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The Constructive Receipt of Dividends

Part III*

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BARGAIN USE OF CORPORATE PROPERTY

It appears to be well settled that where a stockholder occupies or uses corporate property for an inadequate consideration, he will be considered to have received additional income from the corporation. Thus, in *Percy M. Chandler*,[1] the taxpayer who was the sole stockholder occupied rent free a residence owned by his corporation. The Board of Tax Appeals upheld the Commissioner's inclusion of the fair rental value of this residence in the taxpayer's income as additional compensation. The court of appeals affirmed,[2] stating:[3]

> In the present case . . . [taxpayer] was under a legal obligation to provide and maintain a home for his family suitable to their station in life. The payment by the corporation of the expenses of maintaining the home selected by Chandler as his family residence did in legal effect discharge this obligation. . . . That the substantial discharge of a legal obligation of the taxpayer represents for tax purposes a distribution to him is well settled.

The taxpayer contended that the corporation made a gift of the

* This is the third and final part of a thesis submitted in partial fulfillment of the requirements for the degree of Master of Law of the Graduate College of the University of Illinois. Part one treats the tax consequences of stockholder advances and loans to the corporation and advances and loans by the corporation to some or all of the stockholders. It appears in 46 Ky. L.J. 515 (1958). Part two treats the tax consequences of compensation paid to the stockholder-officers of the corporation, rentals and royalties paid to stockholders, and distribution of property and bargain sales and purchases. It appears in 47 Ky. L.J. 17 (1958).

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1 41 B.T.A. 165 (1940).

2 119 F. 2d 623 (3d Cir. 1941).

3 Id. at 628.

use of the residence to him. The court disposed of this contention by stating:[4]

> The corporate 'person' may be deemed by a fiction of the law to have abilities normally ascribed to man but the fiction cannot be indulged to the extent of endowing the corporation with feelings of love and affection for its stockholders, officers and directors. It is only because of the love and affection which a normal human donor feels for members of his family that it is presumed by the law that a transfer of property by him to them is a gift. The basis for such a presumption is entirely absent when the donor is a corporation.

The same result was reached in *Dean v. Commissioner,*[5] where the court refused to disregard the corporate entity. There the taxpayer and his wife transferred title to a residence, which they owned and occupied, to their corporation at the insistence of a bank to whom the corporation was indebted. The court held that the fair rental value of the residence was income to the husband stating that there was nothing to show that the corporate existence was anything but bona fide.

Even where the stockholder pays a rental for the use of corporate property, he may still be considered to have received income. In *Henry B. Peacock, Jr.,*[6] the sole stockholder occupied a residence owned by the corporation paying a rental of $900 a year. The fair rental value was $2,100 per year. He was held to have received income to the extent of the difference between the rent paid and the fair rental value of the property. The court stated:[7]

> We are of the opinion that petitioner and his mother, the sole owners of . . . the corporation, occupied its property at a bargain rental, and that the lease was not a bona fide arms-length transaction . . . whether the petitioner's share of the difference between $2,100 and $900 be deemed compensation for services, nominal or otherwise, or merely gain, it was taxable income.

In practically all the cases in which the issue has been presented, it has been held that the value represented by the use

[4] Id. at 627.
[5] 187 F. 2d 1019 (3d Cir. 1951).
[6] P-H 1956 T.C. Mem. Dec. § 56245.
[7] Id. at 1019.

of the property was compensation for services rendered by the stockholder and not a dividend.[8] The significance of so holding is that the full amount will be subject to tax even though the corporation has little or no earnings. In *Charles A. Fruehauf*,[9] the taxpayer argued that the difference was not compensation. There the rental value of the property was over $10,000. Since earnings and profits of the corporation available for dividends during the year amounted to only $2,300, the taxpayer sought to invoke Section 115(a) of the 1939 Code which would have limited his realization of taxable income to $2,300. The Board of Tax Appeals held, however, that the full amount was compensation and as such was taxable in full regardless of corporate profits. The tax burden in this area is further compounded by the fact that the corporation is not entitled to any additional deduction for compensation.[10]

