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Taxation

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TAXATION

I. INCOME TAX

A. *Definition of a Life Insurance Company*

In *Superior Life Insurance Co. v. United States*[1] the main issue before the court was whether Superior Life Insurance Co. constituted a life insurance company as defined in Section 801 of the Internal Revenue Code of 1954.[2] Superior paid its income taxes as a life insurance company from 1960 to 1964. In 1968 the Internal Revenue Service demanded and received from Superior income tax deficiencies for the period from 1960 to 1964. If Superior qualified as a life insurance company under Section 801, the demand by the Internal Revenue would be unfounded and Superior would be allowed recovery.

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1. 322 F. Supp. 921 (D.S.C. 1971).
2. INT. REV. CODE of 1954, § 801 provides in part

(a) LIFE INSURANCE COMPANY DEFINED.

[T]he term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if—

1) its life insurance reserves (as defined in sub-section (b)), plus

2) unearned premiums, and unpaid losses (whether or not ascertained), or non cancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 per cent of its total reserves (as defined in subsection (c)).

(b) LIFE INSURANCE RESERVES DEFINED.

1) IN GENERAL

. . . [L]ife insurance reserves mean amounts

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(c) TOTAL RESERVES DEFINED.

. . . [T]he term total reserve means—

1) life insurance reserves

2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, . . .

Superior was engaged in the business of issuing credit life, health, and accident insurance. Superior was a subsidiary of Stephenson Finance Co. The majority of Superior's insurance policies were sold through Stephenson. The mechanics of the sale of insurance through Stephenson was clearly described in the court's opinion:

> When an individual borrowed money from Stephenson, he was offered the opportunity, by the Stephenson employee making the loan, to obtain coverage under the Group Policy. If the borrower desired to obtain coverage under the Group Policy, the amount of the loan from Stephenson to the borrower was increased by an amount sufficient to pay, for the entire term of the policy, (i) the life insurance premium and (ii) the accident and health insurance premiums. The amount of the insurance premiums was treated as part of the loan and the principal amount of the note of the borrower to Stephenson included this amount as principal, with interest being charged thereon. The proceeds of the loan which the borrower received, did not, however, include any portion of the insurance premiums, but rather the entire amount of the insurance premiums was withheld by Stephenson from the proceeds of the loan and retained by it as a reserve for premiums to become due with respect to the Certificate of Insurance so issued. The amount retained by Stephenson was carried on the books of Stephenson as a liability entitled "Reserve for A & H Premiums." The amount so withheld is referred to hereinafter as the "liability account."[3]

On the first day of the month immediately following the month in which a Certificate of Insurance was issued, Stephenson paid to Superior (1) the life insurance premium for the entire term and (2) the first monthly payment on the health and accident coverage. Superior maintained reserves on all policies issued. Mortality reserves on the life policies were maintained in accordance with the "Commissioner's 1941 Standard Ordinary Table of Mortality". Gross unearned premium reserves were maintained on the health and accident coverage. No reserves were maintained on the Stephenson held health and accident premiums to become due.

The I.R.S. contended that Superior did not qualify as a life insurance company on the basis that the reserves carried on Stephenson's books were, in fact, an unearned premium reserve of Superior. The I.R.S. also contended that the unearned premium reserves carried by Superior, together with the "liability account" carried by Stephenson

3. 322 F. Supp. at 925.

did not constitute life insurance reserves so that Superior's life insurance reserves did not equal more than fifty per cent of its total insurance reserves as required by Section 801.[4] The government made three arguments in support of its contention that the reserves carried on Stephenson's books should have been reported by Superior: (1) the arrangement between Stephenson and Superior was made to avoid taxes and therefore should not be given effect for tax purposes; (2) Superior was deemed to have received the accident and health premiums under the doctrine of "constructive receipt;" (3) the "liability account" was properly allocable from Stephenson to Superior under Section 482.[5]

