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Taxability of Life Insurance Proceeds Paid to Stockholders of Closely Held Corporations

TAXABILITY OF LIFE INSURANCE PROCEEDS PAID TO STOCKHOLDERS OF CLOSELY-HELD CORPORATIONS

The taxability of insurance proceeds paid upon policies covering the lives of key persons and stockholders of closely-held corporations presents an interesting and unique problem for the tax planner. The choice of similar programs may lead to vastly different tax consequences, and careless planning may subject surviving stockholders to taxation under the theory of constructive dividends. This problem is by no means new for in 1925 the Commissioner of Internal Revenue ruled that:

Where the proceeds of a life insurance policy are paid to a cor-

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61. "While the plaintiff might have applied for a certificate of identity for the purpose of following the procedure set forth in Section 360, there is nothing in this case to indicate that he ever did or that such a certificate has been issued to him. Instead he has *chosen* to bring this action under the Declaratory Judgment Act for a judgment declaring him to be a United States citizen." Cort v. Herter, 187 F. Supp. 683, 685 (D.D.C. 1960). (Emphasis added.)

62. 122 F. Supp. 709 (D.D.C. 1954).

63. Legislative history cited notes 46, 47 *supra.*

64. This case was argued October 11, 1961 but the decision is still pending. 30 U.S.L. WEEK 3134 (1961).

65. *Cf.* text accompanying note 11 *supra.*

> poration as beneficiary the fund loses its identity after such payment, and dividends paid by the corporation to its stockholders out of such fund are taxable in the same manner and to the same extent as other dividends.[1]

This ruling seems to have established a firm policy on the part of the Internal Revenue Service as to the taxation of proceeds of life insurance policies insuring important members of closely-held corporations,[2] for in 1961, the Commissioner stated the position of the Service as being substantially the same:

> It is the position of the Service that life insurance proceeds paid to shareholders of a corporation are taxable as dividends in cases where the corporation uses its earnings to pay the insurance premiums and has all the incidents of ownership including the right to name itself beneficiary and, therefore, is not entitled to, and does not in fact, receive the proceeds.[3]

It is apparent that the latter ruling goes beyond the former in that it makes the proceeds taxable even though they are paid directly to the stockholder and not distributed through the corporation. The Commissioner undoubtedly has broadened the scope of this policy because of the multitude of litigation revolving around this subject since the release of the 1925 ruling.

The latest ruling was released as a result of *Ducros v. Commissioner*,[4] a recent case involving a small closely-held corporation. The corporation president applied for insurance on his own life naming the corporation as beneficiary and giving the corporation the right to change beneficiaries. Subsequently, the corporation became vested with all incidents of ownership and changed the beneficiary from the corporation to the stockholders. The corporation paid all the premiums, and when the president died the proceeds were paid directly to the stockholder-beneficiaries. It was held that the proceeds were not a distribution by the corporation and were not taxable as income to the stockholder-beneficiaries.

1. I. T. 2131, IV-1 CUM. BULL. 90 (1925).
2. HENN, CORPORATIONS, § 257 (1961). "The 'close corporation,' 'closed corporation' or 'closely-held corporation'—or 'one-man corporation,' 'family corporation,' 'incorporated partnership,' or 'chartered partnership,' as it is variously called—is, as its name implies a corporation whose stock is held by a single shareholder or by a closely-knit group of shareholders. It differs from the public-issue corporation in that there is no public issue or trading of its voting shares."
3. Rev. Rul. 61-134, 1961 INT. REV. BULL. No. 29, at 20.
4. 272 F.2d 49 (6th Cir. 1959).

The *Ducros* case was decided in November 1959, by the Court of Appeals for the Sixth Circuit, and this precise issue has not been before a federal court since. However, lest any speculation should arise concerning the possible tax loopholes that the *Ducros* holding might foster, the Commissioner made it clear that the Internal Revenue Service will not follow the decision of the Sixth Circuit in the *Ducros* case.[5]