The recent case of *Louis Greenspun*,[11] however, suggests dividend treatment so that the status of the earnings and profits of the corporation would serve to limit the realization of income by stockholders. Whether this decision will set a trend cannot be determined at this time. In this case the taxpayer owned a farm where he maintained his residence. A corporation of which he was president and principal stockholders spent large sums fixing up the farm as a horticultural showplace where customers of the company were entertained. Later the taxpayer sold the farm to the corporation but continued to live there, paying a monthly rental of $500. The Tax Court held that the amounts which the corporation spent for operating and maintaining the farm prior to the sale were not deductible as ordinary and necessary business expenses by the corporation and constituted additional income to the taxpayer. The question as to whether the taxpayer realized additional income through the use of the farm and machinery which the corporation owned after the sale was not raised by the Commissioner and the Tax Court did not determine this question. On appeal, the court of appeals affirmed,[12] holding that the expenditures made by the corporation in beautifying

[8] Charles A. Frauehauf, 30 B.T.A. 449 (1934); E. M. Dobson, P-H 1946 T.C. Mem. Dec. § 46182.
[9] Supra note 8.
[10] Reynard Corporation, 37 B.T.A. 552 (1938).
[11] 23 T.C. 138 (1954).
[12] 229 F. 2d 947 (8th Cir. 1956).

the farm constituted corporate distributions in the nature of dividends which were non-deductible. Thus, if the *Greenspun* decision were followed, it would appear to be open to the stockholder to argue in any subsequent case that such a distribution would not be taxable to him unless the corporation had sufficient earnings and profits to support a taxable dividend. It would be better to avoid receipt of such a dividend, however, and the wiser path would be for the stockholders to retain title to their residential properties.

The only method by which a stockholder-employee may avoid the receipt of additional compensation or a dividend by the use of corporate property is through application of the "convenience of the employer rule." By incorporating regulations which have been in effect for some time, Section 119 of the 1954 Code provides that there shall be excluded from gross income the value of any lodgings furnished an employee for the convenience of the employer if "the employee is required to accept such lodgings on the business premises of his employer as a condition of his employment." It would be an extraordinary case where a stockholder could take advantage of this section. However *McCarty v. Cripe*,[13] contained facts which brought the case within the "convenience" rule. There the court held that the stockholder-employee did not realize income from the rent-free occupancy of a hotel apartment which was furnished for the convenience and necessity of the corporation. The stockholder-employee managed the hotel and his services were available and required on a 24-hour basis. However, even where a case can be brought within the "convenience of the employer rule," it may be held that part of the rental value is not attributable to the "convenience of the employer" and is to be included in gross income.[14]

Chapter II

PAYMENTS ON BEHALF OF THE STOCKHOLDER BY THE CORPORATION

Where direct payments are made by the corporation on behalf of a stockholder in discharge of the latter's obligations, it

[13] 44 AFTR 978 (D. C. Ind. 1952), *aff'd*, 201 F. 2d 679 (7th Cir. 1953), without discussion of this point.

[14] Olin O. Ellis, 6 T.C. 138 (1946).

is settled law that such a payment will constitute a dividend to the stockholder if corporate profits and earnings are sufficient to support a taxable dividend.[15] Where payments are made in a more indirect manner, a question arises whether such payments are on behalf of the corporation or are for the personal benefit of the stockholder. Section 162(a) of the Code allows as a deduction all the "ordinary and necessary expenses" paid or incurred during the taxable year in carrying on any trade or business. Business expenses and deductions of closely held corporations are usually scrutinized by the service to determine whether the expenses were paid for the benefit of the corporation or whether they are personal, living, or family expenses of the stockholders. In any case where the stockholder of a close corporation has received an "economic benefit" from a particular expenditure made by the corporation, there is a strong possibility that he will be deemed to have received other additional compensation or a constructive dividend from the corporation. Whether a particular expenditure is a personal, living or family expense or a legitimate corporate expense usually turns on the question of whether the expenditure is ordinary and necessary within Section 162(a) relating to the deduction of corporate business expenses. The line between these two situations is not always clear.

