THE INCOME TAX LIABILITY OF ANNUITIES AND SIMILAR PERIODICAL PAYMENTS

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Since the income tax amendment to the Constitution of the United States was adopted in 1913, followed by the series of Revenue Acts, the courts of the United States have been quite regularly employed in the difficult task of determining the meaning of the term "income." The task is not alone one of statutory construction, for, since the sixteenth amendment grants Congress the power to tax incomes only, the court must frequently decide whether a given subject matter is income, before considering whether a given revenue act purports to tax it. Moreover, although income taxation was resorted to for a comparatively brief period during the Civil War, the history of federal income taxation is relatively short, and, for this reason, many difficult cases cannot yet be hung upon the peg of judicial precedent. Hence, there is still room for speculation as to the proper treatment for income tax purposes of some rather common sorts of receipts, since some of the more interesting cases have never been passed upon by higher authority than the Treasury Department. Among these are annuities and similar periodical payments, which have not yet been assigned a place by the courts in the scheme of federal taxation, although they have invited a rather varied treatment at the hands of the Department.

1 The Sixteenth Amendment provides: "The Congress shall have power 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." The amendment was certified by the Secretary of State on February 25, 1913, to have been ratified by the requisite number of states.


3 For a discussion of the Civil War income taxes, see Seligman, The Income Tax (2d ed. 1914) 430 et seq.
To give point to the discussion of their income tax liability, we may divide into four groups the commoner provisions for periodical payments and annuities:

I. Annuity contracts entered into as commercial or business transactions whereby A transfers money or property to B in consideration of B's agreement to pay an annuity to A or some other designated beneficiary.

II. Annuity contracts not entered into as commercial or business transactions, although as in I, A transfers property or money to B in consideration of B's agreement to pay an annuity to a designated beneficiary.

III. Terminable rights to the income of property held in trust.

IV. Terminable charges upon property, created by will.

Consider a typical case of the first group. A, a father, wishes to provide for monthly payments to his daughter X. He therefore procures a ten year endowment policy in the B life insurance company, which, in consideration of a single payment of $15,000, agrees to pay X $100 monthly for life, beginning ten years later, with provisions for other beneficiaries in the event of X's death. At the end of ten years, A and X being both alive, X begins to receive the monthly payments. Are they taxable income to her?

Although Sec. 213 (a) of the Revenue Act of 1921, defining gross income, lists a number of forms of income, annuities are not included. The section does not, however, purport to catalogue exhaustively all the varieties of taxable receipts. It will be necessary, therefore, to examine the other sections of the act to ascertain whether annuities were within the legislative concept of "gains or profits and income derived from any source whatever."

Annuities and annuity contracts are mentioned in at least three sections of the act, 213 (b) (2), 221, and 256. By paragraph (2) of Sec. 213 (b), amounts received by an insured as a return of premiums paid by him under an annuity contract are exempted from income taxation. This provision inferentially aids the probable contention of the Treasury Department that annuities are income. The Revenue Acts purport

"Sec. 213. That for the purposes of this title . . . . the term 'gross income'—
(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal services, . . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever . . . ." 42 Stat. at L. at p. 238.

"Sec. 213. That for the purposes of this title . . . . the term 'gross income'—
(b) Does not include the following items, which shall be exempt from taxation under this title:
(1) The proceeds of life insurance policies paid upon the death of the insured;
to lay a tax upon incomes only, within the authority granted by the sixteenth amendment. The exemption here given does not apply to all annuity contracts, but only to parts of the payments of certain specified ones. The inference may, then, be urged, that Congress considered payments to an annuitant ordinarily to be income, for if to tax such payments is to tax capital, no exemption would have been necessary.

A more direct indication of the probable legislative intent is contained in Sec. 221, which provides for withholding the tax on income of non-resident aliens at its source. Congress here specifically named annuities as one of the various kinds of income from which the tax was to be withheld. It is noteworthy that a similar withholding provision, likewise naming annuities, has been included in all the Revenue Acts since 1913. Again in Sec. 256, which requires a return of information from the payer, of the name of the recipient and the amount of income over $1000, annuities are specified as one of the forms of income. *These two provisions, therefore, would indicate that when Congress used the term "income" elsewhere in the acts, it intended it to include at least those items it listed here as constituting income, among them annuities.*

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(a) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(b) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);" 42 Stat. at L. p. 238.

(In this discussion, I have habitually referred to the provisions of the Revenue Act of 1921, and U. S. Treasury Regulations 62 issued thereunder, rather than to earlier acts or regulations. Important differences have generally been noted.)

"Sec. 221. (a) That all individuals, corporations, and partnerships, in whatever capacity acting . . . having the control, receipt, custody, disposal, or payment, of interest, . . . rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income of any non-resident alien individual . . . shall . . . deduct and withhold from such annual or periodical gains, profits and income a tax equal to eight per centum thereof . . . ." 42 Stat. at L. p. 238.—(italics mine)

Art. 362 of U. S. Treasury Regs. 45 and 62, interpreting this provision, reads:

"Only (a) fixed or determinable, (b) annual or periodical income is subject to withholding. Among such income, giving an idea of the general character of income intended, the statute specifies interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. But other kinds of income may be included. . . . That the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical. . . ."

1 Act of October 3, 1913, Sec. II, Par. E (38 Stat. at L. 114, 169); Act of Sept. 8, 1916, Sec. 9 (b), as amended October 3, 1917 (39 Stat. at L. 300, 332); Sec. 221, Act of February 24, 1919 (40 Stat. at L. 1057, 1072).

