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Sixth Circuit: Split-dollar life insurance, economic benefit treated as distribution of property to shareholder

The U.S. Court of Appeals for the Sixth Circuit—in a case of “first impression”—reversed a memorandum opinion of the U.S. Tax Court in which that court concluded that the taxpayers had to treat as income the economic benefits resulting from their S corporation’s payment of a premium on the taxpayer-husband’s life insurance policy under a compensatory split-dollar arrangement.

The Sixth Circuit concluded that the Tax Court had not considered Reg. section 1.301-1—that is, the tax regulation measure specifically requiring that such economic benefits be treated as shareholder distributions—and reversed the Tax Court’s decision and remanded for further proceedings.

The case is: *Machacek v. Commissioner*, No. 17-1131 (6th Cir. October 12, 2018). Read the Sixth Circuit’s [decision](#) [PDF 335 KB]

Summary

The taxpayers’ S corporation provided the taxpayer-husband with a life insurance policy and paid the \$100,000 annual premium in 2005. The S corporation deducted the \$100,000 premium (thus, that amount was not included in the taxpayers’ individual income tax return). The taxpayers also did not include as income the economic benefits flowing from the increase in value of the life insurance policy.

The taxpayers did not dispute that the S corporation was not allowed to deduct the premium payment. Rather, the dispute concerned the tax treatment of the economic benefits flowing to the taxpayer-husband as a result of the S corporation’s payment of the premium.

The Tax Court held that the taxpayers must account for the economic benefits in their individual income.

The Sixth Circuit reversed, finding that the Tax Court erred in failing to note that the economic benefits must be treated as a distribution of property by the S corporation to the shareholders—notwithstanding that the economic benefits flowed from a compensatory split-dollar arrangement.

The appeals court found that Reg. section 1.301-1(q)(1)(i) is dispositive—noting further that the Sixth Circuit was not aware of any case discussion the regulation in any context.

The Sixth Circuit concluded that when a shareholder receives economic benefits from a split-dollar arrangement, the regulation requires that those benefits must be treated as a distribution of property to the shareholder.

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