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LEGAL NOTES

B. M. ANDERSON*

FEDERAL INCOME TAX—DEDUCTIBILITY OF LOAN INTEREST ON ANNUITY CONTRACT: *Knetsch v. United States* (United States Supreme Court, November 14, 1960) 364 U.S. 361. Knetsch procured from Sam Houston Life Insurance Company in 1953 ten "deferred annuity savings bonds," each in the face amount of $400,000 and bearing interest at 2½ percent compounded annually. He gave the company his check for $4,000 and signed $4,000,000 of nonrecourse annuity loan notes covering the balance. The notes bore interest at 3½ percent payable in advance. On the same day he paid the first year's interest in the amount of $140,000 but was permitted to borrow $99,000 a few days later. In his income tax return for 1953 he deducted the $140,000 interest he paid in the beginning plus $3,465 which he paid a few days later, representing interest in advance on the additional $99,000 which he borrowed.

For 1954 essentially this same procedure was followed except that the total interest paid for that year had increased to $147,105. The Commissioner of Internal Revenue disallowed the claimed interest deductions and determined a deficiency for each of the two years involved. Knetsch then paid the amount demanded and brought this action to recover.

The United States District Court found that there was no commercial economic substance to the transaction and that as to the payment of interest the transaction was a sham. While the contract called for a monthly annuity of $90,171 at maturity, if the annuitant had continued to borrow on the contract the annuity would have amounted to only $43 a month.

The Court of Appeals for the Ninth Circuit affirmed the decision of the trial court, and on this appeal to the United States Supreme Court the judgment again was affirmed. Knetsch claimed that Congress, in effect, authorized the deduction in enacting the 1954 Code when it prevented such deductions as to contracts purchased after March 1, 1954. This contention was denied. The Court in its opinion stated:

> Provisions denying deductions for amounts paid on indebtedness incurred to purchase or carry insurance contracts are not new in the revenue acts. A provision applicable to all annuities, but not to life insurance or endowment contracts, was in the statute from 1932 to 1934, 47 Stat. 179. It was added at a time when Congress was developing a policy to deny a deduction for interest allocable to tax-exempt income; the proceeds of annuities were excluded from gross income up to the amount of the consideration paid in by the annuitant. See H.R. Rep. No. 708, 72d Cong., 1st Sess. p. 11. The provision was repealed by the Revenue Act of 1934, 48 Stat. 688, when the method

* B. M. Anderson, not a member of the Society, is a member of the Alabama, Connecticut and United States Supreme Court Bars and is the author of the Third Edition of *Vance on Insurance.*

by which annuity payments were taken into gross income was changed in such way that more would be included. 48 Stat. 687. See S. Rep. No. 558, 73d Cong., 2d Sess., p. 24.

Congress then in 1942 denied a deduction for amounts paid on indebtedness incurred to purchase single premium life insurance and endowment contracts. This provision was enacted by an amendment to the 1939 Code, 56 Stat. 827, "to close a loophole" in respect of interest allocable to partially exempt income. See Hearings before Senate Finance Committee on H.R. 7378, 77th Cong., 2d Sess., p. 54; § 22 (b) (1) of the 1939 Code (now § 101 (a) (1) of the 1954 Code).

The 1954 provision extending the denial to amounts paid on indebtedness incurred to purchase or carry single premium annuities appears to us simply to expand the application of the policy in respect of interest allocable to partially exempt income. The proofs are perhaps not as strong as in the case of life insurance and endowment contracts, but in the absence of any contrary expression of the Congress, their import is clear enough. There is *first* the fact that the provision was incorporated in the section covering life insurance and endowment contracts, which unquestionably was adopted to further that policy. There is *second* the fact that Congress' attention was directed to annuities in 1954; the same 1954 statute again changed the basis for taking part of the proceeds of annuities into gross income. See § 72 (b) of the 1954 Code. These are signs that Congress' long standing concern with the problem of interest allocable to partially exempt income, and not any concern with sham transactions explains the provision.

Moreover the provision itself negates any suggestion that sham transactions were the congressional concern, for the deduction denied is of certain interest payments on actual "indebtedness." And we see nothing in the Senate Finance and House Ways and Means Committee Reports on § 264, H.R. Rep. No. 1337, 83d Cong., 2d Sess., p. 31; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 38, to suggest that Congress in exempting pre-1954 annuities intended to protect sham transactions.

