Some Incidental Problems in the Taxation of Annuity Contracts Under the Federal Income Tax Law

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A previous article on the taxation of commercial annuity contracts under the federal income tax dealt with various problems in the taxation of periodical payments and death benefit payments under such policies. In addition to such types of payments, there are also miscellaneous gains and losses realized in transactions involving these contracts. Although they are of less common occurrence, certain problems which have arisen in connection with the taxation of these miscellaneous transactions merit some critical examination.

1. Taxation of Proceeds Received Upon Surrender of Annuity Contracts.

Ordinarily, simple life annuity contracts, temporary life annuity contracts, refund annuity contracts, annuities certain, and joint and survivor annuity contracts do not contain surrender features whether they are immediate or deferred. Of the other types of annuity contracts "re-
retirement contracts", and "insurance with annuity" com-

promises periodical payments to the annuitant for the duration of his life (occasionally for the duration of some third person's life).

A temporary life annuity contract is one in which the insurance company promises to make the periodical payments to the annuitant for a specified period only, or until the prior death of the annuitant. Neither of the above types include death benefit provisions.

Refund annuity contracts guarantee a minimum return of the consideration paid. Should the annuitant die before the total amount of payments made to him equal the premium paid, the company promises to continue the payments to a named beneficiary until their total amount equals the consideration.

Annuities certain are somewhat similar to refund annuity contracts. They provide for a guaranteed number of payments irrespective of the death of the measuring life, to be continued to a beneficiary upon the premature death of the annuitant before all of the guaranteed payments are received.

Joint and survivor annuity contracts provide for annuity payments to two or more persons jointly during their lifetime, the payments to continue to the survivors or survivor for life.

The above types of annuities may be immediate—to take effect upon the payment of a single premium, or deferred—to take effect at some time after payment of a single premium or to take effect after payment of premium in installments over a period of time. For more detailed explanation of these types of contracts and variations of these types of contracts see article cited in note 1 and Meisenholder, Taxation of Annuity Contracts Under Estate and Inheritance Taxes, 39 Mich. L. Rev. 856 (1941).

Sometimes refund contracts and annuities certain contain a provision that the annuitant may receive a surrender value. This surrender value is in force only so long as the total payments made to the annuitant do not equal or exceed the consideration paid, and it usually consists of the commuted value of the guaranteed payments that have not been paid at the time of surrender (occasionally less a surrender charge). Unless the contract is a participating contract, there will be no gain over cost realized if the amount is received in a lump sum.

If an optional type of periodical payment is available and chosen upon surrender, such payments would be treated as are payments under similar options available to purchasers or beneficiaries of endowment contracts. These options are discussed in Meisenholder, Taxation of Annuity Contracts Under Federal Income Tax, 40 Mich. L. Rev. 1005 at 1031-1032 (1942). Present governmental rulings, as mentioned there, distinguish between periodic payments which will be equal to or less than interest and earnings on the proceeds left with the company. The former type payments are treated as annuity payments and taxed by the usual three per cent method under Section 22 (see note 7, infra) and the latter type of payments are considered income in their
tracts, may involve some difficulties.3

However, upon surrender of "annuity with death benefit" contracts and of insurance and annuity policies where the insurance policy will be issued only with the annuity policy, it may well be that the taxpayer will realize a gain.4
There is a 1940 ruling that the entire amount of periodic payments under such contracts shall be considered as income (prior to surrender), and although this ruling is supported by a recent Tax Court Case, there are also several other cases which point to the conclusion that such payments are to be treated as annuity payments and taxed as such under Section 22(b) (2) of the Internal Revenue Code. Thus it may be that when existing policies are surrendered, the amount received plus untaxed periodical payments or untaxed portions thereof previously received will of the “insured” or “annuitant” a face amount usually slightly less than the amount of a single cash premium. Until the “annuitant” dies he is paid guaranteed periodical payments approximating from two to five per cent of the amount of the death benefit. Thus the annuity and death benefit features are in force concurrently. There is a constant cash surrender value to an amount equaling or approximating the death benefit in force until the death of the annuitant.

The above plan, embodied in one contract, is varied by a plan under which two policies are issued—a single-premium whole-life insurance policy issued only with a single-premium immediate life annuity. As in the case of an annuity with death benefit, the policies are issued on a non-medical basis. It is required that the total purchase price of both policies shall be about ten per cent greater than the face amount of the insurance. When an insurance with death benefit policy is surrendered, the entire policy is usually cancelled, but in the instant transaction, the insurance policy alone may be surrendered leaving the annuity policy in force. The surrender values are increasing values, but less than in an ordinary single premium insurance policy. See article cited in note 1 and Meisenholder, Taxation of Annuity Contracts under Estate and Inheritance Taxes, 39 Mich. L. Rev. 856 at 878-880 for further description of the above types of contracts.


6 Bodine v. Commissioner, 103 F. 2d 982 (C.C.A. 3d, 1919), (annuity with death benefit); Commissioner v. Meyer, 139 F. 2d 256 (C.C.A. 6th, 1943) (separate insurance and annuity policies issued in one transaction). See also Helvering v. Meredith, 140 F. 2d 973 (C.C.A. 8th, 1944). These cases hold that the annuity feature should be considered separately from the insurance feature and therefore that the periodical payments should be considered annuities under Section 22 (b) (2) of the INTERNAL REVENUE CODE (see note 7). As indicated in Meisenholder, Taxation of Annuity Contracts Under Federal Income Tax, 39 Mich. L. Rev. 1005 at 1033-1037 (1942), these decisions are questionable. The decisions cited in the last paragraph of note 2, supra, also have some bearing on this problem.

