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Marketplace

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IRS Disagrees with 6th Circuit on Taxation of Split-Dollar Insurance for S Corporation Owner-Employees

Market trend: On May 28, 2021, the IRS formally released an action on decision announcing its refusal to follow the decision of the 6th Circuit in *Machacek v. Commissioner*, 906 F.3d 429 (6th Cir. 2018). Meanwhile, in *Ruben De Los Santos, et ux. v. Commissioner*, 156 T.C. No. 9 (2021), the Tax Court sided with the IRS and expressly rejected the 6th Circuit's decision in *Machacek*.

Synopsis: The question raised in these cases is whether the economic benefit of split-dollar life insurance policies owned by an S corporation that provide a benefit to an S corporation owner-employee should be treated as a non-taxable shareholder distribution or as taxable compensation. In *Machacek, the 6th Circuit Court of Appeals overruled the Tax Court and held that those economic benefits should be treated as shareholder distributions that were not taxable to the S corporation owners. The Tax Court in De Los Santos* – which arose in a jurisdiction outside of the 6th Circuit and therefore was not bound by the 6th Circuit's *Machacek* decision – ruled the opposite – *i.e.*, that the economic benefit was taxable as a compensatory split-dollar arrangement. The IRS sided with the Tax Court in both cases, and has now formally announced its decision not to follow *Machacek*, meaning that S corporation owner-employees who wish to treat the economic benefit of split-dollar policies as non-taxable shareholder distributions may be subject to challenge from the IRS if they are outside the 6th Circuit (which covers Kentucky, Michigan, Ohio and Tennessee).

Takeaways: These decisions set up a jurisdictional split as to whether the economic benefits of split-dollar arrangements are considered taxable compensation or non-taxable shareholder distributions for owner-employees of S corporations. S corporations with split-dollar arrangements should monitor the decisions in their jurisdictions, but if located outside the 6th Circuit, they should understand that the IRS position will likely be to challenge treatment of the economic benefit as a non-taxable shareholder distribution.

Background on Split-Dollar Arrangements

Regulations under Section 61 of the Internal Revenue Code of the 1986, as amended (the "Code"), define and describe the taxation of "split-dollar" life insurance arrangements.[1] Under these regulations, split-dollar life arrangements generally include arrangements in which one party (such as an employer) pays all or some portion of the premiums and another party (such as an employee) holds some of the economic rights under the policy, such as the right to name the beneficiary of the death benefits or rights to access any policy cash values.

The IRS regulations divide these split-dollar programs into one of two categories:

- "Compensatory" arrangements, in which the arrangement is entered into in connection with a person's performance of services (and is not a group term life insurance arrangement under Section 79 of the Code), or
- "Shareholder" arrangements, in which the arrangement is entered into between a corporation and another person in that person's capacity as a shareholder.

For compensatory arrangements in which the owner of the policy is the employer or other service recipient, the non-owner/service provider generally must recognize taxable ordinary income each year on the "economic benefit" provided by the policy.[2] The nature of the "economic benefit" depends on the details of the arrangement, but likely includes the value of the term life insurance coverage for the year, and possibly the value of any underlying cash value that the non-owner/service provider can access.

In contrast, those economic benefits under a shareholder arrangement are generally treated as a distribution of property to the shareholder each year. For shareholders in a S-corporation, a distribution of property may not be taxable to the extent it represents a return of prior, after-tax earnings previously allocated to the shareholder and held in the S corporation.

[1] See Treas. Reg. §1.61-22.
[2] Split-dollar arrangements can also be designed where the employee/service provider owns the policy, in which case the payment of premiums by the employer/service recipient is treated as a loan under the "loan regime" tax rules found at Treas. Reg. §1.7872-15.

The *Machacek Case*

In *Machacek*, an S corporation established a split-dollar program for its employees, including the owners who also provided services to the corporation.[3] The corporation owned the policies and paid the premiums, and the owner-employees benefited from the increase in policy cash values. The owner-employees reported those economic benefits as a distribution of property under Section 301 of the Code, which was not taxable to them as S corporation owners.