Three of the nine justices dissented on the basis that the contracts were true annuity contracts and that the "interest" was, in fact, interest. They agreed that tax avoidance was the dominating motive behind the transaction but expressed the opinion that the remedy was legislation by the Congress.

AGENCY CONVENTION—TAXABILITY OF REIMBURSED COST TO AGENT: *Patterson v. Thomas* (C. A. 5, March 16, 1961) 289 F.2d 108. Thomas, a Liberty National agent, attended a company convention in Old Point Comfort, Virginia, as a member of the Torch Club, composed of outstanding field representatives. The company either paid or reimbursed him for his own travel and hotel expenses and those of his wife. Members of the Torch Club were either encouraged or required to attend such meetings.

The Government claimed that the expenses of Thomas and his wife reimbursed or paid by Liberty National constituted taxable income to them and the amount was not deductible as a business expense. The basis of the Government's claim was that the trip was primarily for pleasure and as a reward for excellent production and that the business aspects were incidental. The meeting lasted three and a half days with two business sessions of two and one-half hours each and with the usual dinners, sightseeing trips and entertainment. Thomas was away from his Birmingham home for about a week.

The United States District Court held that the expenses of both Thomas and his wife were as to them not gross income; and if, indeed, these sums represented gross income, they were deductible as ordinary and necessary business expenses. The Government appealed this decision to the Court of Appeals for the Fifth Circuit. Two of the three judges before whom the appeal came were of the opinion that the trip was primarily a pleasure trip and not a business trip, that the expenses borne by Liberty National constituted gross income to Thomas and his wife, and that Thomas was entitled to deduct only a pro-rata portion of his expenses at the hotel based on the time he spent at the business meetings. He was allowed no deduction for travel expenses to and from the hotel nor for any expenses incurred by his wife and borne by Liberty National.

In reaching the determination that the trip was primarily for pleasure and not for business and that the expenses were not deductible, the court considered four principal factors. These were: the amount of time spent on personal activities as compared with the time spent on activities directly relating to the business of the agent; the fact that the convention was sponsored by the taxpayer's employer and its only participants were the taxpayer's co-employees; the fact that the convention was held at a resort hotel; and the fact that Liberty National had promoted the convention as a meeting where participants would have a good time.

The dissenting judge agreed that the reimbursed expenses constituted gross income to Thomas and his wife, but he was of the opinion that the expenses incurred by both came within the category of ordinary and necessary business expenses. He pointed out the practical necessity of attendance at the meeting by the agent and his wife.

The principles of this case apply to all business gatherings and the case definitely has far-reaching implications. The companies must emphasize the business nature of gatherings and must place less emphasis on the pleasurable aspects in order to avoid having agents or employees taxed on account of reimbursed expenses. It also becomes quite important for the agent or employee to keep adequate records to show how the time at the meeting was spent.

MISREPRESENTATION—CONFLICTING ANSWERS TO QUESTIONS: *Variety Homes v. Postal Life Insurance Company* (C. A. 2, February 17, 1961) 287 F.2d 320. Variety Homes owned two life insurance policies on the life of Singer, its executive. He died a year and a half after taking out the policies and Postal Life claimed that it was not liable for the face amounts because of alleged misrepresentation by Singer.

Singer admitted in his application that he had a coronary attack in 1952 and he answered "yes" to a question reading, "Fainting, palpitation, pain around heart, high blood pressure, shortness of breath or any indication of disease of the heart or arteries?" Singer also gave the names of his physicians. The examining physician for Postal Life filled out answers to certain questions and one statement written in by the examining physician was that Singer was "asymptomatic." Postal Life's contention was that on the basis of this state-

ment over the signature of the insured, it was led to believe that the insured had not had symptoms of heart trouble since his coronary attack in 1952.

