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Community Property

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COMMUNITY PROPERTY

Surrender Value of Community Insurance Subject to Inheritance Tax. In *In re Leuthold's Estate*,[1] the Washington court held that the cash surrender value of a life insurance policy, purchased with community funds, is a community interest of the non-insured spouse and is property within the inheritance statute and, as such, subject to an inheritance tax. The court expressly overruled the *In re Knight's Estate*[2] case.

The facts of the *Leuthold* case are as follows: Mrs. Leuthold died testate, and the state attempted to impose an inheritance tax upon the one-half interest in the cash surrender value of six life insurance policies on the life of her surviving spouse. All premiums paid prior to the death of Mrs. Leuthold were paid with community funds. The state contended Mrs. Leuthold owned a one-half interest in the policies, as community property, which she passed to her legatees, thereby effecting a taxable event under the statute. The lower court, however, held against the state on the authority of *In re Knight's Estate*. In that case the court said, "even if the cash surrender value of a life insurance policy be considered to be property, still it is not property which passes *by will or by the statute of inheritance.*"[3] (Emphasis by the court.)

On appeal, the supreme court at first affirmed[4] but, on rehearing, reversed the decision of the trial court.

Analysis of the insurance policies involved is necessary to understand the logic which led the court to adopt its new position. All were level-premium, straight-life policies, the cash value of which increased each year. This type of policy is dual in nature, having both indemnity and investment features.[5]

The court pointed out that, as the premiums were paid with com-

[1] 52 Wn.2d 299, 324 P.2d 1103 (1958).
[2] 31 Wn.2d 813, 199 P.2d 89 (1948).
[3] 52 Wn.2d 299, 301, 324 P.2d 1103, 1104 (1958), quoting *In re* Knight's Estate, 31 Wn.2d 813, 199 P.2d 89 (1948).
[4] *In re* Leuthold's Estate, 150 Wash. Dec. 227, 310 P.2d 872 (1958).
[5] The court in the Leuthold case, quoting from pages 11 and 13 of Joseph B. McLean's treatise, *Life Insurance,* provides a more enlightening description of the principles underlying this type of policy: "[T]he level-premium plan, in fact, introduces an entirely new element into the scheme of operation: the invested fund formed by the excess payments. This fund is called the *reserve,* which is rather an unfortunate term since it is really not a reserve in the ordinary commercial sense implying surplus but is a fund which the company must maintain if it is to be able to pay all death claims and without which it would be insolvent. Moreover, the existence of this reserve causes a radical change in the true amount and cost of insurance. Comparing a level-premium plan with a yearly-renewable-term policy of the same face amount, we note that under the former, when a policyholder dies, the accumulated reserve on his policy will, of

munity funds, the life insurance policies were community personal property, not mere expectancies or choses in action, at the time of Mrs. Leuthold's death under the reasoning of *Occidental Life Ins. Co. v. Powers.*[6]

The court then reasoned that the right to receive the cash surrender value of the policy, being an incident of it, would also be community property, following the analysis of *Thompson v. Calvert,*[7] a Texas case with substantially the same fact pattern which sustained inclusion in the deceased wife's estate for inheritance tax purposes of half the cash value of life insurance policies on the husband's life. Citing the cases of *Poe v. Seaborn*[8] and *Hopkins v. Bacon*[9] for the proposition that the community property laws of the two states are substantially the same with respect to the vested interests of the wife, the court then described itself as "convinced that the rights of a wife in Washington, with respect to community property, are as substantial as those of a wife in Texas, and that the reasoning of the Texas court in *Thomson v. Calvert,* . . . is sound, and that we should adopt it in this case."[10]

The court, with reference to its previous position, said: "[O]ur decision in *In re Knight's Estate* . . . was incorrect in holding that the cash surrender value of a life insurance policy is not property 'which passes by will or the statute of inheritance.' In our opinion, the state in this case is taxing the receipt by Mrs. Leuthold's legatees, pursuant to her will . . . and . . . is entitled to do so."[11]

Under the *Leuthold* case, the court has classified the cash surrender value of insurance policies as another community asset arising from contract and subject to the distribution qualifications placed on all

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course, be available as a part of the 'face amount' payable. Consequently, as the reserve increases, the insurance, or *amount at risk* (face amount *less* reserve), decreases. Thus the increasing death *rate* is offset by a decreasing effective amount of insurance, and the cost is kept down to a practicable figure.

