UNITED STATES TAX COURT
WASHINGTON, DC 20217

RUI-KANG ZHANG & JAU-FEI CHEN,	)
Petitioner(s),	)
v.	) Docket No. 10488-10.
COMMISSIONER OF INTERNAL REVENUE,	)
Respondent	)

ORDER

This case arises from the distribution of life-insurance policies to petitioners back in 2004. Both petitioners and the Commissioner recognize that this triggers an inclusion of some measure of the value of those policies in petitioners' 2004 taxable income.

But the measure of that value is higher if the policies were "vested" than if they were "distributed". The Commissioner unsurprisingly argues that although the policies ended up being distributed, they were also vested. This means that he can tax the policies not at fair market value, but at a higher value that would be determined "without regard to any lapse restriction". 26 C.F.R. § 1.402(b)-1(b)(2)(i).

There's no genuine dispute about any material fact here, but is the Commissioner entitled to judgment as a matter of law?

Background

Petitioners are shareholders and employees of an S corporation that adopted something called the National Benefit Plan and Trust Agreement. This and similar plans have been the impetus for numerous cases in our Court. Some such arrangements caused problems because they dressed up multiple single-employer benefit plans as single multiemployer plans. Multiemployer plans get some tax advantages under I.R.C. §§ 419 and 419A. When the Commissioner started looking into them, some quickly folded. And some of the small businesses that had adopted such plans didn't want to defend them and instead wound down their participation. *Schwab v. Commissioner*, 136 T.C. 120, 122-23 (2011); *Cadwell v. Commissioner*, 136 T.C. 38, 43-44 (2011); *Gluckman v. Commissioner*, 104 T.C.M. 651, 652-53 (2012).

That's what happened here. Petitioners' corporation adopted the National Benefit Plan in 2003. The Plan aimed to provide life insurance for petitioners that the corporation would pay for. The corporation claimed deductions for the cost of the two policies involved, which were owned by a nonexempt trust.[1] By late 2003 the IRS started scrutinizing such plans, and it seemed likely that the Treasury Department would issue regulations to deprive them of the tax advantages they had been marketed as having. *Schwab v. Commissioner*, 715 F.3d 1169, 1173 (9th Cir. 2013). And petitioners here decided to wind down their involvement in 2004. Their corporation passed a resolution that told the Plan's trustee to notify the Plan's administrator that it wanted to withdraw. The administrator identified petitioners as the Plan's covered employees who were entitled to receive a share of the Plan's assets. By August 3, 2004, the Plan administrator had transferred ownership of both life-insurance policies from the Plan's trustee to the individual petitioners.

Petitioners then reported on their 2004 income tax return what they assert were those policies' combined fair market value at distribution -- about $160,000[2] -- plus a severance cash distribution that was a little over $30,000 for a total amount of just over $200,000 in taxable income. The Commissioner disagreed during audit and instead argues that the policies produced a much higher addition to their income of nearly $550,000.

In August 2005, petitioners let one of the policies lapse as worthless and cashed in the other for a bit more than $160,000.

Discussion

Two paragraphs of Code section 402 are at play in this case:

[1] We assume the parties know the technical terms like "nonexempt trust" that we use here.

[2] This amount is less the policies' surrender charges. At the time of distribution, one of the policies had a surrender charge exceeding its accumulation value. The parties disagree about whether petitioners' reported fair market value was accurate, but recognize this as a disputed fact.

> Section 402(b)(1), which provides that "[c]ontributions to an employees' trust made by an employer . . . shall be included in the gross income of the employee in accordance with section 83 (relating to property transferred in connection with performance of services). . . ."; and
>
> Section 402(b)(2) which provides that "[t]he 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 . . . ."

Focus on the statutory cross-references. The first paragraph's reference to section 83 is particularly a reference to section 83(a)(1), which speaks of the "fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse)". I.R.C. § 83(a)(1). Life-insurance policies typically have surrender charges for the first several years they're in effect, but which then shrink or disappear with the passage of time. They are, in short, *not* a restriction that "will never lapse." Policies without such restrictions would, however, be worth more than those with such restrictions -- all other things being equal. (The difference between petitioners' and the Commissioner's valuation of the policies here shows the effect of ignoring surrender charges and other factors that would typically affect value in the real world.)

No wonder the Commissioner would like to tax petitioners under paragraph (b)(1).

Paragraph (b)(2), in contrast, includes in a taxpayer's gross income only the "amount actually distributed or made available," a phrase that we held in *Schwab* means fair market value. *Schwab v. Commissioner*, 136 T.C. 120, 131 (2011), *aff'd*, 715 F.3d 1169, 1179 (9th Cir. 2013).

A. The Commissioner argues that, under the terms of petitioners' Plan, their decision to terminate their corporation's involvement and distribute the policies to themselves as individuals was not merely a *distribution*, but *both* a distribution and a vesting. For the Commissioner, that means that both paragraphs of section 402(b) apply.

