Cornell Law Review

Volume 43
Issue 3 *Spring 1958*

Article 1

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CORNELL
LAW QUARTERLY

VOLUME 43 SPRING, 1958 NUMBER 3

A DEFENSE OF THE TAX COURT'S RESULT IN PRUNIER AND CASALE

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Occasionally the always slightly febrile world of federal tax law undergoes a series of shocks, generally attributable to some pronouncements of the Treasury, the Tax Court, or the Supreme Court, which cause a sizeable part of the tax bar to pen articles and notes describing the unfortunate consequences of these misguided determinations.[1] The object of these writings, to persuade the other portions of the Judiciary or Congress to obviate these consequences, often has been achieved in recent years. In the past few months this pattern of events has been repeated largely as a result of two Tax Court decisions—*Prunier*[2] and *Casale*.[3] Both now have been reversed[4] and huzzas can be heard distinctly by even the most untrained ear. There is much to be said in favor of this victory and, since most of it has been said, a paper repeating these points would serve no purpose. However, the results of these Tax Court decisions, if not their reasoning, as they affect contracts between the shareholders of a closely held corporation and their corporations providing for the purchase of shares of a deceased shareholder, deserve a better defense than they have received thus far. This paper is to present that defense.

I. THE PROBLEM AND ITS ISSUES

The facts of *Prunier* and *Casale* are well known. In the former, J. S. Prunier & Sons, Inc., whose stock was almost entirely owned by Henry E. Prunier, president and treasurer, and Joseph E. Prunier, vice-president, paid premiums on insurance policies totalling $45,000 on each of the lives of Henry and Joseph during the taxable year of 1950. In this year none of the policies or their endorsements named J. S. Prunier

† See Contributors' Section, Masthead, p. 449, for biographical data.
1 That this is an honorable calling is obvious.
2 28 T.C. 19 (1957).
3 26 T.C. 1020 (1956).
4 Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957) and Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957).

Sons, Inc., as beneficiary, nor was there anything therein indicating that the corporation was the owner of the policies.[5] However, the corporate minute book contained an entry evidencing an agreement between Henry and Joseph executed late in 1946 which provided that in the event of the death of either, the policies each had on the life of the other "shall go to the corporation" and "this money is to be used by the corporation to buy out the interest of the party that dies."[6] In addition, the corporate minutes reflected that on November 2, 1950 the stockholders agreed that the fair value of all the corporate stock was $110,000 and that this value was to be used when the corporation purchased the "interest" of a deceased stockholder "with the insurance money."[7] The Tax

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5 The policies generally seemed to indicate that the usual incidents of ownership were held by the beneficiary-brother. The status in 1950 appearing from the policies was as follows:

1942 Policy Covering Joseph's Life In The Amount of $5,000.
Beneficiary—Henry
Incidents of Ownership—Henry possessed the exclusive right to change the beneficiary while living; if not, Joseph was to have such right.

1942 Policy Covering Henry's Life In The Amount of $5,000.
Beneficiary—Joseph
Incidents of Ownership—Joseph possessed the exclusive right to change the beneficiary while living; if not, Henry was to have such rights.

1946 Policy Covering Joseph's Life In The Amount of $5,000.
Beneficiary—Henry
Incidents of Ownership—Henry possessed the exclusive right to change the beneficiary while living; if not, Joseph was to have such rights.

1946 Policy Covering Henry's Life In The Amount of $5,000.
Beneficiary—Joseph
Incidents of Ownership—Joseph possessed the exclusive right to change the beneficiary while living; if not, Henry was to have such rights.

1947 Policy Covering Joseph's Life In The Amount of $10,000.
Beneficiary—Henry
Incidents of Ownership—Application by Joseph stated all rights were to be shared by insured and beneficiary which was to be the corporation.

1947 Policy Covering Henry's Life In The Amount of $10,000.
Beneficiary—Joseph
Incidents of Ownership—Application by Henry stated all rights to be shared by insured and Joseph.

1950 Policy Covering Joseph's Life In The Amount of $25,000.
Beneficiary—Henry
Incidents of Ownership—Nothing indicated in the Tax Court Findings of Fact.

1950 Policy Covering Henry's Life In The Amount of $25,000.
Beneficiary—Joseph
Incidents of Ownership—Nothing indicated in the Tax Court Findings of Fact.

6 The text of the entry is as follows:

It is understood and agreed that any policies that Henry . . . has on Joseph . . . and any policies that Joseph has on Henry . . . shall go to the corporations in the event of the death of either of them and this money is to be used by the corporation to buy out the interest of the party that dies.

These policies are the ones that the corporation pays the premiums on.

This will apply to any policies that may be bought in the future. 28 T.C. at 21.

7 The entry reflecting this agreement reads as follows:

A special meeting of the stockholders and directors of J. S. Prunier & Sons, Inc., was held at the office of the corporation, on Thursday, November 2, 1950 at 7:30 P.M.

On motion duly made and seconded, the following was proposed and agreed upon and made part of the by-laws:

It was agreed by and between Joseph E. Prunier, Vice-President and Henry E. Prunier, President and Treasurer and present stockholders that the fair value of the

Court in its findings of fact stated that at the time the policies were written the insurance agent was informed by Henry and Joseph of the agreements which the policies were to carry out; that no deduction for the premiums paid was claimed by the corporation; that the corporate surplus was adjusted on Schedule M of the corporate return for premiums paid on life of an officer "where the corporation is directly or indirectly a beneficiary"; and that Henry and Joseph intended that the corporation should be the owner of the "proceeds of the policies" on the life of a deceased shareholder for the sole purpose of purchasing the stock of the deceased at the agreed upon price. The issue was whether the premium payments were taxable income to Henry and Joseph.

In *Casale* the taxpayer was the president and principal stockholder of O. Casale Inc., owning ninety-eight of the one-hundred shares of its outstanding stock. In December, 1948 the corporation was authorized by its board of directors, consisting of the taxpayer, his daughter, and an employee of the corporation, to enter into a contract with the taxpayer whereby the corporation would become obligated to pay him, upon certain contingencies, a monthly income upon his reaching the age of sixty-five, or, should he die prior thereto, to his nominee or estate, a certain sum. On the same date the corporation entered into a contract with the taxpayer providing for deferred compensation in the form of $500 per month upon his reaching the age of sixty-five, or, should he sooner die, the sum of $50,000 to his nominee or estate. A few days after this corporate action The Equitable Life Assurance Society issued to the corporation an insurance policy on the life of the taxpayer whose terms generally coincided with the obligations the corporation had undertaken in its contract with the taxpayer. The corporation was designated as the beneficiary of the policy, possessed the right to assign, or change the beneficiary of the policy, and had the right to receive dividends under the policy and to borrow thereon up to its cash surrender value. The contract between the corporation and the taxpayer

Corporation stock is: ONE HUNDRED AND TEN THOUSAND DOLLARS ($110,000.00) and it is their desire that this be the value used should a stockholder sever his connection with the corporation, or in the event of death of either that the corporation will purchase the interest of the deceased party at said value, with the insurance money.

It was also voted, at said meeting that both Joseph E. and Henry E. Prunier would issue each five of their shares to Irene M. Prunier, Clerk.

In witness whereof they have executed this agreement, on this third day of November 1950.

[sgd.] Joseph E. Prunier
Vice-Pres.
[sgd.] Henry E. Prunier
President & Treas.

Witness: [sgd.] Omer E. Prunier
28 T.C. at 22.

provided that his and his nominee's rights under the contract would be forfeited should he voluntarily leave the employ of the corporation against its wishes prior to reaching the age of sixty-five, or should he, subsequent to retirement, accept employment from any competitor of the corporation without its consent. However, termination of his employment because of insolvency of the corporation was not to be regarded as a voluntary leaving of his employment.[8] During the taxable year 1950, the corporation, which was engaged in the business of making topcoats, overcoats and raincoats, paid a premium of $6,839.50 on the policy issued by Equitable. The issue was whether the premium payment was a taxable dividend to the taxpayer.

The Tax Court in *Prunier,* after distinguishing situations in which the corporation is a beneficiary of policies from those where the estate or family of a corporate employee or officer is the beneficiary,[9] held that the corporation was neither the beneficial owner nor the beneficiary of the policies and that the premiums were taxable income to Henry and Joseph. This holding was based on three observations—that the corporation would not be enriched by the receipt of the proceeds from the policies on the life of a deceased shareholder because, apparently, the entire amount was to be paid to the estate of the deceased in exchange for his stock; that the policies themselves did not indicate that the corporation was to be the beneficiary; and that, by the purchase of the stock of the deceased, the survivor would have his proportional interest in the corporation increased at no cost to him in addition to acquiring the power to designate the beneficiary of the policies covering his life. In reversing, the first circuit, speaking through Chief Judge Magruder, concluded: (a) that the corporation under Massachusetts local law was the beneficial owner of the eight policies because it could have obtained the help of a court of equity to recover the proceeds, (b) that to consider

8 The pertinent provision reads as follows:

. . . provided, however, that the said ORESTE CASALE and any person or persons designated by him to receive the above mentioned pension payments after his death and his estate shall forfeit all right to the said pension payments if the said ORESTE CASALE voluntarily leaves the employ of this CORPORATION, against the wishes of the CORPORATION, prior to the date upon which he attains the age of 65 years, or such earlier date for his retirement as may be agreed upon; it being understood that for the purposes of this agreement and for the accrual of his rights to the payments herein provided he will be deemed as continuing in the employ of this CORPORATION until he attains the age of 65, or until any other earlier retirement date agreed upon, if his employment is in fact terminated (1) by the CORPORATION without fault on his part, (2) because of this CORPORATION's insolvency or (3) because of any wrongful act or default on the part of the CORPORATION: and further provided that if the said ORESTE CASALE subsequent to such retirement accepts employment from any competitor of this CORPORATION, without the consent of this CORPORATION, all right to any further pension payments hereunder shall be forfeited by him and by any person or persons designated by him to receive such payments and by his estate.

247 F.2d at 444.

9 See p. 360 infra.

any corporate benefit as a benefit to the shareholders, pro tanto, would ignore the corporate entity, a position not being urged by the government, (c) that the corporation would be enriched by the receipt of the insurance proceeds and the purchase of the stock of the deceased shareholder because the stock would be an asset of the corporation, (d) that the purchase of the insurance served a business purpose of the corporation, (e) that there was "limited utility" in the distinction between stockholder purposes and corporate business purposes, and (f) that the tax consequences upon death of either Henry and Joseph were not before the court.

A different line of approach was taken by the Tax Court in *Casale*. Stating that the issue was whether the entire transaction was "a sham for tax purposes," the court, after pointing to: (a) the similarity of the arrangement involved and one in which the taxpayer owned the policy upon which the corporation paid the premium, (b) the commanding position the taxpayer occupied in the corporation, (c) the immediate economic benefit the taxpayer received upon the payment of the first premium, (d) the remoteness of any possibility of forfeiture of rights by the taxpayer, (e) the short life of the corporation, and (f) its failure to declare dividends, concluded that the transaction "lacked bona fides and was merely a device whereby petitioner attempted to avail himself of corporate funds without incurring a tax upon their use." Consequently, the premium payment was equivalent to a dividend. This statement of the issue was rejected by the second circuit, speaking through Judge Hincks. As this court saw it the question was, "Are corporate expenditures of a corporation actively engaged in business deemed to be proportionate distributions to controlling shareholders for tax purposes?"[10] Since the answer to this question is obviously no, the court devoted itself to establishing that the corporation was not a sham or alter ego of the shareholder and that the premium payments were "corporate expenditures." The sham argument was put aside by pointing to the substantial business done by the corporation. The premium payments were made "corporate expenditures" by observing that the insurance policy acquired by the corporation was a corporate asset subject to the claims of creditors of the corporation, including the taxpayer, that the proceeds of the policies could exceed the amount of the corporation's obligation to the taxpayer, and that no immediate personal benefit resulted from the corporate purchase of the policy. Thus, the premium payments were not dividends.