7 Section 22 (b) (2), INTERNAL REVENUE CODE provides: “Amounts
exceed the consideration paid for the policies. In such case the taxpayer would realize a gain.\(^8\)

In order to obtain a reduction of taxes it has been contended unsuccessfully that Section 117 of the Internal Revenue Code governs the treatment of such gains realized upon the surrender of annuity with death benefit contracts, as well as upon surrender of insurance contracts.\(^9\)

While amounts received upon surrender of contracts which are admittedly annuity, endowment, or life insurance contracts are to be taxed according to Section 22 (b) (2), the contention has been made that such amounts are gains "upon the sale or exchange of a capital asset" and are not to be included directly in gross income,\(^10\) or constitute "amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other received as an annuity under an annuity or endowment contract shall be included in gross income: except that there shall be excluded from gross income the excess of the amount received in the taxable year over an amount equal to 3 per centum of the aggregate premiums or consideration paid for such annuity (whether or not paid during such year), until the aggregate amount excluded from gross income under this chapter or prior income tax laws in respect of such annuity equals the aggregate premiums or consideration paid for such annuity."

\(^8\) If the amount is not paid in a lump sum but in some form of periodical payment, the periodical payments should be treated as such payments when received under an endowment contract. See note 2, supra.


\(^10\) Section 117(b), INTERNAL REVENUE CODE: "In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss or net income . . . ."
evidences of indebtedness issued by any corporation . . . , with interest coupons or in registered form." The basic feeling behind these views is that the receipt of such amounts involves a capital transaction with a transfer of assets in an "investment" situation.

Soon after the adoption of the provisions specifically dealing with the taxation of capital gains and losses it was ruled by the government that amounts received upon the redemption of bonds were not amounts received upon the sale or exchange of property and that any gain in such transactions was therefore to be considered ordinary income. The Board of Tax Appeals in 1929, however, held to the opposite effect in the case of bonds to be called at the option of the issuer, and the government changed its ruling to accord with that decision. In 1932 the Board of Tax Appeals reversed its decision, and a new departmental ruling was published. Then in 1934 the present Section 117(f) was enacted disposing of the problem as it related to the retirement of bonds.

In cases since 1934, but arising under the revenue acts prior to 1934, conflicting decisions were reached concerning the treatment of the redemption of bonds upon maturity or at the call of the issuer. Finally, the Supreme Court decided in the Fairbanks case that the gains from such

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11 Section 117(f), INTERNAL REVENUE CODE: "For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes or certificates, or other evidences of indebtedness, issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."


13 Werner v. Commissioner, 15 B.T.A. 482 (1929) (bonds called in by corporation).


15 Watson v. Commissioner, 27 B.T.A. 463 (1932) (bonds paid at maturity).


17 Averill v. Commissioner, 101 F. 2d 644 (C.C.A. 1st 1938). The Court held that the gain upon the surrender of bonds at maturity was a gain resulting from the exchange or sale of capital assets under Sections 101 (a) and (c) of the Revenue Act of 1928. The redemption of the bonds was conceived to be a sale of a specialty. Emphasis was also placed upon the view that Section 117 (f) of the Revenue Act of
transactions were not gains derived from the sale or exchange of property under the Acts prior to 1934.\textsuperscript{18}

This decision seems to establish the conclusion that gains in connection with life insurance contracts are not to be treated as capital gains subject to the provisions of Section 117(a) and (b).\textsuperscript{19} While the retirement of bonds at or before maturity is not a transaction exactly on all fours with the payment of amounts on the maturity or surrender of a life insurance contract, such contracts involve payments by an obligor upon a contract with a resulting extinction of the obligation to the extent therein specified. If the bond transactions should not be considered sales or exchanges, insurance transactions should not be. Reference might also be made to a ruling that the cancellation of notes on the payment of a consideration by the maker and the return of the notes to the maker is not a sale or exchange of property within Section 117.\textsuperscript{20} All of these cases have been cited for the proposition that payment of an obligation according to its terms does not involve an exchange or sale of property under the statutory phrase in Section 117(a). The proposition has been based upon the "ordinary" and "common" meaning of sale and exchange as well as an interpretation of the 1934 enactment of Section 117(f) as an addition to the Section rather than a construction of previous revenue acts.\textsuperscript{21}

In the decisions holding that gains from "annuity with death benefit" contracts and life insurance policies are not included within the language of Section 117(f),\textsuperscript{22} it was


\textsuperscript{19} See note 9, supra.


\textsuperscript{21} Fairbanks v. United States, note 18, supra.

\textsuperscript{22} Avery v. Commissioner, 111 F. 2d 19 (C.C.A. 9th 1940), (endow-
pointed out that bonds were distinguished from endowment and insurance contracts in Section 22, and that if Section 117(f) were applied, the first sentence of Section 22(b)(2) would be superfluous since the two Sections contain different formulas for measuring the gain. From this fact the conclusion was drawn that Congress would have specifically mentioned endowment contracts and insurance contracts in Section 117(f) had it been intended to include them. The limited character of the Section was also pointed out.