"*Investment in the Level-premium Plan.* It is very important to note that under the level-premium plan a policy of $1,000 does not give actual *insurance* of $1,000, (i.e., the company is never 'on the risk' for that amount) but only of $1,000 *less* the policyholder's own accumulated excess payments. It is thus evident, as already pointed out, that the plan is not pure insurance but rather a combination of a decreasing insurance with an increasing investment, the two amounts being computed mathematically in such a way that in any year their *sum* is equal to the 'fact amount' payable under the policy." *In re* Leuthold's Estate, 52 Wn.2d 299, 303, 324 P.2d 1103, 1106 (1958).

[6] 192 Wash. 475, 74 P.2d 27 (1937). See also *In re* Towey's Estate, 22 Wn.2d 212, 155 P.2d 273 (1945); Northwestern Life Ins. Co. v. Perrigo, 47 Wn.2d 291, 287 P.2d 334 (1955); *In re* Coffey's Estate, 195 Wash. 379, 81 P.2d 283 (1938); Lang v. Commissioner, 304 U.S. 264 (1938).

[7] 301 S.W.2d 496 (Tex. Civ. App. 1957).

[8] 282 U.S. 101 (1930).

[9] 282 U.S. 122 (1930).

[10] 52 Wn.2d 299, 308, 324 P.2d 1103, 1109 (1958).

[11] 52 Wn.2d 299, 309, 324 P.2d 1103, 1109 (1958).

community property. Such a classification has the potential for creating rather complicated problems in the future.

On analysis, the interest of the non-insured spouse's heirs appears to be a tenancy in common with the surviving spouse of a fractional interest in the policy. A multiple ownership has come into existence to replace the ownership formerly in the marital community. In the case of insurance policies, the interest of the community is determined by what proportion of the policy premiums were paid from community funds.[12] Since the valuation of policies, such as the ones under consideration, at any time prior to the event when full payment becomes due, is measured by the cash surrender value, it follows that in the *Leuthold* case the deceased owned one-half of the total cash surrender value at the time of her demise.

It should be noted, however, that what the heirs possess is an ownership of a fractional interest in the policy and that the cash surrender value at the time of the passing of the interest is merely a convenient way of calculating it. The importance of this lies in the fact the cash surrender value is not a fixed amount, since it will continue to grow if additional premiums are paid. Any additional premiums will not be paid from community assets. Hence the heirs' percentage share ownership will gradually decline and the heirs can be described as tenants in common in a *progressively declining* percentage of the asset (assuming the surviving spouse continues paying premiums).

The position of the husband, with respect to both the heirs of the deceased wife and the insurance company, also presents a problem. The husband, by contracting for the policy and paying all of the premiums from community funds, in effect, made the community a party to the contract with the insurance company. The husband was an agent of the community and had a power to control the disposition of the policies.[13] The proposition that the husband is only an *agent* of the community is strengthened by Washington decisions such as *Marston v. Rue*[14] and the *Occidental*[15] case, which curtail the husband's power to act independently with reference to the policies.[16]

[12] *In re* Coffey's Estate, 195 Wash. 379, 81 P.2d 283 (1938). Lang v. Commissioner, 304 U.S. 264 (1938).

[13] RCW 26.16.030; Daniels v. Spear, 65 Wash. 121, 117 Pac. 737 (1911); Catlin v. Mills, 140 Wash. 1, 247 Pac. 1013 (1926); Metropolitan Life Ins. Co. v. Skov, 51 F. Supp. 470 (1943).

[14] Marston v. Rue, 92 Wash. 129, 159 Pac. 111 (1916).

[15] Occidental Life Ins. Co. v. Powers, 192 Wash. 475, 74 P.2d 27 (1937).

