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The *WRNewswire* is created exclusively for AALU Members by insurance experts led ***by Steve Leimberg, Lawrence Brody and Linas Sudzius. WRNewswire #16.01.19*** was written by ***Steve Leimberg,*** co-author with **Howard Zaritsky,** of the treatise Tax Planning With Life Insurance, Publisher of Leimberg Information Services, Inc. (LISI) and Creator of estate and financial planning NumberCruncher Software.

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TOPIC: Section 83, 402(b), and 1035 Taxation of Section 419A(f)(6) Plan Participant

CITES: *O'connor v. Commissioner*, T.C. Memo. 2015-244 (December 16, 2015); *Gluckman v. Commissioner*, T.C. Memo.2012–329, aff'd, 545 F. App'x 59 (2d Cir.2013); *Greene v. Commissioner*, 85 T.C. 1024 (1985); *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. No. 1 (July 13, 2015); Notice 2007-83, 2007-2 C.B. 960.

SUMMARY: Here, the Tax Court decided that an owner-plan participant was taxable under Code Section 402(b)(1) on the net cash or "accumulation" value of a policy either when the employer terminated its participation in a 419A(f)(6) plan or when the ownership of the policy in question was effectively transferred to him by a plan trustee. The court further ruled that the transfer did not qualify for the non-recognition of gain under Code Section 1035 because the required exchange of policies did not occur.

Since there was no evidence that any of the advisers the taxpayers may have consulted were qualified tax advisers familiar with the tax aspects of the transactions at issue in this case, the court further imposed a 20% accuracy-related penalty under Code Section 6662.

RELEVANCE: This case is an example of the many tools that the IRS has to currently tax an employee on the value of a life insurance contract. For instance, the Service will often use the doctrine of constructive receipt under Reg. Sec. 1.451 to assert that an employee should be taxable on a corporate asset when it has been "set apart for him, or otherwise made available." Likewise, the IRS will often apply a combination of Code Sections 61 and 301 which makes distributions to shareholders taxable as constructive dividends.

Here, the IRS premised its case on the fact that O'connor, the owner-employee, was vested in his policy either when:

- the employer terminated its participation in the original plan by submitting its corporate resolution to that effect to the creator of the new plan or

- when a transfer of policy ownership form was provided to O'connor giving him the legal right to transfer the policy to a new owner.

Either of these events trigger taxation of the net cash value of the policy under Code Sections 402(b)(1) and 83.

The case also illustrates that strict compliance is necessary to fall within the non-recognition protection of Code Section 1035(a)(1). There must be an actual or constructive exchange of policies to be able to rely on Section 1035.

This case is further a warning of the danger of tax reporting penalties. Clients must not blindly rely on the representation of promoters or other advisors to avoid reporting penalties, especially where their conclusions are based on statements made by a plan's promoter agent, or insurance carrier. Reliance on information provided by such parties will not protect the taxpayer from reporting penalties. So beware: Reliance will not be considered reasonable if the adviser suffers from "a conflict of interest that the taxpayer knew of or should have known about." The taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith.

Reasonable cause sufficient to avoid an accuracy-related penalty exists only when a taxpayer (1) selects a competent tax adviser, and (2) supplies the adviser with all relevant information and, (3) in a manner consistent with ordinary business care and prudence, relies and acts on the adviser's professional judgment as to the taxpayer's tax obligations.

Finally, this case re-emphasizes the importance of seeking and taking competent and *independent* tax advice when considering a sophisticated planning idea and a reminder that our clients are ultimately responsible for their *own* due diligence.

FACTS: Jeremiah O'connor was an employee of his wholly owned S corporation, J.P. O'connor Hardware, Inc. JPO Hardware's participation in and withdrawal from the plan triggered the issues in this case.

In 1998, JPO Hardware became a participating employer in an arrangement purported to be a Code Section 419A(f)(6) "10 or more employer" welfare benefit plan providing death benefits to selected employees. Each participating employer made cash contributions to a trust associated with the plan to fund the death benefits for covered employees. The plan trustee used the cash to pay premiums for a policy on the life of each covered employee and also owned and was the beneficiary of the policies.

