Iii. Annuities Under § 2039

funding spouse be given, as she or he frequently is, a life estate in the trust. Revenue Ruling 74-556 should, therefore, be a welcome addition to the list of interpretive decisions regarding § 2038 and its companions, §§ 2035-2037.

III. ANNUITIES UNDER § 2039

Under § 2039 of the Internal Revenue Code of 1954[1] the gross estate of a decedent must include the value of an annuity or "other payment" receivable by any beneficiary following the decedent's death under the terms of a contract or agreement which satisfies four conditions:

1. the contract or agreement[2] is not a life insurance policy on the life of decedent;
2. the contract or agreement was entered into after March 3, 1931;
3. the annuity or other payment[3] is receivable by any beneficiary by reason of the beneficiary surviving the decedent;
4. under the contract or agreement, either an annuity or other payment was payable to decedent,[4] either alone or in conjunction with another for his life, or for any period not ascertainable without reference to his death; or the decedent possessed the right to receive[5] the annuity or payment, either alone or in conjunction with another for his life, or for any period not ascertainable without reference to his death, or for any period which did not in fact end before his death.[6] It is important to note, however, that even though § 2039 is

[1] INT. REV. CODE OF 1954, § 2039(a).

[2] The terms "contract or agreement" include any arrangement, understanding or plan or any combination thereof arising by reason of the decedent's employment. "Voluntary" payments are not taxable under § 2039 because they are not received under any form of contract or agreement. Treas. Reg. § 20.2039-1(b)(1)(ii) and (2) ex. 4 (1958).

[3] "Annuity or other payment" refers to one or more payments extending over any period of time. Payments may be equal or unequal, conditional or unconditional, periodic or sporadic. Treas. Reg. § 20.2039-1(b)(i)(ii) (1958).

[4] The phrase "was payable to decedent" means that at the time of death, the decedent was in fact receiving an annuity or other payment, whether or not he had an enforceable right to have the payments continued. *Id.*

[5] "Possessed the right to receive" means that immediately before his death the decedent had an enforceable right to receive payments at some time in the future, whether or not at the time of his death he had a present right to receive the payments. *Id.*

[6] The term "not ascertainable without reference to his death or for any period

entitled "Annuities," it is not limited in its application to taxation of annuities, nor are annuities taxed under that section exclusively.[7]

Section 2039(c) provides exceptions to the inclusion of payments in the gross estate of the decedent. The essence of the exceptions is that the payments be received under "qualified" plans.[8] In order to be qualified, it is generally required that the payments be received by a beneficiary other than the executor of a decedent's estate, that the payments be received under one of four sets of requirements as to the nature of the plan or trust,[9] and that the payments not be attributable to contributions made by the decedent himself. Unlike contributions made under § 2039(a) and (b), contributions by the employer which qualify under § 2039(c) are not considered attributable to the decedent.[10] If the above requirements are satisfied, then only the proportionate value of the annuity plan that decedent himself purchased or contributed is included in his gross estate.[11]

The provisions of § 2039 are intricate and cases rendered under those provisions reveal many traps for the unwary practitioner developing or recommending retirement plans for clients.[12] In addition to the complexities of § 2039 itself, important consequences in regard to annuities and other survivorship benefits arise from other sections of the federal estate tax law as well as from applicable administrative and judicial doctrines. Among other developments[13] in 1974, the Tax

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which did not in fact end before his death" has the same meaning as that used in § 2036 and defined by Treasury Regulation § 20.2036-1. Treas. Reg. § 2039-1(b)(i)(ii) (1958); see 1 H. HARRIS, HANDLING FEDERAL ESTATE AND GIFT TAXES § 180 (J. Rasch rev. ed. 1972).

