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NOTES

In re Kapoor: Life Insurance, Divorce, and Inheritance Tax

In *In re Kapoor*,¹ a case of first impression, the Supreme Court of North Carolina construed the term "debts of decedent" as it is used in N.C. Gen. Stat. section 105-9(4).² The court held that a separation agreement between a decedent and his first wife, which required the decedent to maintain life insurance policies, the proceeds of which would be used to establish a trust fund for the benefit of his ex-wife and their children, created a valid contractual obligation. Therefore, the policy proceeds could be deducted from the value of the taxable estate for inheritance tax purposes as a "debt of the decedent."

The testamentary trust funded by the proceeds of life insurance policies has gained considerable use in divorce and separation agreements because of its relatively low immediate cost compared to the large payoff when the insured dies. In holding that the proceeds of such policies used to establish a trust fund for the benefit of children pursuant to a separation agreement were deductible from a decedent husband's taxable estate, and in defining the criteria that must be met to qualify for the deduction, *In re Kapoor* allows substantial inheritance tax advantages when such a device is used.³

The approach taken by the North Carolina Supreme Court in determining the inheritance tax consequences of the terms of a separation agreement differs markedly from that taken by the courts that follow

1. 303 N.C. 102, 277 S.E.2d 403 (1981).

2. N.C. GEN. STAT. § 105-9 (1979) provides:

In determining the clear market value of property taxed under this Article, or schedule, the following deductions, and no others, shall be allowed: (1) Taxes accrued and unpaid at the death of the decedent and unpaid ad valorem taxes accruing during the calendar year of death (4) Debts of decedent, (5) Estate and inheritance taxes paid to other states, and death duties paid to foreign countries.

Deductions are also allowed for drainage and street assessments, funeral and burial expenses, the cost of a monument, commissions of executors and administrators actually paid, and costs of administration of the estate. N.C. GEN. STAT. § 105-9(2), (3), (6)-(8) (1979).

3. The possible income tax liability on the proceeds is a complex and unresolved question which is beyond the scope of this casenote. Generally the proceeds of a life insurance policy paid by reason of the death of the insured are not taxable as income. But if the proceeds are being paid to a divorced spouse as alimony or through an alimony trust they are considered income to the recipient. Payments for child support are not considered income. If the use of payments is not delineated as such the court will decide what percentage is for child support and tax the remainder as alimony. If the policy was transferred for valuable consideration, for example the surrender of marital rights, the proceeds would be excludable up to the value of those rights, but any excess could be considered income. See generally 59 A.L.R.3d 9 (1974).

the Internal Revenue Code in construing state tax statutes. The I.R.C. applies special rules when evaluating the terms of a separation agreement.⁴ Justice Carlton, however, writing for the court in *In re Kapoor*, examined the separation agreement in question as he would have examined any contract. As will be shown, this difference in approach could have the effect of allowing tax deductions in North Carolina under certain circumstances where deductions would not be allowed for federal estate tax purposes.

The importance of minimizing the burden of state inheritance taxes has been increased by the changes made in the federal estate tax rules in the Economic Recovery Act of 1981.⁵ Under the old law the federal estate tax burden was invariably much higher than that imposed by the state. Under the new federal estate tax rules, however, many estates will have to pay no federal taxes at all.⁶ Consequently, any state taxes that can be avoided will directly benefit the taxpayer.

When Dr. Shankar N. Kapoor died he was survived by his second wife, Nancy N. Kapoor, his former wife, Ruth Kapoor, and two children by his first marriage, Karl and Pamela Kapoor. Prior to their divorce, he and his first wife executed a separation agreement that provided for the support and maintenance of his former wife and children during his lifetime and for the establishment of a trust funded by the proceeds of life insurance policies to continue the support payments after his death. The terms of the separation agreement obligated Dr. Kapoor to "maintain in full force and effect . . . a life insurance trust in the amount of at least \$150,000 for the benefit of Ruth Kapoor and/or their children Dr. Kapoor agrees to make timely payment of all premiums due on the policies placed in the trust."⁷

