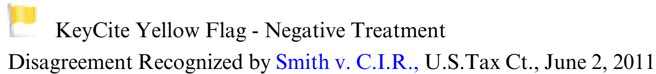
KeyCite Yellow Flag - Negative Treatment
Disagreement Recognized by Smith v. C.I.R., U.S.Tax Ct., June 2, 2011

54 T.C. 742
United States Tax Court

JACK E. GOLSEN AND SYLVIA H. GOLSEN, PETITIONERS
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 5863-65.
|
Filed April 9, 1970.

Attorneys and Law Firms

***743** Julian P. Kornfeld and Robert B. Milsten, for the petitioners.

Harold Friedman, for the respondent.

T purchased 20 'executive special' life insurance policies that were specially designed, calling for abnormally high premiums and providing for correspondingly high loan and cash surrender values. As part of a prearranged plan T not only 'paid' the first year's premiums but also made 'payments' into a 'prepaid premium fund' in respect of the premiums to become due in the next 4 years, and he simultaneously 'borrowed' back not only the full amount of the 'prepaid premium fund' but also the full loan value of the policies created by the first year's premium. His 'interest' obligations in respect of such 'loans' were at the annual rate of 4 percent, whereas the company's 'interest' obligation to him on the 'prepaid premium fund' was at the rate of 3 percent. The plan contemplated the 'borrowing' annually of the full amount of the annual increase in the cash surrender value of the policies, which was greater than the amount to be paid annually into the 'prepaid premium fund' to maintain it for a 4-year period. The net result of the transaction was that, apart from a portion of the cash actually paid by T as the first year's premium, no part of his out-of-pocket costs over the life of the policies would be treated as premium but would all be reflected as 'interest' paid by him. Held: T's out-of-pocket costs were in substance the true cost of the insurance purchased by him and he did not in fact pay any 'interest' on borrowed funds. T is not entitled to any deduction for 'interest' paid. Sec. 163. I.R.C. 1954. The result follows Goldman v. United States, 403 F.2d 776 (C.A. 10), rather than the contrary holding in Campbell v. Cen-Tex, Inc., 337 F.2d 688 (C.A. 5). The present case is within the Tenth Circuit and is therefore governed by Goldman. To the extent that Arthur L. Lawrence, 27 T.C. 713, is inconsistent herewith it is overruled.

The Commissioner determined a deficiency of $2,918.15 in petitioner's income tax for 1962. The only issue is whether a $12,441.40 payment made by petitioner Jack E. Golsen to the Western Security Life Insurance Co. is deductible as an interest payment pursuant to section 163, I.R.C. 1954.

FINDINGS OF FACT

The parties have stipulated certain facts, which, together with the attached exhibits, are incorporated herein by this reference.

Petitioners Jack E. and Sylvia H. Golsen are husband and wife. They filed a joint Federal income tax return for the calendar year 1962 with the district director of internal revenue, Oklahoma City, Okla., and resided in Oklahoma City at the time the petition was filed in this case.

During the latter part of 1961 and during 1962, Jack E. Golsen (Golsen) served as president of Hart Industrial Supply Co. and several affiliated corporations. The corporations were privately owned and did business in Texas and Oklahoma. By the end of 1961 the corporations had incurred indebtedness to banks in the aggregate amount of about $1.75 million, and Golsen had personally guaranteed all of it. Golsen was also personally indebted to a bank in the amount of $15,000. Moreover, during 1961 he had purchased 50 percent of the stock of the L & S Bearing Co. for approximately $625,000.

In December of 1961, Golsen carried about $230,000 in life insurance protection. In addition, several of the corporations whose loans he had guaranteed had taken out insurance on his life. However, in view of the size of his potential liabilities and his relatively illiquid financial position in late 1961, Golsen though that he ought to purchase additional life insurance to protect his family in the event of his unexpected death.

On or about December 28, 1961, an application was made to Western Security Life Insurance Co. of Oklahoma City (hereinafter sometimes referred to as Western or the

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insurance company) for insurance on Golsen's life. The application 'executive special' policies of $50,000 each, with Mrs. Golsen as the beneficiary and the couple's three children as contingent beneficiaries. No cash was submitted with the application.

Subsequently, on or before January 31, 1962, Western issued to Golsen such life insurance in the amount of $1 million embodied in 20 'executive special' policies, each with a face amount of $50,000 and ***744** an effective date of December 28, 1961.[1] On the date of issue Golsen was 33 years old and had a life expectancy of 35.15 years.

The 'executive special' policies appeared on their face to be whole life policies, providing for aggregate premiums of $68,180 a year for the first 20 years and $18,180 (reflecting a reduction of $50,000) a year thereafter. The premiums during the first 20 years were substantially higher than were actuarially required, and consequently the aggregate amount payable on death ('death benefits') as well as the cash surrender and loan values increased substantially during each of the first 20 years. The following table shows by policy year, the total death benefits, cash or loan values, and the net death benefits remaining if loans in the maximum permissible amounts were made against the policies:

Policy year......................	Total death benefit	Cash or loan value [1]	Net death benefit
1....................................	$1,108,000	$50,000	$1,058,000
2....................................	1,216,000	116,940	1,099,060
3....................................	1,324,000	185,440	1,138,560
4....................................	1,432,000	255,500	1,176,500
5....................................	1,540,000	327,130	1,212,870
6....................................	1,648,000	400,350	1,247,650
7....................................	1,756,000	475,140	1,280,860
8....................................	1,864,000	551,500	1,312,500
9....................................	1,972,000	629,420	1,342,580
10..................................	2,080,000	708,880	1,371,120
11..................................	2,188,000	789,860	1,398,140
12..................................	2,296,000	872,330	1,423,670
13..................................	2,404,000	956,250	1,447,750
14..................................	2,512,000	1,041,590	1,470,410
15..................................	2,620,000	1,128,270	1,491,730

