

# Taxation--Stock Retirement Agreements--Life Insurance Premiums Paid by Corporation Held Not Taxable Income to Stockholder (Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957))

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A few New York cases take the view that a payee can never be a holder in due course.<sup>20</sup> In *Alpert v. City Motor Sales, Inc.*,<sup>21</sup> the court held that a payee could not be a holder in due course and stated that *Munn v. Boasberg* had conclusively determined the point. It would seem, however, that the court overly extended the *Munn* rule to apply to all cases wherein a payee seeks to prove himself a holder in due course.

The Court in the instant case, by holding that a payee can be a holder in due course, impliedly rejected the *Alpert* case's interpretation of *Munn v. Boasberg*,<sup>22</sup> stating that the law in New York has not been definitively settled by the Court of Appeals.

Under the Uniform Commercial Code all uncertainty about a payee being able to qualify as a holder in due course is resolved by the Code specifically stating that the payee can so be.<sup>23</sup>

While no New York case gives a section by section examination of the Negotiable Instruments Law to determine the point, the position adopted by most of the courts, that a payee can be a holder in due course, follows the spirit of the Negotiable Instruments Law when read in its entirety.



TAXATION — STOCK RETIREMENT AGREEMENTS — LIFE INSURANCE PREMIUMS PAID BY CORPORATION HELD NOT TAXABLE INCOME TO STOCKHOLDER.—Petitioners, two brothers who were substantially the sole stockholders in a corporation, each took out policies of insurance on his own life, naming his brother as beneficiary. Both brothers agreed that the insurance proceeds would be used by the corporation to purchase the deceased brother's stock. During the taxable year, the corporation paid the premiums on these policies. The Commissioner and the Tax Court determined that the premiums were taxable income to the insured officer-stockholders. The United States Court of Appeals, reversing, held that the premiums were not taxable income since the corporation, although not named as such, was the real bene-

<sup>20</sup> See, e.g., *Cohen v. Rossmore*, 225 App. Div. 300, 233 N.Y. Supp. 196 (1st Dep't 1929).

<sup>21</sup> 194 Misc. 909, 90 N.Y.S.2d 479 (Albany City Ct. 1949).

<sup>22</sup> The decision of *Alpert v. City Motor Sales, Inc.* appears consistent with *Munn v. Boasberg* since the facts were similar and the question of the agency of the transferor was involved. However, since the agency question was not involved in the instant case, it would seem that to have followed the *Alpert* interpretation would have led to an incorrect decision.

<sup>23</sup> UNIFORM COMMERCIAL CODE § 3-302(2). West Virginia also specifically includes a payee in its definition of holder in due course: a holder in due course is ". . . a holder, including a payee, who has taken the instrument under the following conditions. . . ." W. VA. CODE ANN. § 4363 (1955).

fiary of the policies and was not a mere conduit through which benefits were conferred upon the brothers. *Prunier v. Commissioner*, 248 F.2d 818 (1st Cir. 1957).

As a general rule, when a corporate-employer pays insurance premiums on the life of an employee whose estate or family is the beneficiary, the premiums are classified as taxable compensation<sup>1</sup> to the employee.<sup>2</sup> They are allowed as deductions by the corporation, if they are ordinary and necessary business expenses.<sup>3</sup> Similarly, when the insured is a stockholder, the premiums are taxable to him as constructive dividends.<sup>4</sup> However, when the corporation is directly or indirectly a beneficiary of the policy, the premiums are categorized as a corporate investment.<sup>5</sup> As such, they are not deductible by the corporation,<sup>6</sup> nor would it seem, are they taxable to the employee or stockholder.<sup>7</sup>

Corporations frequently make use of such policies to fund conventional stock-retirement agreements,<sup>8</sup> which have been defined as arrangements

(1) under which the corporation binds itself to retire the stock of a deceased stockholder at some agreed-upon fair valuation; and

<sup>1</sup> INT. REV. CODE OF 1954, § 61(a) (1) (gross income includes compensation for services).

<sup>2</sup> *Commissioner v. Bonwit*, 87 F.2d 764 (2d Cir.), cert. denied, 302 U.S. 694 (1937); *Yuengling v. Commissioner*, 69 F.2d 971 (3d Cir. 1934); *N. Loring Danforth*, 18 B.T.A. 1221 (1930). See also *George Matthew Adams*, 18 B.T.A. 381 (1929). However, a qualification imposed by Rev. Rul. 54-165, 1954-1 Cum. Bull. 17 should be noted wherein contributions by an employer for group term insurance for employees are not includible in the employee's income. But when group permanent life insurance is involved, the premiums are taxable income to employee. *Mim. 6477*, 1950-1 Cum. Bull. 16.

