De Los Santos v. Commissioner, 156 T. C. No. 9 (U. S. Tax Court 2021)

In a ruling that clarifies the tax treatment of split-dollar life insurance arrangements in S corporations, the U. S. Tax Court determined that benefits received by a shareholder-employee under such a plan are taxable as ordinary income, not as a distribution under Section 301. This decision impacts how S corporations must account for employee fringe benefits, particularly life insurance, and reinforces the importance of distinguishing between compensation and shareholder distributions in tax law.

Parties

Plaintiffs (Petitioners): Ruben De Los Santos and Martha De Los Santos, designated as Petitioners at both trial and appeal stages.

Defendant (Respondent): Commissioner of Internal Revenue, designated as Respondent at both trial and appeal stages.

Facts

Ruben De Los Santos, a medical doctor, was the sole shareholder of Dr. Ruben De Los Santos MD, PA, an S corporation. During 2011 and 2012, the S corporation employed Ruben and his wife Martha, who served as the office manager, along with four other employees. The corporation adopted an employee welfare benefit plan known as the Legacy Employee Welfare Benefit Plan, funded through contributions to the Legacy Employee Welfare Benefit Trust. Under this plan, Ruben and Martha were entitled to a $12. 5 million death benefit, while the other employees received a $10,000 death benefit. The plan was classified as a compensatory split-dollar life insurance arrangement under the applicable regulations, and the economic benefits derived from it were deemed taxable income to the De Los Santoses. They did not report these benefits on their tax returns, prompting the IRS to issue a notice of deficiency determining that the benefits were taxable as ordinary income.

Procedural History

The De Los Santoses petitioned the U. S. Tax Court for redetermination of the deficiency after receiving the IRS notice. They filed a motion for partial summary judgment arguing that the economic benefits should be treated as a distribution under Section 301 due to Ruben’s status as a shareholder. The Tax Court had previously held in a related memorandum opinion that the arrangement was a compensatory split-dollar life insurance plan, and the economic benefits were taxable. In the current case, the Tax Court denied the De Los Santoses’ motion for partial summary judgment, affirming that the benefits were taxable as ordinary income.

Issue(s)

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Whether the economic benefits received by Ruben De Los Santos under the compensatory split-dollar life insurance arrangement should be taxable to him as a distribution under Section 301 of the Internal Revenue Code, or as ordinary income?

Rule(s) of Law

Section 301 of the Internal Revenue Code governs distributions of property by a corporation to its shareholders, applicable only when the payment is made "with respect to its stock. " Section 1372 of the Internal Revenue Code treats S corporations as partnerships for the purpose of taxing employee fringe benefits, and any shareholder owning more than 2% of the corporation's stock is treated as a partner. Under Section 1. 61-22 of the Income Tax Regulations, economic benefits provided under a split-dollar life insurance arrangement are taxable to the non-owner of the policy. In a compensatory arrangement, these benefits are generally treated as compensation.

Holding

The court held that the economic benefits received by Ruben De Los Santos under the compensatory split-dollar life insurance arrangement were not taxable as a distribution under Section 301, but rather as ordinary income. This decision was based on the fact that the benefits were provided to Ruben in his capacity as an employee, not as a shareholder. Furthermore, under Section 1372, the S corporation was treated as a partnership for the purposes of taxing employee fringe benefits, and thus the benefits were categorized as "guaranteed payments" under Section 707(c), which are taxable as ordinary income.

Reasoning

The court's reasoning focused on the distinction between payments made to shareholders in their capacity as shareholders versus payments made in another capacity, such as an employee. The court emphasized that Section 301 only applies to distributions made "with respect to its stock," and thus payments made to shareholders in their capacity as employees are not covered by this section. The court rejected the argument put forth by the De Los Santoses, which was based on a Sixth Circuit decision in Machacek v. Commissioner, that all economic benefits under a split-dollar life insurance arrangement should be treated as distributions under Section 301. The court found this interpretation inconsistent with the statutory language of Section 301 and the broader regulatory framework, particularly noting that the split-dollar regulations differentiate between compensatory and shareholder arrangements. The court further reasoned that treating S corporations as partnerships under Section 1372 for fringe benefit purposes meant that the economic benefits were to be treated as "guaranteed payments" under Section 707(c), which are taxable as ordinary income. The court's analysis also considered policy implications, noting that a contrary ruling could allow S corporations to avoid employment taxes on fringe benefits, contrary to the

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intent of the regulations. The court's decision was influenced by the need to maintain consistency with the statutory and regulatory framework governing the taxation of split-dollar life insurance arrangements and employee fringe benefits in S corporations.

Disposition

The court denied the De Los Santoses' motion for partial summary judgment, maintaining that the economic benefits received under the compensatory split-dollar life insurance arrangement were taxable as ordinary income.

Significance/Impact

The De Los Santos decision has significant implications for the taxation of split-dollar life insurance arrangements within S corporations. It reaffirms the principle that benefits received by shareholder-employees under such arrangements are to be treated as ordinary income when provided in the context of employment, rather than as distributions under Section 301. This ruling clarifies the application of Section 1372, which treats S corporations as partnerships for fringe benefit taxation purposes, thereby categorizing these benefits as "guaranteed payments" taxable as ordinary income. The decision also highlights the importance of distinguishing between the capacities in which payments are received from corporations, impacting tax planning and compliance for S corporations and their shareholders. It may influence future cases and regulatory guidance concerning the taxation of similar arrangements, emphasizing the need for clear delineation between compensatory and shareholder benefits. The court's rejection of the Sixth Circuit's interpretation in Machacek further underscores the complexity and ongoing debate within the tax law community regarding the treatment of split-dollar life insurance arrangements.

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