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## Taxation - Federal Estate Tax - Insurance and Annuity Combinations

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TAXATION—FEDERAL ESTATE TAX—INSURANCE AND ANNUITY COMBINATIONS—Decedent, aged seventy-six, invested in three single premium life insurance policies. Issuance of each was conditioned on the purchase of a single life, nonrefundable annuity of specified value, and no physical examination was required. Each combination was balanced so that the total premium, exclusive of loading charges, equalled the face value of the insurance. The resulting correlation between compound interest and annuity disbursements made the guaranteed payments to the annuitant correspond precisely with the expected income of a reinvestment of the entire deposit by the insurer.<sup>1</sup> Decedent retained the annuity rights, but all present and future interests in the life policies were transferred to her children and the plaintiff-executor eight years prior to her death.<sup>2</sup> The Commissioner contended that the insurance proceeds were subject to an estate tax under I.R.C., section 2036, which includes in the gross estate the value of any property of which decedent has at any time made a transfer for less than a full and adequate consideration "under which he has retained for life . . . (i) the possession or enjoyment of, or the right to income from, the property. . . ."<sup>3</sup> This contention was rejected by the district court<sup>4</sup> but accepted by the Court of Appeals for the Third Circuit.<sup>5</sup> On appeal to the United States Supreme Court, *held*, reversed, three justices dissenting. Although each combination was the product of a single, integrated transaction, the contracts were from the time of issuance separate and distinct and decedent could not, therefore, be said to have retained a life interest in the transferred property. *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958).

Essentially, the basic question in the case was what constituted the "property" which decedent transferred to the donees. Because of the actuarial relationship, the government took the position that each policy of life insurance with its corresponding annuity made one indivisible investment. The company's agreement would thus be viewed as being to return the principal sum at death with interest payable to decedent in the meantime, the gift to the insurance beneficiary consisting of a remainder interest only. Such an approach has been accepted by a

<sup>1</sup> For a detailed explanation of the actuarial concepts involved, see *Commissioner v. Keller's Estate*, (3d Cir. 1940) 113 F. (2d) 833.

<sup>2</sup> Decedent's children were named primary beneficiaries and the plaintiff-executor contingent beneficiary to take under trust the share of any child that might pre-decease the insured. Two of the policies appear to confer the right of cash surrender on the children directly and not in their capacities as beneficiaries. That right in the third policy was eventually transferred to the plaintiff pursuant to an agreement making the aforesaid trust thereafter unalterable and irrevocable.

<sup>3</sup> I.R.C. (1939), §811(c)(1)(B), as amended 63 Stat. 894, §7(a) (1949), involved in the principal case, was reenacted unchanged as I.R.C. (1954), §2036.

<sup>4</sup> *Fidelity-Philadelphia Trust Co. v. Smith*, (E.D. Pa. 1956) 142 F. Supp. 561.

<sup>5</sup> *Fidelity-Philadelphia Trust Co. v. Smith*, (3d Cir. 1957) 241 F. (2d) 690.

majority of courts passing on this type of arrangement.<sup>6</sup> Moreover, the Supreme Court previously has decided that the life insurance proceeds in this context are not to be considered "insurance" for estate tax purposes,<sup>7</sup> a result which now appears settled<sup>8</sup> and which is explainable only if the two contracts are considered an entity. But in the principal case the Court concluded that each policy is a separate item of property, stressing that the annuity could have been acquired alone, that it would have continued unimpaired had the life policy been extinguished, and that either could have been separately assigned.<sup>9</sup> The result appears to have been reached primarily because the contracts, after issuance, had a formally independent existence. The Court has often stated, however, that it will look to substance rather than form or legal niceties in matters of taxation.<sup>10</sup> In view of this and of the fact that both the petitioner's and government's arguments are logically sound, it would seem more satisfactory to approach the basic question by also considering whether the economic realities and statutory purpose decree that the contracts *should* be thought of as indivisible. In an analogous series of cases the decedent made in substance a complete and irrevocable transfer of property in return for a contractual promise of certain payments for the remainder of his life. The transferred property generally has been held to be free of any estate tax liability on grounds that the donor could not be said to have retained any possessory interest or enjoyment therein.<sup>11</sup> Similarly, trans-

<sup>6</sup> *Burr v. Commissioner*, (2d Cir. 1946) 156 F. (2d) 871; *Conway v. Glenn*, (6th Cir. 1952) 193 F. (2d) 965; *Estate of Reynolds*, 45 B.T.A. 44 (1941). *Contra*, *Bohnen v. Harrison*, (7th Cir. 1952) 199 F. (2d) 492, *affd. per curiam* 345 U.S. 946 (1953), by an equally divided Court. The tax court has held that an actual surrender by the donee prior to the transferor's death would avoid the tax. *Estate of Hutchinson*, 20 T.C. 749 (1953). Reasoning from substance, however, it is difficult to see why this event, which has no effect either on decedent or her estate, should reverse the outcome.

