2 T.C. 220 (1943)

Payments received in installments from an insurance company under a settlement option elected upon surrender of an endowment policy are not considered annuity payments if the installment amounts are calculated without reference to the payee's life expectancy.

Summary

George Thornley surrendered endowment policies before maturity and elected to receive the cash surrender values in installments. The IRS argued these payments were annuities and thus taxable under Section 22(b)(2) of the Revenue Act of 1936. Thornley also sold stock he received after his partnership was incorporated, leading to a dispute over the holding period for capital gains calculations. The Tax Court held that the insurance installment payments were not annuities because they were not based on life expectancy. It further held that Thornley received the stock in exchange for partnership assets, not the partnership interest itself, impacting the holding period calculation.

Facts

1. In 1930, Thornley purchased two 23-year endowment policies from Berkshire Life Insurance Co.
2. In 1935, he surrendered these policies before maturity and elected to receive the cash surrender values in monthly installments over 20 years under "Settlement Option A."
3. Between 1924 and 1925, Thornley obtained seven endowment policies from Phoenix Mutual Life Insurance Co.
4. In 1936, he surrendered these Phoenix policies, electing to receive their cash values in annual installments over 10 years under "Option 3."
5. Thornley had been a partner in N.W. Ayer & Son, an advertising agency. The partnership was incorporated in 1929.
6. Thornley received stock in the new corporation in exchange for his partnership interest.
7. In 1937, Thornley sold some of this stock, reporting a capital gain.

Procedural History

1. The Commissioner of Internal Revenue determined a deficiency in Thornley's 1937 income tax.
2. The Commissioner argued that a portion of the insurance installment payments should be included in gross income as annuities under Section 22(b)(2) and disputed Thornley's calculation of the holding period for the stock sale.
3. Thornley petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

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1. Whether installment payments received by Thornley from insurance companies upon surrender of endowment policies prior to maturity constitute “amounts received as an annuity” under Section 22(b)(2) of the Revenue Act of 1936.
2. Whether the stock sold by Thornley in 1937 was held for more than ten years for purposes of computing capital gains under Section 117 of the Revenue Act of 1936.

Holding

1. No, because the installment payments were calculated based on a fixed schedule, not on Thornley’s life expectancy; therefore, they do not fall under the definition of “amounts received as an annuity” under Section 22(b)(2).
2. No, because Thornley received the stock in exchange for his interest in the partnership’s assets, not in exchange for his partnership interest itself. The holding period of the assets determines the holding period of the stock.

Court’s Reasoning

1. The court reasoned that the term “annuity” in Section 22(b)(2) was intended to have the meaning insurance companies and actuaries customarily give it: payments computed with reference to the age, sex, and life of the payee. The court stated, “A Life Annuity, often called simply an Annuity, is a series of payments depending upon the continuance of a given life or combination of lives.”
2. The installment payments Thornley received were not based on mortality tables or life expectancy; they were fixed amounts paid over a set period. The court emphasized that Thornley retained a property interest in the proceeds of the policies, akin to leaving money on deposit with the company at interest.
3. The court distinguished this situation from an annuity purchase where the annuitant surrenders all rights to the principal.
4. Regarding the stock sale, the court emphasized the 1929 agreement dissolving the partnership and transferring its assets to the corporation. The agreement stipulated that stock would be issued in exchange for the assets transferred.
5. The court found that Thornley exchanged his interest in the partnership assets (specific partnership property) for the stock, not his “interest in the partnership” itself, which would have included undistributed profits loaned to the corporation. Therefore, the holding period for the stock only included the period the partnership held the assets.

Practical Implications

1. This case clarifies the distinction between annuity payments and other forms of installment payments received from insurance companies, particularly in the context of surrendered endowment policies.
2. It highlights the importance of analyzing the specific terms of settlement options in insurance contracts to determine the tax treatment of payments

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received.

3. For tax purposes, the determination of whether payments are based on life expectancy is crucial for classifying them as annuities.
4. The case underscores that, when a partnership incorporates, the exchange of partnership assets for corporate stock does not necessarily mean the partner's holding period for the stock includes the entire duration of their partnership interest; rather, it depends on the holding period of the underlying assets transferred.
5. Practitioners should carefully examine the terms of agreements dissolving partnerships and transferring assets to corporations to accurately determine the holding period for stock received in such transactions.

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