The most questionable items are in the area of travel and entertainment expenses. The Commissioner has ordered his agents to bear down on travel and entertainment expenses and more significantly, he has directed that any disallowed portion be taxed as a dividend to the stockholders receiving the benefit of the expenditures.[16] Recent decisions indicate that the courts are going along with this action. However, in some of the cases it is not clear whether the additional income which results from the disallowance of a deduction is compensation or dividends.

In *Alex Silverman*,[17] the deductibility of traveling expenses was before the court. The corporation paid the traveling ex-

[15] Emil Liecht, P-H 1941 T.C. Mem. Dec. § 41111, *aff'd*, 137 F. 2d 433 (8th Cir. 1943), discharge of stockholders debt; Mark Kleenden, P-H 1944 T.C. Mem. Dec. § 44345, discharge of personal notes of stockholder; Municipal Securities Co., P-H 1945 T.C. Mem. Dec. § 45046, personal legal and accounting expenses of the stockholder.

[16] IR-Circ. 57-85 (June 20, 1957).

[17] 28 T.C. 1061 (1957), *aff'd*, (8th Cir. April 16, 1958).

penses of a stockholder-officer and his wife on a European buying trip. The Commissioner disallowed as an ordinary and necessary business expense 50% of the cost of the trip on the grounds that these were personal expenses and determined that this was additional income to the stockholder. The evidence showed that the wife's presence did not serve a bona fide business purpose, and that she was there on a honeymoon trip. The court upheld the Commissioner's contention that the part of the expense attributable to the wife was additional income to the stockholder without indicating whether it was compensation or dividends stating:[18]

> It is also well settled that where funds of a corporation are disbursed for the personal use or economic benefit of a stockholder or his immediate family, there being no intention of repayment, the amounts so disbursed are either the equivalent of corporate distributions or additional compensation for services (depending on the facts and circumstances), especially in the case of dealings between closely held corporations and their stockholders.

As to the stockholder's contention that the portion of the expenses attributable to his wife was a wedding gift by the corporation to her, it was stated by the court that:[19]

> Under such circumstances, the corporation's payment of funds for the personal use of Alex's wife, which also was of economic benefit to him, must be shown to have been a disbursement which satisfied all of the legal requirements of a gift. The proof should be very clear and certain that a bona fide gift was made by the corporation, applying all of the tests as they would be applied in dealings between a corporation and an individual dealing at arm's length.

The court then concluded that there was no gift here, pointing to the lack of director's authorization or stockholder's approval of a gift of corporate funds and the fact that the corporation had treated this sum on its books as a business expense. The court stated that it was unnecessary to decide whether this disbursement represented additional compensation or a constructive dividend for, in either event, it represented additional income

[18] Id. at 1064.
[19] Id. at 1067.

to the stockholder. It is believed that the court was not accurate in this last statement. If the disbursement represented addiional compensation, it should be deductible from corporate income as an ordinary and necessary expense provided the total compensation paid the shareholder was reasonable. On the other hand, if the additional sum was a distribution of property to the shareholder, it would not be taxable if earnings and profits of the corporation were insufficient to support a taxable dividend. However, neither of these questions was presented and argued by the taxpayer. Where traveling is done both for business and pleasure, the regulations have established a somewhat arbitrary dividing line as to when they will be deductible. It is provided that if the trip is *primarily personal,* the traveling expenses are not deductible even though the taxpayer does engage in some business while on the trip.[20] As to when a trip shall be deemed *primarily personal* it is provided:[21]

> Whether a trip is related primarily to the taxpayer's trade or business or is primarily social in nature depends on the facts and circumstances of each case. The amount of time during the trip which is spent on personal activities compared to the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal.