The important question now is whether other courts will follow the reasoning of the *Ducros* case or whether they will yield to the position taken by the Commissioner. In attempting to answer this question, a brief look at the background against which *Ducros* was decided will be helpful. The situation involved so-called "key-man" life insurance.[6] This is the practice of procuring insurance on the life of an important official such as the president or principal stockholder of a closely-held or family corporation, the purpose of which is to compensate the corporation for the loss of the services of the important official. This insurance is also utilized to fund stock purchase agreements by means of which control of a closely-held corporation is maintained within a select group. There are two basic methods by which this latter purpose may be accomplished.[7] There is the "cross-purchase" agreement whereby each stockholder (or partner in the case of a partnership) takes out insurance on the lives of the other stockholders (or partners), names himself beneficiary under each policy, and promises to use the proceeds to purchase the interest of each deceased stockholder. The other method is the "entity-purchase" plan whereby the corporation or partnership itself takes out insurance on the life of each stockholder or partner, names itself beneficiary, and agrees to use the proceeds to purchase the interest of each deceased stockholder or partner. Either of these two methods may be used with variations.[8]

Key-man life insurance has long been used for the purpose of funding stock purchase agreements, and it was expressly recognized as a valid business transaction in *Emeloid Co. v. Commissioner*.[9] The corporation purchased single premium life insurance policies on the lives of its two

5. Rev. Rul. 61-134, *supra* note 3.

6. HARNETT, TAXATION OF LIFE INSURANCE 6 (1957): "Another common form of business life insurance is the so-called 'key-man' insurance. Under this practice, companies may insure the lives of employees whose death either at any time or at a specific time will cause great financial injury to the firm."

7. Note, 71 HARV. L. REV. 687, 688 (1958).

8. For example, a trust device may be used whereby the proceeds are made payable to the trustee who then may distribute the funds to the surviving stockholders or purchase the deceased's stock and hold it for the benefit of the surviving stockholders. See Golden v. Commissioner, 113 F.2d 590 (3rd Cir. 1940) and Doran v. Commissioner, 246 F.2d 934 (9th Cir. 1957).

9. 189 F.2d 230 (3rd Cir. 1951).

principal stockholder-officers as key men, with the purpose of providing for the continuity of efficient management by allowing the corporation to buy the first deceased's interest. The corporation borrowed the money with which to make the premium payment, and it was held that such borrowed funds constituted "borrowed invested capital" for excess profits tax purposes. In so holding the court said:

> What corporate purpose could be considered more essential than key man insurance? The business that insures its buildings and machinery and automobiles from every possible hazard can hardly be expected to exercise less care in protecting itself against the loss of two of its most vital assets—managerial skill and experience. In fact, the government has not seriously contended here that key man insurance is not a proper corporate purpose.[10]

The problem lies in determining whether proceeds paid to the stockholder-beneficiaries are corporate distributions or whether they are insurance proceeds payable by reason of the death of the insured. If the latter, then of course they are not taxable under provisions of the Internal Revenue Code.[11] This, then, is the very essence of the controversy between the *Ducros* holding and the Commissioner's ruling. The Commissioner's contention is that such proceeds are a dividend flowing from the corporation to the stockholder-beneficiaries,[12] and as such are taxable within the meaning of § 301 of the Internal Revenue Code of 1954.[13]

To be taxable as gross income under § 301, the distribution by the corporation must come within the meaning of a "dividend" as defined by § 316 (a) of the Code.[14] Upon the plain meaning of § 316 (a), it is

10. *Id.* at 233.

11. INT. REV. CODE OF 1954, § 101 (a) (1): "General Rule—Except as otherwise provided in paragraph (2) and in subsection (d), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured."

12. Rev. Rul. 61-134, *supra* note 3.

13. INT. REV. CODE OF 1954, § 301 (c) (1): "Amount constituting dividend.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income."

14. INT. REV. CODE OF 1954, § 316 (a): "General rule.—For purposes of this subtitle, the term 'dividend' means any distribution of property made by a corporation to its shareholders—(1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301

difficult to see how the Commissioner can consider it to cover insurance proceeds paid directly to the stockholder. This section defines a dividend as ". . . any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits . . . ." It is apparent that payment of life insurance proceeds is not a dividend within the normal concept of the term.[15] How then can such payments be taxed as dividends? The underlying theory is that the payments are economic gains flowing to the stockholder from the corporation, and that the net effect is the same as if such payments were ordinary dividends. Apparently the fact that the payments are made directly to the stockholder-beneficiary from the insurance company and not paid to the corporation and subsequently distributed to the stockholder makes no difference to the Commissioner.

