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INCOME-TAX TREATMENT OF LIFE INSURANCE PROCEEDS

WILLIAM J. BOWE

Congress, having given only the vaguest definition of gross income in Section 22(a) of the Internal Revenue Code,[1] was apparently unwilling to leave the determination of what constitutes gross income exclusively to the courts. It therefore provided in Section 22(b) for certain exclusions from the broad concept of income enunciated in subsection (a). Principal among these exclusions was "property acquired by gift, bequest, devise, or inheritance." There was grave doubt whether the proceeds of life insurance would be held by the courts to fall within the exempted classification. Historically, the law never regarded insurance as testamentary in character. The proceeds do not pass under the laws of succession, nor need the policy designations comply with the requirements of the Statute of Wills in order to be effective.[2] On the other hand, if the courts, following traditional property concepts, classified a beneficiary designation as a lifetime gift, would the full proceeds be exempt?[3] Congress avoided such uncertainties by providing in the original Code that the proceeds of life insurance, with certain exceptions, should be exempt from income tax.[4]

[1]Section 22(a) of the Code contains the "general definition" of gross income. The heart of the "definition," which in substantially its present form has been part of the statutory law since the 1913 Act, reads as follows: "'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commmerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

[2]ATKINSON, WILLS 124 (1937). FLA. STAT. §222.13 (1949) allows an insured, whenever the insurance is for the benefit of his estate or payable to his estate, executors, administrators or assigns, to bequeath the proceeds of such policy by will in the same manner in which he may devise or bequeath other property. Such proceeds, when bequeathed, are deemed to pass by will, whereas if he does not bequeath them they inure to the benefit of his wife and children under the provisions of Sec. 222.13 and not under the statute of descents, New York Life Ins. Co. v. Valz, 141 F.2d 1014 (5th Cir. 1944); Milam v. Davis, 97 Fla. 916, 969, 123 So. 668, 687 (1929).

[3]*Cf.* Irwin v. Gavit, 268 U.S. 161 (1925).

[4]The present version of this exclusion reads as follows:

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It is important, however, to keep in mind the Congressional objective of exempting gifts, both lifetime and testamentary, from income tax to understand fully the treatment of life insurance proceeds under the federal income tax laws. In addition to excluding from gross income the value of property inherited at death, the law exempts from income taxation all appreciation in the value of assets owned by a decedent. Thus, if *A* invested $3,000 in stock in 1947 and it has a market value of $5,000 on the date of his death in 1951, the profit of $2,000 wholly escapes income taxation. This is so because no gain is recognized to the decedent, there having been no realization by him. When his legatee later sells the stock the gain will be limited to the excess of the sale price over $5,000, because Section 113(a)(5) specifically provides that the basis to the legatee of property acquired by inheritance shall be its value at the date of his testator's death.[5]

Under the exclusionary rule of Section 22(b)(1) a similar result is reached with respect to insurance proceeds. Thus, if *A* pays $3,000

"Sec. 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) . . . ."

Sec. 22(b)(2)(A), dealing with annuities, contains the following provisions relating to insurance proceeds:

"*In General.* — 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, but if such amounts (when added to amounts received before the taxable year under such contract) exceed the aggregate premiums or consideration paid (whether or not paid during the taxable year) then the excess shall be included in gross income . . . . 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) or this paragraph. The preceding sentence shall not apply in the case of such a 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. This subparagraph and paragraph (1) shall not apply with respect to so much of a payment under a life insurance, endowment, or annuity contract, or any interest therein, as, under section 22(k) is includible in gross income . . . ."

[5]One year from the date of death if the optional valuation date for estate tax purposes is used, INT. REV. CODE §813(c)(5).

of net premiums over the years on a $5,000 policy on his life, the $2,000 profit will not be subject to income tax to the insured or his estate or to his beneficiary. This income tax exclusion goes somewhat further with respect to insurance policies than the rule relating to the appreciated value of property in general, since if *A* has paid $3,000 of net premiums on a $5,000 policy on his brother *B's* life the proceeds will still be free from income tax, although here the proceeds are not received as a lifetime or testamentary gift.[6]

Proceeds Received by Reason of Death

By a Donee Beneficiary of the Insured. As noted above, the Code provides that there shall not be included in gross income and there shall be exempt from income taxation amounts received under a life insurance contract paid by reason of the death of an insured, whether in a single sum or otherwise. It is immaterial whether the payee is an individual, trust, partnership or corporation.[7] When, however, the entire proceeds are held by the insurer under an agreement to pay interest thereon, the interest payments must be included in the taxable income of the recipient. Thus, when the policy provides that the widow shall receive the interest on the proceeds during her life and the face amount of the policy shall on her death be paid to the children, the interest payments received by her are taxable to her but the payments received by the children on her death are exempt from income tax.[8]

The proceeds are exempt whether paid in a lump sum or in installments. The 1913 Act stated that the proceeds "paid upon the death of the person insured . . . shall not be included as income."[9] In 1926 the provision was expanded to exclude from gross income and exempt from tax:[10]

> "Amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or in install-

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[6]Indeed, such a transaction lacks any of the elements of a gift, but the existence of this exemption is justified by the policy favoring insurance, particularly inasmuch as the legal requirement that only one with an insurable interest may apply for a policy on the life of another forestalls abuse of this governmental policy.

[7]U. S. Treas. Reg. 111, §29.22 (1946).