Dr. Kapoor fulfilled his obligations, and at his death the trustee, Wachovia Bank & Trust Co., collected the policy proceeds, \$151,754.63. Because Dr. Kapoor had retained certain incidents of ownership in the policies, the executor of his estate included the policy proceeds in the gross estate when he filed the estate and inheritance tax returns with the United States Internal Revenue Service and the North Carolina Department of Revenue.⁸

The executor then requested a refund of that part of the taxes paid on the insurance proceeds, claiming that the insurance proceeds were

4. See *infra* text accompanying notes 43-62.

5. Pub. L. No. 97-34, 95 Stat. 172 (1981). Perhaps the most significant changes are the increase in the unified transfer tax credit, I.R.C. § 2010 (1982), which will exempt the first \$600,000 transferred when the Act is fully implemented in 1987, and the provision for an unlimited marital deduction, *id.* § 2207(A), effective January 1, 1981.

6. "When the (Economic Recovery Tax) Act is fully implemented in 1987, less than 0.5% of all estates are expected to be subject to tax." BACHE HALSEY STUART SHIELDS, INC., *THE TAX ACT—WHAT IT MEANS TO THE INDIVIDUAL* 18 (1981).

7. 303 N.C. at 107, 277 S.E.2d at 408.

8. See *infra* text accompanying notes 64-69.

deductible from the gross estate under the Internal Revenue Code section 2053(a)(3)-(4)⁹ and N.C. Gen. Stat. section 105-9(4). The Internal Revenue Service allowed the claim for refund, but the requested refund from the North Carolina Department of Revenue was denied.¹⁰

The executor requested a hearing on the denial before the Secretary of Revenue,¹¹ who also denied the claim for refund. The executor then filed for review by the Tax Review Board,¹² which affirmed the decision of the Secretary of Revenue.¹³ The executor then petitioned for judicial review.¹⁴ Judge Hamilton H. Hobgood of the Superior Court, Wake County reversed the decision of the review board and ordered the Department of Revenue to refund \$14,510.58, the amount of tax paid on the insurance proceeds, plus interest to the petitioner.

The Secretary of Revenue appealed that decision and the court of appeals reversed the superior court.¹⁵ In denying the request for refund the court of appeals reasoned:

The generally accepted meaning of 'debt' is 'something owed' from one person to another . . . what decedent owed under the pertinent provision of the separation agreement was a 'life insurance trust in the amount of at least \$150,000' maintained in full force and effect, and this obligation was fulfilled by the payment of the necessary life insurance premiums. At the time of decedent's death no debt existed with respect to this obligation . . . Since decedent had totally satisfied his contractual obligation, no debt existed and no deduction under G.S. § 105-9(4) is proper.¹⁶

The Supreme Court of North Carolina allowed the executor's petition for discretionary review and reversed the decision of the court of appeals. The court held that the \$150,000 insurance proceeds required to fund the trust was a "debt of the decedent" for purposes of an inheritance tax deduction, that being the obligation intended by the parties,

9. I.R.C. § 2053(a)(3)-(4) (1982) provides:

(a) General Rule—For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts— . . . (3) for claims against the estate, and (4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate.

10. 303 N.C. at 104, 277 S.E.2d at 405-406.

11. A hearing on the denial of a claim for refund may be requested pursuant to N.C. GEN. STAT. § 105-266.1 (1979). The procedures governing such a hearing are outlined in N.C. GEN. STAT. § 105-241.1 (1979).

12. N.C. GEN. STAT. § 105-241.2 (1979) provides for review of a decision of the Secretary of Revenue by the Tax Review Board.

13. N.C. Tax Review Board Administrative Decision No. 152 (June 21, 1978).

14. "The Administrative Procedure Act allows judicial review of a final agency decision in a contested case when all relevant administrative remedies have been exhausted and there is no adequate judicial review provided under any other statute." 303 N.C. at 104, 277 S.E.2d at 406 (citing N.C. GEN. STAT. § 150A-43 (1978)).

15. *In re Estate of Kapoor*, 47 N.C. App. 500, 267 S.E.2d 418 (1980).

16. *Id.* at 501, 267 S.E.2d at 419.

validly contracted for and supported by consideration.¹⁷ To reach its conclusion the court used a three-step analysis. First the court defined the term "debts of the decedent" as it was used in the statute, then the court examined the facts of the case to determine what the decedent's true debt was under the separation agreement, and finally the court decided if that debt had been validly contracted for.

