Schwager v. Commissioner, 64 T. C. 781 (1975)

The decedent's ability to prevent changes to a life insurance policy's beneficiary, even if exercised in conjunction with another, constitutes an incident of ownership requiring inclusion of the policy's proceeds in the gross estate for estate tax purposes.

Summary

In Schwager v. Commissioner, the U. S. Tax Court ruled that the decedent's retention of the right to veto changes to the beneficiary of a split-dollar life insurance policy was an incident of ownership under IRC Section 2042(2). The policy, owned by the decedent's employer but with the decedent's wife as beneficiary, could not have its beneficiary changed without the decedent's consent. Despite an Estate Tax Closing Letter being issued and the estate distributing all assets, the court held that the IRS could still determine a deficiency and assert transferee liability against the estate's beneficiary. This decision underscores that even a negative power over a policy's beneficiary designation can trigger estate tax inclusion, and procedural steps like closing letters do not bar the IRS from later action if no examination occurred.

Facts

In 1957, David G. Schwager's employer, Davis & Kreeger Co. , obtained a split-dollar life insurance policy from New York Life Insurance Co. on Schwager's life. The policy designated the employer as the owner and beneficiary of the cash surrender value, while Schwager's wife, Eleanor M. Schwager, was the beneficiary of the remaining proceeds. An amendment to the policy required Schwager's written consent for any change to his wife's beneficiary status. Schwager died in 1967, and his estate filed a federal estate tax return in 1968, excluding the policy's proceeds. The estate received a closing letter in February 1969, and all assets were distributed. In 1970, the IRS began examining the return and ultimately asserted transferee liability against Eleanor Schwager for the estate tax deficiency.

Procedural History

The estate timely filed a federal estate tax return on November 27, 1968, which was accepted by the IRS. An Estate Tax Closing Letter was issued on February 7, 1969. In June 1970, the IRS initiated an examination of the return, the first such contact with the estate. After unsuccessful attempts to resolve the issues, the IRS issued a statutory notice of transferee liability to Eleanor Schwager on November 30, 1971. She then petitioned the U. S. Tax Court for a redetermination of the deficiency.

Issue(s)

1. Whether the issuance of an Estate Tax Closing Letter precluded the IRS from determining a deficiency against the estate.

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2. Whether the decedent's retention of a veto power over changes to the beneficiary of a life insurance policy constituted an incident of ownership requiring inclusion of the policy's proceeds in his gross estate under IRC Section 2042(2).

Holding

1. No, because the case was not closed after examination, and the IRS's failure to follow reopening procedures did not curtail its right to issue a statutory notice of transferee liability. The Estate Tax Closing Letter did not estop the IRS from asserting transferee liability.
2. Yes, because the decedent's ability to prevent changes to the beneficiary designation was an incident of ownership exercisable in conjunction with his employer, thus requiring inclusion of the policy's proceeds in his gross estate under IRC Section 2042(2).

Court's Reasoning

The court determined that the IRS was not bound by its own procedural rules like Revenue Procedure 68-28, as these were directory rather than mandatory. The case had not been closed after examination, so the IRS did not need to follow reopening procedures. The court rejected the argument that the Estate Tax Closing Letter estopped the IRS from asserting transferee liability, as it was not a closing agreement under IRC Section 7121. On the substantive issue, the court held that the decedent's veto power over changes to the beneficiary was an incident of ownership. The court emphasized that even a "fractional" power could trigger estate tax inclusion, citing cases like United States v. Rhode Island Hospital Trust Co. and Commissioner v. Karagheusian's Estate. The court distinguished this from mere trustee powers or rights to receive dividends, focusing on the economic benefit the decedent retained through his ability to protect his wife's interest in the policy.

Practical Implications

This decision underscores the broad interpretation of "incidents of ownership" for estate tax purposes, particularly in split-dollar life insurance arrangements. Practitioners must advise clients that even seemingly minor or negative powers over policy beneficiaries can lead to estate tax inclusion. The ruling also clarifies that IRS procedural rules are not binding, and an Estate Tax Closing Letter does not prevent the IRS from later asserting deficiencies if no examination occurred. This case has been cited in subsequent rulings on life insurance policy ownership, such as Estate of Lumpkin v. Commissioner, and remains relevant in estate planning involving life insurance policies where control over beneficiaries is a concern.

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