INHERITANCE TAX: Taxability of (a) life insurance; (b) Insurance trusts; (c) annuity contracts.

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Honorable Richard R. Nacy,
State Treasurer,
Jefferson City, Missouri.

Dear Sir:

This department is in receipt of your request for an opinion respecting the taxation of the proceeds of insurance contracts under the inheritance tax laws of Missouri. In order to better present our discussion of this rather broad subject, we have subdivided the opinion into three classes, i.e., life insurance generally, insurance trusts and annuity contracts.

<u>Life Insurance, Annuity Insurance and Insurance Trusts</u>

A comprehensive discussion of the above types of insurance contracts is impossible within the limited space of this opinion. However, it is necessary, for the purpose of deciding whether or not the proceeds of these contracts are subject to the inheritance tax laws of the State of Missouri, that some regard be given here as to the fundamental character of these contracts.

Life insurance may be simply defined as a contract dependent upon human life whereby one, for a stipulated consideration, usually called a premium, agrees to pay another a sum certain upon the happening of a given event or contingency, usually death, or upon the termination of a specified period. Judge Napton, in the early case of State ex rel. Attorney General v. Merchants Exchange Mutual Benevolent Society, 72 Mo. 146, places the judicial stamp of approval upon the definition as given by Buynon, who defined "life insurance" to be "that in which one party agrees to pay a given sum upon the happening of a particular event consequent upon the duration of human life in consideration of the immediate payment of a smaller sum or certain equivalent periodical payments by another."

Couch, in his Cyclopedia of Insurance Law, regards annuity insurance as a contract to pay the insured, or a named person or persons, a sum or sums periodically during life or for a certain period. It may be said that an annuity is generally understood to be an agreement to pay a specified sum to the annuitant annually during life, or in fixed installments at stated intervals during a definite period. Fidelity Invest. Asso. v. Emmerson, 318 Ill. 548.

An insurance trust, generally speaking, is an agreement between a person and a trustee, usually a trust company, whereby the trustee agrees to collect and hold the proceeds of life insurance policies for the benefit of certain beneficiaries either named in the trust agreement or in the will of the insured. These trusts take two forms - funded and unfunded. Couch defines these two classes as follows:

> "A funded life insurance policy may be said to be a trust established with life insurance policies, plus investments, or funds paid into the trust yielding income sufficient to enable the trustee to pay the premiums on the policies; and an unfunded life insurance trust is a trust established with life policies, the premiums of which are paid by the insured."

<u>Ordinary Life Insurance Payable to a Named Beneficiary</u>

While in a few of the states life insurance is expressly made subject to the succession taxes, in the majority (which class embraces Missouri) there is no statutory mention made of insurance. In these states the courts that have passed on the question have uniformly held that life insurance payable to a designated beneficiary was not subject to the inheritance tax laws upon the theory that the property received by the beneficiary is by reason of the contract with the insurance company and not by reason of having been a part of the decedent's estate.

This theory of law is clearly set forth by Rugg, C.J., in the leading case of Tyler v. Treasurer and Receiver General, 226 Mass. 306, wherein he says:

> "The insured has no title to the amount due on the policy. He does not and cannot make a gift of that. The right to that amount as an instant obligation does not spring into existence

> until after his death. Even then the money belongs to the insurer, who is charged with the duty by the contract to pay to the beneficiary. So far as the insured is a 'grantor', to use the word of the statute, the only thing which he grants or can grant is an interest in a contract. So far as he can make a 'gift', the only thing which he has to give is a right in a contract. By designating a beneficiary both the 'grant' and the 'gift', so far as either exist at all, take effect in enjoyment and possession at once. Such a relation does not by fair intendment come within the descriptive words of the statute as 'property.....which shall pass....by....gift....... made or intended to take effect in possession or enjoyment after the death of the grantor."
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> See also Bullen's Estate, 143 Wis. 512."

