

# PLANNING RESPECTING LIFE INSURANCE ENDOWMENT AND ANNUITY CONTRACTS

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If Earl Beaver were to die tomorrow, his beneficiaries would receive \$100,000 as life insurance proceeds. These insurance proceeds would be exempt from income tax, but would be included in his gross estate for estate tax purposes. A review of a few of the more important principles governing income, estate and gift taxation of insurance is appropriate, as a background for suggested changes in this insurance program.

## INCOME TAXATION OF AMOUNTS RECEIVED DURING THE LIFETIME OF THE INSURED

Section 72 of the 1954 Code governs the income tax treatment of any amount received under an annuity, endowment or life insurance policy, during the lifetime of the insured. This section must be consulted, therefore, to determine the income tax treatment of dividends, cash surrender value, proceeds of endowment or annuity policies, or refunds of premiums received upon conversion of a policy into another type of policy providing a smaller amount of insurance coverage.

### *Dividends*

A dividend on a life insurance policy is treated as a refund of premiums and is excluded from gross income, except to the extent that it, when added to other amounts previously received tax free under the policy, exceeds the aggregate premiums paid on the policy.<sup>1</sup> In the case of an annuity policy, a dividend is taxed in the same manner, if received prior to the "annuity starting date" or the date upon which the first annuity payment is received, whichever is later.<sup>2</sup> If the dividend is received after that date, the entire amount is included in gross income.<sup>3</sup>

### *The Cash Surrender Value*

The cash surrender value received upon surrender of a life insurance annuity, or endowment policy is taxable only to the extent that it, when added to all other amounts previously received tax free under

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<sup>1</sup> INT. REV. CODE OF 1954, § 72(e)(1)(B).

<sup>2</sup> See INT. REV. CODE OF 1954, § 72(c)(4), for the meaning of "the annuity starting date." Generally, it means the first day of the first period for which an annuity payment is received under the policy. The statute indicates that a dividend received after the annuity starting date would be fully taxable. Cf. INT. REV. CODE OF 1954, § 72(e)(1)(A). The regulations state, however, that the crucial date is the annuity starting date or the date on which the first annuity payment is made, whichever is later. Rev. Reg. § 1.72-11(b).

<sup>3</sup> INT. REV. CODE OF 1954, § 72(e)(1)(A).

the policy, exceeds the aggregate premiums paid on the policy.<sup>4</sup> In the event that the amount received upon surrender of a life insurance policy is less than net premiums paid for it, no loss is allowed.<sup>5</sup>

*Payments upon Maturity of an Endowment Policy*

Receipt of a lump sum upon maturity of an endowment contract is taxed in the same manner as the cash surrender value received on surrender of a policy; the excess of the amount received, when added to all amounts previously received tax free under the contract, over the aggregate premiums paid, is taxable as ordinary income.<sup>6</sup> Since this excess represents the accumulated earnings on premiums invested over a number of years, the inclusion of the entire amount in the income of a single year will usually produce an unfortunate tax result. Prior to the enactment of the 1954 Code, a taxpayer could avoid this undesirable result only by foreseeing it before the endowment policy matured. He could then elect one of the annuity or other installment options usually provided for in such a contract, in which event the amount received under the option would be taxed in subsequent years as an annuity. If he failed to make such an election until after maturity of the policy, he was deemed to have constructively received the amount which would otherwise have been payable as a lump sum in the year of maturity of the policy.<sup>7</sup>

Under Section 72(h), a taxpayer is now given the opportunity to select an installment option at any time within sixty days after maturity of the policy.<sup>8</sup> That subsection provides that if an election is made within this limited period, no part of the lump sum will be includable in income at the time the lump sum became payable. The statute is silent as to the effect of an election of a settlement option prior to the maturity date of the policy, or subsequent to the sixty day period. Presumably, the decisions under the 1939 Code dealing with elections made before maturity are applicable where the election is made before the policy matures, and in that event there will be no constructive receipt at the time of maturity of the policy. If the election is made after expiration of the sixty day period, there will presumably be a constructive receipt. Whether the constructive receipt will be deemed to have occurred on the date of the maturity of the policy, or upon the later date when the sixty day grace period expires, is an open question.

