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Welfare Benefit Plans Redux: Here We Go Again!

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In the Spring 2009 issue of *The ASPPA Journal*, an article regarding welfare benefit plans was published. In a nutshell, it was an explanation of why welfare benefit plans purporting to comply with IRS requirements (especially under Code Section 419 and 419A) were still a viable plan design for small business clients and not an abusive tax shelter. There were positions in that previous article that must not go unchallenged. It is also fair to say that the subject of welfare benefit plans is a difficult and confusing interplay of law and regulations, and that expertise on the topic seems to be at a premium.

It is imperative that if one of your clients or his or her advisor brings to you a “funded” welfare benefit plan purporting to give your client big deductions, your antennae must go up! One of the hallmarks of this scheme will be large amounts of life insurance; it seems like we have been through this scenario many times before. Now, what supposedly makes it different *this time* is that the promoters assure us that *their* particular promotion is different from those other programs with which the IRS has found fault. Of course, that is the same assurance that we have seen in all the prior programs that the IRS has knocked down over and over. Some of you may remember the Section 79 insurance schemes or the abusive VEBAs and multiemployer welfare plan arrangements; even more of you will remember the abusive type of fully insured defined benefit plans [412(i) plans] or the “springing” cash value policies designed to strip money, tax free, from retirement plans. Never underestimate the creative mind of the insurance industry when there are large commissions at hand.

While it is certainly true that Congress created legitimate tax deductible benefit programs within



the tax code for certain welfare benefit plans, these are generally intended for unions, true multiemployer associations and large companies. It is not true that Congress contemplated these programs would be appropriate to provide, for example, lavish post-retirement medical care or cash value life insurance on a deductible basis for the small medical practice with a doctor, a spouse and two medical assistants!

Let's make one thing very clear—the IRS does not like the abusive use of these programs and they are doing everything they can to shut them down.

You must take that as a given, and your client must decide if he or she really wants to be challenging the IRS on this design. Some insurance companies have even announced they will no longer sell *any* insurance policies to a 419(e) welfare benefit plan.

Of course, as the IRS issues rules and attempts to clamp down on what it sees as abusive programs, the promoters make their own interpretations of those new rules and make modifications to their programs so that *this time* (at least, in their view) their program is “good” *under the new rules*. However, the history is that the IRS challenges even the so-called “good” programs and it could cost your clients a fortune in penalties. For example, in the 412(i) arena we are receiving many reports of huge amounts of taxes, fines and penalties being assessed on “innocent” consumers of these tax-avoidance schemes. A group of these taxpayers has even banded together to petition Congress for relief from the fines and penalties (but they accept as a given the loss of the deductions).

In my opinion, the recently published article utilized logical fallacies to conclude that the designs being suggested would be just fine. The IRS issued a series of three items *as a package* (two Notices and one Revenue Ruling), yet the crux of the justification in the article for the viability of these programs was the application of a narrow interpretation to one of the notices. That conclusion seems to be like trying to apply the retirement plan nondiscrimination rules by reference only to IRC Section 401(a)(4) and ignoring the complementary rules under Section 410(b), 401(l) and 414(s).

There are two significant analyses in the article with which I have problems. The first is that it appears that the author believes that if a welfare plan provides *both* pre- and post-retirement benefits, it is not subject to the listed transaction rules *because* it provides the post-retirement benefits (even though the author admits many benefit professionals believe otherwise). However, in the article, the author does go on to assume that the other benefit professionals are correct on this point, but he still tries to make his argument on other points. Even here, I believe his analysis is faulty.

From the author’s discussion, he clearly believes that the IRS will not treat annuity contracts as cash value life insurance contracts (the author’s design that includes pre-retirement benefits appears to depend on term insurance with annuities for its existence). I do not believe the IRS will be so generous. For a quick refresher, an annuity contract: (1) is a contract issued by a life insurance company; (2) depends on life contingencies for its benefit structure; and (3) has cash values. That it does not provide an insured death benefit as in a

traditional whole life contract is correct; that the lack of an insured death benefit makes it any less a cash value life insurance contract is *not* correct. This particular analysis (that annuity contracts *are* cash value life insurance contracts) is something that has not been noted in any other discussions of 419 plans that I have seen anywhere, and pursuing the concept would probably be worth the solicitation of an opinion regarding it from the IRS. And if the IRS has not yet thought of it, they will.

