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Internal Revenue - Deductions and Credits - Whether Payments Made on a Nominal Loan from an Insurer, Where Loan Proceedsd Were Used to Acquire Benefits of Annuity Contract with Insurer, Are Proper Deductions for Federal Income Tax Purposes

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tion was no longer outstanding, since it had been previously transferred by the plaintiff and cancelled. Pursuant to the applicable statute, damages were awarded the defendants at their suggestion.[20] The reviewing tribunal reversed and remanded the award of damages since it was excessive, but did not preclude the defendants from recovery.

In the principal case, the defendant neglected to raise an objection to the issuance of the preliminary injunction notwithstanding the plaintiff's failure to post the bond required by statute. It seems unlikely that the defendant's failure to interpose resistance was due to a mistake or the like, since the defendant's attorney stated, by affidavit, that on the day prior to the issuance of the injunction he had researched the applicable statute and precedents. It seems probable that, had the defendant called the attention of the court to the statutory requirement, the injunction would not have issued wrongfully and hence no damage would have ensued.[21]

By holding that one is not entitled to recover damages where he fails to seasonably object to the issuance of an injunction the court had adhered to the policy of equity which precludes parties from recovering damages caused by their own errors and omissions. Even though the court is presumed to know and take judicial notice of the laws of the forum, it still remains incumbent upon the litigant to inform the tribunal of the applicable statutory requirements so as to prevent the entry of erroneous orders. To permit parties, who fail to interpose resistance, to recover damages would, in effect, open the door to temptation, since unscrupulous litigants could intentionally remain mute in the hope that an injunction would issue wrongfully and then seek redress by way of damages.

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INTERNAL REVENUE—DEDUCTIONS AND CREDITS—WHETHER PAYMENTS MADE ON A NOMINAL LOAN FROM AN INSURER, WHERE LOAN PROCEEDS WERE USED TO ACQUIRE BENEFITS OF ANNUITY CONTRACT WITH INSURER, ARE PROPER DEDUCTIONS FOR FEDERAL INCOME TAX PURPOSES—A question of general interest to members of the legal profession, those engaged in tax work, and indeed, many taxpayers, was raised in the recent case of *Knetsch v. United States*.[1] The plaintiffs there concerned had purchased certain

20 Ill. Rev. Stat. 1959, Vol. 2, Ch. 69, § 12.

21 The issuance of an injunction to restrain the enforcement of a judgment is wrongful when the statutory bond is not posted, Grossman v. Davis, 117 Ill. App. 354 (1904); Packer v. Roberts, 44 Ill. App. 232 (1892).

1 272 F. (2d) 200 (1959), affirming 58-2 U. S. T. C. 69, 739; certiorari granted, 361 U. S. 958.

annuity savings bonds from an insurance company,[2] for which they gave a small cash payment and executed ten notes in a substantial amount for the balance of the stated premiums. The notes called for annual interest at 3½% but were lacking in any element of personal liability and were secured only by the annuity contract bonds so issued.[3] In succeeding years the plaintiffs made further payments on the notes, received corresponding credits against the purchase price of the bonds, re-borrowed the amounts so paid under the new notes, paid interest thereon at the stated rate, and claimed a deduction for this interest in each of the corresponding taxable years.[4] Upon disallowance of these deductions, the tax deficiencies were paid under protest and suit was brought in an appropriate federal court for refund thereof. Relief was denied by the district court where it was found that the annuity bonds so purchased afforded plaintiffs neither profit nor insurance; that the only possible benefit from the transactions was in the form of a contemplated tax saving because of the interest so charged;[5] and that the alleged interest was not interest in fact but was merely the purchase price of a tax deduction.[6] On appeal by the taxpayers this judgment was affirmed by the United States Court of Appeals for the Ninth Circuit.

2 The purchase was made in 1953, prior to the March 1, 1954, Internal Revenue Code revisions. Int. Rev. Code Sec. 264(a). Disallowance of the deduction as to annuity contracts applied only to those purchased after March 1, 1954. Section 264 further provides that "no deduction shall be allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract . . . A contract shall be treated as a single premium contract (1) if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or (2) if an amount is deposited after March 1, 1954 with the insurer for payment of a substantial number of future premiums on the contract." Exactly what constitutes a substantial number has not been litigated, but this provision has resulted in the discontinuance of advance premium deposits as an integral part of any current loan plan. While single premium loan contracts, as in the case of Knetsch v. United States, are no longer permissible, current loan plans could be affected by this decision.