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<sup>4</sup> INT. REV. CODE OF 1954, § 72(e) (1), (2).

<sup>5</sup> The difference between the premium cost and the amount received upon surrender of the policy was the cost of current insurance protection. *Standard Brewing Co.*, 6 B.T.A. 980 (1927), I.T. 1944, III-1 CUM. BULL. 145.

<sup>6</sup> INT. REV. CODE OF 1954, § 72(e) (1), (2) (B).

<sup>7</sup> See I.T. 3963, 1949-2 CUM. BULL. 36.

<sup>8</sup> The statute refers only to the choice of an option provided for in the endowment contract. The regulations, however, state that subsection (h) shall be applicable if the taxpayer "irrevocably agrees with the obligor" to receive payments which will be taxed as an annuity under Section 72. Rev. Reg. § 1.72-12.

The 1954 Code added another relief provision that will alleviate the burden of the tax upon the maturity of an endowment policy, for some taxpayers. Section 72(e)(3) provides that the tax attributable to receipt of the taxable portion of any lump sum paid under an annuity, endowment, or life insurance policy shall be limited to the aggregate tax which would have been attributable to the receipt of the taxable portion of the lump sum, if it had been received rateably over the year in which it was in fact received, and the two preceding taxable years. This provision avoids some of the effect of the bunching of such income into one year.<sup>9</sup>

#### *Amounts Received as Annuities*

While the term "annuity" is not defined, the initial sentence of Section 72 makes it clear that the provisions dealing with the method of taxing amounts received as annuities apply not only to payments measured by the duration of one or more lives, but also to a fixed number of installment payments. Both types of payment consist of a combination of a return of the capital investment in the insurance policy, and interest on that investment. They are now both classified as an "amount received as annuities" and the same method is used to identify the nontaxable portion of both types of payment.<sup>10</sup> The portion of each annuity payment which may be excluded from income as a return of capital is determined by applying an "exclusion ratio" to each annuity payment. The exclusion ratio, which must be determined as of the "annuity starting date," is the ratio of the total "investment in the contract" to the total "expected return" under the contract. Once determined, the excludable portion of each payment remains the same throughout the entire period that payments are received under the policy. The three key phrases "investment in the contract," "expected return," and "annuity starting date" are defined in the statute, and further defined at considerable length in the regulations.<sup>11</sup>

The "investment in the contract" is defined as the aggregate premiums paid "for the contract" as of the annuity starting date, minus the aggregate amount received tax free under the contract before that date.<sup>12</sup>

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<sup>9</sup> A high-bracket taxpayer would find it more advantageous to sell the endowment policy to a third person prior to maturity, if the gain upon the sale is taxable as a capital gain. See the discussion of this problem *infra*.

<sup>10</sup> Under the 1939 Code, payments based upon life expectancy were taxed under the "three per cent rule," *i.e.* the portion of the amount received in each taxable year which exceeded three per cent of the premium cost was excluded from gross income until such time as the cost had been recovered; thereafter the full amount of the annuity payments was taxable. INT. REV. CODE OF 1939, § 22(b)(2)-(A). Installment payments which were not determined by reference to life expectancy were not deemed to be annuities. Such payments were excluded from gross income until the cost of the contract had been recovered and were thereafter included in full in gross income. Rev. Reg. § 39.22(b)(2)-1.

<sup>11</sup> INT. REV. CODE OF 1954, § 72(c); Rev. Reg. §§ 1.72-4-1.72-10.

<sup>12</sup> INT. REV. CODE OF 1954, § 72(c)(1).

Thus, a reduction of the investment in the contract is required to be made for all dividends and other tax free payments received under the contract. In the case of annuity policies under which payments were received prior to January 1, 1954, this reduction must reflect the portion of the installment payments received tax free under the different rules which applied under the 1939 Code.<sup>13</sup>

If the policy includes a refund feature, the investment in the contract must be reduced by the cost of the refund feature. This adjustment may be computed by following the instructions and using the tables set forth in the regulations.<sup>14</sup> No other adjustment is required by the statute and regulations. An endowment or annuity policy frequently provides for life insurance protection, waiver of premiums in the event of disability, or other additional benefits. The regulations do not require a reduction in the "investment in the contract" to reflect the costs of such additional benefits which are acquired by payment of the premiums, but which are not reflected in the annuity payments.