2 Sec. 256. That all individuals, corporations, and partnerships, in whatever capacity acting . . . making payment to another individual, corporation or
Since annuities are not specifically designated in Sec. 213 as part of gross income, it will be desirable to determine as definitely as we can what that word means, relying upon the indications from the other portions of the act as only one step in the determination. It is well established that Congress used the term "income" in its ordinary meaning commonly understood by the people at the time they adopted the sixteenth amendment. The economist's definition is quite broad: "the money value of the net accretion in one's economic power between two points of time." The courts, however, as in Merchants' Loan & Trust Co. v. Smietanka have generally refused to adopt economists' or lexicographers' definitions, relying upon what they conceive to be more generally understood meanings. The judicial concept of income may be illustrated by Judge Learned Hand's opinion in United States v. Oregon-Washington R. & Nav. Co.: "However, the tax, though it includes income 'from all sources' nevertheless includes 'income' only, and the meaning of that word is not to be found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech. The implied distinction . . . is between permanent sources of wealth and more or less periodic earnings . . . . The word unquestionably imports, at least so it seems to us, the current distinction between what is commonly treated as the increase or increment from the exercise of some economically productive power of one sort or another, and the power itself."

The same distinction is brought out by Justice Pitney in the majority opinion in Eisner v. Macomber. These opinions both show that the partnership, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits and income . . . of $1000 or more in any taxable year . . . shall render a true and accurate return to the Commissioner . . . setting forth the amount of such gains, profits and income . . . ." 42 Stat. at L. at p. 269.—(italics mine)

Art. 1073 of Regs. 62 provides in part: "Payments of the following character, although over $1000, need not be reported in returns of information . . . (f) annuities representing the return of capital." This administrative provision is probably designed to carry out the statutory exemption granted by Sec. 213 (b) (2) (note 5 supra), although there may be a question whether the terms "return of premium paid" are synonymous with "return of capital." The statutory provision might be literally interpreted to mean that part of the premiums actually returned by the company during the course of the insured's payments, as, for example, the so-called dividends paid by a mutual insurance company. The Department has not, however, interpreted the statute thus narrowly.


*See note 9 supra.*

two chief characteristics of most incomes are (1) more or less regular recurrence over a period of time,\(^\text{14}\) and (2) separation from capital. Although an annuity as defined by Coke: "An annuity is the yearly payment of a certain summe of money granted to another in fee for life or yeares, charging the person of the grantor onely,"\(^\text{15}\) arguably falls within these definitions, it would be more convincing to determine with greater exactness whether annuities are commonly thought of as income, by examining the income tax acts of other jurisdictions, which preceded and succeeded our own.

The English income tax system was doubtless the most widely known at the time the sixteenth amendment was adopted, for it had been in continuous operation since 1842.\(^\text{16}\) During that whole period, England has taxed annuities as incomes.\(^\text{17}\) To be sure the English schedules specifically refer to "annuities" and "annual payments" as being taxable. But it is notable that the English judges have not applied the tax to all periodical payments, but have endeavored to distinguish the thing taxable as an annuity from other receipts resembling it, and sometimes even loosely called annuities.\(^\text{18}\) The distinction may be indicated by to which it was applied in the Doyle Case. \(\text{[Doyle v. Mitchell Bros. Co. (1918) 247 U. S. 179, 38 Sup. Ct. 467.]}\) The quotation is from Stratton's Independence v. Howne (1913) 231 U. S. 399, 415, 34 Sup. Ct. 136, 140.

"Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. 'Derived—from—capital';—'the gain—derived—from—capital,' etc. Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived,' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;—that is income derived from property . . ."

\(^{19}\) To be sure, in Merchants' Loan & Trust Co. v. Smietanka (supra note 9), and in Doyle v. Mitchell Bros. Co. referred to by the court in Eisner v. Macomber (note 13 supra), the Supreme Court held that a gain derived from a sale or conversion of capital assets was income. These decisions do not, of course, change the general proposition that the common conception of income involves a periodicity of receipt. See also Trefry v. Putnam (1917) 227 Mass. 522, 116 N. E. 904; L. R. A. 1917, F 806, note.


\(^{21}\) For the earlier English income tax acts, see Dowell, Income Tax Laws (8th ed. 1918) lxv et seq. The 1803 Act (43 Geo. III, c. 122) taxed "Profits arising from" annuities as income.


\(^{23}\) The distinction is well put in an excellent article by John M. Maguire, Capitalization of Periodical Payments by Gift (1920) 34 Harv. L. Rev. 20, 28.
two quotations, one from an early and one from a recent English case. In *Foley v. Fletcher* Baron Watson said:

"An annuity means where an income is purchased with a sum of money, and the capital has gone and has ceased to exist, the principal having been converted into an annuity." In other words, the true annuitant does not actually receive back any part of the principal he paid, but merely an income purchased with it. That income is taxable. The difficulty of making the distinction, but its essential validity, is indicated by Rowlatt, J., in *Jones v. Comm'r. of Inland Revenue*.

"There is no law of nature or any invariable principle that because it can be said that a certain payment is the consideration for the transfer of property it must be looked upon as price in the character of principal. In each case, regard must be had to what the sum is. A man may sell his property for a sum to be paid in instalments, and when that is the case, the payments to him are not income. *Foley v. Fletcher*, 3 H. & N. 769. Or a man may sell his property for an annuity. In that case the income tax act applies."

