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Taxation: Insurance Proceeds from Insurance-Annuity Combination as Part of Decedent's Estate

John Convery

NOTES

TAXATION: INSURANCE PROCEEDS FROM INSURANCE-ANNUITY COMBINATION AS PART OF DECEDENT'S ESTATE

In handing down its decision in *Fidelity-Philadelphia Trust Co. v. Smith, Collector of Internal Revenue*,[1] the Supreme Court has provided what appears to be a foolproof method for a taxpayer to divest himself of ownership of property for estate tax purposes and yet retain a life income from the property.

The decedent, in 1934 at the age of 76, purchased three single premium life insurance policies totaling $350,000 at a cost of $313,941. The decedent was not required to take a physical examination but, as a condition to issuance of the insurance policies, she was required to purchase three single premium non-refundable annuities at a total cost of $70,509. These paid $8,762 annually This requirement effectively eliminated any risk the companies might have incurred in insuring the decedent since the face amount of insurance would always approximate the total paid for both insurance and annuities plus interest thereon less the annuity payments and other expenses incurred in connection with the policies.

The decedent's four children were named primary beneficiaries of the life insurance policies. The taxpayer was named trustee of shares of any children predeceasing decedent. In 1934 decedent assigned all rights and benefits under two of the life insurance policies to her children and under the third to the appellee as trustee and filed a gift tax return thereon in 1935. In 1938 decedent amended this trust so that it became unalterable and irrevocable. She retained the annuities and received annual payments thereon until she died in 1946.

The question before the Court was whether the insurance proceeds were includible in the estate under Section 811 (c) (1) (B)[2] of the Internal Revenue Code of 1939. This section includes in the estate a decedent's interest in property transferred without adequate and full consideration under which transfer the decedent

> . has retained for his life . . (1) the possession or enjoyment of, or the right to income from the property.

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1 356 U.S. 274 (1958).

2 Int. Rev. Code of 1939, § 811. Gross Estate: "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated, except real property situated outside of the United States.

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"(c) (as amended, ch. 720, § 7 (a), 63 Stat. 891, 894 (1949)). Transfers in contemplation of, or taking effect at, death (1) General rule. To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise.

" .

"(B) under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not, in fact, end before his death (i) the possession or enjoyment of, or the right to the income from, the property, or (ii) the right, either along or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; ." (now INT. REV. CODE OF 1954, § 2036(a)).

The district court held in favor of the taxpayer.[3] This was reversed by the circuit court[4] but reinstated by the Supreme Court.[5]

Perhaps the problem in the instant case might be more easily understood through an analysis of the precise incidents of this type of transaction.

First, no insurance risk is present because, regardless of when the insured dies, neither party suffers any loss. Nevertheless the insurance companies treat the insurance policies on their books as insurance by adding to their reserves annually, thereby increasing the cash surrender value of the policies. The reserves for the annuity policies are correspondingly reduced annually. If the insured dies before the insurance policy reserves have accumulated to the point where they equal the face value of the policies, it would appear that the companies suffer a loss. However, this "loss" is offset by the unused reserve of the annuity policies. Obviously, this is the reason for the issuance of the annuities as a condition precedent to the issuance of insurance to an elderly person on a non-medical basis from the standpoint of the insurance companies. Conversely, the "profit" realized by the insured's beneficiaries as a result of the premature death of the insured is offset by the "loss" on the non-refundable annuities.

Tax benefits accrue to the estate under this decision in that the estate avoids both gift and estate taxes on the difference between the face value of the insurance policies and their cash surrender value at the time the gift is made. Also, the decedent pays only the lower gift tax rates on the cash surrender value at the time the gift is made.

With this decision the Supreme Court has, for the first time, rendered an opinion on this particular set of facts. However, the basic issue involved had apparently been settled in 1941 by *Helvering v. Le Gierse*[6] which, with one notable exception,[7] has been used as a guide by the lower courts in deciding similar cases. In *Le Gierse* the court looked through the form of the transaction to its substance and held that proceeds received from an insurance policy which could be purchased only if an annuity policy were purchased as a condition precedent were not insurance proceeds to be excluded from the gross estate under Section 302 (g) of the Revenue Code of 1926.[8] The reasoning employed in arriving at this conclusion was based upon the fact that there is no insurance risk present in a transaction such as this and the decedent had merely embarked upon an investment program. In this regard the court accurately reasoned as follows:[9]

> Certainly the mere presence of the customary provisions does not create risk, *and the fact that the policy could have been assigned* is immaterial since, no matter who held the policy and the annuity, the two contracts, relating to the life of the one to whom they were originally issued, still counteracted each other. . . . From the company's viewpoint, insurance looks to longevity, annuity to transiency. (Emphasis added.)