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16..................................	2,728,000	1,216,250	1,511,750
17..................................	2,836,000	1,305,430	1,530,570
18..................................	2,944,000	1,395,730	1,548,270
19..................................	3,052,000	1,487,060	1,564,940
20..................................	3,160,000	1,579,280	1,580,720
22..................................	3,160,000	1,664,100	1,495,900
27..................................	3,160,000	1,876,110	1,283,890
32..................................	3,160,000	2,082,770	1,077,230

Interest on policy loans was payable at the rate of 4 percent a year.

The 'executive special' policies implemented an insurance program embodying the following principal elements: First, the insured would 'borrow'[2] from Western the entire amount of the first-year loan value, which he would use simultaneously to pay the greater part of the first year's premium. Second, he would at the same time 'borrow' a much larger sum from Western, and with most of the proceeds of the 'loan' he would simultaneously establish a so-called 'prepaid ***745** premium fund' in the amount of the present value of the aggregate annual premiums for the following 4 years, discounted at an annual rate of 3 percent. Western would undertake to pay interest on the 'prepaid premium fund' at the rate of 3 percent a year, and that fund, when supplemented by the interest increments paid by Western, would be sufficient at each of the next four anniversary dates of the policies to pay the annual aggregate premium of $68,180. Third, at the beginning of the first year, the insured would simultaneously pay in advance that year's 4 percent 'interest' on the sums he 'borrowed.' Fourth, as the 'prepaid premium fund' was reduced each year thereafter by the purported payment of premiums therefrom for such year, the insured would in turn 'replenish' the fund by a 'prepayment' in respect of the premiums to become due 4 years thereafter. The amount thus to be added to the fund each year was $60,577.90, which, at 3-percent compound interest was expected to increase to $68,180 4 years thereafter and accordingly be sufficient to pay the premiums falling due at that time. Fifth, each year after the issuance of the policies, the insured would 'borrow' the full amount of the increase in the loan value of the policies for that year, which would be greater than the $60,577.90 added to the 'prepaid premium fund' (see col. 3 of table p. 744 supra), and he would simultaneously use part of the proceeds of such 'loan' to pay the full amount of $60,577.90 to be added to the 'prepaid premium fund' and would use the balance to pay part of the annual 'interest' charges on his growing indebtedness to Western. Sixth, thus, after the first year, no part of the insured's out-of-pocket costs would be allocable to premiums, and, as a consequence of treating the 'interest' as deductible, the insured's actual cost of the insurance purchased by him would either be comparatively nominal or result in a net profit to him. The insured would never be personally liable on any of his 'loans,' the policies would never in fact have any cash surrender value as a result of the 'loans,' and the death benefits would be those shown in the last column of the table at page 744 supra.

Prior to acquisition of the policies Golsen was furnished with a schedule (based upon assumed insurance in the amount of $100,000) outlining the mechanics of the 'executive special' plan. The schedule showed that under the plan there would be no net cash premium outlay after the first year and that if the 'interest' payments were treated as deductible for income tax purposes, the actual net cost of the insurance over the first 20 years to the taxpayer at an assumed tax bracket would be a comparatively nominal amount, and in some years there might even be a net profit. That schedule (when multiplied by 10 so as to conform to the $1 million insurance involved

herein) in general reflects the plan which Golsen and Western ultimately adopted. It is set forth below:

JACK GOLSEN

(Annual Premium — $6,818

(a) (Discounted Premium—$6,057.79........... *Age 33* *Base — $100,000*

(1)....... Year...	(2) Guaranteed cash value	(3) Prepaid premium fund	(4) Total cash value- incl. prepaid premium	(5) Amount of loan	(6) Interest at 4%	(7) Net cash premium outlay	(8) Total net outlay with 52% tax credit	(9) Net insurance estate after deducting loan	(10 Annual increase in cash value	(11) Net cost or profit after deducting excess cash
1.........	$5,000	$26,103.39	$31,103.39	$31,103.39	$1,244.14	$1,057.80	$1,654.99	$105,800	0	0
2.........	11,694	26,103.39	37,797.39	37,797.39	1,511.90	0	725.71	109,906	$636.21	($89.50)
3.........	18,544	26,103.39	44,647.39	44,647.39	1,785.90	0	857.23	113,856	792.21	(65.01)
4.........	25,550	26,103.39	51,653.39	51,653.39	2,066.14	0	991.75	117,650	948.21	(43.54)
5.........	32,713	26,103.39	58,816.39	58,816.39	2,352.66	0	1,129.28	121,287	1,105.21	(24.07)
6.........	40,035	26,103.39	66,138.39	66,138.39	2,645.54	0	1,269.86	124,765	1,264.21	(5.65)
7.........	47,514	26,103.39	73,617.39	73,617.39	2,944.70	0	1,413.46	128,086	1,421.21	7.75
8.........	55,150	26,103.39	81,253.39	81,253.39	3,250.14	0	1,560.07	131,250	1,578.21	18.14
9.........	62,942	26,103.39	89,045.39	89,045.39	3,561.82	0	1,709.67	134,258	1,734.21	24.54
10.......	70,888	26,103.39	96,991.39	96,991.39	3,879.66	0	1,862.24	137,112	1,888.21	25.97