The result would appear to be commendable with respect to life insurance contracts. Life insurance policies are not "bonds, debentures, notes," nor are they "evidences of indebtedness" issued by any corporation with interest coupons or in registered form. The House Committee Report states that the Section provides that "amounts received upon the retirement of corporate bonds and similar evidences of indebtedness shall be considered as amounts received in exchange therefor." Although the exclusion of bond retirements from Section 117 prior to 1935 was based upon the same reasoning that justified the exclusion of life insurance policy gains, the specific inclusion of bonds by the adoption of Section 117(f) did not necessarily carry with it other types of contracts not specifically mentioned. While in a certain sense life insurance contracts sometimes are investment contracts and represent an obligation, they are not the ordinary types of corporate securities and individual indebtedness to which the statute refers. Insurance contracts have been recognized as distinct from other types of contracts for hundreds of years. Upon the assignment of insurance contracts the contention that the gain is taxable under Section 117 would be much more plausible since there is a transaction similar to a sale, but

21 Avery v. Commissioner, note 22, supra.


25 The statute is meant to include only ordinary types of securities of corporations and individuals of the types specifically mentioned. Gerard v. Commissioner, 40 B.T.A. 64 (1939); Herder v. Helvering, 106 F. 2d 153 (App. D. C. 1939).
an assignment is certainly a different sort of transaction in end results than surrender or payment at maturity. The policy behind the Section\textsuperscript{26} does not apply to payments at maturity since a tax will not retard such payments. These contracts are not subject to increases in values as are other properties, and are entered into as instruments of saving combined with insurance protection.

In the cases reaching the above results in connection with annuity with death benefit contracts, the contracts were considered as combined insurance and annuity contracts and not as mere investment contracts.\textsuperscript{27} One important basis for the result in the cases was that the policies were to be governed by Section 22 as annuity and insurance policies. But, if, as a government ruling holds, the policies are neither insurance nor annuity policies, but mere investment contracts, they do not come within Section 22.\textsuperscript{28} Would this conclusion concerning the nature of the policies affect the results of the cases? It is likely that it would not. The most important arguments for exclusion of gains upon surrender of insurance policies and annuity policies are based upon what the scope of Section 117 should be and not upon an interpretation of Section 22. Thus the principal arguments that Section 117 does not govern the insurance policy gains also apply to the annuity with death benefit gains. Whether or not annuity with death benefit contracts (as well as separate insurance and annuity policies issued in one transaction) are considered as insurance or annuity policies within Section 22, the gains realized upon surrender of such policies should not be brought within Section 117.

\textsuperscript{26}"The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of tax revenue, have been blocked by this feature of the present law. In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill in section 206 adds a new section . . ." House of Representatives Report No. 350, 67th Cong. 1st Sess. (1921), 1939-1 (Part 1) Cum. Bull. 176.

\textsuperscript{27} Bodine v. Commissioner, note 9, supra.

\textsuperscript{28} See note 6, supra.

It has been held in several cases that no loss is incurred upon the surrender of an insurance policy at an amount less than the amount of premiums paid upon the policy. In these cases if there had been a loss it would probably have been deductible. It is said that the cost to be used as a basis for computing loss is not the entire amount of premiums paid (less dividends). It is held that to take such entire cost would ignore the fact that the insured has had insurance protection for the period in which the contract has been in force, and that the cost of such protection is necessarily a current cost. Under this view it is said that premiums collected represent amounts over and above the current cost of insurance, such amounts being represented in the reserve value of the contract. This reserve value is considered the investment or saving element of the contract, being available to the insured upon surrender of the contract. The allocation between the cost of the investment element and the cost of current insurance protection is then made by taking into account the fact that the reserve amount represents the amount of the premiums set aside for future payment by the company, (the investment element). In the absence of contrary proof it is presumed that the reserve amount is received upon surrender and that no loss is incurred because the amount invested is the amount received. Under this view it is said that if the entire premiums were taken as cost,


30 London Shoe Co. v. Commissioner, 80 F. 2d 230 (C.C.A. 2d 1935). However, in Appeal of Standard Brewing Co., 6 B.T.A. 980 (1927) and I. T. 1944, III-1 Cum. Bull. 145 (1924), this point was not mentioned. In nearly all insurance contracts the surrender value does not equal the reserve value because of a surrender charge. This charge is in force at least in the earlier period the policy is in force, and its size depends also upon the type of policy involved. If the viewpoint of the taxpayer
there would in effect be a deduction of the cost of the insurance protection already received, which deduction would not otherwise be allowed. In *Lucas v. Alexander* it was held that the taxpayer received a net gain over the 1913 value of the policies which gain was part of the gain over the entire amount of premiums that had been paid upon the contract. The gain over the 1913 value only was held taxable. It was stated in the decision, however, that under a policy taken out after 1913 the gain would be the total amounts received upon the contract less the amount of premiums paid. The amount of gain under Section 22(b) (2) is of course calculated on the basis of the premiums paid. Since this method of computation of gains is used, it has been held in one case that the same basis of cost should be taken to compute losses. Under this case the transaction would be viewed from the vantage point of the taxpayer, because

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1. See note 53, infra.
3. "By the expenditure of $78,100 in premiums, the insured secured a return of $120,797, resulting in an economic and realized money gain to him of $42,697. The question of liability for the tax on this gain is different from that mooted by counsel, but not decided in United States v. Supplee-Biddle Hardware Co., 265 U. S. 189, 194, which was whether insurance upon the life of a corporate officer, paid at his death to the corporation, could be constitutionally subjected to a tax on income. Here the amount paid was not a death benefit or in the nature of a gift to a beneficiary and was in no sense an indemnity for, or repayment of, an economic loss suffered by the insured, but was a profit or gain upon his premium investment, and would seem to be plainly embraced within the provisions of section 312 taxing 'gains or profits and income derived from any source whatever' and exempted as such from tax by any other provision of the act . . ." *Lucas v. Alexander*, 279 U. S. 573, 576-577, 49 S. Ct. 426 (1929).
he is not concerned with the mechanics of the transaction from a technical viewpoint. It is said that as far as the taxpayer is concerned, the receipt of an amount less than the amount he has paid out is a loss to him. While these arguments have weight the tax authorities apparently insist that no loss is incurred.

