Estate of J. E. Horne, Deceased, Andrew Berry, Executor, and Amelia S. Horne, Petitioners v. Commissioner of Internal Revenue, Respondent, 64 T. C. 1020 (1975)

Proceeds of life insurance owned by a corporation on a shareholder's life, payable to a shareholder beneficiary, are not taxable as a constructive dividend to the beneficiary when the decedent was the controlling shareholder.

Summary

In Estate of Horne v. Commissioner, the Tax Court ruled that life insurance proceeds paid to Amelia Horne, the named beneficiary and a shareholder of Horne Investment Co. , were not taxable as a constructive dividend. The corporation owned the policies on the life of J. E. Horne, its controlling shareholder, and paid all premiums. The court found that attributing the insurance proceeds as a dividend from the corporation would conflict with estate tax regulations attributing the policy's incidents of ownership to the decedent, thereby excluding the proceeds from the beneficiary's income under IRC section 101(a)(1).

Facts

Horne Motors, Inc. , and East End Motor Co. took out life insurance policies on J. E. Horne in 1949. Both corporations merged into Horne Investment Co. , which retained ownership of the policies. In 1966, the company changed the beneficiary to Amelia S. Horne, J. E. Horne's wife and a shareholder. J. E. Horne died in 1970, and the insurance company paid the proceeds to Amelia. The corporation had paid all premiums and recorded the cash surrender values as assets on its books. At the time of his death, J. E. Horne owned a majority of the corporation's shares.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the petitioners' 1970 federal income tax, asserting that the insurance proceeds were taxable as a constructive dividend to Amelia Horne. The petitioners contested this at the U. S. Tax Court, which ultimately ruled in their favor.

Issue(s)

1. Whether the proceeds of life insurance policies, owned by a corporation on the life of a shareholder and paid to a named beneficiary who is also a shareholder, are taxable as a constructive dividend to the beneficiary.

Holding

1. No, because the proceeds were not taxable as a constructive dividend to Amelia Horne. The court reasoned that attributing the proceeds as a dividend would conflict with estate tax regulations attributing the policy's incidents of ownership to the

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decedent, thereby excluding the proceeds from the beneficiary's income under IRC section 101(a)(1).

Court's Reasoning

The court applied IRC section 101(a)(1), which excludes life insurance proceeds from gross income when paid due to the insured's death. The Commissioner argued that the proceeds were a constructive dividend under IRC sections 316(a)(1) and 301(c)(1), given that the corporation owned the policies and paid the premiums. However, the court rejected this argument, citing estate tax regulations (26 C. F. R. 20. 2042-1(c)(6)) that attribute the policy's incidents of ownership to the decedent when he is the controlling shareholder. This attribution would treat the transfer of proceeds to Amelia as coming from the decedent, not the corporation, aligning with the exclusion under section 101(a)(1). The court emphasized the inconsistency between treating the proceeds as a transfer from the decedent for estate tax purposes and a distribution from the corporation for income tax purposes. The court also noted the potential for double taxation if both the estate and income tax positions were upheld.

Practical Implications

This decision clarifies that when a corporation owns life insurance on a controlling shareholder's life and names a shareholder as beneficiary, the proceeds paid to the beneficiary are not taxable as a constructive dividend. Attorneys should consider the interplay between estate and income tax laws when advising clients on corporate-owned life insurance policies. This ruling may encourage the use of such policies as part of estate planning strategies, as it affirms the tax-exempt status of proceeds under specific circumstances. Future cases involving similar arrangements should analyze the control and ownership dynamics to determine the tax treatment of insurance proceeds. Subsequent cases like Ducros v. Commissioner have applied similar reasoning, reinforcing the principle that life insurance proceeds are generally not taxable as dividends when paid to a named beneficiary.

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