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11	78,986	26,103.39	105,089.39	105,089.39	4,203.58	0	2,017.72	139,814	2,040.21	22.49
12	87,233	26,103.39	113,336.39	113,336.39	4,533.46	0	2,176.06	142,367	2,189.21	13.15
13	95,625	26,103.39	121,728.39	121,728.39	4,869.14	0	2,337.19	144,775	2,334.21	(2.98)
14	104,159	26,103.39	130,262.39	130,262.39	5,210.50	0	2,501.04	147,041	2,476.21	(24.83)
15	112,827	26,103.39	138,930.39	138,930.39	5,557.22	0	2,667.47	149,173	2,610.21	(57.26)
16	121,625	26,103.39	147,728.39	147,728.39	5,909.14	0	2,836.39	151,175	2,740.21	(96.18)
17	130,543	19,864.24	150,407.24	150,407.24	6,016.29	0	2,887.82	153,057	2,678.85	(208.97)
18	139,573	13,437.60	153,010.60	153,010.60	6,120.42	0	2,937.80	154,827	2,503.36	(334.44)
19	148,706	6,818.00	155,524.00	155,524.00	6,220.96	0	2,986.06	156,494	2,513.40	(472.66)
20	157,928	0	157,928.00	157,928.00	6,317.12	0	3,032.22	158,072	2,404.00	(628.22)
					80,200.43	1,057.80	39,554.03	....	35,957.76	(1,941.28)

***747** In terms of the particular data appearing thereon the schedule was based upon a plan purporting to provide for a whole life policy with the following features:

(1) increasing death benefits for the first 20 years (col. (9));

(2) an increasing 'guaranteed cash value' which would be available for 'borrowing' or cash surrender by the insured (col. (2));

(3) establishment in the first policy year of a 'prepaid premium fund' (col. (3));

(4) maintenance thereafter of a level 'prepaid premium fund' by annual prepayment of a premium four years in advance (col. (3));

(5) availability of the prepaid premium fund, as a supplement to the 'guaranteed cash value' of the policy, for additional 'borrowing' by the insured (col. (4));

(6) annual 'borrowing' by the insured of amounts sufficient to exhaust the total amount available for loans (the sum of the prepaid premium fund and the guaranteed cash value) (cols. (4) and (5));

(7) allocation of a portion of each annual 'loan' to the insured's annual premium prepayment and use of the remainder of such 'loan' to offset in part his annual 'interest payments on his outstanding 'loan' (cols. (5) and (10) and fig. (a));

(8) annual payments by the insured which, after the first year, were to be designated exclusively as 'interest' payments on the then outstanding 'loan' (cols. (6) and (7)); and

(9) deductibility of the insured's annual payments as interest payments for Federal income tax purposes (col. (8)). [3]

As previously stated, Western issued 20 'executive special' policies, or contracts of insurance, to Golsen in the aggregate face amount of $1 million. Pursuant to the 'executive special' plan, the following occurred on or about January 31, 1962, i.e., on the first date on which any payments were made in respect of the policies.

(1) Golsen issued a check in the amount of $321,611.90 to Western purportedly in payment of the first year's premium of $68,180 for the policies, plus a 'prepayment' of $253,431.90 to create the 'prepaid premium fund' which, when supplemented by the 3-percent interest accumulating thereon, would be sufficient to pay the next four annual premiums on the policies.

(2) Golsen 'borrowed' from Western the full cash value of each policy, or a total of $50,000.

(3) Golsen also 'borrowed' an additional $261,033.90 from Western making a total of $311,033.90 'borrowed' from Western.[4] 'Interest' ***748** was payable on his entire 'indebtedness' at the rate of 4 percent a year.

(4) In accordance with (2) and (3), Western issued a check to Golsen in the amount of $311,033.90.

(5) Golsen 'paid' Western $12,441.40 by check, purportedly as four percent 'interest' on the aggregate of $311,033.90 'borrowed' from Western.

(6) The foregoing $12,441.40 check cleared the bank on February 2, 1962.

On the date Golsen's $321,611.90 check was written, there were not sufficient funds in petitioner's bank account to cover the check; payment thereof was dependent on the deposit of Western's $311,033.90 check.

Golsen's actual out-of-pocket expense in regard to this transaction was $10,578 of amounts designated as 'premiums' or 'advance premiums' plus the $12,441.40 'interest' which is here in issue.

Attached to each contract were two form documents entitled 'Receipt and Prepayment of Premiums Agreement' (prepayment Agreement) and 'Loan Agreement and Assignment of Policy' (Loan Agreement). The Prepayment Agreement form was executed by the president and secretary of Western and provided in part as follows:

Western Security Life Insurance Company acknowledges the receipt of $12,671.59 as prepayment of premiums under this policy.

It is hereby agreed that in the event of the death of the Insured or application for any of the non-forfeiture benefits of said policy, all premiums paid beyond the current policy year will be commuted at 3% per annum compound interest. Such commuted amount will be paid as a part of the proceeds of the policy in the event of death or in the event of the application for non-forfeiture benefits will be returned to the owner of the policy.

For the purpose of making loans on the policy, it is understood and agreed that the Company will include the present value of the prepaid premiums as a part of the loan, cash surrender, and reserve value of this policy.

