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Taxation -- Stock Purchase Agreements -- Life Insurance Premiums as Constructive Dividends

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duction in one year would result in distorting taxable income has been applied to prepayment of rentals,[16] bonuses for the acquisition of leases,[17] bonuses for the cancellation of leases,[18] and commissions for negotiating leases.[19] On the other hand, it has been held that prepaid interest is deductible in the year paid by a cash basis taxpayer.[20]

It is unfortunate that the courts have reached numerous conflicting decisions on matters that should be kept uniform, simple, and clear. It is submitted that there should be no difference in the tax treatment of a three year prepayment of fire insurance premium, interest, or rent.

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Taxation—Stock Purchase Agreements—Life Insurance Premiums as Constructive Dividends

The Internal Revenue Code of 1939 defined the term "dividend" as "any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year . . . ."[1] With a slight change, this definition has been repeated in the Internal Revenue Code of 1954.[2]

In *Sanders v. Fox*[3] it was held that premiums paid by a closely held corporation for life insurance policies on the lives of the stockholders were taxable as dividends to the stockholders in proportion to their holdings.[4] The policies had been taken out pursuant to an agreement between the corporation and stockholders providing that the corporation would insure each stockholder and that the proceeds would be used to buy the shares of a deceased stockholder.[5] The agreement recited that the insured would designate the beneficiary, but that the corporation would be considered the owner of the policies during the lifetime of the

[16] Baton Coal Co. v. Commissioner, 51 F.2d 469 (3d Cir.), *cert. denied,* 284 U.S. 674 (1931).
[17] Home Trust Co. v. Commissioner, 65 F.2d 532 (8th Cir. 1933).
[18] Steele-Wedeles Co., 30 B.T.A. 841 (1934); Harriet B. Borland, 27 B.T.A. 538 (1933).
[19] Bonwit Teller & Co. v. Commissioner, 53 F.2d 381 (2d Cir. 1931), *cert. denied,* 284 U.S. 690 (1932).
[20] John D. Fackler, 39 B.T.A. 395 (1939) (three year payment); Court Holding Co., 2 T.C. 531 (1943), *rev'd on other grounds,* 143 F.2d 823 (5th Cir. 1944), *rev'd without discussion of this point,* 324 U.S. 331 (1945); Joseph H. Konigsberg, P-H 1946 T.C. Mem. Dec. ¶ 46024 (five year payment).

[1] Int. Rev. Code of 1939, § 115(a), 53 STAT. 46 (now INT. REV. CODE OF 1954, § 316).
[2] *Ibid.*
[3] 149 F. Supp. 942 (D. Utah 1957).
[4] "The Corporation did not claim the premiums as a deduction for income tax purposes, but accounted for these premiums as an asset on its balance sheet." *Id.* at 945.
[5] The consideration given by the stockholder was his promise not to sell his stock except as specified in the agreement.

insured. On the death of the insured the beneficiary named by him "would receive the insurance proceeds on the condition that the beneficiary would sell the stock of the decedent to the corporation at an adjusted price determined by the stockholders," plus a pro-rata share of the cash surrender value of all the policies, or the amount of the proceeds of the policy, whichever was greater.[6]

In holding against the taxpayer, the court stressed that the parties who really benefited from the life insurance were the stockholders,[7] and that while no dividends were declared, the payment of the premiums by the corporation amounted to a constructive dividend.[8] That the court was willing, if necessary, to look through the corporate entity was indicated by its quoting at length from the Tax Court decision of *Oreste Casale*[9] and paraphrasing language in that case with the statement that, "For all practical purposes it might be stated the four stockholders were the corporation . . . ."[10]

The Court of Appeals for the Second Circuit, in reversing the Tax Court decision of the *Casale* case,[11] applied reasoning which presents an interesting contrast to that adopted in *Sanders v. Fox*.

Casale, who owned ninety-eight percent of the stock of O. Casale, Inc., and who was also president and chairman of the board, entered into a deferred compensation agreement with the corporation which provided that on his reaching age sixty-five, the corporation would pay him a monthly income, and if he died prior thereto, would pay a certain sum to his nominees.[12] The corporation then purchased a $50,000 retirement income policy on the life of Casale, paid all premiums, and was the owner and beneficiary of the policy.[13] At maturity or on the death of Casale, all proceeds of the policy were to be paid to the corporation.

[6] *Sanders v. Fox*, 149 F. Supp. 942, 945 (D. Utah 1957). It is important to note here that while the agreement gave the insured the right to designate the beneficiary, the fact that the beneficiary would receive the insurance proceeds only on condition that he sell to the corporation indicates that the corporation retained additional rights in the proceeds not discussed by the court.

[7] The stockholder (actually his beneficiary) was given a guaranteed market for stock that might otherwise be difficult to sell, and should he survive and the decedent's stock be retained by the corporation, his proportionate share of ownership of the corporation would be increased.