As to the government's first argument the court reasoned that a "[d]esire by Superior to reduce or avoid federal income taxes in the normal conduct of its business, the issuance and sale of credit insurance, would be not merely a legitimate consideration, *but rather a mandatory one if good business practice were to be followed.*"[6] The court dismissed the government's contention of constructive receipt of the "liability account" on the basis that Superior had no right to withdraw funds for payment of the premium until the due date.[7] The court refused to apply Section 482 (to allocate the "liability account" from Stephenson to Superior) because the Group Policy

> [W]as an arm's length business arrangement, was authorized by the statutes of South Carolina,[8] was approved by the South Carolina Insurance Department, and was the result of the natural conflict of interest existing between Superior and Stephenson, relative to the payment and receipt of the insurance premium.[9]

Having dismissed each of the government's arguments which supported the contention that the "liability account" carried by Stephenson should have been reported by Superior, the court held that Superior qualified as a life insurance company under Section 801 and was therefore entitled to relief. Although the court felt that this determination

4. INT. REV. CODE of 1954, § 801(a).

5. INT. REV. CODE of 1954, § 482 provides for the allocation of income and deduction among two or more organizations which are owned or controlled by the same interest when the allocation is necessary to prevent the evasion of taxes.

6. 322 F. Supp. at 929 (emphasis added).

7. Treas. Reg. § 1.451-2 (1960) provides that the power to withdraw funds upon demand is necessary for the doctrine of "constructive receipt" to operate.

8. S.C. CODE ANN. § 37-305 (1962).

9. 322 F. Supp. at 932.

was sufficient to grant Superior relief, they proceeded to discuss the issue of whether the "liability account" constituted an unearned premium reserve or an advance premium, and the issue of whether all of Superior's reserves qualified as life insurance reserves on the basis that they were maintained as life insurance reserves combined with health and accident insurance.[11]

The court indicated that the liability account would constitute an unearned premium if reportable by Superior. If the account was an unearned premium it would be considered part of the total insurance reserves for the purpose of qualifying Superior as a life insurance company under Section 801. Therefore, had the court held the "liability account" to be reportable by Superior, Superior's life insurance reserves would have constituted less than 50% of the total insurance reserves. However, the court also indicated that since the life insurance reserves of Superior were substantial and the life insurance policies were combined with health and accident, all the insurance reserves of Superior constituted life insurance reserves. It would seem, therefore, that even if the "liability account" of Stephenson was reportable by Superior, Superior may have still qualified as a life insurance company under Section 801.

B. Loan Company Deduction for Loss Reserves

In *Peoples Federal Savings and Loan Association v. United States*[12] the plaintiff-taxpayer brought an action to recover income taxes pursuant to Section 593 of the Internal Revenue Code of 1954.[13] The 1962 amendment to Section 593 required the taxpayer, in order to qualify for a deduction, to "establish and maintain a reserve for losses on qualifying real property loans, a reserve for losses on non

10. The court cited Revenue Ruling 69-270, the Internal Revenue Service, in distinguishing an unearned premium from an advance premium:

> Unearned premiums, as defined in section 1.801-3(e) of the Regulations are these amounts that cover the cost of carrying the insurance risk proportionate to the unexpired period of the policy term, the coverage of which began on a premium due date that is already past. *On the other hand advance premiums are amounts that have been received but are not yet due.* (Emphasis added).

322 F. Supp. at 933.

11. INT. REV. CODE of 1954, § 801(a).

12. 320 F. Supp. 179 (D.S.C. 1970).

13. INT. REV. CODE of 1954, § 593(a) provides for tax deductions for losses on loans to "any mutual savings bank not having capital stock represented by shares. . . ."

qualifying loans, and a supplemental reserve for losses on loans."[14] The approved method for complying with this amendment was to record the reserves on a general ledger and on a subsidiary ledger. The plaintiff had followed this procedure in all the years prior to 1965, recording the reserve account on the general and subsidiary ledgers on March 15 of each year when the income tax return was filed. In 1966, however, the plaintiff failed to make entries of the reserves on the subsidiary ledger until August 4. There was evidence of the reserves as the plaintiff had computed the deductions on its tax return and had entered the loss reserves on its general ledger on March 15 of that year.

