Federal Income Tax--Life Insurance Proceeds--Assignment of Policy as Collateral Security (St. Louis Refrigerating & Cold Storage Co. v. United States, 162 F.2d 394 (8th Cir. 1947))

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FEDERAL INCOME TAX—LIFE INSURANCE PROCEEDS—ASSIGNMENT OF POLICY AS COLLATERAL SECURITY.—The St. Louis Refrigerating Co., the taxpayer, was owed over $25,000 by J. C. Walton in January, 1932. On October 23, 1932, Walton assigned three life insurance policies to the taxpayer as collateral security for a series of notes which he had given to the corporation. The debtor's wife, the beneficiary of the policies which had a face value of $25,000, joined in the assignment. The printed assignment of the policies recited a consideration of one dollar.

During the taxpayer's fiscal year ending April 30, 1933, it charged off as a bad debt the $25,000 evidenced by Walton's notes thereby reducing its tax liability for the period.

Subsequently on December 17, 1941, Walton died and the taxpayer recovered $18,188.70 representing the proceeds of the life insurance policies after deductions for loans and interest.

The Commissioner of Internal Revenue assessed and the taxpayer paid a deficiency based on the inclusion in the taxpayer's gross income of the proceeds of the life insurance policies less the premiums which had been paid by the taxpayer.

The taxpayer filed a claim for refund claiming the proceeds of the insurance policies should have been excluded from gross income. The claim was rejected and the taxpayer brought an action to recover the income taxes paid by it.

The district court granted a judgment for the defendant. Held, affirmed. Proceeds of life insurance policies received by the assignee constituted recovery of bad debt losses previously deducted and were taxable income in the year received. St. Louis Refrigerating & Cold Storage Co. v. United States, 162 F. 2d 394 (C. C. A. 8th 1947).

The Commissioner of Internal Revenue assessed the tax on the proceeds of the life insurance policies because the policies had been assigned as security for the notes which Walton had given to the taxpayer and the plaintiff had previously written off the notes as a bad debt thereby obtaining a tax benefit.

The plaintiff asserts that since it had paid no valuable consideration for the assignment the proceeds of the policies should not be included in taxable income for under § 22(b)(1) of the Internal Revenue Code "Amounts received under a life insurance contract paid by reason of the death of the insured . . ." are excluded from the taxpayer's gross income for tax purposes. On the other hand, if the court finds there was a valuable consideration paid, it consisted of the amount originally advanced by it to Walton, and as the proceeds of the insurance policies were less than the consideration plus the premiums paid by the plaintiff subsequent to the assignment, the proceeds should be excluded under § 22(b)(2) of the Internal Revenue Code which in effect excludes from taxable income the premiums and actual value of the consideration paid by the transferee of a policy.

1 INT. REV. CODE § 22(b)(12).
The court states such a transfer as was made here was not an absolute transfer of a life insurance policy but merely a pledge as collateral security for the notes, for if the notes were paid the beneficiary would have been entitled to the proceeds. Thus the insurance contract would lose its character as insurance. Section 22(b)(1) of the Internal Revenue Code contemplates the exclusion of the amount received under a life insurance contract paid by reason of death of the insured to the beneficiary of the policy only. The transferee of the policy is entitled to have only the actual value of the consideration paid for the transfer excluded from his gross income. The actual value of the consideration for the assignment is not necessarily represented by the face value of the notes. The plaintiff did not prove their actual value. Their charge off in 1933 indicates the actual value was less than face value. The plaintiff must show the actual value of the consideration, for the burden of establishing the tax as invalid or erroneously exacted is upon him.

The plaintiff relied heavily on Durr Drug Co. v. United States in which case the taxpayer was allowed to exclude the proceeds received from a life insurance policy procured by a debtor employee at the insistence of his creditor employer, who became the beneficiary. There also, a previous deduction taken for the bad debt resulted in a tax benefit for the taxpayer. In that instance, however, the creditor was the sole beneficiary from the inception of the policy and no transfer was involved as in the present case.

Recoveries are the result of the collection or sale of a bad debt. In this instance the recovery was from the proceeds of the collateral security, and merely because the proceeds of the policy would have been exempt to the beneficiary named does not make them exempt when they became a matter of exchange rather than insurance. The bad debt had been charged off in 1933 whereby the taxpayer had received a tax deduction, therefore it was not entitled to a recovery exclusion. As a result, the collection became income in 1941, the year in which it was received.

L. Z.