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Taxation of Life Insurance Proceeds Under Section 22(b)(1) of the Internal Revenue Code

Insured took out a "Whole Life Policy" for \$100,000. The policy bestowed upon the insured the right to select one of three settlement options, or upon the beneficiary if the insured had not exercised such right. Insured died without having selected any of the options, and beneficiary chose option C, which provided that she was to have the whole or any part of the proceeds of the policy at the death of the insured paid in either 10, 15, 20, or 25 stipulated payments based upon a mortality table.^{1*} If the beneficiary should survive the number of installments selected, similar installments were to be continued during her lifetime. Should she die before the total installments were paid, the remaining installments were to be commuted and paid to her estate. Under option C the beneficiary chose to have the proceeds paid in 120 monthly installments over a 10-year period, amounting to \$597 monthly.^{2*} During 1940 the beneficiary received from the insurance company \$6,294, consisting of 10 monthly installments of \$597 each, with the last nine of these installments increased by monthly dividends of \$36 each. She reported this income as non-taxable for the year. The life insurance company, in accordance with Treasury Regulations, filed with the Treasury Department Form 1099, reporting \$2,009.51 of the sum paid beneficiary as "Taxable Portion of Total Paid under Supplementary Contracts." This sum now claimed to be taxable by the Commissioner under Treasury Regulations 103, Section 19.22(b)(1)-1^{3*} is obtained as follows:

* Age of Beneficiary	Number of Installments Stipulated			
	10	15	20	25
58	\$70.67	\$65.24	\$59.29	\$53.65

The table applies pro rata per \$1,000 of the amount to be so paid.

^{2*} \$8.45 per cent of 100 times \$70.67 with cents omitted.

^{3*} "Life insurance—Amounts paid by reason of the death of the insured.—The proceeds of life insurance policies, paid by reason of the death of an insured to his estate or to a beneficiary (individual, partnership, or corporation), directly or in trust, are excluded from the gross income of the beneficiary, except in the case of certain transferees as provided in section 19.22(b)(2)(A)-3 and in the case of a spouse to whom such payments are income under section 22(k). If, however, such proceeds are held by the insurer under an agreement to pay interest thereon, the interest payments must be included in gross income. *In the case of a beneficiary to whom payments are made in installments pursuant to an option exercised by such beneficiary, the amount exempted is the amount payable immediately after the death of the insured had such beneficiary not elected to exercise an option to receive the proceeds of the policy or any part thereof at a later date or dates.* [Italics supplied.] In any mode of settlement pursuant to an agreement of the insurer with a beneficiary the portion of each distribution which is to be included in gross income shall be determined as follows:

"(a) *Proceeds held by the insurer.*—If the proceeds are held by the insurer under an agreement with a beneficiary to distribute either the increment to such proceeds currently, or the proceeds and increment in equal installments until both are exhausted, there shall be included in gross income, the increment so paid to the beneficiary, or so credited to the fund in each year by the insurer.

"(b) *Proceeds payable in installments for a fixed number of years.*—If, pur-

Face Value of Policy (\$100,000)

_____ = \$5,141.39
 Life Expectancy of Beneficiary on Basis of Mortality Tables
 (19.45)

\$5,141.39 x 10 (Number of Monthly payments received
 during first taxable year)

_____ = \$4,284.49
 12 Months

\$6,294.00 (Sum paid beneficiary, including \$324 dividends)

4,284.49 (Admitted non-taxable income)

\$2,009.51 (Sum claimed to be taxable)

The Commissioner also argues that the beneficiary, by electing option C, entered into a new contract with the insurer and that the part of the payments in excess of the amount payable in a lump sum at the death of the insured is taxable. The sum left with the insurance

_____ pursuant to such agreement, the proceeds are payable in installments for a fixed number of years, the amount that would have been payable by the insurance company immediately upon the death of the insured (if payment at a later date had not been provided for) is to be divided by the total number of installments payable over the fixed number of years for which payment is to be made, and the quotient represents the portion of each installment to be excluded from gross income. The amount of each installment in excess of such excluded portion is to be included in gross income. For example, if, at the insured's death, \$1,000 would have been payable in a single installment, but 10 equal annual payments are made in lieu thereof, the portion of the installment received during any taxable year to be excluded from gross income is \$100 (\$1,000 divided by 10). Any amount received as an installment in excess of \$100 is to be included in gross income.