The "annuity starting date" is defined as "the first day of the first period for which an amount is received as an annuity under the contract, except that if such date is before January 1, 1954, the annuity starting date is January 1, 1954."<sup>15</sup>

The "expected return" is the aggregate amount payable under the contract, also determined as of the annuity starting date. The regulations set forth actuarial tables for use in computing the expected return under contracts where life expectancy is a factor.<sup>16</sup>

The regulations deal specifically with many of the special problems which arise in connection with annuities, such as the method of taxing payments under variable amount annuities,<sup>17</sup> and joint and survivor annuities.<sup>18</sup> In most cases the computation of the taxable portion of annuity payments will be complicated. Most insurance companies will, upon request, make the necessary computations and advise as to the method of reporting the receipt of annuity payments for tax purposes.

#### *Employee Annuities*

Section 72(d) contains a simplified alternative method of taxing some employee annuity payments. If this section applies, all annuity payments will be excluded from income until the amounts so excluded equal the consideration for the contract contributed by the employee;

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<sup>13</sup> See note 10 *supra*.

<sup>14</sup> See Rev. Reg. §§ 1.72-7, 1.72-9. The payments received by the refund beneficiary, after the annuitant's death, are taxed as "amounts not received as annuities." Therefore, such payments are not subjected to tax until the payments received tax free (including amounts received by the annuitant) exceed the investment in the contract. See Rev. Reg. § 1.72-11(c).

<sup>15</sup> INT. REV. CODE OF 1954, § 72(c)(4).

<sup>16</sup> Rev. Reg. § 1.72-9.

<sup>17</sup> Rev. Reg. §§ 1.72-2(b)(3), 1.72-5(f).

<sup>18</sup> Rev. Reg. § 1.72-5(b).

thereafter, all amounts received will be included in gross income. The section applies if:

- (i) an employer contributed part of the consideration for the contract, and
- (ii) during the first three years of the annuity payment period, the aggregate amount receivable exceeds the consideration contributed by the employee.

For this purpose, the employee is deemed to have contributed amounts paid by the employer, if such amounts were includable in the employee's income when paid.<sup>19</sup> Employer contributions are includable in the employee's income if the employee, at the time of premium payment by the employer, had nonforfeitable rights in an annuity which was not purchased under a qualified plan.<sup>20</sup>

#### *Transfers of Policy*

If a policy is transferred without consideration, the transferee is placed in the shoes of the transferor and taxed accordingly.<sup>21</sup> In the case of a transfer for value a new exclusion ratio must be computed for the transferee. His investment in the contract is determined on the basis of the consideration paid for the policy, plus subsequent premiums paid by the transferee.<sup>22</sup> The regulations indicate that this rule will be applied whenever any consideration, even if it is nominal, is paid for the policy. This may mean that a transfer for inadequate consideration would have the consequence of depriving the transferee of the benefit of any part of the premiums paid by the transferor in determining the taxable portion of payments received under the policy.<sup>23</sup>

#### *Exchanges of Policies*

Section 1035 provides for nonrecognition of any gain realized on certain exchanges of endowment, annuity or life insurance contracts. The section applies to an exchange of:

- (i) a life insurance policy for another life insurance policy or

<sup>19</sup> Employer contributions which were taxable to the employee when made are also deemed to have been made by the employee for purposes of computing his investment in the contract when the annuity payments are taxable under the general rule of Section 72(b), rather than under the special provisions of Section 72(d). See INT. REV. CODE OF 1954, § 72(f).

<sup>20</sup> Rev. Reg. § 1.403(b)-1.

<sup>21</sup> Rev. Reg. § 1.72-10(b).

<sup>22</sup> INT. REV. CODE OF 1954, § 72(g); Rev. Reg. § 1.72-10(a).

<sup>23</sup> The language of Section 72(g) suggests a more liberal rule than that indicated by the regulations. Section 72(g) provides that the transferee for value rule is to apply only "to the extent that the contract (or interest therein) does not, in the hands of the transferee, have a basis which is determined by reference to the basis in the hands of the transferor. . . ." (Emphasis added.) To the extent that a transfer for an inadequate consideration is a gift, it would seem that the transferee's basis is the same as his transferor's, and therefore to this extent he should have the benefit of the transferor's investment in the contract. See Rev. Reg. § 1.1015-4.

an endowment or an annuity;

(ii) an endowment policy for another endowment policy which provides for payments beginning no later than payments would have begun under the policy exchanged, or for an annuity; or

(iii) an annuity for an annuity.