This distinction, though, was brought out clearly in the *Ducros* case. The court, in *Ducros,* distinguished the case of *Cummings v. Commissioner*[16] where the corporation insured the life of its president and named itself as sole beneficiary. The distinguishing feature was that under a predetermined plan, the proceeds, when paid to the corporation upon the insured's death, were then redistributed to the surviving stockholders. It was held that the amounts received by the stockholders were not exempt from taxation. The court also distinguished *Ducros* from *Golden v. Commissioner,*[17] another case where exemption was denied. There the corporation was the owner and beneficiary of eleven policies on the life of its president. It assigned the beneficial interests to a trust company which collected the proceeds upon the president's death and distributed them to the stockholders. The distributions were held taxable as "dividends" measured by the amount of the proceeds of the policies. The distinction was based on the corporation's having retained valuable incidents of ownership in *Golden.*

The government apparently could see no distinction between *Cummings* and *Ducros* since it argued in the latter case that:

> The transactions here must be considered as if the corporation had received the proceeds (which had been purchased by premiums paid out of corporate funds) and then had distributed them to its shareholders. The short-cut method used by which the corporation designated beneficiaries who were to receive

applies, such distribution shall be treated as a distribution of property for purposes of this subsection."

15. See HENN, CORPORATIONS, § 318 (1961) for a good discussion of what constitutes a dividend.

16. 73 F.2d 477 (1st Cir. 1934).

17. 113 F.2d 590 (3rd Cir. 1940).

> directly the proceeds from a policy which it alone owned is of no consequence in determining the taxability of the proceeds.[18]

The court failed to be impressed by this argument, because the corporation was not entitled to receive the proceeds under the provisions of the policy. The court would not consider the case as if the corporation were so entitled.

No mention was made in the *Ducros* case of *Doran v. Commissioner*,[19] although a similar result was obtained. In that case the corporation procured insurance policies on the lives of corporate stockholders. The corporation was to pay the premiums and the proceeds were to be paid to trustees who were then to purchase the deceased party's stock and hold it for the surviving stockholders. Upon receiving the proceeds of one of the policies, the trustees purchased the stock as planned, and the court held that the surviving stockholders did not receive a taxable dividend. Although there was a trust arrangement involved in *Doran* as in *Golden*, the two cases were distinguished by the fact that the corporation in *Doran* was not named beneficiary of the policies originally and thus had no interest which could be assigned to the trustees. Therefore, no incidents of ownership could have been retained by the corporation. Consequently the stockholders were entitled to claim an income tax exemption for the proceeds of the policy.

If the Commissioner recognizes the ruling in the *Doran* case as valid, then certainly an argument for the *Ducros* decision can be maintained by analogizing the two. In both cases the corporation paid the premiums, and in both cases the proceeds were paid to the stockholders rather than to the corporation. In *Ducros*, the proceeds were paid directly to the stockholders while in *Doran*, the proceeds were paid to a trustee who purchased the deceased's stock for the surviving stockholders. In both, however, the result was to place surviving stockholders in a position to acquire the deceased party's stock. It was not the presence of the trust arrangement in *Doran* which prevented tax liability, for, as was shown by the *Golden* case, the use of a trust for the purpose of distributing the proceeds is immaterial. There was no liability in *Doran* because the corporation was never a beneficiary and never had an interest that could have been assigned to the trustee. Of course, in *Ducros* the corporation was the original beneficiary, and after subsequently acquiring full ownership it changed the beneficiaries to the stockholders.

This, then is the reason that the Commissioner fails to recognize

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18. Ducros v. Commissioner, 272 F.2d 49, 52 (6th Cir. 1959).
19. 246 F.2d 934 (9th Cir. 1957).

Ducros—the fact that incidents of ownership were retained by the corporation because it still had the right to change beneficiaries. The court answered this by stating that although the corporation had the right, it did not exercise it, and the stockholders actually were the beneficiaries at the death of the insured. This would seem to render the case analogous to *Doran*. The Commissioner's position that the proceeds are taxable as dividends where the corporation has ". . . all the incidents of ownership including the right to name itself beneficiary, even though the Corporation does not name itself beneficiary . . ."[20] obviously is the same as the unsuccessful argument offered by the Government in *Ducros*.[21] Although the Commissioner has a method by which to distinguish *Ducros* from *Doran*, certainly a valid argument for supporting the *Ducros* holding could be maintained along these lines.