Special rules of construction apply when a statute concerning taxation is construed. If an ambiguous term appears in a statute that provides for taxation, the term is construed against the state in favor of the taxpayer.¹⁸ "But when the statute provides for an *exemption* from taxation a contrary rule applies and any ambiguities are resolved in favor of taxation."¹⁹

In light of these canons of construction the Secretary of Revenue contended that because N.C. Gen. Stat. section 105-9 defines the *deductions* allowed in determining the value of the property subject to inheritance taxes, the term "debts of the decedent" should be "construed narrowly and technically to include only those obligations of the decedent which were due and owing prior to his death and as to which the person to whom the obligation was owed could have maintained a suit."²⁰ This reasoning formed the basis of the court of appeals decision.

Justice Carlton acknowledged the existence of the special canons of construction used in construing tax statutes. He also remarked that he would consider the construction placed upon a tax statute by the Commissioner of Revenue but that he would not be bound by it. He stated, "Our primary task in interpreting a tax statute, as with all other statutes, is to ascertain and adhere to the intent of the legislature. The cardinal principle of statutory construction is that the intent of the legislature is controlling."²¹ He repeated this point in answering the contention of the petitioner that the definition of "debts of the decedent" in the North Carolina statute should be the same as that of "claims against the estate" as used in the corresponding statute dealing with deductions allowable in computing the value of the taxable estate for federal estate tax purposes.²²

While the federal provisions provide some guidance, absent a clear indication of legislative intent to parallel federal law by use of identical language or otherwise, we cannot accept federal law as controlling. Instead, we will look to 'the language of the statute, the spirit of the act,

17. 303 N.C. at 111, 277 S.E.2d at 409-10.

18. *Id.* at 106, 277 S.E.2d at 407.

19. *Id.* (citations omitted) (emphasis added).

20. *Id.*

21. *Id.* (citations omitted).

22. I.R.C. § 2053(a)(3)-(4) (1982).

and what the act seeks to accomplish.²³

Long before the court decided *In re Kapoor* the Attorney General had offered several opinions as to what obligations would constitute allowable deductions under section 105-9(4). These three opinions are consistent with the interpretation the court gave to the term "debts of the decedent," and illustrative of other "debts."

In one opinion the decedent was a tenant by the entirety in real property subject to a mortgage. The value of his interest in the real property was included in the N.C. Inheritance Tax Return and a corresponding deduction was allowed under section 105-9(4) equal to the indebtedness.²⁴

In another, the decedent was indebted to a financial institution which indebtedness was secured by a life insurance policy. While the proceeds of the insurance were includible in the N.C. Inheritance Tax Return, a corresponding deduction was allowed under section § 105-9(4) equal to the indebtedness.²⁵

The situation in a third opinion was that the decedent had devised property to her stepson in payment for support that the stepson had furnished her during his lifetime. The Attorney General said that if the claim of the stepson for which the devise was made was based on a contract or agreement, such as would make the claim legally enforceable, the estate would be entitled to a deduction.²⁶

Another example of a "debt of the decedent" that has been ruled an allowable deduction in other states under provisions very similar to section 105-9(4) is a contract in which the decedent agrees to make a specific bequest in his will to someone in exchange for valuable consideration.²⁷ In *In re Greiner's Estate*,²⁸ an Illinois case, as part of divorce proceedings Lucille and Clarence Greiner made a settlement of their respective property and support right wherein Clarence agreed to, inter alia, pay \$1,500 per month alimony and to execute a will irrevocably bequeathing Lucille \$50,000 providing that she survived him and had not remarried at his death. After Clarence died, the Supreme Court of Illinois held that Lucille had taken the legacy not by virtue of Clarence's will but by virtue of the contract, which was supported by con-

23. 303 N.C. at 107-08, 277 S.E.2d at 408 (quoting *Stevenson v. City of Durham*, 281 N.C. 300, 303, 188 S.E.2d 281, 283 (1972)).

24. 26 Op. N.C. Att'y Gen. 115 (July 24, 1940).

25. 27 Op. N.C. Att'y Gen. 176 (Oct. 8, 1943).

