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THE LIFE INSURANCE AND ANNUITY COMBINATION POLICY

In 1941 when the Supreme Court decided *Helvering v. LeGierse*[1] the taxation of the life insurance and annuity combination policy was thought to be settled in the Government's favor. However, after *Fidelity-Philadelphia Trust Co. v. Smith*[2] the road again appeared open to obtain substantial tax savings by using the life insurance and annuity combination policy. In an effort to clarify the Government's position in the area, Revenue Rulings 65-57 and 65-69[3] were issued last year. These rulings invite an examination of the life insurance and annuity combination policy.

In *Helvering v. LeGierse*[4] the decedent, at the age of eighty, entered into two contracts with an insurance company less than one month before her death. The first of these was an annuity contract which provided for the payment of $589.80 annually for life to the decedent at a cost of $4,179. The second contract was a single premium life insurance policy with a premium of $22,946 which provided for the payment of $25,000 upon her death. Decedent retained both policies until her death. Decedent was not required to pass a physical examination.[5] It was found that the insurance contract would not have been issued without the annuity contract.[6] Considering both contracts together, it is clear that the insurance company would merely be paying interest on the single premium payment in the form of an annuity and, upon the death of the insured, would pay the principal to the named beneficiary.[7] The Court held that, considering both contracts together, there was lacking the element of "risk" commonly and historically involved in insurance. In defining amounts receivable as insurance, the Court held that "the amounts must be received as the result of a transaction which involved an actual 'insurance risk' at

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1. 312 U.S. 531 (1941).
2. 356 U.S. 274 (1958).
3. 1965-1 CUM. BULL. 56 and 440.
4. 312 U.S. 531 (1941).
5. The Board of Tax Appeals found that although no physical examination was required, she was "in good health for one of her years and had a life expectancy of between four and five years." 39 B.T.A. 1134, 1140 (1939).
6. The reason that the insurance would not have been issued without the annuity was because decedent's advanced age involved a much more difficult task of underwriting. In this case the rate charged was one which was actuarially based on the rates charged people of other ages and not based on the premium that would normally have been charged a person of her age. 39 B.T.A. 1134, 1138-39 (1939). However, it is significant that the insurer did not ordinarily issue single premium ordinary life insurance to persons over 70 years of age without a physical examination.
7. See Commissioner v. Keller, 113 F.2d 833 (3d Cir. 1940), *aff'd*, 312 U.S. 543 (1940) for a step-by-step analysis of this contention.

the time the transaction was executed."[8] Thus, this was not life insurance and the $25,000 proceeds were includible in decedent's gross estate "as a transfer to take effect in possession or enjoyment at or after death."[9] The Court made no mention of income tax consequences for there probably were none, either because the proceeds were excludible as a gift, bequest, or devise,[10] or possibly as proceeds of life insurance.[11] This suggested that the definition of life insurance for income tax purposes is different than for estate tax purposes.

In *Fidelity-Philadelphia Trust Co. v. Smith*,[12] the Supreme Court was faced with a similar annuity-insurance combination, with one significant difference: the decedent insured had irrevocably assigned the insurance policies to the beneficiaries more than three years prior to her death and had paid a gift tax on the transfer.[13] Both parties agreed that the inclusion of the proceeds in gross estate was not determined by the life insurance provisions.[14] The Commissioner sought to include the proceeds in the estate as a transfer with a retained life estate, *i.e.*, the annuity.[15] The Court, in finding the proceeds non-includible in gross estate, stated: "The use and enjoyment of the annuity policies were entirely independent of the life insurance policies. Because of this independence, the Commissioner may not by aggregating the two types of policies into one investment, conclude that by receiving the annuities, the decedent had retained income from the life insurance contracts."[16]

Fidelity-Philadelphia raised no income tax issues,[17] but the Court did refer, with apparent approval, to several lower court cases which had subjected the annuity portion of the combination to income tax but only on the portion of the aggregate premium which had been allocated to the annuity.[18] The Commissioner has recently ruled that in the future the proceeds of the "insurance" policy in such a combination will

