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Federal Estate Tax - Marital Deduction - Annuity for Life with Guaranteed Certain Payments Not Divided Into Two Properties by Insurer's Accounting Treatment

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FEDERAL ESTATE TAX — MARITAL DEDUCTION — ANNUITY FOR LIFE WITH GUARANTEED CERTAIN PAYMENTS NOT DIVIDED INTO TWO PROPERTIES BY INSURER'S ACCOUNTING TREATMENT — Plaintiff, executor of decedent's estate, brought suit to recover an overpayment of federal estate tax. Decedent had purchased a life insurance policy[1] and had elected an option under which proceeds would be paid to his wife in monthly payments for her life; however, the option also guaranteed a minimum of 240 payments. In the event the wife died before 240 payments were made, payments were to continue to decedent's daughter, or on the death of both wife and daughter, the commuted value of the remaining guaranteed payments would be paid in lump sum to the estate of the survivor. The insurers made book entries allocating $17,956.41 of the total proceeds to fund the 240 guaranteed payments — or "annuity certain" — and $7,231.09 to fund the annuity payable to the wife to the extent that she might live longer than 240 months — "contingent life annuity." No division of the proceeds was made by the terms of the policy. The federal estate tax was paid on the value of both the annuity certain and the contingent life annuity. Plaintiff then brought suit for a refund of the tax on the value of the contingent life annuity claiming that the separate accounting treatment of this annuity made it separate property, and that it therefore qualified for the marital deduction since the wife's interest in the contingent annuity was exclusive.[2] The district court accepted this theory, and allowed the refund,[3] but was reversed by the Court of Appeals for the Second Circuit.[4] On certiorari to the United States Supreme Court, *held*, affirmed, three Justices dissenting.[5] Because separate book entries by the insurer allocating portions of the total insur-

1 Another policy with identical provisions was also involved.

2 The marital deduction and terminable interest provisions of the 1939 Code were applicable to the principal case. Int. Rev. Code of 1939, § 812(e), ch. 361, 62 Stat. 117 (1948) (now INT. REV. CODE OF 1954, § 2056). However, since § 2056 contains the same words as the 1948 amendment, it will hereinafter be referred to when discussing the principal case instead of the equivalent section of the 1939 Code.

The "terminable interest" provisions are prescribed by §§ 2056(b)(1)(A) and 2056(b)(1)(B):

"(b) Limitation in the case of Life Estate or other terminable interest.

"(1) General Rule — Where on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest —

"(A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and

"(B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse. . . ."

3 Meyer v. United States, 166 F. Supp. 629 (W.D.N.Y. 1958). The district court followed the decision of Estate of Reilly v. Commissioner, 239 F.2d 797 (3d Cir. 1957), 43 VA. L. REV. 587 (1957).

4 Meyer v. United States, 275 F.2d 83 (2d Cir. 1959), 35 N.Y.U.L. REV. 849 (1960).

5 Mr. Justice Douglas, with whom Mr. Justice Clark and Mr. Justice Brennan joined, dissented.

ance proceeds to fund the contingent and certain payments of an annuity are not sufficient to divide this annuity into separate properties, the proceeds constituted one "property" in which the widow had a terminable, and therefore a non-deductible, interest. *Meyer v. United States*, 364 U.S. 410 (1960).

In 1948 the Congress, in an attempt to equalize the tax burdens between common law and community property states,[6] passed the marital deduction provisions which allowed a deduction of as much as one half of the value of the decedent's adjusted gross estate for certain property passing from the decedent to his surviving spouse.[7] However, property passing to the surviving spouse which comes within the "terminable interest" provision will not qualify as marital deduction property.[8] Thus in the principal case the annuity certain was conceded to be unavailable for the marital deduction since the wife's interest in it would terminate if she died before 240 payments were made, and a third person, decedent's daughter, to whom an interest passed for less than adequate consideration might enjoy the rest of the guaranteed proceeds. If the Court were willing to regard the contingent life annuity as separate property, however, that portion of the value of the contract would not come within the terminable interest provisions, for the annuity was owned exclusively by the wife. On facts similar to those in the principal case the Third Circuit in *Estate of Reilly v. Commissioner*[9] did accept the argument that separate book entries by the insurer made the contingent life annuity separate property which would then qualify as marital deduction property. The Supreme Court here refused to accept this "two properties" argument, although it did not decide whether two properties could ever exist in the total proceeds. The Court merely decided that here, since the total proceeds were not divided by the terms of the policy, only one "property" existed.

