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Taxation—Fire Insurance Premium—Deductibility in Year of Payment by Cash Basis Taxpayer

The problem of whether a cash basis taxpayer may deduct in the year of payment the full premium on a fire insurance policy which covers a period of more than one year or whether he must prorate the deduction over the term of the policy has been troublesome to the courts and to the Commissioner of Internal Revenue.

In *Waldheim Realty and Investment Co. v. Commissioner*,¹ the taxpayer corporation had purchased single-premium policies covering a number of years and had deducted the full premium on each policy as a business expense in the year of payment. The corporation kept its books and made its tax return on a cash basis and had since 1905 uniformly treated such insurance premiums as business expense in the year paid. The Commissioner disallowed the deduction and assessed a deficiency. The Eighth Circuit held that the corporation could deduct the premiums in the years paid and was not required to prorate the premiums over the years of coverage.

The problem had its beginning in 1934, when the Commissioner of Internal Revenue ruled that a cash basis taxpayer could deduct only the pro rata portion of the insurance in the year of payment.² In 1938, the First Circuit decided in *Welch v. De Blois*³ that a prepaid premium on a policy running several years was deductible in its entire amount in the year of payment by a cash basis taxpayer. The Commissioner accepted the decision and revoked the ruling made in 1934.⁴ *Welch v. De Blois* was overruled in 1942 by *Commissioner v. Boylston Market Ass'n*⁵ The Commissioner then revoked his ruling of 1938 and reverted to his original position requiring proration.⁶ Now comes the *Waldheim Realty and Investment Co.* case. Will the Commissioner revoke the 1943 ruling and issue one similar to the one of 1938?

These three cases are the only ones found where appellate courts have decided the question of deductibility of fire insurance premiums by a taxpayer who files on the cash basis. It is interesting to note that in each of these cases the court upheld the method of accounting employed by the taxpayer.

The cash basis taxpayer reports income in the year received and deductions in the year paid, whereas the accrual basis taxpayer reports income in the year earned and deductions in the year in which the expense is incurred.⁷ It can readily be seen that the accrual method

¹ 245 F.2d 823 (8th Cir. 1957).

² G.C.M. 13148, XXIII-1 CUM. BULL. 67 (1934).

³ 94 F.2d 842 (1st Cir. 1938).

⁵ 131 F.2d 966 (1st Cir. 1942).

⁴ G.C.M. 20307, 1938-1 CUM. BULL. 157.

⁶ G.C.M. 23587, 1943 CUM. BULL. 213.

⁷ The methods of accounting specifically permitted by INT. REV. CODE OF 1954, § 446 (c), are not limited to the cash and accrual basis. This section also allows

presents a more accurate reflection of income in terms of economic gain. The cash method falls short of being a perfect measure of income because generally at the end of a taxable year some amounts due the taxpayer will not have been collected and some amounts owed by him will not have been paid. But this method has the virtue of simplicity.

In the field of deductions generally, a departure from a strict application of the cash method is made (1) when the disbursement is a capital one and (2) when, even though an ordinary expense, allowance of deduction in the year of payment would distort income. Once an outlay is determined to be a capital expenditure, the deduction of the entire amount in the year of payment is disallowed on the grounds that the Code permits only a deduction for depreciation or amortization over the useful life of the asset which is acquired. There will be no decrease in the economic wealth of the taxpayer if the value of the asset acquired equals his expenditure. A clear example of a capital outlay is the purchase of a building.

The court in *Commissioner v. Boylston Market Ass'n* said that it could find no basis for distinguishing between prepaid rentals, which have been held to be a capital expense,⁸ and prepaid insurance, and that by treating prepaid insurance as a capital expense it was obtaining some degree of consistency.⁹ But in *Waldheim Realty and Investment Co. v. Commissioner* the idea that prepaid insurance was a capital asset was rejected, although the court conceded that prepaid rent was a capital asset. Why would these two disbursements require different tax treatment? The court said:

The payment of insurance premiums adds nothing to the taxpayer's plant or equipment or his ability to produce income. In this respect the insurance premium differs from prepaid rent . . . as such expenditures [rent] are for the purpose of providing the taxpayer the place in which to carry on his business.¹⁰

One important objective of business firms in purchasing fire insurance coverage is the assurance that if fire does occur the insurance proceeds will enable them to restore their premises to a condition proper for

"any other method permitted by this chapter," such as the completed contract and installment method, and "any combination of foregoing methods permitted under regulations prescribed by the Secretary or his delegate."