While the statute does not so provide, the regulations require that the policies exchanged must relate to the same insured. While the statute provides that the new policy shall take the same cost basis as the old policy, pursuant to Section 1031, there is no reference in the statute to the determination of the exclusion ratio after such an exchange has occurred. The regulations appropriately indicate, however, that this determination shall be made on the basis of premiums paid and amounts received under both the old and the new policy.<sup>24</sup> While the statute does not expressly so state, these provisions apply to exchanges made by the owner of a policy with the insurance company which issued the policy.<sup>25</sup> Taxable gain will be realized upon any exchange of policies not covered by this provision.<sup>26</sup> No loss is recognized upon such an exchange of any policy which provides an element of life insurance protection.<sup>27</sup>

#### INCOME TAXATION OF AMOUNTS PAID BY REASON OF INSURED'S DEATH

Section 72 governs the taxation of all amounts received under insurance contracts, except amounts paid by reason of the death of the insured. Taxation of such amounts is governed by Section 101, which preserves, but somewhat limits, the long standing income tax exemption for the proceeds of a life insurance policy paid upon the death of the insured. Except for a limited exception in the case of a surviving spouse, there is no longer an exemption granted for the interest element involved in payments under deferred payment settlement options. The interest portion of such deferred payments of the life insurance proceeds is now taxed, whether paid in fixed installments, for the life of the beneficiary, or otherwise.

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<sup>24</sup> See Rev. Reg. §§ 1.72-4(b)(2), 1.72-11(e).

<sup>25</sup> The purpose of this provision was to facilitate such exchanges.

<sup>26</sup> Rev. Rul 264, 1954-2 CUM. BULL. 57; *Parsons v. Commissioner*, 16 T.C. 256 (1951). The taxpayer in the *Parsons* case did not raise the issue of whether the gain qualified as a capital gain. An argument could be made, on the basis of the statutory language used in Sections 1035 and 1222, that a substitution by the issuing company of one policy for another constitutes a "sale or exchange" within the meaning of Section 1222. It is likely, however, that that transaction would be characterized as a payment upon surrender of the old policy, and an investment of the proceeds in a new policy. Cf. *Parsons* and Rev. Rul. 54-264, *supra*. If such a characterization of the transaction were adopted, Section 72(e) would be applicable, and the gain would be taxed as ordinary income. See pp. 97-98 *infra* for a discussion of the consequences of a sale of a policy to a third person.

<sup>27</sup> See note 5 *supra*.

*Installment Options*

Section 101(a)(1) provides that life insurance proceeds are excluded from gross income, except in cases where there has been a transfer for value of the policy, and in cases where a settlement option provides for deferral of payment of the insurance proceeds. In the event that such a settlement option has been selected, Section 101(d) provides that the insurance proceeds shall be prorated over the period during which payments are to be made and that the amount excluded from income in any year shall not exceed the proration, except in the case of a surviving spouse who is entitled to an additional exclusion of \$1,000 per year.<sup>28</sup> The effect of this provision is to preserve, but only to the surviving spouse and only to the extent of \$1,000 annually, the former income tax advantage of installment options. The additional \$1,000 annual exclusion is not applicable to interest paid by the insurer under an interest option.

The regulations provide that the proration is to be made by a method which is similar to that used for annuities.<sup>29</sup> The amount which would have been payable in a lump sum at the date of death is substituted for the investment in the contract. This amount is generally stated in the policy; if it is not, it may be obtained from the insurance company.<sup>30</sup> Where the policy provides for guaranteed payment of a specified number of installments, in the event of the death of a primary beneficiary, a reduction equal to the present value of the guaranteed payment is required to be made in the lump sum which is prorated over the life expectancy of the primary beneficiary;<sup>31</sup> receipt of the guaranteed payments by another, after the death of the primary beneficiary, is not taxed.<sup>32</sup>