"If the proceeds are payable in installments for a taxable year beginning after December 31, 1941 to a spouse who was divorced or legally separated from the insured under a court decree, such proceeds are to be excluded from the income of such spouse to the extent provided in the preceding paragraph only if not required to be included in her gross income under section 22(k), relating to alimony income. Thus, if under the terms of a divorce decree, an insurance policy upon the life of the husband is to be purchased by him to provide a principal sum of \$10,000 payable upon his death in 10 annual installments, with interest, to his divorced wife, the full amount of such installments received by the wife, including the interest, is to be included in her income. See further section 22(b)(2), section 22(k), section 19.22(b)(2)(A)-4 and section 19.22(k)-1.

"(c) *Proceeds payable in installments during the life of the beneficiary.*—If, pursuant to such agreement, the proceeds are payable in installments during the life of the beneficiary the amount of each installment that is to be included in gross income will be determined as in paragraph (b) of this section, except that the number of years to be used in the specified computation will be determined by the life expectancy of the beneficiary, as calculated by the table of mortality used by the particular insurance company in determining the amount of the annuity.

"(d) *Proceeds payable for a fixed number of years and for continued life.*—If pursuant to such agreement, the proceeds are payable in installments for a fixed number of years and for continued life, the amount of each installment that is to be included in gross income will be determined either as provided in paragraph (b) of this section if the fixed number of years for which payment is to be made exceeds the life expectancy of the beneficiary, as calculated by the table of mortality used by the particular insurance company in determining the amount of the annuity; or, as provided in paragraph (c) of this section if such life expectancy exceeds the specified fixed period."

company according to the Commissioner's contention, was in the nature of a loan from which she received interest or compensation for the use of the funds. *Held*, the installments are computed according to a schedule contained in the policy. No part of them are denominated as interest, but—unlike dividends—are payable whether the company earns money or not. The rights flow from the policy granted the beneficiary and are paid by reason of the death of the insured. Therefore, of the \$6,294 received, only \$324.00 in dividends is taxable.⁴

"While Congress has power to require inclusion in gross income increments of moneys payable by reason of the maturing of life insurance contracts by death of the insured, it has not done so under the provisions of the Revenue Act of 1934."⁵ The history of Congressional action pertaining to insurance installments plainly shows that such payments are to be exempt from taxation. Section 213(b)(1) of the Revenue Act of 1924, and previous acts exempted: "(1) The proceeds of life insurance policies paid upon the death of the insured."^{6*}

This provision was modified in the Revenue Act of 1926, Section 213(b)(1), which provided for the exclusion from gross income any "Amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or *in installments*. . . ."⁷ The change in the 1926 Act was intended ". . . to prevent any interpretation which would deny exemption in the case of installments."⁸ The phrase "or otherwise" in the 1934 Act supplanted "or in installments" in the Acts from 1926 through 1932 to make it clear ". . . that the proceeds of a life insurance policy payable by reason of the death of the insured in the form of an annuity are not includible in gross income."⁹

"The Commissioner of Internal Revenue has authority to prescribe rules and regulations to administer the Revenue Act of 1934 under powers conferred upon him by Section 32 thereof. Any regulation consistent with the law is valid and its promulgation a proper exercise of the power conferred upon him, but it does not empower him to change or alter the law.

"The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law . . . but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regula-

⁴ *Pierce v. Com'r of Int. Rev.*, 2 T. C. No. 106 (1943).

⁵ *Allis v. LaBudde*, 128 F. (2d) 838 (C. C. A. 7th, 1942).

^{6*} 43 STAT. 267 (1924). For a comparative analysis on the statutes covering this point see BARTON AND BROWNING, *FEDERAL INCOME AND ESTATE LAWS* (7th ed. 1936), p. 21.

⁷ 44 STAT. 24 (1926).

⁸ Conference Report, H. R. 1, 69th Cong., 1st Sess., p. 33.