The cause for alarm which developed at the time of the Tax Court

10 247 F.2d at 443.

decisions in these cases is not difficult to appreciate. Probably many stockholders of closely held corporations had entered into properly drawn contracts with their corporation which provided: (1) that insurance on their lives would be obtained by the corporation, (2) that the premiums would be paid by the corporation, (3) that the corporation would be the beneficiary and beneficial owner of the policies, and (4) that upon the death of a stockholder the proceeds, along with whatever additional cash may be necessary, were to be used by the corporation to purchase the shares of the deceased. Others, as in *Prunier,* had entered into badly drafted arrangements having a similar purpose but which left some doubt as to the beneficiary, or beneficial owner, of the policies. Were the premium payments taxable dividends in each instance? If so, what was thought to be a highly advantageous arrangement for reducing income taxes on corporate income at the shareholder level would be eliminated.[11]

Consequently, it is small wonder then that *Prunier* and *Casale* attracted attention, and that the Service is making an effort to curb the use of these arrangements. This highly probable revenue loss can be

[11] To illustrate, assume A and B each own 50% of the total outstanding stock of the X Corporation which has assets of $100,000, capital of $25,000, and surplus of $75,000. Assume further that both shareholders are taxed at an effective rate of 40%; that B's basis in his stock is $12,500, that A, B, and X Corporation enter into an arrangement such as described; that the premiums on the policies covering the life of A and B amount to $4,000 each; that the policies provide for $50,000 payable upon death; and that the contract with X Corporation expressly provides that the value of the proceeds of insurance upon death and the value of the policy covering the life of the survivor are not to be considered in valuing the stock of the deceased shareholder. If the insurance premiums paid by X are not taxable to A and B only $8,000 in corporate earnings after taxes are required to carry the policies whereas should such premiums be considered taxable dividends corporate earnings after taxes in the amount of $13,334 would be necessary. This results from the fact that at an effective rate of 40% a distribution to A or B of $6,667 is necessary to yield to them the after tax sum of $4,000. Thus each year the arrangement continues the Treasury fails to collect $2,667 in taxes from each shareholder—a total of $5,334. At the end of ten years the revenue loss will amount to $53,340 in round figures. Should A die at this time, the value of the business being the same as here assumed, his estate would receive $50,000 in exchange for his shares and B then would own all the controlling stock of X which has assets of $100,000 plus the cash surrender value of the policy on B's life.

Assuming this policy has a cash surrender value of $10,000, the liquidation of X Corporation would yield a gain to B of $97,500 ($110,000—12,500). The maximum tax to B would amount to $24,375. This may be the only income tax, and it is by no means an inevitable one, which is incurred at the shareholder level in this entire transaction. See p. 371 infra. Had the premiums been taxed as dividends the income tax cost would be $53,340 plus a certain amount of gain to B on liquidation. The liquidation gain should not be as great as in the example used since the $50,000 in insurance proceeds should go to increase B's basis in his stock where B is charged with income as a result of the premium payments. The low basis afforded the surviving shareholder in the example is a disadvantage of these arrangements. See, White, Business Insurance 397 (2d ed. 1956). Of course, other assumptions of fact would produce different income tax consequences. Generally speaking, however, the higher the tax rate of the shareholders, the longer the premiums are paid before the death of a shareholder, and the greater the value of the deceased shareholders stock, the larger the income tax savings. Of course, a bargain purchase of the deceased's shares, although resulting in a greater potential tax upon sale or liquidation by the survivor, is not a tragedy to the survivor. For a comparison of a stock retirement plan with a cross purchase arrangement with premiums paid from salary, see Steinberg, "Funding Stock-Redemption Agreements With Insurance," 35 Taxes 669, 672 (1957).

shrugged off with the hard headed observation, based on impeccable authority, that every taxpayer has the legal right to decrease, or altogether avoid, his taxes by any means the law permits[12] and that to "demand more in the name of morals is mere cant."[13] This would finish the matter but for two things. First, the law is not *clearly* in line with the taxpayer's assertions, the first and second circuit to the contrary notwithstanding. And second, not *every* taxpayer who is a shareholder of a closely held corporation can take advantage of the stock retirement arrangement apparently sanctioned by *Prunier* and *Casale.* Some are forced by reason of the attribution of stock ownership rules of section 318 and the redemption provisions of section 302 of the Code to employ "cross-purchase" arrangements whereby the policies are held and premiums paid by the shareholders, thus requiring a distribution of corporate earnings to the shareholders with the attending tax at the shareholder level.

The disastrous effect of section 318 when combined with section 302 has been pointed out on numerous occasions.[14] One illustration will suffice. Suppose the X corporation has outstanding only 100 shares of voting common stock of which father owns 50 shares, mother 30 shares, and son 20 shares. Father's will leaves one-half of his estate to mother and the residue, after taxes, to son. An agreement among the three and the X corporation, whereby father's shares were to be purchased by the corporation upon his death, would be a highly dangerous and inadvisable arrangement since the proceeds would be considered a dividend distribution to father's estate. The reasons for this bear repeating. The purchase of father's stock is a redemption of his stock within the meanings of the Code.[15] Redemptions will result in dividend treatment to the distributee unless: (1) the distribution is not essentially equivalent to a dividend, or (2) it is substantially disproportionate as defined in the Code, or (3) terminates the shareholder's interest.[16] The distribution to father's estate will probably not be considered "not essentially equivalent to a dividend."[17] In addition, the retirement of all father's

[12] Gregory v. Helvering, 293 U.S. 465, 469 (1935); Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953).

[13] Judge Hand dissenting in Commissioner v. Newman, 159 F.2d 848, 850 (2d Cir. 1947).

[14] E.g., Hoffman, "1954 Code Can Turn Buy-Sell Agreements into Disastrous Tax Traps for Stockholders," 4 J. Taxation 322 (1956); Winton, "Tax Traps in Stockholders Agreements," 2 Practical Lawyer, No. 3, 78 (1956); Roeder, "Distributions in Redemption of Stock," N.Y.U. 15th Inst. on Fed. Tax 475 (1957).

[15] Int. Rev. Code of 1954, § 317(b).

[16] Int. Rev. Code of 1954, § 302.

[17] Rev. Rul. 55-515, 1955-2 Cum. Bull. 222. The ruling sets forth this test. "The question of whether a redemption of stock is essentially equivalent to a taxable dividend depends primarily upon the net effect of the distribution rather than the motive or plan of the stockholders or the corporation. A redemption of stock which does not as a practical matter change the essential relationship between the stockholders and the corporation is generally considered equivalent to a dividend." (223) Because of the constructive ownership rules there will probably be no required change in the essential relationship. Indeed, the

stock by payment to his estate will not result "in a termination of the shareholder's interest" because the estate is considered to own the stock of its beneficiaries[18]—mother and son in this case. Thus, the estate "owns" all the stock both before and after the redemption.[19] This being so, there obviously has been no substantially disproportionate redemption of stock because one requirement of such a redemption is that the shareholder, the estate here, following distribution own "less than 50 per cent of the total combined voting power of all classes of stock entitled to vote."[20] Thus, the redemption would be a dividend to father's estate. Should the corporation fund its obligation with insurance the receipt of the proceeds by the estate would be a dividend distribution, thus bunching the income avoided at the shareholder level under the rationale of *Prunier* and *Casale.*

So, in essence, the arrangement so unnecessarily blessed with vigor in *Prunier* can be a tax haven for only a chosen few. And these few, selected because of the absence of a family relationship or certain testamentary dispositions, have no justifiable claim to this advantage. And certainly it should not exist as an aid to marketing insurance. Not only does the arrangement do violence to the principle that equals should be taxed equally, but any intelligent tax relief to small business should not proceed on such a capricious basis. However, this is "mere cant" if the law, as now written, requires the result.

As indicated, this may not be the case although admittedly the issue is close. *The thesis of this paper is that where the stock retirement contract gives the estate of a deceased shareholder an enforceable right to have the proceeds of insurance received by the corporation applied to the purchase of the stock of the deceased, the premiums paid on such policies should be considered as dividends to the shareholders to the extent of the earnings and profits of the corporation, notwithstanding the fact that the insurance policy is owned and premiums paid by the corporation.* The legal issues are obvious. The existence of a dividend requires a *distribution* of property out of its earnings and profits by a corporation in respect to its stock *to its shareholders.*[21] This simply means that corporate gains must in some way be realized by the share-

scope of the first exception is probably quite narrow. See, Roeder, supra note 14, at 485. A statutory change which could alter the position stated in the text has been suggested. Sub-chapter C Advisory Group Proposed Amendments § 3 (1957).

18 Int. Rev. Code of 1954 § 318(a)(2)(A).

19 The possibility of avoiding attribution of a beneficiary's shares to the estate by distributing the devise or bequest to the beneficiary before the redemption is not available here since if Mother received a distribution before redemption the estate would still own all the Son's shares who in turn would own all his Mother's. U.S. Treas. Reg. § 1. 318-3(a) (1955); Int. Rev. Code of 1954 § 318(a)(1)(A)(ii).

20 Int. Rev. Code of 1954 § 302(b)(2)(B).

21 Int. Rev. Code of 1954, §§ 301(a), (c), 316(a).

holders at the shareholder level. In short, to support the thesis here advanced, a showing of realization of gain by the shareholders to the extent of the premiums paid is necessary. The demonstration will proceed by suggesting, as others have done before, the ingredients of such a realization and how these exist in the ordinary stock retirement plan.

II. Realization Aspects

Some years ago Henry C. Simons, whose works should be read more extensively than seems to be the case, observed that the problem of the proper tax treatment of stock dividends was proximately "one of undistributed corporate earnings" and "at bottom . . . [attributable to] the present avoidance loopholes at gift and death."[22] Much the same can be said of the problem discussed here. If there were any accounting for growth in the shares at the time of either death or gift, the concern with use of the corporate form to insulate the shareholders from tax on its earnings would diminish. The deceased shareholder would be taxed on the difference between his basis and the insurance proceeds and the survivor would account for the difference between his cost and the value of his shares at the date of gift or death. This pattern, joined with the abolition of the distinction between ordinary income and capital gains rates, would eliminate the necessity for urging that the premium payments generally should be considered income to the shareholder. The gains resulting to the shareholders from investment in insurance would be accounted for when the shareholder parted with his investment.