The other, perhaps more significant oversight, again in my opinion, is the complete avoidance of a discussion of the scheme being basically a program of deferred compensation, for that is truly what it is—that is the way it is sold and that is the (only) way clients buy it. In the notice that receives particular attention in the article (Notice 2007-83), the IRS clearly states that: “Depending on the facts and circumstances of a particular arrangement, contributions to a purported welfare benefit fund on behalf of an employee who is a shareholder may properly be characterized as dividend income to the owner, the value of which is includible in the owner’s gross income, and for which amounts are not deductible by the corporation.” It goes on to say (in part): “In addition, an arrangement may properly be characterized as a non-qualified deferred compensation plan for purposes for IRC Section 409A.”

The previous article includes the comment that: “Plans that provide post-retirement benefits, such as life insurance or medical reimbursement benefits, are not described in the Notice. It should follow, then, that such plans are not listed transactions...”

It is true that a plan that provides no pre-retirement benefits but provides only post-retirement death and/or medical benefits is not the subject of Notice 2007-83, and thus the plan is not *automatically* going to be subject to the listed transaction rules. Because the Notice does not automatically make these arrangements listed transactions, the promoters of these programs perceive in this language a new plan design to market: “Let’s design a plan that provides *no* pre-retirement benefits, that only provides post-retirement death and medical benefits, and we are guaranteed not to be troubled by any IRS attacks.”

I agree that such a plan will not fall into the listed transaction requirements, at least, not yet (except, possibly as noted below). However, I would be very concerned that at some later date the IRS might change its mind, so vigilance will be the hallmark. In the IRS attack on purported welfare benefit plans, they have had no compunction in applying the rules retroactively. In fact, they state that “further guidance might be

forthcoming and might not apply prospectively only.” How is that for giving you a warm and fuzzy feeling in your tummy? Nonetheless, at this time, and for purposes of this article, let’s concede that it is *not* a listed transaction.

Even though it might not be a *listed transaction*, the IRS very clearly states that the post-retirement medical deduction will *not* be allowed “*unless the employer actually intends to use the contributions for that purpose.*” This language should concern any practitioner or client who is considering the installation of such a program. This phrase means that the IRS will be able to challenge the *intent* of the small business owner who is accumulating all this money; they will want to get into his or her head to determine the intent of the program. It also likely means that all the marketing material (which usually provides examples of how this money will *not* be used for such purposes) will be subject to review by the IRS. And, don’t forget, just like in Notice 2007-83, the IRS can find that this program is properly characterized as dividends or as non-qualified deferred compensation subject to IRC Section 404(a)(5) or 409A (or both). Not a welcomed fight, for sure.

As noted above, there is a possible significant exception to the “post-retirement only” plan being exempt from the listed transaction rules. There is a provision in Notice 2007-83 that provides that *any* transaction that is *substantially similar* to the transaction as defined in the notice is *also* a listed transaction. If the IRS were to determine that a transaction involving a post-retirement benefit only plan is “close enough” to meet this provision (which is, alas, a facts and circumstances determination *made by the IRS*), then we might have a listed transaction which the client knew nothing about. The problem with such a result is that there are now filing requirements that most likely have not been met, with severe income tax penalties measured in the hundreds of thousands of dollars! For example, if the funding of the post retirement benefits was exclusively with cash value life insurance, an argument might be made that the program is now *substantially similar* to the listed transactions enumerated in Notice 2007-83 (part of the reason why some insurance companies have ceased writing any insurance contracts for any of these type of welfare benefit programs). Bad news for everyone!

Let’s not forget that Notice 2007-84 also reminds us that if the IRS finds, on a facts and circumstances basis, that any of the benefits of the “post-retirement only” plan are disqualified benefits for purposes of IRC Section 4976, the employer will be subject to a 100% excise tax (and that includes any part of the fund reverting to the employer).

The IRS also may impose penalties on persons involved in the arrangements described in Notice 2007-84 *or similar arrangements* as follows: (1) under the accuracy-related penalties of Section 6662, 20% of the underpayment, paid by the taxpayer; (2) under the tax return preparer liability of Section 6694, the greater of \$1,000 or 50% of the income for the return, paid by the preparer; (3) under the promoting of abusive tax shelters penalty of Section 6700, \$1,000 per activity or, if lesser, 100% of the gross income derived, paid by the person who promotes it; and (4) under the aiding and abetting the understatement of tax liability of Section 6701, \$1,000.

The area of Section 419 is under intense scrutiny at the Service, and many employers with such plans are being audited. While it is (or might be) possible that a retiree medical plan with cash value insurance would provide deductions to the sponsor, the vast majority of welfare plans that I have seen come to me via my clients are of the variety that are clearly problematic. They are almost always plans that seem to be designed for the sole purpose of selling (high commission) cash value life insurance which “primarily benefits the owners or other key employees of the businesses” (a key phrase from Notice 2007-84).