When the *Ducros* decision was announced it appeared that the taxpayers had won a victory in the field of taxability of insurance proceeds just as they seem to have done in the related field of taxability of insurance premiums.[22] Although the *Ducros* decision dealt only with the taxability of proceeds, closely allied to this issue is that of the taxability of premiums paid by the corporation on policies covering the lives of its key men. The overall problem of taxability of insurance premiums is beyond the scope of this note,[23] but in order to focus more clearly upon the problem of taxation of proceeds, a brief look at the status of the law in regard to taxation of premiums is warranted.

Underlying the discussion up to this point is the concept of double taxation of corporate profits. Under existing tax laws, profits earned by a corporation in its normal course of operations are taxed as income to the corporation. These same profits, when subsequently distributed to the stockholders as dividends, are again taxed as income to the stockholders. Hence, there now exists a standard of double taxation. When a corporation pays the premiums on a life insurance policy and a stockholder collects the proceeds, it would seem that at some point of time the stockholder has received income from the corporation. If *Ducros* were followed, however, there would be no income taxable to the stockholder

20. Rev. Rul. 61-134, *supra* note 3.

21. See note 18 *supra* and accompanying text.

22. Rev. Rul. 59-184, 1959-1 CUM. BULL. 65 (1959): "Where a corporation purchases life insurance on the lives of its stockholders, the proceeds of which are to be used in payment for the stock of stockholder, the premiums on such insurance do not constitute income to the stockholder, even though the stockholder has the right to designate a beneficiary, provided such right of the beneficiary to receive the proceeds is conditioned upon the transfer of the corporate stock to the corporation."

23. For more extensive treatment of this topic, see generally Note, *The Use of Life Insurance to Fund Agreements Providing for Disposition of a Business Interest at Death*, 71 HARV. L. REV. 687 (1958); Annot., 73 A.L.R. 2d 708 (1960).

when the proceeds were received; and, according to a recent line of cases, neither would there be income taxable to the stockholder when the corporation paid the premiums. In *Casale v. Commissioner*[24] the corporation insured the life of its president and chief stockholder for the purpose of funding a deferred income plan for him, naming itself beneficiary and retaining the rights to assign the policy. The premium paid by the corporation was held not to be a distribution of a taxable dividend by the corporation to the president. In *Prunier v. Commissioner*[25] a closely-held family corporation paid the premiums on the insurance covering the lives of the two principal stockholders upon the understanding that the proceeds would go to the corporation to be used to buy the stock of the deceased stockholder. Again it was held that such premium payments by the corporation did not constitute taxable income to the stockholder. Under circumstances similar to those in *Casale* and *Prunier,* a like result was obtained in *Sanders v. Fox.*[26] Thus, if neither the premiums paid by the corporation nor the proceeds when paid to the stockholder are taxed, then not only is there no double tax, there is no tax at all levied upon these sums. This runs counter to the whole scheme of double taxation.

The Commissioner has acquiesced in the decisions discussed above and has declared that they will be followed by the Internal Revenue Service.[27]

The problem as presented above, however, was stated rather broadly, because premium payments are not automatically tax exempt to the stockholder. As the cases seem to bear out, the taxability problem centers around whether the corporation or the stockholder will receive the proceeds. In *Casale* and *Prunier* the corporation in each case was the beneficiary of the policies upon which it paid the premiums. In *Yuengling v. Commissioner,*[28] where the taxpayer owned all the capital stock in a corporation and the corporation paid the premiums on policies on the taxpayer's life with the proceeds payable to his wife and children, the payment of the premiums was held to be a benefit to the taxpayer and