However, such is not the case. Gift and death transfers result in no realization of gain to the transferor, and, in the case of death, the growth in the shareholder's investment escapes taxation altogether. Considering for the moment that the tax imposed at the corporate level is to compensate for these limitations,[23] the issue in *Prunier* was simply whether this tax at the corporate level was a fairer approximation of the appropriate tax on the increase in the net worth of the shareholders than would be attained by treating the insurance premiums as dividend income to the shareholders *and* imposing a tax at the corporate level. It is extremely difficult to generalize on this, but the odds are that in most cases the latter procedure would yield a more accurate estimate.[24]

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22 Simons, "Federal Tax Reform," 14 U. Chi. L. Rev. 20, 47 (1946).

23 Simons, supra note 22, at 32 makes this observation. " As we have argued throughout, personal income taxes are good taxes; corporation income taxes are bad; and complicated admixtures of the two are, in principle and in practice, monstrosities. Present realization procedure in the personal tax, however, offers us choice only among such monstrosities."

24 There is a complicating nuance which prevents extending this statement to Casale. In it the real possibility of taxing to the shareholder, as dividends, the proceeds of the insurance distributed to him or his estate means that the profit from the corporate investment in insurance will probably be taxed to the shareholder. See Lawthers, "Weakness in Casale Decision: Insolvency Could Destroy Benefit to Owner-Employee," 5 J. Taxation 342

However this may be, the stockholders in stock retirement plans desire, as do stockholders generally, to have corporate earnings retained by the corporation until the potential tax on the growth of their investment can be avoided, or eliminated, by gift or death. Thus, the issue becomes one of the taxation of undistributed corporate earnings. Fundamentally, the present tax structure makes available to the Treasury only two courses of action. It can seek to apply the provisions of the accumulated earnings tax set forth in sections 531 through 537 of the Code, about which something will be said later, or it can assert that the profits have in fact been distributed. To succeed in showing a distribution there must be a showing of realization of income by the shareholder. This is what the stock dividend, as well as the early reorganization cases were about,[25] and no less is true of *Prunier* and *Casale*. A finding of income realized by the shareholders in a stock retirement plan should be no easier, nor appreciably more difficult, than it was in those cases.

What then do those decisions, glossed as they are by related cases,[26] teach as to the essentials of realization by a shareholder of accumulated corporate gains?

Here the path is well travelled and no attempt will be made to forge new ways. Rather, the existing views will be summarized and somewhat sharpened. To commence, two key passages of *Eisner v. Macomber*[27]—by now a somewhat lonely, but somehow wonderfully defiant figure—will be recalled. These two, both of which once were part of the catechism of realization dogma, have been chosen because they reveal the premises of that decision, so ably demonstrated long ago by Seligman.[28] The first, almost poetic in its redundancy, is this:

> Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *"derived"*, that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description.[29]

(1956). Of course, the observation made in the text assumes the surviving shareholder would not be taxed on the proceeds as a dividend distribution. But see p. 371 infra.

25 The cases referred to are as follows: Helvering v. Sprouse, 318 U.S. 604 (1943); Helvering v. Griffiths, 318 U.S. 371 (1943); Helvering v. Gowran, 302 U.S. 238 (1937); Koshland v. Helvering, 298 U.S. 441 (1936); Marr v. United States, 268 U.S. 536 (1925); Cullinan v. Walker, 262 U.S. 134 (1923); Rockefeller v. United States, 257 U.S. 176 (1921); United States v. Phellis, 257 U.S. 156 (1921); Eisner v. Macomber, 252 U.S. 189 (1920).

26 Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Bruun, 309 U.S. 461 (1940).

27 252 U.S. 189 (1920).

28 Seligman, "Implications and Effects of the Stock Dividend Decision," 21 Colum. L. Rev. 313 (1921).

29 252 U.S. at 207.

Here, as Seligman points out, is revealed the requirement that realization of income requires its separation from capital along with the warning that the requirement is seriously intended. Further proof of this, as well as the admonition that the corporate entity cannot be ignored in determining whether there has been such a separation, is revealed in this passage.

> The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment.[30]

How these brave words came to stand for less than their logical import is well remembered. Mr. Justice Brandeis in *Marr v. United States* expressly approved the argument that in a corporate reorganization the "gain in value resulting from profits" is taxable to the shareholder "when it is represented by an essentially different interest in the same business enterprise or property. . . ."[31] He distinguished *Eisner v. Macomber* and its principal satellite, *Weiss v. Stearn*,[32] by pointing out that in *Marr* the stockholders after the distribution did not have "the same proportional interest of the same kind in essentially the same corporation."[33] Mr. Justice Roberts in *Helvering v. Sprouse*[34] refined the test for recognizing taxable stock dividends by observing that "there must be a change brought about by the issue of shares as a dividend whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest."[35]

In the earlier case of *Helvering v. Bruun*,[36] the same Justice had further restricted the scope of *Eisner v. Macomber* by observing:

> Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from liability, *or other profit realized from the completion of a transaction.* The fact that gain is a portion of the value of property received by the taxpayer in the transaction does not negative its realization.[37] (Emphasis added.)

30 Id. at 211.
31 268 U.S. 536, 540 (1925).
32 265 U.S. 242 (1924).
33 268 U.S. at 542.
34 318 U.S. 604 (1943).
35 Id. at 608.
36 309 U.S. 461 (1940).
37 Id. at 469.

However, in *Helvering v. Horst*,[38] decided in the term following *Bruun*, Mr. Justice Roberts dissented from perhaps the most nearly explicit rejection of the philosophy of *Eisner v. Macomber* yet uttered by the Court. In finding that the donor of a negotiable interest coupon realized income where the donee received payment thereon in the same year in which the transfer was made, the Court, in speaking of the rule that income is not taxable until realized, said:

> The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property.[39]

The gift of the coupon was found to be the "final event of enjoyment" since the donor used the coupon to obtain a "satisfaction which is procurable only by the expenditure of money or money's worth."[40] Finally, whatever vitality remained in the notion that the presence of income required a severance from capital disappeared when the Court in *Commissioner v. Glenshaw Glass Co.*[41] found that punitive damages for fraud and treble damages for violations of the federal antitrust laws constituted taxable income even though such receipts can hardly be said to be "derived from capital." Citing *Bruun* and *United States v. Kirby Lumber Co.*,[42] the Court gently put aside *Eisner v. Macomber* and held such damages taxable because they were "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[43]

The writers are not entirely agreed as to the meaning of these decisions. Magill, in his study of stock dividends published in 1936,[44] approved the test that Dean Hall had earlier expressed in the following form:

> Perhaps the best crucial test of a corporate stockholder's having "realized" a dividend, so as to make it taxable as income, is that as a result of the transaction he obtains a new interest in property differing either (1) in *kind* or (2) in *extent* from that which he had before.[45]

In 1945, Magill pointed out that the stock dividend and corporate reorganization cases, in making a change of the form or extent of the

38 311 U.S. 112 (1940).
39 Id. at 116.
40 Id. at 117.
41 348 U.S. 426 (1955).
42 284 U.S. 1 (1931).
43 348 U.S. at 431.
44 Magill, "Realization of Income Through Corporate Distributions," 36 Colum. L. Rev. 519, 532 (1936).
45 Note, "Exchange of Securities in Corporate Reorganization As Income," 20 Ill. L. Rev. 601, 602 (1926).

investment the touchstone of taxability, had established "a reasonable and convenient occasion for taking stock of the accretion in value to the investment as represented by the distribution which the stockholders have received."[46] Easily recognized change of circumstances was also relied upon by Surrey as a proper occasion for imposing a tax upon previously untaxed economic gain.[47] Leaning on *Bruun,* Surrey bluntly asserted that the requirement of realization is nothing but an admonition that, where the taxpayer's wealth has increased, the time chosen to tax this increase be convenient from the standpoint of the government and the taxpayer. How much "fairness to the taxpayer"[47a] is implicit in Surrey's notion of convenience is not clear. However this may be, manifestly realization does not turn upon "severance" or "disposition" in his thinking. Bittker has been no less emphatic.

> Despite *Eisner v. Macomber,* I think all taxpayers could be put on an annual inventory basis with appreciation and depreciation being tallied up and taken into the tax return at year's end.[48]

And Dean Griswold, as a matter of constitutional law, probably accepts this view, although his expressions were more guarded.[49] Against this host, monolithic in their unanimity, one must set the truculent assertions of Roehner and Roehner who recently have insisted that realization is a constitutional doctrine which establishes that income from capital exists only when something is " 'coming in' for the use of capital."[50]

Whatever the case may be as a matter of constitutional law, Dean Griswold appears right when he insists that our tax system requires realization, in addition to a mere increase in wealth, as a conditon to the imposition of an income tax.[51] However, the requirement serves many purposes. It restrains the hand of the tax gatherer while there is a serious doubt about whether the gain is more hope than fulfillment[52]

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46 Magill, Taxable Income (rev. ed. 1945).

47 Surrey, "The Supreme Court and The Federal Income Tax: Some Implications of the Recent Decisions," 35 Ill. L. Rev. 779, 784 (1941).

47a Surrey, supra note 47, at 792.

48 Bittker, "Charitable Gifts of Income and The Internal Revenue Code: Another View," 65 Harv. L. Rev. 1375, 1380 (1952).

49 Griswold, "Charitable Gifts of Income and The Internal Revenue Code," 65 Harv. L. Rev. 84 (1951). At p. 86 he says: "There was a time when our tax law was much concerned with problems of realization. It now would appear to some that perhaps this approach was unduly conceptualistic, and that the tax law has made progress in freeing itself somewhat from the rigidity of the older test." However, in his reply to Bittker, 65 Harv. L. Rev. 1389 (1952), he said, "For better or for worse, we are operating under a tax system which regards realization as of some importance. Even though this may not necessarily be a constitutional requirement, it is a practical conclusion. Without 'realization' of some sort, we do not take income into account. Consequently, the mere having of unrealized appreciation is not income."

50 Roehner and Roehner, "Realization: Administrative Convenience or Constitutional Requirement?" 8 Tax L. Rev. 173, 183 (1952).

51 Griswold, supra note 49.

52 E.g., the taxation of annuity payments where appreciated property is exchanged for an annuity. Rev. Rul. 239, 1953-2 Cum. Bull. 53.

and while the calculation of its amount is extremely difficult.[53] As indicated by Magill and Surrey, the requirement fixes the time of the tax in accordance with certain notions of expediency; and in certain instances, as in the case of transfer by death or gift, eliminates the tax because of deep seated ideas about the undesirability of making such occasions taxable events. By equating realization with control of the earning process and the receipt of benefits which, in the language of *Horst,* "can be obtained only by the expenditures of money or property," the requirement prevents avoidance of the progressive rate structure by identifying the proper taxpayer to whom income should be charged. And in the corporate area, it serves to maintain the distinction between corporate and shareholder income—a distinction made necessary, if not by the constitution, certainly by the Code's imposition of a tax at the corporate level.

Any doctrine laden, as realization is, with such a purposive overload can hardly have rigid requirements. The cloth must be cut to the pattern. For example, a mere enhancement in the value of shares owned by a shareholder because of corporate business profits should not be taxed to the shareholder because this eliminates a distinction, albeit perhaps not a wise one, deeply rooted in the Code itself. On the other hand, the corporate structure should not be used to shield from the income tax the shareholder who derives benefits, distinct from those normally flowing to a shareholder because of the success of the trade or business of the corporation, through accumulation and investment of the corporate earnings. The doctrine of realization is sufficiently flexible to make this distinction. The receipt of such benefits, where adequately measurable, constitutes "an essentially different interest in the same business enterprise or property," "profit realized from the completion of a transaction," satisfactions "procurable only by the expenditure of money or money's worth," and a convenient and expedient time to impose the tax.