26. 32 Op. N.C. Att'y Gen. 439 (June 12, 1954).

27. See generally 59 A.L.R. 3d 969 (1974). The note points out that in states that have estate taxes based on the right to transfer property at death, this type of deduction will never be allowed. It is only in states that have inheritance taxes like North Carolina's, based on the right to succeed to the decedent's property, that it would make a difference whether the bequest was made to satisfy a contractual obligation or for some other reason.

28. 412 Ill. 591, 107 N.E.2d 836 (1952).

sideration. The court held that the effect of the court's order was to decree a debt against the estate and that the will was merely the means chosen to comply with the degree and satisfy the debt. Therefore, Lucille took the \$50,000 as a creditor of the estate and not under the laws of succession and the legacy was thus deductible as a debt of the decedent.

After studying the North Carolina inheritance tax laws Justice Carlton concluded that "the Legislature intended that the value of the gross estate be reduced by the amount of the obligations associated with the property included therein."²⁹

The effect of this conclusion is to give the term "debts of the decedent" a very broad construction, making it equivalent to obligations associated with the property included in the value of the gross estate, in addition to the obvious personal debts that the decedent owed at the time of his death. This definition clearly rejected the Commissioner's suggested narrow construction, which would have limited deductible debts to those due and owing prior to decedent's death. Although Justice Carlton also rejected the petitioner's claim that the court should be controlled by the comparable I.R.C. sections in construing section 105-9(4), the construction he gave to the term "debts of the decedent" encompassed both the claims and the indebtedness provisions of I.R.C. section 2053.³⁰

Having defined "debts of the decedent" the court then examined the separation agreement to determine exactly what the decedent's true debt was under its provisions. Paragraph 5 of the agreement provided:

5. That as part of the consideration of this agreement the Party of the First Part Dr. Kapoor agrees to simultaneously establish, and thereafter maintain in the amount of at least \$150,000.00 for the benefit of the Party of the Second Part and/or children. Dr. Kapoor agrees to make timely payments of all premiums due on the policies placed in said trust and further agrees to repay the principal and interest of all loans against said policies within two years from the date of this agreement from his funds or from those of his estate.³¹

The court concluded that Dr. Kapoor's "debt" under the agreement was \$150,000, reasoning: "What Mrs. Kapoor bargained for, and what she gave up her marital rights for, was not the amount of money required to maintain the policies, but was the proceeds the policies would yield at Dr. Kapoor's death."³² The court went on to say that his obligation was to leave "a trust in the amount of at least \$150,000; the

29. The court specifically noted that N.C. GEN. STAT. § 105-9(1), (2), and (5) are clearly obligations associated with *property* included in the gross estate. See *supra* note 2.

30. See *supra* note 8.

31. New Brief of Appellant at 4, 303 N.C. 102, 277 S.E.2d 403.

32. 303 N.C. at 109, 277 S.E. at 408-09.

obligation to purchase insurance and to pay the premiums was merely the method chosen by the parties to fund the trust and to guarantee the corpus."³³

That the amount of the proceeds is the debt becomes even more clear when a breach of the agreement by Dr. Kapoor at the time of his death is hypothesized . . . Had Dr. Kapoor failed to maintain the policies, Mrs. Kapoor would have a claim against the estate for the full amount of the proceeds, not just the amount of premiums unpaid and that amount would be deductible as a debt of the decedent.³⁴

The court's thinking parallels that of the I.R.C. expressed in Revenue Ruling 76-113³⁵ which held:

In a case where the divorce decree provided for the payment, upon the decedent's death, to the decedent's former spouse of a specific sum of money and the decedent provided funds thereof by the purchase of life insurance . . . the payment of the required amount would be a personal obligation of the decedent and should the insurance company be unable to meet its obligation, would be payable from the decedent's estate . . . and deductible from the gross estate under section 2053(a)(3) of the Code.³⁶

The final step in the court's analysis was to determine if the decedent's debt was a valid contractual obligation, supported by consideration. The duty of a husband and father to pay alimony or child support is generally personal and terminates at his death without creating a charge against his estate.³⁷ He may, however, create an obligation by contract to make those payments, an obligation which will survive him and create a charge against his estate, but his intention to do so must be clearly expressed in the agreement.³⁸

The separation agreement in this case obligated Dr. Kapoor to estab-

33. *Id.*

34. *Id.*

35. Rev. Rul. 76-113, 1976-1 C.B. 276.

36. *Id.* at 277. This ruling also states:

The payment of insurance proceeds to the former spouse represents the satisfaction of an indebtedness created in settlement of the decedent's marital obligations. Since the insurance proceeds are includible in the decedent's estate at full value (by reason of the decedent's reversionary interest in the policy), the obligation to pay the proceeds to the decedent's former spouse is an indebtedness against the property included in the value of the gross estate for purposes of section 2053(a)(4) of the Code.