Entertainment expenses have also been held to be a constructive dividend in several recent cases. In *Greenspun v. Commissioner,*[22] the taxpayer was the principal stockholder of a corporation engaged in the manufacture of pipe. Finding it difficult to compete with other companies engaged in the same business by the use of conventional promotional techniques, it was decided to create a horticultural showplace at the stockholder's farm for the purpose of entertaining customers. The corporation expended large sums for flowers, shrubbery, farm tools, fertilizer and machinery. The evidence showed that some customers were entertained at the farm, but did not show the times or number of customers involved. The farm was also used as the stockholder's home and for the entertainment of

20 Proposed U.S. Treas. Reg. § 1.162-2(f)(2)(1955).
21 Proposed U.S. Treas. Reg. § 1.162-2(b)(2)(1955).
22 229 F. 2d 947 (8th Cir. 1956).

relatives and friends. The court held that the relationship between the "aesthetic stimulation of customers" and his "order for pipe was much too oblique" and disallowed a deduction of these expenses by the corporation. The court in its opinion stated that these expenditures constituted constructive dividends to the stockholder.

The need of keeping adequate records to substantiate travel and entertainment deductions was vividly brought out in the recent case of *B. F. Crabbe.*[23] In this case the taxpayer was president and majority stockholder of a corporation engaged in the business of selling water works and sewerage materials in the states of Kentucky, Tennessee, North Carolina, South Carolina, Georgia, Alabama and Florida. In connection with the business of the corporation it was necessary to visit and entertain customers in these states. Because of lack of substantiation, the Commissioner allowed only 50, 43 and 41 per cent of the traveling and entertainment expenses, respectively, for the three fiscal years in question and determined that the disallowed portion for two years amounting to $9,953.03 was a constructive dividend to the stockholder. The major portions of the amounts were withdrawn from the corporation in the form of checks payable to cash. The evidence also showed that the stockholder's wife accompanied him on several trips. The Tax Court sustained the Commissioner's determination and held that the stockholder received constructive dividends since *he did not show that the corporation had insufficient earnings and profits for this purpose.*

Many other types of purported business expenses also receive special scrutiny by the Commissioner for the purpose of imposing a constructive dividend. In *Beer v. United States,*[24] the corporation incurred expenses of $31,000 in settlement of a claim against the corporation, its directors and the stockholders. The corporation claimed a deduction for this item as an ordinary and necessary business expense. The court found that the purpose of the settlement was to prevent a threatened receivership which would adversely affect the business of the corporation and cause a reduction in the value of the stock in the stockholder's

[23] P-H 1956 T.C. Mem. Dec. § 56052.
[24] 132 F. Supp. 282 (D.C. Ala. 1955).

hands with a consequent reduction in dividend payments. Accordingly, it was held that the expenses were incurred for the benefit of the stockholders and not the corporation, and that the $31,000 expenditure was correctly treated by the Commissioner as a constructive dividend to each stockholder to the extent of his pro rata portion.

In *American Properties, Inc.*,[25] a corporation engaged in the rental of real estate deducted as an ordinary and necessary business expense the cost of designing, constructing and racing speedboats. Speedboats were the personal hobby of the sole stockholder and none of the boats had ever been sold though many people had offered to buy them. There was some indication that the corporation might undertake the manufacture of these boats on a commercial scale in the future, but nothing had been done along these lines and plans were indefinite as to when such manufacturing might start. The court found that there was no intention of immediately embarking upon a business venture and that the expenses were made for the personal pleasure of the stockholder. The court then held that the expenses incurred by the corporation constituted constructive dividends to the stockholder since there were sufficient earnings and profits for this purpose. That there must be sufficient earnings and profits in these cases to support a taxable dividend was also brought out in the *Crabbe* decision. In that case, the corporation paid a law firm $2,000 for defending the stockholder against a conspiracy indictment. The court agreed with the Commissioner that this expenditure was personal in nature and indicated that it would ordinarily be treated as a dividend, but since the Commissioner failed to prove the amount of earnings and profits it was held that this sum was not taxable to the stockholder.

Chapter III

PURCHASE OF INSURANCE BY THE CORPORATION UPON THE LIVES OF THE STOCKHOLDERS

Since management and ownership of a close corporation are practically synonymous, the death of one of the stockholders

[25] 28 T.C. 1100 (1957).

can have far reaching consequences. Although the corporate entity continues, the stock of the deceased stockholder may fall into the hands of outsiders who may disrupt the harmonious management of the corporation. Consequently, it is desirable that the stockholders devise a plan for acquisition of the stock of a deceased stockholder. To accomplish this objective and to provide liquid funds for this purpose, stock-purchase agreements funded with insurance have become the accepted pattern in recent years. Where the corporation pays premiums on insurance upon the life of a stockholder whose estate or family is the beneficiary, it is clear that the stockholder has received a dividend distribution from the corporation.[26] On the other hand, where the corporation is directly or indirectly a beneficiary under the policy, premiums paid by the corporation are not dividends to a stockholder. The determination of the question as to whether the stockholder has received constructive dividends turns on the question as to who stands to benefit from the policy and who is in substance the beneficiary under the policy. The rules are easy to state, but hard to apply as has been demonstrated by several recent cases.