Any indebtedness applicable to this Agreement will be deducted in any settlement due the beneficiary or the owner of the policy.

The Loan Agreement form had been executed by Golsen on December 28, 1961, and provided in part as follows:

LOAN AGREEMENT AND
ASSIGNMENT OF POLICY

Pursuant to the provisions of Policy Number * * * issued by WESTERN SECURITY LIFE INSURANCE COMPANY of Oklahoma City, Oklahoma, on the life of Jack E. Golsen (The Insured), in consideration of a loan of Three Hundred Eleven Thousand Thirty Three and 90/100 Dollars ($311,033.90) by said Company, the receipt of which is hereby acknowledged, the undersigned hereby pledges, assigns, and transfers to said Company, its successors and assigns, said Policy and all rights and benefits thereunder, to secure the payment of said loan ***749** and the interest thereon and any other indebtedness to the Company on said Policy.

AUTOMATIC PREMIUM LOAN FOR PREPAYMENT OF PREMIUMS: The insured requests the Company, on each anniversary of the above numbered policy, to advance so much of the net cash value as is available at that time towards the prepayment of the next unpaid annual premium and agrees that any sum so advanced towards prepayment of said premium shall be an additional loan on said policy; provided, however that any sum advanced toward the prepayment of any premium or premiums due one or more years from such anniversary shall be maintained by the Company as deposit for the payment of such premiums when due and the said deposit, or balance thereof, will be credited with interest on each subsequent anniversary at the rate of three percent (3%) per annum, compounded annually.

It Is Hereby Agreed by the Undersigned:

First— That interest shall be paid to said Company in advance at the beginning of each policy year, at the rate of 4% per annum on the amount of said loan, and that said interest, if not paid when due, shall be added to the

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principal and bear interest at the same rate and under the same conditions.

The $311,033.90 ‘loan’ referred to in the foregoing agreement was composed of $50,000, the full first-year loan value of the policies, plus $261,033.90 purportedly borrowed by Golsen from Western, as previously described.

On each subsequent year thereafter until the time of the trial herein, Golsen purported to borrow the entire amount of the annual increase in the cash value of the insurance policies as soon as it became available for borrowing each year. Thus at no time did any of the policies have a cash surrender value. The purported annual borrowing took the form of ‘loans' to prepay the annual insurance premiums in accordance with the Loan Agreement and a ‘loan’ of the remaining cash value directly to Golsen. A schedule of the approximate total cash values and ‘loans' on the policies over the policies' first 20 years is set out below:

Year.............	Cash value	Increase in cash value from preceding year	“Borrowing” used to pay discounted premium	Remaining cash value available for payment of “interest”
(1)................	(2)	(3)	(4)	(5)
1...................	$50,000	$50,000	$50,000.00	0
2...................	116,940	66,940	60,577.90	$6,362.10
3...................	185,440	68,500	60,577.90	7,922.10
4...................	255,500	70,060	60,577.90	9,482.10
5...................	327,130	71,630	60,577.90	11,052.10
6...................	400,350	73,220	60,577.90	12,642.10
7...................	475,140	74,790	60,577.90	14,212.10
8...................	551,500	76,360	60,577.90	15,782.10
9...................	629,420	77,920	60,577.90	17,342.10
10.................	708,880	79,460	60,577.90	18,882.10
11.................	789,860	80,980	60,577.90	20,402.10
12.................	872,330	82,470	60,577.90	21,892.10
13.................	956,250	83,920	60,577.90	23,342.10

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14..................	1,041,590	85,340	60,577.90	24,762.10
15..................	1,128,270	86,680	60,577.90	26,102.10
16..................	1,216,250	87,980	60,577.90	27,402.10
17..................	1,305,430	89,180	62,391.50	26,788.50
18..................	1,395,730	90,300	64,266.40	26,033.60
19..................	1,487,060	91,330	67,196.00	24,134.00
20..................	1,579,280	92,220	68,180.00	24,040.00

***750** Each year, Golsen purported to borrow from Western the amounts listed in cols. (4) and (5), which represented the annual increase in the cash value of the policies (col. (3)). At the same time, Golsen purported to pay to Western 4-percent interest on the aggregate 'cash value' of the policies (all of which he had 'borrowed') and 4-percent interest on the purported loan of $261,033.90 (the 'prepaid premium fund').

The following table reflects the approximate amounts of Golsen's annual 'interest' payments, Western's annual 'loans' to Golsen, and Golsen's resulting out-of-pocket expenses (the difference between the first two amounts) as they were incurred and as they were anticipated under the 'executive special' plan:

Year...............	"Interest" payments	"Loans" to Golsen after "borrowing" to prepay premium	Out-of-pocket expenses
1....................	$12,441.40	....	[1] $23,019.40
2....................	15,119.00	$6,362.10	8,756.90
3....................	17,859.00	7,922.10	9,936.90
4....................	20,661.40	9,482.10	11,179.30
5....................	23,526.60	11,052.10	12,474.50
6....................	26,455.40	12,642.10	13,813.30
7....................	29,447.00	14,212.10	15,234.90
8....................	32,501.40	15,782.10	16,719.30

9..................	35,618.20	17,342.10	18,276.10
10..................	38,796.60	18,882.10	19,914.50
11..................	42,035.80	20,402.10	21,633.70
12..................	45,334.60	21,892.10	23,442.50
13..................	48,691.40	23,342.10	25,349.30
14..................	52,105.00	24,762.10	27,342.90
15..................	55,572.20	26,102.10	29,470.10
16..................	59,091.40	27,402.10	31,689.30
17..................	60,162.90	26,788.50	33,374.40
18..................	61,204.20	26,033.60	35,170.60
19..................	62,209.60	24,134.00	38,075.60
20..................	63,171.20	24,040.00	39,131.20

Thus, prior to 1966 (year No. 5 in the above table) Golsen received a letter from Western which declared in part:

DECEMBER 10, 1965.