*Transfers for Value*

The general exclusion of life insurance proceeds from gross income does not apply if there has been any transfer of the policy for a valuable consideration, other than certain specifically excepted types of transfers. Where there has been a transfer for value, Section 101(a)(2) limits the amount that is excluded from income to the consideration paid for the policy, plus subsequent premiums paid by the transferee. The general rule excluding life insurance proceeds from income applies, however, if the transfer for value was to the insured, a partner of the insured, a partnership in which he is a partner, or a corporation in which he is a shareholder or officer. This permits most of the transfers commonly encountered in business arrangements. It does not include, however,

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<sup>28</sup> INT. REV. CODE OF 1954, § 101(d)(1).

<sup>29</sup> Rev. Reg. § 1.101-4.

<sup>30</sup> INT. REV. CODE OF 1954, § 101(d)(2)(B), defines the amount to be prorated as the present value, at the date of death, of the agreement to make the deferred payments to the beneficiary, discounted on the basis of the interest rates and mortality tables used by the insurer in calculating the payments provided for in the settlement option.

<sup>31</sup> Rev. Reg. § 1.101-4(c), (e).

<sup>32</sup> Rev. Reg. § 1.101-4(d)(3).

transfers among shareholders of the same corporation, or from a corporation to a shareholder other than the insured. These omissions have sometimes created problems in creating, or altering, plans for funding corporate buy and sell agreements with life insurance.

### *Employee Death Benefits*

Section 101(b) creates an exclusion from gross income for payments, up to \$5,000 in the case of any employee, which are made to his beneficiary or his estate by reason of the death of the employee. The exclusion will not apply if the employee had a nonforfeitable right to the payment before his death, unless the payment to which he had such a right is a total distribution made within one year under a retirement plan described in Section 401. The exclusion is available in the case of some, but not all, employees' annuity payments. The rather complex application of the statute to such payments has been fully discussed elsewhere.<sup>33</sup>

### ESTATE TAX ON LIFE INSURANCE PROCEEDS

#### *Insurance Includable in the Gross Estate*

Insurance on the life of a decedent is includable in his gross estate if:

- (i) payable to the estate, or
- (ii) to other beneficiaries, and the decedent possessed at his death any incident of ownership of the policy.

For this purpose, an incident of ownership is defined as including a reversionary interest if the value of that interest exceeded five per cent of the value of the policy immediately before death.<sup>34</sup>

Prior to the 1954 Code, life insurance proceeds were included in the gross estate to the extent that the decedent had at any time paid premiums on the policy.<sup>35</sup> The elimination of this ground for including insurance in the estate creates the possibility for the first time of making lifetime transfers of insurance upon which the insured has paid premiums, and thus removing the proceeds of such policies from the insured's taxable estate. To achieve this end, it remains necessary that the insured divest himself of all the incidents of ownership, *i.e.* the right to change the beneficiary, to borrow against the policy, surrender the policy for its cash value, etc. Most insurance companies provide their own forms of absolute assignment designed to achieve this purpose.

It might appear that the definition of an incident of ownership as including certain reversionary interests would often cause inclusion of insurance in the gross estate, despite the fact that a complete assignment

<sup>33</sup> See Casner, *Estate Planning*, 68 HARV. L. REV. 433, 440 (1955).

<sup>34</sup> INT. REV. CODE OF 1954, § 2042.

<sup>35</sup> INT. REV. CODE OF 1939, § 811(g)(2). The possibility of re-enactment of this test has been put to rest, at least temporarily, by the elimination from H. R. 8381 of a proposal for a modified premium payment test.



had been made. This possibility is more apparent than real. The regulations recognize that the right of a third person, "exercisable by such person alone and in all events," to obtain the cash value of the policy will in all cases result in the value of a reversionary interest of the insured being less than five per cent. Thus, whenever the right to claim the cash value is transferred to a single individual, the insurance will not be included in the transferor's estate under Section 2042.<sup>36</sup>