Variety Homes brought this action against Postal Life and in the United States District Court recovered judgment against Postal Life. On appeal to the Court of Appeals for the Second Circuit, this judgment was affirmed. The Court found that Postal Life was not privileged to rely on the medical term "asymptomatic" inserted by its own doctor but held, in effect, that Postal Life was put on notice that Singer may have had symptoms after his heart attack. In its opinion the Court, Moore, C.J., stated:

> Singer did not use the word "asymptomatic." It was written by Postal's examining doctor presumably after an adequate opportunity to ask the insurance applicant all necessary and relevant questions concerning his heart condition. It is inconceivable that Dr. Marshall, upon being advised of the pains in the heart and shortness of breath, would not have inquired concerning the period in which these symptoms occurred—particularly after being advised that Singer had consulted Dr. Steincrohn, a Hartford heart specialist, subsequent to his original attack. Although Postal was given this information by Singer, who willingly executed authorizations, no effort was made by Postal to communicate with this doctor to inquire concerning Singer's condition and to obtain directly from him, without the possible bias if obtained from Singer, his opinion as to Singer's state of health.
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> The very purpose of the elaborate questionnaire required from insurance applicants is to supply information upon which the insurance company can make an informed judgment as to whether it will accept the risk. Inquiry as to the names of doctors treating applicants for the past five years cannot be a meaningless gesture. The physical examination by the insurance company's doctor also must have some significance. Surely all this carefully planned and organized system does not fade into oblivion upon an applicant's self-diagnosis of "asymptomatic." How frequently does the average layman patient, upon being asked by a doctor how he feels, reply, "Oh! quite asymptomatic, thank you"? Even Postal's doctor conceded this to be a "medical term." Just as an insurance contract "should not be couched in language as to the construction of which lawyers and courts may honestly differ," so too should those portions of the application which are filled out by a physician not be worded so as to be misleading or ambiguous when read by a layman.

SURRENDER OF POLICY FOR CASH VALUE—EFFECTIVE DATE OF SURRENDER. *Franklin Life Insurance Company v. Smithers* (C. A. 5, January 24, 1961) 285 F.2d 875. On June 6, 1957 Smithers wrote to Franklin Life, asking for the necessary papers to surrender his life policy. The June 1 premium had just been paid by a draft on the policyholder and hence no premium was in default. On June 17 the company wrote him sending surrender forms to be executed in the presence of a notary public and returned. In this letter the company stated: "As soon as these requested items are received, our prompt attention will be given to your policy surrender and our check mailed."

Smithers signed the surrender form June 21 and his policy and this form were received by the company on June 25. The company had changed the surrender form after it was signed to indicate slightly more due to Smithers.

The Franklin Life contended that the policy had been effectively surrendered prior to the insured's death on June 22 and that its liability was limited to the cash surrender value represented by its check. The beneficiary claimed that there was no legal surrender and that the amount owing was the face amount less indebtedness. The beneficiary sued and the United States District Court granted judgment in her favor. On appeal to the United States Court of Appeals for the Fifth Circuit, this judgment was affirmed. The Court took the position that a notice to surrender the policy was all that was required to effect a surrender, but that the parties had entered into a new agreement with different terms. The Court held that the surrender was not effected prior to the insured's death and accordingly affirmed the judgment of the United States District Court. One of the three judges concurred on the basis that the June 1 premium covered the month of June and both parties intended the surrender to take effect at the end of June. The Court in its opinion stated:

> Here, the insured accepted the new offer by the insurance company, i.e. that he sign the receipt and release and have it witnessed by a notary public and mail it to the company within ten days, as a condition to the company's giving its *prompt attention* to his policy surrender. Thus, the novation was complete, and both parties were bound by its terms, one of which was the receipt and release be *received* by the Company in order for it to act upon the surrender. Important legal relationships flowed from these terms. For instance, if Smithers had lived, the amount of his surrender value would depend upon the date on which his surrender became effective, since under the law of Louisiana any unearned premiums collected by the insurer would have to be credited to the insured. Here, however, much more important legal rights depended upon the terms of the novation. It cannot be considered as a possibility that the question of coverage under the policy was in a fluid state, to be decided unilaterally by either party according to which way the ball bounced. How better, then, to fix the date of the end of coverage by referring to the terms of the novation itself—"Sign the Receipt and Release before a notary public and return it with the policy within ten days, and upon receipt, attention will be given." This language unequivocally, we think, when accepted by the insured in modification of his already existing contract right meant that if the release and policy were actually received at the home office *within ten days*, the surrender would then become effective. Here, the stipulation is to the effect that the "requested items" were received at the home office three days after Smithers' death. Thus, under the terms of the new agreement, specified by the insurance company, the surrender did not become effective during the life of the insured. It must follow, therefore, that the policy was in effect at his death.