Obviously the courts in fashioning realization so as to remove the shield must be mindful of the words of Congress. Thus, Code sections 531 through 537 dealing with accumulated corporate earnings are supreme in their area, but their existence should not preclude judicious application of realization where the shareholder benefits are broader and more varied than merely avoiding a tax at the shareholder level by accumulations of highly liquid assets beyond the reasonable needs of the business.

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[53] Burnet v. Logan, 283 U.S. 404 (1931); Proposed Reg. § 1.001-1(a). This proposed regulation contains this sentence: "The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value." To the same effect is U.S. Treas. Reg. 118, § 39.44-4 (1953). It may well be doubted whether this is an entirely accurate statement of Burnet v. Logan or the present Tax Court position. See Hurlburt, 25 T.C. 1286 (1956).

It comes to this. *A shareholder should be considered as having realized accumulated earnings and profits of the corporation in the form of dividends when such gains in an ascertainable amount are primarily devoted to purposes which serve interests of the shareholder distinct from his interest as a proprietor of the business conducted by the corporation.* When this occurs all the tests of realization seem satisfied, including the one laid down by Hall and Magill in their discussion of the stock dividend and reorganization cases. That is, there has been a change in the form and extent of the investment. The path blazed by the stock dividend and reorganization cases can be followed farther by providing that where an ascertainable amount of earnings and profits so devoted remain subject to the claims of corporate creditors the basis of the shareholder's stock should be increased by that amount.[54] If receipt by the shareholder of a scrap of paper is essential, a copy of the stock retirement contract will suffice.

The practicality of this approach rests upon establishing the feasibility of distinguishing between what might be called the business interest of the shareholder and his other interests. Its application to stock retirement plans depends upon showing that corporate expenditures, in funding such plans with insurance, primarily serve the non-business interests of the shareholder. The persuasiveness of the approach will depend upon whether it has been applied by the courts. A showing of practicality and applicability, together with persuasive case support, is the task of the balance of the paper.

III. Analysis of the Interests of a Shareholder

The interests of a shareholder, like Gaul, may be divided into three parts—his interest in the business activity of the corporation, his interest in the investment represented by the stock, and his personal interests which include all interests unrelated to the corporation. Obviously there is not much difficulty in distinguishing between the purely personal interests of a shareholder and his interest as a proprietor of the trade or business being carried on. This is readily perceivable, and many cases have held that corporate expenditures advancing such personal interests constitute dividends. Fairly typical is *Louis Greenspon.*[55] One issue was whether corporate funds paid for operating and maintaining a farm owned by the principal shareholder were deductible by

[54] See p. 373 infra. It has been suggested that where such earnings and profits remain subject to the claims of creditors there is a basis for asserting no distribution because of the control retained by the corporation. Levine, "More on Casale: decision was wrong because there was no severance of corporate property." 6 J. Taxation 289 (1957). The cases certainly suggest such an analysis; however, it is difficult to base a solid argument on this point in the light of the stock dividend and reorganization cases.

[55] 23 T.C. 138 (1954).

the corporation where there was an insufficient showing that the expenditures aided the business of the corporation. It was held that the corporation was not entitled to a deduction and that the expenditure amounted to a dividend notwithstanding the lack of corporate formality. Another similar, but perhaps more sophisticated, instance is *Clark v. Commissioner*.[56] Here the controlling shareholder, after establishing an irrevocable trust for his children with the corporation as trustee, had the corporation transfer to itself, as trustee, all its earnings and profits. The distribution was taxable to the shareholder. Examples could be multiplied.[57] Indeed, *Casale* itself falls within this category.

The situation is different when it comes to distinguishing the shareholder's business interest from his interest as an investor in corporate stock. Perhaps the distinction can best be seen by the light of an example. The purchase, by a corporation engaged in the sale of widgets, of machinery necessary to produce widgets serves the business interest of its shareholders; whereas the purchase by the same corporation of a safe deposit box, which it must permit the shareholders to use as a repository of their shares because of a contract, serves their investment interest. In the case of the safe deposit box it can be argued easily, and perhaps convincingly, that the corporate act advanced corporate purposes in that it contributed to the continuity of the corporate business by helping to eliminate problems arising from lost shares. However, it cannot be gainsaid that the expenditure substantially is to serve an interest of the shareholder distinct from his interest as an owner of a widget making company, or from his purely personal interests.

The activities of a shareholder incident to the management of his investment are gain-seeking activities which, under *Higgins v. Commissioner*,[58] do not constitute a trade or business even though the corporation is so engaged. The type of activities which generally fall within this area may be further illustrated by recalling those expenditures which provide a basis for a deduction under section 212 of the Code. Thus, investment counsel, custodial fees, clerical help, and travel expenses[59] necessary to the management of stock investments advance an interest of the shareholder distinct from his interest in the business decisions of those who manage the corporations in which he holds shares.

In respect to these business decisions, the shareholders' hopes, fears,

[56] 84 F.2d 725 (3d Cir. 1936).
[57] E.g., Byers v. Commissioner, 199 F.2d 273 (8th Cir. 1952); Helvering v. Gordon, 87 F.2d 663 (8th Cir. 1937); Ned Wayburn, 32 B.T.A. 813 (1935); Joseph Morgenstern, P-H 1955 T.C. Mem. Dec. ¶ 55,086. Compare with Sanitary Farms Dairy, Inc., 25 T.C. 463 (1955) and Rev. Rul. 56-583, 1956-2 Cum. Bull. 117.
[58] 312 U.S. 212 (1941).
[59] But see, Rev. Rul. 56-511, 1956-2 Cum. Bull. 170.

joys and sorrows *are* those of the corporation; but this unity does not extend to the investment interest. In *New Colonial Ice Co., Inc. v. Helvering*[60] the Supreme Court pointed to a still prevailing axiom of taxation when it said, "As a general rule a corporation and its stockholders are deemed separate entities and this is true in respect of tax problems."[61] That this separateness results in a discernible line between the business of the corporation—and, accordingly, the business interest of the shareholder—and the investment interest of the shareholder has been made apparent by several decisions of the Court. One of the earliest was *Klein v. Board of Supervisors*[62] where, in upholding a Kentucky statute imposing a tax upon shares owned by a domiciliary where less than seventy-five per cent of the total property of the corporation was located within the state, Mr. Justice Holmes pointed out that while the "expectations of the corporation are the backbone of the value of the shares, yet the latter may get additional value from another source."[63] The stock is different from the property of the corporation and so, accordingly, is the interest of the shareholder in respect to the two.

The point is also neatly made in *Burnet v. Clark*[64] where, in denying a deduction under the then existing operating loss carryover provisions of payments made by a majority shareholder in performance of his guarantee of the corporate obligations on the ground that the shareholder was not engaged in a business even though his guarantee was to promote the business success of the corporation, the Court emphasized that the business of the corporation was not the business of the shareholder. That is, management and conservation of his investment in the corporation was distinguishable from the corporate business.

Probably the most dramatic illustrations of this fact are set forth in *Deputy v. Du Pont*[65] and *Interstate Transit Lines v. Commissioner.*[66] In the former, the Court pointed out that expenses incurred by a shareholder in selling the corporation stock to its executives, which, because of legal difficulties, could not be sold by the corporation, were proximately related to the business of the corporation and not the shareholder's business. The same conclusion was reached, even though the nexus between shareholder and corporation was even closer, in *Interstate Transit Lines*. There the corporate parent sought to deduct, as an

60 292 U.S. 435 (1934).
61 Id. at 442.
62 282 U.S. 19 (1930).
63 Id. at 23.
64 287 U.S. 410 (1932).
65 308 U.S. 488 (1940).
66 319 U.S. 590 (1943).

ordinary and necessary expense, a payment made to its subsidiary pursuant to a contract whereby the parent was to manage the subsidiary's finances, pay its bills, and absorb all its operating profits and deficits. The payment, to cover an operating deficit, was not deductible because it was not an expense of the parent's business. The shareholder and his company were not engaged in the same business—their destiny not coterminous—their problems not identical.

While these decisions underscore the separateness of the individual shareholder from the corporation, the converse also has been firmly established. Thus, in *Moline Properties Inc. v. Commissioner,*[67] a corporation entirely owned by an individual shareholder and created because of business necessity was taxable as an entity even though its business was quite limited in scope; and in *National Carbide Corp. v. Commissioner,*[68] income of wholly owned subsidiaries, formed or operated for business purposes, was taxable to them and not to the parent, even though all profits in excess of six per cent on their capitalization was paid over to the parent pursuant to a contract between it and the subsidiaries. And finally, in *United States v. Cumberland Public Service Co.*[69] and *Commissioner v. Court Holding Co.,*[70] the practicability of distinguishing between corporate acts on the one hand, and shareholder acts on the other, was sufficiently apparent to warrant making it the foundation of both decisions.

These deeds and words of the Supreme Court justify two important conclusions. First, they indicate, although admittedly they do not prove, that it is feasible to distinguish between a shareholder's concern with his investment in the corporation and his concern with the business of the corporation. Second, and more important, by clearly establishing that the business of the corporation is not the business of the shareholder, they imply, when joined with *Higgins*, the corollary that *the gain seeking activities of the shareholders in the nature of investment management are not the business of the corporation.*

These conclusions are in no way inconsistent with the assertion by the first circuit in *Prunier* that there was "limited utility" in the distinction between stockholder purposes and corporate business purposes. The distinction, rejected in *Lewis v. Commissioner,*[71] an earlier first circuit decision, as a basis for determining whether a statutory reorganization had occurred, did have "limited utility" in that context. But the point

67 319 U.S. 436 (1943).
68 336 U.S. 422 (1949).
69 338 U.S. 451 (1950).
70 324 U.S. 331 (1945).
71 176 F.2d 646 (1st Cir. 1949).

being made in this analysis of the shareholder's interest is quite different. This can best be seen by setting forth the properly rejected distinction and the reasons for its disapproval as stated by Judges Maris and Goodrich in their dissent in *Bazley v. Commissioner*.[72]

> . . . We have long since passed the place in our thinking where we view the corporation as "an artificial being, invisible, intangible and existing only in contemplation of law." We think of it as a device that shareholders use to carry on their business as a group. A corporation does not have purposes apart from its shareholders. *Shareholders, of course, may have conflicting interests among themselves with regard to the conduct of their common enterprise. They may fight with each other, perhaps, in order to elect A instead of B to the directorship of their company. And, of course, aside from their interest in the common enterprise, called their corporation, they have interests as varied as hopes and desires of human beings.* But when we talk about the interest of shareholders in connection with the business enterprise and have a finding of fact that such and such a thing was done and that it was to the stockholders' business advantage, *speaking of them as a group*, we do not find substance in a distinction between the business advantages of the shareholders with respect to the corporation and the business advantages of the corporation itself. (Emphasis added.)

