10 T.C. 44 (1948)

Distributions from an annuity contract characterized as 'dividends,' which represent a share of the insurance company's divisible surplus, are taxable as income and are not considered a return of premium unless the contract explicitly states otherwise.

Summary

The petitioner received monthly annuity payments and a 'dividend' from an annuity contract purchased on her behalf. The Commissioner included both the annuity payments and the dividend in her taxable income. The petitioner argued the 'dividend' should be treated as a return of premium, not taxable income, and that taxing the annuity income was unconstitutional. The Tax Court held that the 'dividend' was taxable income because the annuity contract did not specify it as a return of premium, and the petitioner failed to prove that the income received was less than 3% of the annuity's cost, thus not demonstrating an unconstitutional tax on capital.

Facts

- Frances Kephart's will directed her executor to purchase an annuity contract for her daughter, Florence Mae Shelley (the petitioner).
- In 1942, the executor purchased a refund annuity contract from Bankers Life Company for a single premium of $30,559.08.
- The contract provided monthly payments of $70.90 to Shelley for life and allowed her to participate in the company's divisible surplus through 'dividends,' which could be taken in cash or used to increase future annuity payments.
- In 1942, Shelley received $283.60 in monthly payments, and in 1943, she received $850.80 in monthly payments and a $253.54 'dividend.'

Procedural History

- The Commissioner of Internal Revenue determined a deficiency in Shelley's income tax for 1943, including the annuity payments and dividend as income.
- Shelley petitioned the Tax Court, arguing the inclusion of these amounts was erroneous and unconstitutional.

Issue(s)

1. Whether the 'dividend' received by the petitioner under the annuity contract constitutes a reduction of the cost of the annuity contract and is therefore not income, or whether it is to be included in gross income under Section 22(a) or as an 'amount received as an annuity' under Section 22(b)(2) of the Internal Revenue Code.
2. Whether Section 22(b)(2) of the Internal Revenue Code, as applied to the facts of this case, is unconstitutional.

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Holding

1. Yes, the ‘dividend’ is includible in gross income because it was not explicitly designated as a return of premium in the annuity contract and represented an increase in benefits.
2. No, Section 22(b)(2) is not unconstitutional as applied here because the petitioner failed to prove that taxing the annuity resulted in a tax on capital rather than income.

Court’s Reasoning

The court reasoned that the ‘dividend’ was not explicitly designated as a return of premium within the annuity contract. The court emphasized that the contract language indicated the ‘dividend’ was intended to augment the income derived from the annuity, not to reduce its cost. Referencing Regulation 111, section 29.22(a)-12, the court distinguished the case from situations where amounts received are explicitly a return of premiums. Furthermore, the court noted that there was no ‘current premium’ against which the dividend could be credited. Regarding the constitutional argument, the court cited *Manne v. Commissioner*, stating that the taxpayer has the burden of proving that the tax imposed is on the return of capital, not income. The petitioner failed to demonstrate that the income received from the annuity was less than 3% of the investment, thus failing to prove an unconstitutional direct tax on property.

Practical Implications

This case clarifies that distributions from annuity contracts labeled as ‘dividends’ are generally considered taxable income unless the contract explicitly defines them as a return of premium. When analyzing annuity contracts for tax purposes, attorneys and taxpayers must carefully examine the contract language to determine the nature of such distributions. Taxpayers claiming that annuity income is, in reality, a return of capital bear the burden of proving that the income received is less than 3% of the investment. This case also highlights the importance of clear contractual language to avoid ambiguity in tax treatment. Later cases might distinguish *Shelley* by focusing on specific language within annuity contracts that characterizes distributions as something other than taxable income, or where the taxpayer can factually demonstrate the unconstitutionality of the tax as applied to their specific income and capital contributions.

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