8. 312 U.S. 531, 539 (1941).
9. 312 U.S. 531, 542 (1941), citing the Revenue Act of 1926, ch. 27, § 302(c), 44 Stat. 70, then the Int. Rev. Code of 1939 (now INT. REV. CODE OF 1954, §§ 2035, 2036, 2037).
10. Int. Rev. Code of 1939, § 22(b)(3) (now INT. REV. CODE OF 1954, § 102).
11. Int. Rev. Code of 1939, § 22(b)(1) (now INT. REV. CODE OF 1954, § 101).
12. 356 U.S. 274 (1958).
13. The possibility of inclusion under § 811(1) of the Int. Rev. Code of 1939 as a gift in contemplation of death was thus avoided.
14. 356 U.S. 274, 277 (1958).
15. Int. Rev. Code of 1939, § 811(c)(1)(B).
16. 356 U.S. 274, 281 (1958). The Court apparently was impressed by the fact that receipt of the annuities was not conditioned upon the continued existence of the life insurance policies, and that the life insurance policies could be surrendered. *Id.* at 280.
17. No mention was made in the text of the opinion of any income tax consequences.
18. 356 U.S. 274, 281 n. 9 (1958), citing Commissioner v. Meyer, 139 F.2d 256 (6th Cir. 1943); Helvering v. Meredith, 140 F.2d 973 (8th Cir. 1944); John Koehrer, 4 T.C.M. 219 (1945).

not be excluded from gross income as life insurance but will be subject to *income tax* to the extent they exceed the net premium paid for that contract.[19] This excess will not be subject to capital gain treatment.[20]

Unfortunately the income, gift, and estate tax consequences in this area are not quite as clear as one might be led to believe. The Commissioner has stated that *LeGierse* was not overruled by *Fidelity-Philadelphia,* but rather is distinguishable from it.[21] The Commissioner attempts to reconcile the decisions by explaining that in *LeGierse* the concept of "insurance" was held to require an actual insurance risk *"at the time the transaction was executed,"* whereas *Fidelity-Philadelphia* only decided that the contracts, *once issued,* were so separable that one could be disposed of independently of the other. The Commissioner then concludes that *Fidelity-Philadelphia* is consistent with the view that, even after issue, the contract lacked the element of risk inherent in insurance and thus was not insurance. This distinction is justified by the fact that both parties in *Fidelity-Philadelphia* conceded that there was no insurance and therefore the requirement in *LeGierse* that there be an insurance element at the time the transaction is executed, regardless of subsequent assignment, remains viable. The petitioner in *Fidelity-Philadelphia* had no reason to argue the point. Because of the assignment of the insurance policy, whether or not it was "insurance" would have no effect on its inclusion in gross estate. It would appear under this reasoning that *Fidelity-Philadelphia* is of no real aid in determining whether an insurance-annuity combination contains an insurance element.

However, in considering the policies separable and individual items of property in *Fidelity-Philadelphia* the Court may have impliedly, and perhaps unintentionally, determined the life insurance argument. If the policies are to be considered separately for section 2036 purposes, it seems reasonable to consider separately the risks borne by each party on each policy. If this separability was intended by the Court to apply in all insurance-annuity combination situations, and not only where the issue raised was whether this was a transfer with a retained life estate, the insurance policy would then necessarily be considered in relation to its

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19. Rev. Rul. 65-57, 1965-1 CUM. BULL. 56. In the fact situation on which this ruling was based, the "insurance policy" had been assigned to the beneficiary by gift.

20. Bodine v. Commissioner, 103 F.2d 982 (3d Cir. 1939), *cert. denied,* 308 U.S. 576 (1939). This case involved a combination life annuity and life insurance policy which was surrendered prior to maturity. There was found to be no sale or exchange and this would hold true even if the policy were held to maturity. *But see* J. J. Rheingold, 10 P-H B.T.A. Mem. 41, 319 (1941), in which capital gain treatment was allowed, but in which there was a clear sale of the policy by the beneficiary to a third person and a sale back to the beneficiary's conservators.

21. Rev. Rul. 65-57, 1965-1 CUM. BULL. 56, 58.

proportionate share of the total premium. The Court held that the annuity policy could be viewed as independent of and not contingent upon the existence of the life insurance policy. If the premiums on the policies may be considered separable, from the perspective of estate tax treatment, at least in the assigned insurance policy situation, the policies must be considered separable, and, as such, there is an insurance risk as defined in *LeGierse*.

Another argument for the proposition that there is a life insurance element in an insurance-annuity combination is based upon the Court's reference in *Fidelity-Philadelphia*,[22] with apparent approval, to the income tax treatment of such combinations in *Commissioner v. Meyer*,[23] *Edna E. Meredith*,[24] and *John Koehrer*.[25] In these cases the aggregate premium was apportioned for income tax purposes between the two policies. Therefore, a portion of the aggregate premium could be attributed to the life insurance policy. This is inferentially conceded by the Commissioner in Revenue Ruling 65-57,[26] which refers to the excess of the proceeds over the "net premiums paid for the contract." Again, there would be an element of risk because the "net premium paid for the contract" is less than the death benefit. This can only be termed as a method of risk-shifting or risk-distributing and that policy must, therefore, be considered life insurance as defined by the Supreme Court.[27] Thus, when viewed from the perspective of income tax treatment of an insurance-annuity combination, the policies can be considered separately and the risk element inherent in all insurance contracts under the *LeGierse* formulation is present in the insurance portion of the combination.