The issue in *Peoples Federal* was whether the plaintiff should have been denied a deduction because of the delay in recording the reserves on the subsidiary ledger. According to Regulation 1.593-5(b), the reserve account must be recorded on the subsidiary ledger "by the close of the taxable year or as soon as practicable thereafter."[15] The I.R.S. contended that under this regulation the plaintiff was required to post its claimed reserves in the subsidiary ledger not later than the date on which it filed its tax return for that year. The defendant cited *Rio Grande Building and Loan Association v. Commissioner*[16] in support of its contention. In the *Rio Grande* case the Tax Court construed Regulation 1.593-5(b) to mean that "generally the limit should be not later than the time at which the taxpayer files its income tax return for the year involved."[17] The court in *Peoples Federal* distinguished the *Rio Grande Case* in that the taxpayer in *Rio Grande* did not "*either in its tax return* or on its ledger, evidence its reserve accounts for any of the years in question."[18]

The plaintiff contended that the Regulation contained no fixed time since it used the flexible phrase "as soon as practical." The court approved this reasoning and held that the plaintiff was entitled to the deduction and that the assessment made because of the delay in plaintiff's bookkeeping was improper. Although the actual holding of the court was that there was no fixed time for recording the loss reserve on the subsidiary ledger, the main considerations which influenced the court in its decision were the special circumstances involved. It was

14. INT. REV. CODE of 1954, § 593(c)(1).
15. Treas. Reg. § 1.593-5(b) (1964).
16. 36 T.C. 657 (1961).
17. 36 T.C. at 664.
18. 320 F. Supp. at 182.

very likely that the delay was a result of the physicial illness of plaintiff's accountant. Also, the loss reserves *had been* computed on the plaintiff's tax return and recorded on the general ledger.

C. *Nonprofit Organization Exemption*

In *Elmwood Cemetery Association v. South Carolina Tax Commission*,[19] the Tax Commission made an assessment against the Elmwood Cemetery Association for income taxes allegedly due for the years 1949 through 1963. Elmwood paid the tax under protest for the year 1949 and brought an action to recover that payment on the basis that it was "[a] non-profit cemetery corporation without capital stock, no part of the net earnings of which inures to the benefit of any private stockholder or individual"[20] and therefore was exempt from payment of income taxes under Section 65-226(3) of the 1962 Code of Laws.[21] Elmwood also sought a declaratory judgment relieving it from payment of taxes assessed for the years following 1949.

The court held that Elmwood could elect to pay under protest the tax for one or more of the years and bring an action to recover the taxes so paid, but could recover only the tax that had been paid under protest. The court refused to grant a declaratory judgment for the assessed taxes that had not been paid. Therefore, in order to be relieved from paying taxes for the period from 1950 through 1963, Elmwood would first have to pay under protest the taxes assessed for that period and then bring an action to recover the taxes so paid.

The South Carolina Supreme Court explained its holding in *Elmwood* in *Perpetual Building & Loan Association v. South Carolina Tax Commission*[22] where the court held that although a taxpayer may elect to pay under protest the tax assessed for one year of a period of years, he may not pay a portion of the tax for one year. For an action to be brought under §§ 65-2661[23] and 65-2662[24] taxes assessed must be paid under protest for at least one full year.

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19. 179 S.E.2d 609 (S.C. 1971).
20. *Id.* at 611.
21. S.C. CODE ANN. § 65-226(3) (1962) exempts eleomosynary corporations from payment of income taxes.
22. *Smith's Adv. Sht.* No. 19190 (S.C., Mar. 24, 1971).
23. S.C. CODE ANN. § 65-2661 (1962).
24. S.C. CODE ANN. § 65-2662 (1962).

II. CONSTITUTIONALITY OF STATUTES

A. Special Student Fee to Pay for Football Stadium

In *Moye v. Board of Trustees*[25] an action was brought by a resident student of the University of South Carolina and his father, a resident and taxpayer of South Carolina, on their own behalf and on behalf of all others similarly situated, asking the court to declare unconstitutional a 1970 Act[26] which authorized the issuance of five million dollars of Special Obligation Bonds for improving the University of South Carolina football stadium. Payment of principal and interest on the bonds was to be made through a "special student fee" imposed upon students of the university.