That the purchase of insurance for the purpose of buying the stock of a deceased stockholder is a valid corporate purpose was expressly brought out in the case of *Emeloid Co. v. Commissioner*.[27] However, whether a bona fide corporate purpose is sufficient to avoid a constructive dividend to the stockholders is uncertain at this time. In the *Emeloid* case, the taxpayer-corporation purchased single premium life insurance policies on the lives of its two principal stockholders. It borrowed $97,500 with which to pay the premiums. Subsequently, a trust agreement was entered into whereby the stockholders and their wives agreed to sell to the corporation the shares of the first stockholder who should die. The proceeds of the insurance policies were used for this purpose. The corporation was named beneficiary under the policies. The basic question in the case was whether the $97,500 qualified as borrowed invested capital within the meaning of the excess profits tax, and this depended on whether the indebtedness was incurred for a business purpose. The Tax

[26] Casper Ranger Construction Co., 1 B.T.A. 942 (1925); Paramount-Richards Theatres, Inc. v. Commissioner, 153 F. 2d 602 (5th Cir. 1946).

[27] 189 F. 2d 230 (3d Cir. 1951), *reversing* 14 T.C. 1295 (1950).

Court held, in effect, that the insurance was purchased to further the interests of the stockholders and did not serve any business purpose of the corporation. The court of appeals reversed. It held that there was a definite business purpose by the purchase of this insurance and stated:[28]

> 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.

Referring to the fact that the corporation was the beneficiary of the policies and that the insurance had been in effect for approximately four years before the trust agreement was executed the court stated:[29]

> The trust was designed to implement that original purpose, and, at the same time, added a further business objective, viz., to provide for continuity of harmonious management. Harmony is the essential catalyst for achieving good management; and good management is the *sine qua non* of long-term business success. . . . Petitioner apparently anticipated that, should one of its key stockholders die, those beneficially interested in his estate might enter into active participation in corporate affairs and possibly introduce an element of friction. Or his estate, not being bound by contract to sell the stock to petitioner, might sell it to adverse interests.

In answer to the Tax Court's holding that the insurance was for the benefit of the stockholders, the court of appeals stated that the benefits to them were incidental and indirect and that it would be difficult to think of any case where the stockholders do not indirectly benefit when the corporation receives funds.

Although the question was not involved, the implication of the *Emeloid* decision was that where the corporation is the designated beneficiary of the policy of insurance on the life of one of its stockholders, the proceeds of which are to be used to purchase his stock upon death, the premiums paid thereon do

[28] Id. at 233.
[29] Ibid.

not constitute constructive dividends to the stockholders. An additional important factor in this case was the fact that the insurance represented an asset on the books of the corporation and could have been reached by creditors of the corporation.

In spite of the language of the *Emeloid* case, however, an analysis of recent decisions indicates that the Tax Court regards as of little significance the corporate purpose underlying the purchase of such insurance, and looks instead to the question of whether the stockholder has received an "economic benefit" from such insurance. If an "economic benefit" can be found, the Tax Court has consistently held that the premium payments by the corporation constitute constructive dividends to the stockholders. Although the courts of appeals have reversed the Tax Court in several of these cases, the current rush of litigation indicates the uncertainty prevailing in this area. In *Lewis v. O'Mally*,[30] the taxpayer who was president and principal stockholder arranged for the corporation to purchase a single premium life insurance policy on his life for $50,000. The corporation was the owner of the policy. However, the stockholder had the right to designate the beneficiary. The corporation from time to time withdrew loans on the policy and subsequently the policy was surrendered and the proceeds were repaid to the corporation. The Commissioner assessed a deficiency against the stockholder on the ground that the $50,000 paid for the insurance constituted a dividend. The district court sustained the Commissioner on the ground that inasmuch as the stockholder had the right to designate the beneficiary, the preminums were dividends to him. The court of appeals reversed, stating that the controlling fact was that the stockholder did not receive a single dollar from this purchase and that he was not benefited. The court stated that it need not decide the question of the tax effect of the right of the stockholder to nominate beneficiaries or the tax consequences if the stöckholder had died. Although there was no stock purchase agreement in this case, it indicates that the Commissioner is looking into all purchases of insurance by a close corporation in an endeavor to find some "economic benefit" to the stockholder. In *Paramount-Richards Theatres, Inc. v. Commissioner*,[31] such a benefit was found. In this case the