This English interpretation is, of course, no criterion in determining the meaning of the Revenue Acts. It is useful, however, in ascertaining what is included in the term income as used in common speech. The fact that, in other principal foreign states, in which income tax acts were in operation at the time the sixteenth amendment was adopted, annuities were usually expressly named as one form of income, also indicates that the common conception of income includes such a periodical receipt as an annuity.

Finally, such state income tax statutes as set forth in detail the various forms of income virtually always include annuities. Compare the case considered by Blackstone in discussing usury, of the repayment of borrowed money: "He therefore" (the borrower) "stipulates (in effect) to repay annually, during his life, some part of the money borrowed; together with legal interest for so much of the principal as annually remains unpaid, and an additional compensation for the extraordinary hazard run of losing that principal entirely by the contingency of the borrower's death: all which considerations, being calculated and blended together, will constitute the just proportion or quantum of the annuity which ought to be granted." (*Commentaries*, Bk. II, *q61.*)

*Quaere*, whether the instalments the lender receives in such a case would be taxable *in toto*, even under the English acts. See *Stobie v. Sec. of State* [1902], 2 K. B. 473, 494; *East Indian Ry. v. Sec. of State* [1905], 2 K. B. 473, 494; *Scoble v. Sec. of State* [1902], I K. B. 494, [1903, H. L.] A. C. 299; *Merchants' Loan & Trust Co. v. Svietanka*, cited in note 9 supra.

The relevant provisions of the various income tax acts are given in *Reports from His Majesty's Representatives Abroad, Respecting Graduated Income Taxes in Foreign States* (1913) at the following pages: Prussia, 42; Saxony, 65; Austria, 100; Switzerland, 106-7; Zurich, 113; Berne, 116; Vaud, 117; The Netherlands, 123; Denmark, 145.

chusetts has taxed the "income from an annuity" at least in theory, since 1835, and Louisiana has, since 1878, taxed "the excess of all annuities, salaries and incomes over $1000 derived from any source, except from property taxed." In other words, such state legislatures as have considered the matter at all have regarded annuities as one form of income. This is very good evidence that the ordinary understanding of the word "income" as used in the United States, includes annuities as one form thereof.

To summarize, then, such indications as the Revenue Acts themselves afford are to the effect that annuities are taxable income. The judicial definitions are broad enough to include annuities as income, since the stress therein is laid upon periodical recurrence and separation from capital, both characteristic of an annuity. The best known income tax acts existing at the time the sixteenth amendment was adopted, in England and continental states, had been treating annuities as taxable income for some time, and the same treatment has been generally followed in the American states. Finally, so far as one can hazard an opinion, it is very likely that the average layman or even the recipient of an annuity considers it as income, to be utilized for current expenditures, rather than to be hoarded to replace a wasting capital asset. Consequently, it may be expected that the Treasury Department will hold that annuities in general are taxable income, subject, of course, to any exemptions or deductions granted by the Act. So far as the published opinions indicate, this view has already been adopted.

I

COMMERCIAL ANNUITY CONTRACTS

It remains to erect on this general foundation a method of treatment for the particular kinds of annuities and other periodical payments designated above. We may consider first the example already given—an annuity purchased by A from the B life insurance company for the benefit of his daughter X. We have already concluded that

1919, sec. 7795; N. D. Laws, 1919, ch. 224, sec. 1; Or. Laws, 1923, ch. 279; Va. Laws, 1918, ch. 219, sec. 1.  
Rev. Sts. 1835, ch. 7, sec. 4; Maguire, op. cit. supra note 18, at p. 36.  
La. Acts, 1878, No. 8, sec. 1; see Kennan, Income Taxation (1910) 215. The tax seems not to have been efficiently collected, and apparently has not been levied since 1899. Seligman, The Income Tax (2d ed. 1914) 413.

27 See, particularly, Regs. 45 and 62, Art. 47; Off. Dec. 170, in 1 Cum. Bull. 76 (issued by the Bureau of Internal Revenue weekly and cumulated semi-annually), which is thus digested for publication: "An individual who receives income from an annuity which has been purchased for his benefit by another person is not liable for tax thereon until the payments received under the terms of the annuity have equaled the amount paid or set aside to purchase or establish same." The inference would be that thereafter the "income from an annuity" would be taxable. *Quaere*, whether the "income from an annuity" is the whole amount received.
annuities in general will probably be treated as taxable income. Are there any exemption provisions applicable to this case? Three paragraphs of Sec. 213 (b) should be borne in mind as possessing possibilities of relief for the annuitant. In the example given, paragraph (1) would not apply, so long at least as the insured A remained alive. The question of the applicability of paragraph (2) is perhaps more difficult. If A was himself the beneficiary of the policy, without question he would be entitled to some exemption. But his daughter X is the beneficiary, not the insured; and she is not receiving a return of premiums paid by her. As we shall have occasion to observe presently, this paragraph does not grant an exemption to all annuities paid under contracts. It is reasonably obvious that it would be held not to apply here.