This passage reveals that the distinction rejected was that which asserted that corporate action was different from the shareholders acting as a group. Put another way, the dissenters stated that group action *is* corporate action and that shareholder-group purposes are corporate purposes.[73] Although there may be some difficulty in squaring this common sense approach with *Court Holding Co.* and *Cumberland Public Service Co.*, there is much to commend it. However, the tripartite analysis of a shareholder's interest being made here is quite different. It distinguishes between the shareholder's concern for the business as a whole—his business interest, his concern with his particular portion thereof—his investment interest, and all his other concerns—his personal interest. That these are not identical is recognized in the italicized portion of the passage quoted. That common efforts by the shareholders to serve their business interests *are* corporate action is implicit in this analysis.

The key to the difference between the business and investment interests of the shareholder is that the investment interest is encountered once we leave the area of objectives held in common with other shareholders. It seems fair to say that generally all shareholders wish for ultimate success of the business being conducted; but the management, the

[72] 155 F.2d 237, 245 (3d Cir. 1946), aff'd, 331 U.S. 737 (1947).

[73] Spear, "'Corporate Business Purpose' in Reorganization," 3 Tax L. Rev. 225, 242, 243 (1947), put it this way. "It is certainly not inconsistent with recognition of the corporate entity to say that the purposes of the corporation and its shareholders-as-a-group are one and the same."

conservation, the realization, or the disposition of that portion of the success (or failure) which the shares represent are matters about which the shareholders can and, more often than not, do have very different ideas and objectives. These matters are the stuff of the investment interest.

Thus, the rejection of the distinction between corporate business purposes and shareholder purposes does not invalidate the analysis presented here. Rather it provides substantiation. In addition, this substantiation, joined with the Supreme Court decisions discussed earlier, establishes the feasibility of distinguishing between the business, investment, and personal interests of the shareholder.

IV. What Shareholder Interests Are Primarily Served by a Stock Retirement Plan?

The essentials of a properly drawn stock retirement plan already have been described and, having determined that an expenditure primarily to serve a non-business interest of a shareholder can be considered a distribution to him, it remains to ascertain the interests of the shareholder primarily being served by such plans. There are two ways to approach this problem. One route is to analyze the precise legal relations between the corporation and the shareholders, and the other route is to examine the mind and, in many cases at least, the heart of the shareholders. The advocates of the results and reasoning of *Prunier* and *Casale* favor the first because it exalts the role of the corporation in the arrangement and lends an aura of credibility to the notion that this contract of the corporation is precisely similar to one looking to the purchase of widget producing machinery. On the other hand, the latter is stressed by those preferring the Tax Court result in these cases.[74] Consequently, this discussion should proceed to examine the motives of the shareholders and mention only in passing the strength of the opposition; but gallantry, or perhaps foolhardiness, decrees otherwise. So the lead is from weakness.

The general rule seems to be that a corporation has the capacity to purchase its stock if it acts in good faith and without prejudice to its creditors, unless the certificate of incorporation or by-laws provide otherwise.[75] Contracts between the corporation and its shareholders

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74 See Swados, "Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement," 26 Fordham L. Rev. 189, 206-10 (1957).

75 Winchell v. Plywood Corp., 324 Mass. 171, 85 N.E.2d 313 (1949); Cross v. Beguelin, 226 App. Div. 349, 235 N.Y. Supp. 336 (First Dep't), aff'd, 252 N.Y. 262, 169 N.E. 378 (1929); Fletcher, Cyclopedia of Corporations § 2848 (perm. ed. rev. repl. 1950). See also Cal. Corp. Code §§ 1700-08 (Deering 1953); Del. Corp. Laws Ann. § 19 (1949); Tex. Bus. Corp. Act art. 2.02, 2.03, 4.09 (1955).

giving to the corporation the right to purchase the stock from the shareholder or his estate are generally specifically enforceable by either party.[76] However, there are limitations on the authority of a corporation to purchase its own shares. For example, in New York the purchase can only be made from surplus;[77] and a similar restriction exists in other jurisdictions.[78] This restriction has led to a rather curious development in New York where the Court of Appeals in *Topken, Loring & Schwartz, Inc. v. Schwartz*[79] found that the promise by the corporation to purchase the stock was not a binding promise because it could not perform if there were no surplus and held the contract to purchase was unenforceable because of insufficient consideration. Holding a conditional promise of this type the equivalent of a "choice to buy or not as it pleased" misconceives the whole concept of mutuality; but the harm done was slight because, as the opinion pointed out, additional consideration furnished by the corporation would cure the defect. In *Greater New York Carpet House v. Herschmann*[80] the Appellate Division of the First Department held that the payment of premiums by the corporation furnished this additional consideration. This decision has been cited approvingly in subsequent New York decisions.[81]

There seems little question but that the corporation has an insurable interest in the lives of its officers, directors, and principal shareholders serving the corporation,[82] and that the payment of the premiums authorized by the shareholders is an appropriate corporate expenditure.[83] Most significant from the standpoint of the *Prunier* and *Casale* advocates is that, where the corporation holds the incidents of ownership of the policy, pays the premiums, and is designated as beneficiary, the policy

[76] Murphy v. George Murphy Inc., 7 Misc. 2d 647, 166 N.Y.S.2d 290 (Sup. Ct. N.Y. County 1957); Goldberg v. Peltier, 75 R.I. 314, 66 A.2d 107 (1949). See, Steinberg, supra note 11, at 675.

[77] Van Slochem v. Villard, 207 N.Y. 587, 101 N.E. 467 (1913); Cross v. Beguelin, note 75 supra.

[78] E.g., In re Semolina Macaroni Co., 109 F. Supp. 453 (D.R.I. 1952); Tiedje v. Aluminum Taper Milling Co., — Cal. —, 296 P.2d 554 (1956); Goodman v. Global Industries, 80 Cal. App. 2d 583, 182 P.2d 300 (1947).

[79] 249 N.Y. 206, 163 N.E. 735 (1928).

[80] 258 App. Div. 649, 17 N.Y.S.2d 483 (First Dep't 1940).

[81] Ionic Shop, Inc. v. Rothfeld, 64 N.Y.S.2d 101, 103 (Sup. Ct. N.Y. County 1946); Christie v. Fifth Madison Corp., 123 N.Y.S.2d 795, 799 (Sup. Ct. N.Y. County 1953); Murphy v. George Murphy, Inc., supra note 76.

[82] United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924); Keckley v. Coshocton Glass Co., 86 Ohio St. 213, 99 N.E. 299 (1912); Annots. 75 A.L.R. 1362 (1931), 143 A.L.R. 293 (1943). N.Y. Ins. Law § 146 requires "a lawful and substantial economic interest in baving the life, health and bodily safety of the person insured continue." Probably the mere stockholder relationship is not enough. Tate v. Commercial Building Association, 97 Va. 74, 33 S.E. 382 (1899); Vance, Insurance 198 (3d ed. 1951). However, an argument of no insurable interest could be made by pointing to the fact that the corporation does not benefit from the proceeds. See pp. 364-65 infra.

[83] Oliver v. Northwestern Mut. Life Ins. Co., 2 F. Supp. 266 (W.D. Pa. 1932), aff'd, 66 F.2d 560 (3d Cir. 1933); Fletcher, op. cit. supra note 75, § 2516.

is owned by the corporation and subject to the claims of its creditors.[84] As previously indicated, this point was strongly relied upon in *Casale*. Further strengthening this position is the recent New York decision in *Newman v. Superintendent of Insurance*,[85] in which it was held that, where the insurance was payable to the corporation which paid the premiums, the insured shareholder had no right to the policy upon the sale of his stock and termination of his relationship with the corporation, even though the shareholders had agreed that the proceeds of the policy were to be paid by the corporation to the surviving widow of the shareholder in exchange for the stock and that the insurance was not to be considered an asset in valuing the stock. The court said the shareholder had no right to the proceeds until "death and payment of the benefit to the corporation."[86]

This suggestion, that the shareholder's interest in the proceeds arises at death, points to a line of thought which, to some extent, undercuts reliance upon these legal relations as a basis for contending that a stock retirement plan serves the business interest of the shareholder. In *Prunier*, the Tax Court stated that the rules of law applicable to the controversy there involved were well settled. Where the estate, or family, of an officer or employee of the corporation was the beneficiary, the premiums were income to the officer or employee and deductible by the corporation; but where the corporation was directly, or indirectly, the beneficiary, the premiums were neither deductible by the corporation nor income to the officer or employee. Similar reasoning made premiums dividends when stockholders were the beneficiaries. These views were not rejected by the first circuit, it viewing the corporation as the beneficial owner of the policies and entitled to have the aid of a court of equity to recover the proceeds. In support of this, several cases, including *Massachusetts Linotyping Corp. v. Fielding*,[87] were cited in which the governing principle was that where one, who is, or can designate, the beneficiary, promises for a sufficient consideration to pay the proceeds to a third person, an equitable right to such proceeds vests in such person subject to the rights of those having superior equities.[88] This theory also would seem adequate to vest the shareholder brothers

[84] Lincoln Nat. Life Ins. Co. v. Scales, 62 F.2d 582 (5th Cir. 1933); Wolter v. Johnston, 34 F.2d 598 (3d Cir. 1929); Collier, Bankruptcy § 70.15(6) (1942). There is no exemption under N.Y. Ins. Law § 166.

[85] 166 N.Y.S.2d 67 (Sup. Ct. N.Y. County 1957).

[86] Id. at 68.

[87] 312 Mass. 147, 43 N.E.2d 521 (1942).

[88] This view is widely recognized, although the precise theory upon which it rests is not certain. See, Thompson v. Van Hise, 133 N.J.L. 524, 45 A.2d 182 (1946); Hirsch v. Auer, 146 N.Y. 13, 40 N.E. 397 (1895); Maher v. Byrnes, 259 App. Div. 272, 18 N.Y.S.2d 838 (First Dep't 1940); Annots. 102 A.L.R. 588 (1936); 1 Richards, Insurance § 115 (5th ed. 1952).

in *Prunier* with similar rights.[89] And if so, they appear to be "beneficiaries."

But whether they are "beneficiaries" within the rules held by the Tax Court to be applicable is not clear. The rules appear to be bottomed on the language of section 264(a)(1) of the Code which denies a deduction to a corporation which pays premiums on insurance covering the life of any officer or employee where it is the beneficiary *directly* or *indirectly*. This means that the denial of the deduction is not controlled by the form of the policy,[90] but rests upon analysis of the economic realities.[91] Thus, the argument would run, looking at the equitable rights of the *Prunier* brothers and using the touchstone of economic reality, they are the beneficiaries. And the generalizations might follow, that in any stock retirement plan funded by insurance the beneficiaries are other than the corporation irrespective of the beneficiary desiguated by the policy.[91a]

Any analysis in terms of economic realities cannot, however, exclude considerations of the immunity of policies and proceeds sometimes afforded by the state exemption laws. Under some of these laws a policy acquired for the purpose of funding a stock retirement plan naming the stockholder's wife as the beneficiary is probably an entirely different kind of corporate asset from one naming the corporation as beneficiary, even though all the normal incidents of ownership, including the right to change the beneficiary, are retained by the corporation in both cases. Where the wife is named, under New York law, for example, the policy

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89 It is interesting that the first circuit, in recognizing the enforceability of the contract to purchase the shares, did not characterize the rights of the brothers as property, or equitable, in nature, but spoke of them as "contractual." There seems no reason why the rights of a shareholder to the proceeds in a properly drawn plan should not be considered as "equitable" in nature.

