16 T.C. 54 (1951)

When a life insurance policy is transferred as payment for a debt, the transferee's basis for determining taxable income upon the policy's proceeds is the policy's cash surrender value at the time of transfer, plus subsequent premiums paid.

Summary

The Federal National Bank acquired a life insurance policy in exchange for releasing a debtor from their obligation. When the insured died, the bank received the policy proceeds. The Tax Court had to determine the taxable portion of these proceeds. The court held that the bank's basis in the policy was the cash surrender value at the time of the transfer, plus the premiums the bank subsequently paid. This amount, along with collection expenses, was deductible from the insurance proceeds. The remaining interest income was taxable.

Facts

Patrick H. Adams owed money to the Security State Bank, a predecessor of Federal National Bank. The debt was secured by a mortgage and a $20,000 life insurance policy. On December 24, 1924, Adams assigned his interest in the life insurance policy to the Federal National Bank. In return, the bank released Adams from his obligations. Adams died, and the bank collected $23,942.36 on the policy ($20,000 principal plus interest). The bank's tax return claimed the entire amount was exempt from taxation. The Commissioner determined a deficiency, arguing the insurance proceeds were taxable income, less the consideration paid for the policy and subsequent premiums.

Procedural History

The Commissioner of Internal Revenue determined a tax deficiency. The Tax Court initially ruled against the bank. The bank appealed, and the Court of Appeals reversed, holding that the Commissioner's determination was invalid. The case was remanded to the Tax Court to determine the correct tax liability. On remand, the Tax Court reached the decision outlined above.

Issue(s)

1. What is the proper method for determining the taxable portion of life insurance proceeds received by a transferee who acquired the policy in exchange for releasing a debt?
2. Whether the dividends should reduce the amount of premiums paid.
3. Whether the respondent has such a burden of proof that though he has shown the consideration above found he has not met that burden of proof because he has not shown the entire consideration.

Holding

1. The bank's basis for determining taxable income is the cash surrender value of the policy at the time of the transfer, plus the premiums the bank subsequently paid because Section 22(b)(2)(A) of the Internal Revenue Code specifies that only the actual value of consideration and subsequent payments are exempt.
2. No, because it is not clear what they mean to this case.
3. No, because the respondent has made a *prima facie* showing and that the petitioner can not urge that there is further consideration without demonstrating what it is.

Court's Reasoning

The court reasoned that when a life insurance policy is transferred for valuable consideration, it becomes a commercial transaction, not simply an insurance matter. Referring to *St. Louis Refrigerating & Cold Storage Co. v. United States, 162 F.2d 394*, the court stated, "Here the recovery was on the collateral security and the incidental fact that the proceeds of this insurance policy would have been exempt to the beneficiary named does not mark it as exempt where it has become a matter of barter rather than a matter of insurance." The court emphasized that Section 22(b)(2)(A) of the Internal Revenue Code only exempts the actual value of the consideration paid for the transfer and the sums subsequently paid. Premiums paid *before* the transfer, when the policy was merely collateral, should have been deducted as business expenses at that time. Because the bank received interest as part of the proceeds, that interest is taxable income less the cost of collection.
The court reasoned that because the petitioner destroyed records it was required to keep by law, it could not claim that the respondent had not met the burden of proof.

Practical Implications

This case clarifies how to calculate the tax implications when a life insurance policy changes hands as part of a debt settlement. It establishes that the transferee's cost basis is the fair market value (cash surrender value) at the time of the transfer, plus subsequent premiums paid. Legal practitioners should be aware that the history of the policy *before* the transfer is largely irrelevant for tax purposes, except for whether the premiums were previously deducted as business expenses. This ruling encourages careful record-keeping and proper accounting for premiums paid on life insurance policies used as collateral or transferred as payment for debts. The destruction of records during a case hurts the party that destroys the records.