The most serious contention of the annuitant would be based upon paragraph (3). At the time the annuity was purchased for X by A, it had an ascertainable value to X: the discounted amount of the payments X would receive during her expectancy. X is the donee beneficiary of the A-B contract; in other words, the right to receive these payments is a gift to her. Therefore, X should not be taxed on her receipts from this policy until and unless they exceed the value to her of her right to receive them, as of the time she became entitled to them; or, alternatively, the difference between this value and the total

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2 See supra note 5.
3 The somewhat inartistic wording of the paragraph makes it questionable exactly what exemption A is entitled to receive, if he is also the beneficiary: whether to (1) that part of each annuity payment which is calculated to be a return of a part of the principal sum paid the insurance company, or (2) an amount equal to the aggregate of all premiums paid, before any payments are taxable income. The Treasury Department has taken the second view in Art. 47 of Regs. 45 and 62.
4 Art. 1563 of Regs. 62 provides in part, "In the case of property acquired by bequest, devise, or inheritance, its value as appraised for the purpose of the Federal estate tax or in the case of estates not subject to that tax its value as appraised in the State court for the purpose of State inheritance taxes shall be deemed its fair market value when acquired." According to the tables contained in U. S. Treas. Regs. 63, relating to the Estate Tax, Art. 15, if X is, for example, 25 at the time the annuity becomes payable to her, its present worth is $21,363.28.
5 See Off. Dec. 170, quoted supra note 27. Compare I. T. 1776, published in the Sept. 10, 1923, Internal Revenue Bulletin. There a donor by written instrument gave bonds to a trustee, to pay the income to X for life, and on his death to deliver the bonds to an incorporated church. The donor wished to deduct the present value of the church's remainder interest under Sec. 214 (a) (11) of the Revenue Act of 1921, as a contribution to a religious organization. It was held that he might do so. Suppose the donor had directed the income to be paid to another church during the life of X, should not the entire value of the bonds be deductible by the donor, subject to the provisions of Sec. 214 (a) (11)? Then, suppose the donor directed the income to be paid to a church for 25 years, remainder to an individual X. Under I. T. 1776, should not the donor be permitted to deduct the present value of the 25 year interest under the same section? Similarly has not the donee of the income received a gift of that value?
TAX LIABILITY OF ANNUITIES

amount it is calculated X should receive over the period of her expectancy is income to the beneficiary, to be spread in some way over the period of expectancy.\(^a\) Undoubtedly these arguments are persuasive and, at one time or another, the Treasury Department has acceded to them.\(^b\) There is considerable force in the contrary position, however. In the first place, what was the gift? It was not the various monthly payments, for these are made by the insurance company to the daughter in return for a valuable consideration received by the company. So far as there was any gift herein, it was of the right to receive these monthly payments, acquired by the daughter as a donee beneficiary of the insurance contract. The right to receive these payments has not been taxed, nor does the Department show any intention of taxing it. The question remains whether the payments themselves, which were not and are not the subject of a gift, but which are being paid by the company because it is its legal duty under the insurance contract to pay them, constitute taxable income.\(^c\)

If it then be urged that the exemption granted by paragraph (3) of Sec. 213 (b) is of the value of the right to receive these payments, the Department can fall back upon Sec. 215 (b),\(^d\) which appeared for the first time in the 1921 act. The deduction for shrinkage of the principal fund there referred to would be claimed, of course, by virtue of the contention that each monthly payment contains an increment of the original sum paid for the contract as well as interest; hence that the principal fund is wasting or shrinking to this extent.\(^e\) The total

\(^{a}\) See Off. Dec. 1108, 5 Cum. Bull. 92. The conflict between this latter decision and Off. Dec. 170 does not seem to have been recognized in the official publications of the Treasury Department.

\(^{b}\) See notes 31 and 32.

\(^{c}\) An analogous result was reached in Off. Dec. 755, 3 Cum. Bull. 212, in which the testator directed his executor to pay an annuity to B and C for their lives, without designating a fund therefor. The executor purchased a single payment endowment insurance policy on D's life, which provided for the payment of the amount of the annuity to B and C. The amounts received by B and C were held to be taxable income.

\(^{d}\) "Sec. 215. (a) That in computing net income, no deduction shall in any case be allowed in respect of

(b) Amounts paid under the laws of any State, Territory, District of Columbia, possession of the United States, or foreign country as income to the holder of a life or terminable interest acquired by gift, bequest or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time. . . ." 42 Stat. at L. at p. 242.

\(^{e}\) The definition of income in the illuminating Report of the Royal Commission on the Income Tax (1920) expressly excludes this deduction for shrinkage, in Par. 184: "We think that in that practical world which alone can be considered for the purposes of taxation, the income which represents the taxable faculty is not a mathematical abstraction, but that net receipt which in the hands of its possessor is usually regarded as income, that is to say, as a receipt out of
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The second type of annuity case involves what appears to be a fairly common family settlement. A widow, A, owns Blackacre, which has yielded her an income of about $5,000 per year. She wishes in her later years to escape the responsibilities of management. She therefore proposes to her children B and C that she will convey Blackacre to them if they will promise to pay her for her support a total of $5,000 per year during her life. This arrangement is duly consummated. A number of troublesome income tax questions immediately arise. (1) May the children B and C deduct on their income tax returns the $5,000 per year which they are paying A? (2) Is the $5,000 per year which current expenditures may be met, subject possibly to some general saving, but not (either in theory or practice) subject to any specific appropriation for the replacement of the capital which is used in earning the income, and which over a long period of years may waste in such use?" 