<sup>7</sup> *Commissioner v. LeGierse*, 312 U.S. 531 (1941). The Court there said, at 539 to 541, that to constitute insurance, "the amounts must be received as the result of a transaction which involved an actual 'insurance risk' at the time the transaction was executed. . . . We cannot find such an insurance risk in the contracts. . . . The . . . annuity and the insurance are opposites; in this combination the one neutralizes the risk customarily inherent in the other." In *LeGierse* there had been no assignment of the insurance rights, but this factor does not appear to be significant. "The principle that the proceeds are not considered 'receivable . . . as insurance' applies whether at death the rights and benefits of the policies are in the hands of the insured or another person." Principal case at 278, note 3. It is clear that as the purpose and result of the interrelationship of the contracts is to avoid incurring any insurance risk, the combined premium in this sense is looked upon by the company as an aggregate sum.

<sup>8</sup> It nevertheless seems arguable that for income tax purposes the proceeds should be considered "insurance" in the hands of the beneficiary. The Court has yet to pass directly on this question.

<sup>9</sup> Principal case at 280.

<sup>10</sup> E.g., *Helvering v. Hallock*, 309 U.S. 106 (1940).

<sup>11</sup> E.g., *Welch v. Hall*, (1st Cir. 1943) 134 F. (2d) 366; *Hirsh v. United States*, (Ct. Cl. 1929) 35 F. (2d) 982. These and similar decisions are often referred to as "private annuity" cases. See generally, *Surrey and Aronson*, "Inter Vivos Transfers and the Federal Estate Tax," 32 *COL. L. REV.* 1332 (1932).

ferred property has not been taxed merely because the donor later made use of, or received benefits from it at the sufferance of the donee. The rationale has been that the statutory language requires such results.<sup>12</sup> Standing alone, however, such an argument is not persuasive since in the area of taxation the courts have never been adverse to treating one situation "as if" it were another when they are convinced this is warranted.<sup>13</sup> Nevertheless, where the contract liability neither restricts nor is dependent upon the donee's use or enjoyment of the gift res, the result that has been reached appears desirable because the interest of the donor does not remain, after the transaction, directly related to that which he has given away; rather, his interest and that of the transferee are independent of one another. On the other hand, in cases involving joint and survivor annuities, where the basic question is identical with that in the principal case, the contract has been held taxable as akin to a trust in which an annual sum is reserved by the settlor to be paid from income and corpus with remainder over.<sup>14</sup> The Court in the instant case distinguishes these cases on the grounds that if the donor's annuity is extinguished the donee's interest is destroyed, and that beneficial enjoyment by the donee is dependent upon and must await the death of the donor.<sup>15</sup> The first argument is not persuasive.<sup>16</sup> But in terms of economic realities the Court would seem justified in drawing a distinction between cases in which the donee could presently obtain possessory enjoyment and those in which he could not. The former situation, in which the donor's death is of formal significance only and where all essential incidents of ownership are vested in the donee, conceivably should result in no estate taxation. The opinions, however, have not stressed this factor as determinative either in the insurance-annuity cases or in cases involving analogous problems. Indeed,

<sup>12</sup> See *Gardner v. Delaney*, (D.C. Mass. 1952) 103 F. Supp. 610 at 616. Compare generally, *Peek v. United States*, (E.D. Pa. 1941) 38 F. Supp. 826.

<sup>13</sup> It has been suggested that this approach be taken if the "annuity" closely approximates the expected income from the property transferred. *Surrey and Aronson*, "Inter Vivos Transfers and the Federal Estate Tax," 32 *COL. L. REV.* 1332 (1932). However in a case where decedent gave to his wife a gift equal in amount to the purchase price of an insurance contract on his life, and himself bought an annuity so she could obtain such a contract, the death proceeds were held to be not includible in his estate. *Estate of Dundore*, P-H 1942 T.C. Mem. Dec. ¶42,028.

<sup>14</sup> E.g., *Commissioner v. Clise*, (9th Cir. 1941) 122 F. (2d) 998; *Forster v. Sauber*, (7th Cir. 1957) 249 F. (2d) 379. Cf. *Old Colony Trust Co. v. Commissioner*, (1st Cir. 1939) 102 F. (2d) 380. Where purchase of the annuity has been by decedent's employer, however, the result has been otherwise. *Commissioner v. Twogood's Estate*, (2d Cir. 1952) 194 F. (2d) 627; *Higgs' Estate v. Commissioner*, (3d Cir. 1950) 184 F. (2d) 427. These latter cases appear to be in basic conflict with the former group, treating the original contract as in reality two separate annuities, a present one for the first annuitant and a deferred one for the survivor. Joint and survivor annuities are now specifically treated in I.R.C., §2039.

