12 T.C. 1028 (1949)

Payments received under settlement options of a life insurance policy, after the policy's surrender, are treated as annuity payments for tax purposes, subject to the 3% rule under Section 22(b)(2) of the Internal Revenue Code.

Summary

Burtha Fisher received payments from insurance companies after surrendering life insurance policies on her husband's life, of which she was the beneficiary, and electing to receive payments under the policies' settlement options. The Tax Court had to determine whether these payments should be treated as proceeds from a life insurance contract or as annuity payments for income tax purposes. The court held that the payments were annuity payments and thus taxable under the 3% annuity provision of Section 22(b)(2) of the Internal Revenue Code. The court reasoned that upon surrendering the policies, Fisher received new agreements characterized as annuities, regardless of their origin in the life insurance contracts.

Facts

In 1923, Frederick Fisher, Burtha's husband, purchased 18 life insurance policies, with Burtha as the irrevocable beneficiary. Burtha paid all the premiums. The policies contained settlement options allowing the beneficiary to receive the proceeds in installments instead of a lump sum. In 1940, Burtha surrendered ten of these policies and elected to receive payments under the settlement options, choosing a 20-year certain and life thereafter option with nine insurers. The insurance companies issued her instruments or certificates for these payments. As to the other eight policies, five companies denied her request, saying the settlement options were only for the insured, not the beneficiary. Burtha surrendered these policies for a lump sum, later purchasing 14 refund annuity contracts from various insurers.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Burtha Fisher's income tax for 1940, including a portion of the payments she received from the insurance companies as taxable income. Fisher petitioned the Tax Court for a redetermination of the deficiency, contesting the inclusion of $4,910.43 in her income under the 3% annuity provision of Section 22(b)(2) of the Internal Revenue Code.

Issue(s)

Whether payments received by the beneficiary of life insurance policies, pursuant to settlement options exercised after the surrender of the original policies, constitute payments from a life insurance contract or annuity payments for income tax purposes under Section 22(b)(2) of the Internal Revenue Code.

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Holding

Yes, because the payments received under the settlement options, after the policies were surrendered, are considered annuity payments, subject to the 3% rule under Section 22(b)(2) of the Internal Revenue Code, regardless of the payments' origin in life insurance contracts.

Court's Reasoning

The court reasoned that Section 22(b)(1) and (2) of the Internal Revenue Code distinguishes between life insurance contracts and annuity contracts. Payments received under a life insurance contract due to the insured's death are generally excluded from gross income. However, amounts received as annuities under an annuity or endowment contract are included in gross income, subject to the 3% rule, which excludes the excess of the amount received over 3% of the aggregate premiums paid until the excluded amount equals the total premiums paid.

The court emphasized that Fisher surrendered her original life insurance policies and, in return, received agreements to pay her sums characterized as annuities. Although the terms of the new contracts were influenced by the original life insurance policies, the payments were made under these new agreements, not under the original life insurance contracts. Therefore, the court held that the payments should be treated as annuity payments for tax purposes. Even if the payments were considered amounts received under a life insurance contract, the court noted that they would not be excluded under subsection (b) and might be taxable under section 22(a).

Practical Implications

This case clarifies that payments received under settlement options of life insurance policies, after the policies have been surrendered, are treated as annuity payments for tax purposes. This determination affects how beneficiaries are taxed on such payments, subjecting them to the 3% rule under Section 22(b)(2) of the Internal Revenue Code. Legal practitioners must analyze the specific circumstances of each case, focusing on whether the original life insurance contract was surrendered and replaced with a new agreement characterizing the payments as annuities. This decision highlights the importance of understanding the tax implications of different settlement options when advising clients on estate planning and life insurance matters. Later cases and IRS rulings would likely consider this decision when addressing similar scenarios, providing further guidance on the taxation of life insurance proceeds and annuity payments.

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