<u>Ordinary Insurance Payable To Decedent's Estate</u>

Insurance policies payable to the estate of a decedent are subject to the inheritance tax laws of this state, that is to say, the proceeds of these policies are subject to the tax. Appeal of Silberman (Sup. Ct. of Errors of Conn.), 134 A. 778. This distinction (that between the policies and the proceeds therefrom) was not observed by the Court of Appeals of New York in the leading case sustaining the taxation of this type of insurance (Matter of Knoedler, 140 N.Y. 377). In that case the Court said:

> "All property which the decedent owned when he died, and which has an appraisable value is to be included, subject, of course, to the payment of debts and to such exceptions as are specifically

> mentioned, but which have no application here. If these policies were not assets, then the appellants derived no title to their proceeds under the will, and they cannot make title through any other source. It is only such property as the testator died seized and possessed of and its increase that they can claim as his legatees. If, when the appellants applied for their share of the estate under the will, the administrator had withheld the moneys collected upon the insurance policies on the ground that they did not pass by the will, his position would have appeared to have been quite as reasonable and tenable as that advanced by the appellant's to resist the collection of this tax."

The proceeds of these policies having been paid to the estate of the decedent, the devolution is controlled either by the will, if one there be, or by the intestate laws of this state. Manifestly, then, the proceeds are within the scope of Section 570, Laws of Missouri, 1931, page 130, wherein it is provided:

> "When the transfer is by will or by the intestate laws of this state from any person dying possessed of the property while a resident of the state."

It has been held by the Supreme Court of the United States (Chase National Bank v. United States, 278 U.S. 327) that the mere reservation of the power to change the beneficiary in a life insurance policy was sufficient to bring the proceeds within the terms of the Federal Estate Tax.

> "And we see no necessity to debate the question whether the policies themselves were so transferred, for we think the power to tax the privilege of transfer at death cannot be controlled by the mere choice of the formalities which may attend the

> donor's bestowal of benefits on another at death, or of the particular methods by which his purpose is affected, so long as he retains control over those benefits with power to direct their future enjoyment until his death. Termination of the power of control at the time of death insures to the benefit of him who owns the property subject to the power, and thus brings about, at death, the completion of that shifting of the economic benefits of property which is the real subject of the tax, just as effectively as would its exercise, which latter may be subjected to a privilege tax."

However, it must be remembered that the Supreme Court in the above case was construing a statute specifically providing for the taxation of life insurance payable to designated beneficiaries in excess of the sum of $40,000. In view of the fact that our statute does not so provide, we do not feel bound by the interpretation of the Supreme Court nor can we subscribe to the theory of law announced therein.

We have said in this opinion that the proceeds of life insurance policies payable to designated beneficiaries were not subject to the inheritance tax law of Missouri. The reserved right to change the beneficiary does not, to our mind, affect the fundamental relationship of the parties to the contract. As to this point, we submit the reasoning of the Supreme Judicial Court of Massachusetts in the case of Tyler v. Treasurer, 226 Mass. 306, 115 N.E. 300, as the correct analysis of the problem:

> "The rights of the beneficiary are vested when the designation is made in accordance with the terms of the contract of insurance. They take complete effect as of that time. They do not wait for their efficacy upon the happening of a future event. They are in no wise modified or increased at the time of the death of the insured.
>
> "The contract of life insurance differs from most other contracts in that it is not intended ordinarily

for the benefit of the insured
but of some dependent. Its
original and fundamental concep-
tion is a provision by small
periodical contributions to secure
a benefit for the family. While
this conception has been enlarged
in some respects and especially
in its commercial aspects, still
the basic elements continue and
are found in all the cases at bar.
The insured retains no ownership
of that which has passed to the
beneficiary under the contract.
A reserved right to change the
beneficiary does not affect the
essential nature of the rights of
the beneficiary so long as they last.
* * * The insured has no title to
the amount due on the policy. He
does not and cannot make a gift
of that. The right to that amount
as an instant obligation does not
spring into existence until after
his death. Even then the money
belongs to the insurer who is
charged with the duty to pay the
beneficiary under the contract. So
far as he can make a 'gift' the only
thing which he has to give is a
right in a contract. By designating
the beneficiary both the grant and
the gift, so far as they exist at
all, take effect in enjoyment and
possession at once. Such a relation
does not by fair intendment come
within the descriptive words of the
statute as 'property which shall
pass by gift made or intended to
take effect in possession or enjoy-
ment after the death of the grantor.'
The conclusion is that the sums
received by the beneficiaries in
accordance with the designations
made in the contract of insurance
are not subject to the succession
tax."