"In Notes on the Revenue Act of 1918, submitted by the Secretary of the Treasury in November, 1919, to the House Committee on Ways and Means, prior to the adoption of the Revenue Act of 1921, it is said (p. 13): "It has been suggested that it is desirable also to clear from doubt the status of life interests or estates. Life tenants have made claim for an obsolescence allowance based upon shrinkage due to the mere passage of time in the so-called capital value of the life interest. Certain State statutes and the decisions thereunder give color to the claim that the value of the life interest at the time received is such a capital value as may serve as the basis of deductions for obsolescence. If these claims are allowed, cases would arise in which a clear income from an unimpaired (sic) corpus divided between the life tenant and remainderman would entirely escape taxation—the income from the property being wiped out by the annual shrinkage or obsolescence of the so-called capital value of the life estate."

"See Maguire, Income Taxes on the Realization of Future Interests (1922) 31 YALE LAW JOURNAL, 367, 375."
taxable income to the mother? (3) Has either party realized any gain or loss from the mere making of the contract? (4) Finally, suppose A dies after 5 years, and thereafter B and C sell Blackacre for $125,000. Have B and C realized any taxable gain on this transaction?

1. If the parties really contracted here in fact as well as in form, it is evident that the transaction was legally a purchase of the land at the price of the promise to pay the annuity. Payments by the children, under this construction, are a capital expenditure on account of the purchase price of the land. There seems to be no basis for the deduction of such payments on the income tax returns of the children.

But if the taxpayer can persuade the Department to look behind the form of the transaction into its substance, he can make a very persuasive argument for a different treatment. In substance, the mother was not bargaining for the equivalent of her property; she was willing to give her children the property, provided she might have the equivalent merely of its income. Gifts on condition are not unknown to the law. It may be granted that the children gave the mother a promise in exchange for the property; and that the Department will have some difficulty in determining what transactions are to be treated as gifts; what, as transfers for good consideration. That there is a recognizable distinction is, however, declared by the Department itself in its regulations relating to estate taxes. In Article 20 of Regulations 63, interpreting Sec. 402 of the Revenue Act of 1921, it is provided that if a transfer of property was not a bona fide sale for a fair consideration, but the decedent reserved to himself income from the property transferred, the part of the property necessary to produce the income shall, for purposes of the estate tax, be included in the gross estate. In other words, such a transaction is treated as being in whole or in part a transfer by way of gift to take effect upon the transferor’s death, on condition of the transferee’s paying an annuity to the transferor.

Note that we are here dealing with an isolated transaction. This result was reached in I. T. 1662, Cum. Bull. II-1, p. 121. The same opinion was given in I. T. 1242, published in Cum. Bull. I-1, p. 61, and in I. T. 1484, Cum. Bull. I-2, p. 66, with the qualification that if the transaction was entered into for profit, annuity payments in excess of the value of the property received in exchange may be deducted as a loss. But has the payer realized either gain or loss until he disposes of the property he received? See Par. 3 and 4 infra.

This article is referred to in Art. 1563 of Regs. 62, evidently as defining what the phrase “property acquired by bequest, devise or inheritance” means. The Department seems not to have adopted the gift on condition analysis in an analogous case where it would have operated to the advantage of the revenues. In Art. 47 of Regs. 62, it is provided: “Annuities paid by religious, charitable, and educational corporations under an annuity contract are subject to tax to the extent that the aggregate amount of the payments to the annuitant exceeds any amounts paid by him as consideration for the contract.” Surely these transfers to religious,
On this basis, the children may properly contend that the amounts of the income paid the transferor are deductible on their income tax returns, for the reason that, in substance, the transferor has reserved to herself the income from the property to this extent. The contention that the transaction was not a contract but a gift on condition would, of course, be more difficult to make where the promise of the annuity was not specifically related to the income realized from any property; where the transferee might dispose of the property freely, and is merely under a personal obligation to pay certain sums to the transferor.

Thus the answer to the first question of this subdivision is by no means clear; both the taxpayer and the Department can point to previous rulings, which lead to opposite results.

2. Various reasons have already been advanced for considering an annuity in general as taxable income. It is clear that the payments which the mother here receives are an annuity within Coke's definition. Is the mother entitled to the benefit of the exemption provision in Section 213 (b) (2), already discussed? Certainly her attorney can make a strong argument in her favor. The Department may oppose his contention with considerable force on the exact wording of the paragraph. It is well settled that exemption provisions in a taxing statute are to be strictly construed against exemption. This exemption in terms is limited to such amounts as are received by an insured as a return of premiums under life insurance, endowment or annuity contracts. The mother here was not an insured, although she may, on one construction, have entered into an annuity contract. Moreover, the Department might well contend that the periodical payments she receives represent the income on the property she transferred, not a return of the "premium"—the value of the property—itself. The payments then would be taxable income to the annuitant.

charitable or educational organizations are generally no more bona fide sales for good consideration than that in the main case. If the transferor, then, is receiving no more than the income of the property transferred, as is probably usually the case (see Miller v. Western College, cited in note 41 supra), he might very well be required to pay income tax thereon. The exemption in Sec. 213 (b) (2) arguably would not apply, for the reasons given in Par. 2 infra.

See Subdivision IV infra for a similar situation.

4See Art. 20 of Regs. 63 provides, however: "A transfer is taxable in accordance with these principles, whether the decedent reserved the annuity out of the property conveyed, or payment thereof to him was made by the grantee upon an express or implied condition to that effect."

4See note 5 supra.

4I. T. 1484, see note 40 supra, supports this view.