⁹ Finance Committee Report No. 558, 73d Cong., 2nd Sess., p. 23.

tion which does not do this, but operates to create a rule out of harmony with the statute is a mere nullity."¹⁰

It is well settled under Section 22(b)(1) of the Internal Revenue Code that amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or otherwise, are to be excluded from taxable gross income, pursuant to an election of settlement option made by the *insured* prior to the maturity of the policy.¹¹ The principal case on this point is *Com'r of Int. Rev. v. Winslow*.^{12*} In this case the X Insurance Society agreed, in consideration of the payment of an annual premium of \$2,569.44, to pay the designated beneficiary [Winslow] \$100,000 on receipt of notice of the death of the insured. The *insured* selected an option providing for payment in 50 annual installments of \$2,000 each and also inserted a "non-commutable clause." After payment of 13 premiums, the insured died. The beneficiary surrendered the policy and received a bond providing for payment of 50 annual installments of \$2,000 each. The installments also called for a three per cent interest rate. It was conceded that the commutation of 50 annual installments of \$2,000 each on the date of the death, would be \$53,000. Beneficiary received \$2,581.40 in 1934 and did not include this sum in his gross income. Altogether he had received from the insurer \$45,473.40, representing 17 annual installments of \$2,000 each, plus \$11,473.40, being the total of the additional payments each year. The Commissioner argued that since the commuted value was \$53,000, and that since \$45,473.40 had been received in prior years untaxed, under Treasury Regulations 86, Section 22(b)(1), the difference of \$7,526.60 representing tax free income, must be spread over the remaining 33 years. This would leave only \$228.08 as the exempt portion of the \$2,581.40 received during 1934. The Board of Tax Appeals held the \$2,000 portion of the installments exempt under Section 22(1)(1) of the Revenue Act of 1934, as arising from the death of the insured, and \$581.40 taxable as income not arising because of the death of the insured. The Circuit Court of Appeals upheld this decision, declaring Treasury Regulations 86 to be invalid insofar as inconsistent with this decision.

The language ". . . amounts received under a life insurance contract

¹⁰ 53 STAT. 32 (1939), 26 U. S. C. A. §62 (1940); *Com'r of Int. Rev. v. Winslow*, 113 F. (2d) 418, 423 (C. C. A. 1st, 1940); *Manhattan Co. v. Com'r of Int. Rev.*, 297 U. S. 129, 134, 56 Sup. Ct. 397, 400, 80 L. ed. 528, 531 (1936).

¹¹ *Kaufman v. U. S.*, 131 F. (2d) 854 (C. C. A. 4th, 1942); *Com'r of Int. Rev. v. Bartlett*, 113 F. (2d) 766 (C. C. A. 2d, 1940); *Com'r of Int. Rev. v. Buck*, 41 B. T. A. 99 (1940), *aff'd*, 120 F. (2d) 775 (C. C. A. 2d, 1941).

^{12*} 39 B. T. A. 373 (1939), *aff'd*, 113 F. (2d) 418 (C. C. A. 1st, 1940). It was on the basis of Section 22(b)(1) as interpreted by this decision that the court held the §324 in the *Pierce* Case to be taxable. This income was paid as dividends and was not received solely "by reason of the death of the insured."

paid by reason of the death of the insured, whether in a single sum or otherwise . . ." is to be interpreted in its ordinary and natural meaning.¹³

It is specifically provided by statute that ". . . if such amounts [premiums due the beneficiary] are held by the insurer under an agreement to pay interest thereon, the interest payments shall be included in gross income."¹⁴ In the case of *United States v. Heilbronner*,¹⁵ the policy provided that the insurers were to pay the defendant beneficiary annual sums described either as "interest" or "annuity" payments without diminution of the corpus of the policy. Upon the death of the defendant the insurers were to pay her children the face value of the policy. The Commissioner refunded the money the beneficiary paid on her return, holding that such sums were paid by the reason of the death of the insured within the meaning of Section 22(b)(1) of the Revenue Act of 1928. A new Commissioner demanded a return of the money, which was refused; and an action was brought in the Federal Court to force a return. The Court held that the money was not paid by reason of the death of the insured, but constituted interest, and ordered a judgment in favor of the United States.

The same general rule applies to dividends received by the beneficiary. In the case of *Kinnear v. Com'r of Int. Rev.*¹⁶ the court held dividends to be paid for reasons other than the death of the insured to be fully taxable.

