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Commissioner v. Estate of Noel: The Double Life of Life Insurance

John McGown, Jr. and Jason Melville***

Introduction

Life insurance has historically lived a double life. In most cases, it is a nonprobate asset and is not included in the estate of the insured for probate purposes.[1] The opposite is true for federal estate tax purposes. Assuming the decedent retained what are known as incidents of ownership over the life insurance policy,[2] the value of the insurance will be included in the gross estate of the insured for federal estate tax purposes.[3] Against this legal background, Marshall Noel applied for two air travel accident insurance policies with death benefits at the Idlewild Airport in New York on June 19, 1956.

I. Description of the Case

A. Procedural Background.

This case originated when the I.R.S. determined that Marshall Noel's estate had a $17,000 estate tax deficiency due to proceeds from two accidental death policies, which were not included in the taxable estate. The estate challenged the determination in the Tax Court, which upheld the I.R.S.'s finding of a deficiency.[4] The estate appealed to the Third Circuit, which reversed the Tax Court,[5] and the United States Supreme Court granted certiorari.

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1 This assumes the estate of the insured is not the beneficiary, and that the proceeds are paid pursuant to a contract with the insurance company to a named beneficiary other than the estate.

2 *See* Treas. Reg. § 20.2042-1(c)(2) ("[A]n incident of ownership includes, among other things, the power to change the beneficiary; the power to surrender or cancel the policy; the power to assign the policy or to revoke an assignment; the power to pledge the policy for a loan; or the power to obtain from the insurer a loan against the surrender value of the policy.").

3 I.R.C. § 2042(2).

4 Estate of Noel v. Comm'r, 39 T.C. 466, 473 (1962).

5 *In re* Estate of Noel, 332 F.2d 950, 954 (3d Cir. 1964).

B. Facts

The Supreme Court decided *Commissioner v. Estate of Noel*[6] on April 29, 1965, almost nine years after the two policies in question were purchased and a mere four weeks after oral argument.

Mr. Noel was set to fly from New York to Venezuela, and before boarding he and his wife purchased two insurance policies for $125,000 on his accidental death, naming his wife as the beneficiary.[7] Mrs. Noel paid for the policies, and she testified that Mr. Noel told the clerk, "They are hers now, I no longer have anything to do with them."[8] The plane crashed in the Atlantic Ocean killing all aboard.[9] Mrs. Noel received $125,000 for the policies, but the executors did not include the proceeds on Mr. Noel's estate tax return.[10]

C. Issues

The Court addressed two issues the estate raised as alternative reasons why the proceeds should not be subject to the federal estate tax. The first reason was that accidental death policies such as these were not on the "life of the decedent" within the meaning of section 2042.[11] The second reason was the decedent did not possess any of the incidents of ownership of the policies when he died.[12]

1. *Issue One: Relevant Facts and Holding*

The appeals court found the difference between an ordinary life insurance policy and these types of accidental death policies to be noteworthy under the statute when determining whether the policies are on the "life of" the decedent.[13] However, a prior decision by the Board of Tax Appeals ruled that this distinction between ordinary life insurance and accidental death insurance was of no significance.[14] The Supreme Court agreed with the Board of Tax Appeals and—given that "such a long-standing administrative interpretation . . . is deemed to have received congressional approval and has the effect of law"—held that

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6 Comm'r v. Estate of Noel, 380 U.S. 678 (1965).
7 *Id.* at 679-80.
8 *Id.* at 680.
9 *Id.*
10 *Id.*
11 *Id.* at 679.
12 *Id.*
13 *In re* Estate of Noel, 332 F.2d 950, 954 (3d Cir. 1964).
14 Ackerman v. Comm'r, 15 B.T.A. 635, 637 (1929) ("In each case the risk assumed by the insurer is the loss of the insured's life, and the payment of the insurance money is contingent upon the loss of life.").

these policies "were taken out on the 'life of the decedent' within the meaning of § 2042(2)."[15]

2. *Issue Two: Relevant Facts and Holding*

Regarding whether Mr. Noel possessed any of the incidents of ownership in the policies when he died, Respondents raised three alternative claims: (1) that Mrs. Noel owned the policies because she bought them; (2) that even if she did not initially own them by purchasing them, her husband subsequently gave them to her, thus giving up his right to assign them or change beneficiaries; and (3) even assuming Mr. Noel had the powers to assign and change beneficiaries, it was merely illusory since it was impossible to exercise them in the time between takeoff and his death.[16]

The Court dismissed the first two claims by finding Mr. Noel still had the legal right to assign the contracts when he died.[17] Regardless of who paid for the policies, the contracts granted Mr. Noel the right to assign or change beneficiaries.[18] That he had not assigned them at the time of his death meant he still maintained that power, despite his purported statement at the time of purchase giving them to his wife.[19]

The Court noted the third claim could be asserted "about a man owning an ordinary life insurance policy who boarded the plane at the same time or for that matter about any man's exercise of ownership over his property while aboard an airplane in the three hours before a fatal crash."[20] It held that the general power to exercise ownership is determinative for federal estate tax purposes, not the "fluctuating . . . capacity to dispose of property which he owns."[21] The Court thus found all three of these claims lacking and held that Mr. Noel did possess the incidents of ownership at the time of his death.[22]

II. Law at Time of Decision

The Board of Tax Appeals addressed the inclusion of accident insurance on one's life in 1929 in the *Ackerman* decision.[23] It held that Congress's use of the general term "insurance upon his own life" in section 302(g) of the Revenue Act of 1924 was broad enough to include