24. 247 F.2d 440 (2nd Cir. 1957).
25. 248 F.2d 818 (1st Cir. 1957).
26. 253 F.2d 855 (10th Cir. 1958). Stockholders in a closely-held corporation entered into an agreement with the corporation where, under a plan funded by insurance covering the lives of the stockholders, the corporation was to redeem their stock. The corporation paid the premiums and the premium payments were not taxable to the stockholders as "constructive dividends."
27. Rev. Rul. 59-184, *supra* note 22: "The decisions of the U. S. Courts of Appeals in the cases of Oreste Casale v. Commissioner, 247 Fed. 2d 440; Henry E. Prunier v. Commissioner, 248 Fed. 2d 818; and Robert V. Sanders v. Charles I. Fox, 253 Fed. 2d 855; involving similar factual situations, will be followed by the Internal Revenue Service."
28. 69 F.2d 971 (3rd Cir. 1934).

properly taxable as income to him. Again, in *Paramount-Richards Theatres v. Commissioner*,[29] the premium payments were held taxable as income to the stockholder. The corporation here was a holding company whose stock was held jointly by another corporation and an individual. The corporate stockholder caused the holding company to procure an insurance policy on the life of the individual stockholder. The holding company paid the premiums and the proceeds were to be used to adjust the purchase price of the deceased individual's stock between the corporate stockholders if they exercised certain options to buy. The court said that the stockholders had used corporate funds for their own benefit in paying the premiums and the premium payments were not ordinary business expenses of the holding company. Accordingly, the premium payments were held to be taxable income to the stockholders. It would appear, then, that whether or not premium payments by the corporation are taxable to the stockholder depends upon whether the corporation or the stockholder receives the proceeds—*i.e.*, if the stockholder receives the proceeds he must pay tax on the premiums.

Whether the corporation or the stockholders will receive the proceeds will usually depend upon which type of buy-sell arrangement is to be used. If the cross-purchase agreement is used, the proceeds traditionally are paid directly to the surviving stockholders to be used by them in purchasing the deceased's interest. If the entity-purchase agreement is used, the proceeds are paid to the corporation which in turn purchases the deceased's outstanding stock. This is known as stock redemption[30] and is not taxable under the Internal Revenue Code of 1954.[31]

The problem encountered here, though, is whether the remaining stockholders have received an economic benefit or "constructive dividend" upon the redemption of the stock by the corporation from the deceased stockholder. For example, assume a situation where each of two persons owns 50% of the outstanding stock in a corporation, and the corporation buys all the stock of one. The remaining stockholder would then own 100% of the outstanding corporate stock. Has he received the equivalent of a corporate dividend? No, according to the recent case of

29. 153 F.2d 602 (5th Cir. 1946).

30. INT. REV. CODE OF 1954, § 317 (b): "Redemption of stock.—For purpose of this part, the term 'property' means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)."

31. INT. REV. CODE OF 1954, § 302 (a):—If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock."

Holsey v. Commissioner.[32] There the payment by the corporation for the purchase of 50% of the outstanding stock by the corporation was held not to be the same as a distribution of a taxable dividend to the remaining stockholder.

It cannot be doubted that the remaining stockholder has achieved some benefit. He has sole managerial authority, and he alone will benefit from any future increases of the market value of the stock. He has not benefited financially, however, on the immediate transaction. For instance, if the corporation has net assets (total assets minus total liabilities) of $400,000, each of the stockholders would have an interest of $200,000. If the corporation bought the stock of one stockholder, it would pay him $200,000 for it, thus reducing the net assets (or net worth) to $200,000, which would represent the interest of the remaining stockholder. He now owns 100% of a corporation worth $200,000, whereas before he owned 50% of a corporation worth $400,000. Thus, he has realized no immediate monetary gain. Under this reasoning, the *Holsey* case seems to be sound law. In any event, the Commissioner has decided to recognize the decision as a valid precedent.[33] Thus, this enhancement in value of the remaining outstanding stock is not a "constructive dividend" for income tax purposes.

Simply stated, *Holsey* can be said to hold that there is no tax imposed under the redemption arrangement. Cross-purchase agreements, however, apparently are subject to taxation. In *Wall v. United States,*[34] the taxpayer owned 50% of the corporate stock and the other 50% was owned by a person who was also the principal owner of the corporation's chief competitor. Desiring to get his competitor out of the corporation, the taxpayer entered into an agreement with him whereby the taxpayer was to buy the competitor's 50% interest for a cash payment plus a balance payable over ten years. About a year and half later, the taxpayer transferred the purchased shares to the corporation, which agreed to assume the payments to the competitor. It was held that these payments by the corporation to the competitor were taxable as income to the taxpayer. *Holsey* was distinguished from *Wall* in that in *Holsey* there was no obligation to buy imposed upon the remaining stockholder. The *Wall*

32. 258 F.2d 865 (3rd Cir. 1958); See also Ward v. Rountree, 193 F. Supp. 154 (M. D. Tenn. 1961).