4Of course, this treatment would be peculiarly applicable if the argument of the children in Par. 1 supra prevails—that is, that the transfer was a gift on condition of paying the income, or part of it, to the mother. If the children are
The contention that the annuity payments are taxable income to the recipient would not necessarily be inconsistent with a holding that the amounts paid by the children are not deductible in their income tax returns. It was pointed out in *Jones v. Comm'rs. of Inland Revenue*\(^9\) and in *Chadwick v. Pearl Life Insurance Co.*\(^6\) that property may be purchased for (1) a lump sum; (2) a lump sum payable in instalments, or (3) an annuity. The transaction is no less a purchase of the property because of the difference in the method of paying the purchase price.

3. Now can the Department search out a taxable gain, or be forced to allow a deductible loss to either of the parties at the time of the making of the contract? Consider first the case of the annuitant. Under Article 1564 of Regulations 62, interpreting Section 202 (a) (b) (c) of the Revenue Act of 1921, both a change in substance and a change into the equivalent of cash are required to complete a transaction from which income may be realized under this section. Although a commercial annuity contract may have a market value, it is very doubtful whether the promise of an annuity under a non-commercial family arrangement can be said to have. Such promises are not marketable for two reasons: (1) since they are usually in the nature of promises to support, they are non-assignable,\(^9\) and hence could not be sold; (2) since they are not based on any calculation of the probable expectancy of the annuitant, who may or may not be the normal healthy individual to whom a commercial insurance company would issue a contract, it would be practically impossible to find a buyer. Further, it is questionable whether under existing court decisions taxable income is realized from the acquisition of a mere hope of receiving income in the future.\(^9\)

Of course, if the Department chooses to treat the transaction as a gift by the annuitant on condition of the payment of the annuity, no gain or loss would be realized by the annuitant.

Now, consider the transaction from the point of view of the children. Suppose we conclude that in a particular case, the payers of the annuity in legal contemplation purchased Blackacre at the price of their promises. It is difficult to see how at that moment they realized any gain or loss. To be sure, the Revenue Acts provide\(^4\) a basis for determining gain or loss from the sale or other disposition of property. Can the

promise of the children to their mother be called property within this section? Clearly it was not property in their hands; it would require an exceedingly strained construction to hold the giving of one's own promise, even for good consideration, to be the disposition of property resulting in gain or loss. Nor should the termination of the children's obligation by the death of their mother be treated as resulting in a taxable gain or loss to the children. To be sure, the amount paid out on account of the property is then determined; but this is only one of the two figures required to ascertain a gain or loss. Moreover, it is obvious that their mother's death was not a disposition of property in the children's hands within Sec. 202.46

4. If we adopt the view that the transaction between the children and their mother was an exchange of property for a promise to support, there seems to be no difficulty in calculating the gain or loss in the event that, after the liability to pay the annuity is determined in some manner, the children sell the property they received. In such a case, both the purchase and the selling prices of the property are fixed.48 If, however, the liability to pay the annuity has not been determined at the time the property is sold, it is certainly more difficult to calculate the taxable gain or loss on the transaction. Although it is undesirable to resort to expectancy tables, in view of the fact that such a calculation will never accord with the actual facts, in this case no other basis would be more reliable. Hence, the cost of the property should be taken to be the product of the mother's expectancy at the time of the contract, multiplied by the annual amounts to be paid by the children.47

If the transfer of the property is treated as a gift on condition of paying the annuity, the basis for a determination of gain or loss following a disposition of the property by the children is governed by Sec. 202 (a) (2) of the Revenue Act of 1921.48

A less common type of annuity having characteristics common both

46 Accordingly, the view of the Department expressed in I. T. 1242 (see note 40 supra): "Should both A and his wife (the annuitants) "die before the taxpayer" (the payer of the annuity) "has repaid the principal to them, the excess of the principal over the amounts already paid to them will represent income to the taxpayer for the year in which liability for future payments ceases" appears unsound. These rulings doubtless represent the desire of the Department to search out and tax a gain at the earliest possible moment.

48 Frequently, however, the taxable gain to the children would be very large, since the annuity is ordinarily less than might have been purchased from a commercial company with the same amount of property. This consideration is a makeweight argument for treating the transaction as a gift on condition.

47 To this effect, see Off. Dec. 945, 4 Cum. Bull. 44.

48 "In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. ... In the case of property acquired by gift on or before December 31, 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof shall be the fair market price or value of such property at the time of such acquisition;"
TAX LIABILITY OF ANNUITIES

I and II also deserves mention. Suppose that A asserts some claim against B, as for breach of promise, which B wishes to compromise without litigation. In consideration of A's release of the claim, B agrees to pay A annually $5000 during A's life. If the conclusion heretofore reached that annuities in general are taxable income is sound, it is reasonably clear that the Treasury Department will be able to exact a tax from A on the annuity she receives. For granted that she surrendered a valuable right, she admittedly gave it up for an annuity. These annual payments are not a replacement of any capital expenditure on her part, nor are they instalments of any fixed purchase price. Although the argument might be advanced again that the exemption in paragraph 2 of Sec. 213 (b) covers all annuities purchased for valuable consideration, the wording of the paragraph hardly supports such a view. The payer of the annuity would probably not be permitted a deduction therefor for the reasons considered in paragraph I above.