[8]United States v. Heilbroner, 100 F.2d 379 (2d Cir. 1938).

[9]38 Stat. 167 (1913).

[10]Revenue Act of 1926, §213(b)(1), 44 Stat. 24 (1926).

ments (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) . . . ."

Committee reports preceding the 1926 Act stated that the phrase "paid by reason of the death of the insured" had been substituted by the House of Representatives for the phrase "paid upon the death of the insured," which had appeared in prior revenue acts, "in order to prevent an interpretation that would deny the exemption in the case of installment payments under the policy."[11]

The Commissioner originally interpreted this exclusion as applying only to installment payments received by a beneficiary under an option elected by the insured prior to his death. He contended that when the beneficiary had the election himself to receive a lump sum or installments and elected installments these were not paid *solely* by reason of death but were paid in part by the request of the beneficiary. His argument was that since the beneficiary had an option of choosing between the principal and the installment option it was as though he had actually received the principal and had reinvested it with the insurer instead of in some other form of security. The courts, however, refused to sustain this interpretation. Judge Learned Hand, in *Commissioner v. Pierce*,[12] disposed of the argument as follows:

"To say that her position was the same as though, having the having the principal in hand, she had exchanged it with the insurer for the option, is untrue in fact and unwarranted in law. Perhaps, if the policy had not contained the options, the beneficiary might still have been able to buy 'Option "C"' from the insurer by a direct bargain; but nothing in the record supports that assumption, and we have no right to make it. Life insurance is a technical subject, and it would be hazardous to say that it made no difference in the beneficiary's powers in dealing with the insurer that the policy contained the options. But even if it did make no difference, it is a fiction to treat the situation as though she had made such a bargain; it is as untrue as it would be to say that if the policy permitted her to be paid in dollars or

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[11]SEN. REP. No. 52, 69th Cong., 1st Sess. 20 (1926); H.R. REP. No. 356, 69th Cong., 1st Sess. 33 (1926); SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 593 (1938).

[12]146 F.2d 388, 390 (2d Cir. 1944).

pounds, and she took pounds, she had bought the pounds from the insurer with the dollars. It is as untrue as it would be to say that, if a testator gives a legatee the choice of money or a chattel and he takes the chattel, he has bought it of the executor."

The Commissioner has now reversed his position, and as a result of an amendment by Treasury Decision 5515, approved May 16, 1946, the Regulations now provide that even in cases in which the insurance proceeds are paid at the election of the beneficiary in installments rather than in a lump sum they shall be excluded from the beneficiary's gross income.[13]

By an Owner of the Policy. The exemption of the proceeds is the same as described above whenever one other than the insured owns the policy[14] and himself receives the proceeds, except in the rather uncommon situation, treated in the next subsection, in which an existing policy has been acquired by purchase.

Thus if a wife insures her husband's life the proceeds, when paid to her on his death, will not be subject to income taxes whether received in a lump sum or in installments. The result will be the same if the proceeds are paid to her donee-beneficiary.[15] On the other hand, if the option selected provides that the full amount shall be retained by the insurer and interest paid thereon, the interest payments must be included in gross income.

By a Purchaser of an Existing Policy. Section 22(b)(2)(A)[16] makes it clear that whenever a life insurance contract has been transferred for a valuable consideration any profit made by the buyer will

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[13]Any additional payments, however, based on the earnings of the insurance company and paid to the beneficiary in excess of the amount provided for in the option, are not paid by reason of the insured's death and therefore are not exempt from taxation, Paul, P-H 1945 TC MEM. DEC. ¶45,021 (1945).

[14]Ownership may have been acquired by original purchase or by gift of the policy.

[15]There are gift tax consequences to such a transaction. No gift occurs when *A*, owning a policy on the life of *X*, revocably designates *B* as beneficiary, since the transfer is incomplete. *A* has retained dominion and control over the contract through his power to change the beneficiary. But a taxable gift does occur on *X's* death. Up to the very moment of *X's* death, *A* owned the unmatured claim against the company. *X's* death not only matured the claim but irrevocably shifted ownership of it to *B*. Goodman v. Commissioner, 156 F.2d 218 (2d Cir. 1946).

[16]See note 4 *supra*.

constitute taxable income.[17] For instance, if he purchases an existing policy for $3,000, thereafter pays $2,000 in premiums, and collects $10,000 on the death of the insured, he will have realized a $5,000 income.[18]

The primary objective of life insurance is to spread the risk of premature death among large groups. In the normal case the policy is purchased and continued in force by the breadwinner as a method of protecting his dependents from the economic loss attending his death. It was probably with this typical case in mind that Congress accorded special treatment to life insurance. It wanted to encourage the purchase of insurance because of the socially desirable purpose it serves. But life insurance may be held as an investment just as one may buy any particular security that shows promise of increasing in value. This will rarely occur in the case of a newly issued policy because of the legal requirement that only one with an insurable interest in the life of the proposed insured may purchase a policy on his life. But once a policy has been issued it becomes freely transferable. For example, if *A* owns a policy on his own life he may at any time sell it or transfer it in satisfaction of a debt even though the person acquiring it has no insurable interest in *A's* life. This rule gives the policy some substantial value during the life of the insured. It enables him, for instance, to pledge the policy as security for loans.[19]

Congress apparently acted upon theory that the acquisition of an existing policy by purchase would possess more of the elements of a speculative investment than the risk-shifting objectives to which it wanted to accord special treatment, but that when a policy was acquired by gift or original issue this speculative feature was not likely to be present. This premise may be questioned.[20]

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[17]Because of hardship resulting from the operation of the rule, the Commissioner has held that it does not apply when the purchaser of the policy is the insured (I.T. 3212, 1938-2 CUM. BULL. 65); and Congress, by virtue of the next-to-last sentence of INT. REV. CODE §22(b)(2)(A), has made it inapplicable to a tax-free reorganization.