[7] Treas. Reg. § 20.2039-1(a) (1958). *See* C. LOWNDES, R. KRAMER, AND J. MCCORD, FEDERAL ESTATE AND GIFT TAXES § 10.1 (3d ed. 1974) [hereinafter cited as C. LOWNDES]. For example, if an annuity contract provides that upon the annuitant's premature death there shall be a refund of part of the cost of the contract, then the amount of the refund is includable in his gross estate under § 2033 of the Code. If the decedent had power to designate the beneficiary to receive the annuity or payments after his death, inclusion would result under § 2039. Also if an annuity arises from an insurance policy it is excluded from the scope of § 2039 and covered by the provisions of § 2042. J. TRACHTMAN, ESTATE PLANNING 120 (rev. ed. 1968).

[8] INT. REV. CODE OF 1954, § 2039(c).

[9] *Id.*, § 2039(c)(1)(2)(3) and (4).

[10] *Id.*, § 2039(c). *See* C. LOWNDES, *supra* note 7, at § 10.4

[11] INT. REV. CODE OF 1954, § 2039(c)(1)(2) and (3). For members of the armed forces, the amount paid to the plan by the government is excludable. *Id.*, § 2039(c)(4).

[12] *See* 2 R. RICE, FAMILY TAX PLANNING Ch. 18, §§ 8, 9 (1974); D. KNICKERBOCKER, 134-2d TAX MANAGEMENT—ANNUITIES (1972, Supp. 1974).

[13] In 1974, the IRS issued two rulings to help clarify provisions in § 2039. One ruling simply established for federal civil employees the benefit of a proportionate amount of a qualified annuity being excluded from a gross estate that is attributable

Court decision in *Estate of Max Silverman*[14] discussed the intricacies of § 2039, including certain administrative and court developed concepts, as well as the applicability of other sections of the Code to annuity problems.

In *Silverman* the decedent was a participant in a qualified pension trust agreement created by his employer in 1942 and approved as qualified in 1944.[15] The trust agreement provided that upon retirement the employee was entitled to payments from the trust and upon the employee's death the named beneficiary, his wife, would receive the payments. Therefore, these payments would normally have been includable in decedent's gross estate because the plan met the four conditions of § 2039(a).[16] However, since the plan was qualified, § 2039(c) ostensibly excluded all the payments from decedent's gross estate because decedent made no contributions to the plan.[17] Nevertheless, the Tax Court concluded that the proceeds were includable in decedent's gross estate because of the decedent's departure from the plan's requirements in the handling of the payments and because of the applicability of § 2033.[18]

The trust agreement provided for a pension trust committee which had the duty of applying to insurance companies for annuity contracts to benefit employees participating in the trust. The committee selected a separate trustee to be sole owner of the contracts until the retirement date of the employer, at which time the income from those contracts would become payable to the employee participant or his beneficiaries. The normal retirement date for any partici-

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to payments by the government. Rev. Rul. 74-557, 1974 INT. REV. BULL. No. 46, *see* notes 8-11 and accompanying text *supra*. The other ruling concerned payments by self-employed individuals to annuity plans. *See* note 29 *infra*. Also, in an attempt to provide better dissemination of information concerning pension plans and taxation problems, Congress passed the Employee Retirement Income Security Act of 1974. *See* note 47 *infra*.

[14] 61 T.C. No. 65, CCH [1974 Transfer Binder] TAX CT. REP. ¶ 32,449 (Feb. 4, 1974).

[15] The plan was qualified under the predecessor of § 401(a) of the present Code, § 165(a) of the Internal Revenue Code of 1939. CCH [1974 Transfer Binder] TAX CT. REP. ¶ 32,449 at 2329.

[16] *See* notes 2-6 and accompanying text *supra*.

[17] CCH [1974 Transfer Binder] TAX CT. REP. ¶ 32,449, at 2329. The trust involved in this case was qualified under § 2039(c)(1) and because employer contributions to such plans are excluded and decedent's employer made all of the contributions to the trust, normally all the proceeds attributable to these contributions would be excluded from decedent's gross estate by the provisions of § 2039(c). *See* notes 10-11 and accompanying text *supra*.