JACK E. GOLSEN

726 W. Sheridan Street

Oklahoma City, Oklahoma

DEAR MR. GOLSEN:

Enclosed is the premium due notices on your policies.

If you wish you may forward your check for the interest due and we will send our check to you so that you actually pay only the net amount due. This would give you a cancelled check for the total amount of interest paid for your income tax files.

Listed below is the amount of the checks which should be exchanged

Your Check	Our Check	Net amount as shown
#12560 thru 79	Jack E. Golsen	on premium notice
$23,526.56	$11,052.96	$12,473.60

The amount of $23,526.56, denominated ‘Your Check,‘ represented the purported interest payments on the $327,130 ‘cash value’ ‘borrowed’ and on the so-called prepaid premium fund. The amount ***751** of $11,052.96, denominated ‘Our Check’ was the approximate[5] difference between the increase in the policies' cash surrender value ($71,630) and the portion of that amount which was purportedly used to prepay the insurance premium ($60,577.90). The amount of $12,473.60 is the difference between $23,526.56 and $11,052.96, and represented the net price which Golsen paid to Western.

Western did not record the 'prepayments' on its books as the actual payment of premiums for future years; rather, it treated the 'prepayments' as a deposit or 'fund' in favor of Golsen, against which (as augmented by interest at 3 percent) it annually charged the future premiums in the amount of $68,180 a year. For the purpose of reporting its income for financial and tax accounting each year Western reported the amount of $68,180 as premium income attributable to the policies here involved; reported the alleged interest in the amount of 4 percent of the cash value borrowed and 4 percent of the prepaid premium fund as interest income; and reported the difference between the 'annual premium' as reflected in the policy and the discounted premium of $60,577.90 as interest expense.

Since the 'executive special' plan contemplated systematic borrowing of each policy's entire cash value, the policies effectively had no cash value and accordingly were comparable to renewable term insurance policies. The so-called annual premium on the 'executive special' policies was set at an artificially high level so as to create an abnormally high cash value in order to facilitate or make possible the purported lending transaction, and Golsen's annual out-of-pocket expense or net cash flow (i.e., the payments denominated as interest, as reduced by the cash that was returned by the insurance company) is merely the amount that was actuarially required to pay for or support the insurance benefits available under the policies when stripped of their cash surrender values. Such 'interest' payments in fact represent the cost to the insured of the insurance benefits provided by the 'executive special' policies under the prearranged plan and do not represent payment for the use of borrowed funds.

Golsen's 'loans' were secured solely by the policies themselves and the so-called premium prepayment fund, without any personal liability on his part; the 'loans' could be canceled at any time without any cash payment, merely by appropriate offsetting book entries, and the full amount of the so-called premium prepayment fund was in fact thus 'charged off' on Western's books on January 26, 1967, accompanied by a corresponding entry reducing Golsen's 'indebtedness' by the amount allocable to such 'fund.'

***752** On their joint Federal income tax return for the calendar year 1962, the Golsens claimed a deduction for 'interest' paid to Western in the amount of $12,441.40. In his notice of deficiency the Commissioner disallowed the deduction.

OPINION

RAUM, Judge:

This case involves an ingenious device which, if successful, would result in petitioner's purchase of a substantial amount of life insurance for the protection of his family at little or no aftertax cost to himself, or possibly even with a net profit in some years. The device is based on an unusual type of insurance policy that appears to have been specially designed for this purpose in which the rates were set at an artificially high level with correspondingly high cash surrender and loan values to begin immediately during the very first year of the life of the policy. The plan contemplated the purchase of a large amount of such insurance, the 'payment' of the first year's premium, the simultaneous 'prepayment' of the next 4 years' premiums discounted at the annual rate of 3 percent, the immediate 'borrowing' of the first year's cash value at 4 percent 'interest,' and the immediate 'borrowing' back of the full reserve value generated by the 'prepayment,' also at 4-percent 'interest.' Each year thereafter, the plan called for the 'borrowing' of the annual increase in the loan or cash value of the policy at 4-percent 'interest'; such increase, as a result of the artificially high premium, was more than sufficient to 'prepay' the discounted amount of the premium which would become due 4 years thereafter. The net result of these complicated maneuvers would be that the insured's net out-of-pocket (pretax) expenditures each year would be equal to the true actuarial cost of the insurance benefits that he was purchasing (i.e., net death benefits in substantial amounts even after the policies had been stripped of their cash surrender values)— although, in form, he appeared to be paying large amounts of 'interest.' At the heart of the device is the deduction allowed in section 163(a) of the 1954 Code with respect to 'interest paid * * * on indebtedness.' And if the device were successful, the deduction would reduce the aftertax cost of the insurance either to a small amount, or nothing at all, or there might even be a net profit, depending upon the tax bracket of the owner of the policy. Apart from a portion of the amount paid the first year as 'premiums' or 'advance premiums,' the remaining cash actually paid that year, and all other actual cash payments made by the insured throughout the life of the policy would be characterized as 'interest.'