[18]This profit from the transaction is taxable as ordinary income, not as capital gain, since payment at maturity does not constitute a sale or exchange; see page 158 *supra*.

[19]It should also be noted that if a creditor insures the life of his debtor, as he may because of his then existing economic interest in that life, the creditor may continue the policy in force even after the debt has been discharged. Once a policy has been validly issued, the insurable interest requirement is satisfied and the contract continues to be legally enforceable in the hands of any subsequent owner.

[20]See Brown, *Transfers of Life Insurance for Valuable Consideration*, 28

Corporation *X* follows a practice of insuring its key executives for the benefit of the corporation. It takes out a policy on *A's* life; it purchases an existing policy on *B's* life for its current cash surrender value. Is there any reason why the tax consequences should differ on the death of *B* from those attending the death of *A*?

Son has a $20,000 policy on which he has paid ten annual premiums. He needs funds to complete the home he is building. Father takes over the policy in exchange for $3,000, its cash value, and thereafter pays the premiums. Should this situation be treated differently from that in which Son is about to surrender the policy because of the premium burden and instead, at Father's suggestion, he gratuitously assigns the policy to Father, who thereafter pays the premiums? In each case Father's motivation is the same, that is, the moral responsibility he feels for Son's dependents.

The factors that motivate the purchase of a life insurance policy are never solely those that influence the acquisition of other investments.[21] Its purchase represents a gamble in the hands of anyone who does not have an economic interest in the insured. This is not to argue that the test of exemption should be whether the owner at the time of the insured's death has an insurable interest, rather than

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TAXES 907, 910 (1950): "The theory has been advanced that in enacting this provision, Congress had in mind levying a tax upon 'speculative' transfers. There is not the slightest evidence to support that conjecture. A speculative transfer is one in which the transferee advances money on the security of an assigned policy but has no insurable interest in the insured. In the early days of life insurance, men occasionally gambled on the lives of others by the purchase of life insurance. This practice was in a large measure responsible for the doctrine of insurable interest which put a stop to that misuse of life insurance. In the nineteenth century, when life insurance in the United States was young, and policies contained no nonforfeiture values, there were instances in which a distressed policyholder would raise money by assigning a policy for a loan or selling it to a party having no insurable interest. When nonforfeiture provisions were incorporated in policy contracts and it was possible for a policyholder to surrender his policy to the insurance company or to borrow on it from the company, there was no longer any occasion for such a transfer. Furthermore, the collateral assignment has taken the place of the absolute assignment where policies are transferred to a third party as security for a loan. Transfers which could be regarded as speculative have been so rare in the past seventy-five years that even if Congress had thought of them in 1926 they could have been disregarded in the interest of fairness to the many thousands of transfers for legitimate and proper purposes. It seems reasonable to state that the speculative transfer would occur less than once in a million death claims today, and as a source of federal revenue it would be practically nil."

[21]See note 20 *supra.*

whether the owner or his transferor paid a valuable consideration for the policy, since such a rule would have equally unsatisfactory results. When an employer insures his employee and the employee subsequently leaves his employment, the employer may well find it desirable to keep the policy in force as a salvage operation. It seems unfair to tax the proceeds as long as income tax deduction is denied for premiums paid and the benefits of an income tax loss denied if the policy is sold or surrendered.[22]

It is submitted that this exception serves no useful purpose and is in many cases a trap for the unwary. The purchase of existing policies presents no greater tax-avoidance opportunities than the purchase of new policies, and therefore there is no basis for the different tax treatment.[23] As long as the exception remains law, however, all dealings with existing policies must be carefully scrutinized; the uninformed will continue to be trapped.[24] About all the rule does is to stimulate

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[22]See page 175 *infra.*

[23]Possible objections that such an exception would lead to purchase of insurance contracts as a gamble could be overcome by a simple requirement that the owner have an insurable interest at the time of acquisition.

[24]Samuel J. Foosaner, a leading commentator on life insurance and taxes, in discussing this exception before the Institute of Life Insurance Law, Southwestern Legal Foundation (1950, p. 92 of the Minutes), said:

> "Unstudied assignments of insurance policies under Section 22(b)(2) have wrought much havoc. With the two single exceptions of transfers made in tax-free organizations, and to the insured himself, the income tax danger is an ever lurking one.
>
> "The impact of Section 22(b)(2) has made itself felt in a number of leading cases. In the *Alcy Hacker* case, (36 B.T.A. 659) a blow-striking result occurred. Here, where the insured had assigned a policy to his wife upon her reimbursing him for premiums expended and thereafter paying future premiums, upon receipt of the proceeds by her daughter (a subsequent transferee), most of the insurance proceeds became subject to income taxation in the daughter's hands.
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> "In the *Premier Products* case, where $100,000 of insurance was carried on the life of the president, he assigned the policies for $8,400 (premiums previously paid). Thereafter the corporation paid approximately $21,000 in premiums. Upon the insured's death, the corporation sought the approximate $100,000 of proceeds on an income tax free basis, under Section 22(b)(1) of the Code. The Commissioner, on the other hand, not only sought to collect income taxes on the excess over the sums paid (namely, the $29,000), but because the corporation was in the excess profits tax bracket, chose to obtain excess profits taxes on such excess. Notwithstanding the fact that the corporation's counsel argued that these sums were abnormal income and, therefore, not subject to excess profits taxes, the Commissioner prevailed."

