Part III -- Administrative, Procedural, and Miscellaneous

Trust Arrangements Purporting to Provide Nondiscriminatory Post-Retirement Medical and Life Insurance Benefits

Notice 2007-84

Sections 419 and 419A of the Internal Revenue Code set forth rules under which employers are permitted to make currently deductible contributions to welfare benefit funds in order to provide their retirees with medical and life insurance benefits. Businesses often maintain welfare benefit funds that comport with the intent of §§ 419 and 419A and do in fact provide meaningful medical and life insurance benefits to retirees on a nondiscriminatory basis, and make substantial contributions to those welfare benefit funds that are fully deductible. Such welfare benefit funds are outside the scope of this notice.

This notice addresses certain trust arrangements that are being promoted to and used by small businesses to avoid federal income and employment taxes. The arrangements described in this notice involve purported welfare benefit funds that, in form, provide post-retirement medical and life insurance benefits to employees on a nondiscriminatory basis, but that, in operation, will primarily benefit the owners or other key employees of the businesses. This notice alerts taxpayers and their representatives that the tax treatment of these arrangements may vary from the claimed tax treatment. The Internal Revenue Service (IRS) may issue further guidance to address these arrangements, and taxpayers should not assume that the guidance will be applied prospectively only.

Concurrently with this notice, the IRS is publishing Notice 2007-83, this Bulletin, which identifies as listed transactions certain transactions involving purported welfare benefit fund arrangements using cash value life insurance policies. The fact that an arrangement is described in this notice does not preclude it from also being a listed transaction under Notice 2007-83 where the arrangement provides benefits to active employees as well as to retired employees

The IRS has previously identified certain other transactions that claim to be welfare benefit funds as listed transactions. Notice 2003-24, 2003-1 C.B. 853, describes certain transactions purporting to meet the exception under § 419A(f)(5) of the Internal Revenue Code for collectively bargained plans. Notice 95-34, 1995-1 C.B. 309, describes transactions that purport to meet the 10-or-more employer plan exception under § 419A(f)(6). Notice 2004-67, 2004-2 C.B. 600, includes transactions described in Notice 2003-24 and Notice 95-34, as well as substantially similar transactions, as listed transactions.

BACKGROUND

Promoted trust arrangements claiming to provide nondiscriminatory post-retirement medical benefits and post-retirement life insurance benefits have recently come to the attention of the IRS. These arrangements, among others, may be referred to by persons advocating the use of the plans as "single employer plans" or "419(e) plans." These purported welfare benefit arrangements are usually sold to small businesses and other closely held businesses as a way to provide post-retirement medical benefits, post-retirement life insurance, and cash and other property to the owners or other key employees of the business on a tax-favored basis through the use of a trust. Those advocating the use of these plans usually assert that the contributions are tax-deductible, but with no corresponding inclusion by the owner or other key employee. Some of these arrangements involve plans that previously had claimed to be 10-or-more employer plans under § 419A(f)(6); some others were established to receive policies transferred from terminating plans that claimed to be 10-or-more employer plans.

A promoted arrangement may involve either a taxable trust or a tax-exempt trust, i.e., a voluntary employees' beneficiary association (VEBA) that has received a determination letter from the IRS that it is described in § 501(c)(9). The trust frequently uses the employer's contributions to purchase cash value life insurance policies on the lives of employees who are owners of the business and, sometimes, on the lives of other key employees.

The amount of the employer's deduction for contributions to one of these plans is often based on a calculation of a reserve associated with each of the plan participants. However, the calculation may be based on an unreasonable assumption that all of the covered employees will eventually receive post-retirement benefits under the plan, or may be based on other actuarial assumptions that either are not reasonable or are not permitted to be reflected in the reserve calculations for purposes of §§ 419 and 419A.