[8] The cases cited by the court in support of the application of the doctrine of constructive dividends are discussed in note 22, *infra*.

[9] 26 T.C. 1020 (1956), *rev'd*, 247 F.2d 440 (2d Cir. 1957).

[10] 149 F. Supp. at 946.

[11] Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957).

[12] As consideration, Casale promised he would not start a competing business, or work for a competitor of the corporation. For a discussion of similar plans see Lasser and Rothschild, *Deferred Compensation for Executives*, 33 HARV. BUS. REV. 89 (1955); McCarthy, *A Survey of Types of Supplementary Compensation for Executives*, 30 TAXES 878 (1952).

[13] As in the principal case, the corporation did not attempt to deduct the premium payments. 5 CCH 1954 STAND. FED. TAX REP. ¶ 8684 states, "Until a short while ago, a consistent pattern of tax treatment was applied. The premiums were not deductible because the corporation was directly or indirectly the beneficiary, and the proceeds were not taxable when received by the beneficiary."

The Commissioner, as in the *Sanders* case, sought to tax the insurance premiums as dividends to the stockholders, asserting that, "For all practical purposes he was the corporation."[14] In refusing to adopt this view, the court pointed out that should the corporation go bankrupt, the policy would be subject to creditors' claims as would any other corporate asset, and that while Casale completely dominated the corporation, he had no legal interest in the policies.[15]

In addition to the fact that the courts in the above cases differed considerably in their willingness to look through the corporate entity,[16] it is interesting to note that each court seemed to apply a different test in reaching its conclusion. In the *Sanders* case the court emphasized the fact that the real benefit of the insurance policies was to the stockholders and not to the corporation.[17] In *Casale,* while acknowledging that the stockholder derived a benefit from the insurance, the court stressed the fact that the stockholder had no "legal interest" in the policy.[18]

In the *Sanders* case, the stock purchase agreement recited that the insurance policies and the values therein were to be considered as a reserve to enable the corporation to acquire the shares of any deceased stockholder.[19] This statement, coupled with the fact that the corporation was named the owner of the policy during the insured's life, would indicate that the policies remained assets of the corporation. Therefore, rather than having the effect of a dividend, the purchase of the life insurance policy was really an appropriation of earned surplus for a

[14] 247 F.2d at 443.

[15] The court also mentioned that the corporation was not bound to use the insurance proceeds to meet its obligations under the deferred compensation contract, but could use any available surplus.

[16] It is settled law that where the corporation is a sham (created solely for purposes of tax avoidance) the corporate entity will be disregarded. See Higgins v. Smith, 308 U.S. 473 (1939); Gregory v. Helvering, 293 U.S. 465 (1935).

[17] The "benefit test" was also applied in Paramount-Richards Theatres Co. v. Commissioner, 153 F.2d 602 (5th Cir. 1946). There, the corporation paid for the life insurance on a stockholder, who was both owner and beneficiary of the policy. In Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957), the court, in holding that life insurance premiums were not taxable as dividends, stated that the real benefit was to the corporation, not the stockholders. During the tax year in question the stockholders were the named beneficiaries, but the insurance proceeds were subject to a stock retirement agreement that was enforceable in equity. The court emphasized the over-all tax scheme of treating the corporation as a separate entity.

[18] The court dealt rather summarily with Paramount-Richards Theatres Co. v. Commissioner, *supra* note 17, by stating that there, the policies were owned by the stockholder and could not have been reached by corporate creditors. Emeloid Co. v. Commissioner, 189 F.2d 230 (3d Cir. 1951), applied the "business reason" test. The court held that purchase of the stockholders' shares to promote harmony among management was a proper business purpose. In that case, the policies were initially purchased as key-man insurance and later assigned under a stock purchase agreement. The court held that loans obtained by the corporation to purchase the policies constituted borrowed, invested capital within the meaning of the excess profits tax, and credit was allowed.

[19] 149 F. Supp. at 944.

specified purpose, namely, to meet the corporate obligations under the stock purchase agreement.[20] The court cited numerous cases in support of its holding that the premiums amounted to constructive dividends,[21] but in each of those cases the funds in question had either been removed from the corporate till, or could have been removed at any time the stockholder chose to exercise a right of withdrawal.[22] In each case the result had been a reduction of earned surplus, which normally occurs upon payment of a dividend.[23]

Little objection may be found to the Commissioner's position where the corporation pays the insurance premiums on a stockholder's life, and the policy is completely owned and controlled by the stockholder.[24]

[20] "Earned surplus is sometimes appropriated—earmarked—by action of the board of directors, for a particular purpose, in which case it is known as *appropriated surplus.*" McFARLAND AND AYERS, ACCOUNTING FUNDAMENTALS 384 (2d ed. 1947).