[18] CCH [1974 Transfer Binder] TAX CT. REP. ¶ 32,449 at 2336-37.

pant was fixed as the contract anniversary date nearest to the employee's sixty-fifth birthday. Furthermore, if employment terminated prior to the normal retirement date, the plan provided that the committee should, after conferring with the participant, direct the trustee either to assign the contracts to the participant or to surrender the contracts for cash value payable to the participant. The plan stated that in any event payments had to commence by the normal retirement date despite the availability of other options in the contracts with the insurance companies.[19]

Max Silverman retired at the age of sixty-one, approximately four years before the normal retirement age provided in the pension trust agreement. Pursuant to the plan's terms, the contracts held for the decedent were assigned to him whereupon he surrendered three for cash value and left the remaining two in the possession of the issuing insurance company with the maturity date intact. Options existed in both contracts to begin the annuity at a later date or an earlier date but in any event not later than the contract anniversary nearest the annuitant's seventieth birthday. The decedent left both contracts with the insurance company, with the contracts accumulating interest on their cash surrender value from the time of his retirement. Decedent died five years after the maturity date stated in the policies and nearly three months after the contract anniversary date nearest his seventieth birthday. Decedent never surrendered the contracts for supplemental policies as the plan required for commencement of annuity payments. After his death, the proceeds of both policies were paid to his wife pursuant to directions in the contracts.

The Tax Court stated in *Silverman* that because the contracts were assigned to the decedent upon his retirement, their proceeds were includable in his gross estate under § 2033 unless excluded by some other provision of the Code.[20] Since decedent was the absolute owner of the annuity contracts, the annuity payments were qualified for inclusion in his estate "to the extent of the interest therein of the decedent."[21] Decedent's estate did not contest the notion that except for § 2039(c) the value of the annuity contracts would be includable in decedent's gross estate. However, the executrix argued that the contract payments were received by the decedent's wife as beneficiary under a qualified trust, and that the payments to decedent's wife should therefore be excludable under § 2039(c). The IRS responded by saying that the proceeds were received under contracts purchased

[19] *Id.* at 2329-30.
[20] *Id.* at 2332.
[21] INT. REV. CODE OF 1954, § 2033.

by the decedent and not by the pension trust. The contention was that because the contracts were assigned to the decedent who left them with the insurance company in lieu of cash payments upon his retirement, the decedent should be deemed to have "constructively received" payment under the pension plan and to have procured the annuity contracts himself. Therefore, § 2039(c) did not apply and the proceeds were taxable to decedent's estate under § 2033.[22]

The Commissioner relied primarily upon the doctrine of "constructive receipt" as exemplified by the Ninth Circuit in *Northern Trust Co. v. United States*.[23] In *Northern Trust*, the annuitant at the age of seventy-seven was assigned contracts providing that actual payments were not to start for another fifteen years. During that fifteen year period the annuitant had the power to convert the contracts into any number of different payment option plans or to surrender the contracts for their cash value. The government contended that this program constituted little more than a sophisticated savings account with the benefits of tax exemptions while interest accrued. Emphasizing substance over form,[24] the court concluded that because of his "unfettered" control over the contracts, the annuitant had constructively received his share of the proceeds prior to his death. Therefore, under § 2033 the proceeds were taxable and were not excludable under § 2039(c).[25]

The executrix of decedent's estate in *Silverman* argued against the applicability of *Northern Trust*. Reliance was placed on two other decisions, *Estate of Harold S. Brooks*[26] and *First Trust Co. v. United States*.[27] Both of these cases were alleged to be factually similar to *Silverman* in that a committee controlled the distribution of proceeds under the annuity plans. It was also contended that substantial opportunity existed for the respective annuitants to affect the methods of distribution as in *Silverman*. In *Brooks*, the annuitant requested

[22] CCH [1974 Transfer Binder] TAX. CT. REP. ¶ 32,449, at 2333-34.