However, if *Fidelity-Philadelphia* is read narrowly, the *LeGierse* formulation retains vitality and there is still no insurance element in the combination. The narrow reading relies upon the fact that although the annuity policy is independent of the insurance policy, the insurance policy is *dependent* upon the annuity. This is true because the annuity policy cannot be surrendered without also surrendering the insurance policy. This is the interpretation given the decision by the Commissioner in issuing Revenue Ruling 65-57. The Commissioner contends that the Court's decision should not be taken to mean that the policies are never to be considered inseparable. Because the annuity policy could not have been surrendered without also surrendering the "insurance" policy, the

22. 356 U.S. 274, 281 n. 9 (1958).
23. 139 F.2d 256 (6th Cir. 1943).
24. 1 T.C.M. 846, *aff'd*, Helvering v. Meredith, 140 F.2d 973 (8th Cir. 1944).
25. 4 T.C.M. 219 (1945).
26. 1965-1 Cum. Bull. 56.
27. See Helvering v. LeGierse, 312 U.S. 531 (1941).

policies were inseparable in that sense and the Court could have considered them as such, but did not. The decision itself settles the question of separability when the issue is retained life estate and it is submitted that the combination should retain the same character even if the issue is life insurance, as in *LeGierse.* This conclusion would be reinforced by the actual issuance, or the possibility of issuance, of the policies in different names, *i.e.,* direct issuance of the insurance portion to the beneficiary rather than by subsequent assignment. The Commissioner's explanation based on the "once issued" distinction in Revenue Ruling 65-57 is inadequate and his "no insurance" argument would fall because, under the Commissioner's reasoning, there is nothing on which to join the contracts "at issue," or "at the time the transaction was executed." On the other hand, the economic realities have not changed at all. The "insurance" policy is still dependent upon the annuity contract.

The entire argument could be rendered moot if the insurance-annuity combination is attacked under section 2039. Both *LeGierse* and *Fidelity-Philadelphia* were decided prior to the 1954 Code when there was no provision analogous to section 2039. Section 2039 includes in the gross estate the value of any payment receivable by a beneficiary by reason of surviving the decedent under any contract except a life insurance contract, under which a payment was payable to the decedent for his life or for a period not ascertainable without reference to his death. The insurance-annuity combination apparently fits this description except that *Fidelity-Philadelphia* held that the Commissioner could not aggregate the two contracts into one, and section 2039 ostensibly refers to a single contract. This section would govern the combination policy in a *LeGierse* situation where, without subsequent transfer of the "insurance" contract, the policies are not considered separable. However, the separability issue would still have to be faced in a *Fidelity-Philadelphia* situation. More important, there is the possibility that even though the contracts have been separated by the transfer to the insurance policy, as in *Fidelity-Philadelphia,* an overriding contract or agreement which encompassed both contracts might be found to exist which would fall within the contract or agreement required by section 2039.[28] In that case, the Court might find that this was neither an annuity nor a life insurance policy, but rather an interest contract[29] which could be includible in gross estate

28. See Treas. Regs. § 20.2039-1(b)(1)(ii) defining "contract or agreement." In the case of contracts set up by an employer, the regulations specifically refer to "any combination of arrangements, understandings or plans." *Ibid.* See also example (6) at Treas. Regs. § 20.2039-1(b)(2).

29. An interest contract as opposed to an annuity does not return to the purchaser any amount of the original investment in addition to the interest earned. Commissioner v. Meyer, 139 F.2d 256 (6th Cir. 1943).

as an "other payment" under section 2039. The whole payment would have to be considered in these circumstances as a gift.[30] As such, there would be no income tax consequences to the beneficiary.[31] Despite economic realities, this line of argument is probably too strained to gain acceptance.