For a revision of this address, see Foosaner, *Life Insurance and Taxes*, 29

the purchase of new policies. The informed employer, partner, or creditor will apply for a new policy on the life of his employee, partner, or debtor. The uninformed will continue to suffer income tax consequences in situations so similar that they seem not to warrant different treatment.

By a Non-donee Beneficiary. Texts on this subject have tended, following the statutory treatment, to discuss the taxability of the proceeds under two headings: (1) when received by reason of death; (2) when received otherwise than by reason of death. It is then stated that the general rule is that the proceeds received by reason of death are exempt from taxation,[25] whereas amounts received otherwise than by reason of death, for example at maturity of an endowment policy or surrender or sale of a policy before maturity, are subject to taxation to the extent that what is received exceeds the owner's cost basis. But these statements can be misleading. Literal compliance with the statute will not always insure freedom from taxation. For this reason the subdivisions above have expressly limited the rules discussed to policy owners and donee-beneficiaries. There are a number of situations in which the proceeds, although paid by reason of death, will be subject to income tax because the payments are non-gift transactions and therefore not within the policy of the exclusion. For example, if A designates his executor as beneficiary of a $5,000 policy and provides in his will that this designation is in lieu of compensation as executor, the proceeds may be fully subject to income tax as compensation if services are required to be rendered in order to entitle him to payment.[26] Similarly, if the same testator were to designate his attorney as beneficiary of another $5,000 policy on condition that the attorney accept this in full payment of all legal services rendered to the decedent during his lifetime, the full proceeds would be taxable to the attorney. Installments paid to a surviving divorced wife under an alimony decree are taxable to her as income.[27] Whenever

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TEX. L. REV. 319, 328 (1951).

[25]Except when the contract was purchased for a valuable consideration. Also excepted are amounts received by a divorced spouse.

[26]*Cf.* Bank of New York v. Helvering, 132 F.2d 773 (2d Cir. 1943). See, however, United States v. Merriam, 263 U.S. 179 (1923). The proceeds are not taxable if the executor does not have to perform services but merely has to qualify as executor.

[27]Prior to 1942, alimony payments were received free of income tax. As a corollary the paying spouse was denied any income tax deduction. With the tremendous increase in rates in the late 'thirties and early 'forties cases arose in

the proceeds are used to satisfy an obligation of the owner of the policy, such amounts may be income to the recipient. In the *Golden* case[28] a corporation had purchased life insurance on its principal executive. It owned the policy and paid all the premiums. It designated its other stockholders as beneficiaries. On the death of the insured the proceeds were paid to the stockholders pursuant to the designation. Thus they received the proceeds by reason of death. The court held, however, that the proceeds constituted dividends and were taxable as such to the stockholders.[29] A corporation has no authority to give away its assets, and any distribution, however indirect, made to its stockholders is a dividend under Section 115 to the extent that the corporation has earnings or profits. The corporation was, therefore, treated as constructively receiving the proceeds

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which husbands were paying 40% of their incomes to their spouses and in excess of 60% of their incomes to the Federal Government. To correct this inequality Congress provided in INT. REV. CODE §§22(k) and 23(u) that, beginning with 1942, alimony payments made periodically by the husband to a divorced or legally separated wife shall be deductible by him and includible in her taxable income. The source of the payment is immaterial. Whether the husband discharges his obligation from income or capital or by way of life insurance, endowment, or annuity contracts makes no difference. At the same time that Secs. 22(k) and 23(u) were added, Sec. 171 was added, providing that trust income to which the divorced or separated wife is entitled shall not be included in her husband's gross income but shall be includible in hers. Further, there is a departure from the strict concept of alimony in that payments made after the death of the divorced husband pursuant to an obligation binding on his estate are included in the income of the wife, Fairbanks, P-H 1950 TC REP. DEC. ¶15.10 (1950). This decision is justified by the fact that the Code makes no reference to alimony as such but rather encompasses all payments made under a decree of divorce or legal separation in discharge of an obligation arising out of the marital relation. Thus, if the decree provides that the wife receive $200 per month for her life and the husband secures the payments that may fall due after his death with his life insurance contracts, the full amount of the proceeds received by the wife will constitute taxable income to her.

[28]Golden v. Commissioner, 113 F.2d 590 (3d Cir. 1940), 39 MICH. L. REV. 498 (1941).

[29]See BOWE, LIFE INSURANCE AND ESTATE TAX PLANNING 17 (1950): "Corporate assets of substantial worth have, as a result of corporate action, found their way into the hands of stockholders. The situation is the same as if the corporation were to direct one of its debtors to pay the debt to its stockholders. Here it directs the insurance company (its debtor) to pay the claim on maturity to three of its four stockholders. The individual income tax on this corporate distribution cannot be avoided by calling it a gift to the stockholders, and the fact that all stockholders are not treated precisely alike will not prevent the distribution (so long as there is a corporate surplus) from being a taxable dividend."

and then paying them out to the stockholders.