The above cases apply to amounts received upon surrender before maturity of “insurance with annuity policies” and “reversionary” annuities (usually not subject to surrender, however). They should not apply to “annuity with death benefit” contracts and insurance policies issued only with annuity policies, since such transactions are not usually life insurance transactions.

Likewise, the above cases are not applicable to the taxation of amounts received upon the surrender of refund annuities and deferred annuities during the deferred period. Various complications would arise if losses were to be treated as losses incurred upon surrender of an insurance policy, but it appears clear that they should not be so treated.

An Income Tax ruling holds that a loss upon surrender of a refund annuity is an ordinary deductible loss incurred in a transaction for profit. This ruling is justifiable at least to the extent that it holds a loss occurred. In a refund annuity the premium represents the cost of the life annuity or other annuity plus the refund feature. If the refund feature were treated separately there would hardly ever

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5 Disenting opinion in London Shoe Co. v. Commissioner, 80 F. 2d 230 (C.C.A. 2d 1935).

6 A simple deferred annuity would not have a surrender value. Some policies which appear to be modified deferred annuities do have a surrender value however. These policies might be classified as "retirement annuities."

In refund annuities where periodical payments are guaranteed and in annuities certain there is often a provision that the commuted value of the guaranteed payments may be taken by the annuitant. Usually there is a surrender charge.


8 I. T. 3567, 1942-2 Cum. Bull. 105. The ruling holds the loss is one incurred in a transaction entered into for profit and is not a capital loss. See also Atkinson v. Early (E. D., Va.) 72,586 P-H Fed 1948.
be a loss,\textsuperscript{39} but if the contract were treated as a whole there would be a loss on account of a surrender charge.\textsuperscript{40} This loss is allowed under the above ruling.

Since no part of the consideration would be allocable to current insurance the basis for loss would be the entire consideration from which would be subtracted amounts already received as annuity payments, plus the amount received upon surrender.

This amount received upon surrender is often the commuted value of the remaining payments on an assumed rate of interest. If any part of a loss were attributable to this factor, it might be possible to say that since the payments themselves were bargained for and their value as of date of surrender is received, any loss on this account is not to be taken into consideration.

The question of whether this loss should be considered as one incurred in a transaction entered into for profit is considered below. The ruling that the loss is not a capital loss is consistent with the cases concerning treatment of gains considered previously.

Since a deferred annuity or a "retirement" annuity is not to be considered as an insurance policy,\textsuperscript{41} the consideration paid (less any amounts received) would likewise be the basis for computing any loss which is claimed to be deductible.\textsuperscript{42}

Other losses than those incurred upon surrender have been claimed in connection with annuity contracts. Thus an alleged loss may be claimed upon the termination of a life or temporary annuity contract by the termination of the

\textsuperscript{39} In Parshelsky v. Commissioner, 135 F. 2d 596 (C.C.A. 2d 1943), a refund annuity is divided by the court into its annuity and refund features for the purposes of deciding the issues in that case. Except for the particular type of fact situation considered in that case there appears to be no warrant for separating the refund and annuity features of a refund contract in most tax situations. Such features can be separated in several ways or on several theories with resultant theoretical cost differences in each case as to the cost of the annuity and of the refund feature.

\textsuperscript{40} See note 36, supra.

\textsuperscript{41} Note 37, supra.

\textsuperscript{42} There is often no surrender charge during the latter part of the deferred period and therefore no loss.
measuring life before the life expectancy period has terminated although the original cost may have been recovered in the periodical payments. A loss might also be claimed under such contracts at the death of the annuitant upon the ground that the annuitant has not received the consideration paid for the contract. Should the annuitant cease to make payments under a deferred annuity contract and forfeit the amounts paid in, he may attempt to establish a deductible loss.

The first major case to arise was *Louis v. Helvering*. On April 19, 1913, the taxpayer had entered into a will settlement in which she promised to give up her right under the will in return for an annuity for the lifetime of her mother. The mother died three years before the end of her life expectancy. The taxpayer claimed that the difference between the stipulated value of the annuity based upon the life expectancy of the mother as of April 19, 1913, and the commuted value of the payments actually received as of such date was a deductible loss. The loss which was claimed was therefore the difference between the supposed cost of the annuity and the value of the annuity as of the date when granted, determined by the actual length of the mother’s life. The result of this contention was that although the taxpayer actually received in periodical payments a total amount greater than the value of the annuity as of April 19, 1913, she was claiming a loss because she did not receive payments to the end of the life expectancy period of the measuring life. In addition to a general criticism that the calculations of the tax payer were entirely theoretical, the Court said that since the amount of the

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In the case of all these annuity and insurance charges it should be noted that there may be no loss in particular cases because of reduction of cost by reason of unreported dividends declared and received in participating policies.