Id. The Internal Revenue Service allowed the claim for refund filed by the executor of Dr. Kapoor's estate based on both I.R.C. § 2053(a)(3) and (4).

37. 303 N.C. at 109, 277 S.E.2d at 409.

38. *Id.* (citing *Layton v. Layton*, 263 N.C. 453, 139 S.E.2d 732 (1965)). In *Layton*, the guardian of decedent's minor children sought to establish that a court order for support and maintenance established an obligation that survived decedent's death and created a charge against his estate. After stating the applicable rules of law, the court held that the purpose of the consent order in issue was only to fix the amount of support and that there was no provision imposing an obligation beyond that required by the principles of common law. 263 N.C. at 457, 139 S.E.2d at 735. See also *Church v. Hancock*, 261 N.C. 764, 136 S.E.2d 81 (1954).

lish a trust in the amount of \$150,000 for the benefit of his wife and children. Article three of the trust agreement provided that so long as Ruth Kapoor survived the grantor and remained unmarried she would be paid the income from the trust quarterly, and any amount freed from the principal of the trust that the trustee deemed necessary for the support, care, and comfort of her and the children, their emergency needs, and for the children's education. Articles four and five provided for the payment of the income and principal to the children upon the death or remarriage of Ruth Kapoor. Article ten provided that as long as Ruth Kapoor lived and remained unmarried, the grantor could not revoke or amend the Agreement and possessed no right in the insurance policies on his life.³⁹

The court held:

These documents evince an unmistakable intention to extend the obligation to provide alimony and child support beyond Dr. Kapoor's death. In exchange for Dr. Kapoor's promise to fund the trust Mrs. Kapoor relinquished all her marital rights and all other claims against Dr. Kapoor. The release of marital rights was valid consideration for Dr. Kapoor's promise and a binding and enforceable contract was thereby created.⁴⁰

It is in this final step in his analysis that Justice Carlton deviates from the provisions of the Federal Estate Tax. I.R.C. section 2053(c)(1)(A) says:

The deduction allowed by this section in the case of claims against the estate, unpaid mortgages, or any indebtedness shall, when founded on a promise or agreement, be limited to the extent that they were contracted for bona fide and for an adequate consideration in money or money's worth

This section raises two questions: when is a claim founded on a promise or agreement; and, what constitutes adequate consideration in money or money's worth.

The Supreme Court answered the first question in *Harris v. Commissioner*.⁴¹ In *Harris* the petitioner and her spouse entered into a separation agreement that divided their considerable assets between them. The Nevada divorce court had specifically approved the terms of the separation agreement and incorporated them into the divorce decree. The court of appeals, however, agreed with the Commissioner of Internal Revenue that the transfers of property were founded both upon the decree and the separation *agreement* and therefore held that the excess value of the property petitioner transferred to her husband over the value of the consideration received constituted a gift to him, which was

39. Brief for Appellees at 4, *In re Estate v. Kapoor*, 47 N.C. App. 500, 267 S.E.2d 418 (1980).

40. 303 N.C. at 110-11, 277 S.E.2d at 409-10.