[16] *E.g.*, National Bank of Commerce v. Lutheran Bhd., 40 Wn.2d 790, 246 P.2d 843 (1952); California Western States Life Ins. Co. v. Jarman, 29 Wn.2d 98, 185 P.2d 494 (1947).

A problem is presented when, upon the demise of the wife, the community is dissolved. The surviving husband is then, as promisee of the insurance contract, placed in the somewhat unique position of appearing to have full power to make any disposition whatever of the policy but, as against the wife's heirs, the right to do so only with his vested half of what were previously community assets. At this point there is no consent to be found between the estate or heirs of the wife and the husband who holds the power. The husband is not an agent for the heirs, although he appears to control their interest. He obviously is not an agent of the community, since it no longer exists. Is his position that of constructive trustee? The answer is, as yet, undetermined, since the question has not been presented to the court.

As a matter of practicality, the husband may wish to escape the responsibilities of a fiduciary and turn over the control of the portion of the policy that belongs to the deceased to the heirs. If so, he may ask the insurance company to split the policy. If the policy is split, both the husband and the heirs will be able to do as they wish with their respective shares.

The question of whether the heirs, without any power to control the asset, though with a right to do so, can exert sufficient pressure on the husband and legally force him to comply with their desires (at least to the extent that their portion will be affected) is still unanswered.

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Distinguishing Community and Separate Property. *In re Bubb's Estate,* 153 Wash. Dec. 117, 331 P.2d 859 (1958). The petitioner and the deceased, Mr. Bubb, were married in 1937 and separated in 1940. Shortly thereafter, the parties entered into a property settlement in which they agreed that all property standing in the name of either party before marriage, together with any property acquired after the date of the agreement, should remain and be the separate property of the respective parties.

After the death of her husband, the petitioner brought an action seeking to have the proceeds from a note belonging to the deceased set aside in lieu of homestead, claiming that it was community property and not subject to the agreement. This note had been given to the deceased by his step-daughter as evidence of a loan made some eleven years after the property agreement was entered into. In order to make the loan to his step-daughter, the deceased had to borrow from a bank, giving the bank as security certain shares of stock which he

had owned before the marriage to petitioner. In 1953, the deceased paid off the bank loan, ostensibly from his own funds. At the time of the decision, there was unpaid on the note from the step-daughter the amount of $6,500.00; and it was from this amount that the petitioner was seeking to recover $6,000.00 in lieu of homestead.

The court held that the property settlement agreement was binding on the parties and that the note from the step-daughter was separate property and therefore subject to the agreement.

The court expressed two reasons for holding that the note constituted separate property. The first was that the source of the note, the bank loan, was made on the deceased's separate credit. Granting that the character of the loan from the bank will determine the character of the step-daughter's note, the question remains, why did the court consider the bank loan as one based on the deceased's separate credit?

In answering that question, the court might have pointed out that in Washington, although, prima facie, a charge against the community exists when a husband acquires an obligation, this presumption is rebutted by satisfactory evidence of a separate property agreement, such as the one the court, in this instance, found valid and binding. Following this reasoning, the loan from the bank would have been established as a separate obligation of the deceased. *Piles v. Bovee* and *Union Securities Co. v. Smith.*[1] Since the court did not urge this rationale in their opinion, what was the reason which led it to the conclusion that the bank loan was based on the deceased's separate credit? Was it because the bank loan was secured by separate property? The case of *Auernheimer v. Gardner*[2] would dispute such a contention. Would the additional factor that the bank loan was eventually paid off with separate funds be enough to make the note separate property? Probably not, though it would make the argument stronger. The Washington case of *In re Finn's Estate*[3] bears upon this aspect.

Two other factors which might affect the determination of the character of the bank loan, though not discussed by the court, deserve some attention at this point.

The first consideration overlooked was the presumption that the husband in a marital community is creating a community obligation

[1] 168 Wash. 538, 12 P.2d 914 (1932); 93 Wash. 115, 160 Pac. 304 (1916).
[2] 177 Wash. 158, 31 P.2d 515 (1934).
[3] 106 Wash. 137, 179 Pac. 103 (1919).

when he obtains a loan. The *Auernheimer* case[4] suggests that this is so. The court did not discuss any such presumption; if the presumption applies and was not rebutted, the step-daughter's note should certainly be considered community property, since it would then represent funds loaned from the community account. What would be needed to overcome the presumption that the husband created a community obligation? Would the fact that the note was secured by separate property do it? Again, the *Auernheimer*[5] case suggests not. Does the fact that, in addition to being secured by separate property, the note was eventually paid off with separate funds, sufficiently rebut the presumption? Since the court did not consider the point, this cannot be known.