In view of the foregoing it is not surprising that the Board of Tax Appeals, when faced with a fact situation identical to that in *Le Gierse, except for the fact*

[3] 142 F. Supp. 561 (E.D. Pa. 1956).

[4] 241 F.2d 690 (3d Cir. 1957).

[5] 356 U.S. 274 (1958).

[6] 312 U.S. 531 (1941).

[7] See Bohnen v. Harrison, 199 F.2d 492 (7th Cir. 1952), *aff'd per curiam,* 345 U.S. 946 (1953) (equally divided court).

[8] Int. Rev. Code of 1926, § 302(g), 44 Stat. 9, 70 (as amended 47 Stat. 169, 279; 48 Stat. 680, 752) provides for excluding from the gross estate of the decedent the first $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life. There is no similar provision in the INT. REV. CODE OF 1954.

[9] 312 U.S. at 541.

that the insurance policies had been irrevocably assigned, considered the policies to be a single inseparable arrangement.[10] And, having concluded that the policies were inseparable, the board held that the proceeds were thereby includible in the decedent's gross estate as a transfer of property in which decedent had retained for his life the enjoyment of or the right to income from the property.

The principle of inseparability as set forth in *Le Gierse* was the law in situations such as this[11] until the 1952 decision in *Bohnen v. Harrison.*[12] There the Seventh Circuit held in favor of the taxpayer, stating that, in their opinion, the decision in *La Gierse* said nothing to impel the conclusion that the decedent retained any interest therein *after complete assignment of the life insurance policies.*

In the principal case the Court was apparently impressed by the *Bohnen* case since it also distinguished *Le Gierse* on the grounds that in this case the policies had been assigned. The fundamental similarity between the cases, both involving transactions which *were essentially investments rather than insurance,* was completely ignored.

The Court then dwelled upon the fact that the annuity policy could have been acquired separately and consequently the two transactions were separable in nature. Again the Court ignored substance and looked merely to form. As a practical matter, the insurance policies could *not* have been acquired separately although the annuity could have been. The purpose of an arrangement of this type being to eliminate the risk of loss to either party, thereby changing what is in form an insurance program to what is in reality an investment program. Indeed, the only difference between this type of program and the annuity with death benefit contract[13] is found in the surrender feature.[14]

Therefore, the government contended that the annuity payments retained until death were in effect interest income from the combined investment of premiums of the life insurance and annuity policies. They were thereby income from property transferred by the decedent. The taxpayer argued that the annuity payments were income from the annuity policies only—that is, a return of capital invested in the annuity plus interest thereon and that the insurance policies were completely separate from the annuities. Of the two positions, that of the government is the more realistic and is also directly in point with *Le Gierse* where the transaction was viewed as an investment rather than insurance.

The trustee in this case was in a position whereby he could have surrendered the insurance policies at any time for their cash value. If this had been done the nature of the two policies would have been changed. They could no longer be treated

[10] Reynolds v. Commissioner, 45 B.T.A. 44 (1941). Noted with approval in 42 COLUM. L. REV. 162 (1942).

[11] Conway v. Glenn, 193 F.2d 965 (6th Cir. 1952); Burr v. Commissioner, 156 F.2d 871 (2d Cir. 1946).

[12] 199 F.2d 492 (7th Cir. 1952); Meisenholder, *Taxation of Annuity Contracts Under Estate and Inheritance Taxes,* 39 MICH. L. REV. 856, 878 (1941).

[13] An annuity with death benefit policy is one wherein a single premium is paid for the single policy and the policy holder then receives an annuity for life with the face amount of insurance payable at death. The face amount is slightly less than the single premium and the annuity to the insured approximates 2% to 5% of the death benefit.

[14] Meisenholder, *Taxation of Annuity Contracts Under Estate and Inheritance Taxes,* 39 MICH. L. REV. 856, 884: "Upon [the insurance policy's] surrender, the annuity remains in force. Under an annuity with death benefit contract, usually the entire face value is the surrender value, and upon surrender both features of the contract are terminated."