That rationale does not necessarily solve the lawyer and executor cases. *A* may give away his assets if he likes. The fact question to be decided is whether he made gifts or whether he paid for services, and in the case suggested above he clearly was not making a gift.

In *St. Louis Refrigerating Co. v. United States*[30] one Watson owed the company $25,000. In 1932 he executed notes as evidence of his indebtedness and assigned as security policies on his life having a face value of $25,000. At the time of the assignment there were loans against the policies amounting to $6,700. In 1933 the company charged off the debt as worthless. It thereafter continued to pay the annual premium and interest on the policy loan, and on Watson's death in 1941 it received the net proceeds — $18,300. The taxpayer argued that the proceeds were received by reason of the death of the insured and hence were within the statutory exclusion. The court, however, sustained the inclusion of the full amount of the proceeds in the company's taxable income as "recovery" income, saying:[31]

> "We think the insurance contract when it was transferred and pledged lost its character as insurance in the hands of the pledgee within the meaning of the statute. It became simply collateral security.
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> "It has been held that the term 'recovery' as applied to bad debts includes the proceeds of the sale of the debt as well as the proceeds from a collection of the debt. Here the recovery was on the collateral security and the incidental fact that the proceeds of this insurance policy would have been exempt to the beneficiary named does not mark it as exempt where it has become a matter of barter rather than a matter of insurance."

It is possible that the proceeds may be taxed twice. If, for example, in the *Golden* case the company had purchased the policy from the insured executive, any profit made by it, that is, the difference between the consideration paid to the executive plus premium payments made thereafter by the company and the face amount of the policy, would be taxable to it and the stockholder recipients would be taxed on the proceeds on the theory of an informal dividend.[32]

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[30]162 F.2d 394 (8th Cir. 1947).

[31]*Id.* at 398.

[32]BOWE, LIFE INSURANCE AND ESTATE TAX PLANNING 16-18 (1950).

PROCEEDS RECEIVED OTHERWISE THAN BY REASON OF DEATH

By a Policy Owner. Section 22(b)(2)(A) provides that amounts received under a life insurance or endowment contract otherwise than by reason of death shall be subject to income tax to the extent that such amounts exceed the aggregate premiums or consideration paid.[33] Amounts may be received, otherwise than by reason of death, upon maturity, sale, exchange, or surrender of a contract. Assume, for example, that *A*, upon his thirtieth birthday, purchase a 20-year endowment policy in the amount of $10,000. Should he die prior to the maturity of the policy, $10,000 will be paid to his beneficiary. If the policy becomes payable by reason of his death, the proceeds will be fully exempt under the exclusionary provisions of Section 22(b)(1). On the other hand, if the policy matures while the insured lives, the gain on the transaction will be taxable under Section 22(b)(2)(A). This gain is ordinarily the difference between the net premiums paid and the face amount of the policy.[34] The "dividends" distributed to policyholders are treated as adjustments of cost rather than distributions of earnings.[35] This is true whether the dividends are used in reduction of premiums or received in cash.

Lump Sum Payments. If *A* in the case suggested had paid premiums of $9,000 prior to the twentieth anniversary of the policy but had received dividends of $500 during the same period, the aggregate net premiums would total $8,500, and his profit upon maturity, if he were entitled to a lump sum payment, would be $1,500. This amount would be taxable as ordinary income, not as capital gain.[36] The favorable capital-gain treatment is available only when the profit results from the sale or exchange of a capital asset. Settlement at maturity does not constitute a sale or exchange. It may be advisable

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[33]See note 4 *supra.*

[34]If the policy was acquired prior to March 1, 1913, the basis, if there is a gain, is the March 1, 1913, value, or the cost or other basis, whichever is higher, INT. REV. CODE §113(a)(14). The basis of a paid-up life insurance policy at March 1, 1913, was held by the Supreme Court to be the amount of its reserve liability at that date and dividend accumulations apportioned to the policy up to that date on the books of the insurance company, Lucas v. Alexander, 279 U.S. 573 (1929). In the case of a policy not paid up on March 1, 1913, there should be added to the value so determined the premiums paid, less any distributions received, subsequent to that date.

[35]U.S. Treas. Reg. 111, §29.22(a)-12, 26 C.F.R. §29.22(a)-12 (1949).

[36]Avery v. Commissioner, 111 F.2d 19 (9th Cir. 1940).

to sell such a policy before maturity[37] or to select before maturity one of the standard options discussed below.

Principal Sum Left at Interest. Endowment policies usually provide for payment of the face amount to the insured or his designated beneficiary on the maturity date unless the insured has prior to that date elected one of the optional settlements. The usual options are: (1) leaving the principal with the insurer at interest; (2) receiving annual installments over the period of the insured's life, generally with a fixed number of installments guaranteed; or (3) receiving annual installments for a specified number of years. If *A*, on or after the maturity date, should elect to leave the principal at interest, he would nevertheless be taxed on the gain, since he would be treated as having constructively received the proceeds and then having redeposited them with the insurer.[38] Interest payments received in succeeding years would be subject to tax, just as is interest on any other deposit. The same result would follow even if he should elect before maturity to receive only interest payments, provided he retained the right to withdraw the principal at any time. It is only when he irrevocably chooses the interest option before maturity, with no retained power to withdraw the principal, that he will avoid or at least delay tax on the gain. If under the terms of the option so elected he will at some future date have the power to withdraw principal, the gain will be taxable to him when that date arrives, since that will be the first time he can be said to have constructively received the proceeds.