PRESENT INCOME TAXATION OF THE ANNUITY-INSURANCE COMBINATION

Prior to Revenue Ruling 65-57,[32] the annuity-insurance combination provided an outstanding device for tax savings. Not only did the taxpayer secure the tax advantages of an ordinary purchase of an annuity, but he could also transfer by gift the insurance portion of the combination and thus favor the objects of his bounty without incurring estate tax on the transfer under *Fidelity-Philadelphia.*[33] The Commissioner has ruled, however, that, in the future, the appreciation in value of the insurance policy over the cost of the policy will be subject to income taxation.[34] Gift tax would be incurred on the transfer of the "insurance" policy, but the Commissioner has publicly accepted *Fidelity-Philadelphia* on the issues actually litigated there and ruled that the proceeds will not be included in gross estate as a transfer with a retained life estate.[35]

Tax savings for fairly large estates entering into a *Fidelity-Philadelphia* situation where the beneficiary's income tax rate is also high is not surprising.[36] However, the tax saving still holds true for estates

30. If the contracts were joinable for the purpose of INT. REV. CODE OF 1954, § 2039 and the value of the payment determined at the time of death of the decedent, surely the Court would have to overlook any "vested" interest in the policy prior to death, at least for purposes of measuring the amount of gift.

31. INT. REV. CODE OF 1954, § 102(a).

32. 1965-1 CUM. BULL. 56.

33. Even though there is a possibility that the gift would be included in his gross estate by virtue of INT. REV. CODE OF 1954, § 2035 as a gift in contemplation of death, in no event will he be worse off because of the estate tax credit for gift tax paid unless the limitations are exceeded. INT. REV. CODE OF 1954, § 2012.

34. Rev. Rul. 65-57, 1965-1 CUM. BULL. 56.

35. Rev. Rul. 65-69, 1965-1 CUM. BULL. 440.

36. As an example, assume a $1,000,000 taxable estate including the insurance for a 65 year old widower, an only son filing a joint return with other taxable income of $44,000 (50% bracket) and a combination policy with a face amount of $100,000. The premium on the insurance would be $75,400. If the insurance policy is given to the son and the proceeds are only subjected to estate tax, the total tax would be as follows, assuming all gift exemptions have been previously used and there have been no previous taxable gifts. The gift tax would be $10,359 as a taxable gift of $75,400 would be made since this is the amount the insurance company would charge for a single premium contract of $100,000 on the life of a person of the age of the father. The net additional tax because of inclusion in the estate would be $26,641 ($100,000 at 37% less gift tax credit of $10,359). The son would receive $73,359 at a cost to his father of $85,759. If the insurance proceeds were only subjected to income tax on the son and not to estate tax, the total tax, assuming all gift exemptions have been previously used, would be as follows. The gift tax would again be $10,359. There would be no estate tax, but the son

of more modest valuations.[37] The reason for this is that the effective tax rate on the proceeds when included in the estate is the highest tax rate for that size estate and the rate is on the whole face amount of the insurance. On the other hand, if the insurance is not included in the estate and only gift and income taxes are levied, the tax impact is normally less because the gift tax is at the rate assessed for the amount of the gift and not the whole estate and the income tax, although at a high percentage, is levied only on the appreciation in value of the policy.[38]

Revenue Ruling 65-57 necessarily assumes that the premium paid for the insurance-annuity combination will be apportioned to determine the gain for income tax purposes. This apportionment is the greatest single variant in the computation of the tax savings obtained through a combination purchase. As the premium apportioned to the insurance policy decreases, the amount of the death benefit which is subject to income tax increases, and vice versa. Thus, the older the insured when the policies are issued, the greater the income tax savings which will be effected under the present ruling.[39]

In conclusion, annuities and life insurance policies can be useful and economical tools in tax planning. However, as with all valuable tools, their usefulness is entirely dependent upon their use in a proper manner by a skillful person. If incorrectly used, the result is likely to be less than desirable.

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would pay income tax on $24,600 ($100,000 policy less premium of $75,400). His taxable income would become $68,600 subjecting him to a tax of $26,950, or $12,890 more because of the inclusion in his taxable income of the insurance amount. Under these circumstances the son receives $87,110 at a cost to his father of $85,759, so that there is a net gain here of $13,751 ($87,110 — $73,359) over the other method. Although the estate tax is only 37% and the income tax rate is 50-55%, the estate tax rate is on the whole amount of the proceeds whereas the income tax rate is on only the excess of the proceeds over the premium.

37. In the event that the taxable estate was of the more modest amount of $250,000 including the insurance, the son in this situation would still receive considerably more by paying income tax on the excess instead of including it in his father's estate. If included in the estate the son would receive $70,000 at a cost to his father of $85,759, whereas if it was only subjected to income tax he would receive again $87,110.

38. In the example above the estate tax is 37% of $100,000, but the gift tax is at various rates with the maximum being 21% on $75,400 and the income tax rate of 50-55% being on only $24,600. Notice too that when the taxable estate was decreased to a quarter of its size, the amount which the son received through including the insurance in the estate increased by only $7,000.

39. In *LeGierse* the insured was 80 and the apportioned premium was roughly 92% of the face amount of the policy, thus income tax would have been levied only on 8% of the face amount.