33. Rev. Rul. 58-614, 1958-2 CUM. BULL. 920 (1958): "The Internal Revenue Service will follow the decision of the U. S. Court of Appeals for the Third Circuit, rendered Sept. 3, 1958, in the case of Joseph R. Holsey v. Commissioner, in cases involving similar facts and circumstances. The decision holds that a remaining shareholder of a corporation does not receive a constructive dividend by way of enhancement in the value of his stock as a result of a purchase by the corporation of another shareholder's stock."

34. 164 F.2d 462 (4th Cir. 1947).

case brought out the distinction between redemption agreements and cross-purchase agreements, although it was a seemingly artificial one. The court relied chiefly upon form rather than substance in reaching its decision. It was the contention of the taxpayer that:

> . . . the two transactions, that is, the transfer from Coleman [competitor] to Wall [taxpayer] in 1937 and the transfer from Wall to Rosedale [corporation] in 1939, should be treated as parts of a single transaction whereby Coleman sold his stock to Rosedale without the intervention of Wall. This, it is said, is the true meaning of what the parties did and hence Wall incurred no tax liability; and we are asked to reach this conclusion since taxation is a practical matter which requires that regard be had to the substance rather than to the form of the taxpayer's acts.[35]

The court refused to consider the two transactions as constituting a single transaction, saying:

> Wall deliberately elected to attain his objective by two distinct transactions and there is no evidence that he was merely acting as an agent for Rosedale when he made the purchase. As was stated in Woodruff v. Commissioner, 5 Cir., 131 F. 2d 429, 430, where a similar contention was advanced and rejected, "if a taxpayer has two legal methods by which he may attain a desired result, the method pursued is determinative for tax purposes without regard to the fact that different tax results would have attached if the alternative procedure had been followed."[36]

If the court had followed the taxpayer's contention, the result would have been a case of stock redemption, and hence, no tax liability. But in construing the two transactions as being separate and distinct, it was simply a matter of the corporation paying the debt of a stockholder, which debt had been incurred in a cross-purchase agreement between two equal stockholders.

The cross-purchase agreement in *Wall* was unfunded, which distinguishes the case from *Ducros,* where the cross-purchase agreement was funded with life insurance; but this factual distinction ought not preclude a comparison of the two. It may be argued that because of the formal distinction employed in *Wall* that the case is not direct authority

35. *Id.* at 465.
36. *Id.* at 466.

for permitting taxation in cross-purchase agreements. If form was important in *Wall,* then form and not merely substance was properly given consideration in *Ducros.* Thus the result in *Ducros* might justifiably make the tax consequences of cross-purchase agreements more desirable.

It has been shown by the *Holsey* case that the advantages gained by the remaining stockholders in stock redemption cases are not "constructive dividends" for tax purposes. Just what is a "constructive dividend," then?[37] The Tax Court has generally held that a stockholder has received a constructive dividend if an "economic benefit" can be found.[38] Apparently, then, "constructive dividend" and "economic benefit" are synonomous. This, however, is not necessarily true. Suppose a corporation purchases a life insurance policy on its president with itself as beneficiary and, upon the insured president's death, collects and retains the proceeds within the corporation. The corporation is not taxed upon the receipt of the proceeds.[39] If it does not distribute the proceeds to the stockholders, then no one is taxed. But have not the stockholders received an economic gain through the increase in the value of their shares? They own the same proportionate share of a now wealthier entity. This is not a "constructive dividend" insofar as income taxes are concerned, though, for:

> In a loose manner of speaking, it can be said that any corporate gain is a benefit, indirectly, to the stockholders, so that if a corporation becomes the beneficial owner of insurance policies, the stockholders receive the benefit thereof. Of course this argument proves too much, for it would lead to the conclusion that profits made by a corporation in its business are automatically taxable income to the stockholders. This is contrary to the taxation scheme of the Internal Revenue Code.[40]

The economic benefit theory thus does not seem to be a completely satisfactory means of determining taxable income.