In September 2002, the plan administrator advised employer participants that, under anticipated final IRS regulations, they would lose their deductions for payments to fund insurance policy premiums under the original plan and that it intended to terminate the arrangement in 2003. Several unsuccessful attempts were made on behalf of JPO Hardware to terminate its participation in the plan and have the policy on O'connor's life transferred directly from the plan to a new plan, the "BS Plan", a separate 419A(f)(6) welfare benefit plan.

The plan administrator advised JPO Hardware to voluntarily terminate its participation in the original plan. That would have required a distribution of the policies directly to covered employees, including O'connor. Consequently, each employee would, at that event, be taxable on the net cash surrender value of his or her policy – even if the employee later transferred the policy to a new plan. The administrator stated that it could not allow a direct transfer of an insurance policy from it to another plan administrator.

In October 2003, JPO Hardware executed a corporate resolution terminating its participation in the original plan. The original plan's administrator, after receiving that resolution, mailed to O'connor a transfer of policy ownership form, signed by the trustee under the original plan as the "Old Owner" of the insured's policy, and a blank change of beneficiary designation form.

In November 2003, a representative of the new BS Plan signed the transfer of policy ownership form as the new owner of the policy. (The policy was not actually transferred until January 2004).

The O'connors argued (1) they could not have received taxable income with respect to the policy transfer any earlier than 2004 when O'connor's policy was *actually* transferred to the BS Plan and (2) that transfer should be exempt from tax under Code Section 1035 which provides for non-recognition of gain on an exchange of life insurance policies.

The IRS argued that the O'connors were taxable in 2003 under Section 402(b)(1) or when JPO Hardware terminated its participation in the original plan or when the original plan administrator provided to the insured the transfer of policy ownership form signed by the original plan trustee, which allowed O'connor to either retain the policy or transfer the policy to a new owner.

Section 402(b)(1) provides employer contributions to a non-exempt employee trust are included in the employee's gross income to the extent that the employee's interest in such contributions is substantially vested at the time the contributions are made. Timing can be crucial. If an employee's rights under a non-exempt employee trust become substantially vested during a taxable year of the employee, and the taxable year of the trust ends with or within such year, the value of the employee's interest in the trust on the date of such vesting is included in the employee's gross income for that taxable year.

"Substantially vested" is defined as the moment when property is either (1) transferable or (2) not subject to a substantial risk of forfeiture. The test of whether or not an employee's risk of forfeiting property is substantial depends on the facts and circumstances. A substantial risk of forfeiture exists where "rights in property that are transferred are conditioned upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied."

It is well established that in cases with facts like those here, the arguments that "We never owned the policies because there was, in essence, a trustee-to-trustee transfer" or "We did not control the policies and our interests in the policies were at all times subject to a substantial risk of forfeiture" will fail. For example, if continued employment is no longer a requirement and the plan could (1) offer the policies for purchase by the employees, (2) distribute the policies to the covered employees, or (3) transfer the policies to another welfare benefit plan, such actions place the underlying policies within the taxpayers' control because they are free to name the policies' new owner and beneficiary, which could have been themselves or another welfare benefit plan. When a taxpayer has dominion and control over property, the value of such property generally will be included in his or her gross income. The manifestation of that control here was the employer's resolution to withdraw from the plan or at the time the taxpayers were sent change of ownership and beneficiary forms. At *either* moment (both occurred in the same tax year in this case), the taxpayers could control their policies. They had the ability to name themselves or another welfare benefit plan as the owner and beneficiary of the underlying policies.

As to the Section 1035 argument, the court here noted that the *same* policy was merely transferred from one owner to another, the only issue being whether O'connor, who had a right to keep the policy instead of opting to have it transferred to the new plan, had income arising out of that right. The foregoing transaction simply is not covered by section 1035, as there must be an actual or, at least, a constructive exchange of one policy for another (new) contact.