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15 Comm'r v. Estate of Noel, 380 U.S. 678, 682 (1965).
16 *Id.* at 682–83.
17 *Id.* at 683.
18 *Id.*
19 *Id.*
20 *Id.* at 684.
21 *Id.*
22 *Id.*
23 Ackerman v. Comm'r, 15 B.T.A. 635, 636 (1929).

both life and casualty insurance, and amounts received under accidental death policies were thus includable in the decedent's gross estate.[24] Until the Third Circuit held for the taxpayer in *In re Estate of Noel*[25] in 1964, no court had deviated from *Ackerman*. The Third Circuit saw a distinction between ordinary life insurance where death was an inevitable event and accidental death insurance where the risk of death was "evitable and not likely to occur."[26] The Third Circuit found this distinction significant, asserting accidental death was simply an extension of accident insurance generally; death was one unlikely possibility among other injuries the policy covered, none of which were intended to be subject to the estate tax.[27] This was a novel concept in the context of the federal estate tax and was quickly dismissed by the Supreme Court.[28]

III. Evaluation of the Supreme Court's Reasoning

The Supreme Court first analyzed whether there was a distinction between ordinary life insurance and accidental death insurance in the context of the statute.[29] The Court pointed out "the language of the statute itself . . . makes no distinction between 'policies on the life of the decedent' which are payable in all events and those payable only if death comes in a certain way or within a certain time."[30] In short, the Court concluded that the factual distinction argued by the taxpayer made no difference under the applicable statute.[31] Second, the Court relied on the contractual terms of the policy to conclude that the decedent had "incidents of ownership" over it.[32] As to the inability to change beneficiaries while in flight, the Court noted that such inability applied to both ordinary life insurance and accidental death insurance, and thus it made no difference.[33]

While the Court's logic was easy to follow, the Court had opportunities to go in different directions. One path was to look at premiums. Premiums for life insurance are paid in order to receive insurance proceeds payable at death. The premiums for the accidental death insurance cover items in addition to death such as loss of a limb, sight, or permanent paralysis. This provided an opportunity for the Court to pro-

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24 *Id.* at 638.
25 *In re* Estate of Noel, 332 F.2d 950, 964 (3d Cir. 1964).
26 *Id.* at 952-53.
27 *Id.* at 953.
28 Comm'r v. Estate of Noel, 380 U.S. 678, 681 (1965).
29 *Id.*
30 *Id.*
31 *Id.* at 682.
32 *Id.* at 683.
33 *Id.* at 683-84.

rate the premium between the two coverages and to include only the portion of the proceeds allocable to the death benefit. This approach would have been based on the Third Circuit's holding in favor of the estate on the basis that air travel accident proceeds are not "insurance under policies on the life of the decedent" under section 2042(2).[34] Such a proration would have been complex and the Court ignored that option.

A second path would have been to distinguish flight insurance from an ordinary life insurance policy on the basis of premiums. Flight insurance premiums are a set dollar amount, with no adjustment for age, health, occupation or moral character.[35] Life insurance, on the other hand, considers such facts in determining the premiums. The Court disregarded such distinction, however. Indeed, while a policy's premium formulation distinguishes ordinary life insurance from other insurance which pays out a death benefit, the broad statutory language of section 2042(2) encapsulates more than just life insurance. Rather, the Court seemed to settle on a binary classification as either "on the life of the decedent" or not.

IV. Importance of the Decision of Current Estate Planning

Estate tax practitioners were using irrevocable life insurance trusts (ILITs) many years prior to *Estate of Noel*. They were and continue to be structured so that the insured has no "incidents of ownership" and therefore are not included in the insured's estate for federal estate tax purposes. The Court, in dictum, sanctioned the use of ILITs at the end of the opinion by stating, "Nothing we have said is to be taken as meaning that a policyholder is without power to divest himself of all incidents of ownership over his insurance policies by a proper gift or assignment, so as to bar its inclusion in his gross estate under § 2042(2)."[36] In essence, the Court said ILITs, when properly done, avoid federal estate tax inclusion. Estate planners have taken that to heart as evidenced by the use of ILITs over the past fifty years.

If the Court had adopted the Third Circuit's view that accidental death insurance does not fall within the purview of life insurance under section 2042(2), the lives of estate planners might be quite different. ILITs could be the second option with accidental death insurance being the primary option. Since the Court rejected such distinction, ILITs have become an important part of insurance planning in the context of estate planning.

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[34] *In re* Estate of Noel, 332 F.2d 950, 954 (3d Cir. 1964).

[35] Brief for Respondent at 17, Comm'r v. Estate of Noel, 380 U.S. 678 (1965) (No. 503).

[36] Comm'r v. Estate of Noel, 380 U.S. 678, 684 (1965).

V. Conclusion

The Supreme Court's decision in *Estate of Noel* held that accidental death insurance, even if not owned by the insured, is includible in the insured's estate for federal estate tax purposes if the insured had certain contractual rights over the policy, such as the power to change beneficiaries. The Court confirmed settled law dating back to a 1929 decision by the Board of Tax Appeals. Perhaps the most important aspect of the Court's decision was its recognition that a policyholder could divest himself or herself of all incidents of ownership and thus exclude the proceeds from his or her taxable estate for federal estate tax purposes, which has strengthened the use of ILITs in estate planning for the past fifty years.