Golsen v. Commissioner, 54 T. C. 742, 1970 U. S. Tax Ct. LEXIS 166 (1970)

Payments labeled as 'interest' on life insurance policy loans may not be deductible if they lack economic substance and are essentially premiums.

Summary

In Golsen v. Commissioner, Jack Golsen purchased life insurance policies with a plan to immediately 'borrow' the cash value and establish a 'prepaid premium fund,' then claim the subsequent 'interest' payments as deductions. The Tax Court held that these payments were not deductible as interest because they lacked economic substance and were, in essence, the cost of the insurance. The decision emphasized the importance of substance over form in tax law and established the Tax Court's practice of following precedent from the Court of Appeals in the circuit where the case arises.

Facts

Jack Golsen purchased $1 million in life insurance from Western Security Life Insurance Co. under an 'executive special' plan. This plan involved paying the first year's premium and simultaneously borrowing back nearly the entire amount paid, including the cash value and a 'prepaid premium fund' for future years. Golsen's annual 'interest' payments on these 'loans' were intended to be treated as tax-deductible, effectively reducing the cost of the insurance. The plan was structured so that after the first year, no additional out-of-pocket premium payments were required, with all subsequent payments designated as 'interest. '

Procedural History

The Commissioner of Internal Revenue disallowed Golsen's claimed interest deduction for 1962. Golsen petitioned the Tax Court, which ruled in favor of the Commissioner. The case was significant for the Tax Court's decision to follow the precedent set by the Tenth Circuit Court of Appeals in Goldman v. United States, overruling its prior stance in Arthur L. Lawrence that it was not bound by circuit court precedents.

Issue(s)

1. Whether the payments Golsen made to Western Security Life Insurance Co. , designated as 'interest' on policy loans, are deductible under Section 163 of the Internal Revenue Code?
2. Whether the Tax Court should follow the precedent of the Court of Appeals for the circuit in which the case arises?

Holding

1. No, because the payments labeled as 'interest' lacked economic substance and

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were essentially the cost of the insurance, not compensation for the use of borrowed funds.
2. Yes, because the Tax Court decided to follow the precedent of the Court of Appeals for the circuit where the case arises, overruling its previous stance in Arthur L. Lawrence.

Court's Reasoning

The Tax Court applied the substance-over-form doctrine, determining that the 'interest' payments were in reality the cost of the insurance, not interest on a loan. The court relied on expert actuarial testimony to conclude that the plan was a sham designed to disguise the true cost of the insurance as deductible interest. The court also cited the Tenth Circuit's decision in Goldman v. United States, which involved a similar insurance arrangement and held such payments nondeductible. In deciding to follow the Tenth Circuit's precedent, the Tax Court overruled its prior decision in Arthur L. Lawrence, adopting a policy of following the law of the circuit to which an appeal would lie. This decision was influenced by considerations of judicial efficiency and the need for uniformity in tax law application.

Practical Implications

This decision has significant implications for tax planning involving life insurance policies and loans. It underscores the importance of economic substance in transactions, warning against attempts to disguise premiums as interest for tax benefits. Practitioners must carefully structure insurance and loan arrangements to ensure they have genuine economic substance. The ruling also affects legal practice by establishing the Tax Court's practice of following circuit precedent, potentially reducing forum shopping and promoting consistency in tax law application across circuits. Later cases have applied or distinguished Golsen based on the economic substance of the transactions involved, and it remains a key precedent in analyzing the deductibility of payments related to insurance policies.

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