⁸ *Galatoire Bros. v. Lines*, 23 F.2d 676 (5th Cir. 1928) (rent paid in advance for forty-five months gave rise to a capital asset); *J. Alland & Bros., Inc. v. United States*, 28 F.2d 792 (D. Mass. 1928) (three and one-half year lease was a capital asset). Both of these decisions relied upon *Duffy v. Central R.R.*, 268 U.S. 55 (1925), where the Court held that amounts expended for improvements by a lessee to comply with the provisions of long term leases were capital investments and therefore not deductible in the year the expenditures were made.

⁹ 131 F.2d at 968.

¹⁰ 245 F.2d at 825.

business purposes. If so, the court's distinction between prepaid rent and prepaid insurance seems vulnerable.

The second ground on which a departure from the strict cash method may be placed is prevention of distortion of net taxable income. The revenue laws have long provided as a general rule that the taxable income shall be computed under the method of accounting regularly used by the taxpayer in keeping his books provided it clearly reflects income.¹¹ The court in the principal case cited *Security Flour Mills Co. v. Commissioner*,¹² which stated: "This [failure clearly to reflect income] must mean distortion of true income, not of a given year, but in the light of ultimate gain, from a series of transactions over a period of years, growing out of, or in some way related to an initial transaction in the taxable year."¹³ *Welch v. De Blois* held that the phrase "clearly reflects income" only means that the taxpayer's books should be kept fairly and accurately. However, in *Caldwell v. Commissioner*,¹⁴ the court held that this phrase meant that the income should be reflected with as much accuracy as standard methods of accounting practice permit.

In determining whether the cash basis taxpayer should be allowed the full premium deduction in the year of payment, two conflicting interests must be weighed. On the one hand, Congress had authorized the use of the cash basis, which does have the virtue of simplicity. A taxpayer who keeps his books on the cash basis should not be put to the labor and expense of adjusting his books to prorate his expenses. On the other hand, it is desirable to limit the taxpayer's power of selecting the year in which the deduction would be most profitable to him if such would not clearly reflect income. Somewhere between these two, a line is to be drawn. Ordinarily, the deduction in the year of payment of a three year premium distorts income.¹⁵ Is its inaccuracy great enough to outweigh the advantage of its simplicity of computation?

The rule that an expenditure must be prorated because total de-

¹¹ *Waldheim Realty and Investment Co. v. Commissioner* was decided under Int. Rev. Code of 1939, § 41, 53 STAT. 24 (now INT. REV. CODE OF 1954, § 446(a), (b)). The 1939 Code provided:

"The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

The language of § 41 first appeared in the Revenue Act of 1921, § 212 (b), 42 STAT. 237, and remained unchanged until the 1954 Code. It was incorporated in the 1954 Code with minor changes in wording.

¹² 321 U.S. 281 (1944).

¹³ *Id.* at 287.

¹⁴ 202 F.2d 112 (2d Cir. 1953).

¹⁵ Conceivably, there could be a situation in which the deduction of a three year premium payment would not distort income. If a taxpayer had three insurance policies, each requiring the same amount of premium for a three year period, the payment of one policy premium annually would not distort income.

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

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

RICHARD J. TUGGLE

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

The Internal Revenue Code of 1939 defined the term "dividend" as "any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year . . ."¹ With a slight change, this definition has been repeated in the Internal Revenue Code of 1954.²

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

¹⁶ *Baton Coal Co. v. Commissioner*, 51 F.2d 469 (3d Cir.), *cert. denied*, 284 U.S. 674 (1931).

¹⁷ *Home Trust Co. v. Commissioner*, 65 F.2d 532 (8th Cir. 1933).

¹⁸ *Steele-Wedeles Co.*, 30 B.T.A. 841 (1934); *Harriet B. Borland*, 27 B.T.A. 538 (1933).

¹⁹ *Bonwit Teller & Co. v. Commissioner*, 53 F.2d 381 (2d Cir. 1931), *cert. denied*, 284 U.S. 690 (1932).

²⁰ *John D. Fackler*, 39 B.T.A. 395 (1939) (three year payment); *Court Holding Co.*, 2 T.C. 531 (1943), *rev'd on other grounds*, 143 F.2d 823 (5th Cir. 1944), *rev'd without discussion of this point*, 324 U.S. 331 (1945); *Joseph H. Konigsberg*, P-H 1946 T.C. Mem. Dec. ¶ 46024 (five year payment).

¹ Int. Rev. Code of 1939, § 115(a), 53 STAT. 46 (NOW INT. REV. CODE OF 1954, § 316).

² *Ibid.*

³ 149 F. Supp. 942 (D. Utah 1957).

⁴ "The Corporation did not claim the premiums as a deduction for income tax purposes, but accounted for these premiums as an asset on its balance sheet." *Id.* at 945.

⁵ The consideration given by the stockholder was his promise not to sell his stock except as specified in the agreement.