90 See Ernest J. Keefe, 15 T.C. 947 (1950); Proposed Reg. § 1.264(b).

91 The case law authorities cited by the Tax Court to support its well established principles tend to bear out this analysis. In two of the cases, Frank F. Yuengling, 27 B.T.A. 782 (1933) and Commissioner v. Bonwit, 87 F.2d 764 (2d Cir. 1937), the employee-shareholder's family seemed to be the owner of the policies. In Yuengling they were assigned to a trustee for their benefit and in Bonwit the corporation retained no power to change the beneficiary. Thus, more was present than merely making them the beneficiary. Cf. Estate of Edward Doerken, 46 B.T.A. 809 (1942). However, only the identity of the beneficiary in the formal sense was discussed in George Matthew Adams, 18 B.T.A. 381 (1929) and N. Loring Danforth, 18 B.T.A. 1221 (1930). O.D. 627, 3 Cum. Bull. 104 (1920) is equivocal. It asserts that premiums paid on insurance covering the life of an officer or employee under which "the corporation is not in any way a beneficiary" will he income to such an officer or employee.

91a Realization by the shareholders of corporate earnings and profits invested in insurance to fund stock retirement plans should occur when there is an enforceable right in the shareholders to have the insurance proceeds applied to retirement of their shares. See p. 346 supra. Currently there is some practice of funding the plans with insurance although no mention of this fact is made in the stock retirement agreement. This should not, under the thesis advanced by this paper, prevent realization by the shareholder unless in fact there is no obligation on the part of the corporation to use the proceeds for stock retirement purposes. Where none exists some protection of the beneficiaries of the deceased sharcholder has been sacrificed for a tax advantage.

and its proceeds may be insulated from attacks by corporate creditors.[92] This means that, while the form of the policy may not control in determining the "beneficiary" within the meaning of the rules laid down by the Tax Court, it cannot be ignored. A policy naming the corporation as beneficiary even where the proceeds must be paid out to purchase stock probably does benefit the corporation in a more substantial way than one naming the estate or wife of the shareholder.

Nonetheless, while recognizing that under a properly drawn stock retirement plan the fact that the cash surrender value of the policies and their proceeds are available to corporate creditors lends strength to the view that the corporation is the real beneficiary of the policy and that, consequently, business interests of the shareholders are being served by the plan, an analysis of the rights of the deceased shareholder's estate, or beneficiaries of that estate, in respect to the proceeds points in other directions. This means we are justified, at least, in turning to examine the mind and heart of the shareholders.

When this is done the case for the investment and personal interest of the shareholders is formidable. Obviously, it is difficult to generalize about the motives of shareholders who enter into these plans. It is believed, however, that there are five reasons, not including income tax saving motives, why these plans are executed—only one of which serves the business interest of the shareholder in the same manner as the purchase of widget producing machinery. These are, with the one serving the business interest placed first, as follows:

1. To provide a plan which will assure continuance of the business of the corporation with desirable associates following the death or retirement of a principal shareholder.[93]

2. To provide a device whereby *unrelated* shareholders of a close

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[92] This observation is based on the following provision of § 166 of N.Y. Ins. Law. "If any policy of insurance has been or shall be effected by any person on the life of another person in favor of a third person beneficiary, or made payable, by assignment, change of beneficiary or otherwise, to a third person, such third person beneficiary, assignee or payee shall be entitled to the proceeds and avails of such policy as against the creditors, personal representatives, trustees in bankruptcy and receivers in state and federal courts of the person insured and of the person effecting the insurance." "Proceeds and avail" include the cash surrender value and the quoted provision is applicable even though a right to change the beneficiary is retained. Thus, if the corporation takes out the policy on the life of the shareholder naming his wife as beneficiary, the policy appears exempt from claims of corporate creditors. Whether this exemption will permit avoidance of the New York rule requiring a corporation to purchase its shares from surplus is uncertain. See, note 77. Cf. Ill. Ann. Stat. c. 73, § 850 (Smith-Hurd 1940); Mass. Ann. Laws c. 175 § 125 (1948). Sometimes the immunity extends only to creditors of the insured. See Ohio Rev. Code Ann. § 3911.10 (Page 1954).

[93] This prospect of continuance will, as the First Circuit in Prunier pointed out, aid the corporation's credit standing during the life of the shareholder. Prunier v. Commissioner, 248 F.2d 818, 822 (1st Cir. 1957). See, Dodd, "Purchase and Redemption By a Corporation of Its Own Shares: The Substantive Law," 89 U. Pa. L. Rev. 697, 723 (1941).

corporation can determine which of them will ultimately acquire the business being conducted by the corporation.

3. To provide a device whereby *related* shareholders of a close corporation can transfer the business to those shareholders who are the natural objects of bounty of the shareholder most likely to predecease.

4. To provide a source of liquid funds for the beneficiaries of the deceased shareholder's estate freed from the burdens of the corporate business.

5. To provide a means of establishing the value of closely held stock for estate tax purposes.[94]

Reason number five is well known, but a word about two, three, and four should be said. In respect to the second and fourth reason, the stock retirement plan, as well as a cross-purchase arrangement, solves a fairly difficult problem. Naturally, none of the shareholders under ordinary circumstances wish to have the business imperiled by death or retirement of any of their number, but at the same time often each wishes that he could finally own the entire concern. But the decision as to the ultimate owner is not easy. Why not leave it to chance? Many important decisions which will not yield to more rational resolution are decided by this method; and permitting the more durable to take almost all, accords with the commonly observed phenomenon of certain rewards accruing to those who have the good fortune to survive their colleagues. So viewed, the stock retirement plan, like the cross-purchase, establishes an understandable and morally justified game of chance in which the loser has the assurance of a cash bounty to his loved ones. This calculated risk, to use an overworked phrase, does not relate to the business of the corporation but to the investment interest of the shareholders. Admittedly it preserves the goose which lays the golden eggs; but more important, it determines who gets the goose and all future eggs.

Although the game of chance sometimes has application even where the shareholders are related, more often the respective ages point strongly to the probable survivors. In this case both the stock retirement and cross-purchase provide a means whereby the shareholder most likely to predecease the others can transmit the business to them. This is an accomplishment which serves the personal and investment interests of the shareholder. These realities are not ignored by writers other than in the tax field. For example, Dean Stevens and Larson, in their case-

[94] Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955); May v. McGowan, 194 F.2d 396 (2d Cir. 1952); Rev. Rul. 54-76, 1954-1, Cum. Bull. 194; Rev. Rul. 54-77, 1954-1, Cum. Bull. 187. This objective is presently difficult to attain where the stock retirement plan is funded by insurance. See, Swados, supra note 74, at 210; note 105 infra.

book on corporation law, pointed out that the chief purpose of these plans is "to facilitate retention of control by the survivors when one stockholder dies, and at the same time provide the cash equivalent of the stock interest of the deceased to his estate."[95] O'Neal stressed the latter point as the basis for suggesting that the shareholders or corporation, as the case may be, have imposed on them an obligation to purchase upon the death of a shareholder.[96] Further, in recommending that the shareholders, rather than directors, in a duly called meeting approve these arrangements, he observed that "this sort of agreement could hardly be said to be ordinary business."[97] More important from the standpoint of tax law, which under *Prunier* and *Casale* seems to be drawing a highly important, but nonetheless artificial, distinction between stock retirement and cross-purchase plans, is the fact that writers in the corporate field tend to regard the two devices as but different means of accomplishing the same ends.[98] This equivalence has been recognized in the New York courts. For example, in *Greater New York Carpet House, Inc. v. Herschmann*,[99] in describing the stock retirement plan funded with insurance there involved, the court said:

> The present agreement was much more than a simple contract for the purchase and sale of stock. It was an attempt by two stockholders who owned all the stock of a corporation to arrange a method whereby the surviving stockholder would acquire complete corporate control. *The provision that the corporation would purchase the survivor's stock was merely the means to an end.*[100] (Emphasis added.)

A similar view was expressed in the recent case, *Murphy v. George Murphy, Inc.*[101]

Thus, an analysis of the motives leading to a stock retirement plan indicates that stock retirement plans primarily serve the personal and investment interests of the shareholders. Further support for this view can be furnished by examining the balance sheet of the corporation before death of the shareholder and after purchase of the shares. Assume that X corporation has authorized and issued 500 shares of voting common having a par value of $100 which are equally owned by A and B. The total assets of X, excluding insurance, have a book value of $100,000, and the corporation carries a policy on the life of A and B

95 Stevens and Larson, Cases on Corporations 573 (2d ed. 1955).

96 O'Neal, "Restrictions on Transfer of Stock In Closely Held Corporations: Planning and Drafting," 65 Harv. L. Rev. 773, 796 (1952).

97 Id. at 789, n. 62.

98 E.g., Israels and Gorman, Corporate Practice 19 (Practising Law Institute 1955). Even White, Business Insurance, c. 13 (2d ed. 1956) distinguishes the two on the basis of the income tax differences.

99 258 App. Div. 649, 17 N.Y.S.2d 483 (1st Dep't 1940).

100 Id. at 651, 17 N.Y.S.2d at 485.

101 7 Misc. 2d 647, 166 N.Y.S.2d 290 (Sup. Ct. N.Y. County 1957).

in the amount of $50,000 each, the proceeds of which are to be used to purchase the stock of the shareholder who predeceases the other. Immediately following A's death and payment of $50,000 by the insurance company, X's assets, excluding any cash surrender value of the policy on B's life, amount to $150,000 and the surplus account now shows a balance of $100,000. Upon purchase of A's shares, X's assets return to $100,000[102] and capital and surplus, adjusted in the manner required by the circumstances or state law,[103] would equal the same amount. The corporation is no richer than before. Indeed, it is poorer to the extent of the loss of A's skill and knowledge and the cash surrender value of A's policy immediately before death! The profit of the transaction accrues to B because his investment has increased in size; but the assets devoted to the business have not increased. In this sense, the insurance proceeds did not enrich the corporation even though they were exchanged for the treasury stock.[104] The result is not changed where the valuation of A's shares includes the insurance policies and proceeds so long as the *entire* amount of proceeds received because of A's death are paid over to his estate. The only difference is that the amount of insurance required greatly increases.[105]

Thus, although it must be admitted that these plans do advance the business interest of the shareholders, a realistic appraisal of the purposes served by them, as well as their economic consequences, leaves no question but that they primarily advance the investment and personal interests of the shareholders. Only one thing remains to be done before the vindication of the Tax Court result in *Prunier* and *Casale* is complete. Persuasive case support for the analysis advanced here, in addition to that already presented, should be mustered to the greatest extent posssible.

V. Case Support for the Investment Interest Analysis

The posture of the decided cases does not unequivocally support the views expressed here; however, neither is there complete repudiation.

102 Treasury stock is not shown as an asset. See, Sunley and Carter, Corporate Accounting 90, 91 (rev. ed. 1944).

103 Ibid.

104 In Prunier, 248 F.2d 818, 821 (1st Cir. 1957) the court reasoned that the corporation was enriched even though the insurance proceeds were exchanged for stock. The implicit premise of this observation is that treasury stock should be considered the same as any other asset. This is improper accounting and unrealistic because the shares are not an asset upon which creditors can realize. Borg v. International Silver Co., 11 F.2d 147 (2d Cir. 1925).