Although proper precautions are taken to prevent life insurance proceeds from being included in the gross estate under Section 2042, the possibility will remain that all or a portion of the proceeds might be includable under Section 2035, if a transfer in contemplation of death has occurred. While the regulations indicate that the entire proceeds will be included if it is found that the policy was transferred in contemplation of death,<sup>37</sup> it has been held that where the transferee subsequently has paid premiums only a pro rata portion of the proceeds, based upon the portion of the premiums paid by the transferor, is includable in his gross estate.<sup>38</sup> Since a transfer cannot be attacked as having been in contemplation of death after three years, this decision suggests that the consequences of death within three years after a transfer might be mitigated if the transferee pays the premiums during the three year period following the transfer. It has been noted by some commentators that the case also suggests that even though a policy may have been transferred many years before the insured's death, any payment of premiums by him within three years of his death might result in the inclusion in his gross estate of a pro rata portion of the entire insurance proceeds, based upon the ratio of the premiums paid within three years of death to the total premiums.<sup>39</sup>

#### *Qualifying Insurance for the Marital Deduction*

Insurance proceeds included in a decedent's estate can qualify for the marital deduction under Section 2056. If an installment option providing for deferred payments to the surviving spouse has been selected, it is necessary that the special requirements of Section 2056(b)(6) be satisfied.

### GIFT TAX ON TRANSFERS OF INSURANCE POLICIES

#### *Valuation*

A gift of an insurance policy is, of course, subject to the gift tax. The taxable event is the transfer of the ownership rights in the policy to another. The value of an insurance policy, for gift tax purposes, is the cost of a comparable policy issued by the same company at the time of

<sup>36</sup> Rev. Reg. § 20.2042-1(c)(3).

<sup>37</sup> See Rev. Reg. § 20.2042-1(a)(2).

<sup>38</sup> *Leibmann v. Hassett*, 148 F.2d 247 (1st Cir. 1945).

<sup>39</sup> See MUNCH, *ESTATE TAX PROBLEMS IN TRANSFERS OF LIFE INSURANCE*, PROC. OF N.Y.U. 15TH ANN. INST. ON FED. TAXATION 219, 227.

the gift.<sup>40</sup> Where premiums remain to be paid on the policy, this value is the "interpolated terminal reserve" on the policy at the time of the assignment, plus the portion of the last premium which is applicable to periods after the date of the gift. The value of a single premium or paid-up policy is the amount the issuing company would charge for a single premium policy in the same amount on the life of a person of the same age as the insured.<sup>41</sup> Any indebtedness against the policy decreases its value for gift tax purposes.<sup>42</sup>

The Internal Revenue Service requires that its form number 938 be filed by the donor of an insurance policy with his gift tax return. The form is to be filled out by the company which issued the policy, and should disclose the relevant valuation data.

### *Annual Exclusion*

If a policy is assigned to a single donee who is given the unrestricted right to exercise the incidents of ownership, the gift will qualify for the annual gift tax exclusion of \$3,000, under Section 2503(b).<sup>43</sup>

If the transfer is made to several donees, as joint owners, it has been held that the gift is of a future interest which does not qualify for the annual exclusion under Section 2503(b).<sup>44</sup> Since no one of the joint owners can exercise any of the ownership rights without the consent of the others, such an arrangement was found to involve a gift of a future interest. Therefore, where gifts to more than one donee are to be made, the benefit of the annual exclusion can be obtained only if the insurance policy is split into several separate policies, and a separate policy is given to each donee.

It will seldom be advisable to transfer an insurance policy outright to a minor. The necessity of the appointment of a guardian to exercise any ownership right and the doubtful wisdom of permitting the cash value, or possibly the insurance proceeds, to become available to a child when he attains the age of twenty-one are two of the more obvious reasons for not making such an outright assignment. On the other hand, a gift of a policy in trust for the minor usually will not qualify for the \$3,000 annual exclusion, unless the trust itself satisfied the provisions of

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<sup>40</sup> Rev. Reg. § 25.2512-6.

<sup>41</sup> Rev. Reg. § 25.2512-6.

<sup>42</sup> Cf. M. K. Leslie, 4 CCH Tax Ct. Mem. 216 (1945); See I.R.S. Form No. 938.

<sup>43</sup> Rev. Rul. 408, 1955-1 CUM. BULL. 113.

