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TOPIC: Tax Court Decides Purported Section 419(e) Plan is Both Deferred Compensation and Split-Dollar

CITES: *Machacek v. Commissioner*; T.C. Memo. 2016-55 (March 28, 2016); *Our Country Home Enterprises, Inc. v. Commissioner*, 145 TC No. 1 (July 13, 2015); *WRNewswire 15.09.13.*

SUMMARY: In this case, the Tax Court ruled that both the deferred compensation rules *and* the split-dollar life insurance regulations can apply to the *same* transaction in a manner that results in (1) disallowance of deductions for employer contributions and (2) full income tax inclusion of the vested accrued benefits of highly compensated employees.

The transaction in this instance involved participation in the "Sterling Plan" (SBP), a purported 419(e) welfare benefit plan previously addressed by the Tax Court in the case *Our Country Home Enterprises, Inc. v. Commissioner*, which was also discussed in *WRNewswire 15.09.13*. In the *Our Country Home* case, the Tax Court ruled that the SBP was not a welfare benefits plan. In this case, the Tax Court went a step further and ruled that the SBP was not only ***not*** a welfare benefit plan but was in fact a non-qualified deferred compensation arrangement. The court further determined that the non-qualified deferred compensation arrangement was discriminatory and thus subject to the rules of Section 402(b)(4).

Based on the application of the Section 402(b)(4) rules, each highly compensated employee was required to include in gross income an amount equal to the previously untaxed vested accrued benefit for the years at issue.

The Tax Court also determined that one of the arrangements reviewed in this case was a compensatory split-dollar life insurance arrangement. The application of the split-dollar life insurance regulations resulted in disallowing employer deductions for contributions to the arrangement.

RELEVANCE: This case reflects the Tax Court's growing arsenal of strategies to prevent welfare benefit plans from purchasing life insurance with tax deductible dollars and then seeking to avoid or defer taxation on the value of the insurance when the benefits are primarily for the owners or highly compensated employees of the participating employers. The Tax Court makes a strong statement in this case against this type of structure by both denying any income tax deduction to the contributing employer (in the instance where the split-dollar rules were applied) and taxing the participant on the value of the vested accrued benefits under the rules of Section 402(b).

The Tax Court determined that both plans at issues, while intended to be Section 419(e) plans into which deductible contributions could be made, were actually non-qualified deferred compensation plans. In making that determination, the court noted that the plans had features that were the hallmarks of such plans (as compared to welfare benefit plans) such as vesting schedules, years of service, and consideration of employee's annual compensation.

Based on its analysis, the court decided that contributions to the plan were not deductible. To add insult to that injury, it also determined that one of the arrangements was also subject to the Section 61-22 split-dollar life insurance regulations, eliminating future employer tax deductions.

The Tax Court also reaffirmed its continued willingness to impose penalties on taxpayers who rely on promoters of such arrangements. Clients considering these arrangements should seek tax counsel competent to advise on the particular arrangement being considered; tax counsel should have access to all relevant information related to the proposal.

FACTS: The Tax Court opinion consolidated two cases regarding participation in the SBP for trial, briefing, and opinion. In a previous opinion on the SPB, in *Our Country*

Home Enterprises, Inc. v. Commissioner, the Tax Court ruled that the SBP was not a welfare benefit plan. That opinion also detailed the operations of the SBP.

John Machacek owned 70% of Machacek, Inc., an S corporation. John's spouse, Marianne Machacek owned 30% of Machacek, Inc. Both John and Marianne were employed by the corporation. In addition, their son, Shawn Machacek was employed by the corporation. In 2005, Shawn Machacek received a W-2 from Machacek, Inc. reflecting compensation of $182,060. In 2006, his W-2 reflected $78,000.

In December, 2002, Machacek, Inc. became a participating employer in SBP, a purported Section 419(e) welfare benefit plan. Upon initial adoption, Machacek, Inc. elected to provide employees with pre-retirement group-term life insurance and post-retirement group-term life insurance. In January, 2005, Machacek, Inc. amended the terms of its participation agreement to add a pre-retirement health expense reimbursement account benefit.