The dissent suggests that the majority's analysis was erroneous because the terminable interest provisions refer to an "interest in property" instead of "property."[10] The indicia of congressional intent indicate that Congress

[6] For discussion, see S. REP. No. 1013, 80th Cong., 2d Sess. 1 (1948); Polasky, *Estate Tax Marital Deduction in Estate Planning*, 3 Tax Counselor's Q., June 1959, p. 1; Comment, 107 U. PA. L. REV. 1176 (1959).

[7] INT. REV. CODE OF 1954, § 2056.

[8] INT. REV. CODE OF 1954, § 2056(b)(1) quoted in note 2 *supra*.

[9] 239 F.2d 797 (3d Cir. 1957). In that case the decedent had elected to have the proceeds of his insurance policy paid to his wife in the form of an annuity for her life with guaranteed payments for 10 years. These payments were to continue to the decedent's children if his wife died within the 10-year period. The insurer allocated portions of the total proceeds by separate book entries; $28,149.63 was entered as the present value of the 10-year certain annuity, and $30,280.46 was entered as the present value of the annuity for the life of the wife which begins at a date 10 years in the future. The court held that this division of the proceeds on the books of the insurance company created "two properties," and it permitted the $30,280.46 to qualify for the marital deduction.

[10] Principal case at 418-19.

intended that these terms have different meanings.[11] The dissent agrees that the total insurance proceeds constitute one "property" and not two but asserts that the annuity certain and the contingent life annuity constitute two "interests" in this property because of the division made in the proceeds by separate book entries. The dissent concludes that the present value of the contingent life annuity qualifies for the marital deduction since the wife's interest in the contingent life annuity is not within the terminable interest provisions.

Two questions are left open by the opinion in the principal case. First, is it possible to say that one person has more than one interest in a single property for purposes of the statute? For example, if the testator devises Blackacre "to my wife for 20 years but if she dies before the expiration of the period, to my son for the remainder of the 20 years, remainder to my wife or her estate," does the wife have one or two interests in Blackacre? Neither the opinion in the principal case nor the regulations under section 2056[12] decide whether "interest in property" means the total of the rights possessed by any one person or whether each right may be designated as a separate "interest in property." A second question raised by the dissent's argument concerns the proper construction of "such property" as used in section 2056 (b) (1) (B). This section provides that property passing to the surviving spouse, although terminable, will not come within the terminable interest provisions if the spouse's ownership is exclusive or, as expressed by the Code, if a third person does not "possess or enjoy any part of *such property* after . . . [the] termination or failure of the interest . . . passing to the surviving spouse. . . ."[13] The dissent's conclusion is valid if "such property" refers to the "interest in property," in this case the contingent life annuity, since the inquiry would then be into whether the surviving spouse's ownership of the particular "interest" was exclusive. But the dissent's argument fails if "such property" refers to the total "property," in this case the total proceeds, for it is then immaterial how many "interests" the surviving spouse has in the total property; the inquiry would be into whether a third person had any interest in any part of the total property.[14] The dissent must answer both these questions before its position can be sustained, and neither the *Reilly* case nor the dissent in the principal case provides answers.

[11] See S. REP. No. 1013, 80th Cong., 2d Sess., Pt. 2, at 4 (1948).

[12] Treas. Reg. § 20.2056 (b)—1 (1958).

[13] INT. REV. CODE OF 1954, § 2056 (b) (1) (B). (Emphasis added.)