3 Interest payable on the annuity bond was set at 2½% per annum, with the net result that the insurer made, as its sale profit, the sum of 1% per year.

4 Interest paid on indebtedness is an allowable deduction under Int. Rev. Code Sec. 163(a).

5 If a policyholder in the 50% tax bracket borrows money at 4% interest and his rate of return on the policy is 2½%, he has a favorable margin of ½% after taking the deduction (2½%—(50% × 4%) = ½%). It does not follow that outright profit will be realized from these transactions since only part of each premium is diverted to the interest-earning cash surrender value of the policy; the balance is used to pay insurance coverage and administrative costs. However, the interest deduction does result in reduced insurance costs for the policyholder. Participation in these plans is rarely recommended to the taxpayer below the 40% bracket since the saving produced by the deduction in lower brackets will not exceed the differential between interest paid and received.

6 The court likened the so called "interest charge" to an annual premium on insurance, a form of purchase price on a deferred payment plan.

Utilizing loan-financed life insurance and annuity plans as a means of securing an interest deduction has long been a popular device for enjoying federal income tax savings. From the single loan transactions that prevailed prior to the enactment of section 264 of the 1954 Internal Revenue Code[7]—more commonly known as bank loan plans—have evolved the currently popular annual loan—or minimum deposit—plans; these are largely financed by the companies themselves and offer high life insurance coverage at reduced rates through the use of the interest deduction. These plans may be maintained by either bank[8] or insurance-company loan, but in either case, the cash surrender value of the policy serves as collateral for the loan. Originally bank loans had been the preferred method of financing these transactions. However, as a result of higher bank loan interest rates,[9] increasing competition from insurance companies, and a general inflationary damper on insurance as an attractive long-term investment, the years since 1956 have witnessed a marked increase in the number of insurance companies which have introduced minimum deposit plans; these offer high initial cash surrender values,[10] which, in turn, permit the policyholder to pay a much larger portion of the first premiums by policy loan and thus provides high insurance coverage for a low cash outlay. These plans are offered in addition to the ordinary policy loan plans which require cash payment of a large part of the early premiums. On the other hand, by using the annual increase in policy cash surrender value as collateral, the policyholder under a minimum deposit plan can continue partial payment of premiums by policy loan and at the same time can utilize his capital for more attractive investments than insurance. Despite the fact that the net death benefit decreases as the loan increases, that any appreciation of premium investment is taxable if the policy is surrendered, and that essentially all the investment aspect of a policy is consumed by continuing loans, the minimum deposit plan is currently very popular with high-bracket taxpayers.

The use of this tax-saving device has not been un-noticed or unchallenged by the Treasury. It has consistently opposed a deduction for

7 See note 2, *ante*.

8 Since the 1954 Code prohibits plans whereby one bank loan in an amount equal to the total discounted costs of premiums is deposited with the insurance company, the term "bank loan plan" is now generally used to describe any current annual payment premium financing plan where bank loans are used.

9 In response to the increase in interest rate by the Federal Reserve System bank loan interest rates rose in 1956 to their highest level since 1934. Encyclopedia Americana, Banks and Banking, at 79 (1957 Annual). This created an unprecedented demand for loans on insurance policies since nearly all insurance companies provide for a 5% loan rate.