46 Cited note 43, supra.
value of the contract had been recovered in payments there was no loss. The statutes, decisions, and rulings were cited to the effect that taxable gain is realized under an annuity contract when the total amounts received exceed the cost of the annuity.

The case therefore decided that a loss based upon the difference between the actual amounts received and the amounts that would have been received had the annuitant lived out his life expectancy is not a loss at all for the purpose of the income tax, provided the amount of the original cost basis has been received. More specifically the difference between the value of the contract based upon the life expectancy of the measuring life and the commuted value of the payments actually received (as of the date when the contract is issued) cannot be considered a loss. These conclusions appear satisfactory.

The case seems more important here, however, because of the language used by the Court when it said, "At the date of the annuity contract the taxpayer had no assurance from any source that her mother would live for the full period of her expectancy as calculated by the mortality tables. The taxpayer accepted the contract upon the basis of its terms which assured her of the payment of the annuity for the actual period of her mother's life and not for the period of her supposed expectancy. Had the contract stipulated for a payment of $5,000 a year for 15 years, 1 month, and 9 days, a default of payment for the first 3 years, 1 month, and 9 days of that period would have caused a loss computable upon a different basis than now obtains in this case. But the contract as executed was not for the payment of the annuity for a fixed term of years, but only for the period of her mother's life."  

This language although unnecessary to the decision was seized upon by the government to support its argument in *Industrial Trust Co. v. Broderick* that there was no loss when the annuitant died before the consideration paid for a life annuity contract had been recovered, and was recognized as a ground of decision in that case.  

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the Industrial Trust Co. case was in addition based upon the proposition that there was no deductible loss in any event because the transaction was not entered into for profit. Since there are alternative grounds for the decision and the Court was hesitant in adopting the argument that there was no loss, the case may not be an authority squarely in point.

Whether the result suggested in this case is desirable depends in part on the nature of annuity contracts in so far as the income tax is concerned. If a life annuity contract is conceived to be the purchase of an income for life and is to be distinguished from other types of capital assets, periodical payments under the contract constitute payments of income under the Sixteenth Amendment. Thus it could be said that even though Congress has seen fit to tax part of such income and has as a matter of policy allowed the taxpayer to recover the cost of his contract if he lives to the requisite age, it does not follow that there was any intention that cost was to be the basis for computing loss. Any loss would not be a loss of capital but would rather be a loss of expected income which would certainly not support a statutory deduction of any kind. The loss would therefore be compared to a loss of expected profit.

On the other hand if no constitutional gain is realized until cost is recovered, a consistent position would make necessary the use of cost as the basis for computing loss. Such loss would not be automatically deductible, but there would at least be a basis for loss. Inasmuch as gains under annuity contracts are treated on the theory that cost may be recovered, it might also be argued that cost should be recovered here also. It could be said that the situation is to be regarded as an investment situation in view of the Congressional treatment.


The Board of Tax Appeals has held that a loss is incurred when the annuitant ceases making premium payments upon a deferred annuity contract and forfeits the amounts paid in.\(^{51}\) Apparently the Board in this case did not take the view that the annuitant has received what he has paid for, or that he has merely lost income. The case seems contrary to the above cases.

A distinction suggested in the *Industrial Trust Co.* case in the lower Court is the difference between a contract which is carried out according to its terms and a contract which is broken. On this basis, the contract has not been broken but has been terminated by the action of one of the parties. The loss might be compared to a loss upon the abandonment of intangible properties.\(^{52}\) It could also be urged that it is similar to that incurred because of a surrender charge. No part of the consideration has been used concretely in favor of the annuitant.

Additional arguments, however, appear to support the *Industrial Trust Co.* case. In a deferred annuity situation the annuitant has paid the consideration for the right to receive an annuity in the future upon continued payment of premiums. In a sense, therefore, he has received what he bargained for. Again it could also be argued that all that would ever accrue to the annuitant under the contract would be income, and that only the right to future income is lost. These considerations would not be applicable when there are options to take the proceeds in other ways than by annuity payment plans. The *Industrial Trust Co.* case does not appear inconsistent with the ruling that a loss may be incurred in surrender of an annuity contract, although there is some doubt here. In any event provisions regarding losses from wagering contracts would not be applicable.\(^{53}\)

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\(^{51}\) Cohan case, note 45, *supra*.


\(^{53}\) Section 23 (h) of the *INTERNAL REVENUE CODE* provides: "Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions." An annuity contract is not a wagering contract. Hult v. Home Life Ins. Co., 213 Ia. 890, 240 N. W. 218 (1932); Rishel v. Pacific Mutual Life Ins. Co., 78 F. 2d 88 (C.C.A. 10th 1935).
It thus appears that losses on surrender and losses on termination of a contract by death of an annuitant are treated differently. But there is support for the position that the second type of loss should be allowed. The above remarks would also apply when the annuitant dies before maturity of deferred period.

In all of the above situations cost should be the basis of loss if the conclusion is reached that there is a loss and that the loss is deductible. There would be no question of the cost of current insurance.

A loss has also been claimed in favor of a refund annuitant upon his death. The refund was to be paid to a named beneficiary. The Board of Tax Appeals held that the case came within the Industrial Trust Co. case. It also said that the loss of the payments beyond those guaranteed was a loss of future profit or income.54

Even if it were conceded that there is a loss upon surrender of a contract, upon the death of an annuitant, or upon the forfeiture of a deferred annuity, the question still remains whether the loss is deductible.