41. 340 U.S. 106 (1950).

taxable.⁴² The Supreme Court reversed saying, "If 'the transfer' is effected by court decree, no 'promise or agreement' of the parties is the operative fact."⁴³

Although *Harris* was a gift tax case, its rationale was applied to I.R.C. section 2053 and section 2043 in Revenue Ruling 60-160⁴⁴ which held:

In a case in which the divorce court has power to decree a settlement of all property rights or to vary the terms of a prior settlement agreement, and does approve the agreement, any indebtedness arising out of such settlement is not considered to be founded upon a promise or agreement but, rather, it is considered to be founded upon such court decree and is, therefore, an allowable deduction from the gross estate in the amount of such indebtedness. If the court does not have the power to disregard the provisions of a previously existing property settlement agreement, a deduction is allowable only to the extent that the transfer does not exceed the reasonable value of the support rights of the wife.⁴⁵

An important aspect of this ruling, sometimes overlooked, is that the divorce court must have the power under state law to vary the terms of the prior settlement agreement. Absent this power, the incorporation of the agreement into the divorce decree will not exempt the transfer of property in exchange for marital rights from the close scrutiny mandated by I.R.C. section 2053. The importance of this provision was emphasized by the court in *Gray v. United States*.⁴⁶ In *Gray*, the proceeds of a life insurance policy on the decedent's life were paid to his former wife pursuant to the terms of a preexisting property settlement agreement that had been approved in their divorce decree. Under California law, the divorce court had no power to modify the terms of the property settlement agreement, therefore, the court of appeals held that the wife's claim against her ex-husband's estate was founded on the agreement, not on the divorce decree and remanded the case for determination of whether the claim was founded on an agreement contracted for adequate and full consideration. The court distinguished *Harris* because it was decided based on Nevada law, under which the divorce court does have the power to alter the terms of the agreement.⁴⁷

Under North Carolina law, once a court has ratified the terms of a separation agreement that provides for a final settlement of property rights, that agreement cannot be subsequently modified by the court insofar as the division of property is concerned without the consent of

42. *Harris v. Commissioner*, 178 F.2d 861 (2d Cir. 1949).

43. 340 U.S. at 111. See also *McMurtry v. Commissioner*, 203 F.2d 659 (1st Cir. 1953).

44. Rev. Rul. 50-160, a960-1 C.B. 374.

45. *Id.* at 375-76.

46. 541 F.2d 228 (9th Cir. 1976).

47. *Id.* at 232.

the parties.⁴⁸ Thus, *Gray* would seem to be controlling in North Carolina.⁴⁹ This makes the I.R.S.'s decision to grant the full refund requested by the executor of Dr. Kapoor's estate somewhat hard to explain.

The second question raised by I.R.C. section 2053(c)(1)(A) is: What constitutes adequate consideration in money or money's worth? The court's statement that "the release of marital rights was valid consideration for Dr. Kapoor's promise"⁵⁰ raises several questions when compared with I.R.C. section 2043(b):

For purposes of this chapter, a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration "in money or money's worth."

In construing this provision the I.R.S. has distinguished marital property rights from marital support rights, the latter being a personal legal obligation whose surrender may constitute consideration in money or money's worth.⁵¹ Most courts have also seemed to require an element of bargaining (perhaps to demonstrate the arms-length aspect of the transaction) to find the relinquishment of marital rights to be valid consideration. This may account for the different treatment of antenuptial agreements compared to separation agreements. In *Sherman v. United States*⁵² the court held that the obligations of the deceased husband's estate under a separation agreement were in consideration of the wife's relinquishment of support rights and not of her property or estate rights and thus were deductible for estate tax purposes. But in *Estate of Ellman*⁵³ the court held that post-death support rights relinquished in a prenuptial agreement were "marital

48. *Bunn v. Bunn*, 262 N.C. 67, 136 S.E.2d 240 (1964).

49. The law appears to be unchanged by the Act for Equitable Distribution of Marital Property, N.C. GEN. STAT. § 50-20 (1981). Subsection (d) of that statute provides that the parties to a divorce may execute a written agreement that provides "for the distribution of the marital property in a manner deemed by the parties to be equitable and the agreement shall be binding on the parties." *Id.* § 50-20 (1981) (emphasis added). While this statement is somewhat ambiguous, equitable distribution statutes of other jurisdictions usually contain a similar provision providing that prior property settlement agreements shall be binding on the court. See, e.g., ILL. ANN. STAT. ch. 40, § 502(b) (Smith-Hurd 1980); WIS. STAT. ANN. § 767.255(11) (West 1981).

50. 303 N.C. at 111, 277 S.E.2d at 410.