At a minimum, this is counterintuitive. Section 402(b)(1) and 402(b)(2) have hitherto been thought to be disjunctive -- the same property cannot be both distributed and be owned by a trustee for the benefit of the person to whom it is distributed. *See Schwab*, 136 T.C. at 130; *Lowe v. Commissioner,* 101 T.C.M. 1525, 1527 (2011).

It's also counterintuitive in a different way -- a taxpayer who elects to receive a distribution with a benefits plan is necessarily telling the plan to segregate a portion of the plan's assets and send it to him. This makes it "available" to him (to quote paragraph (b)(2)). The Commissioner's logic would make a routine distribution of pension assets a taxable two-step: Step one would be the pension fund's cutting a check, or making it "transferable or . . . not subject to a substantial risk of forfeiture", I.R.C. § 83(a)(1), by popping it into an envelope; step two would be when the taxpayer actually receives the same check in the mail and opens it, which would on this theory be a "distribution", I.R.C. § 83(b)(2).

This would render section 402(b)(2) superfluous, which courts are loathe to do. *Chevron Mining Inc. v. United States*, 863 F.3d 1261, 1274 (10th Cir. 2017).[3]

Even the Commissioner's textual argument specific to this case doesn't cohere once one looks at it. He argues that according to the Plan's terms, once petitioners' corporation notified the Plan of its withdrawal, petitioners became "beneficial owners" of the policies. The reason is that the notification triggered the Plan's obligation to identify petitioners and fix their claim to the Plan's assets, creating "a separate [vesting] event" at "a slightly different moment in time" than distribution. But this Plan had an unusual feature -- the notification didn't take effect immediately, but only started a 23-month waiting period during which petitioners could forfeit their benefits by dying or leaving the corporation's employ.

The Commissioner admits that this meant there wasn't really vesting right away. But, he says, petitioners in this case agreed to an amendment to the Trust to waive the 23-month waiting period. This means that there really wasn't a risk of forfeiture, and so the vesting rules of section 402(b)(1) apply. He then carefully notes

> The waiver of the 23 month waiting period was a standardized form that was provided by the Plan Administrator to each withdrawing Employer as part of the normal withdrawal package.

Thus a "normal part of the withdrawal package" is evidence that the Code section that governs vesting in a named beneficiary applies in addition to the Code section that governs withdrawals.

This doesn't work.

B. Textualism doesn't always work when a nook of tax law gets filled up with caselaw, and the parties argue about the cases too. Four cases in particular are relevant:

[3] This case is appealable to the Tenth Circuit as petitioners resided in Utah at the time they filed their petition with this Court. *See* I.R.C. § 7482(b).

> *Cadwell v. Commissioner*, 136 T.C. 38, 44 (2011), *aff'd*, 483 F. App'x 847 (2012), in which a purported multiemployer plan holding life-insurance policies was split into single-employer plans for the benefit of the taxpayers;
>
> *Schwab v. Commissioner*, 136 T.C. 120, 123 (2011), *aff'd*, 715 F.3d 1169 (9th Cir. 2013), in which life-insurance policies were distributed to individual taxpayers in their own names following employer's withdrawal from the plan;
>
> *Lowe v. Commissioner*, 101 T.C.M. 1525, 1526 (2011), in which the termination of benefits plan caused trust to distribute life-insurance policy to an individual in his own name; and
>
> *Gluckman v. Commissioner*, 104 T.C.M. 651, 652-53 (2012), *aff'd*, 545 F. App'x 59 (2d Cir. 2013), in which life-insurance policies were distributed from one nonexempt trust under one benefits plan to another under a different plan with the signature and approval of individuals who never owned the policies in their own names.

We recognize that the Commissioner argues *Gluckman* supports his position because of our focus in that case on the control exercised by the individual taxpayers over the ultimate destination of their life-insurance policies, but that fact was important as evidence that the policies were no longer subject to a substantial risk of forfeiture in their new home. The taxpayers there did not argue and there was no proof that they ever owned the policies themselves. We held in *Cadwell* and *Gluckman* that section 402(b)(1) applied because the transfers were to another plan, and plans in which there was no risk of forfeiture. In *Schwab* and *Lowe*, we held that section 402(b)(2) applied because the policies ended up being distributed to and owned by the individual taxpayers.

In this case the policies also ended up being distributed to and owned by the individual taxpayers. We therefore conclude that this is a case where section 402(b)(2) applies.

It is therefore

ORDERED that respondent's motion for summary judgment as supplemented is denied. It is also

ORDERED that the parties shall file a status report on or before December 21, 2018 to describe whether the case is likely to settle or will instead need to be prepared for trial at the Court's next trip to Buffalo.

(Signed) Mark V. Holmes
Judge

Dated: Washington, D.C.
October 24, 2018