And in the recent case of In Re Killien's Estate (Sup. Ct. Wash.) 35 P. (2d) 11, the Court said (l.c. 19):

> "Therefore, as life insurance is a contract made by one person for the benefit of another, in which contract the death of the insured is not a factor except as fixing the time for performance by the insurance company, and as the right to make the contract and the right to fix the time for performance do not depend upon permission from the state, the contract of insurance, where the proceeds thereof are payable to a designated beneficiary, is not subject to the inheritance tax. The reservation of the right to change the beneficiary of a policy of insurance does not render the proceeds of the policy subject to an inheritance tax."

There is but one exception to the above rule, i.e., where there has been an assignment of the policy or policies in contemplation of death. This is a difficult question, differing in every instance by reason of the facts involved in each particular case. However, it would seem that if the assured actually assigned a policy of insurance in contemplation of death so the proceeds would be payable to a designated beneficiary and not to his estate, the proceeds thereof should be subject to tax.

> "In the present case, however, the decedent by the assignments to his son-in-law transferred interests or claims of value which, in my opinion, were made 'in contemplation of death' and are taxable." In Re Einstein's Estate, 186 N.Y.S. 931.

This does not, in our opinion, conflict with our theory of the law respecting the reserved right to change the beneficiary inasmuch as, in the above instance, the proceeds of the insurance policies pass to the ultimate beneficiary, not by reason of the contract with the insurance company, but by reason of the assignment from the decedent.

> "Accordingly, an insured may assign a life insurance policy

> which is payable to his 'legal representatives' * * * and to this even though the assignee has no insurable interest and the assent of the insurer has not been obtained." Couch, Cyclopedia of Insurance Law.

Life Insurance Trusts

We have in the preliminary subdivision of this opinion called attention to the fundamental nature of insurance trusts. However, for the purpose of taxation, the distinction between funded and unfunded trusts is of little moment in that, in both types, the trustee receives the proceeds by reason of the contract with the insurance companies.

Perhaps the most common form of these trusts is the unfunded trust, that is, the assured pays the premium on the policies, the proceeds of which, upon the death of the assured, are paid by the insurance company to a trustee. The trustee then distributes the funds according to the terms of the trust instrument entered into between the trustee and the decedent.

The leading case considering the taxation of a life insurance trust is the case of In Re Vorhees' Estate, 193 N.Y.S. 168. In that case the Court said:

> "The intent of the assured with respect to these policies seems plain; he acquired the several policies and assigned them to provide a trust fund for the benefit of his wife, his son, and others after his death; and by the trust deeds he directed how, under what conditions, when, and to whom payments therefrom should be made after his death. By his plan he was not distributing after death property valuable to him or his estate. Unless he made the contracts with the insurance companies, and paid the premiums, there would be no sums coming in therefrom, and, having made the contracts, except in the event of a default in payment of the premiums, the contracts of insurance would be

of little value to him or his estate. If he failed to pay the premiums on the ten-year renewable term policies, they would lapse, and on the four straight life policies there is but a small paid-up value. He has, indeed, by his trust deeds, directed how the proceeds of these policies shall be distributed after death, and named the conditions under which the beneficiaries should take. But this is the effect in principle of every life policy payable at death to another than the assured or his estate.

"Considering the nature of the property, we do not consider that the plan of the assured should be held to be of a testamentary character.

* * *

"We conclude, therefore, that the assured assigned and delivered these policies before death; that the transfers of the policies and their proceeds were not made in contemplation of death, nor made to take effect in possession or enjoyment upon death only, within the meaning of the statute; that the proceeds of the policies under the assignments thereof came rightfully into the hands of the Provident Life & Trust Company of Philadelphia; that they never became the property of the estate of the deceased; and that there has not been and cannot be a transfer of the proceeds of the policies under the will of the deceased or the intestate laws of the state."

In the case of In Re Headrich's Estate, 236 N.Y.S.395, the Court passed upon the question wherein an independent trust company was named as trustee. The Court said:

> "It is the contention of the appellant that where the policy is payable either in a limited sum or in installments to the beneficiaries, they would not be taxable, but that the additional, possibly more beneficial, step makes them subject to the tax. With this contention this court cannot agree. Under such a trust arrangement the trust beneficiaries are as truly the equitable owners of the proceeds as if they had been named as beneficiaries therein. The trustee has a mere legal title and in equity the substance rather than the form of the transaction is of transcendent importance."