51. Rev. Rul. 68-379, 1968-2 C.B. 414 (superseding E.T. 19, 1946-2 C.B. 166). The Internal Revenue Service reasons that the satisfaction of this legal obligation does not diminish the husband's estate more than any other legal obligation, but that a transfer to a wife in settlement of inheritance rights is a present transfer of what would otherwise be a major portion of the husband's taxable estate at death. See generally R. STEPHENS, G. MAXWELL, & S. LIND, *FEDERAL ESTATE AND GIFT TAXATION*, § 2043 (3d ed. 1974).

52. 462 F.2d 577 (5th Cir. 1972).

53. 59 T.C. 367 (1972).

rights" proscribed by I.R.C. section 2043(b) and therefore not good consideration and denied a deduction.

Justice Carlton did not address this question in his opinion and it is possible that he meant that the release of any marital rights could be regarded as adequate consideration. As Justice Reed wrote in his dissent in *Merrill v. Fahs*⁵⁴

Whether the transferor of the sums paid for the release of dower and other marital rights, received adequate and full consideration in money and money's worth is a question of fact The trial court thus found the present value of the release of the taxpayer's estate from the wife's survivorship rights largely exceeded the amount paid by the taxpayer and that the transactions between the parties were made in good faith for business reasons and not an attempt to evade or avoid taxes Its determination, we think, also makes clear that the husband's estate received practical advantages of value in excess of the cost paid.⁵⁵

If this is the view which has been adopted by the North Carolina Supreme Court it would be possible under certain circumstances for a decedent's estate to be subject to federal estate taxes while avoiding entirely any state inheritance tax. Thus, had *Merrill* been decided under North Carolina law as articulated by Justice Carlton in *In re Kapoor*, the trial court's opinion would probably not have been reversed. While as a general rule courts will not examine the adequacy of the consideration supporting a contract,⁵⁶ for determination of the Federal Estate and Gift Tax consequences of a transaction, the value of the consideration received is usually compared to the value of the consideration given. Under the I.R.C. when marital rights are surrendered in exchange for some amount of money they are first separated into property rights and support rights. The property rights are then discounted pursuant to I.R.C. section 2043(b). The support rights are valued using many factors (e.g. the standard of living to be maintained, number and ages of the children, age of the wife and her ability to support herself, actuarial tables to project future needs, etc.) and their present cash value is compared to the terms of the settlement unless they have been incorporated into a divorce decree. Any excess of the settlement amount over the value of the support rights is usually deemed a gift which is subject to estate or gift tax.

One result of this approach has been to disallow deductions for support payments to adult "children." The courts have generally held that

54. 324 U.S. 308 (1944). The Court held that the release of marital rights in a prenuptial agreement in exchange for the establishment of an irrevocable trust was not "adequate and full consideration in money or money's worth" and hence the husband should have paid gift taxes on the trust he established for his wife. *Id.* at 312-13.

55. *Id.* at 413-15 (Reed, J., dissenting).

56. See generally J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* § 4-3 (2d ed. 1977).

because a parent's duty to support his children ends when they reach their majority, any payments for the support of such children are voluntary and hence subject to estate or gift tax.⁵⁷

The North Carolina Supreme Court has apparently chosen to evaluate separation agreements as they would any other contract. This approach would seem to include a reluctance to evaluate the adequacy of the considerations exchanged, creating another possible situation where a North Carolina resident could avoid state inheritance taxes but still be subject to federal estate or gift taxes.⁵⁸

A fundamental tenet of inheritance tax law that underlies this case is that the proceeds of a life insurance policy are includable in the gross taxable estate, even if they are not paid into the estate, if the decedent retained any "incident of ownership" in the policy. Following the guidelines laid down by the court⁵⁹ federal law is controlling in this area because the North Carolina statute which provides for the taxation of life insurance proceeds⁶⁰ is virtually identical to the corresponding section of the I.R.C.⁶¹ Examples of incidents of ownership are: "the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc."⁶² A reversionary interest in the policy or its proceeds, the value of which exceeds five percent of the value of the policy, is also defined as an incident of ownership in both I.R.C. section 2042(2) and N.C. Gen. Stat. section 105-13(2).