[30] 140 F. 2d 735 (8th Cir. 1944).
[31] Supra note 26.

corporation took out an insurance policy on the life of its stockholder for the purpose of funding a stock-purchase agreement. The stockholder was entitled to designate the beneficiary. The court found that both the corporation and the stockholder were benefited and held that the stockholder was taxable on the portion of the premium payments allocable to his stock interest in the corporation as a constructive dividend. *Sanders v. Fox*,[32] is another case in which an "economic benefit" was found by the district court. Here the corporation and its four stockholders entered into an agreement which provided that the corporation was to purchase the stock of any deceased stockholder. The agreement required the corporation to purchase insurance on the lives of each of the stockholders to fund the stock-purchase plan. The corporation was to pay the premiums and be designated the owner of the policies. The insured stockholders, however, were given the right to designate the beneficiaries. The Commissioner assessed a deficiency against the stockholders on the ground that the insurance premiums were constructive dividends to them. The district court stated that the pivotal point for decision was whether the stockholders, or the corporation, or both, derived economic benefits from the insurance. In sustaining the Commissioner, the court conceded that the corporation would benefit from the fact that the plan assured it of keeping its stock intact, but pointed out that the stockholders were benefited since the death of each stockholder would result in a larger portion of the capital and surplus being owned by the surviving stockholders. The court also pointed out that under the plan a definite fund was created which would guarantee to the stockholder's beneficiary receipt of the fair market value of the stock upon his death. On appeal, the court of appeals reversed,[33] holding that the stockholders received no present "economic benefit" and that the value of their estates had not been increased. The court stated that even though the stockholders could designate beneficiaries, the proceeds of the policies were made subject to the agreement and the corporation retained ownership of the policies. The court stated:[34]

[32] 149 F. Supp. 942 (1957).
[33] P-H 1958 Fed. Tax Serv. para 58611 (10th Cir. Mar. 20, 1958).
[34] Id. at 581387.

> The immediate present benefits to the stockholder . . . such as the assurance of a market at a guaranteed minimum return on his stock, the appreciation of the value of his stock, and the retention of corporate officers acceptable to his limited group, are not taxable incidents. . . . *The immediate benefits* of the investment redound to the corporation. Under such circumstances it is not proper to impress premium presently being paid with the label of constructive dividends. *Upon the death or withdrawal of a stockholder, tax complications including the possibility* of *an assessment of constructive dividends may arise.* . . . (Emphasis added.)

That the Tax Court continues to lay little stress on corporate purpose was recently demonstrated in *Henry E. Prunier.*[35] Two brothers owned substantially all the stock of a corporation. The corporation paid the premiums on policies of insurance totaling $45,000 on their lives. Each of the stockholders was named beneficiary of the policies on the other's life, although it was intended that the corporation was to use the proceeds to purchase the stock interest of the stockholder who should first die. The Commissioner assessed a deficiency against the taxpayers on the ground that the premiums paid on the insurance during 1950 represented dividends from the corporation. It was only in 1952, after the Commissioner had given notice of the deficiencies that the corporation was designated beneficiary of the policies. In sustaining the Commissioner, the Tax Court pointed out that the corporation would not have been enriched by receiving the proceeds because they were insufficient to pay the full value of the stock; that the corporation's indebtedness to creditors would have remained undiminshed; and that while the corporation would have eliminated the decedent's stock interest, the proportional interest of the surviving stockholder would have been greatly increased. The court then stated:[36]

> [S]ince the record does not otherwise indicate any benefits which might flow to the corporation from the purchase of a deceased insured's stock interest, we conclude that during the taxable year the corporation was neither the beneficial owner nor beneficiary of the insurance policies. . . .

