "only, of course, in such installments, at such times and in such manner as is stipulated in the policies." As though to further bolster its opinion, the Court stated that any compulsory acceleration of the payments would constitute an impairment of the obligation of the contracts between the insurance companies and the decedent: Moreland's Estate, 351 Pa. 623 (April 9, 1945).

The solution of the problem under the Pennsylvania rule is unsatisfactory. Its legal casuistry fails to be persuasive in the face of the realities of the situation. Would the Court hold the same, if the sovereign had been unable to collect its tax from the executor who had no estate assets with which to discharge the payment of the tax? One hardly believes so. The same Court has found no difficulty in transmitting to a creditor by way of subrogation the mantle of the sovereign's right to collect taxes in the case where a purchaser at a sheriff's sale of real estate is obliged to pay the delinquent taxes assessed against the premises prior to the sale, and thereafter, seeks to reimburse himself from the registered title holder before the sale: Fidelity-Philadelphia Trust Company vs. Land Title Bank & Trust Co. 326 Pa. 262 (1937).

Why should the Court have felt itself so constricted by the terms of the Apportionment Act? Does not the Orphans Court of Pennsylvania, before whom this proceeding was initiated, have the inherent powers of a Court of Equity to enforce under the equitable doctrine of contribution an apportionment of the burden of Federal Estate Tax? Heinz Estate, 313 Pa. 6 (1933); Hunter's, Penna. Orphans Court Commonplace Book P. 946-7.

When we consider the problem from the social aspect, the answer given by the Pennsylvania rule is also unacceptable. Let us suppose that at the time of the decedent's death, the proceeds of the life insurance policies were set up under one of the options in the policies, to pay a monthly income to the beneficiaries. They are usually the widow or members of the decedent's immediate family. Should the monthly installments be attached by the executor to recover the pro rata share of Federal Estate tax due from the beneficiaries, it would in many instances result

in depriving the decedent's dependents of their basic means of support from this intended source—at least for such period of time as the number of monthly installments required to satisfy the beneficiaries' share of the Federal Estate tax. This, at a time when the family is called upon to meet the difficult problems of readjustment following in the wake of the death of its "breadwinner." Moreover, the fact that the recovered sums are paid to the executor of the estate does not guarantee that they will be made available for the benefit of the decedent's family. His Will may have disposed of his estate in favor of others in reliance upon the provisions made for the family through his life insurance; or the estate may not have been solvent; or there may have been an abatement of legacies so that the recovered items would inure to the benefit of persons other than the decedent's dependents. From the viewpoint of the family, it would be better in many instances for their share of the Federal Estate tax to be paid in one lump sum to the executor. Thereafter the monthly installments from insurance, although reduced in amount would be uninterruptedly paid over to them following the decedent's death. This would obviously be better for the family's welfare than to be denied any such payments for months or perhaps years until the Federal Estate tax liability is discharged.

The New York rule commends itself to us as the one which more nearly achieves the most equitable and socially desirable solution of this problem.