The rules discussed above are applicable in the usual case in which a lump sum is payable unless one of the other options is elected before maturity. But if the contract gives him the right to elect the option desired on or after maturity, it is believed that he will not be taxed on the unrealized profit in the event he elects, within the time al-

[37]There must be a genuine sale; *cf.* Commissioner v. Court Holding Co., 324 U.S. 331 (1945). *But cf.* United States v. Cumberland Public Service Co., 338 U.S. 451 (1950).

[38]The doctrine of constructive receipt attributes to a taxpayer any income that is unqualifiedly available to him, that is, his for the asking. Thus uncollected interest on savings accounts, uncut bond coupons, and uncalled-for salary checks, are all taxable in the year the items first become collectible. In the words of Mr. Justice Holmes, "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not," Corliss v. Bowers, 281 U.S. 376, 378 (1930).

lowed, to leave the money at interest, since, although the profit is available to him, other choices are equally available. His right to the proceeds is not unconditional but involves the surrender of other valuable rights. There are no decided cases on this point, but what authority there is justifies this conclusion.[39] The reasons for the view expressed and the authorities inferentially sustaining it will be found in the following discussion of installment payments, where a similar situation is treated in some detail.

Installment Payments. If *A* in the case suggested had elected prior to maturity to receive the proceeds in installments, the tax treatment of the amounts received would depend on whether the installments were to continue for the period of his life or were to be paid for a fixed number of years.[40] If the installments are based on the insured's life expectancy, the payments received are taxed as annuities under the 3% rule, that is, the portion of each payment equal to 3% of the cost of the contract will be taxed as income; the excess will be treated as return of capital.[41] Only after the exempted portion equals his cost will the full amount of each yearly payment be taxed. Assume that prior to maturity *A* had elected to have the proceeds paid as a life annuity of $536.40 (20-year period certain).

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[39]*Cf.* Blum v. Higgins, 150 F.2d 471 (2d Cir. 1945).

[40]See 1 MERTENS, LAW OF FEDERAL INCOME TAXATION §6.32 (Supp. 1950): "In view of the amendment of Reg. 111, Sec. 29.22(b)(2)-2, made on February 13, 1949, by TD 5684, CB 1949-1, p. 50, the Department reconsidered the various rulings holding that periodical installments received under endowment contracts, or so-called annuity contracts, for a fixed term of years are amounts received as annuities. Under the Regulations prior to the amendment, the term 'annuities' included amounts received in periodical installments, whether annually, semi-annually, quarterly, monthly, or otherwise, and whether for a fixed period, such as a term of years, or for an indefinite period, such as for life, or for life and a guaranteed fixed period, which installments were payable over a period longer than one year. The amendment now provides that periodical installments received for a fixed period of time under endowment contracts, so-called annuity contracts, or supplemental agreements for optional settlement of the surrender or maturity value of life insurance contracts payable otherwise than upon death of the insured are not annuities because the amounts so received are not based on a computation with reference to life expectancy and mortality tables. Such amounts are not subject to the 3% rule applicable to annuities, but are excluded from gross income until the amounts received during the taxable year, when added to the amounts received in earlier years, exceed the aggregate premiums or consideration paid for the contracts. GCM 26595, 1950 IRB-21, p. 5, revoking GCM 21666, CB 1940-1, p. 116 and GCM 22519, CB 1941-1, p. 330."

[41]INT. REV. CODE §22(b)(2).

It will be remembered that his cost was $8,500. There is no tax on maturity, since the proceeds are not available to him. Each year $255 (3% of $8,500) will be subject to tax; the remaining $281.40 is exempt. More than 30 years will elapse before the exempted portions of the yearly payments equal his cost. Any further installments after that time will be fully taxable.

On the other hand, if the installments are to be paid over a specified number of years or in specified amounts until the proceeds are exhausted, no part of any installment is taxed until the total of all installments received exceeds the cost.[42] If *A* had elected, instead of an annuity, annual installments of $632 for 20 years, it would take him slightly more than 13 years to get back his cost. No portion of the $632 yearly payments would be taxed during this period. The entire $632 would be taxable each year thereafter.

The rules discussed immediately above are based on the assumption that the election was made before maturity. If the election is made at or after maturity, then under the doctrine of constructive receipt *A* will be taxed on $1,500 gain. He will be regarded as having received the proceeds of $10,000 and then having used them to purchase either an annuity or fixed period settlement. In these latter cases, therefore, his cost basis for the application of the 3% rule if he elected a life annuity or for the determination of the number of tax-free payments he may receive under a fixed-period settlement will be $10,000, not $8,500. Whether he elects before or after maturity his gain is subject to tax, but election before maturity will spread it over the years and may result in material tax savings because of our system of progressive rates.

There may be cases in which this preferential tax treatment will be available even though the option is exercised at or after maturity. As previously indicated, if there is a contract right to elect the settlement desired after maturity it is doubtful whether the doctrine of constructive receipt is properly applicable. In this situation *A* does not have an unqualified right to the proceeds. He has a choice between one of several privileges, and the reasoning of the *Pierce* case[43] seems to be equally applicable here.