Under some arrangements, the plan documents may indicate that post-retirement benefits will be provided on a nondiscriminatory basis when, in fact, only a few employees (primarily the employees who are also owners of the business) will ever receive those benefits. To the extent a trust holds excess assets not needed to pay the original benefits, the owner will also receive a substantial portion of those assets. Under some arrangements this will be accomplished through the use of "loans" to the owners. For some arrangements, the plan will be amended to provide benefits other than the plan's original post-retirement medical or life insurance benefits. For others, the plan will be terminated prior to the payment of the post-retirement benefits and the timing of the termination and the methods used to allocate the remaining assets are structured so that the owners and other key employees will receive, directly or indirectly, all or a substantial portion of the assets held by the trust.

Persons advocating the use of these plans claim that the employer's contributions for the post-retirement medical and life benefits are deductible under §§ 419 and 419A as additions to a qualified asset account. They may also claim that owners or other key employees receive the economic benefits from the contributions with little or no income inclusion.

LAW

Sections 419 and 419A prescribe limits on the amount of deductions for contributions paid or accrued by an employer to a welfare benefit fund. A welfare benefit fund generally consists of a taxable or exempt trust, corporation, or other organization that is part of a plan of an employer through which the employer provides welfare benefits to employees or their beneficiaries. Under § 419, the employer's contributions to a welfare benefit fund are deductible only if they would otherwise be deductible under Chapter 1 of the Code, and the amount of the deduction is limited to the welfare benefit fund's qualified cost for the taxable year.

One component of qualified cost is a fund's qualified direct cost for the year, which is the amount (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided during the year if those benefits had been provided directly by the employer, and the employer had used the cash receipts and disbursements method of accounting. A second component of qualified cost is any addition to a qualified asset account for the taxable year, but only to the extent the addition does not exceed specified limits. Further, the qualified cost for the taxable year is reduced by the fund's after-tax income for the year.

Under § 419A(a), the term "qualified asset account" means any account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, supplemental unemployment benefits or severance pay benefits, or life insurance benefits. Sections 419A(b) and 419A(c)(1) generally limit the additions to a qualified asset account to an amount that is reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for the benefits referred to above, plus administrative costs with respect to those claims.

Section 419A(c)(2) allows additional limited reserves for post-retirement medical and post-retirement life insurance benefits. The reserves must be funded over the working lives of the covered employees and must be actuarially determined on a level basis using assumptions that are reasonable in the aggregate as necessary for the post-retirement benefits to be provided to the covered employees. For purposes of § 419A(c)(2), contributions to a reserve are deductible under § 419A only if the contributions are intended to actually accumulate for the purpose of funding the post-retirement benefits. General Signal Corporation v. Commissioner, 142 F.2d 546 (2d Cir. 1998).

Under § 419A(c)(2)(A), the reserve for post-retirement medical benefits is further limited by the requirement that it be determined on the basis of current medical costs. In addition, for post-retirement life insurance the maximum insurance coverage that can be taken into account with respect to any covered employee is $50,000 of coverage. Moreover, in the case of post-retirement benefits for or on behalf of a key employee (as defined in § 416(i)(1)), § 419A(d) requires that a separate account be established for any medical or life insurance benefits provided with respect to the key employee, and any medical or life insurance benefits provided with respect to the key employee after retirement may only be paid from the separate account. Under § 419A(e)(1), in order for reserves for post-retirement medical and life insurance benefits to be taken into account the plan must meet the nondiscrimination requirements of § 505(b) with respect to those benefits (even if those requirements do not otherwise apply to the plan).

A plan meets the nondiscrimination requirements of § 505(b) only if (i) each class of benefits under the plan is provided under a classification of employees which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are highly compensated individuals, and (ii) in the case of each class of benefits, such benefits do not discriminate in favor of employees who are highly compensated individuals. Under § 505(b)(3), in the case of any benefit for which another section of the Code provides nondiscrimination rules (e.g., § 105(h) in the case of a self-insured medical reimbursement plan), those rules apply instead with respect to the benefit. Under §§ 105(h)(8) and 414(t), all employees who are treated as employed by a single employer under the rules of § 414(b), (c), or (m) are treated as employed by a single employer for purposes of §§ 105(h), 79, and 505.