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The Government contends that the 'loan' features of such insurance contracts are devoid of economic substance, that taking these features as part of an integrated plan, no true 'indebtedness' was created nor ***753** was any bona fide 'interest paid (regardless of whether any such feature might otherwise qualify under the statute if considered individually in isolation from the companion features), [6] that the substance of the transaction was that the 'interest' merely reflected the annual price which the insured paid for life insurance protection, and that such payment is nothing more than a nondeductible personal expense.

The nature of the problem is one that the Court is obviously ill-equipped to handle without expert actuarial assistance, and it was fortunate in this case to have the benefit of the testimony of an actuary who appeared to us to be highly qualified, and who presented a clear and convincing analysis of the transaction before us. That testimony established to our satisfaction that the receipt and prepayment agreement and the loan agreement and assignment of policy had no essential relationship whatever to the insurance benefits provided under the insurance contracts, that when, in accordance with the prearranged plan, the policy was stripped of its artificially high cash surrender values, such policy was merely the equivalent of renewable term insurance, and that actuarially the net cash which the insured in fact paid to the insurance company, however described, merely represented the true cost of the insurance purchased. In the latter connection, the actuary testified as follows:

The payments that are denominated as interest, when reduced by the cash that was returned from the insurance company, are the amounts that are left to support the insurance. In other words, they are the cost to the insured for which, in return, he gets the death benefit protection promised by the insurance company.

We are satisfied as to the soundness of this testimony and accept it as true. The purported loans herein were utterly devoid of economic substance and were simply the means whereby the true cost of the insurance— i.e., the true premiums in respect of the insurance really purchased — was reflected in the purported 'interest' allegedly 'paid' on such 'loans.' The 'interest' was thus not in fact compensation paid for the use of borrowed funds, the essential prerequisite for the deduction. See Old Colony R. Co. v. Commissioner, 284 U.S. 552, 560; Deputy v. DuPont, 308 U.S. 448, 497-498. As a consequence, if substance ***754** rather than form were to govern the result herein, we would conclude that the 'interest' deduction here claimed is not allowable. [7]

It has repeatedly been held that the substance of a transaction rather than the form in which it is cast is determinative of tax consequences unless it appears from an examination of the statute and its purpose that form was intended to govern. The following represent merely a random selection from a wide variety of such cases that are too numerous for comprehensive listing: Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 265-267; Commission v. Court Holding Co., 324 U.S. 331, 334; Griffiths v. Helvering, 308 U.S. 355; Higgins v. Smith, 308 U.S. 473; Minnesota Tea Co. v. Helvering, 302 U.S. 609; Gregory v. Helvering, 293 U.S. 465; Weller v. Commissioner, 270 F.2d 294 (C.A. 3), affirming 31 T.C. 33 and W. Stuart Emmons, 31 T.C. 26; William R. Lovett, 37 T.C. 317. The thought was forcefully expressed in the now familiar language of Minnesota Tea Co. v. Helvering, 302 U.S.at 613, as follows: 'A given result at the end of a straight path is not made a different result because reached by following a devious path.' In terms of the present case, 'the given result at the end of (the) straight path' was the payment of the cost for insurance protection, and 'the different result by following a devious path' was reflected in the attempt to make such payments appear to be interest through the involved 'loan' transactions.

Insurance and annuity policies are peculiarly susceptible of manipulation so as to create illusion, and, in applying the substance-versus-form doctrine in such instances courts have at times referred to the transactions under review as 'shams,' or have characterized them as lacking in 'business purpose,' cf. Knetsch v. United States, 364 U.S. 361. Petitioners have seized upon such language, urging upon us that Golsen's transaction was not a 'sham,' that he was seriously buying ***755** life insurance for the protection of his family, and that there was thus no absence of 'business purpose.' The difficulty with that position is that, granted that there was a legitimate reason for the underlying acquisition of life insurance, there does not appear to be any such reason for the otherwise wholly meaningless superstructure of 'loans' erected on that base. The point was articulated with telling clarity in Ballagh v. United States, 331 F.2d 874 (Ct. Cl.), certiorari denied 379 U.S. 887, where the Court of Claims stated (p. 878): plaintiff is wide of the mark in supposing that his primary purpose of providing retirement income can make valid what would otherwise be a sham. For the transaction

which we find to be a sham is not the initial insurance contract but the prepayment of all of the premiums and the loan agreement. We do not question that plaintiff's motive in buying the policy was a legitimate one. However, the subsequent prepayment of all premiums by borrowing from the insurance company itself was not necessary in so providing retirement income, and we find that such loan transaction did 'not appreciably affect his beneficial interest except to reduce his tax.'

See also Minchin v. Commissioner, 335 F.2d 30, 32 (C.A. 2).

Petitioners claim to find support for their position in this case by reason of the fact that Golsen's policies were issued in 1961 or early 1962. They rely upon section 264(a)(3) which was added to the 1954 Code in 1964 [8] and which provides as follows:

SEC. 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

(a) GENERAL RULE— NO deduction shall be allowed for—

(3) Except as provided in subsection (c), any amount paid or accrued on indebtedness incurred or continued to purchase a carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase all of the increases in the cash value of such contract (either from the insurer or otherwise).

* * * Paragraph (3) shall apply only in respect of contracts purchased after August 6, 1963.