If the loss were not connected with a business, the main question would be whether the contract was entered into for profit.55 This question is confused to some extent with the question of whether there was any loss at all. Four

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54 Section 23 (e) of the INTERNAL REVENUE CODE states: "In computing net income there shall be allowed as deductions: . . . (e) Losses by individuals. — In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise . . .

2. if incurred in any transaction entered into for profit though not connected with the trade or business: . . ."
cases and one ruling appear pertinent to commercial annuity transactions. In a case concerning a deferred annuity forfeiture, the Board held that under the particular facts involved, there was a transaction for profit. The Board relied partly upon the fact that the taxpayer abandoned his contract upon the advice of his lawyer that it was "unprofitable." In Cohen v. Commissioner, the taxpayer surrendered policies to the successor of an original bankrupt insurance company for new policies and received less than the surrender value because of the lien arising from the bankruptcy. In a divided decision it was held that the insurance transaction was a transaction for profit and that the loss was deductible. The Board relied on the general nature of an insurance policy (other than term insurance policies). It was pointed out that there was an "investment" element, the reserve, which drew interest, somewhat like a bank account, and that the policy also participated in dividends. But it was also stated that the part of cost that could be attributed to current insurance protection amounted to personal expense, although that question was not involved. In the Industrial Trust Co. case it was held that there was no loss, but if there were such loss, it was not deductible.

Finally in the ruling concerning surrender losses it was held that the loss was incurred in a transaction for profit and this view was followed in a recent District Court Case. It is usually held that whether a particular transaction is entered into for profit depends upon the particular facts of the case. In both the Cohen and Industrial Trust Co. cases all that was taken into account was the nature of the contract. In the Cohen case the Board of Tax Appeals emphasized the investment and profit seeking side of the contract and disregarded the insurance protection features. On the other hand the Court in the latter case emphasized the "security" or "insurance" side of the transaction there considered.

56 Cohan case, cited note 45, supra.
57 44 B.T.A. 709 (1941).
58 The purpose or motive of the taxpayer depending on all of the cir-
For the present, however, the above mentioned ruling settles the matter. It apparently relies on the inherent nature of a refund annuity transaction and thus applies to all losses under annuity transactions.

Nevertheless it would be possible to confine its scope in the future to surrender transactions on the ground that there is no particular reason to emphasize either the “investment” side of the transaction or the “security” or “insurance” side. It would be possible to take the following approach. In the Industrial Trust Co. case the Court relied on the nature of a life annuity but at the same time distinguished the Cohen case on its facts. It would seem proper to assume that the primary function of a life annuity is to provide financial security during the life of the annuitant and to conclude that such a contract is not entered into for profit in the absence of facts showing any motive on the part of the taxpayer. But if the taxpayer could show that he had a profit motive because of some special circumstance, then the loss could be considered deductible.

Losses in connection with refund annuities—such as losses upon surrender (when commuted value of guaranteed payments are paid—less a surrender charge)—are not different because of the nature of such a contract. It might be urged that the most the annuitant has absolutely contracted for on the face of the contract is a return of his original investment.

On the other hand “annuity with death benefit” contracts and transactions in which insurance policies will be issued only with the issuance of an annuity policy would appear to be similar to bank accounts because the purchaser has contracted for a gain that is sure to result. In the case of these contracts, the element of profit taking is more likely to appear since no insurance annuity element will be involved unless the life insurance feature may be surrendered separately and is so surrendered.

cumstances is the crux of the inquiry. E. M. Carnick, 21 B.T.A. 12 (1930). See also Lihme v. Anderson, 18 F. Supp. 566 (S.D.N.Y. 1936); Farish v. Commissioner, 36 B.T.A. 1114 (1937), reversed 103 2d 63 (C.C.A. 5th 1939), and cases cited in Cohen v. Commissioner, note 57, supra,
3. The Taxation of Gains and Losses in Connection with the Assignment of Annuity Policies for a Valuable Consideration.

Section 22(b)(2) of the Internal Revenue Code contains the only language of the income tax statute dealing specifically with the taxation of gains in connection with assignment of insurance policies and annuity contracts. It reads, "In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance, endowment, or annuity contract, or any interest therein, only the actual value of such consideration and the amount of the premiums and other sums subsequently paid by the transferee shall be exempt from taxation under paragraph (1) of this paragraph. The preceding sentence shall not apply in the case of such transfer if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor..."

The application of the statute to annuity payments received by the transferee under annuity contracts involves no difficult problems. Usually the above provision governs with the qualification that the consideration for the transfer plus premiums subsequently paid by the transferee are to be used in place of the original consideration paid for the contract by the transferor. The transferee is thus allowed to recover only his own cost by the three per cent method.

The arbitrary character of the statutory scheme of Sec-

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59 Section 22(b)(2), Internal Revenue Code. With the exception of the last sentence, this provision first appeared in Sec. 213(b)(2) of the Revenue Act of 1926. The section also provides for special treatment of annuity payments under a contract purchased by a husband for his wife to settle alimony obligations. See Section 22(k), Internal Revenue Code.

The last sentence of Section 22(b)(2) quoted above is primarily operative when there is a tax free exchange or a transfer of the policy by virtue of a corporate reorganization.

