13 T.C. 901 (1949)

Life insurance proceeds applied to a corporation's debt, where the policy was assigned to the lender as security and the insured intended the proceeds as the primary payment source, are not includible in the corporation's equity invested capital for tax purposes.

Summary

Mims Hotel Corporation sought to include life insurance proceeds in its equity invested capital for excess profits tax credit. The insurance policy on a principal stockholder's life was assigned to a lender as security for a corporate loan, with the agreement that the proceeds would liquidate the debt upon the stockholder's death. The Tax Court held that because the stockholder intended the proceeds to be the primary payment source for the debt, the proceeds did not constitute a contribution to capital and could not be included in equity invested capital. The court also determined the depreciable life of slip covers and reupholstered furnishings to be four years.

Facts

Mims Hotel Corporation obtained a loan from Shenandoah Life Insurance Co. to construct a hotel. As a condition of the loan, the corporation's two principal stockholders each took out a $50,000 life insurance policy, assigning the policies to Shenandoah as security. The assignment specified that the insurance proceeds would be used to liquidate the loan in the event of the insured's death. The corporation paid the policy premiums and carried the policies as assets on its books. Upon the death of one stockholder, the insurance proceeds were applied to the outstanding loan balance.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the corporation's excess profits tax, disallowing the inclusion of the life insurance proceeds in its equity invested capital. Mims Hotel Corporation petitioned the Tax Court for review.

Issue(s)

1. Whether life insurance proceeds applied to a corporation's debt, under a policy assigned as loan security, constitute money or property paid in as a contribution to capital for equity invested capital purposes.
2. What is the appropriate depreciable life for slip covers and reupholstered hotel furnishings?

Holding

1. No, because the insured stockholder intended the life insurance proceeds to be

the primary source of payment for the corporation's debt, not a contribution to capital.
2. Four years, because the evidence presented supported a four-year useful life for the slip covers and reupholstered furnishings.

Court's Reasoning

The court reasoned that the proceeds were not a contribution to capital under Section 718(a) of the Internal Revenue Code. The court emphasized the intent of the insured, John W. Mims, in procuring the insurance policy. The court determined that Mims intended the insurance proceeds to be the "primary fund" for repaying the loan. The court distinguished the case from situations where a stockholder's estate would have a right of subrogation against the corporation. The court found significant that the corporation paid the premiums and treated the policy as an asset. The court cited *Walker v. Penick's Executor*, 122 Va. 664 (1918), where a similar arrangement was held to preclude subrogation rights. Regarding depreciation, the court accepted the testimony indicating a four-year useful life for the hotel furnishings. The court noted that "the insured created the proceeds of the policy on his life the primary fund for the payment of the loan note secured by the policy… Under this view of the case, no question of exoneration or subrogation can arise."

Practical Implications

This case clarifies that the source and intent behind life insurance policies used as collateral for corporate loans are crucial in determining their tax treatment. Attorneys should carefully analyze the assignment agreements and the insured's intent to determine whether the proceeds should be considered a contribution to capital. This case highlights the importance of documenting the intended use of insurance policies to avoid disputes with the IRS. This decision emphasizes that even if stockholders forgive a debt, it is important to show that it was an additional contribution to the corporation's capital to increase their investment. It shows that the surrounding circumstances must be considered when looking at these types of tax questions and there is no clear bright line rule. Cases following Mims will look to the intent of the parties, the actions of the parties, and any written agreements to make a determination.