[21] 149 F. Supp. at 948. The term "constructive dividend" should not be confused with "constructive receipt." See Hedrick v. Commissioner, 154 F.2d 90 (2d Cir. 1946); Note, *Constructive Receipts: When Must the Taxpayer Pay?,* 45 ILL. L. REV. 77 (1950).

[22] Regensberg v. Commissioner, 144 F.2d 41 (2d Cir.), *cert. denied,* 323 U.S. 783 (1944) (Stockholders obtained interest-free "loans" from the corporation. Corporation made no attempt to collect "loans" until Commissioner investigated. *Held,* loans were taxable as dividends even though no formal declaration.); Fitch v. Helvering, 70 F.2d 583 (8th Cir. 1934) (Stockholder indebted to corporation. Directors cancelled debt by declaring a gift to stockholder. Gift credited against accumulated surplus. *Held,* taxable as income to stockholder.); Christopher v. Burnet, 55 F.2d 527 (D.C. Cir. 1931) (Controlling stockholder withdrew funds from corporation at no interest. Funds never repaid or any evidence of indebtedness executed. *Held,* withdrawals taxable as dividends though no formal declaration.); Phelps v. Commissioner, 54 F.2d 289 (7th Cir. 1931), *cert. denied,* 285 U.S. 558 (1932) (Corporation purchased 7200 of 7500 outstanding shares. After purchase, the only property owned by the corporation was real estate. *Held,* gain was taxable as a liquidating dividend rather than a gain resulting from a sale.); Chattanooga Sav. Bank v. Brewer, 17 F.2d 79 (6th Cir.), *cert. denied,* 274 U.S. 751 (1927) (In 1920, stockholders withdrew funds from corporation through a drawing account in proportion to their holdings. Corporation declared a dividend in 1921 which was credited against drawing accounts. *Held,* amounts withdrawn were taxable as a dividend in 1920.). For a general discussion of this problem see Werner, *Stockholders' Withdrawals—Loans or Dividends?,* 10 TAX L. REV. 569 (1955).

Cases not cited by the court, but dealing with the question of constructive dividends: Weise v. Commissioner, 93 F.2d 921 (8th Cir.), *cert. denied,* 304 U.S. 562 (1938) (Over a period of years stockholder "borrowed" a total of $103,000 from the corporation, free from interest and for which no evidences of debt were given. In 1932, the corporation wiped out the debt and reduced surplus by $103,000. *Held,* stockholder received a $103,000 dividend in 1932.); Hadley v. Commissioner, 36 F.2d 543 (D.C. Cir. 1929) (Earnings credited to an account for each stockholder, roughly in proportion to their holdings with each shareholder having unrestricted right to withdraw from his account. *Held,* taxable as dividends.).

The court also cited Estate of Weil, 22 T.C. 1267 (1954); Estate of Salt, 17 T.C. 92 (1951); Third Nat'l Bank v. United States, 64 F. Supp. 198 (M.D. Tenn. 1946); and Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936), all holding that where an estate is obligated to sell the stock or interest of the deceased at a certain price, that price is the proper valuation to be placed on the stock or interest for estate tax purposes.

[23] "It is a sound principle of accounting that dividends are payable out of earned surplus." McFARLAND AND AYERS, *op. cit. supra* note 20, at 390.

[24] Paramount-Richards Theatres Co. v. Commissioner, 153 F.2d 602 (5th Cir. 1946). That such a result will not always be reached is indicated by Lewis v. O'Malley, 140 F.2d 735 (8th Cir. 1944).

There still may be no objection to a finding that an outlay results in a dividend though not formally declared as such.[25] However, it is difficult to support the view that the stockholder has received a dividend when the asset he supposedly received is still owned by the corporation, and remains subject to creditors' claims and the hazards of business.[26]

Perhaps inclusion of the following provisions in a life insurance funded stock purchase agreement would permit the taxpayer to avoid the result of the *Sanders* case. *First,* state that the corporation is not bound to the use of any specific funds with which to purchase the shares of a deceased stockholder.[27] *Second,* state clearly that the corporation is the beneficiary and sole owner of the policies, and that all proceeds are payable only to the corporation. *Third,* provide that the stockholder has no legal interest in the policies, and that all rights exercisable under the policy (loan, cash surrender, change of beneficiary, etc.) are exercisable solely by the corporation. *Fourth,* emphasize that the agreement is for the benefit of the corporation and not the stockholders.[28]

Should the Commissioner be more successful in the future in having corporation-paid life insurance premiums declared taxable as dividends to the insured stockholders, it is likely that closely held corporations will stop financing stock purchase agreements with life insurance. Rather than purchase life insurance, the corporation will retain surplus with which to meet its obligations under the stock purchase agreement.[29] It is the writer's feeling that the parties who will probably be hurt most by decisions such as that of *Sanders v. Fox* will be shareholders of cor-

[25] Regensberg v. Commissioner, 144 F.2d 41 (2d Cir.), *cert. denied,* 323 U.S. 783 (1944); Christopher v. Burnet, 55 F.2d 527 (D.C. Cir. 1931); Hadley v. Commissioner, 36 F.2d 543 (D.C. Cir. 1929); Werner, *Stockholders' Withdrawals —Loans or Dividends?,* 10 TAX L. REV. 569 (1955).