10 Minimum deposit plans extend over a longer period the costs that are usually paid within the first 2 years under an ordinary loan plan, thereby reducing the required amount of cash outlay.

any interest paid under these plans and has long sought complete disallowance by Congress, arguing that the deduction creates a tax loophole since interest earned by the policy is tax-free. In 1942 Congress disallowed any deduction for interest paid on loans to finance single premium insurance and endowment contract.[11] In 1954 interest deductions were disallowed on single premium annuity contracts,[12] and the definition of single premium contract was broadened.[13] The Treasury's dissatisfaction with these restrictions is evidenced by a list of unintended benefits and hardships submitted to the House Ways and Means Subcommittee on Internal Revenue Taxation in November, 1956.[14] At hearings held by the subcommittee[15] the recommendation was made that a deduction be disallowed whenever a policy was obtained under a plan which contemplated paying a substantial number of premiums by means of indebtedness. Representatives of the insurance industry testified both for and against further statutory disallowance.[16] Both factions, however, united against policyholder intent as an objective means of determining disallowance, and expressed concern that it would prohibit the use of credit by those needing insurance protection. This proposal was rejected by the Ways and Means Committee in July, 1957. After hearings before the Senate Finance Committee in February, 1958,[17] with all segments of the insurance industry

11 Int. Rev. Code, Sec. 24(a)(6).

12 See note 2, *ante.*

13 See note 2, *ante.*

14 Staffs of the Joint Comm. on Internal Revenue Taxation, 84th Cong., 2d Sess., and the Treasury Dept., List of Substantive Unintended Benefits and Hardships and Additional Problems for the Technical Amendments Bill of 1957, at 10, item 21 (1956).

15 Hearings on Technical Amendments to the Internal Revenue Code before the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, 84th Cong., 2d Sess. 95, 168, 325 (1956).

16 Proponents of the plan argue that it provides high insurance coverage at lower rates at an age when the policyholder needs high protection and yet prefers to use capital for other investment purposes. Several companies have countered the criticism that the net death benefit decreases as total indebtedness increases by incorporating level term insurance provisions in the plans to stabilize coverage. Opponents of the plan contend that it is frequently sold to persons who are not in a sufficiently high tax bracket to justify the investment, and that clients are not always made aware that it is the tax deduction of interest that makes these plans economically feasible. The minimum deposit plan is also attacked as being dangerous to the insurance company since the satisfaction of costs is extended over a longer period. If many policies lapse during their early years, which they may if policyholders lose interest as the interest payments increase and death benefits decrease, and since the loans are made without personal liability, the insurance companies could well suffer considerable losses. Minimum deposit and bank loan plans are further evaluated in Van Cleve, The Bank Loan Plan: One Point of View, 10 J. Am. Soc'y C. L. U. 167 (1956); National Underwriter (Life Insurance), Jan. 3, 1959, pp. 1, 2, 12; Allowance of Interest Deduction Under Loan-Financed Insurance Plans, Monthly Digest of Tax Articles, Vol. 10, No. 6 (March 1960), as condensed from 47 Cal. L. R. 3 (1959), pp. 602-606.

17 Hearings on H. R. 8381 Before the Senate Committee on Finance, 85th Cong., 2d Sess., 35, 43, 95, 393 (1958).

opposing it, the proposal was again rejected, apparently due to the lack of satisfactory criteria for enforcement. At present no further legislative action concerning the proposal is pending.

Reflecting the restrictions imposed by Congress, and in light of the Supreme Court's narrow definition of "interest",[18] the courts have also questioned the deductibility of these payments. Litigation has been confined to single premium annuity transactions in which the policyholder had borrowed from the insurance company to pay the single premium, having given a note without recourse,[19] the interest payments on the loan being the only actual disbursements. These transactions were attacked by the Commission in a 1954 Revenue Ruling,[20] which claimed that the deductions should be disallowed on two grounds: (1) the transactions were sham in that their only purpose was to create an interest deduction;[21] and (2) there was no real indebtedness since no use of borrowed funds was provided,[22] the "interest" payments in reality representing the prem-

18 The Supreme Court has defined the term interest as used in the Internal Revenue Code on several occasions. In Old Colony Railroad Co. v. Commissioner of Internal Revenue, 284 U. S. 552, (1932), 76 L. Ed. 484, 489, it was held to be "the amount which one has contracted to pay for the use of borrowed money." Here the court rejected the idea that Congress meant "effective interest" with the theory of accounting or that "Congress used the word having in mind any other concept other than the usual, ordinary, and everyday meaning of the term." Again, in Deputy v. DuPont, 308 U. S. 488, (1940), 60 S. Ct. 363, the court stated that ". . . although an indebtedness is an obligation, an obligation is not necessarily an indebtedness within the meaning of sec. 23(b). Nor are all carrying charges interest. . . . We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world interest on indebtedness means compensation for the use or forebearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense."