In 2005 and 2006, five employees out of eight (in 2005) and seven (in 2006) were eligible to participate in the Machacek, Inc. plan. Out of five eligible employees in 2005 and 2006, the only participants in the SBP were John Machacek, Shawn Machacek, and Matthew Beebe. John Machacek was fully vested under the plan terms in 2005.

The trust associated with the Machacek plan was "the Machacek, Inc. Employee Welfare Benefit's Trust" (Machacek Trust), a non-exempt employees' trust. Machacek, Inc. contributed $100,000 to the Machacek Trust in both 2004 and 2005. The assets held by the Machacek Trust included a life insurance policy on John Machacek (Machacek Policy) purchased on April 10, 2003, and an annuity with John Machacek as the annuitant (purchased in 1997 and transferred to the trust in 2003).

The Machacek, Inc. contributions in 2004 and 2005 were used to pay the $100,000 annual premiums on the Machacek Policy. The face value of the Machacek Policy in each of those years was $1,398,015.

In 2005, a timely premium was not made on the Machacek Policy and the policy lapsed. The Machacek Policy included a provision allowing for reinstatement. In June 2005, the SPB submitted an application for reinstatement of Machacek's policy. To pay the premium upon reinstatement of the policy, there was a withdrawal from the Machacek Annuity, after which the value of the annuity was zero.

Brenda S. Jones was the sole owner of Adstracts Inc., a C corporation. Abstracts adopted the SBP effective January 1, 2003. Adstracts elected not to provide its employees with any benefits.

In 2005 and 2006, only 12 Adstracts employees (out of 26 in 2005 and 23 in 2006) were eligible to participate in the SBP. None of the eligible employees, other than Brenda Jones, were participants in the plan.

The trust associated with the Adstracts Inc. plan was a non-exempt employees' trust (Adstracts Trust). The Adstracts Trust held an annuity contract, purchased on July 23, 1997. Brenda Jones was the annuitant in 2005 and 2006. The trust was owner and beneficiary.

The value of the Adstracts annuity as of December 31, 2005 was $243,448. On December 31, 2006, the value of that annuity was $271,414.

Adstracts made no contributions to the SBP in 2005 or 2006. Jones was fully vested in SBP benefits in 2006. As sole shareholder of Adstracts, Jones had full control over establishing the participation and vesting requirements of the SBP.

The IRS argued in both cases that:

[1] Machacek, Inc.'s and Adstracts Inc.'s respective SBP's represented participation in discriminatory deferred compensation arrangements that were structured to benefit only select employees rather than to provide welfare benefits generally for the employees of Machacek, Inc. and Adstracts Inc.

[2] The payments made by Machacek's, Inc. and Adstracts Inc. to their respective SBPs should be treated as payments to a non-qualified deferred compensation arrangement rather than a welfare benefits plan.

[3] The SBP's for Machacek, Inc. and Adstracts Inc. should be governed by Section 402(b)(4) on the basis that both plans fail to meet the non-discrimination coverage requirements of Section 410(b).

In the Machacek case, the IRS additionally argued that:

[1] The Machacek, Inc. SBP was subject to the split-dollar life insurance regulations. The IRS argued that although the Machacek life insurance policy had been

purchased prior to September 17, 2003 (the effective date of the applicable split-dollar regulations), the reinstatement of the policy in 2006, following lapse, was a material modification, resulting in application of the regulations. Alternatively, the IRS argued that the 2005 addition of health reimbursement benefits was a material modification for purposes of applying the split-dollar regulations. (The court ruled that the policy reinstatement was not a material modification but the addition of a benefit was.)

[2] The Machacek, Inc. SBP was a compensatory life insurance arrangement within the meaning of Section 1.61-22(b)(2)(ii) of the split-dollar life insurance regulations.

[3] Machacek, Inc. was not entitled to deduct its contribution to the SBP in 2005 because the contribution did not qualify under the rules of Sections 162 and 83.

The taxpayers argued that:

[1] The IRS took the same position concerning non-qualified deferred compensation in *Our Country Home Enterprises., Inc. v. Commissioner* and that position was rejected. The taxpayers urged the court to apply only the split-dollar regulations.