<sup>3</sup> INT. REV. CODE OF 1954, § 162(a); *Berizzi Bros. Co.*, 16 B.T.A. 1307 (1929). See also Rev. Rul. 210, 1953-2 Cum. Bull. 114, wherein premiums paid by an employer on individual accident insurance policies for each of its salesmen are deductible as business expenses, even though the salesmen had full rights including that of naming the beneficiary.

<sup>4</sup> *Paramount-Richards Theatres, Inc. v. Commissioner*, 153 F.2d 602 (5th Cir. 1946); *Sanders v. Fox*, 149 F. Supp. 942 (D. Utah 1957); cf. *Casper Ranger Constr. Co.*, 1 B.T.A. 942 (1925).

<sup>5</sup> *Casale v. Commissioner*, 247 F.2d 440 (2d Cir. 1957). See also *Merrimac Hat Corp.*, 29 B.T.A. 690 (1934).

<sup>6</sup> INT. REV. CODE OF 1954, § 264(a) provides: "No deduction shall be allowed for—(1) Premiums paid on any life insurance policy covering the life of any officer and employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy." (Emphasis added.)

<sup>7</sup> Cf. O.D. 627, 3 Cum. Bull. 104 (1919-21). See also *Casale v. Commissioner*, note 5 *supra*.

<sup>8</sup> See *Mannheimer & Friedman, Stock-Retirement Agreements—The Prunier and Sanders Cases*, 35 TAXES 567, 572 (1957); MONTGOMERY, FEDERAL TAXES, part 17, p. 47 (35th ed. 1954).

(2) under which, if it is funded by life insurance, the corporation owns the life insurance, lock, stock and barrel, and the corporation or a trustee acting on its behalf is named beneficiary.<sup>9</sup>

No case has been found in which the Commissioner has asserted the taxability of premiums paid in a situation involving a conventional stock-retirement agreement. The Commissioner, however, has successfully taxed the premiums of some stock-retirement agreements which fail to meet these apparently accepted standards.<sup>10</sup> For example, in *Paramount-Richards Theatres, Inc. v. Commissioner*,<sup>11</sup> a corporation, in funding a stock-retirement agreement, paid premiums on a policy which named a *stockholder as beneficiary*. As the corporation had no right to the proceeds and no obligation to buy the decedent's stock, the premiums were taxed as dividends distributed to the insured stockholder.<sup>12</sup>

In the instant case, also, the principal *stockholders* were both the insured and the named *beneficiaries*. Despite an agreement entered on the corporation's minutes that the proceeds were to be used by the corporation to purchase decedent's stock, the lower court held the premiums taxable to the individual stockholders.<sup>13</sup> The *Paramount* and *Prunier* decisions cast doubt upon the feasibility of utilizing stock-retirement agreements.<sup>14</sup> They raised the possibility that, even under a conventional stock-retirement agreement, the courts would disregard the benefits flowing to the corporation and hold the insured stockholders taxable on the premiums.<sup>15</sup>

The United States Court of Appeals, in the present case, has apparently settled the uncertainty in this area, although the case did not concern a conventional stock-retirement agreement. The First Circuit, interpreting state law,<sup>16</sup> held beneficial ownership of the in-

<sup>9</sup> Mannheimer & Friedman, *supra* note 8, at 568.

<sup>10</sup> See *Paramount-Richards Theatres, Inc. v. Commissioner*, 153 F.2d 602 (5th Cir. 1946).

<sup>11</sup> 153 F.2d 602 (5th Cir. 1946).

<sup>12</sup> *But see Sanders v. Fox*, 149 F. Supp. 942 (D. Utah 1957), now on appeal, 6 CCH 1958 STAND. FED. TAX REP. 62111, where the court, despite the naming of the corporation as beneficiary, disregarded the resulting benefits to the corporation, and taxed the insured stockholders on the premiums as a dividend distribution.

<sup>13</sup> *Henry E. Prunier*, 28 T.C. 19 (1957).

<sup>14</sup> See Steinberg, *Funding Stock-Redemption Agreements with Life Insurance*, 35 TAXES 669 (1957).

<sup>15</sup> Compare Steinberg, note 14 *supra*, with Mannheimer & Friedman, *Stock-Retirement Agreements—The Prunier and Sanders Cases*, 35 TAXES 567 (1957).

<sup>16</sup> *Massachusetts Linotyping Corp. v. Fielding*, 312 Mass. 147, 43 N.E.2d 521 (1942). See *Handrahan v. Moore*, 332 Mass. 300, 124 N.E.2d 808 (1955); *Brierly v. Equitable Aid Union*, 170 Mass. 218, 48 N.E. 1090 (1898).