[23] 389 F.2d 731 (7th Cir. 1968). *See* Treas. Reg. § 1.451-2, *as amended*, T.D. 6723, 29 F.R. 5342 (1964), T.D. 7154, 36 F.R. 24997 (1971); Corliss v. Bowers, 281 U.S. 376 (1930); Estate of Ralph E. Wilson, 40 T.C. 543 (1963).

[24] *Id.* at 734 *citing* Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). It also seems apparent that the advanced age of the annuitant together with the extremely advanced age of ninty-five as the time for first receipt of annuity payments added impetus to the government's case. The intent of the annuitant to provide the survivor beneficiaries tax exempt proceeds rather than to provide funds for his own retirement is suspiciously apparent. *See* 389 F.2d at 734.

[25] 389 F.2d at 733-34.

[26] 50 T.C. 285 (1968).

[27] 321 F. Supp. 1025 (D. Minn. 1970).

that a lump sum payment be made to him on his retirement. However, the trustees denied his request and placed the payment into a separate trust. The annuitant could make suggestions as to how to invest the funds, as he did on approximately fifty occasions, but the trustees' decision was still final in this respect and not all of the annuitant's suggestions were accepted.[28] Similarly, in *First Trust Co.* the annuitant owned approximately ninety-seven percent of the company's stock[29] and thereby possessed substantial power to force the annuity's trustees to follow his wishes in regard to investment and distribution of his proceeds. However, because the trustees in the past never acquiesced in demands to withdraw annuitants' interests unless the trustees deemed it proper, the annuity payments, as in *Brooks*, were excludable under § 2039(c) as being under qualified trusts, and were not deemed constructively received by the annuitants.[30] Both *Brooks* and *First Trust Co.* stand for the proposition that constructive receipt does not occur where a taxpayer's control of funds is subject to substantial limitations not imposed by the taxpayer on himself.[31]

Despite the litigants' concern over the constructive receipt doctrine, the court in *Silverman* employed another rationale to include the payments in decedent's gross estate. Section 2039(c) was analyzed to determine if the payments received by the beneficiary really qualified for exemption from the gross estate. The court began by recognizing that § 2039(c) provides for exclusion from the gross estate of the " 'value of an annuity or other payment' receivable by a beneficiary other than the executor 'under . . . an employees' trust (or under a contract purchased by an employees' trust) forming a part of a pension . . . plan' which, at the time of decedent's separation from employment . . . meets the requirements of §401(a) . . . ."[32] The court held that the beneficiary did not receive an "annuity,"[33]

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[28] 50 T.C. at 588-91.

[29] Nearly complete ownership of a business is to be differentiated from self-employment when considering § 2039(c). According to a recent revenue ruling a self-employed individual on whose behalf contributions to a qualified plan are made "shall be considered to be contributions or payments made by the decedent." Rev. Rul. 119, 1974-1 CUM. BULL. 276. This ruling places the self-employed individual in the position of being unable to take advantage of the value of payments attributed to employer contributions.

[30] 321 F. Supp. 15 1026, 1028.

[31] Avery v. Commissioner, 292 U.S. 210 (1934); Commissioner v. Oates, 207 F.2d 711 (7th Cir. 1953), *aff'g* Oates v. Commissioner, 18 T.C. 570 (1952).

[32] CCH [1974 Transfer Binder] TAX CT. REP. ¶ 32,449, at 2334 *quoting* INT. REV. CODE OF 1954, § 2039(c) (1).