60 A letter of a Deputy Commissioner, however, states that an assignment to the insured is not to be treated as an assignment for a valuable consideration. 464 C.C.H. ¶ 6259. The prior sentences will apply. See I.T. 3212, XVII-2, Cum. Bull. 65 (1938).
tion 22(b)(2) is illustrated here. It seems to indicate that the assignment shall be in part treated as a sale, the exemption being based on the cost to the transferee.

Insofar as an original purchaser is concerned the Section was enacted on the basis that the original purchaser receives a certain return of interest upon his money which is allocable to each payment because the insurance company in calculating the premiums takes a certain rate of interest into account. This is the basic idea of the three per cent method. But the consideration paid upon an assignment might not have any direct relation to tables used by the insurance company or to any calculations of the company. Therefore the scheme of the statute based upon such calculations does not seem to have any necessary relation to the return on the investment of the transferee. In other words here there is no assurance whatsoever that the transferee will receive his capital plus interest at the end of the life expectancy period of the annuitant, because the consideration paid for the contract will be fixed with several other possible factors in view as well.61

A special problem arises when an insurance contract is again transferred by the transferee but not for a valuable consideration and proceeds are received upon the death of the insured. The question in such case is whether the proceeds are exempt under Section 22(b)(1) or are taxable by virtue of the last sentence of Section 22(b)(2) under that Section. It has been held that the transferee's basis is the basis for taxation.62 In the case of an annuity contract, however, or an insurance contract under which proceeds are payable other than upon the death of the insured, the problem would be raised whether the original consider-

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61 Considerations pertaining to the individual concerning his health, mental well-being, etc. might enter into the picture on the assignment of an annuity for a valuable consideration.

62 Hacker v. Commissioner, 36 B.T.A. 659 (1937); see, however, I.T. 3212, XVII-2 Cum. Bull. 65 (1938). The situation would be different if the original transfer were made under circumstances making original transferor taxable. See last paragraph of note 67. There is also a possibility that the assignment might involve gift tax liability and not income tax liability. See Pritchard v. Commissioner, 3 C.C.H. T.C.M. 1125 (1944), noted 58 Harv. L. R. 284 (1944). See also Paul Studies in Federal Taxation, Third Series; pp. 364-365 (1940).
ation is taken as the donee's cost or whether the consider-
ation paid for the contract by the first transferee (the second transferor) is to be used in calculating the tax. There are no rulings concerning this situation, but if such a case arises the government could claim the original cost should be used if that position appears favorable.

For the above clause to apply, the transfer must be for a valuable consideration and not merely for love and affection. A commercial or sale situation must be indicated. If no such consideration is present, then the first part of Section 22(b)(2) would apply by its terms, and the an-
nuity payments would be considered just as if they were payments under a gift annuity.61

Taxation of gains realized upon assignment by the trans-
feror is a subject not disposed of easily. In the case of in-
surance and annuity contracts, the statute would not spec-
ifically cover the taxation of gains because it treats spec-
ifically of amounts received "under life insurance or en-
dowment contracts."62 Here the amounts are received upon the sale or exchange of the policies. And the transferor appears taxable to the extent that the amounts he received upon the transfer exceed the amounts paid for the contract, less amounts received tax-free prior to the transfer. Furthermore, the gain, if any, could be said to be taxable gain under Section 117(a) because it is realized upon the sale or exchange of a capital asset.63 The result would be that an avenue of evasion is opened under certain types of contracts for a policy holder who is the beneficiary. He could transfer the policy just prior to the maturity date, or before any surrender of it, and would be enabled to ob-
tain the benefit of the capital gains provision which he could not otherwise obtain.

In relation to insurance policies often confused with an-

(1940) in regard to insurance policies and Regulation III, Sec. 22(b)
(2)-3.

62 Section 22(b)(2), note 7, supra.

63 Thus prior to the enactment in 1934 of Section 117(f) it was pos-
sible to transfer bonds for a consideration and obtain the benefit of
Section 117, although upon retirement of the bonds that section was
held not to apply. McKee v. Commissioner, 35 B.T.A. 230 (1937).
nuity contracts, the above method of taxation is inconsistent with the treatment of losses upon surrender of such contracts. The gain would be computed upon the basis of cost, but such cost could be said not to be the amount of premiums paid for the contract but the reserve value of the contract upon the reasoning examined in the loss cases. If the cost of earned insurance is not to be included in the loss cases, it certainly should not be included here. Losses likewise would be figured upon the basis of the reserve value of the contract, for the cases treated losses upon assignment exactly as losses upon surrender, in so far as the basis for computing loss is concerned.

4. The Taxation of Dividends.

Ordinarily annuity contracts such as immediate life annuities, refund annuities, survivorship annuities and the more simple forms of deferred annuities are not participating contracts and the question of the taxation of dividends will not arise. Within the last few years, however, some of these types have been issued as participating. "Retirement" contracts usually are participating.

Under any contracts which are considered life insurance or endowment contracts, dividends received in cash are not taxable in so far as other amounts received under the

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64 See note 29, supra.

This discussion relates to so-called annuity contracts which can be considered life insurance contracts, (such as insurance with annuity contracts) which are assigned before maturity.