On the other hand the Revenue Department has ruled that "There should . . . be excluded from gross income not only the principal sum or capital value of the life insurance policy as of the date of the death of the insured but also any amounts added to such principal sum (when it is paid in installments), pursuant to an option exercised by the insured, by reason of the running of time."¹⁷ Similarly it has been held that a small increase in each monthly installment payment after a certain date because of the discontinuance by the insurer of an administrative expense is excluded from gross income, the court holding such to have been received under the insurance contract, or to have been a gift exempt from taxation under Section 22(b)(3) of the Revenue Act of 1934.¹⁸

In the case of *Allis v. LaBudde*¹⁹ the beneficiary's husband carried policies providing for monthly payment to the beneficiary for a period of 10 years and thereafter during beneficiary's lifetime. The insured

¹³ *Helvering v. San Joaquin Co.*, 297 U. S. 497, 56 Sup. Ct. 569, 80 L. ed. 824 (1936).

¹⁴ 53 STAT. 10 (1939), 26 U. S. C. A. §22(b)(1) (1940).

¹⁵ 100 F. (2d) 379 (C. C. A. 2d, 1938).

¹⁶ 20 B. T. A. 718 (1930).

¹⁷ General Counsel's Memorandum, 23523, 1943-6-11376.

¹⁸ *Com'r of Int. Rev. v. Bartlett*, 113 F. (2d) 766 (C. C. A. 2d, 1940).

¹⁹ 128 F. (2d) 838 (C. C. A. 7th, 1942).

died in 1918. Beneficiary did not include the installments paid after the 10-year period during either 1934 or 1935. The Commissioner of Internal Revenue attempted to include these sums in her gross income under Regulations 86, Section 22(b)(1)-1; but the Circuit Court of Appeals held this regulation to be inconsistent with the intent of Congress and excluded these sums from gross income.

As a result of the *Winslow* Case, the *Allis* Case and other similar cases, the Commissioner amended previous regulations. In "Regulations One-Eleven," Section 29.22(b)(1)-1, as released October 28, 1943, the Commissioner provided that "In case of a beneficiary to whom payments are made in installments pursuant to an option exercised by such *beneficiary*, the amount exempted is the amount payable immediately after the death of the insured had such beneficiary not elected to exercise an option to receive the proceeds of the policy or any part thereof at a later date or dates." The consistency of this regulation with the statute as laid down by Congress was tested in the *Pierce* Case, *supra*, and was declared inconsistent with Congressional intent as laid down in the statute. Previously the same court had said: "Whether such arrangement with the company was made by the beneficiary or by the insured is regarded as immaterial."^{20*} Without the use of this dictum the court now said that by death of the insured the beneficiary acquired one of several property rights, and in exercising any of them, the right would spring from the policy.²¹

Thus it appears that the Courts have consistently followed the will of Congress that there shall be excluded from gross income ". . . amounts received under a life insurance contract *paid by reason of the death of the insured, whether in a single sum or otherwise. . .*"²² (Italics ours.)

Congress having provided for income taxation, it might be argued that the Commissioner, through his Regulations, was attempting to carry out the purpose of the Sixteenth Amendment, which authorizes Congress to ". . . lay and collect taxes on *incomes, from whatever source derived*, without apportionment among the several states, and without regard to any census or enumeration."²³ (Italics ours.) Income may be defined as "that *gain or recurrent benefit* (usually measured in money) which proceeds from labor, business, or property."²⁴ (Italics ours.) The Federal Court has defined income as "all gain from capital, labor, or-both."²⁵

^{20*} *Winslow v. Com'r of Int. Rev.*, 39 B. T. A. 373 (1939), in commenting upon G. C. M. 13796, XIII-2 C. B. 41 (October 2, 1934).

²¹ *Latterman v. Guardian Life Insurance Co.*, 280 N. Y. 102, 19 N. E. (2d) 978 (1939).

²² 53 STAT. 10 (1939), 26 U. S. C. A. §22(b)(1) (1940).

²³ U. S. Const. Amend. XVI.

²⁴ WEBSTER'S NEW INTERNATIONAL DICTIONARY (2nd ed.), p. 1258.

²⁵ *In re Owl Drug Co.*, 21 Fed. Supp. 907, 909 (1937).

Most policies have an option providing for immediate settlement with the beneficiary upon the death of the insured. This sum, payable immediately, may be called theoretically an investment, which is non-taxable. However, upon exercising an option calling for installment payments over a period of years, the sum total received is greater than the amount receivable immediately upon the death of the insured. This "gain" is in reality "income" on the "investment."

An illustrative example is as follows. Suppose the policy provides for settlement with the beneficiary under two options:

- (1) The face value of the policy, \$50,000, is to be paid immediately.
- (2) Leaving the proceeds with the insurer, the insurer to pay 10 annual installments of \$6,000 each.