By the terms of the trust agreement, Dr. Kapoor reserved the right to diminish the trust by \$50,000 if Ruth Kapoor remarried and to "exercise all present and future policy privileges, receive all dividends . . . , obtain advances or loans," etc., if Ruth Kapoor predeceased him.⁶³ Had Dr. Kapoor not retained those incidents of ownership, the policy proceeds would not have been includable in his taxable estate. The court made an oblique reference to this in a footnote.⁶⁴

57. See, e.g., *In re Estate of Hartshorne*, 402 F.2d 592 (2d Cir. 1968); *Rosenthal v. Commissioner*, 205 F.2d 505 (2d Cir. 1953).

58. Under the recently enacted Act for Equitable Distribution of Marital Property, N.C. GEN. STAT. § 50-20 (1981), the court has the duty to provide for an equitable distribution of the marital property between the parties. It seems unlikely that this Act will affect the court's approach to the inheritance tax problems which sometimes arise from property settlements accompanying divorces.

59. See *supra* text accompanying note 22.

60. N.C. GEN. STAT. § 105-13(2) (1979).

61. I.R.C. § 2042(2) (1982).

62. Treas. Reg. 20.2-42-1(c)(2) (1974).

63. New Brief of Appellant at 303 N.C. 102, 277 S.E.2d 403 (1981).

64. "We note that our decision will not have the effect of allowing a deduction in cases in which the life insurance proceeds are not part of the property taxed under our statutes even though there is still a 'debt of the decedent.' N.C. GEN. STAT. § 105-9, the sole statute providing

Who must pay the estate taxes resulting from the inclusion of the proceeds of a life insurance policy in the taxable estate? I.R.C. section 2206 provides:

Unless the decedent directs otherwise in his will, if any part of the gross estate on which tax has been paid consists of proceeds of policies of insurance on the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds of such policies bear to the taxable estate.

While there is no North Carolina statute corresponding to I.R.C. section 2206, the common law dictates a similar result. The court of appeals said in *First National Bank of Shelby v. Dixon*:⁶⁵

Although no N.C. statute or case deals precisely with the question before us, we are constrained by equity and the example of our federal and sister state governments to hold that where proceeds of a life insurance policy are includable in a decedent's taxable estate by reason of G.S. § 105-13, a lien for taxes arises against the beneficiary is primarily liable for the taxes so incurred as provided by G.S. § 105-15. Therefore, the personal representative of an estate may proceed against the beneficiary of such insurance policy, or may retain such assets in the estate as would otherwise pass to the beneficiary and proceed under G.S. § 105-18 to obtain the ratable share of tax incurred by the estate by reason of the includable process.⁶⁶

CONCLUSION

In *In re Kapoor* the North Carolina Supreme Court construed the term "debts of decedent" as it is used in North Carolina General Statutes section 105-9(4) to include not only the personal debts of the decedent, but also obligations associated with the property in the decedent's estate. More importantly, Justice Carlton articulated his approach to the problem, which varies in certain key aspects from the rules used in the I.R.C. He applied basic principles of contract law to determine whether the "decedent's debt" under his separation agreement had been validly contracted for, and whether he had received consideration. Having answered those questions in the affirmative, he did not attempt to value the consideration (decedent's ex-wife's marital rights) that the decedent had received.

Under I.R.C. section 2043, release of marital property rights is specially defined as *not* being consideration in money or money's worth.

for deductions, allows a deduction which is associated with certain property only when that property is taxed under the inheritance laws. If the insurance proceeds were not includable as property of decedent, no deduction for indebtedness associated with those proceeds will be allowed.

303 N.C. at 111, 277 S.E.2d at 410, n.4.

65. 38 N.C. App. 430, 248 S.E.2d 416 (1978).

66. *Id.* at 434, 248 S.E.2d at 420.

Giving up marital support rights may be consideration such as would support a claim against a decedent's estate that would be allowable as a deduction under the Internal Revenue Code compared with the value of what was received in exchange, and the difference would be taxable as a gift.

The difference in the two approaches would seem to benefit the North Carolina taxpayer who dies after executing a separation agreement that includes a life insurance trust for the benefit of his ex-spouse as one of its provisions. The avoidance of the close scrutiny and comparison of the value of the marital rights given up and the amount of the settlement could only lessen the taxes on his estate.

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