Another problem somewhat related to the transfer of annuity contracts for a valuable consideration is the problem of the taxation of the transferor when a policy has been transferred as a gift or the annuitant is a donee annuitant. This problem is similar to that mentioned in Melsenholder, Taxation of Annuity Contracts, 40 Mich. L. Rev. 1005, p. 1023 (1942). If the purchaser or assignor of a contract retains power to change a beneficiary or to surrender the contract, he may be taxable.
contract plus the dividends do not exceed the consideration paid. If the consideration paid has been received back, amounts received as dividends are taxable.\textsuperscript{68}

However, in the case of contracts which are annuity contracts and which cannot be considered life insurance or endowment contracts, the taxation of dividends received presents a problem. There are no rulings or decisions. In the case of dividends which may be credited against current premiums, amounts received are not subject to tax until the total of all amounts received tax-free equals the consideration paid.\textsuperscript{69} Where annuity contracts are concerned, however, this rule would appear to apply only to dividends received during the deferred period under deferred annuity contracts where the consideration is payable in installments. It has no application to immediate annuity contracts, and the amounts received under these contracts would not be amounts received under insurance or endowment contracts within Section 22(b)(2) if such contracts were not supplementary contracts.\textsuperscript{70}

It might be possible to treat the payment of such dividends as part of the annuity payments received and tax the

\textsuperscript{68} Dividends are "Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts and other than amounts received as annuities) under a life insurance or endowment contract," Sec. 22(b)(2). See T. D. 2137, 17 Int. Rev. Treas. Decs. 49 (1915), O. D. 490, 2 C. B. 85 (1920); O. D. 433, 2 C. B. 91 (1920). This treatment is accorded dividends in many of the rulings cited in footnotes concerning treatment of other proceeds received during the life of the insured.

Article 22(a)-12, Regulations III, is also applicable. It provides: "Amounts received as a return of premiums paid under life insurance, endowment, or annuity contracts, and the so-called 'dividend' of a mutual insurance company which may be credited against the current premium, are not subject to tax."

Interest on accumulated dividends is taxable. Special ruling of September 22, 1941, by Deputy Commissioner, 413 C. C. H. $\|\$ 6505. See also special ruling of February 16, 1943, 433 C.C.H. $\|\$ 6218, and I. T. 3413, 1940-2 Cum. Bull. 58.

\textsuperscript{69} See note 68, supra.

\textsuperscript{70} The first sentence of Section 22(b)(2) of the INTERNAL REVENUE CODE states: "Amounts received (other than . . . ) under a life insurance or endowment contract . . . " The second sentence covers "amounts received as an annuity under an annuity contract . . . "
entire periodical amounts received in accordance with the three per cent method. Although such treatment is not specifically authorized under the statute as now written, this method is similar to that prescribed prior to 1934 and could therefore be said to be justified by the history of the present provision concerning annuity contracts.\(^7\)

But the fact remains that this type of dividend payment is not exempted from taxation at all under Section 22(b) (2) as it now stands. Furthermore, such dividends are a return on investment and can be compared to dividends on ordinary stock or to interest. Participating annuity contracts provide for a fixed annuity payment plus dividend payment and there is ordinarily no practical problem of determining what part of an amount received is received as a dividend.

The above discussion also applies to dividends received under “annuity with death benefit” contracts except that in the case of these contracts the regulation concerning dividends under annuity contracts is not even applicable and it seems that any and all dividends received should be taxable just as the periodical payments are.\(^7\)

It might also be noted that Article 22(a)-12 of the Regulations favors the taxpayer in so far as it applies to dividends received during the deferred period under installment “retirement” annuities and even to dividends received during the deferred period under simple installment deferred annuities with no refund or death benefit provisions during the deferred period. Dividends received under these circumstances are not amounts exempted from taxation under Section 22(b) (2) and no good reason appears for exemption of such amounts by virtue of Article 22(a)-12. In these situations it appears that an option to apply the dividends to reduce the premiums paid should not determine the nature of the dividends as income. Such an option is only one of various options usually offered. If the actual

\(^7\) The REVENUE ACTS from 1926 to 1932 exempted “Amounts received . . . under a life insurance, endowment, or annuity contract . . . ” etc.

\(^7\) This comment would also apply to annuity and life insurance contracts when they are issued together pursuant to rules of the insurance company, at least until the insurance contract has been surrendered. The entire amounts received would be taxed here.
character of the dividend is examined, it will be seen that they arise from the surplus of the company which exists because of unanticipated returns on investments of the insurance company, death rates experienced different from those indicated by mortality tables used, savings in loading expenses, gains from surrender or lapse of policies, etc. The nature of the dividends thus appears clearly to be a return on investment. Again an analogy could be made to corporate dividends or to interest.

5. Conclusion.

Recent cases and rulings relating to the subject matter of the previous article on income taxation of annuity contracts have not been considered in detail. A revision of that article would be primarily a rehash. But it is clearly indicated by all the rulings and cases in this field that uncertainty still exists as to proper methods for taxing various types of gains and losses under the present income tax statute.

This small segment of the income taxation field presents a miniature picture of a typical situation in income taxation. Broad general statutory clauses were enacted apparently without sufficient consideration of detailed problems involved in the technical subject matter covered. Scattered attempts to avoid taxation (or to reduce tax payable) have resulted in scattered and often inconsistent Income Tax rulings. Cases taken to court have established further inconsistent and confused bases for taxation.

Interest of the public in annuity contracts in spite of an economic situation adverse to sale of such contracts means, however, that interest in the income taxation of these contracts will continue. As a result further rulings and cases can be expected to settle some of the present problems. Nevertheless general clarification can be and should be attained by revision of provisions of the statute and regulations relating to annuity transactions.