See also, In Re Marshall's Estate (Sup. Ct. Minn) 228 N. W. 920.

The case of Fagan v. Bugbee (decided by the Supreme Court of New Jersey) 143 Atl. 807 is interesting for its conflict in theory with the cases heretofore cited. In holding the proceeds of insurance policies taxable where payable to a trustee for designated beneficiaries, the Court said (l. c. 809):

> "The beneficiaries in the present case take by deed of trust and not by contract of insurance. It is the nature of the vehicle which conveys the right of the property and not the nature of the property itself which determines the taxability of the transfer; hence, we conclude the tax was properly levied."

The conclusion of the court is surprising when considered in the light of the review of the fundamentals made by the Court. In the course of the opinion, the Court recognizes that the trustee acquired merely a bare legal title to the funds and that the beneficial title was in the widow and three children of the deceased. It is fundamental in equity that the substance and not the form governs, and we confess we can see no logic or reason supporting the taxation of proceeds of insurance policies when payable to a trustees for the benefit of beneficiaries and yet exempt from tax the proceeds of policies payable direct to certain beneficiaries. The appointment of the trustee, as is pointed out in the Haedrich Case, is merely a protective incident and does not affect the fundamental character of the transfer. We cannot, therefore, adhere to the ruling of the New Jersey Court, and respectfully submit that conclusions arrived at by the New York Courts provide the correct rules of law applicable to this question.

However, if the deed of trust names no beneficiaries and it is therein provided that the trustees pay over the income and principal consisting of the proceeds of life insurance policies in accordance with the provisions set forth in the settlor's will, then it would appear that the property passes to the beneficiaries, not by reason of the trust agreement, but by reason of the will, and therefore is subject to the Missouri succession tax.

This concept of inheritance tax law is clearly stated by the Supreme Court of Pennsylvania in the case of In Re Myers' Estate, 164 A. 611. In that case the deed of trust recited that it was made for the purpose of settling and securing the proceeds of the policies and provides that the trustees shall pay over the income therefrom and the principal in accordance with the provisions set forth in the settlor's will. The Court, in holding the proceeds subject to tax, said:

> "In the instant case, the settlor retained complete title and control. No other interest than his, vested or contingent, arose until his death. The deed of trust accomplished nothing in respect to disposition of the proceeds of the policies. This failure resulted, not from any fortuitous events over which the settlor had no control, but from the clear intent of the language of the deed itself, and of the testator's will. The deed created no interest; it named no beneficiaries. It was incomplete and meaningless. It transferred no property to any one; it divested the settlor of no beneficial interest whatever. Distribution of the principal was expressly made dependent on the terms of testator's will; nothing could pass to beneficiaries except in that manner. It was not even necessary for him to amend

> or revoke the trust or any part of it in order to control its ultimate disposition. He could do that by his will."

A transfer of property in this manner presents a clear and unmistakable attempt to evade the succession laws of Missouri. While it is proper and correct to, by watchfulness and care, avoid taxes, evasion cannot be condoned.

Annuity Contracts by Insurance Companies.

There are a great number of insurance annuity contracts issued by insurance companies, the provisions of which are many and varied. It would be quite impossible to render a blanket opinion covering all of these contracts; therefore, we shall, for the purpose of this opinion, limit ourselves to a discussion of that type of contract wherein the "assured" retains the right to revoke the contract and have the single premium repaid to him by the companies.