The court might also have considered the fact that the petitioner and the deceased were living apart and that both the bank loan and the step-daughter's note were acquired after the separation. In Washington, the two cases of *Togliatti v. Robertson*[6] and *In re Armstrong's Estate*[7] have held that property acquired after separation is individual and separate. Would this also be true of an obligation? The court did not consider this question.

The statement by the court that the money which the note from the step-daughter represented was obtained on the deceased's separate credit suggests that the presumption of a community obligation did not arise because the parties were living apart or, in the alternative, if such a presumption did arise, it was rebutted by the fact that the deceased's separate property was used to secure the loan. The latter conclusion would conflict with the *Auernheimer* case.[8]

The second reason the court gave for considering the step-daughter's note to be separate property was that it was directly traceable to Mr. Bubb's separate property—his stock. Is this accurate? It would have been clearer had the court said that, since the funds which Mr. Bubb lent his step-daughter were those obtained from the bank loan, the step-daughter's promissory note was directly traceable to the bank loan, the character of which determined the nature of the step-daughter's promissory note. The question of whether the bank loan was intended to be a separate or community obligation would still

[4] 177 Wash. 158, 31 P.2d 515 (1934). See also Beyers v. Moore, 45 Wn.2d 68, 272 P.2d 626 (1954); Meng v. Security State Bank, 16 Wn.2d 215, 133 P.2d 293 (1943); and Morrison v. Dungan, 182 Wash. 503, 47 P.2d 988 (1935).
[5] 177 Wash. 158, 31 P.2d 515 (1934).
[6] 29 Wn.2d 844, 190 P.2d 575 (1948).
[7] 33 Wn.2d 118, 204 P.2d 500 (1949).
[8] 177 Wash. 158, 31 P.2d 515 (1934).

control, and the fact that the loan was secured by separate property would not be enough to establish it as having the character of a separate obligation, if the holding of the *Auernheimer* case[9] is to be followed.

A method the court might successfully have employed in tracing the note to the separate property would have been to show that the bank, in making the loan to Mr. Bubb, was relying directly on the security of the stock and not on the credit of Mr. Bubb, either as an individual or as a member of the marital community. The fact that the stock was his separate property undoubtedly would have led the court to conclude that the bank loan was a separate obligation and therefore, since that separate obligation was the source of the loan to the step-daughter, her promissory note would also be his separate property.

Assuming that the note was, in fact, the separate property of the deceased, the solution of the court would be correct. The question demains, what are the underlying bases for the conclusion that the note was separate property? The answer is not apparent in the opinion.

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CONSTITUTIONAL LAW

Court Interpretation of the Power to Amend the Initiative. *In State ex rel. O'Connell v. Meyers*[1] the court held that the legislature's power to *amend* an initiative measure adopted by the electorate was "unlimited" and included the power to repeal sections of the act, "to alter, modify, take away or add to" the initiative "in such manner as it saw fit," provided the "subject matter" remained the same.

As a result of the legislature's failure to apportion and redistrict the membership of the state legislature since 1901,[2] the people did so by adopting initiative 199 at the 1956 general election.[3] Subsequently, the legislature at the 1957 regular session apportioned and redistricted by a different method in the form of chapter 289, an "amendment" to initiative 199.[4]

Both initiative 199 and chapter 289 were enacted in compliance with that portion of article 2, section 3, of the state constitution which

[9] 177 Wash. 158, 31 P.2d 515 (1934).

[1] 51 Wn.2d 454, 464, 319 P.2d 828 (1957).
[2] Laws of 1901, c. 60, at 79.
[3] Laws of 1957, c. 5 at 11.
[4] Laws of 1957, c. 289, at 147.