The IRS objected to this treatment and contended that (i) the split-dollar program was a compensatory arrangement under the relevant split-dollar regulations and (ii) those regulations require the economic benefit to be treated as taxable compensation to all participating employees, including the S corporation owner-employees. The case was litigated and the Tax Court agreed with the IRS's position that the economic benefits were taxable compensation.[4]

The taxpayers appealed the Tax Court decision to the 6th Circuit Court of Appeals. The 6th Circuit reversed the Tax Court, agreeing with the taxpayers that the economic benefits should be treated as shareholder distributions of property under Section 301 of the Code. While the 6th Circuit acknowledged that the program at issue was a compensatory split-dollar arrangement, it looked to the treatment of split-dollar arrangements under Code Section 301 and, especially, Treas. Reg. §1.301-1(q)(1), which provides, in part, that that the provision of economic benefits "by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement . . . is treated as a distribution of property." The 6th Circuit, looking at this regulatory language in isolation, decided that it effectively controlled over the Code Section 61 split-dollar regulations as to a shareholder, even an S-corporation owner-employee covered by a compensatory arrangement. As a result, the 6th Circuit agreed with the taxpayers that they were allowed to treat the economic benefits as a distribution of property to themselves as shareholders of the S corporation under Code Section 301 rather than as taxable compensation under Code Section 61.

The *De Los Santos Case*

The facts in *De Los Santos* mirror those in *Machacek*.[5] The owner-employees of the S corporation participated in a split-dollar life insurance program sponsored by the S corporation for its employees. As in *Machacek,* the owner-employees took the tax position that their economic benefits under the policy were distributions of property to themselves as shareholders, which under S corporation tax rules were not taxable.

[3] A copy of the *Machacek* decision can be found here: https://www.opn.ca6.uscourts.gov/opinions.pdf/18a0228p-06.pdf
[4] See *Machacek v. Commissioner*, T.C. MEMO. 2016-55.
[5] A copy of the *De Los Santos* decision can be found here: https://scholar.google.com/scholar_case?case=11213707720036021575&q=de+los+Santos&hl=en&as_sdt=4,192

Once again, the IRS objected to this treatment. The Tax Court heard the case after the 6th Circuit's decision in *Machacek*. The 6th Circuit decision controls in the states covered by the 6th Circuit – specifically, Kentucky, Michigan, Ohio and Tennessee. But the *De Los Santos* case arose outside the 6th Circuit. As a result, the Tax Court was not bound by the 6th Circuit's decision.

The Tax Court closely inspected the arguments relied on by the 6th Circuit. The problem with the 6th Circuit's analysis, according to the Tax Court, is that it too narrowly focused on the language in Treas. Reg. §1.301-1(q)(1) (regarding treatment of split-dollar arrangements for shareholders), and failed to properly consider more general language at Treas. Reg. §1.301-1(a), which states as follows (emphasis added):

> *Section* 301 provides the general rule for treatment of distributions . . . of property by a corporation to a shareholder **with respect to its stock**.

The Tax Court held that this general language limits the scope of Treas. Reg. §1.301-1(q)(1) to those situations in which the split-dollar economic benefit is provided in respect to the owner-employee's stock ownership, rather than as compensation for services. As a result, the Tax Court found that the provisions of the Section 61 regulations related to compensatory split-dollar arrangements control for an S corporation shareholder under a split-dollar arrangement provided as consideration for services rendered to the corporation. The taxpayers were required to recognize the economic benefits as taxable compensation, not as a shareholder distribution of property.

IRS Nonacquiescence to *Machacek*

On May 28, 2021, the IRS formally released an "action on decision" in which announced its intent to not acquiesce to the 6th Circuit's position in *Machacek*.[6] In this action, the IRS acknowledges that *Machacek* controls for tax cases appealable within the 6th Circuit that have substantially the same facts. But the IRS continues to state its objections to the reasoning in that decision, and favorably cites the *De Los Santos* Tax Court holding.

For cases that are appealable outside the 6th Circuit, the IRS action on decision expressly states that the IRS intends to litigate any tax position taken contrary to the *De Los Santos* holding. Even inside the 6th Circuit, the IRS will narrowly construe *Machacek* and will look for any differences in facts that could lead to a different conclusion.

[6] A copy of the IRS action on decision can be found here: https://www.irs.gov/pub/irs-aod/aod-2021-02.pdf

Conclusion

Eventually, other Courts of Appeal may weigh in on this issue, perhaps resulting in a split in circuits. A Supreme Court decision on this issue is probably unlikely, but not impossible if the various Courts of Appeal cannot agree.

In the meantime, S corporations that sponsor compensatory split-dollar arrangements (and their advisors) should closely follow the continued developments on this issue in the courts. If the S corporation is in a jurisdiction covered by the 6th Circuit with facts that substantially mirror those in *Machacek,* the favorable tax position in *Machacek* could potentially be taken in reliance on the 6th Circuit's position, although this should be done so carefully, after review with the corporation's key tax and financial advisors. For S corporations located outside the 6th Circuit, reliance on the decision in *Machacek* will, for the time being, be much more precarious.