105 Under Proposed Reg. § 20.2042-1(c)(6) the failure to include the proceeds of insurance in valuing stock may destroy the efficacy of the plan as fixing the estate tax valuation of the shares. Whether such failure will always upset the presumption of full and adequate consideration provided where the agreement is the result of arm's length bargaining between strangers by Proposed Reg. 20.2031-2(h) is not clear.

The truth of the matter is that, viewed from the standpoint of the approach suggested in this paper, the Tax Court speaks in a contradictory fashion, the circuits are in conflict, and the Supreme Court is uncommitted, save to the extent that the cases discussed earlier in the analysis of a shareholder's interests tend to give support.

The cases which furnish the basis for this conclusion have various pivots. Some involve distinguishing between a dividend, and an ordinary and necessary expense incurred in the trade or business of the corporation; others turn on the difference between capital expenditures and dividends; still others concern themselves with drawing the line between partial liquidations, or redemptions, and dividends; and finally the problem sometimes is to separate losses suffered by the corporation from dividends paid by it. Notwithstanding the variety of statutory background involved, it is fair to say that most of the cases reveal a common approach. That is, in determining the character of the particular corporate action the courts attempt to determine whether the action was predominantly beneficial to the *corporation,* or to all, or part, of the *shareholders.* This is unfortunate for two reasons.

In the first place, the test tends to obscure the distinction between the investment and business interest of the shareholder which often results in the tacit assumption that a shareholder has only two interests—business and personal. Hampered by this false assumption, the inclination often times is to regard any corporate expenditure which does not predominantly promote an object unrelated to corporate activity as something other than a dividend. Secondly, overlooking the investment interest almost destroys any hope of successfully asserting a dividend when the corporate action in question results in the acquisition of an asset. How can an action predominantly be for the personal benefit of a shareholder when the corporation obtained a valuable asset as its result? The song of *Casale* has been performed numerous times.

This judicial myopia has not been universal. There are cases where the vision, aided sometimes by the refraction provided by *Higgins v. Commissioner, Deputy v. Du Pont,* and *Interstate Transit Lines v. Commissioner,* has been clear and discerning. Consider this one. In *Knight-Campbell Music Co. v. Commissioner,*[106] the issue was the deductibility by the corporation of legal fees incurred when the two principal common stockholders, against whom preferred stockholders had obtained a personal judgment running to the corporation together with the appointment of a receiver to liquidate the business, employed attorneys to resist liquidation and obtain the return of the corporation. The successful

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[106] 155 F.2d 837 (10th Cir. 1946).

efforts of the attorneys resulted in a cancellation of the personal judgment and retirement of the preferred stock. The fee was originally paid by the two common stockholders at the insistence of a corporate creditor and they were later reimbursed by the corporation. A deduction by the corporation as an ordinary and necessary expense was denied because the voluntary assumption of an obligation arising from efforts of the shareholders to free themselves from personal judgments was not an ordinary and necessary expense of the corporate business. The investment interest of the shareholders was recognized because, although the expenditure bore a closer relation to the corporate destiny than one to build a swimming pool in the common stockholders' back yard, fundamentally the expense was incurred to adjust a conflict between shareholders relating to their part of the business. A handful of cases involving similar facts have displayed equally good vision.[107]

Payments made to adjust control of the corporation between shareholders have been recognized by the Tax Court as serving the investment interest of the shareholder. Thus, in *Jackson Howell*[108] it held that a redemption of some of the shareholder's shares, designed to preserve their same fractional interests in the corporation, and made necessary by the elimination of a trust as a shareholder, was a taxable dividend under the 1939 Code and this was so even though the trust's elimination originated with a demand by Chevrolet under whom the corporation held a dealership. The court recognized that the redemption of the shares held by the trust would not be a dividend, but distinguished the redemptions made to maintain the status quo of corporate control by pointing out that these were not required by Chevrolet's demand that the trust be eliminated as a shareholder.[109] Similar recognition was ac-

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107 Hales-Mullaly, Inc. v. Commissioner, 131 F.2d 509 (10th Cir. 1942) (sums paid for legal fees and to compromise litigation based on alleged fraud of principal shareholders of taxpayer committed prior to its organization in the nature of a conspiracy to procure business of plaintiff but for which taxpayer may have been liable not deductible because not ordinary nor incurred in carrying on business of taxpayer); One Hundred Five West Fifty-Fifth Street, Inc. v. Commissioner, 42 F.2d 849 (2d Cir. 1930) (payments by corporate taxpayer in settlement of dispute between its shareholders over right of one of them to subscribe for its stock were neither a loss nor a deductible expense of taxpayer.); George D. Mann, 33 B.T.A. 281 (1935) (sums paid by corporations to assist shareholder purehase stock from wife wbere in divorce action there had been a dispute as to the ownership of the stock was taxable dividend); Appeal of Forty-Four Cigar Co., 2 B.T.A. 1156 (1925) (payments made by corporation to relative of its president to cease efforts to oust president from control of taxpayer were neither an expense or loss of the corporation).

108 26 T.C. 846 (1956), affirmed sub nom. Phelps v. Commissioner, 247 F.2d 156 (9th Cir. 1957).

109 Compare Jackson Howell, supra note 108, with Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940); James F. Boyle, 14 T.C. 1382 (1950), aff'd, 187 F.2d 557 (3d Cir.), cert. denied, 342 U.S. 817 (1951). Compare these cases with Trico Products Corp., 46 B.T.A. 346 (1942), aff'd, 137 F.2d 424 (2d Cir.), cert. denied, 320 U.S. 799 (1943), rehearing denied, 321 U.S. 801 (1944).

corded this interest in *Joseph R. Holsey*[110] and *Louis H. Zipp.*[111] In the former the purchase by the corporation of fifty per cent of its stock pursuant to an option assigned to it by the shareholder who held the other half of the stock was a taxable dividend to the assignor of the option. The Tax Court saw no distinction between this transaction and the assumption and discharge of the assignor's obligation to purchase, had he exercised the option on his own behalf. In the latter the redemption of a principal shareholder's stock with funds borrowed by the corporation for this purpose was a dividend to the remaining shareholders who, after a disagreement with the principal shareholder on business policy, wished to acquire the entire business free from any control or obstruction by him.

Perhaps the recent ninth circuit decision in *Doran v. Commissioner,*[112] wherein the court looked through the confusing form of the transaction to find that the insurance policies paid for by the corporation were purchased for, and on behalf of, the shareholders who used the proceeds to purchase the stock of a deceased shareholder, stands for an incipient awareness that corporate expenditures for insurance premiums whose proceeds are to be exchanged for a deceased shareholder's stock foster the investment interest. Certainly this can be said of a brace of early cases which have been cited extensively in the literature concerning stock retirement plans—*Paramount-Richards Theatres v. Commissioner,*[113] and *Casper Ranger Construction Co.*[114] In the first case, the shareholder was held taxable on premiums paid by the corporation on policies which named the shareholder's wife as beneficiary, the shareholder retaining a right to change that designation where the proceeds were to be used to adjust the purchase price of stock between shareholders. *Interstate Transit Lines* and *Deputy v. du Pont* fignred prominently in the fifth circuit's opinion. In *Casper Ranger Construction Co.* payment of premiums by the corporation on policies under which it was not the beneficiary was considered dividend income to the insured stockholders.

Finally, recognition of the views stated herein can be readily seen in *Sanders v. Fox.*[115] Premiums paid by the corporation to fund a stock retirement plan were taxable dividends to the shareholders. The court, after examining what it considered to be the substance of the transaction, concluded that the "benefits" flowing to the shareholders from the cor-

110 28 T.C. No. 107 (1957).
111 28 T.C. No. 32 (1957).
112 246 F.2d 934 (9th Cir. 1957).
113 153 F.2d 602 (5th Cir. 1946).
114 1 B.T.A. 942 (1925).
115 149 F. Supp. 942 (D. Utah 1957), appeal pending 10th Circuit.

porate expenditures were sufficient to justify treating them as dividends.

However, as indicated, the Tax Court speaks with a divided voice. Notwithstanding its clear tones in *Prunier, Casale, Jackson Howell, Holsey* and *Zipp,* rejection of the analysis here advanced is implicit in its recent decision in *Shoe Corporation of America.*[116] The issue was the deductibility of litigation expenses incurred in a stockholder's derivative suit which resulted in an injunction preventing the corporate management from accomplishing a recapitalization plan which was designed to vest control of the corporation in the family of which management was a part. The state court issuing the injunction directed that the fees, including the costs of the shareholder plaintiff, be paid by the corporation. All were held deductible as ordinary and necessary expenses even though plainly these were disbursements primarily advancing the investment interests of shareholders. Put in the language necessary for denial of the deduction, the fees were not expenses of the corporate business notwithstanding the state court decree. This decree merely recognized the fairness of charging the fees in accordance with the stock ownership of the shareholders.

The decision of the Tax Court appears to be bottomed upon an acceptance of the views of its Judge Bruce, expressed in a dissent in *James E. Caldwell & Co.,*[117] which were incorporated in the sixth circuit's reversal of that case.[118] The pertinent issue in *Caldwell* was the deductibility of something in excess of $120,000, paid by the corporate taxpayer as the result of a judgment taken against it and some of its shareholders, because of certain improper acts in milking the assets of another corporation and an expenditure of $1500 paid to an attorney for assistance in determining how the liability would be apportioned between the judgment debtors. The holding that the fees were not deductible drew heavily upon *Kornhauser v. United States*[119] and *Deputy v. du Pont,* while Judge Bruce emphasized the fact that the state court found the corporate taxpayer to be a joint tortfeasor whose only course was to pay the judgment. The case, perhaps, is distingnishable from *Shoe Corporation of America* in that the state court findings do not absolutely preclude a finding that the corporate wrongs were serving the business interests of the shareholders; but it is more probable that they served their personal interests and that the payments involved did likewise.

The disagreement exists in the circuit courts also. In addition to

116 29 T.C. No. 33 (1957). Compare with Royal Cotton Mill Company, 29 T.C. No. 84 (1958).
117 24 T.C. 597, 615 (1955). See, Fred F. Fischer, P-H 1947 T.C. Mem. Dec. ¶ 47,131 for earlier misconceptions in this area.
118 234 F.2d 660 (6th Cir. 1956).
119 276 U.S. 145 (1928).

Prunier and *Casale,* which clash with the substance of *Knight-Campbell Music Co.* and *Doran,* the eighth circuit decision in *Tucker v. Commissioner* also conflicts.[120] There, to prevent the corporation's loss of its Ford dealership, it was necessary for Tucker to acquire a majority interest therein. In accomplishing this Tucker purchased stock from another to whom, as a part of the same transaction, the corporation agreed to pay a certain sum over a five-year period. Although recognizing that the corporate payments benefited Tucker, the court found equal benefits flowing to the corporation and its other shareholders—a finding which, in its view, precluded charging Tucker with dividends to the extent of such payments.

Nowhere is the deceptive nature of the "benefit" analysis better revealed than in this case. Expenditures which directly serve the investment interest always further, to some extent, the group's ability to carry on the business for which they joined together. In that sense they always provide a benefit to the corporation, but the immediate and primary objective is to affect the investment the shareholder has in the business. To repeat, this cannot be fully grasped so long as "the weighing of benefits" occupies the court's attention.

