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TAXATION - FEDERAL INCOME TAX - EXEMPTION OF LIFE INSURANCE PROCEEDS WHEN PAID IN THE FORM OF ANNUITY

Spencer E. Irons
University of Michigan Law School

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TAXATION — FEDERAL INCOME TAX — EXEMPTION OF LIFE INSURANCE PROCEEDS WHEN PAID IN THE FORM OF ANNUITY — A taxpayer was the beneficiary of life insurance policies which required the insurance company to make fifty annual payments of $2,000 each. At the death of the insured in 1917, the commuted value of this obligation was $53,000. Prior to 1934, the taxpayer had received seventeen payments, aggregating $45,473.40,[1] no part of which had been reported as income. For the year 1934, the taxpayer received $2,581.40, of which $2,000 was the annual payment, and $581.40 was an "excess interest" dividend. He again failed to include any of the amount in his gross income. The commissioner determined that under the Revenue Act of 1934 [2] $53,000 was the total amount to be exempted under the policy as a payment "by reason of the death of the insured." Since $45,473.40 had already been received by the beneficiary, only $7,526.60 of future payments would be exempt, and this sum, spread evenly over the remaining twenty-three years of the annuity, would provide an exemption of only $228.08 per year. The board of tax appeals upheld the commissioner as to the $581.40, but reversed as to the $2,000, holding the latter amount entirely exempt on the ground that the

[1] $34,000 had been paid in 17 installments of $2,000 each, and $11,473.40 had been paid as "excess interest" dividends, which had resulted from earnings of the insurance company in excess of 3%.

[2] 48 Stat. L. 687 (1934), 26 U. S. C. (1934), § 22 (b): "Exclusions from gross income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter: (1) Life insurance.—Amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or otherwise (but if such amounts are held by the insurer under an agreement to pay interest thereon, the interest payments shall be included in gross income). . . ." The same provisions are found in the 1936, 1938, and 1939 acts.

amount arising from the death of the insured was $100,000.[3] On appeal to the circuit court of appeals, *held* the treasury regulation on which the commissioner relied [4] is invalid and the board's determination of exemption should be affirmed. *Commissioner of Internal Revenue v. Winslow*, (C. C. A. 1st, 1940) 113 F. (2d) 418.[5]

Congress has indicated a policy to exclude from gross income "amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or otherwise." [6] In cases like the present one, where the proceeds of the policy are to be paid in installments, the problem is to determine what part of each payment is paid as principal, and what part as "interest." The board, in deciding that $100,000 (and not the $53,000 commuted value) was the sum to be paid by reason of the death and was therefore the amount of the exemption even though payable in fifty installments, adopted one approach to the problem and followed it to its logical conclusion. When, however, the circuit court of appeals adopted the commissioner's approach that the policy was for $53,000, the same conclusion did not follow so easily. It is clear that if the beneficiary had been paid in cash upon the death of the insured, and if he had used this cash to purchase an annuity, he would have been taxed upon all receipts from the annuity in excess of cost.[7] The principal case, however, excludes this excess from gross income. The $581.40, received in addition to the principal installment of $2,000, was held to be part of gross income on the ground that it was a distribution of earnings. The court's position on this point is upheld by past decisions,[8] but if this amount is held to be a gain currently

[3] Winslow v. Commissioner, 39 B. T. A. 373 (1939).

[4] Treas. Reg. 86, art. 22 (b) (1) (1934): "The amount exempted is the amount payable had the insured or the beneficiary not elected to exercise an option to receive the proceeds of the policy or any part thereof at a later date or dates. If the policy provides no option for payment upon the death of the insured, or provides only for payments in installments, there is exempted only the amount which the insurance company would have paid immediately after the death of the insured had the policy not provided for payment at a later date or dates. Any increment thereto is taxable." Under the treasury's scheme, the amount of the exemption is divided equally among the payments to be made. In the present case, the commissioner determined that there was $7,526.60 remaining of the taxpayer's $53,000 exemption, and he consequently spread this amount over the 23 remaining years in which the payments were to be made.

[5] The Circuit Court of Appeals for the Second Circuit, in Commissioner v. Bartlett, (C. C. A. 2d, 1940) 113 F. (2d) 766, reached the same conclusion as the Winslow case. The installment payments were to continue for 240 months, and then for the continued life of the beneficiary.

[6] Revenue Act of 1934, 48 Stat. L. 687 (1934), 26 U. S. C. (1934), § 22 (b) (1).

[7] Revenue Act of 1934, 48 Stat. L. 687 (1934), 26 U. S. C. (1934), § 22 (b) (2).

[8] United States v. Heilbroner, (C. C. A. 2d, 1938) 100 F. (2d) 379. Here the insurer held the proceeds of life insurance as a trust for the life of the taxpayer, and was obligated to turn them over, upon his death, to certain named children. The payments to the taxpayer were held to be includible within the gross income. See also: Kinnear v. Commissioner, 20 B. T. A. 718 (1930).

derived from the principal invested, it is hard to distinguish it from the increment which went to make up part of the $2,000. Neither sum should be exempted from taxation, since both are merely income from an investment. The court said that "each $2,000 installment paid to the respondent, even though it be considered as part annuity, must be excluded from the gross income," [9] since all of it arose out of the death of the insured. This interpretation is not in harmony with other parts of the tax structure. For estate tax purposes the law looks only to the commuted value of a life insurance policy payable in installments. It is reasonable to suppose that Congress intended to exclude from gross income only the proceeds of policies which are reportable for estate tax purposes.[10] On the other hand, in the taxing of an insurance company, it has been held that no part of an installment payment on an insurance policy can be deducted as interest expense, and that full payment constitutes a primary obligation arising from the policy.[11] Of course "interest expense" to the insurer may be defined differently than "interest income" to the beneficiary, so there would be no necessary inconsistency between this holding and a holding that the beneficiary must pay an income tax on the proceeds of the annuity above the commuted value.[12]

Spencer E. Irons

[9] Principal case, 113 F. (2d) at 423.

[10] United States v. Heilbroner, (C. C. A. 2d, 1938) 100 F. (2d) 379 at 381; Revenue Act of 1926, § 302 (g), 44 Stat. L. 71 (1926), 26 U. S. C. (1934), § 411 (g).

[11] Penn Mut. Life Ins. Co. v. Commissioner, (C. C. A. 3rd, 1937) 92 F. (2d) 962.

[12] The principal case has also been noted in 50 YALE L. J. 322 (1940).