Funkhouser v. Commissioner, 58 T. C. 940 (1972); 1972 U. S. Tax Ct. LEXIS 62

The cost of life insurance protection provided under a qualified employer's pension and profit-sharing plans is includable in the gross income of the employee.

Summary

In Funkhouser v. Commissioner, the Tax Court addressed whether the cost of life insurance protection provided to employees under qualified pension and profit-sharing plans should be included in their gross income. The court held that these costs are taxable under section 72(m)(3) of the Internal Revenue Code of 1954, despite forfeiture provisions in the plans that might affect the cash surrender value of the policies. The decision emphasized that the taxability of life insurance protection is determined by the right of the employee or their beneficiary to receive the proceeds upon the employee's death, not by the potential forfeiture of the cash surrender value.

Facts

Ross H. Funkhouser and Arthur D. Burnett were employees of Copeland Sausage Co. , participating in the company's pension and profit-sharing plans. Both plans were qualified under sections 401(a) and 501(a) of the Internal Revenue Code. The pension plan required life insurance contracts to be purchased on eligible employees, with the policies owned by the trustee. The profit-sharing plan allowed for life insurance purchases, but the value of such contracts had to be converted to an annuity at retirement. Both plans included forfeiture provisions related to the cash surrender value of the policies in cases of dishonesty, competition, or termination. The Commissioner of Internal Revenue determined that the costs of life insurance protection provided to Funkhouser and Burnett were taxable income under section 72(m)(3).

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the federal income taxes of Funkhouser and Burnett for the years 1964-1967, asserting that the costs of life insurance protection under their employer's plans were includable in their gross income. Funkhouser and Burnett petitioned the U. S. Tax Court to challenge these determinations. The Tax Court heard the case and issued its decision on September 11, 1972.

Issue(s)

1. Whether the cost of life insurance protection provided to employees under qualified pension and profit-sharing plans is includable in their gross income under section 72(m)(3) of the Internal Revenue Code of 1954.

Holding

1. Yes, because the cost of life insurance protection is includable in the gross income of the employee under section 72(m)(3) when the proceeds are payable to the employee or their beneficiary, regardless of forfeiture provisions affecting the cash surrender value of the policies.

Court’s Reasoning

The Tax Court reasoned that the cost of life insurance protection provided under qualified plans must be included in the employee’s gross income in the year it is paid, as per section 72(m)(3). The court interpreted the regulations to mean that only the cash surrender value of the policy, not the life insurance protection itself, could be subject to forfeiture by the trust. The court emphasized that the taxability of life insurance protection hinges on whether the proceeds are payable to the employee or their beneficiary upon death, not on the potential forfeiture of other policy values. The court also considered prior decisions and statutory schemes, concluding that the regulations should be interpreted consistently with the statute to include the costs of life insurance protection in income.

Practical Implications

This decision clarifies that the cost of life insurance protection under qualified pension and profit-sharing plans is taxable to the employee, even if the plans contain forfeiture provisions related to the cash surrender value. Attorneys and tax professionals should advise clients participating in such plans to account for these costs in their annual tax filings. The ruling impacts how employers structure their employee benefit plans, as they must inform employees of the tax implications of life insurance protection. Subsequent cases have followed this precedent, reinforcing the principle that the tax treatment of life insurance protection in qualified plans is determined by the right of the employee or their beneficiary to receive the proceeds upon death.