[35] 28 T.C. 19 (1957).
[36] Id. at 26.

It then held that the stockholders' interests in the policies were of such magnitude and of such value as to constitute them direct or indirect beneficiaries of the policies. Three judges dissented, pointing out that the corporation could go into a court of equity and obtain the proceeds of the policies. They also stated that a corporation's purchase of its own stock can be viewed as a corporate purpose, and that it would be difficult to think of any case where the stockholders do not indirectly benefit when the corporation receives funds. Agreeing with these dissenting Tax Court judges, the court of appeals reversed,[37] and pointed out that the corporation was beneficial owner of the insurance under Massachusetts law. In answer to the argument that the stockholders were benefited by the insurance the court stated:[38]

> 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 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 the corporation are automatically taxable income to the stockholder. This is contrary to the taxation scheme of the Internal Revenue Code.

The court held that the Tax Court could not ignore the fact that the corporation was a separate legal entity and a separate tax unit. It also pointed out that although the corporation may have been contractually bound to apply the proceeds of the policy to buy the interest of a deceased stockholder, this did not mean that the corporation would not have been "enriched" by collecting the face amount of the policy. As to corporate purpose, the court said that "if it were necessary to look for a corporate business purpose, in the present case, we could refer to the arguments in Mannheimer and Friedman, 'Stock-Retirement Agreements'". In this article the authors stated:[39]

> Even while the decedent is still alive, the agreement and insurance benefit the corporation because they tend to stabilize the corporation's business. If the bank knows about the agreement, it may well be inclined to extend

[37] 248 F. 2d 818 (1st Cir. 1957).
[38] Id. at 821.
[39] Mannheimer & Friedman, Stock-Retirement Agreements, 28 Taxes 423,425 (1950).

> credit more liberally to the corporation because the possibility of inexperienced stockholders injecting themselves into the management is eliminated. If the key employees are informed of the agreement, it will be an inducement to them to remain with the corporation because they realize that the continuation of the business in the hands of the survivor is assured—and with it their jobs.

The recent case of *Oresta Casale*,[40] is another case where the Tax Court readily found a constructive dividend only to be reversed. Here the corporation purchased a combined life and annuity policy on the life of its president and principal stockholder to fund a deferred compensation agreement. The corporation was declared the owner and beneficiary of the policy. The Commissioner determined a deficiency based on the ground that the premium of $6,839.50 paid by the corporation was a constructive dividend to the stockholder. He argued that the transaction was lacking in bona fides and was no more than a device whereby the taxpayer purchased a retirement annuity for himself with corporate funds. The Tax Court agreed with the Commissioner's contention stating:[41]

> [W]e must conclude that the corporation was no more than a mere conduit running from the insurer to petitioner, or his beneficiaries, with respect to the payments which might have come due under the insurance contract.

The second circuit court of appeals reversed,[42] stating several reasons for its conclusion. First, the court stated that the Tax Court's finding that the corporate entity was a "sham" was based solely on the fact that the controlling stockholder could direct the activities of the corporation and concluded:[43]

> [W]e have been cited no case or legislative provision which supports the proposition that the entity of a corporation which is actively engaged in a commercial enterprise may be disregarded for tax purposes merely because it is wholly owned or controlled by a single person.

Secondly, the court pointed out that the corporation possessed the right to assign the policy, the right to change its beneficiary,

40 26 T.C. 1020 (1956).
41 Id. at 1025.
42 247 F.2d 440 (2d Cir. 1957).
43 Id. at 445.

the right to receive dividends, and the right to borrow on the policy, while the stockholder, on the other hand, had nothing more than a contract right to deferred compensation payments which would have been terminated by insolvency of the corporation. The court distinguished the *Paramount-Richards Theatres* case on the grounds that there the policy belonged to the individuals and could not have been reached by the corporate creditors. It was concluded that the stockholder received no "immediate personal benefit" and therefore, he could not be held to have received constructive dividends fróm the corporation.