[2] The SBP was never intended to be a tax exempt trust and had consistently filed Form 1041s as a taxable trust. As a result, the rules of Section 402(b)(4) should not apply.

[3] Applying Section 402(b)(4)(A) would result in violation of taxpayers' constitutional right to be taxed only on "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." (The Tax Court rejected this argument based on rejection of a similar argument in *Yarish v. Commissioner*, 139 T.C. at 98.)

With respect to the application of the split-dollar life insurance regulations, Machacek, Inc. argued that:

[1] The Machacek, Inc. participation in the SBP was not a compensatory split-dollar life insurance arrangement because the arrangement was a legitimate welfare

benefit plan. (The Tax Court dismissed this argument on the basis of its decision in *Our Country Homes*.)

[2] The Machaceks had already reported as income the current cost of insurance on the W-2s that were issued to the Machacek's. (The court rejected this argument on the basis that the W-2 amounts reported differed from what the court calculated as the actual costs of the death benefits.)

The court noted that the preamble to Section 61 contemplated that more than one set of rules might apply in certain instances and concluded that this case was one of those situations. The court applied the analysis of Section 1.61-22(b)(2)(ii) to determine that the arrangements at issue were compensatory, whether considering the applicability of Section 402(b) or the split-dollar rules.

A non-qualified deferred compensation plan is a plan or arrangement between an employer and employee providing for deferral of compensation to sometime in the future. Compensation is deferred in an instance where an employee has the right to receive compensation in a given year but defers such amount to a later year. The deferral must be other than short-term.

A welfare benefits plan is an employer sponsored plan pursuant to Section 419(e). Such plans provide certain benefits, such as life, health, long-term care, and disability to employees.

The court readily determined that the Machacek, Inc. and Adstract, Inc. plans were not welfare benefit plans. Both plans had features of non-qualified deferred compensation plans. Non-qualified deferred compensation plans are typically subject to the rules of 409A. The court determined that liability under 409A was not at issue and reached its results by concluding that both of the trusts at issue were non-qualified discriminatory trusts.

Section 402(b)(4) provides that if one of the reasons a trust is not exempt is the failure to meet the nondiscrimination in plan coverage rules of Section 410, then the income of any highly compensated employee shall include an amount equal to the vested accrued benefit of such employee as of the close of the taxable year of the trust.

Section 414(q) defines a "highly compensated" employee as any employee who was a 5% owner during the year or preceding year, or for the preceding year, had

compensation from the employer in excess of a certain amount, or was in the top paid group of employees for such preceding year.

With respect to the Adstracts Trust, the Tax Court applied only Section 402(b) because the only asset of the trust was an annuity. Because Brenda was a highly compensated employee and fully able to control the vesting requirements, she was required to report as income all previously untaxed vested accrued benefits under the SBP for the years at issue.

In applying both Section 402(b)(4) and the split-dollar life insurance regulations to the Machacek, Inc. SBP, the court applied the split-dollar life insurance regulations to the Machacek Policy and Section 402(b)(4) to the Machacek Annuity.

The non-owner of a life insurance contract who is a party to a split-dollar life insurance arrangement must include in income the economic benefit of the arrangement. Regulation Section 1.61-22(d)(2) provides that the economic benefit includes (1) the cost of life insurance protection provided to the non-owner during the year; plus (2) the amount of policy cash value to which the non-owner had access during the year; plus (3) the value of any other economic benefits provided to the non-owner.

With respect to the annuity, the Machaceks were required to include in income any vested accrued benefit that had not been taxed previously.

With respect to the life insurance policy, the court concluded that the Machaceks were required to include in income for the years at issue the previously unreported and untaxed accumulation value of the Machacek Policy. Additionally, the Machaceks were required to include in income the cost of the death benefits for the 2005 and 2006 tax years.

The contribution to the plan in 2005 by Machacek, Inc. was used solely to pay the life insurance premium on the Machacek Policy. Because the court determined that the arrangement was not a welfare benefit plan but rather a split-dollar life insurance arrangement, the contributions by Machacek, Inc. were determined to be non-deductible.

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