The plaintiffs' main argument was that the act was unconstitutional in that the "special student fee" constituted a tax which violated Article X, Section 1 of the South Carolina Constitution, which provides for a uniform and equal rate of taxation.

The circuit court reasoned that the special student fee did not come under the definition of a tax, "an obligation for support of the government as a whole, a contribution to the public treasury out of which are paid all general expenses of government."[27] Although the supreme court did not agree with this definition, it affirmed the holding of the circuit court on the basis that the imposition of the student fee came under the statutory authority[28] of the Board of Trustees. The student was not being taxed, but was simply paying a fee which was lawfully required of him for the privilege of attending the university.

B. Exemption for South Carolina Public Service Authority

In *Morgan v. Watts*[29] the plaintiff taxpayer challenged the constitutionality of Act No. 432 of 1969, Section 18,[30] on the basis that it

25. 177 S.E.2d 137 (S.C. 1970).
26. 566 S.C. STATS. AT LARGE 2724 (1970).
"An Act To Empower The Trustees Of The University of Carolina To Issue Special Obligation Bonds To Pay For The Cost Of Enlarging And Improving Carolina Stadium; To Prescribe The Conditions Under Which Such Bonds May Be Issued And To Make Provision For The Payment Thereof."
27. 177 S.E.2d at 138.
28. S.C. CODE ANN. § 22-104 (1962).
29. 178 S.E.2d 147 (S.C. 1970).
30. 56. S.C. STATS. AT LARGE 740 (1969).

undertook to exempt privately owned property from taxation. Section 18 provides that "all property leased to and operated by the South Carolina Public Service Authority for the generation or transmission of electric power shall, for all tax purposes, be considered the property of the Authority."[31]

The property in question consisted of electrical facilities leased to the Authority by Central Electric Power Cooperative, Inc. Although the court recognized that in effect Central was merely a conduit through which the Authority was financing the purchase of the systems, the property was considered leased property for the purpose of deciding the issue.

The plaintiff invoked Article X, Section 1 of the South Carolina Constitution which provides for a uniform and equal rate of assessment and taxation. The court reasoned that the generation and transmission of electric power by the Authority was a public function and held, therefore, that the property leased by the Authority came under the "municipal purposes" exception to the equality requirement of Article X. The court further held that Sections 4[32] and 5[33] of Article X did not prohibit the legislature from creating exemptions not included in those sections. The court also dismissed plaintiff's contention that Section 18 of the 1969 Act was a special law where a general law could be made applicable as prohibited in Article III, Section 34 of the South Carolina Constitution.[34] The court held that the accomplishment of the legislative purpose "by legislation tailored to meet the peculiar needs of this agency is not within the evil of special and local legislation which the framers sought to remedy by Article III, Section 34."[35]

III. ESTATE TAX—MARITAL DEDUCTION

In *Burnett v. United States*[36] the plaintiff-executrix brought an action to recover estate taxes paid, claiming that the gift under her husband's will qualified for a marital deduction as provided in the

31. S.C. CODE ANN. § 59-8 (1962).

32. S.C. CONST. art. 10, § 4 provides for the exemption of various properties.

33. S.C. CONST. art. 10 § 5 provides for exemptions from taxes levied for corporate purposes.

34. S.C. CONST. art. 3, § 34.

35. *Id.*

36. 314 F. Supp. 492 (D.S.C. 1970).

Internal Revenue Code.[37] The district court noted that state law determines the quality and quantity of the surviving spouse's title under a will while federal law determines whether such interest qualifies for a marital deduction.[38] The court applied South Carolina law in its interpretation of the will and held that the plaintiff had been given a life estate without the power to make a gift of the devised property. Without the power to make a gift of the life estate, an allowance of a marital deduction under Section 2056(5) of the Internal Revenue Code could not be granted.

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37. INT. REV. CODE of 1954, § 2056.

38. In presenting this as a settled proposition of law, the court cited Pierpont v. Commissioner, 336 F.2d 227, 281 (4th Cir. 1964), *cert. den.* 380 U.S. 908.