The point is defective. Of course, section 264(a)(3) does not prohibit the deduction in respect of policies purchased before August 6, 1963, and there was no specific prohibition prior thereto in the Internal Revenue Code against such deduction. [9] But petitioners' right to the claimed deduction is based upon section 163, not section 264. The latter simply denies, or disallows, or prohibits deductions that might otherwise ***756** be allowable under some other provision of the statute. It does not confer the right to any deduction, [10] and the August 6, 1963, date represents merely the starting point for the operative effect of the specific disallowance provisions of section 264(a)(3). A closely parallel situation was considered in Knetsch v. United States, 364 U.S. at 367, where the Supreme Court held that a similar provision relating to deductions denied under section 264(a)(2) did not confer a right to deduction in respect of contracts purchased prior to the stated operative date of those provisions. [11] If the deduction sought by petitioners did not come within the provisions of section 163 prior to the 1964 amendment to the Code, nothing in that amendment retroactively created any such right. Cf. W. Lee McLane, Jr., 46 T.C. 140, affirmed 377 F.2d 557 (C.A. 9), certiorari denied 389 U.S. 1038.

The precise question relating to the deductibility of 'interest' like that involved herein has been adjudicated by two Courts of Appeals. In one case, Campbell v. Cen-Tex., Inc., 377 F.2d 688 (C.A. 5), decision went for the taxpayer; [12] in the other, Goldman v. United States, 403 F.2d 776 (C.A. 10), affirming 273 F.Supp. 137 (W.D. Okla.), the Government prevailed. Goldman involved the same insurance company, the same type of policies, and the same financial arrangements as are before us in the present case. Cen-Tex involved a different insurance company but dealt with comparable financing arrangements. Despite some rather feeble attempts on the part of each side herein to distinguish the case adverse to it, we think that both cases are in point. It is our view that the Government's position is correct.

Moreover, we think that we are in any event bound by Goldman since it was decided by the Court of Appeals for the same circuit within which the present case arises. In thus concluding that we must follow Goldman, we recognize the contrary thrust of the oft-criticized ***757** [13] case of Arthur L. Lawrence, 27 T.C. 713. Notwithstanding a number of the considerations which originally led us to that decision, it is our best judgment that better judicial administration. [14] requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone. [15]

Section 7482(a), I.R.C. 1954, [16] charges the Courts of Appeals with the primary responsibility for review of our decisions, and we think that where the Court of Appeals to which appeal lies has already passed upon the issue before us, efficient and harmonious judicial administration calls for us to follow the decision of that court. Moreover, the practice we are adopting does not jeopardize the Federal interest in uniform application of the internal revenue laws which we emphasized in Lawrence. We shall remain able

to foster uniformity by giving effect to our own views in cases appealable to courts whose views have not yet been expressed, and, even where the relevant Court of Appeals has already made its views known, by explaining why we agree or disagree with the precedent that we feel constrained to follow. See Note, 57 Colum.L.Rev.,supra at 723.

To the extent that Lawrence is inconsistent with the views expressed ***758** herein it is hereby overruled. We note, however, that some of our decisions, because they involve two or more taxpayers, may be appealable to more than one circuit. This case presents no such problem, and accordingly we need not decide now what course to take in the event that we are faced with it.

In view of the conclusion reached above we find it unnecessary to consider the Government's alternative contention that the claimed deduction is in any event forbidden by section 264(a)(2).

Reviewed by the Court.

Decision will be entered for the respondent.

WITHEY, J., dissenting: While I agree with the conclusion of the Court on the merits of this case, I dissent on the reversal of this Court's position on Arthur L. Lawrence, 27 T.C. 713, by the majority.

All Citations

54 T.C. 742

Footnotes

1 At about the same time some of the corporations in which Golsen had an interest purchased similar policies on his life in the aggregate amount of $1 million. Since the application referred to above sought insurance in the total amount of $2 million, the policies purchased by the corporations may have related in some manner to that application. However, such policies are not involved in this case.

1 Loan value is available at any time during the policy year stated if premium is paid to end of such year.

2 In order to avoid any characterization as to the genuineness of such borrowing, the parties have used the term ‘allegedly borrowed’ in their stipulation of facts. A similar procedure is adopted in these findings; the word ‘borrow’ and like terms are enclosed in quotation marks simply to describe the events which occurred without drawing any conclusion at this point as to the existence of any bona fide debt, etc.

3 The ‘52% Tax Cr.‘ in the schedule apparently contemplated the purchase of insurance on Golsen's life by a corporation with income taxable at a 52-percent rate.

4 One year's interest at 3 percent on the $253,431.90 ‘prepayment’ is $7,602.96, and such ‘prepayment’ plus such interest are substantially equal (within a difference of less than $1) to the $261,033.90 ‘borrowed’ by Golsen. Since Golsen's obligation in respect of his ‘loan’ from Western was to pay annual ‘interest’ in advance at 4 percent, and since Western's obligation in respect of interest on the ‘prepaid’ premiums was only 3 percent, its ‘loan’ of the entire $253,431.90 ‘prepayment’ plus 1 year's advance interest thereon to Golsen was entirely riskless from its point of view. Golsen, in substance, merely ‘borrowed’ back simultaneously the entire ‘prepayment’ plus 1 year's interest.