III
TERMABLE RIGHTS TO THE INCOME OF PROPERTY HELD IN TRUST

The income tax liability of annual amounts received by the beneficiary of a trust rests upon a somewhat stronger statutory basis than that of

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5 For such a holding, see Smith v. Shaw [1918] P. Div. 47.
6 The holding contained in Solicitor's Opinion 132, Cum. Bull. I-1, p. 92, that damages received for alienation of affections and in I. T. 1804 (Internal Revenue Bulletin of October 15, 1923) that damages received for breach of contract to marry are not taxable income would not apply, since these opinions contemplate a lump sum payment. In our case, doubtless A could avoid income tax on the amount received from B by bargaining for (1) a lump sum; (2) a lump sum payable in instalments. In any case, the question would be, what did she bargain for?
7 Quoted in note 5 supra.
8 See supra p. 240.
9 An interesting variation of this situation occurs where A promises not to contest a will, in consideration of an agreement by a beneficiary B to pay A an annuity. The additional point is, of course, whether the amounts A receives are in the nature of a bequest under the will and hence exempt. In most jurisdictions, it is quite properly held that A takes his annuity under the contract and not under the will. See Smith v. Shaw, supra note 59; Gleason and Otis, Inheritance Taxation (3d ed. 1922) 94; Hastings v. Nesmith (1905) 188 Mass. 190, 74 N. E. 323; Brandeis v. Atkins (1910) 204 Mass. 471, 90 N. E. 861; Baxter v. Treasurer (1911) 209 Mass. 459, 95 N. E. 854.
10 Since this conclusion may effect a taxation of this amount twice, as part of B's income not subject to deduction and as part of A's, it is open to practical question at any rate. See, however, Justice Holmes's opinion in Ft. Smith Lumber Co. v. Arkansas (1920) 251 U. S. 532, 40 Sup. Ct. 304. A's and B's attorneys may also be able to use to advantage Gould v. Gould (1917) 245 U. S. 151, 38 Sup. Ct. 33, wherein it was held that monthly payments of alimony were not income to the recipient under the 1913 Act. The Department would doubtless argue that the Gould decision is really based upon the peculiar character of alimony, as a substitute for a husband's support.
the two classes of annuities already discussed. If the Department is finally upheld in taxing the annuity received by A in case I above, it is more than likely that it will be successful in taxing the amounts received by the trust beneficiary. The large amounts frequently involved in cases of this type, as well as the distinctive provisions of the statute, makes detailed discussion desirable.

Suppose D dies testate, leaving securities worth $1,000,000 to T in trust to pay the income thereof to A, D's widow, for life; remainder to B, D's child, absolutely. Suppose that the annual income to A amounts to $40,000. Does she realize any taxable income therefrom?

The contentions of the widow A will be similar to those advanced by the recipient of the annuity purchased for her benefit by her father, considered in I above. Of these, the most likely is that D made A a bequest to the extent of the value of A's life interest at the time of D's death; that A should not be liable to income taxation on amounts she receives from T until they exceed this calculated amount. By the use of expectancy tables, a value can readily be placed upon A's bequest, but it is equally true that this value is purely hypothetical and bound to be inaccurate in any actual case. Of course these practical considerations must give way, if A can bring her case within the statutory exemption.

The stumbling-block in A's path is Section 219 of the Revenue Act of 1921. Its provisions outline a thorough-going system for the tax-

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6 At p. 235.
7 This contention is based, of course, on the provisions of Sec. 213 (b) (3) quoted in note 5 supra.
A might advance an alternative contention that the separate payments are a series of bequests, and are exempt from income taxation in toto. In Off. Dec. 120, 1 Cum. Bull. 84, the Department held that a donor of bond coupons must pay income tax on the interest as it fell due. If so, does not the recipient take such periodical payments tax-free?
9 If A were 50 at the date of D's death, and the income of the trust estate to be paid her was $40,000 per year, the value of A's interest at that time would be $498,812.80, according to the tables used for Federal Estate Tax purposes.
10 The pertinent provisions are:

(a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including:

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;
(3) Income held for future distribution under the terms of the will or trust; and
(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals,

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212,

(c) In cases under paragraphs (1), (2), or (3) of subdivision (a).... the
tion of trust estates. In such a case as we are considering, the terms of the section state that the beneficiary shall pay the tax on his distributive share. Hence if the share received by A in our case is in fact income, its taxability is provided for in Section 219.

Many of the reasons for treating annuities as income apply here. If "income" as used in the Sixteenth Amendment and the Revenue Acts has the meaning commonly understood in ordinary speech, it seems unquestionable that the proceeds received from invested trust estates fall within the term. It is highly unlikely that the popular conception of the classification of these receipts as income is qualified by the technical calculation that, since the interest of the recipient is wasting as he approaches the end of his expectancy, something should be deducted from each payment to represent this shrinkage.69

But, whatever the ordinary understanding may be, does the exemption of the value of property acquired by bequest or devise in Section 213 draw at least a portion of A's receipts from the trust out of the operation of Section 219? Again, the contentions of the Department will probably be those already noted under I supra.70 It will be contended that the property received by devise or bequest by A was merely the right to the periodical payments she receives; that the value of this right has not been taxed as income.71 Again, the Department will rely

tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary. . . .

(d) In cases under paragraph (4) of subdivision (a), . . . . the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary that part of the income of the estate or trust for its taxable year which, pursuant to the instrument or order governing the distribution, is distributable to such beneficiary, whether distributed or not, . . . . In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust." 42 Stat. at L. at p. 246.