In *Blum v. Higgins*[44] the taxpayer purchased two 15-year endowment policies. On maturity he was to receive $150,000 unless prior to that time he elected to leave the principal amount with the company

[42]See note 40 *supra.*

[43]See page 160 *supra.*

[44]150 F.2d 471 (2d Cir. 1945).

under one of the standard options. A few days before maturity he elected the interest option but retained the privilege of withdrawing the principal at any time. He argued that he was not in constructive receipt of the proceeds in the year of maturity because he would have had to surrender valuable rights to get the cash. These valuable rights consisted in an established practice of the company to permit an insured to change from one option to another even after an election of options had been made and put into effect. But the court, in language that is pertinent to the problems under discussion, held, apparently because there was no contractual right to elect after maturity, that the doctrine of constructive receipt applied:[45]

> "True, the insurance company did maintain the practice of permitting an insured who had elected one option to change to another. And if the policy had given such a right, we should probably say that the insured had not constructively received the proceeds of the policy, for this right to change the options B and C would have presented a valuable legal privilege which would have to be surrendered if cash were chosen instead of Option A. But that possibility of conversion from one option to another is not part of the insurance contract; it is not even a revocable offer on the part of the company. At any time, even after the insured had requested a change from one settlement form to another, the insurance company could refuse to permit the change. It would seem therefore that the taxpayer would be called upon to surrender no legal right or privilege in order to take cash instead of Option A."

If the contract had given the insured the option to elect after maturity it would seem to follow that the cash proceeds are not unqualifiedly available to him, since to get them he must surrender other valuable rights. In short, he has no right to the cash but rather a choice between the cash and one of the other settlements.

Gift of Policy. Whenever the insured irrevocably assigns his rights in the policy to another before maturity without receiving any consideration therefor, he has made a gift of the contract and the usual gift rules apply. When a donor transfers stock by way of gift, all future dividends and other distributions are taxable to his donee. Similarly, payments under a transferred policy are taxable to the

[45] *Id.* at 473.

donee. As in the case of gifts of other property, the donee of a policy takes his donor's cost basis for purposes of computing gain.[46] Should the donee pay premiums, his cost basis will be adjusted to reflect these. Should the donor continue to pay the premiums, the amount of each premium payment so made will constitute a further gift. The cost in either event at maturity will be the aggregate net premiums paid by both donor and donee.

If the policy matures by reason of death, the proceeds will be exempt from income tax.[47] If it matures otherwise than by reason of death, the tax consequences to the donee will be the same as they would have been to the donor. If he receives the proceeds or if they are unqualifiedly available to him at maturity, he will be immediately taxed on the gain from the entire transaction. If before maturity an irrevocable election of one of the options has been made, the method of payment will determine the tax treatment. The same may be true even if the election is made after maturity pursuant to a right given in the contract. An overall family income tax saving may result from a gift of an endowment policy before maturity to several donees within the family group if the donees are in lower tax brackets than the donor. But the estate tax consequences of such a gift if the donor should die before maturity of the policy must be considered.[48]

Surrender of the Policy. It is possible that there may be a gain on the surrender of an endowment policy for its cash surrender value.[49] When the policy is surrendered for a cash value exceeding the net premiums paid, the difference is taxable as ordinary income rather than as a capital gain, since no sale or exchange is involved.[50] It may be profitable taxwise either to sell the policy to another who can then surrender with only nominal gain[51] or to delay the realization of any gain until a later year when the taxpayer has offsetting losses,

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[46]INT. REV. CODE §113(a)(2).

[47]See page 159 *supra.*

[48]BOWE, TAX PLANNING FOR ESTATES 50 (1949).

[49]Assume a $10,000 20-year endowment contract issued at age 35, with annual net premiums of $419.70 based on American Experience Table at 3%. If the insured pays the premiums for 19 years the policy will have cost him $7,974.30 and its cash surrender value will be $9,289.10. Thus there would be a taxable gain of $657.40 (50% of $1,314.80) on surrender of the policy, or, on the alternative method, a gain of $1,314.80 taxable at the rate of 25%.

[50]Perkins v. Commissioner, 41 B.T.A. 1225 (1940).

[51]But see note 34 *supra.*

meanwhile borrowing on the policy, if necessary, to take care of his present needs.

Sale of the Policy. Any gain on the sale of a policy will receive the benefit of capital-gain treatment. Assuming that the seller has owned the policy for more than six months, only fifty percent of the actual gain will be subjected to tax. Further, the maximum tax under the alternative method of computing capital-gains tax cannot exceed twenty-five percent of the actual profit realized on the sale.[52]

Loss on Sale or Surrender of Policy. No loss is recognized for tax purposes on the sale or surrender of a policy.[53] This result is justified on the theory that the taxpayer has had the benefit of the protection over the years. This seems basically sound except perhaps in the case of a taxpayer who purchased an existing policy for a valuable consideration. Here the policy is treated as an investment, and because the purchaser will be taxed on a portion of the proceeds even though payable by reason of death, his loss should logically be allowed.

Life insurance is a bundle of complicated mathematics. It combines investment with insurance protection. The investment portion is represented by the cash surrender value.[54] If the portion of the

[52]INT. REV. CODE §117.

[53]London Shoe Co. v. Commissioner, 80 F.2d 230 (2d Cir. 1935); Standard Brewing Co., 6 B.T.A. 980 (1927).