1 Includes $10,578 premium payment made in year (1).

5 The discrepancy between the figure in the letter ($11,052.96) and the actual difference ($11,052.10) is unexplained.

6 Compare Gordon MacRae, 34 T.C. 20, 27, affirmed and remanded 294 F.2d 56 (C.A. 9), certiorari denied 368 U.S. 955: ‘The steps taken, each in itself a legitimate commercial operation, were here each mirror images, and add up to zero. The various purchases and sales, each real without the other, neutralize one another and fairly shout to the world the essential nullity of what was done. No purchase and no sale is essentially identical with what was done here, i.e., identical and virtually simultaneous purchases and sales. The choice of the more complicated and involved method of doing nothing had no purpose, save the erection of the facade upon which petitioners now seek to rely.’

7 Moreover, even apart from the essential character of the transaction as reflecting the payment of premiums rather than interest, the payments under consideration do not in fact appear to represent compensation for the use of borrowed funds. Thus in 1962 Golsen purported simultaneously to pay premiums on each of his policies and then ‘borrow’ back nearly the entire amount which he had just paid out. At the same time, he also purported to pay ‘interest’ on the funds which he had just ‘borrowed.’ The net result of the transaction was that Golsen paid ‘interest’ (at the rate of 4 percent)to Western in order to obtain the use of funds which were originally his and which he had transferred to Western (where they would ‘earn’ 3 percent) for the very purpose of borrowing back— a transaction that was utterly lacking in economic substance.

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It is, of course, not unheard of for the owner of a policy to borrow the current cash value; one of the advantages of such a policy is that it provides a ready source of funds in the event of a need for cash for any purpose. But it is plain that from the outset Golsen intended to 'borrow back' funds immediately after 'paying' them over to Western. Unlike a lender, Western did not give up the use of funds from which it would have otherwise derived benefit. Unlike a borrower, Golsen did not obtain the use of funds which he would not otherwise have enjoyed.

8 See sec. 215, Revenue Act of 1964.

9 See H. Rept. No. 749, 88th Cong., 1st Sess., pp. 61, 62; S. Rept. No. 830, 88th Cong., 2d Sess., pp. 77-79.

10 See Weller v. Commissioner, 270 F.2d 294, 298 (C.A. 3), where the Court of Appeals said:
'Section 24(a) (predecessor sec. 264) applies to specific items that are not deductible. The section does not even purport to indicate what items are deductible and, therefore, legislative history indicating that annuity contracts were specifically not included therein fails to conclude the issue. Regardless of Section 24(a)(6), the taxpayers' payments must still qualify as interest under Section 23(b) (predecessor sec. 163) to be deductible.' See also dissent of Wisdom, J., in United States v. Bond, 258 F.2d 577, 584 (C.A. 5), which was cited with apparent approval by the Supreme Court in Knetsch v. United States, 364 U.S. 361, 366 fn. 4.

11 The committee reports with respect to those provisions, which the Supreme Court found not to be controlling in Knetsch, 364 U.S.at 369 fn. 7, bear a close resemblance to the committee reports relied upon by petitioners herein, fn. 9 supra.

12 The same result was reached in two District Court cases. Priester Machinery Co. v. United States, 296 F.Supp. 604 (W.D. Tenn.); Wanvig v. United States, 295 F.Supp. 882 (E.D. Wis.), affirmed on another issue 423 F.2d 769 (C.A. 7, 1970).

13 Norvel Jeff Mclellan, 51 T.C. 462, 465-467 (concurring opinion); Automobile Club of New York, Inc., 32 T.C. 906, 923-926 (dissenting opinion), affirmed 304 F.2d 781 (C.A. 2); Robert M. Dann, 30 T.C. 499, 510 (dissenting opinion); Del Cotto, 'The Need for a Court of Tax Appeals: An argument and a Study,' 12 Buffalo L.Rev. 5, 8-10 (1962); Vom Baur & Coburn, 'Tax Court Wrong in Denying Taxpayer the Rule Laid Down in His Circuit,' 8 J.Taxation 228 (1958); Orkin, 'The Finality of the Court of Appeals Decisions in the Tax Court: A Dichotomy of Opinion,' 43 A.B.A.J. 945 (1957); Note, 'Heresy in the Hierarchy: Tax Court Rejection of Court of Appeals Precedents,' 57 Colum.L.Rev. 717 (1957); Note, 'Controversy Between the Tax Court and Courts of Appeals: Is the Tax Court Bound by the Precedent of Its Reviewing Court?' 7 Duke L.J. 45 (1957); Note, 'The Tax Court, the Courts of Appeals, and Pyramiding Judicial Review,' 9 Stan.L.Rev. 827 (1957); Case note, 70 Harv.L.Rev. 1313 (1957). See also Sullivan v. Commissioner, 241 F.2d 46 (C.A. 7), affirmed 356 U.S. 27; Stern v. Commissioner, 242 F.2d 322 (C.A. 6), affirmed 357 U.S. 39; Stacey Mfg. Co. v. Commissioner, 237 F.2d 605 (C.A. 6).

14 The importance of the Lawrence doctrine in respect of the functioning of this Court has been grossly exaggerated by some of the critics of that decision. That case was decided Jan. 25, 1957, and this is the first time during the intervening period of somewhat in excess of 13 years that the Court has ever deemed it appropriate to face the question whether or not to apply the Lawrence doctrine.

15 Sec. 7482(b)(2), I.R.C. 1954, grants venue in any Court of Appeals designated by both the Government and the taxpayer by written stipulation. However, if the Court of Appeals to which an appeal would otherwise lie has already passed upon the question in issue, it is hardly likely that the party prevailing before the Tax Court would join in such a stipulation.

16 SEC. 7482. COURTS OF REVIEW.
(a) JURISDICTION.— THE United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of Title 28 of the United States Code.

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