RESERVE TAX—PENSION PLAN ON COMPANY EMPLOYEES: *State Tax Commission v. John Hancock Mutual Life Insurance Company* (Massachusetts Supreme Judicial Court, December 8, 1960) 170 N.E.2d 711. John Hancock, as insurer, issued to the company, as employer, in 1938 a contributory group annuity contract. The company, still subject to the reserve tax and not to the premium tax, excluded from its reserve for tax purposes that portion of the reserve liability attributable to its own contributions to the group annuity contract covering its Massachusetts employees. The Tax Commissioner assessed a

deficiency in 1957 based on the inclusion by him of this reserve liability attributable to the company contribution. The Appellate Tax Board granted John Hancock an abatement and from this decision an appeal was taken by the State Tax Commission to the Massachusetts Supreme Judicial Court.

The Supreme Judicial Court affirmed the decision of the Appellate Tax Board on the basis that the law did not clearly impose a tax on the reserves built up by the company contributions. It accordingly resolved this doubt in favor of the taxpayer.

ACQUISITION OF FIRE AND CASUALTY INSURANCE STOCK BY LIFE INSURER—DOING BUSINESS: *Connecticut General Life Insurance Company v. Superintendent of Insurance of New York* (New York Court of Appeals, June 1, 1961)—N.Y.2d—, —N.E.2d—. Connecticut General Life Insurance Company commenced this declaratory judgment action against the New York Superintendent of Insurance to establish its right to acquire controlling stock interest in one or more fire and casualty insurance companies without having its New York license revoked.

In 1956 the Attorney General had ruled that the proposed acquisition by Connecticut General of controlling stock interest in a particular Connecticut fire and casualty insurance company would have violated the "comply in substance" provisions of Section 90 of the Insurance Law, relating to investments. Subsequently, in 1958, Section 90 was amended to restore the prior interpretation of the law, which was to the effect that there was substantial compliance if the out-of-state insurance company had adequate surplus funds without attributing any value to the stock of the subsidiary.

After the passage of this 1958 legislation the Superintendent claimed that Connecticut General was still barred from acquiring controlling stock interest in a fire or casualty insurance company. The basis of the Superintendent's claim (which the Attorney General did not pass on in 1956) was that after such acquisition Connecticut General itself would be doing the business of the subsidiary in violation of Sections 42 and 193 of the New York Insurance Law. Connecticut General claimed that the business of the subsidiary could not be attributed under the circumstances to the parent corporation. Connecticut General also claimed that two other Connecticut life insurance companies doing business in New York owned controlling stock interests in fire and casualty subsidiaries and that numerous fire and casualty insurance companies doing business in New York owned controlling stock interests in life insurance companies. Connecticut General therefore claimed the Superintendent not only misinterpreted the New York law but that in view of this action in renewing annually the licenses of the other companies, Connecticut General was being denied equal protection of the laws contrary to the Fourteenth Amendment to the United States Constitution. Connecticut General also claimed that the interpretation was in violation of the due process provisions of the Fourteenth Amendment.

In the New York Supreme Court (the trial court) both Connecticut General and the Superintendent moved for a summary judgment on the basis of con-

ceded facts. Connecticut General's motion was denied and the Superintendent's motion granted. From this judgment Connecticut General appealed to the Appellate Division, First Department. In that court four of the five justices were of the opinion that the judgment of the trial court was correct and accordingly affirmed. Connecticut General's claim that its rights under the Federal Constitution were violated was dismissed rather summarily.

One of the justices dissented on the basis that the business of the subsidiary could not be attributed to the parent and that accordingly Connecticut General was entitled to the declaratory judgment which it sought.

On further appeal by Connecticut General to the New York Court of Appeals, the highest court in that state, the contentions of Connecticut General were in every particular upheld. However, three of the seven judges dissented.

