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From:
Sent: Friday, August 24, 2012 4:37:07 PM
To:
Cc:
Subject: Question re: taxpayer treatment of insurance benefit

You submitted a question about a taxpayer's duty of consistency with regard to inclusion of insurance premiums (or the subsequent benefit) as income. In this case, the taxpayer was a 2% shareholder-employee in an S-corporation which paid disability insurance premiums for the taxpayer from which the taxpayer did not include as income. In , the taxpayer collected $ in disability benefit. He now proposes that he should have included the premium payments as income all along, and for that reason the benefit should not be included as income. He also proposes to amend his one open return to include whatever premiums were paid in that year as income.

Your question was coordinated with , which determined that the taxpayer's position regarding the correct treatment of the premium payments was "technically correct" (i.e., an S-corp is treated as a partnership and a 2% shareholder-employee is treated as a partner under section 1372(a), and the partner is required to include the premiums as income in the years that they are paid). See Notice 2008-1, 2008-1 C.B. 251, for clarification regarding a 2% shareholder-employee's treatment of certain insurance premiums. Rev.Rul. 2004-55, 2004-1 C.B. 1081, deals with the payment of insurance premiums by employers outside of the S corporation- 2% shareholder context and provides that where an insured has made an irrevocable election prior to the plan year to treat employer-paid premiums as income, any resulting benefit may be excluded from income. The revenue ruling further provides that if an insured does not make such an election prior to the plan year, any potential benefit is includible in the insured's gross income. Consequently, we agree with further conclusion that a taxpayer should not be allowed to retroactively make this election on equitable grounds. We agree that this would create a large loophole that everyone receiving such a benefit would employ -- namely, to exclude the premiums from income and then subsequently amend one return to then exclude the benefit from income. If the taxpayer excluded the premiums, he should not also be able to exclude the benefit.

In addition, the duty of consistency doctrine could also be invoked. The duty of consistency is "based on the theory that the taxpayer owes the Commissioner the duty to be consistent with his tax treatment of items and will not be permitted to benefit from the taxpayer's own prior error or omission." Cluck v. Commissioner, 105 T.C. 324, 331 (1995). See generally, Bittker & Lokken, Federal Taxation of Income, Estates and Gifts ¶ 4.3.7 (RIA 2009), and cases cited therein. The doctrine requires the presence of three elements: (1) the taxpayer represented a fact or reported an item for federal income tax purposes for a particular year; (2) the Service acquiesced in or relied upon the representation of fact for the reported item for that year; and (3) the taxpayer attempts to change the representation or reporting in a subsequent year after the period of limitation bars adjustments for the initial year and the change is detrimental to the Service. LeFever v. Commissioner, 103 T.C. 525, 543 (1994), aff'd, 100 F.3d 778 (l0th Cir. 1996); Herrington v. Commissioner, 854 F.2d 755 (5th Cir. 1988); Estate of Ashman v. Commissioner, T.C. Memo. 1998-145, aff'd, 231 F.3d 541 (9th Cir. 2000). "If this test is met, the Commissioner may act as if the previous representation, on which he relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary." Herrington, 854 F.2d at 758. While each duty-of-consistency case is evaluated on its own facts, this situation is similar to the one in Grayson v. United

States, 437 F.Supp. 58 (D.C. Ala. 1977). In that case, the district court opined that a pension beneficiary could not exclude employer pension contributions from income in the years in which they were made and then, after the statute of limitations for those years had run, claim inconsistently that the contributions should have been included in the closed years. Applying the doctrine here is a bit of a stretch given that there is one open year and the duty of consistency doctrine generally requires closed years. But the revenue ruling seems to plug that gap in that an irrevocable election had to be made to include the premiums paid as income before the next succeeding year. That would mean that an election would have had to have been made in the year before the last open year.

Moreover, the Code "does not explicitly provide either for a taxpayer's filing, or for the Commissioner's acceptance, of an amended return; instead, an amended return is a creature of administrative origin and grace." Badaracco v. Commissioner, 464 U.S. 386, 393 (1984) (citing Hillsboro National Bank v. Commissioner, 460 U.S. 370, 378 n.10 (1983)). Consequently, we need not accept taxpayer's proposed amended return. [redacted]

Please let me know if you have any further questions.