<sup>44</sup> Skouras v. Commissioner, 14 T.C. 523 (1950), *aff'd*, 188 F.2d 831 (2d Cir. 1951); Cf. John M. Smyth, 2 CCH Tax Ct. Mem. 4 (1943); Nashville Trust Co., 2 CCH Tax Ct. Mem. 992 (1943). The absence of a cash surrender value at the time of assignment might cause a gift of the policy, or payment of premiums on it, to be classified as a gift of a future interest. See Nashville Trust Co., *supra*; but cf. Rev. Rul. 55-408, *supra* note 43.

Section 2503(c).<sup>45</sup> As noted in the earlier discussion of this provision,<sup>46</sup> it also requires that the property in the trust be distributable to the minor at age twenty-one.

Payment of premiums on previously transferred policies are taxable gifts in the amount of the premium payment. Such payments will qualify for the \$3,000 annual exclusion, if the ownership rights in the policy are held by a single donee.

#### INTEREST ON INDEBTEDNESS INCURRED TO PURCHASE OR CARRY LIFE INSURANCE ENDOWMENT OR ANNUITY CONTRACTS

Section 264 provides that no deduction shall be allowed for interest payments on any indebtedness incurred to purchase or carry a single premium life insurance, endowment or annuity contract. The section expressly defines a single premium contract as including one on which "substantially all" of the premiums are paid within a period of four years from the date of purchase, or one upon which an amount is deposited with the insurer for payment of "a substantial number" of future premiums. Neither of the phrases "substantially all" or "a substantial number" are defined in the statute or regulations. There is no prohibition of deducting the interest paid upon indebtedness incurred to provide funds for payment of the annual premiums on a policy. Any prepayment of more than one or two annual premiums, however, will invite a disallowance of the entire interest with respect to premium loans in connection with the policy.

There are few guideposts which will help in determining the meaning of the broad phrase "indebtedness incurred to purchase or carry" a single premium policy. In a broad sense, any indebtedness incurred by a taxpayer who owns such a policy could be regarded as an indebtedness to "carry" the policy. It has never been suggested that the term has such a broad scope, but on the other hand it should not be assumed that application of this provision would require the government to trace the borrowed funds to show an application of the same funds to the purchase of a policy, or to the payment of a previous indebtedness incurred to purchase a policy.<sup>47</sup> There is some authority under the related section dealing with indebtedness incurred to purchase or carry tax exempt securities, which would indicate that the test to be applied is a subjective one, *i.e.* whether or not the reason for the borrowing was to finance the purchase of tax exempt securities. In one instance, it has been ruled that even though the funds borrowed could be traced in part to such a

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<sup>45</sup> Gifts to certain trusts other than those described in Section 2503(c) also may qualify for the annual exclusion. See *Kieckhefer v. Commissioner*, 189 F.2d 118 (7th Cir. 1951).

<sup>46</sup> See discussion of Section 2503(c) by Kohn, *Gift Planning to Save Taxes*, 20 OHIO ST. L.J. 61, 66-68 (1959).

<sup>47</sup> *Cf.* Bernard H. Jacobson, 28 T.C. 579 (1957).

purchase, the section did not apply because the investment was temporary and the borrowing was made for a different purpose.<sup>48</sup>

SUGGESTIONS WITH REGARD TO  
MR. BEAVER'S INSURANCE PROGRAM

*His Present Situation*

Since Mr. Beaver owns all of the policies on his life, the entire proceeds of these policies will be included in his gross estate for estate tax purposes. The proceeds may or may not qualify for the marital deduction, depending upon the beneficiary designation and the form of settlement option which is in effect at the time of his death. His ownership of the endowment contract presents a potential income tax problem in the year that it will mature.

*Possible Improvements in Mr. Beaver's Tax Situation  
Through Transfers of Insurance Policies*

Mr. Beaver can reduce his potential estate tax liability through assignment to his wife or children of certain of the policies he now owns, or other policies which he might obtain by exchanging his present policies for new ones to be issued by the issuing companies. The decision as to which policies to give away, to whom and how to make the gifts (whether outright or in trust) depends upon those factors discussed *supra*.<sup>49</sup> It is appropriate here, however, to compare insurance with other types of property as an appropriate subject for an intra-family gift.

Since an insurance policy is not income producing property, it may be given away without reducing current income. This could be an advantage or disadvantage depending upon whether the objective is to reduce both income and estate taxes, or to reduce estate taxes without sacrificing current income.

