

## PART VI: EMPLOYEE DEATH BENEFITS

### In General

#### **3599. If an employer is under contract to pay a death benefit to an employee's surviving spouse, is the benefit taxable income to the surviving spouse?**

Death benefits payable under a contract, or pursuant to an established plan of the employer, are taxable income.<sup>1</sup> Employee death benefits that are payable by reason of the death of certain terrorist attack victims or astronauts are excludable from gross income.<sup>2</sup>

Frequently, death benefits are funded by insurance on the life of the employee, with the insurance owned by and payable to the employer. The fact that the death payments come from proceeds received tax-free by the employer does not cause them to be tax-exempt to the employee's surviving spouse. The surviving spouse receives them as compensation payments from the employer and not as life insurance proceeds.<sup>3</sup> (For tax effects of insurance funding, see Q 245, Q 246, and Q 263). Employee death benefits rarely qualify as life insurance benefits wholly excludable under IRC Section 101(a) (Q 62, Q 64, Q 243).<sup>4</sup> Death benefits payable to an employee's surviving spouse under a split-dollar arrangement, however, may be received free of income tax obligations (Q 3898, Q 3899).

Contractual death benefits are "income in respect of a decedent."<sup>5</sup> Consequently, where an estate tax has been paid, the recipient of the death payments is entitled to an income tax deduction for that portion of the estate tax attributable to the value of the payments.

#### **3600. Is a contractual death benefit payable to a surviving spouse deductible by an employer?**

The employer can deduct the death payments provided they represent reasonable additional compensation for the employee's services (Q 3515).<sup>6</sup> Payments can be deducted only in the year they are includable in the employee's income, regardless of the accounting method used by the employer.<sup>7</sup> An employer may not deduct a death benefit paid to (or received by) a surviving spouse to the extent that the employee recognized the value of the arrangement for income tax purposes or purchased the contractual right to the death benefit (Q 3898, Q 3899).

Questions as to whether death payments constitute compensation for an employee's services and, if so, whether the compensation is reasonable typically arise only in connection with payments for stockholder-employees of a close corporation. In several cases it has been held that the payments, even though made under contract, were not compensation but were payments under a plan to provide financial security for the families of the stockholder-employees.

1. *Simpson v. U.S.*, 261 F.2d 497 (7th Cir. 1958); *Robinson v. Comm.*, 42 TC 403 (1964).

2. IRC Sec. 101(i).

3. *Essenfeld v. Comm.*, 311 F.2d 208 (2nd Cir. 1962).

4. See *Edgar v. Comm.*, TC Memo 1979-524.

5. *Est. of Wright v. Comm.*, 336 F.2d 121 (2nd Cir. 1964).

6. *Southern Fruit Distributors v. U.S.*, 32 AFTR 2d 5598 (M.D. Fla. 1973).

7. IRC Sec. 404(a)(5); Rev. Rul. 55-212, 1955-1 CB 299.

Hence, the deductions were disallowed.<sup>1</sup> On the other hand, payments were held reasonable and for a substantial business purpose in *M. Buten and Sons, Inc. v. Comm.*<sup>2</sup>

An employer who prefunds welfare benefit fund benefits will be subject to limits discussed in Q 3965 and Q 3969. If the funded benefit is considered deferred compensation, the deduction is subject to the rules in Q 3523 or Q 3560.

### **3601. If an employer voluntarily pays a death benefit to an employee's surviving spouse, is the benefit taxable income to the surviving spouse? Is it deductible by the employer?**

The IRS has taken the position that voluntary death benefits are not gifts, but compensation and therefore taxable income.<sup>3</sup> The courts, following the rules laid down by the United States Supreme Court in *Commissioner v. Duberstein*,<sup>4</sup> have divided on the question of whether these payments are tax-free gifts or taxable compensation. Each case has been decided on its facts.<sup>5</sup>

Payments made after December 31, 1986 by an employer "to, or for the benefit of" an employee are not excludable as gifts, however.<sup>6</sup> Thus, a death benefit paid by an employer after December 31, 1986 would appear to be a payment for the benefit of an employee and, if so, would not be excludable as a gift. Employee death benefits that are payable by reason of the death of certain terrorist attack victims or astronauts are excludable from gross income.<sup>7</sup>

To be deductible by the employer, a voluntary death benefit must qualify as an ordinary and necessary business expense.<sup>8</sup> Payments will be deductible, therefore, if the circumstances show that they are additional reasonable compensation for the employee's services, or otherwise qualify as an ordinary and necessary business expense.<sup>9</sup>

The deduction will be denied if the facts indicate that the payment was purely a gift or was made for the personal satisfaction of the directors.<sup>10</sup>

Where the surviving spouse is a controlling stockholder, the payments may very likely be treated as constructive dividends. In such a case, the entire death benefit would be taxable to the surviving spouse and not deductible by the corporation.<sup>11</sup> Even where the surviving

1. *Willmark Serv. Sys., Inc. v. Comm.*, 368 F.2d 359 (2d Cir. 1966); *Wallace v. Comm.*, TC Memo 1967-11; *M.S.D. Inc. v. U.S.*, 611 F. 2d 373 (6th Cir. 1979).

2. TC Memo 1972-44.

3. Rev. Rul. 62-102, 1962-2 CB 37.

4. 363 U.S. 278 (1960).

5. See *Sweeney v. Comm.*, TC Memo 1987-550.

6. IRC Sec. 102(c).

7. IRC Sec. 101(i).

8. IRC Sec. 404(a)(5); Treas. Reg. §1.404(a)-12.

9. *Rubber Assoc., Inc. v. Comm.*, 335 F.2d 75 (6th Cir. 1964); *Associated Ark. Newspapers Inc. v. Johnson*, 18 AFTR 2d 5894 (E.D. Ark. 1966); *Fifth Ave. Coach Lines, Inc. v. Comm.*, 31 TC 1080 (1959).

10. *Loewy Drug Co. v. Comm.*, 356 F.2d 928 (4th Cir. 1966); *Vesuvius Crucible Co. v. Comm.*, 356 F.2d 948 (3rd Cir. 1965); *Montgomery Eng'g Co. v. Comm.*, 344 F.2d 996 (3rd Cir. 1965); *Greentree's Inc. v. U.S.* 16 AFTR 2d 5368 (E.D. Va. 1965); *Fouke Fur Co. v. Comm.*, 261 F. Supp. 367 (E.D. Mo. 1966).

11. *Schnee-Block Co., Inc. v. Comm.*, 329 F.2d 875 (2nd Cir. 1964); *Nickerson Lumber Co. v. U.S.*, 214 F. Supp. 87 (D. Mass. 1963); *Bacon v. Comm.*, 12 AFTR 2d 6076 (E.D. Ky. 1963).

spouse does not own a controlling interest, the payments may be treated as dividends, if the corporation is owned by a closely knit family group.<sup>1</sup> The payments will not be treated as dividends merely because the employee was a minority stockholder. They also will not be treated as dividends in all cases where the surviving spouse is a substantial, but not a controlling, stockholder.<sup>2</sup>

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1. *Jordanos, Inc. v. Comm.*, 396 F.2d 829 (9th Cir. 1968).

2. *Plastic Binding Corp. v. Comm.*, TC Memo 1967-147; see also *John C. Nordt Co. v. Comm.*, 46 TC 431 (1966).