<sup>15</sup> Principal case at 279, note 5.

<sup>16</sup> The contract involved is often irrevocable and thus the question of extinguishment is not material. E.g., *Commissioner v. Clise*, note 14 supra.

the Supreme Court expressly rejected it in interpreting section 811 (c) (1) (C) of the 1939 code,<sup>17</sup> and it remains to be seen whether it will be incorporated as a limitation on the principal decision. Further, desirable as this distinction may be, it is a difficult one to arrive at through any analysis of section 2036 itself since it necessarily involves as a point of reference the point of the transferee. In the comparatively early case of *May v. Heiner*,<sup>18</sup> the Court held an irrevocable trust with life interest retained not to be subject to an estate tax under the "take effect at death" clause. What is now section 2036 was Congress' answer to this decision and appears to have been specifically aimed at including in the taxable estate transfers where actual possession is postponed until death though title vests indefeasibly in the donee at an earlier date.<sup>19</sup> In view of this objective it should be arguable that if decedent in the instant case gave the rights of cash surrender to the donees other than as beneficiaries,<sup>20</sup> the situation is outside the intended reach of the relevant taxing provision since the donor's death is no longer of pivotal significance. The manner in which the section is written, however, requires analysis from the viewpoint of the donor.<sup>21</sup> This being so, the persuasiveness of the principal decision rests on finding a meaningful difference between the instant case and that of an irrevocable trust with life interest retained. The latter appears clearly within the purview of section 2036 even though the remainder beneficiaries may, absent express disabling restraints, alienate their interests prior to the transferor's death.<sup>22</sup> Such a difference may lie in the fact that to decedent the contracts were distinct since they served separate purposes and, as

<sup>17</sup> *Goldstone v. United States*, 325 U.S. 687 (1945). The case involved an insurance-annuity combination where the donor-"insured" retained a contingent reversionary interest in the entire proceeds of both contracts but gave the donee-beneficiary the power to cut off this interest at any time. However, as the donee did not do this the Court held that as a matter of objective fact the transfer was not finally effectuated until the donor's death.

<sup>18</sup> 281 U.S. 238 (1930).

<sup>19</sup> See 74 CONG. REC. 77199 (1931); H. Rep. 1412, 81st Cong., 1st sess. (1949).

<sup>20</sup> If the donees held this right as beneficiaries its effective exercise would have been contingent on the children surviving the decedent. See principal case, appellate court opinion at 692, note 5 supra. In this situation, which has not been present in similar cases, the better view would clearly appear to be that of upholding the tax since the effective enjoyment would necessarily have been postponed until the donor's death.

<sup>21</sup> That is, the ultimate question in each case is not what the donee can or cannot do but what, if anything, the donor has retained. After promulgation of the predecessor of §2036, the Court reversed *May v. Heiner*, note 18 supra, in *Commissioner v. Estate of Church*, 335 U.S. 632 (1949). This decision, with others such as *Goldstone v. United States*, note 17 supra, and *Helvering v. Hallock*, note 10 supra, shows the Court, undoubtedly influenced by the passage of what is now §2036, coming to interpret the "take effect at death" clause also from the viewpoint of the donor.

<sup>22</sup> There is in fact a greater likelihood that an indefeasible remainder interest in a trust would be prematurely conveyed than that an insurance policy of comparable face value would be surrendered since the discounted value of the former interest almost always exceeds the cash surrender value of the latter.

noted in the opinion, were independently assignable with the possibility that the insurance could have been surrendered without affecting the annuity. As opposed to the trust situation, the donor from her viewpoint did not retain any interest in that which she transferred. And the fact that the relationship upon which the government's position rests was created not at her instance but at that of the company, and for a purpose not directly relevant to the issue under consideration, would indicate that the Court was correct in accepting the viewpoint of the donor in this case.<sup>23</sup> The decision, then, conforms with those in the "private annuity" cases and on the whole appears desirable, at least when viewed in the comparatively narrow context of the fact situation actually involved. But when considered in relation to the overall backdrop of section 2036, it becomes apparent that the Court has given to insurance companies a device which, if effectively exploited, can virtually emasculate that section of the code.

*John B. Schwemm, S.Ed.*

<sup>23</sup> As previously indicated, §2036 views the ultimate question of taxability in terms of the donor rather than the donee. But the principal case involved the additional, initial question of what "property" was transferred. The determination of this question depends largely on whether the original transaction is viewed from the standpoint of the donor or that of the insurance company, and it would appear unwarranted to rely solely on the structure of §2036 for this answer.