

## RECENT DEVELOPMENTS

### FEDERAL TAX CLAIMS ON PROCEEDS OF LIFE INSURANCE POLICIES

*Commissioner of Internal Revenue v. Stern,*  
357 U.S. 39 (1958)

In a proceeding under the transferee provision of the Internal Revenue Code of 1939<sup>1</sup> the government sought to recover income tax deficiencies owed by a deceased taxpayer from the beneficiary of the latter's life insurance policies.<sup>2</sup> The Tax Court had held the beneficiary, taxpayer's widow, liable for the full amount of the deficiencies. In affirming the decision of the court of appeals,<sup>3</sup> the Supreme Court held that under the applicable Kentucky statute<sup>4</sup> the federal government could not, as creditor, hold the widow liable for the unpaid taxes.

The majority of the court looked first to the legislative history which accompanied the predecessor of Section 311<sup>5</sup> and found that the congressional purpose was to provide a new *procedure* by which the government could enforce tax deficiencies against transferees and *not* to alter their substantive liability.<sup>6</sup> Rejecting the government's argument

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<sup>1</sup> INT. REV. CODE OF 1939, § 311, 53 Stat. 90 (1939): "(a) Method of collection. The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds): (1) Transferees. The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter. . . . (f) Definition of 'transferee.' As used in this section, the term 'transferee' includes heir, legatee, devisee, and distributee." This section was re-enacted in substantially the same language in INT. REV. CODE OF 1954, § 6901. It was intended to correspond to "existing law." See H.R. REP. No. 1337, 83d Cong., 2d Sess. 553 (1954).

<sup>2</sup> Insured's tax deficiencies for the years 1944 through 1947, including interest and penalties, amounted to \$32,777.51. The proceeds and cash surrender value of the policies at his death totaled \$47,282.02 and \$27,259.68 respectively.

<sup>3</sup> 242 F.2d 322 (6th Cir. 1957).

<sup>4</sup> KY. REV. STAT. §§ 297.140, 297.150 (1935) (now KY. REV. STAT. §§ 304.691, 304.695 (1950)).

<sup>5</sup> Revenue Act of 1926, ch. 27, § 280, 44 Stat. 61.

<sup>6</sup> "Without in any way changing the extent of such liability of the transferee under existing law . . . this section enforces such liability . . . in the same manner as liability for a tax deficiency is enforced; . . . Such a proceeding is in lieu of the present equity proceeding. . . ." H. R. REP. No. 356, 69th Cong., 1st Sess. 43-44 (1925). The summary administrative remedy allowed against the taxpayer himself consists of notice by the commissioner to the taxpayer and opportunity either to

that *uniform* liability on the part of transferees should be established by federal decisional law, the court concluded that in view of precedent in the federal courts<sup>7</sup> and Congress' manifestation of a policy in favor of non-uniform liability<sup>8</sup> the existence and extent of such liability should be determined by *state* law. The applicable Kentucky statute provided that where, as here, premiums have not been paid in fraud of creditors, the beneficiary of a life insurance policy is not liable to the insured's creditors;<sup>9</sup> and since no tax lien had been attached to the policy prior to insured's death, the government's rights were precisely those which other creditors would have under Kentucky law.

The Ohio statute which protects beneficiaries of life insurance policies against claims of insured's creditors is designed for the benefit of wives, children, dependent relatives and creditors who have been named beneficiaries of the insured.<sup>10</sup> In order to be exempt, the policy and its proceeds must be held for the benefit of a person within the classes named in the statute, although the insured may reserve the right to change the beneficiary.<sup>11</sup> The statute limits the amount of the pro-

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with review by the courts. REV. STAT. § 3187 (1875), as amended by the Internal Revenue Act of 1924, 43 Stat. 343, (now INT. REV. CODE OF 1954, §§ 6331, 6334).

pay and sue for the refund or else to proceed before the Board of Tax Appeals, <sup>7</sup> *Botz v. Helvering*, 134 F.2d 538 (8th Cir. 1943); *United States v. Goldblatt Bros., Inc.*, 128 F.2d 576 (7th Cir. 1942); *Weil v. Commissioner*, 91 F.2d 944 (2d Cir. 1937); *Hutton v. Commissioner*, 59 F.2d 66 (9th Cir. 1932).

<sup>8</sup> ". . . [T]he varying definitions of liability under state statutes resulted in an absence of uniformity of liability. Yet Congress, with knowledge that this was 'existing law' at the time the predecessor section to § 311 was enacted, has refrained from disturbing the prevailing practice. Uniformity is not always the federal policy." *Commissioner v. Stern*, 357 U.S. 39, 45 (1958).

<sup>9</sup> See statutes cited note 4 *supra*.

<sup>10</sup> OHIO REV. CODE § 3911.10 (1955), which provides as follows: "All contracts of life or endowment insurance or annuities upon the life of any person, or any interest therein, which may hereafter mature and which have been taken out for the benefit of, or made payable by change of beneficiary, transfer, or assignment to, the wife or children, or any relative dependent upon such person, or any creditor, . . . shall be held, together with the proceeds or avails of such contracts, subject to a change of beneficiary if desired, free from all claims of the creditors of such insured or annuitant. Subject to the statute of limitations, the amount of any premium upon said contracts, endowments, or annuities, paid in fraud of creditors, with interest thereon, shall inure to their benefit from the proceeds of the contracts, but the company issuing any such contract is discharged of all liability thereon by the payment of its proceeds in accordance with its terms, unless, before such payment, written notice is given to it by a creditor, specifying the amount of his claim and the premiums which he alleges have been fraudulently paid."

