Estate of Smead v. Commissioner, 79 T. C. 69 (1982)

The conversion privilege in a group life insurance policy, contingent upon termination of employment, is not considered an incident of ownership for estate tax purposes.

Summary

In Estate of Smead v. Commissioner, the Tax Court ruled that the proceeds of a group life insurance policy were not includable in the decedent's gross estate under IRC §2042(2). The decedent, an employee of Ford Motor Co. , was covered by a supplemental survivor income benefit plan. The court determined that the only right the decedent possessed was a conversion privilege to individual insurance upon termination of employment, which was deemed too contingent and remote to be an incident of ownership. This decision clarifies that for estate tax purposes, rights contingent on employment termination do not constitute incidents of ownership.

Facts

James R. Smead died in 1975 while employed by Ford Motor Co. as a general sales manager. Ford provided a supplemental survivor income benefit plan through an insurance policy with John Hancock Mutual Life Insurance Co. The policy named Smead's widow and child as beneficiaries. Upon Smead's death, the policy's commuted value was $132,956. 59. The policy included a conversion privilege allowing Smead to convert the group policy to an individual policy within 31 days of employment termination. Smead had no control over policy terms or beneficiaries and did not assign any rights under the policy.

Procedural History

The executor of Smead's estate filed a federal estate tax return excluding the insurance proceeds. The Commissioner determined a deficiency, asserting that the proceeds should be included in the gross estate under IRC §2042(2) due to Smead's alleged incidents of ownership. The case was submitted to the Tax Court, which ruled in favor of the estate, holding that the conversion privilege was not an incident of ownership.

Issue(s)

1. Whether the conversion privilege in the group life insurance policy constitutes an incident of ownership under IRC §2042(2).

Holding

1. No, because the conversion privilege was contingent upon the termination of employment, which is not considered an incident of ownership under IRC §2042(2).

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Court’s Reasoning

The court analyzed whether Smead’s conversion privilege constituted an incident of ownership under IRC §2042(2). It noted that while the statute does not define “incidents of ownership,” the regulations provide examples such as the power to change beneficiaries or surrender the policy. The court referenced prior cases where contingent rights were not considered incidents of ownership, such as in Estate of Smith and Estate of Beauregard. The court emphasized that the conversion privilege was contingent upon employment termination, an event Smead could control only by voluntarily quitting his job, which carried potentially adverse economic consequences. The court concluded that this right was too contingent and remote to be considered an incident of ownership, aligning with IRS rulings like Rev. Rul. 72-307, which distinguishes powers exercisable only by employment termination from direct incidents of ownership. The court rejected the Commissioner’s attempt to distinguish between the power to cancel and convert insurance, asserting that both rights are similarly contingent on employment termination.

Practical Implications

This decision impacts how group life insurance policies are treated for estate tax purposes. Attorneys should note that conversion privileges contingent on employment termination are not incidents of ownership, potentially excluding such proceeds from the estate. This ruling may affect estate planning strategies involving group life insurance, encouraging the use of individual policies or irrevocable assignments to ensure proceeds are not taxed. Businesses offering group life insurance can be reassured that such benefits will not inadvertently increase the taxable estate of their employees. Subsequent cases, such as Estate of Connelly, have continued to apply this principle, distinguishing between direct incidents of ownership and rights contingent on employment-related actions.

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