A gift of a life insurance contract will offer the prospect of a greater estate tax saving, at a smaller gift tax cost, than a gift of most other types of property. This results from the fact that the entire insurance proceeds would be taxable in the estate, whereas only the cost of a comparable policy is subject to the gift tax at the time of the gift. Thus, the appreciation in value of a life insurance policy, which occurs by reason of death, may be removed from the taxable estate by making a gift of the policy before this appreciation occurs.

If Mr. Beaver made a gift of property other than life insurance, the property in the hands of the donee would have the same cost basis as it had in Mr. Beaver's hands.<sup>50</sup> The donee would lose the benefit of the stepped-up cost basis which he would otherwise have acquired if

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<sup>48</sup> Rev. Rul. 389, 1955-1 CUM. BULL. 276.

<sup>49</sup> Kohn, *supra* note 46, at 73-74.

<sup>50</sup> The code now provides for an increase in the donee's basis equal to the gift tax paid by the donor and attributable to the gift. 1958 Technical Amendments Act, § 43, adding a new subsection (d) to INT. REV. CODE OF 1954, § 1015.

Mr. Beaver had retained the property until his death and it had been included in his gross estate. Since the insurance proceeds will be received tax free by his donees at the time of his death, this loss of a stepped-up cost basis is unimportant where insurance policies are involved.

For one or more of the foregoing reasons, it might well be determined that it is preferable for Mr. Beaver to make a gift of insurance policies rather than of some other property. The inclination to assign insurance policies in order to save estate taxes should not be followed, however, until it has first been determined that there are sufficient liquid assets, other than the insurance, available for payment of tax and administration costs at death. In most cases, it will be well for the insured to retain sufficient insurance to cover these predicted death costs. It is sometimes possible, however, to work out an arrangement whereby the donee of the insurance policies will use the proceeds to purchase nonliquid assets from the estate, and thus assure the liquidity of the estate, even though the insurance is not part of the gross estate for estate tax purposes.

Having determined to make gifts of insurance policies, there remains the problem of determining which policies to give away. A gift of a paid-up policy will obviously result in a higher gift tax. On the other hand, a gift of such a policy does not require arrangements for payment of future premiums, and avoids the possibility that such premium payments might provide a basis for a claim that some part of the proceeds of the policy should be included in the decedent's gross estate on the ground that the premium payments within three years of death constituted a partial transfer of the policy itself in contemplation of death. In Mr. Beaver's case, the value of the paid-up policy appears to be less than the \$6,000 exclusion which is available to Mr. Beaver and his wife, and therefore the gift tax is not a factor to be considered here. In any event, we would suggest that any additional life insurance on Mr. Beaver's life should be purchased either by Mrs. Beaver or by his children. This will insure that the proceeds of the new policies will not be included in his taxable estate.

#### *Possible Dispositions of the Endowment Policy*

The endowment policy could be exchanged for an annuity contract, under which payments will commence no later than the maturity date of the present policy. Such an exchange could be made at any time prior to the expiration of sixty days after maturity of the policy under Section 72(h). No taxable gain would be recognized under Section 1035. If Mr. Beaver anticipates retirement and a consequent reduction in his earned income at approximately the same time that the endowment policy will mature, such an exchange may well be advisable. Unless the endowment matures more than three years after his retirement, which is quite unlikely, he can hope for no relief from the tax consequences of the maturity of the policy under the respread provisions of Section 72(e)(3). As the maturity date of the policy approaches, and if no other solution

appears possible, Mr. Beaver can then consider whether he wishes to undertake the litigation costs which would be involved in any attempt to convert the income to be realized on maturity of the policy into capital gain income through a sale of the policy, prior to maturity, to a third person. The tax consequences of such a sale have recently been litigated before the Tax Court and the Court of Claims. The Tax Court upheld the taxpayer's contention that a long term capital gain was realized. The Court of Claims held that the gain realized constituted ordinary income because the transaction involved the sale of an income right.<sup>51</sup>

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<sup>51</sup> Compare *Percy W. Phillips*, 30 T.C. 87 (1958), with *Arnfeld v. United States*, 163 F. Supp. 865 (Ct. Cl. 1958).