<sup>11</sup> *Foulks v. Foulks*, 49 Ohio App. 291, 197 N.E. 201 (1934); *Baxter v. Old Nat'l City Bank*, 46 Ohio App. 533, 189 N.E. 514 (1933). If the insured changes the beneficiary to a person not within the enumerated classes, the exemption is removed, and the policy and its proceeds may then be subjected to the satisfaction of a debt. *Hoffman v. Weiland*, 64 Ohio App. 467, 29 N.E.2d 33 (1940).

ceeds to which such claims may attach to those premiums which have been paid in fraud of creditors.<sup>12</sup> Fraud within the meaning of the statute includes constructive fraud.<sup>13</sup>

It is apparent that the fact situation presented by the *Stern* case would require the same result in Ohio. Since the beneficiary, insured's widow, falls within a protected class and since there is no evidence to support a finding that any premiums were paid with intent to defraud creditors, the proceeds of the life insurance policies would be exempt from claims by the federal government as an *unsecured* creditor.

One important qualification to the above rule must be noted, however. In *United States v. Bess*, decided the same day as the *Stern* case, the Supreme Court held that a *lien* on the *cash surrender value* of life policies for unpaid federal income taxes owed by the insured attached to the property before insured's death and followed the property into the beneficiary's hands under the transferee provision of the Internal Revenue Code.<sup>14</sup> In that case, prior to the death of the insured, *notice* and *demand* had been made upon him for payment of income tax deficiencies owing from previous years. Under federal law the government had thereby acquired a lien upon all property, real or personal, belonging to the insured.<sup>15</sup> The court held that such lien did not attach to the proceeds of the insurance policies<sup>16</sup> but that insured did have "property" or "rights to property" within the meaning of Section 3670 in the cash surrender value<sup>17</sup> to which the federal lien attached during his lifetime. It was held, further, that once it is determined that state law creates sufficient interests in the insured to satisfy the requirements of Section 3670, state law is inoperative to prevent attachment of liens created by federal statutes in favor of the United States.<sup>18</sup> Hence, the New Jersey

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<sup>12</sup> See note 10 *supra*. See also OHIO REV. CODE § 3911.15 (1953).

<sup>13</sup> *John Weenink & Sons Co. v. Blahd*, 73 Ohio App. 67, 54 N.E.2d 426 (1943). In *Doethlaff v. Penn Mut. Life Ins. Co.*, 117 F.2d 582, *cert. denied*, *Gardner v. Doethlaff*, 313 U.S. 579 (1941), the statutory phrase "in fraud of creditors" was construed to mean intent to hinder, delay and defraud creditors, the question of intent being one of ultimate fact; and it was held that the payment of premiums by an insured while insolvent was not fraudulent where the premiums paid bore a reasonable relation to the financial condition of the insured, there being no actual intent to defraud creditors.

<sup>14</sup> 357 U.S. 51 (1958).

<sup>15</sup> INT. REV. CODE OF 1939, § 3670, 53 Stat. 448 (1939): "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) 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."

<sup>16</sup> *United States v. Bess*, *supra* note 14, at 56, citing *Cannon v. Nicholas*, 80 F.2d 934 (10th Cir. 1935).

<sup>17</sup> *United States v. Hoper*, 242 F.2d 468 (7th Cir. 1957); *Knox v. Great W. Life Assur. Co.*, 212 F.2d 784 (6th Cir. 1954).

<sup>18</sup> *Fink v. O'Neil*, 106 U. S. 272 (1882).

statute exempting the proceeds of life policies from claims by creditors<sup>19</sup> did not prevent the attachment of the federal lien. Treating the premiums making up the cash surrender value, for the purposes of Section 3670, as a "fund" held by the insurer for the benefit of the insured,<sup>20</sup> the court held that there was a transfer of property from the insured to the beneficiary and that the lien which attached to the property before the former's death followed the property into the latter's hands.<sup>21</sup>

Until Congress speaks to the contrary, the liability of beneficiaries of life insurance policies for unpaid federal tax deficiencies owed by their insureds will be determined by state law, provided the government stands in no better position than an unsecured creditor of the deceased taxpayer. In opening the door to nonuniformity of liability for federal taxes in this area, the court felt that Congress did not intend that a body of federal decisional law should be formulated to govern actions by the government when in actions by private creditors in diversity cases state law must be applied by the federal courts.<sup>22</sup> "That effort is plainly not justified when there exists a flexible body of pertinent state law continuously being adapted to changing circumstances affecting all creditors."<sup>23</sup>

*William L. Clark*

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<sup>19</sup> N.J. STAT. ANN., § 17:34-29 (1902).

<sup>20</sup> *In re McKinley*, 15 Fed. 535 (1883), approved in *Burlington v. Crouse*, 228 U.S. 459 (1913), and *Hiscock v. Mertens*, 205 U.S. 202 (1907).

<sup>21</sup> The dissent by Justices Harlan and Burton rejected the "fund" theory, citing *United States v. Behrens*, 230 F.2d 504 (2d Cir. 1956), and argued that the cash surrender value of life insurance policies, though properly considered property of the taxpayer to which federal tax liens attached *during taxpayer's life*, came to an end upon taxpayer's death and that the lien terminated therewith.

<sup>22</sup> *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938).

<sup>23</sup> *Commissioner v. Stern*, *supra* note 8, at 45.