19 The fact that the note is without recourse is of no import in determining whether there is real indebtedness. W. Stuart Emmons, 31 T. C. 26 (1958), affirmed 270 F. (2d) 294 (1959) noted that nonrecourse is typical of insurance company loans to policyholders and that companies normally do not lend more than the cash value of the policy, such cash value serving as collateral. The court recognized that interest paid by cash basis taxpayers on policy loans is deductible regardless of personal liability.

20 Regulations 118, section 39.23(b); Rev. Rul. 54-94, 1954—1 Cum. Bull. 53. When their attention became focused on the so-called "tax saving" plans, the Internal Revenue Service made the following ruling: "Amounts claimed as 'interest' in connection with so-called tax savings plans the purpose of which is to obtain an interest deduction for Federal income tax purposes are not deductible under section 23(b) of the Internal Revenue Code."

21 The basis of this decision by the Commissioner was apparently Gregory v. Helvering, 293 U. S. 465 (1935) which involved the creation of a corporate entity for the purpose of transferring shares of stock to the taxpayer, and to reduce taxes on said transfer. The plan was held not to be within the intent of the tax statute since it had no business purpose and was used only to achieve a reduction in taxes. This case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability; rather than being limited to corporate reorganizations, it has been applied to the federal tax statutes generally.

22 See note 18, *ante*.

iums paid for the annuity. With one exception, in the case of *United States* v. *Bond*,[23] the courts have displayed a consistent trend toward disallowance of these interest payments as tax deductions.[24] The case of Knetsch is representative of this trend; aside from dates and amounts, the facts of the other cases do not differ materially. In these cases, where additional and continuing policy loans prevented the annuity policies from representing any real value, the decision pertaining to each case has reasoned in accord with the Revenue Ruling that they were sham transactions and that no real indebtedness existed.

The issue of form versus substance as regards taxation has been before the court on a number of occasions involving numerous factual situations.[25] A study of these decisions and the various comments made

23 United States v. Bond, 258 F. (2d) 577, (1958). The court found the bonds to be legitimate annuity contracts, thereby establishing valid indebtedness.

24 Knetsch v. United States, see note 1, ante; see Emmons case, note 19, ante; Weller v. Commissioner of Internal Revenue, 270 F. (2d) 294 (1959).

25 a) The Supreme Court stated in Commissioner of Internal Revenue v. Court Holding Co., 324 U. S. 331, 334 (1945), "The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. . . . To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." b) Judge Learned Hand in Gilbert v. Commissioner of Internal Revenue, 248 F. (2d) 399, 411-412 (C. A. 2, 1957) commented, ". . . If, however, the taxpayer enters upon a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose." c) In Higgins v. Smith, 308 U. S. 473 (1940), 60 S. Ct. 355, it was held that, "The Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation." d) In Talbot Mills v. Commissioner of Internal Revenue, 326 U. S. 521 (1946), and Matthiessen v. Commissioner of Internal Revenue, 194 F. (2d) 659 (1952), is found the holding that the amounts paid by the taxpayer are not in substance payments for the use of borrowed money. As a matter of substance the taxpayer does not borrow any money, hence there is no "debt" on which he pays "interest." An instrument that is called a "note" will not be treated as an indebtedness where it does not in fact represent an indebtedness. e) In Commissioner of Internal Revenue v. Transport Trading and Terminal Corp., 176 F. (2d) 570, 572 (1949), the Court of Appeals for the Second Circuit emphasized that "in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." f) United States v. Gilbert Associates, Inc., 345 U. S. 361 (1953): For the purpose of the federal tax laws, the substance of transactions is to be determined uniformly in relation to the meaning and intendment of the federal laws. g) Griffiths v. Helvering, 308 U. S. 355 (1939): Taxes cannot be escaped by anticipating arrangements and contracts however skilfully devised . . . by which the fruits are attributed to a different tree from that on which they grew. h) See note 21, ante.

by the courts gives an indication of the ultimate conclusion that is forthcoming concerning the disallowance of these interest payments as tax deductions.[26]

