Matthies v. Comm'r, 134 T. C. 141 (2010)

In Matthies v. Comm'r, the U. S. Tax Court ruled that the bargain element from the sale of a life insurance policy by a profit-sharing plan to its beneficiary was taxable income. The court determined the policy's value without reducing for surrender charges, impacting how such transactions are valued for tax purposes. This decision clarifies the tax implications of bargain sales from qualified plans, affecting future estate planning and tax strategies involving life insurance policies.

Parties

Karl L. Matthies and Deborah Matthies were the petitioners. They were the beneficiaries of a profit-sharing plan established by their wholly owned S corporation, Bellagio Partners, Inc. The respondent was the Commissioner of Internal Revenue. The case proceeded through the U. S. Tax Court, with no appeals mentioned in the provided text.

Facts

Karl L. Matthies, a stock analyst, and Deborah Matthies established Bellagio Partners, Inc. , an S corporation, and subsequently set up a profit-sharing plan. They followed a Pension Asset Transfer (PAT) plan suggested by their advisors, which involved using IRA funds to purchase a life insurance policy through the profit-sharing plan. In 1999, the plan bought a Hartford Life last survivor interest-sensitive life insurance policy. Over the next two years, Karl Matthies transferred funds from his IRA to the plan, which were used to pay premiums on the policy.

On December 29, 2000, the profit-sharing plan sold the insurance policy to Karl Matthies for $315,023, slightly above its net cash surrender value of $305,866. 74 but significantly below its account value of $1,368,327. 33. The policy had a surrender charge of $1,062,460. 59 at the time of the sale. Subsequently, the policy was transferred to a family irrevocable trust and exchanged for another policy without surrender charges.

Procedural History

The Commissioner of Internal Revenue determined that the difference between the policy's account value and the amount paid by Karl Matthies constituted taxable income, resulting in a deficiency of $294,925 for each of the years 2000 and 2001, along with an accuracy-related penalty for negligence under I. R. C. § 6662(a). The Matthieses contested these determinations in the U. S. Tax Court, arguing that the policy should be valued at its net cash surrender value. The case was heard by Judge Michael B. Thornton, and no further appeals were noted.

Issue(s)

Whether the bargain element from the sale of a life insurance policy by a qualified

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profit-sharing plan to its beneficiary constitutes taxable income under I. R. C. § 61?

Whether the value of the life insurance policy for tax purposes should be reduced by any surrender charges?

Whether the taxpayers are liable for the accuracy-related penalty for negligence under I. R. C. § 6662(a)?

Rule(s) of Law

I. R. C. § 61(a) provides that gross income includes all income from whatever source derived.

Treas. Reg. § 1. 402(a)-1(a)(2) states that for distributions of life insurance contracts from qualified plans, the "entire cash value" of the contract is includable in the distributee's gross income.

I. R. C. § 72(e)(3)(A)(i) defines "cash value" as determined without regard to any surrender charge.

I. R. C. § 6662(a) imposes a penalty for negligence or disregard of rules or regulations.

Holding

The court held that the bargain element from the sale of the life insurance policy by the profit-sharing plan to Karl Matthies, calculated as the difference between the policy's account value of $1,368,327. 33 and the amount paid of $315,023, was taxable income under I. R. C. § 61. The value of the policy for tax purposes was determined to be its entire cash value without any reduction for surrender charges, in accordance with Treas. Reg. § 1. 402(a)-1(a)(2). The court also held that the taxpayers were not liable for the accuracy-related penalty for negligence under I. R. C. § 6662(a), as they had a reasonable basis for their return position.

Reasoning

The court reasoned that the transaction between the profit-sharing plan and Karl Matthies was not an arm's length transaction, as the plan was established to facilitate this specific transfer, and the price was set by the taxpayers' advisors. The court applied the principle that income may result from a bargain sale when the parties have a special relationship, as established in cases like *Commissioner v. Lo Bue* and *Commissioner v. Smith*.

Regarding the valuation of the policy, the court interpreted "entire cash value" under Treas. Reg. § 1. 402(a)-1(a)(2) to mean the cash value without reduction for surrender charges, consistent with the definitions in I. R. C. §§ 72(e)(3)(A)(i) and 7702(f)(2)(A). This interpretation was supported by the subsequent transfer of the

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policy to a trust, where the entire account value was credited without deduction for surrender charges.

The court found that the taxpayers had a reasonable basis for their return position due to the ambiguity in the existing regulations and the IRS's later clarification in the 2005 amendments to Treas. Reg. § 1. 402(a)-1(a)(1)(iii). Therefore, the negligence penalty was not applicable.

Disposition

The court's decision was to include the bargain element of $1,053,304 in the taxpayers' gross income for 2000, but they were not liable for the accuracy-related penalty for negligence.

Significance/Impact

This case clarified the tax treatment of bargain sales of life insurance policies from qualified plans to beneficiaries, establishing that the "entire cash value" without surrender charges is the appropriate measure for determining taxable income. It also highlighted the importance of a reasonable basis for tax return positions in avoiding negligence penalties. The decision impacts estate planning strategies involving life insurance policies and the valuation of such policies for tax purposes, potentially affecting future IRS guidance and taxpayer planning.

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