This form of contract has recently been construed by the Supreme Court of Minnesota. (State ex rel. Thornton v. Probate Court, 186 Minn. 351) In that case, each of three life insurance companies authorized to do business in this state issued, during the first part of 1931, so-called annuity policies or contracts to Joseph M. Thornton, who thereafter died testate on July 1, 1931. At the time these contracts were issued Thornton paid to each company the sum of $30,000. No future payments or premiums were required. None of the contracts contemplated any segregation of assets applicable to or securing the payments to be made under the contracts, but the above named sums paid by Thornton became the absolute property of the company receiving the same. Each company agreed to pay Thornton annually a specified sum, beginning with the year 1932. The sum so agreed to be paid each year was $900 by one company, $1,050 by another, and $980 by the third. Besides these annuities, the companies agreed that during Thornton's lifetime there would be guaranteed earnings on the sums paid in equal to three and one-half per cent, and that he would be paid such additional amount as might be allocated to him by the board of directors of each company out of interest earnings in excess of three and one-half per cent. The Court, in holding the proceeds of these contracts subject to the succession tax of Minnesota, said:

"The policy contracts here involved are not what are ordinarily known as annuity contracts in which a definite annual sum is to be paid the annuitant during his life or the life of some other person named in the contract, and in which such annual payments absorb portions of the principal. The annual rate of interest earned by the companies upon their total investments exceeded five per cent up to the time these contracts were issued, and it seemed probable that the annuities to be paid under this type of contracts would exceed five per cent in the future. Except in what is known as business insurance, the right to change beneficiaries is common to all life insurance; and so is the right to cancel the contract and receive the full cash surrender value thereof; also the right to borrow on and hypothecate the contract or policy. The amount paid the beneficiaries was $94,712.99. There were here no annuity payments, for Thornton died before the year in which such were to be paid; and under the contracts the beneficiaries, in addition to the $30,000, were entitled to receive a sum equal to the single premium paid less annuity payments. If the insured died before the time of making the first payment each company agreed to pay to the beneficiaries the total amount of the premium paid; and each company assumed the risk of the small earnings and depreciation and loss on its investment, the result of which might be that the company would be required to make, during Thornton's lifetime, a larger annual payment than it earned, and upon Thornton's death, pay to the beneficiaries an amount in excess of the benefits accruing to it from the premium paid. The contracts are made part of the stipulation. These are very lengthy and need not be noted except as to provisions deemed important to determine the question for decision. Among these are that the $30,000 Thornton paid to each company it agreed to repay to him at any time during his lifetime upon 90 days' notice. He also reserved the right to change beneficiaries. No physical examination seems to be required of the one who pays the consideration for such contracts.

* * *

"But our inheritance or succession tax statute as it now stands does not in terms cover ordinary life insurance.

"Although the contracts here in question have features in common with ordinary life insurance policies, their true effect and scope are vastly different. It cannot well be denied that the $90,000 Thornton paid to these companies remained virtually at his disposal, use, and control as long as he lived and passed at his death to the beneficiaries he named. True, the money he paid became the property of the companies, but they guaranteed to him a certain percentage of earnings thereon each year and agreed to pay him specified annuities each year, together with such dividends as might be earned and allocated to the fund his $90,000 helped to create. As long as he lived he had the right, upon notice, to have $90,000 returned. It seems to us this $90,000, under these contracts, stands precisely in the same relation to him as if he had deposited that amount in a bank under a contract similar to one of these. There would be an obligation to pay the whole sum paid or deposited to him, if demanded in his lifetime, and to appointed beneficiaries upon his death. This obligation was an estate or property right of his to which the beneficiaries named succeeded at his death, and is subject to the tax.

"An examination of the various provisions of the contracts before us

> strongly suggests that the reason for their coming into existence was the desire to evade the expense of probating estates and the burden of the succession tax. Quite a saving can be made in this manner if a person is in position to convert his estate into cash and pay it all to a responsible corporation upon its agreement to pay a stipulated annuity each year during life and certain dividends, or to pay back the whole amount paid in whenever desired. The law will look behind the name of contracts--these so-called insurance policies--and ascertain their scope and purpose to determine whether or not they come within the operation of the succession tax."

CONCLUSION

In view of the foregoing, we respectfully submit the following conclusions:

(a) The proceeds of insurance policies payable to the estate of a decedent are subject to tax.

(b) The proceeds of insurance policies payable to named beneficiaries are not subject to tax, except where policies are assigned in contemplation of death.

(c) The proceeds of insurance policies passing to named beneficiaries through the medium of trust agreements are not subject to tax except in those cases wherein the provisions of the will provide for the trust.

(d) The proceeds of single premium insurance contracts wherein the right to have the premium returned at any time is retained by the "assured" are subject to tax.

Respectfully submitted,

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APPROVED:

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