6 The conclusion is somewhat supported by the decisions of the Supreme Court in the mining cases, in which it was held that, for purposes of the Corporation Tax Act of 1909, the income of mining corporations included the proceeds of ores mined, without deduction for the value of such ore in place as depreciation within the act, even though the production of this income involved, of course, a wasting of the capital asset, the ore. See Straton's Independence v. Howbert (1913) 231 U. S. 399, 415, 34 Sup. Ct. 136, 140; Von Baumbach v. Sargent Land Co. (1917) 242 U. S. 593, 37 Sup. Ct. 202; United States v. Biwabik Mining Co. (1918) 247 U. S. 116, 38 Sup. Ct. 462. See also the definition of income in note 36 supra.

The possible hardship in this method of taxation in the English mining and annuity cases has been considered in Murray and Carter, A Guide to Income Tax Procedure (6th ed. 1911) 318 et seq.

7 For a discussion of the inclusion of the value of this right within the exemption provision see the article by Maguire cited in note 38 supra.

See also Off. Dec. 755, 3 Cum. Bull. 212, digested in note 34 supra, for a similar case in which the Department taxed an annuity provided by will.
upon Section 215 (b), specifically providing that amounts paid to the
“holder of a life interest acquired by gift, bequest or devise shall not be
reduced by any deduction for shrinkage (by whatever name called) in
the value of such interest due to the lapse of time.” This provision
was inserted particularly to meet the situation here treated. Whether
the same holding could be supported under the Revenue Act of 1918,
which did not contain the provisions of Section 215 (b), is of course
more doubtful.

IV

TERMINABLE CHARGES ON PROPERTY, CREATED BY WILL

The result in the final case should depend almost entirely upon those
reached in the three preceding cases. A typical situation is this: T by
his will leaves real and personal property to his son B, charging the
real property with the payment of $5000 per year to his widow A
during her life. Although Coke’s definition of an annuity would not
include these payments, courts frequently so speak of them. The
regulations of the Treasury Department provide that the $5000 which
A receives is taxable income. The reasons for the insertion of this
provision must have been similar to those just considered under III—
that the amounts A receives are commonly understood to be income,
and that the exemption provisions of Section 213 (b) (2) and (3) do
not properly apply, particularly in view of Section 215 (b). Since

See Notes on the Revenue Act of 1918, p. 13, quoted in note 37 supra.

In Gavit v. Irwin (1921, N. D. N. Y.) 275 Fed. 643, the district court held
under the 1913 act that amounts received by plaintiff under provisions of a will
whereby an estate was bequeathed to trustees who were directed to pay plaintiff’s
daughter during her minority amounts necessary for her support, and one half the
balance to plaintiff during his life and the life and minority of the daughter, were
not taxable income, on the theory that the plaintiff had no interest in the capital
of the trust fund. Quaere, whether this is a sound distinction. See Drummond v.
Collins [1914] 2 K. B. 643.

The judgment in the Gavit case was affirmed by the Circuit Court of Appeals
of the Second Circuit on December 10, 1923, on this ground: “While the moneys
received by the defendant-in-error are income as to the estate, they are not income
as to the defendant-in-error. We think he acquired the moneys by bequest or
device and they are not taxable.”

See e. g. Merrill v. Bickford (1876) 65 Me. 118; Wyckoff v. Wyckoff (1891,
Ch.) 48 N. J. Eq. 113, 21 Atl. 287.

Although the land is charged, the devisee becomes personally liable for the
payments of the sums to A, by accepting the devise. See 2 R. C. L. 7, and cases
L. R. A. (n. s.) 815 et seq.

Art. 47 of Regs. 62 provides in part: “... An annuity charged upon
devised land is income taxable to the annuitant, whether paid by the devisee out
of the rents of the land or from other sources.”

not charged on particular property, which, under the particular facts, was held
taxable income to the recipient. This ruling appears to be sound for reasons
given under Subdivision I supra.
this particular holding is embodied in the regulations, the attorney for A would expect summary treatment at the hands of the Department of a claim for exemption of all or part of these amounts. In the courts, the best attack would be based on the provisions of the oft-cited Section 213 (b) (3), along lines already sufficiently familiar to the reader; its success would be problematical.

The Regulations do not require the devisee to report as taxable income the rents and profits paid to the annuitant, and deny him the right to deduct from his taxable income any sums paid the annuitant.\footnote{Art. 47, Regs. 62. Note that, if the annuity is greater than the rents, the devisee would be personally liable to pay it, and would not, under the Regulations, be allowed any deduction therefor.}

Since the periodical payments are an equitable charge upon the land,\footnote{See citations in note 74 supra.} this exemption seems entirely justifiable, since to the extent of the charge, the annuitant, not the devisee, is the equitable owner of proceeds of the land.

\textbf{V} \hspace{1cm} \textbf{CONCLUSION}

In the light of the historical background of income taxation generally, as well as of the specific provisions of the Revenue Acts, it is quite likely that annuities in general will be considered to be taxable income, subject to the exemptions granted by the acts. The scope of these exemption provisions, however, is by no means clear. Although the Department has not yet committed itself to any consistent course of treatment, it would be expected to adopt a strict construction of the exemptions according to their exact terms, in the full consciousness that some anomalous situations are bound to result. The final presentation and determination of these questions before the Federal courts will be doubly important—because of the wide-spread ramifications of the problems of annuities and similar periodical payments throughout the whole field of income tax law and because of the very large sums of money sure to be at stake.