[54]This was pointed out in London Shoe Co. v. Commissioner, 80 F.2d 230, 231 (2d Cir. 1935), in which the loss claimed, *i.e.*, the difference between the cash surrender value and the net premiums paid, was denied: "In the earlier years of a policy, the annual life premium is in excess of the amount required to pay the current cost of insurance protection and such excess is retained by the insurance company as a reserve and increased at compound interest at an agreed rate for the purpose of making good the deficiency in later years when the annual premium is no longer sufficient to pay for the actual cost of insurance. The fund accumulated out of the excess premiums is known as the 'reserve' on the policy and represents the investment portion of the premium payments held for the benefit of the policyholder. In case the policy is surrendered or allowed to lapse, the holder may receive the reserve held for his benefit known as the 'cash surrender value,' which represents the equity of the insured in the policy above the amounts paid for protection. The nature of a 'surrender value' was described by the Florida District Court in Re Morgan, 282 F. 650, substantially as above. In order to determine whether there was any loss in the present case, the taxpayer would have to show what portion of the premiums was attributable to investments and whether the cash surrender value was less than such portion. It may be assumed, in the absence of any proof to the contrary, that the cash surrender corresponds with the amount of the reserve; that is to say, with the excess of premiums over what was required for protection."

premium paid for protection is to receive tax recognition, it would seem properly to be obtainable through the allowance of a yearly deduction from the taxpayer's gross income. But there are countervailing considerations which caused Congress to deny any deductions for premiums paid.[55]

By a Donee Beneficiary. The discussion pertaining to the receipt of the proceeds during the insured's life has heretofore assumed payment to the owner of the policy. In many cases the owner of the policy will designate another to receive the proceeds on maturity, retaining all of the incidents of ownership, including power to change the beneficiary. When payment is made under these circumstances in a lump sum, the proceeds will be taxed to the owner rather than the recipient.[56] The situation here is identical with the typical revocable trust, and since the owner has "unfettered control" over the proceeds up to the very moment of payment he must bear the tax burden. When, however, the owner irrevocably designates the beneficiary before maturity, there would seem to be no opportunity for the application of the constructive-receipt doctrine. The same is true when the proceeds are paid under the interest-income or one of the installment options, since the owner cannot change the beneficiary.

By a Non-donee Beneficiary. It seems worth noting, as was done

[55]In most cases premiums fall within the category of personal living expenses, deduction for which is denied under INT. REV. CODE §24(a); see U.S. Treas. Reg. 111, §29.24-1, 26 C.F.R. §29.24-1 (1949). Even when premium payments would constitute business expenses, Congress has disallowed deduction on the theory that since the proceeds are normally exempt from income tax the cost of obtaining this exempt income should not be deductible. INT. REV. CODE §24(a)(4) forbids deduction of "premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy . . . ." Deduction may be permitted provided the payor has no interest in the policy. Premiums paid on group life insurance are deductible, G.C.M. 16069, XV-1 CUM. BULL. 84 (1936). Premiums paid on policies owned by employees may be deductible as additional compensation if the "reasonable compensation" requirement of INT. REV. CODE §23(a) is satisfied, Brown Agency, Inc. v. Commissioner, 21 B.T.A. 1111 (1931). Premiums paid on policies irrevocably assigned to a charity may be deducted within the limitations of INT. REV. CODE §§23(o) or 23(q). For a case in which deductions were allowed as a business expense see First Nat. Bank v. Jones, 53 F. Supp. 842 (W.D. Okla. 1943).

[56]In addition to incurring income tax on the gain, the owner will become liable for a gift tax; see note 15 *supra*. The rule of the *Goodman* case is equally applicable if an event other than death matures the policy.

in the discussion of proceeds payable by reason of death, that whenever the owner directs that the payments be made to another in discharge of an obligation the full amount of each payment is taxable to the owner. There is no room here for the application of either the 3% rule or the rule relating to fixed-period settlements, since the payments lose their character of annuity payments. Thus, if under an annuity option in an endowment contract installments are paid to a divorced wife pursuant to a court decree, the full amount of each payment will be taxable to her.[57] Similarly, if an insured under an endowment contract is indebted to *X* for services rendered and to secure payment designates *X* as beneficiary of his policy, *X* on receipt of the proceeds may be taxed on the full amount as compensation income. In each of these cases the insured, because the proceeds are used to discharge his obligation, would be treated as having constructively received them and therefore would be taxed on the profit.[58] The situation is exactly as though the insured had himself received the proceeds and then turned them over to his creditor in satisfaction of the claim.

Conclusion

Life insurance proceeds, even when paid by reason of death, are not necessarily excluded from taxable income. Whenever the policy becomes the object of barter the proceeds lose their exempt character. Similarly, if the payment of the proceeds is in discharge of a legal obligation of the policy owner, the proceeds will be taxed in full to the recipient. All profits made on the contract, if realized during the insured's life, will be subjected to income tax. Unless the policy is sold or exchanged the profit is taxed as ordinary income and not as capital gain. While a sale of the policy for an amount in excess of its cost will result in capital gain, a loss, if any, will not be recognized.

To the extent that the proceeds are subject to tax, the tax is imposed, on the theory of constructive receipt, on the owner of the policy on the date or dates the payments become due, even though actual payment pursuant to his designation is made to another. This may result in taxation of the proceeds partly to the owner and fully to the actual recipient whenever the owner directs the insurer to pay the proceeds on maturity to another in settlement of a legal obligation.

[57]U.S. Treas. Reg. 111, §29.22(b)(2)-4, 26 C.F.R. §29.22(b)(2)-4 (1949).
[58]*Cf.* Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).