[26] If a stockholder leaves the earned surplus within the corporation, makes a legacy of his stock with a collateral agreement that the legatees sell the stock to the corporation, not only is the ordinary income tax avoided, but the legatees who, under INT. REV. CODE OF 1954, § 1014, acquire the stock at a new basis (value at decedent's death), are able to avoid capital gains tax. However, there is the possibility that the government might then allege that the accumulations of surplus were excessive and subject to the accumulated earnings tax imposed by INT. REV. CODE OF 1954, § 531.

[27] This can be accomplished by including a clause stating that any available surplus may be used to meet the corporation's obligations under the agreement. If the agreement recites that the insurance proceeds must be used, the Commissioner has grounds for asserting that the stockholder has a legal interest in that particular asset.

[28] The benefits to the corporation may be considered largely illusory, but such things as continuity of management and corporate policies, harmony among management, and the fact that the policies are sound investments with good loan values have been accepted by the courts. See Emeloid Co. v. Commissioner, 189 F.2d 230 (3d Cir. 1951); Lewis v. O'Malley, 140 F.2d 735 (8th Cir. 1944).

[29] The corporation could become a "self-insurer" for this particular obligation. See Lewis v. O'Malley, *supra* note 28, for a holding that investment of corporate funds to meet the corporate obligations under a stock purchase agreement was a proper business purpose. It would not be advisable to appropriate the earned surplus to a specific fund since then the Commissioner might asert that the stockholders have vested rights in the fund.

porations that cannot afford to finance stock purchase agreements internally and the life insurance companies who will lose many potential buyers of business life insurance.

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Torts—Privacy—Bad Debt Letters to Employer

In a Georgia case, *Gouldman-Taber Pontiac, Inc. v. Zerbst*,[1] the defendant had written the plaintiff's employer a letter in which the plaintiff's debt was described and the employer's aid in collecting the debt was solicited. The employer confronted the plaintiff with the letter, asked her to explain her failure to pay, and informed her that the letter would be kept in the permanent file on her until the defendant sent another letter stating the debt had been paid. An action was brought by the plaintiff for damages for invasion of her privacy, which invasion was alleged to have caused her great mental pain and distress. Held, an employee has a right of privacy as against his employer in the matter of the debts he owes, and a creditor who gives such information to the employer is liable to the employee for an invasion of his privacy.[2] Judge Townsend concurring specially in denying a motion for rehearing stated, "The spirit and intent of Georgia law on the subject of the right to sue in tort for an invasion of the right of privacy is sufficiently broad to cover a case such as is made here. I do not think this rule of law should be given lip service only. Coercive action which tends to limit the free choice of an individual in resisting what he feels to be an unjust claim for money upon him is reprehensible, and there have been many times in this state where employment was so scarce that to threaten an employee with discharge was equivalent to threatening him with starvation."[3]

A tort action for the invasion of the right of privacy has been recognized in twenty states, Alaska, and the District of Columbia.[4] It has been limited by statute in two other states[5] and has been declared

[1] 99 S.E.2d 475 (Ga. 1957).

[2] The court referred to McDaniel v. Atlanta Coca Cola Bottling Co., 60 Ga. App. 92, 2 S.E.2d 810 (1939), wherein it was held that publication or commercialization of the information by the defendant is not necessary in order for the plaintiff to recover for an invasion of privacy. The court also adverted to Quina v. Roberts, 16 So. 2d 558 (La. App. 1944), wherein the defendant's letter to the plaintiff's employer requesting aid in collecting a debt of $1.45 was held to warrant a recovery by the plaintiff of $100. (The *Gouldman-Taber Pontiac* and the *Quina* cases are the two most extreme holdings protecting a debtor from an invasion of his privacy by a creditor.) That the plaintiff claimed the alleged debt was not owed and that the defendant had not brought suit nor gotten judgment against her was emphasized by the court in the principal case.

[3] 99 S.E.2d at 479.

[4] Annots., 138 A.L.R. 25 (1942), 168 A.L.R. 448 (1947), 14 A.L.R.2d 753 (1950), A.L.R. Supp. Service 771 (1957).

[5] UTAH CODE ANN. §§ 76-4-8, 9 (1953), Donahue v. Warner Bros. Pictures