The Court held that the Superintendent erroneously construed the New York law and further held that "very real constitutional problems would arise" if the Superintendent's construction of the law were adopted.

The Court recognized that until the 1955-56 controversy with Connecticut General the doing business sections—sections 42 and 193—had not been construed to prevent life insurance companies of other states from acquiring fire and casualty subsidiaries and continuing to be licensed in New York. It held that the 1958 amendment to the investment section—section 90—merely restored the prior interpretation of this section. The Court refused to recognize that there was any legal significance in the cut-off date of October 17, 1958 which the Superintendent fixed, holding acquisitions to that time were proper but forbidding acquisitions thereafter. The Court also rejected the Superintendent's contention that the general revision of the New York Insurance Law in 1939 made any material change either in the investment sections or in the doing business sections as applied to out-of-state life insurance companies.

The Court pointed out the general rule is that a corporation is not doing the business of its subsidiary, that no public policy would be offended by the consummation by Connecticut General of the proposed acquisition and that Connecticut General, Aetna and Travelers were in the same legal position.

The Court ordered entry by the trial court of the declaratory judgment sought by Connecticut General.

The three dissenting judges held, contrary to the view of the majority, that the State's public policy was being offended and the interest of policyholders was being jeopardized. They took the position that Connecticut General could not complain about the action of the Superintendent in continuing to license Aetna and Travelers. The dissenting judges expressed the view that the Superintendent may have been in error in continuing to license these other companies, but claimed that this error did not constitute conscious discrimination against Connecticut General. The dissenting judges took the position that the life insurance company in acquiring controlling interest of the fire and casualty company was itself engaging in the fire and casualty business contrary to public policy and contrary to law.

Group Life Insurance—Extraterritorial Operation of the Law: *State Mutual Life Assurance Company v. Texas* (Texas Court of Civil Appeals, March 15, 1961) 345 S.W.2d 325. Texas, through its Attorney General, filed this action seeking to revoke State Mutual's license to do business in Texas. The State's claim was that, contrary to Texas law, State Mutual had issued in the District of Columbia a group life insurance contract covering the lives of employees of Texas member companies of the National Association of Securities Dealers. It seemed to be conceded that a group life contract issued to such an association of employers was not proper under Texas law. State Mutual's claim was that it could properly cover Texas employees of Texas employers consistent with the Texas law under its contract issued and delivered elsewhere.

The contract in question was issued to the trustees in Washington. Employer members of the National Association of Securities Dealers paid the entire cost without contributions from the insured employees. Certificates were issued in the normal manner.

The Texas Group Insurance Law by its terms applied to policies of group life insurance the statement "issued or delivered in this State." The law also stated in another section: "Except as may be provided in this article, it shall be unlawful to make a contract of life insurance covering a group in this State. . . ."

The trial court held that the insuring of the lives in Texas under the Association's policy issued in the District of Columbia was in violation of Texas law. On appeal to the Court of Civil Appeals for the Third Supreme Judicial District, that Court reversed on the basis that there was no clear violation of Texas law. The Court examined many cases from Texas and from the United States Supreme Court relating to the power of the state to regulate insurance activities outside of the state. In reaching the conclusion that State Mutual had not violated Texas law by covering the Texas citizens, the Court stated:

> These cases lead us to believe that the mere fact that the insured reside in Texas and that the payment of money to a beneficiary, who may or may not reside in Texas, is the only obligation of the insurance contract to be performed in this State are probably not of sufficient local importance to justify the State in ousting appellant from Texas for having made it, beyond its borders, and lawful where made.
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> Liberally construing Art. 3.50, as we feel compelled to do, and bearing in mind the general rules of statutory construction that the Act as a whole must be looked to, and that specific provisions control more general provisions, and that the statute should not be construed so as to make its constitutionality doubtful and that the validity of the statute should be sustained if any reasonable construction can achieve it, we hold that Sec. 4 of Art. 3.50 does not control the activities of foreign insurance companies licensed to do and engaging in an insurance business in this State beyond the borders of this State, and that the specific provisions of the statute prohibiting the issuance or delivery in this State of certain policies of insurance are paramount to and control the more general wording of the penalty and enforcement provisions of Sec. 4 of Art. 3.50.