If you are involved in any situation where a client is asking for your review or for an opinion on such a program, there are two things you need to do for your client:

1. You need to tell them that YOU are not an expert and can’t give them an opinion (unless you actually are, and are willing to risk your own hide on that opinion); and
2. You need to make sure that they get to a competent, independent legal/accounting advisor with substantial expertise in this area who can give them a truly informed and knowledgeable opinion.

There is another item that deserves review, and that is a Tax Court case (DeAngelis) released on December 5, 2007 and decided by the very knowledgeable Judge Laro (who also wrote the opinions on the well known *Booth* and *Neonatology* tax court cases). Although this case involved a multiple employer 419A(f)(6) plan involving several doctor groups and providing severance and pre-retirement death benefits, Judge Laro’s comments are well worth reading. The benefits under this structure were provided by whole life contracts issued on the doctors and an office manager.

After an extensive review of the transactions that led to the implementation of this plan and the purchase of the insurance, Judge Laro opened his opinion with the following sentence:

While it is certainly true that Congress created legitimate tax deductible benefit programs within the tax code for certain welfare benefit plans, these are generally intended for unions, true multiemployer associations and large companies.

“We are faced once again with an issue arising from a plan designed to aggressively bolster the sale of insurance products through a claim of permissible tax savings.”

Judge Laro did not even look at the statutory language of IRC Section 419 and 419A; instead he focused on whether these deductions were permissible as “ordinary and necessary” business expenses under IRC Section 162. Judge Laro did not think they were:

“While the ... plan may have been cleverly designed to appear to be a welfare benefits plan and marketed as such, the facts of these cases establish that the plan was nothing more than a subterfuge through which the participating doctors ... used surplus cash of the PCs (professional corporations) to purchase cash-laden whole life insurance contracts primarily for the benefit of the participating doctors personally. While employers are not generally prohibited from funding term insurance for their employees and deducting the premiums on that insurance under Section 162(a), employees are not allowed to disguise their investments in life insurance as deductible benefit-plan expenses when those investments accumulate cash value for employees personally.”

We can expect that the IRS will mercilessly wield this new approach to welfare benefit plan deductions with power and efficiency while slicing through these schemes and preserving the government’s revenue!

The last item that requires comment is Revenue Ruling 2007-65, the third and last part of the released ruling package (including the two Notices, 2007-83 and 84). Revenue Ruling 2007-65 specifically addresses the deductibility of premiums paid by the 419(e) plan on cash value life insurance policies (and remember, I think that can be expanded to include annuity contracts). It concludes that even if an arrangement is a welfare benefit plan under 419(e), an employer would not be entitled to a deduction with respect to any premiums paid if the fund or employer is directly or indirectly a beneficiary under the life insurance policy with the meaning of IRC Section 264(a). The IRS contends (and will no doubt assert) that in many of the arrangements under discussion, the fund or employer are direct or indirect beneficiaries under the policy and therefore any contributions used to pay the premiums are not deductible. That should be viewed, possibly, as the so-called “final nail in the coffin.”

The previous article omitted a discussion of this Revenue Ruling (but it did admit that the Revenue Ruling was a part of the IRS guidance package). The article attempted to suggest that a taxpayer would be able to take the deductions because they are allowed under the Internal Revenue Code (the law), but

seemed to dismiss the IRS’s ability to effectively implement that law (and limit any deductions) through properly issued regulations, rulings and other processes available to it. This approach is a risky, dangerous and potentially expensive approach to take. It amounts to saying “I don’t care what the IRS says you can do, the law says otherwise.” The only way you have to win that fight is in court, and it is a rare client who purposely wants to take on that very expensive fight.

The IRS has told us that they don’t like these schemes; they’ve told us that they’re going to do everything possible to discredit and disallow them. Is that really a fight our clients want to take on?

Over the years, I have noted one unflinching characteristic of these schemes, and that is that the promoter specifically says that they *do not* guarantee the tax results, and that you should check with your own adviser for an interpretation of the law. I have had a very simple approach to dealing with these schemes over the years. After taking the client through the complex legal analysis, I simply say: why don’t you ask the insurance company that is selling the insurance to guarantee the deduction in writing, and if they won’t do that (and they won’t), ask them to apply for a private letter ruling from the IRS on your behalf that appropriately outlines the transaction and asks for IRS review and blessing. In all the years of taking this approach, *neither* of those things have ever happened, and all the clients who made the requests and were turned down have, wisely, realized that they were not particularly interested in playing Russian roulette with their tax returns!

Caveat Emptor! 

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