Apparently there is no rigid definition to be applied to the term "constructive dividend." It affords the courts a convenient tool to use in settling a particular tax dispute but would probably lose its utility if

37. For an excellent discussion of this topic see Brafford, *The Constructive Receipt of Dividends,* 47 Ky. L.J. 378 (1959).
38. *Id.* at 389.
39. United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924). It was held that as to receipt of proceeds of life insurance policies paid upon the death of the insured, there is no distinction between an individual beneficiary and a corporate beneficiary for income tax purposes. Thus, a corporate beneficiary is entitled to an exemption of such proceeds just as an individual is entitled to such exemption.
40. Prunier v. Commissioner, 248 F.2d 818, 821 (1st Cir. 1947).

reduced to concrete form. Although the term is not capable of precise definition in itself, the courts have produced some guidelines for use in determining whether there has or has not been a constructive dividend granted by a corporation. It has consistently been stated that substance and not form is controlling in determining tax consequences.[41] Likewise, there does not have to be a formal declaration of a dividend in order for there to be a constructive dividend.[42] Nor does the income have to be actually received to constitute a constructive dividend.[43]

A constructive dividend may result by corporate income being diverted to controlling stockholders,[44] by cancellation by a corporation of a debt due from a stockholder[45] or even by the payment of a fine by the corporation for a stockholder.[46] The idea of constructive dividends, therefore, is one capable of wide application.

Although the term "constructive dividend" is used liberally by courts in tax cases, it does not appear in the Commissioner's ruling on the *Ducros* case. The term employed by the Commissioner is "taxable dividend."[47] This difference in terminology is of slight consequence, for if read in context the term "taxable dividend" implies "taxable constructive dividend."

CONCLUSION

Since the *Ducros* decision was not appealed to the Supreme Court, the issues involved are not yet settled, and other courts may conclude that the issues should be resolved another way. Undoubtedly the Commissioner's ruling will have some influence upon courts which must decide the issue, but it is submitted that the ruling should not be controlling. As has been pointed out, there are forceful arguments that can be advanced

41. See, *e.g.*, Helvering v. Gordon, 87 F.2d 663 (8th Cir. 1937); Dawkins v. Commissioner, 238 F.2d 174, 176 (8th Cir. 1956); Erickson v. United States, 189 F. Supp. 521 (S.D. Ill. 1960).

42. Simon v. Commissioner, 248 F.2d 869, 875 (8th Cir. 1957); Hash v. Commissioner, 273 F.2d 248, 250 (4th Cir. 1959); Sachs v. Commissioner, 277 F.2d 879, 882 (8th Cir. 1960); Jaeger Motor Car Co. v. Commissioner, 284 F.2d 127 (7th Cir. 1960).

43. Clark v. Commissioner, 266 F.2d 698, 713 (9th Cir. 1959).

44. Dawkins v. Commissioner, 238 F.2d 174, 178 (8th Cir. 1956); Simon v. Commissioner, 248 F.2d 869, 873 (8th Cir. 1957).

45. Hash v. Commissioner, 273 F.2d 248 (4th Cir. 1959). The president-stockholder's personal account was credited, reducing the balance of the account (which represented president's indebtedness to the corporation). This credit was the amount found taxable by the Commissioner who held that it was a "dividend" to the president.

46. Sachs v. Commissioner, 277 F.2d 879 (8th Cir. 1960). The president of the corporation was fined pursuant to a conviction of unlawfully attempting to evade part of the income tax owed by the corporation. The voluntary payment of his fine by the corporation was held to be, in effect, a payment of dividends and the payment was part of his gross income for tax purposes.

47. Rev. Rul. 61-134, *supra* note 3.

in favor of *Ducros;* and it should be remembered that the existence of *Ducros* abolishes the artificial, but crucial, tax distinctions between cross-purchase and stock redemption plans. The most important lesson to be learned from the foregoing is that great care must be exercised when life insurance is utilized to fund stock purchase agreements in order that adverse tax consequences may be avoided. The tax planner who determines to use the *Ducros* rationale may be charting a course which leads to litigation and possibly additional tax liability. Where a *Ducros* situation is involved, caution should be the keynote, as it is very difficult to predict the final determination of the issue.