For New York cases, similar to those relied on in Massachusetts, which would reasonably allow the same conclusion, see *Stronge v. Knights of Pythias*, 189 N.Y. 346, 32 N.E. 433 (1907); *Ehrlich v. Cohn*, 1 A.D.2d 1003, 151 N.Y.S.2d 802 (1st Dep't 1956); *Locomotive Engineers Mut. Life & Acc. Ins. Ass'n v. Locke*, 251 App. Div. 146, 295 N.Y.S. 689 (4th Dep't), *aff'd mem.*,

insurance policies, as distinguished from full legal ownership in conventional stock-retirement agreements, to be sufficient legally to bind the corporation to this stock-retirement agreement.<sup>17</sup> In doing so, the Court seems to admit a fortiori the nontaxability of premiums paid by a corporation in connection with a conventional stock-retirement arrangement.

The Court also upholds the validity of the corporate entity theory<sup>18</sup> in this area of the law by stating:

We do not understand that the majority of the Tax Court reached the conclusion they did on any notion of "disregarding the corporate fiction." Human beings take advantage of laws permitting incorporation because they think it will be economically advantageous. . . . That is so whether the corporation is a "closely held" company owned by two stockholders, or one having two thousand stockholders.<sup>19</sup>

This view, as applied to stock-retirement agreements, seems consistent with the reasoning of the Second Circuit as expressed in *Casale v. Commissioner*,<sup>20</sup> a case involving a deferred compensation plan funded by insurance on the principal stockholder's life.<sup>21</sup> The court there decided that, where the policy was a corporate asset and therefore subject to claims of corporate creditors, the insured stockholder received no immediate benefit at the time the corporation paid the premiums.<sup>22</sup>

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277 N.Y. 584, 13 N.E.2d 781 (1937); *Zies v. New York Life Ins. Co.*, 237 App. Div. 367, 261 N.Y.S. 709 (1st Dep't 1933); *Salinas v. Salinas*, 187 Misc. 509, 62 N.Y.S.2d 385 (Sup. Ct.), *aff'd mem.*, 271 App. Div. 917, 67 N.Y.S.2d 692 (1st Dep't 1947).

<sup>17</sup> For Massachusetts cases cited in the *Prunier* case on this point, see *Hurley v. Ornsteen*, 311 Mass. 477, 42 N.E.2d 273 (1942); *Murray v. C. N. Nelson Lumber Co.*, 143 Mass. 250, 9 N.E. 634 (1887); *Lyndeborough Glass Co. v. Massachusetts Glass Co.*, 111 Mass. 315 (1873); *Sherman v. Fitch*, 98 Mass. 59 (1867).

<sup>18</sup> See PRASHKER, CORPORATIONS 8 (2d ed. 1949). Following a group of cases discussing the corporate entity theory, the author states that this group of cases ". . . involves the proposition that a shareholder of a corporation has no individual claim to the title or possession of the assets of the corporation by virtue of his status as shareholder." *Ibid.* This proposition serves as an acceptable definition of the corporate entity theory.

<sup>19</sup> *Prunier v. Commissioner*, 248 F.2d 818, 821 (1st Cir. 1957). *But see Sanders v. Fox*, 149 F. Supp. 942 (D. Utah 1957), now on appeal, 6 CCH 1958 STAND. FED. TAX REP. 62111, which appears inconsistent with the present attitude of the appellate courts. For brief summary of case see note 12 *supra*.

For corporate benefits recognized by the *Prunier* case, see also Mannheimer & Friedman, *Stock-Retirement Agreements*, 28 TAXES 423, 425 (1950).

<sup>20</sup> 247 F.2d 440 (2d Cir. 1957).

<sup>21</sup> See also *Emeloid Co. v. Commissioner*, 189 F.2d 230 (3d Cir. 1951); *Lewis v. O'Malley*, 140 F.2d 735 (8th Cir. 1944); *Edgar M. Docherty*, 47 B.T.A. 462 (1942) (where the courts recognized benefits, including that of continuity of harmonious management, derived by a corporation from a stock-retirement agreement).

<sup>22</sup> See also *Lincoln Nat. Life Ins. Co. v. Scales*, 62 F.2d 582 (5th Cir. 1933).

Before utilizing conventional stock-retirement agreements or varying plans, however, the taxpayer should be aware of the recent *Joseph R. Holsey* decision.<sup>23</sup> In that case a stockholder who held an option to purchase the remaining fifty per cent outstanding stock of the corporation assigned his option to the corporation, and the amount paid by the corporation in retiring this stock was held taxable income to the remaining stockholder. Although the *Holsey* case has been criticized,<sup>24</sup> the Commissioner may have succeeded in limiting the tax advantages resulting from an acceptable stock-retirement arrangement.

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<sup>23</sup> 28 T.C. 962 (1957).

<sup>24</sup> See Hobbet, *The New Attack on Stock Redemptions*, 35 TAXES 830 (1957). The author states that "... it is quite possible that *Holsey* will be reversed if appealed. . . ." *Id.* at 841.