Sections 104(a)(3) and 105(b),(c), and (d) exclude from gross income certain amounts received by an employee through accident and health insurance. Section 105(e) provides that for purposes of §§ 104 and 105, amounts received through an "accident and health plan for employees" are treated as amounts received through accident or health insurance. Thus, the plan must exist primarily for the benefit of employees, as opposed to shareholders. See, e.g., Larkin v. Commissioner, 48 T.C. 629 (1967), aff'd, 394 F.2d 494 (1st Cir. 1968) (holding that the plan was merely a device to use corporate earnings to meet the anticipated medical needs of the shareholders).

Section 4976(a) imposes on an employer an excise tax in the amount of 100 percent of the amount of any disqualified benefit provided with respect to a welfare benefit fund maintained by the employer. Under § 4976(b)(1), a "disqualified benefit" means (i) any post-retirement medical benefit or life insurance benefit provided with respect to a key employee if a separate account is required to be established for the key employee under § 419A(d) and the

payment is not from that employee's account; (ii) any post-retirement medical benefit or life insurance benefit provided with respect to an individual in whose favor discrimination is prohibited unless the plan meets the requirements of § 505(b) with respect to the benefit (whether or not the § 505(b) requirements apply to the plan); and (iii) any portion of a welfare benefit fund reverting to the benefit of the employer.

INTENT TO CHALLENGE ARRANGEMENTS

The IRS may challenge the claimed tax benefits for the above-described arrangements for various reasons. Depending on the facts and circumstances of a particular arrangement, contributions to a purported welfare benefit arrangement on behalf of an employee who is an owner may properly be characterized as dividends or as non-qualified deferred compensation subject to § 404(a)(5) or 409A (or both), or the arrangement may be subject to the rules for split-dollar life insurance arrangements. See Notice 2007-83.

If, based on the facts and circumstances, an arrangement described above is properly characterized as a welfare benefit fund, an employer's deductions for contributions to the welfare benefit trust or other fund are subject to the rules of §§ 419 and 419A. Under those rules, deductions for post-retirement medical and life benefits are subject to a number of limitations and requirements, including the use of reasonable actuarial assumptions, the requirement that the plan meet the nondiscrimination requirements of § 505(b) (determined after application of the rules of § 414(b), (c), and (m)), a prohibition against considering future increases in medical costs, and a limit on the reserves for post-retirement life insurance benefits to the reserves that would apply with respect to $50,000 of coverage. Moreover, in order to obtain a deduction for reserves for post-retirement medical or life benefits, the taxpayer cannot get a deduction unless the employer actually intends to use the contributions for that purpose.

The tax benefit rule may require that some or all of the deductions taken by the employer in earlier years be included in its income in a later year in which an event occurs that is fundamentally inconsistent with the premise on which the deductions were initially based. (For a further discussion of the tax benefit rule, see Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983)).

Further, the IRS intends to challenge the claimed value of property distributed from a trust, including life insurance policies, whenever the property has not been properly valued by the taxpayer.

Finally, based on the facts and circumstances of a particular arrangement, some or all of the benefits or distributions provided to or for the benefit of employees who are also owners or other key employees may be disqualified benefits for purposes of § 4976 subjecting the employer to a 100% excise tax.

Taxpayers should be aware that the IRS may impose penalties on persons involved in these arrangements or similar arrangements (including the accuracy-related penalty under § 6662) and, as applicable, on persons who participate in the promotion or reporting of these arrangements or similar arrangements (including the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701).

The above rules apply whether the trust used to provide benefits under the arrangement is a taxable trust or a VEBA. While the trust may have received a determination letter stating the trust is exempt under § 501(c)(9), a letter of this type does not address the tax deductibility of contributions to the trust with respect to the employer, nor the income inclusion with respect to the employees.

DRAFTING INFORMATION

The principal authors of this notice are Larry Isaacs of the Employee Plans, Tax Exempt and Government Entities Division and Betty Clary of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Mr. Isaacs at RetirementPlanQuestions@irs.gov or Ms. Clary at (202) 622-6080 (not a toll-free call).