Schwab v. Commissioner, 136 T. C. 120 (2011)

In Schwab v. Commissioner, the U. S. Tax Court ruled that the fair market value of life insurance policies distributed from a terminated nonqualified employee-benefit plan must be included in the recipient's income, even if the policies had negative net cash surrender values due to surrender charges. This decision clarifies the tax treatment of such distributions, emphasizing that fair market value, rather than stated policy value or net cash surrender value, governs the amount actually distributed under section 402(b) of the Internal Revenue Code.

Parties

Michael P. Schwab and Kathryn J. Kleinman (Petitioners) were the taxpayers who received the life insurance policies from the terminated plan. They were represented by Jay Weill. The respondent was the Commissioner of Internal Revenue, represented by Brian E. Derdowski, Jr. , and Brian Bilheimer.

Facts

Schwab and Kleinman, sole shareholders and employees of Angels & Cowboys, Inc. , participated in the Advantage 419 Trust, a nonqualified employee-benefit plan designed to conform with section 419A(f)(6) of the Internal Revenue Code. The plan was administered by Benistar and later by BISYS. In October 2003, due to changes in IRS regulations, BISYS terminated the plan and distributed variable universal life insurance policies to Schwab and Kleinman. At the time of distribution, Schwab's policy had a stated policy value of $48,667 and Kleinman's had $32,576. However, both policies had surrender charges that exceeded their stated values, resulting in negative net cash surrender values. Schwab continued to pay premiums on his policy, while Kleinman's policy lapsed due to non-payment of further premiums.

Procedural History

Schwab and Kleinman did not report the distribution of the policies as income on their 2003 joint tax return. The Commissioner issued a notice of deficiency, asserting that the stated policy values should be included in income. Schwab and Kleinman timely petitioned the Tax Court, which conducted a trial in San Francisco. The court applied a de novo standard of review.

Issue(s)

Whether the fair market value of life insurance policies distributed from a terminated nonqualified employee-benefit plan, which had negative net cash surrender values due to surrender charges, should be included in the recipient's income under section 402(b) of the Internal Revenue Code?

Rule(s) of Law

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Under section 402(b) of the Internal Revenue Code, the amount actually distributed or made available to any distributee by any trust described in paragraph (1) shall be taxable to the distributee, in the taxable year in which so distributed or made available, under section 72 (relating to annuities).

Holding

The Tax Court held that the fair market value of the life insurance policies distributed to Schwab and Kleinman, which included the remaining paid-up insurance coverage, must be included in their income under section 402(b). The court determined that the fair market value at the time of distribution was the value of the paid-up insurance coverage attributable to the single premium paid by Angels & Cowboys, Inc. , which amounted to $2,665. 95 in total for both policies.

Reasoning

The court reasoned that the term "amount actually distributed" in section 402(b) should be interpreted as the fair market value of the distributed property at the time of distribution. The court rejected the Commissioner's argument that surrender charges should be disregarded, noting that the relevant regulation, section 1. 402(b)-1(c), did not mention lapse restrictions or surrender charges. The court also considered the unique nature of the variable universal life policies, which were tied to the performance of the S&P 500 index and had no positive net cash surrender value at the time of distribution. The court found that the policies had value only to the extent of the paid-up insurance coverage remaining from the single premium paid by Angels & Cowboys, Inc. The court also declined to impose penalties under section 6662, finding that Schwab and Kleinman made a reasonable attempt to comply with the tax laws and that the understatement of income was minimal.

Disposition

The Tax Court ruled in favor of Schwab and Kleinman, holding that the fair market value of the distributed policies was $2,665. 95, which must be included in their income. The court did not sustain the Commissioner's determination of penalties. The case was set for further computations under Rule 155.

Significance/Impact

Schwab v. Commissioner clarifies the tax treatment of life insurance policies distributed from terminated nonqualified employee-benefit plans, emphasizing that fair market value, rather than stated policy value or net cash surrender value, governs the amount actually distributed under section 402(b). This decision may impact the tax planning of small business owners and professionals who participate in such plans, as it requires them to include the fair market value of distributed policies in their income, even if the policies have negative net cash surrender values. The case also highlights the importance of considering the unique features of

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variable universal life policies in determining their value for tax purposes.

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