The one opposing decision reached in a case of this nature is that of *United States* v. *Bond*,[27] where the deduction of interest paid in 1952 on notes executed for the purchase of single premium annuity bonds was upheld and the contention that there was no real indebtedness was rejected. In the Bond case, however, which also occurred before section 264 of the 1954 Code abolished single premium loan plans, the policyholder did not strip his policy of all value by additional loans, and it was possible to realize a modest profit under the annuity plan without the tax deduction (although the deduction feature was unquestionably the overriding motive in inducing Bond to so invest). Whether this factor sufficiently distinguishes the Bond case from those in which the deduction was disallowed is a matter for speculation; it is more probable that the courts are in basic disagreement. The basic significance of the question lies in the application of the later annuity decisions to current loan plans. For example, the "trend of disallowance" that is apparent in the Knetsch, Weller, and Emmons cases has more recently been echoed in a number of cases which have disallowed an interest deduction on loans made to purchase United States Treasury notes.[28]

With strong controversy over the minimum deposit plan continuing within the insurance industry, and neither Congress or state regulatory bodies apparently willing or able to resolve the issue, what, then, will be the ultimate solution reached by the Supreme Court? Although the interest deduction is the heart of the minimum deposit and other policy-loan plans, they cannot be dismissed as sham transactions since their main purpose is not to create an interest deduction but to provide high insurance coverage at reduced costs. On the other hand, a sound argument can be made, at least when continuing policy loans are used to finance premiums, that there is no real indebtedness since no use of borrowed money is provided, and that payments designated as interest are, in substance, direct payments for insurance protection and consequently should not be deductible.

26 See note 1, *ante*.

27 See note 23, *ante*.

28 Such loans were made popular by the fact that nontaxable interest income plus tax savings generally exceeded the interest payable. Goodstein v. Commissioner of Internal Revenue, 267 F. (2d) 127 (1959); Sonnabend v. Commissioner of Internal Revenue, 267 F. (2d) 319 (1959).

On the basis of the evidence presented, it is not likely that action by the Supreme Court will result in the abolition of loan financed insurance; the definition of "interest" for tax purposes will probably be clarified and existing statutes interpreted in a manner that can be expected to curtail the abuses of the interest-deduction factor in loan-financed annuity contracts.

W. D. WALLACE

INTERNAL REVENUE—DEDUCTIONS IN GENERAL—WHETHER INSURANCE PROCEEDS RETAINED UNDER A SETTLEMENT OPTION MAY QUALIFY FOR THE MARITAL DEDUCTION—An interesting attempt to define what constitutes a terminable interest in relation to life insurance policy proceeds is to be found in the recent case of *Estate of Werbe* v. *United States*.[1] In that case certain policies of insurance on the life of the decedent provided that the proceeds of the policies, payable on receipt of proof of death, were to be retained by the insurance company which was then to make monthly payments to the decedent's widow. The policy provisions further stated that in the event the wife should not survive, or should die while the above-mentioned settlement was operative, any amount due on the proceeds was to be equally divided between the insured's sons as secondary beneficiaries. The widow was also given the right to make withdrawals in whole or in part from the proceeds retained by the insurer, but only on interest payment dates, the first of which would fall one month after the death of the insured for certain of these policies and a year later for one other, and then in amounts not smaller than a sum stipulated. Following the decedent's death, and the filing of an estate tax return, the Commissioner of Internal Revenue excluded the value of these five insurance policies in determining for estate tax purposes the amount of the marital deduction. An additional tax was paid and the taxpayer then sued for a refund of an alleged overpayment. Both the district court and the Court of Appeals for the Seventh Circuit, agreeing with the Commissioner, concluded that the widow had only a terminable rather than an absolute interest in the proceeds of the insurance policies, because the proceeds could pass to the sons for less than full consideration and also because she did not have a power of appointment exercisable in all events, so recovery of the additional tax paid was denied.

The marital deduction[2] provision was inserted in the Internal Revenue Act of 1948 to equalize tax advantages in the common law and community property states and its purpose was to permit the surviving spouse to

1 273 F. (2d) 201 (1959), affirming 178 F. Supp. 704 (1959).

2 Int. Rev. Code, Sec. 812(e).