[33] CCH [1974 Transfer Binder] TAX CT. REP. ¶ 32,499, at 2334.

and the question therefore became whether the beneficiary received "other payment . . . under an employees' trust (or under a contract purchased by an employees' trust) forming part of a pension . . . plan."[34]

It was reasonably clear that the beneficiary received nothing under the employees' trust because the decedent had long before death received absolute ownership of the contracts. Nor could it be said that the beneficiary received the payments under a contract purchased by an employees' trust forming part of a pension plan. The court reasoned that the contracts purchased by the employees' trust *which formed part of a pension plan* would have to be contracts for an annuity commencing payment on the contract anniversary date closest to the annuitant's sixty-fifth birthday. However, the contracts that decedent left in the possession of the insurance company never commenced payment on the contract anniversary date. The restrictions imposed by the qualified pension plan were eliminated by nonpayment on the stipulated date. Therefore, the contracts owned by the decedent failed to constitute contracts purchased under an employees' trust. Since § 2039(c)(1) was the only provision under which the contracts could qualify for exclusion from the estate, the payments were includable.[35] Both concurring opinions agreed in this reasoning.[36]

However, the majority opinion proceeded even further, declaring that exclusion under § 2039(c) is not pre-emptive of other sections of the Code that could tax annuities falling within their provisions. Despite the opening language of § 2039(c),[37] the court concluded that because of the Second Circuit decision in *Commissioner v. Estate of Albright*[38] the exclusion under § 2039(c) should be pre-emptive as to payments which would be includable in decedent's gross estate solely due to the provisions of § 2039(a) and (b).[39]

In *Albright*, the Second Circuit reversed a Tax Court decision[40] that payments under a qualified pension plan were excludable when in fact the payments were totally attributable to contributions of the decedent employee. However, the court used extraordinary reasoning

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[34] *Id.*

[35] *Id.* at 2335.

[36] *Id.* at 2337.

[37] "Notwithstanding the provisions of this section or of any provision of law . . ." INT. REV. CODE OF 1954, § 2039(c).

[38] 356 F.2d 319 (2d Cir. 1966), *rev'g* Estate of Raymond G. Albright, 42 T.C. 643 (1964).

[39] CCH [1974 Transfer Binder] TAX CT. REP. ¶ 32,449, at 2336.

[40] Estate of Raymond G. Albright, 42 T.C. 643 (1964).

to justify its holding. In reaching its decision the court concluded that the "history and spirit of federal estate legislation" established that in enacting § 2039 Congress intended to perpetuate the pre-existing rules that often included payments received by a beneficiary which were attributable to decedent's contributions to the cost of the contract.[41] The apportionment formula of § 2039(c)[42] was deemed applicable only in situations in which the decedent's beneficiary receives a payment that is attributable to both the employer and employee. Because Mrs. Albright, the beneficiary, received payments only attributable to the decedent's contributions, the Second Circuit therefore concluded that the payments were fully includable. However, the court included the payments not because of the apportionment formula within § 2039(c), but because the rules which preceded § 2039 demanded their inclusion.[43] This reasoning is extraordinary because even if the apportionment formula were applicable, the proceeds would have been includable since the decedent's proportionate contribution to the proceeds represented the entire amount contributed. Furthermore, § 2039(c) provides specifically that any amount paid to the qualified plan that is attributable to the decedent is not excludable.[44]

The Tax Court in *Silverman* attempted to expand on this reasoning to indicate that § 2039(c) is limited in its applicability to § 2039(a) and (b), since those subsections deal with the inclusion of payments attributable to both the employer and decedent. However, there was no indication in *Albright* that § 2039(c) was limited in its exclusion powers to property included under § 2039(a) and (b). The court's reasoning in *Silverman*, therefore, appears unnecessarily broad in regard to the relationship between § 2039(c) and § 2039(a) and (b). In fact both concurring opinions stated that the majority opinion's reasoning as to the subsection of § 2039 was unnecessary. The two opinions concurred with the inclusion of the proceeds in

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[41] 356 F.2d at 323.

[42] *See* notes 10-11 and accompanying text *supra*.

[43] 356 F.2d at 323.

[44] § 2039(c) states:

> . . . .
>
> If such amounts payable after death of the decedent . . . are attributable to any extent to payments or contributions made by the decedent, no exclusion shall be allowed for that part of the value of such amounts in the proportion that the total payments or contributions made by the decedent bears to the total payments or contributions made.

INT. REV. CODE OF 1954, § 2039(c).