[14] If the position of the dissent on this point is accepted, it is clear that it cannot be applied to all divided property problems. For example, if the testator devises Blackacre to his wife for life, remainder to his son, "such property" must apply to the fee interest of Blackacre, for the wife's interest is deemed to be within the terminable interest provisions. Treas. Reg. § 20.2056 (b)-1 (g) *example* (1) (1958). The question then arises, in the case of other types of divided property, such as the insurance proceeds in the principal case, does "such property" have the same meaning? If it does not, which must be the position of the dissent, query, in which cases does "such property" mean the "interest in property" and in which cases does it refer to the "total property"?

There is one further difficulty in the position of the dissent. The argument that separate interests in property existed relies on the book entries made by the insurance company and not on the actions of the decedent. Regardless of what actuarial method lay behind the insurer's allocation of the total proceeds to finance the annuity payments to the wife and the daughter, the interest devised by the testator remains the same. But if the dissent's argument is accepted, the method used by the insurer to allocate the total proceeds to finance the annuities would change the amount of the marital deduction. For example, in the principal case the insurer made one book entry representing the present value of the 20-year annuity certain and made another entry representing the present value of the annuity for the life of the wife from a date beginning in 20 years. It would have been possible, however, for the insurance company to handle the funding of the annuity by different book entries. The insurer could have first made a book entry of the present value of an ordinary 20-year annuity to the wife, wherein no payments would be made after the wife's death,[15] and made another entry to provide the amount necessary to fund an annuity for the life of the wife beginning at a date 20 years hence. If these accounting entries had been made by the insurance company, the wife's interest would be exclusive in the amount of the proceeds so set aside, and the daughter's interest would be limited to the remaining amount of the proceeds.[16] Thus although the decedent acted the same way in both cases, the amount of the marital deduction would vary with the book entries made by the insurance company.

While the position of the dissent may be criticized, the majority opinion is concerned with the form and not the substance of the property interests created. The decedent could have purchased two insurance policies which would have achieved identical benefits for his wife and daughter, and the value of the policy providing for the contingent life annuity would in this event qualify for the marital deduction. Similarly, in *Fidelity-Philadelphia Trust Co. v. Smith*[17] the Court appeared to favor form over substance. In that case the decedent aged seventy-six invested in three single premium life

[15] Since the wife might die within the 20-year period, this entry will be less than that for the present value of a 20-year annuity certain.

[16] To illustrate the difference in actuarial treatment and the resulting difference in the amount of the marital deduction, let (x) = the present value of an ordinary 20-year annuity to the wife, no more payments to be made on or after the wife's death; let (y) = the present value of the refund feature which on the death of the wife before 20 years would pay the rest of the 20-year certain annuity to the daughter; and let (z) = the present value of an annuity for the life of the wife beginning in 20 years for the rest of her life, payment contingent on the wife's being alive. Then $(x + y + z)$ = the total value of the policy and $(x + y)$ = the present value of a 20-year certain annuity. The method used by the insurer in the principal case necessitated making two book entries: $(x + y)$ and (z). If the dissent's approach were adopted, (z) would equal the amount of the marital deduction. The alternative method would necessitate three book entries: (x), (y), and (z). Since the daughter has an interest only in (y), $(x + z)$ would equal the amount of the marital deduction if this alternative method of accounting entries were used.

[17] 356 U.S. 274 (1958), 56 MICH. L. REV. 1366 (1958).

insurance policies the issuance of each of which was conditioned upon the purchase of a single premium annuity of specified value; no physical examination was required. The effect of this transaction was substantially identical to the creation of a trust with a reserved life estate. Nevertheless, the Court held that although each combination was the product of a single, integrated transaction, the contracts were from the time of issuance separate and distinct and therefore that decedent could not be said to have retained a life interest in the transferred property. Thus in both of these cases the Supreme Court has sacrificed substance for form as it struggled to apply the Code to property interests divided in time.

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