Facts somewhat similar to the *Prunier* case were presented in *Doran v. Commissioner.*[44] There the corporation paid premiums on insurance on the lives of the six stockholders. The proceeds were payable to trustees as beneficiaries and owners of the policies to be used by them to purchase the stock of any of the stockholders who died. The purchase was to be made for the benefit of the surviving stockholders. On the death of one of the stockholders, the proceeds were so applied. The Tax Court held that the trustees were agents of the corporation and that the corporation received the proceeds of the insurance. Thus the surviving stockholders were deemed to have realized a dividend by the purchase of the deceased stockholder's shares for their benefit. It appears that the premiums paid by the corporation were clearly dividends and no contention was made as to this amount. The court of appeals reversed, holding that the insurance in question was purchased by the trustees for and on behalf of the individual stockholders and that the corporation was not beneficiary of either the insurance or the trust. The language of the court implied, however, that if the corporation had been named beneficiary and had so used the proceeds, the surviving stockholders would have realized a dividend from the corporation for the full amount of such proceeds. This result was also implied in the *Sanders* case.

Until certainty is introduced into this area, it appears that stock-purchase agreements funded with insurance might well be a hazardous undertaking so far as the constructive receipt of dividends is concerned. Although the *Emeloid* and *Prunier* deci-

[44] 246 F. 2d 934 (9th Cir. 1957).

sions held that where the corporation is named beneficiary of the policy, no constructive dividends are received by the stockholders, *Doran and Sanders* leave doubt. On the contrary the implications are that this factor would give rise to such a dividend.

Conclusion

The tax problems relating to the closely held corporation which are discussed herein are only a few of the tax problems with which such corporations must cope. They are sufficient, however, to point up the fact that the present method of taxing the income of closely held corporations is far from satisfactory. These problems arise from the recognition of the corporation as an independent and separate taxable entity, when as a practical matter, they are little more than incorporated partnerships or sole proprietorships. Not only does recognition of the corporate entity make transactions between closely held corporations and their stockholders uncertain tax-wise, but such recognition gives rise to tax avoidance and tax manipulation schemes.

The obvious solution would appear to be to disregard the corporate entity for tax purposes and to tax the stockholders of a closely held corporation directly upon their proportionate shares of corporate income in the same manner in which the income of partnerships is taxed to the partners. As has been previously mentioned, this is certainly not an innovation. Of course corporations have undergone tremendous growth both in size and in number since the Civil War era. Therefore, for such a system of taxation to be administratively feasible, a distinction would have to be made between corporations which can rightly be labeled closely held and those which are public corporations due either to their size or number of stockholders. Any distinction based upon the number of stockholders or upon an arbitrary amount of capitalization would appear to be unwise. It may be possible to make a distinction between those corporations whose stock is sold to the public through the stock exchanges, and those whose stock is closely held and is not sold in any recognized market. Stock ownership is relatively stable in this area and it should not be difficult to make the distinction.

A provision permitting corporations to be treated as partnerships for tax purposes was added to the Internal Revenue Code of 1954 as section 1351 by the Senate. This provision was deleted, however, in conference. The election applied only in the case of corporations, having only one class of stock, organized after December 31, 1953, owned by not more than 10 stockholders, all of whom are active in the business, and all of whom consent to the election. If such provisions were adopted it would be necessary of course to provide exceptions to the general rule. To deal with corporations such as Ford Motor Company prior to the release of its stock to the public, the proposed method of taxation would have to be made optional. Some corporations would not elect partnership treatment of their income. However, there are many cases where the corporations are organized for the purpose of providing limited liability for the stockholders and where the stockholders would gladly shed the tax problems which arise from the recognition of the corporation as a separate taxable entity.*

* [Editor's Comment] After the writing of this article, Congress amended the Internal Revenue Code to allow certain close corporations, if they so choose, to be treated tax-wise as if they are partnerships. See Int. Rev. Code of 1954, §§ 1371-77.