Another decision of the eighth circuit, *Lewis v. O'Malley*[121] is often cited as generally supporting the views of the first and second circuits in *Prunier* and *Casale.* There the corporation purchased a single premium insurance policy on the life of its president and principal shareholder which gave him the power to designate the beneficiary thereof. Notwithstanding the fact that the corporation was never designated as beneficiary, the facts indicated that the policy had been treated consistently as an asset of the corporation for the purpose of maintaining the credit rating of the corporation. The premium was not considered a dividend. The case is sound on its facts. Apparently the premium was primarily to advance the business interest of the shareholder and not a personal or investment interest.

The other circuit court mainstay of those who applaud the disposition at that level of *Prunier* and *Casale* cannot, however, be turned aside in this manner. This is the third circuit decision in *Emeloid Co., Inc. v. Commissioner,*[122] in which it was held, somewhat gratuitously it should be said, that "borrowed investment capital," as used in the World War II Excess Profits Tax Act, included sums borrowed to purchase single premium policies where proceeds were to be used in a stock retirement

120 Earlier the eighth circuit in Ruben v. Commissioner, 97 F.2d 926 (8th Cir. 1938) rejected an investment interest analysis in a situation having a strong similarity to the facts of James E. Caldwell & Co., note 117 and 118 supra.

121 140 F.2d 735 (8th Cir. 1944).

122 189 F.2d 230 (3d Cir. 1951).

plan. To reach this view it was necessary to find that the indebtedness was incurred "for business reasons." This was done by stressing the business reason mentioned earlier[123] and ignoring the other motivations behind these arrangements. Notwithstanding the residuum of taxpayer appeal that lurks in every excess profits tax case, the case deserves the reliance placed upon it. Its reasoning is inconsistent with the analysis made in this paper, even though a gimlet-eyed view could possibly warrant the assertion that a finding that a loan was incurred "for business reasons" is not in conflict with a determination that it was *primarily* for investment reasons.

The decisions reviewed here constitute the main stream of applicable authority—and, as said before, the direction indicated is not clear. If anything, however, the trend is against the position here taken; but, of course, this does not establish its correctness. In any event, these cases and the reasoning advanced heretofore constitute the defense of the Tax Court's result in *Prunier* and *Casale*. Only a few remnants need attention before the case is complete.

VI. Remnants and Reiterations

The first circuit in *Prunier* closed its opinion with what might be regarded as an ominous caveat. "What will happen when one of the brothers dies is not before us," were the court's dark words. This expression suggests, in addition to unexpressed judicial difficulties with realization problems, that the taxpayer's victory might well be a pyrrhic one with disaster in the form of bunched dividend income awaiting the execution of the plan. Obviously the caveat is sound so far as the estate of the deceased shareholder is concerned because of the treacherous nature of sections 302 and 318 of the Code. Furthermore, the partially submerged reef built by these sections will probably not be eliminated by taxing the premiums to the shareholders, although such a course would lend some support to a taxpayer's contention that the tax consequences throughout should be made equivalent to a cross-purchase arrangement.[124]

Whether the caveat was in any way directed to the surviving shareholders is uncertain; however, speculation on taxation of these heretofore supposed fortunate individuals opens interesting vistas. Immediately two theories can be imagined which might be used to reach the gain of the survivors. The first would be to treat the insurance proceeds used to redeem the stock as a dividend distribution to the survivors and

123 See p. 362 supra.
124 See note 17 supra.

increase the basis of their stock by the same amount.[125] The second would be to determine the increase in the net worth of the survivors, resulting from the death of a shareholder and the execution of the plan, and treat that amount as a gain to the survivors taxable at ordinary rates. Presumably this amount could be treated as a dividend from the standpoint of corporate earnings and profits and the basis of the stock held by the survivors would be increased pro tanto. While in some instances the amount of income to the survivors would be the same irrespective of the theory employed, this would not always be the case because of the variations in the manner in which the shares are valued under the agreement.

Assuming that it is desirable to withhold the arm of the tax gatherer until death of a shareholder and that the estate of the deceased does not receive the black bean, the second of the two theories seems preferable from the standpoint of logic and fairness. To treat the proceeds as a dividend distribution seems inconsistent with a refusal to treat the premiums as dividends (do not both serve the investment interest?), and, furthermore, the amount of the proceeds may not correspond with the actual increase in value of the survivor's shares. This increase is the proper measure of the taxpayer's increase in net worth. Nonetheless the first theory has *Joseph H. Holsey,*[126] *Zipp,* and *Doran* to lean upon, while the second is bedeviled by realization difficulties.

There is, however, something draconic about allowing the earnings and profits of the corporation to be converted into insurance without tax consequences and then harshly extending the government's hand at the time of death to receive the deferred tax swollen by the progessive rates. In addition, the identity of the obligor is capricious because of the mechanistic workings of the Code; and, when it permits the estate of the deceased to escape its jaws, the uncertainty of the amount to be imposed upon the survivors is quite vexing. It appears much wiser to treat the premiums as dividends in proportion to the stock ownership

125 Support for this approach can be found in Note, 67 Yale L.J. 112, 119, n.34 (1957).

126 In Note, 67 Yale L.J. 112, 118 (1957) the author states: "As a departure from existing law, Holsey should be construed to embody these considerations and to require taxation of all shareholders whose proportionate interests are increased by stock redemptions." The approach and reasoning of this note generally supports the position stated in this paper; however, conceding the possibility of taxing the survivors, it seems much fairer where stock retirement plans are funded by insurance to treat the premium payments as dividends rather than the disbursements of the proceeds. The Holsey doctrine can be reserved for other situations where the result and purpose of redemption is to achieve a present, or gradual, readjustment of ownership and control between shareholders which does not amount to a genuine contraction of the business that alters its scope and character and which is not prompted solely by the desire of a shareholder to withdraw from the enterprise. For a discussion of some related problems in the redemption area, see, Bittker, "Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954," 9 Stan. L. Rev. 13 (1956). But see, Note, 71 Harv. L. Rev. 687, 707 (1958).

and correspondingly increase each shareholder's basis in his stock by the amount for which he was charged.[127] So approached, the redemption would have no immediate tax consequences to either the survivors or the estate of the deceased.[128] While an amendment to the Code is probably necessary to accomplish this result in many family corporations, there seems to be no obstacle so far as other closely held corporations are concerned.

Now one more remnant—and the term here is plainly apt. It is the accumulated earnings tax. It has already been indicated that this provision of the Code does not provide the proper solution to the problem posed by stock retirement plans funded with insurance. This is true for three reasons.

In the first place, an investment of corporate earnings in insurance is significantly different from accumulating cash, or other similarly liquid assets, even where both are for the purpose of redeeming the shares of a deceased shareholder. Insurance has a peculiar characteristic—the capacity to instantly increase in value upon the death of the insured—which cash does not possess. This means that in respect of insurance, the corporation does not have the freedom of use that attaches to cash. To convert insurance into cash, or in any other asset for that matter, destroys a valuable characteristic, and one, in the case of a now uninsurable shareholder, not obtainable from any other source. These are familiar observations, for they are the heart of the inducement offered by insurance companies in suggesting that insurance be used to fund a stock retirement plan. Their validity prohibits comparison with accumulation of cash or other liquid assets, and suggests means other than the accumulated earnings tax for dealing with efforts to use the

127 There are some logical difficulties to this approach which should be revealed. In the first place, the benefit to the shareholder from the premium payment may not be commensurate with the amount of premium charged to him. For example, X, who owns 70% of the stock, does not receive an equivalent benefit where the only other shareholder is Y, who is unrelated to X and a much younger man. However, no more fair method of allocating the income than in proportion to the stock ownership appears feasible. Second, while the text suggests regarding the entire premiums as reinvested in the corporate business to reflect the fact that the policy does remain available to the creditors of the business, it is clear in fact, that only the portion of the premium which goes to increase the cash surrender value is so available. The balance of the premium was the cost of the coverage for the premium period. This suggests that the increase in stock basis should be restricted to the amount of the increase of the cash surrender value of the policies held by the corporation. Or perhaps these facts suggest that the dividend might be restricted in amount to the cost of coverage for the premium period and that the basis remain unchanged. Admittedly these are possibilities; and it is a desire for simplicity, more than logic, which prompts the suggestion made in the text. It does not seem to be an unreasonable one. See Steinberg, supra note 11, at n.13.

128 That is, the estate of the decedent will receive an amount in exchange for its stock equal to its basis therein and no distribution will be considered to have been made to the survivors. Probably the excess of the proceeds over the aggregate premiums paid will constitute earnings and profits available for distribution. Rev. Rul. 54-230, 1954-1 Cum. Bull. 114; White, Business Insurance 396 (2d ed. 1956).

corporate structure to avoid tax at the shareholder level revealed in stock retirement plans.

Secondly, the accumulated earnings tax makes even-handed treatment of corporations and shareholders so using the corporate structure impossible. This results from the $60,000 minimum accumulation permitted without adverse tax consequences under the present Code. Some corporations would be free to employ stock retirement plans while others could do so only at considerable risk. To extend the advantage of these plans only to small corporations is to encourage the development of multiple corporations and to employ an unsuitable means of assisting the survival of small business.

Thirdly, use of the accumulated earnings tax to block the evil of these plans requires somewhat the same type of analysis as advanced here in support of taxing the premiums as dividends. To show that not only is the corporation being availed of for the purpose of avoiding the income tax, but that the accumulated earnings and profits are in excess of the present, or anticipated, reasonable needs of the business,[129] would require establishing that an accumulation for an investment purpose serves no reasonable need of the business.[130] The route, thus, offers only additional hazards, not a safe procedure.

Now the reiterations. The Tax Court result in *Prunier* and *Casale*, although not its precise reasoning, is approved on the grounds here stated. The premiums in stock retirement plans substantially serve interests of the shareholders distinct from their interest in the business success of the corporation and should be considered as dividend distributions to the shareholders which are immediately reinvested and become assets available to corporate creditors. The issue is a close one; but there is no insuperable obstacle to the fair solution outlined here.

129 A showing that the corporation was formed or availed of for the purpose of avoiding the income tax with respect to its shareholders may be made even though the accumulations are not beyond the reasonable needs of the business. United Business Corp. of America, 19 B.T.A. 809 (1930), aff'd, 62 F.2d 754 (2d Cir. 1933); Pelton Steel Casting Co., 28 T.C. 153 (1957), aff'd, — F.2d — (7th Cir. 1958). However, a showing that the accumulation was not beyond the reasonable needs of the business reduces, or eliminates, the penalty because of the mechanics of the accumulated earnings credit.

130 Thus the avoidance of Emeloid Co. v. Commissioner, 189 F.2d 230 (3d Cir. 1951) would require emphasis on such decisions as Trico Products Co., 46 B.T.A. 346 (1942), aff'd, 137 F.2d 424 (2d Cir.), cert. denied, 320 U.S. 799 (1943), rehearing denied, 321 U.S. 801 (1944), which appears to have recognized the investment interest. The same can be said of Pelton Steel Casting Co., 28 T.C. 153 (1957), aff'd, — F.2d — (7th Cir. 1958). The court spoke of the "business" needs of the shareholders as distinguished from the "business" needs of the corporation.