As a result of choosing option (2) the beneficiary receives an extra net non-taxable income of \$10,000 over the 10-year period, or \$1,000 annually. If the policy provided for a stipulated number of installments, and an extension for life of the beneficiary provided his life exceed the number of guaranteed installments, as in the *Allis Case*, *supra*, any amounts received above the face value of the policy may be regarded as income in economic usage and as a practical matter; and yet remain non-taxable.

Under the Revenue Act of 1934 and subsequent laws the yearly income received from an annuity is divided into two parts. Three per cent of the cost of the annuity is included in gross income; and the remainder, if any, is to be excluded. As soon as the aggregate amount excluded equals the cost of the annuity, any sums received thereafter are to be included in gross income.^{26*} This rule also applies to life insurance and endowment policies paid other than by reason of the death of the insured. An exception to this rule is an annuity payable to a wife in settlement of alimony, which is fully taxable.²⁷

The Court has defined an annuity ". . . as a sum paid yearly or at other specified intervals in return for the payment of a fixed sum by the annuitant. The annuity itself is the totality of the payment to be made under the contract."²⁸ The Revenue Department has defined it thus: "A stated sum payable periodically at stated times during life, or a specified number of years under an obligation to make payments in consideration of a gross sum paid for such obligation, which gross sum is exhausted in the making of the periodic payments."²⁹

^{26*} 53 STAT. 10 (1939), 26 U. S. C. A. §22(b)(2) (1940); Regulations One-Eleven, Section 29.22(b)(2)-1. For a comparison of the law on this point see BARTON AND BROWNING, FEDERAL INCOME AND ESTATE LAWS (7th ed., 1936), p. 21.

²⁷ 56 STAT. 816 (1942); 26 U. S. C. A. §22(k) (Supp. 1943); Regulations One-Eleven, Section 29.22(k)-1.

²⁸ *Bodine v. Com'r of Int. Rev.*, 103 F. (2d) 982, 984 (C. C. A. 3rd, 1939).

²⁹ General Counsel's Memorandum 21666, C. B. 1940-1, cited in *Frackelton v. Com'r of Int. Rev.*, 46 B. T. A. 883, 894 (1942).

A somewhat similar treatment might be made in the case of insurance installments. Rather than tax the sum total of the premiums paid to the insurer at three per cent, a tax might be levied on the cash value of the policy at the time of the death of the insured, exempting all income above three per cent taxable income until the excluded non-taxable income reaches the face value of the policy. This plan in no way would tax the corpus of the policy, but would be a tax on the income only.

It is evident that Congress is leaving untouched an abundant source of taxable income. In this era when every available source should be tapped, it is suggested that Section 22(b)(1) be amended so as to include sums paid above the value of the policy at the time of the death.

CECIL J. HILL.

Negligence—Res Ipsa Loquitur—Application to Unexplained Airplane Accidents

In a recent North Carolina case of first impression the Supreme Court refused to apply the doctrine of *res ipsa loquitur* to an unexplained airplane accident. The facts of the case were that a passenger invited by the pilot for a ride was injured when the plane crashed without any apparent reason. Both the plaintiff and the pilot testified that the plane went into a spin and crashed, and that neither had any knowledge of the reason why. The Court said that "The doctrine of *res ipsa loquitur* does not apply because any number of causes may have been responsible for the plane falling, including causes over which the pilot had absolutely no control, it being common knowledge that aeroplanes do fall without the fault of the pilot."¹

Translated literally, *res ipsa loquitur* means "the thing speaks for itself." The doctrine had its origin in 1863 in an English case where a barrel of flour fell from a second story window and injured the plaintiff.² It involves the use of circumstantial evidence to establish the plaintiff's case by allowing an inference or presumption of negligence to arise from the circumstances of the accident itself. An accident resulting in injury must be accompanied by surrounding circumstances which, viewed in the light of the entire situation, give rise to an inference of negligence. From the layman's point of view it can be stated as follows: "What is required is evidence from which reasonable men may conclude that, upon the whole, it is more likely that there was negligence than there was not."³

The development of the doctrine has led to much confusion in

¹ Smith v. Whitley, 223 N. C. 534, 535, 27 S. E. (2d) 442, 443 (1943).

² Bryne v. Boadle, 2 H. & C. 722, 159 Eng. Rep. 299 (1863).

³ PROSSER, TORTS (1941) §43.