24 T.C. 528 (1955)

The basis of a survivor's interest in an annuity for tax purposes is determined by the consideration paid by the original annuitant, not the value of the interest included in the deceased annuitant's gross estate, unless the deceased annuitant died after December 31, 1950, due to specific legislative changes.

Summary

The case concerns the taxability of annuity payments received by Joseph Morschauser III as the surviving annuitant of his grandfather's retirement annuity. The core issue was whether the basis for calculating the taxable portion of the annuity should be based on the grandfather's contributions to the annuity or the value of the survivor's interest included in the grandfather's gross estate. The Tax Court, applying the law as it stood before a 1951 amendment, held that the basis was the grandfather's investment, not the estate tax valuation, because the grandfather died before the effective date of the amendment. Therefore, the entire annuity payments received by the grandson were taxable because the grandfather had fully recovered his investment tax-free before his death.

Facts

Joseph Morschauser's grandfather, a member of the New York State Employees' Retirement System, elected to receive a reduced annuity with the provision that half of the annuity would be paid to his grandson, Joseph Morschauser III, after his death. Joseph Morschauser, the grandfather, fully recovered his contributions to the retirement fund, tax-free, by the time of his death on November 3, 1947. The value of the survivor's annuity interest at the time of the grandfather's death was included in his gross estate for federal estate tax purposes. Joseph Morschauser III received $4,242.12 annually from the annuity in 1951, 1952, and 1953. He included a portion of these payments as taxable income, based on 3% of the value of the survivor's interest included in the grandfather's gross estate, relying on the pre-1951 tax rules.

Procedural History

Joseph Morschauser III filed income tax returns for 1951, 1952, and 1953, reporting a portion of his annuity income. The Commissioner of Internal Revenue determined deficiencies, asserting that the entire annuity payments were taxable. The case was brought before the United States Tax Court for review of the Commissioner's determination.

Issue(s)

1. Whether the basis for determining the taxable portion of the annuity payments received by Joseph Morschauser III should be based on the value of the survivor's interest included in the grandfather's gross estate.

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2. Whether the entire amount of the annuity payments received by Joseph Morschauser III was includible in his gross income.

Holding

1. No, because the basis for determining the taxable portion of the annuity payments is based on the consideration paid by the original annuitant, not the value included in the grandfather's estate, as the grandfather died before the crucial date for the 1951 tax law changes.

2. Yes, because the grandfather had fully recovered his investment in the annuity before his death, thus making the entire annuity payment taxable for the grandson.

Court's Reasoning

The court's reasoning centered on the interpretation of Section 22(b)(2) of the Internal Revenue Code of 1939, which governed the taxation of annuities, and the 1951 amendments. The court relied heavily on prior case law, particularly *Title Guarantee & Trust Co., Executor*, which established that the inclusion of an annuity's value in the deceased's gross estate did not, by itself, change the basis for the survivor's tax liability. The court noted that the 1951 amendments to the tax code specifically addressed survivor annuities, but the grandfather's death in 1947 fell before the effective date (January 1, 1951) of the critical changes. These changes, made in the Revenue Act of 1951, would have allowed the survivor to use the estate-tax value as basis, but the law change applied only to decedents dying after December 31, 1950. The court stated, "That this result was intended by Congress is clearly indicated by the legislative history of the 1951 amendments." Therefore, the grandfather's basis, which had been fully recovered before his death, determined the taxability of the payments received by his grandson.

Practical Implications

This case highlights the importance of the decedent's date of death in determining the tax treatment of survivor annuities. Attorneys and tax professionals must carefully examine the dates of death to determine which version of the tax code applies. Cases concerning annuity payments require an examination of how much the original annuitant invested in the contract and whether the payments exceed the investment. The key takeaway is that the basis of an annuity is critical for determining the tax consequences of the annuity's income. The case underscores the importance of accurately determining the basis of an annuity and the crucial date for the tax regulations. Subsequent rulings and case law have further clarified the application of these principles, including how the basis is determined where the decedent died after the 1951 changes. This case serves as a reminder of the complexity of tax law and the need to stay updated on legislative changes.

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