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Welfare Benefit Plans After IRS Notice 2007-83

by Jeffrey I. Bleiweis

The combination of the tumbling stock market and declining home values has created a storm that threatens the retirement security of many Americans. Add to that the skyrocketing cost of medical care and the uncertainty surrounding Medicare, and you have a perfect storm of bad news that has caused Americans to look at retirement with fear and trepidation, instead of with hope and excitement.

While you may not be able to do anything about the declining stock market or the housing crisis, there is a way that you, as a benefits, tax, insurance or accounting advisor, can help relieve your clients' retirement fears by ensuring that they will have enough money to pay for medical care after retirement. It is called a "welfare benefit plan," and it allows an employer to pre-fund post-retirement medical reimbursement benefits on a tax-deductible basis. The employer simply makes annual contributions to a trust on a level basis over the working life of an employee to fund a reserve that will reimburse the employee for qualified medical costs incurred by the employee after retirement. In addition, by funding the plan with insurance and annuity products, the employer can guarantee that the funds will be available at retirement without having to worry that benefits will be eroded by poor market performance.

Background

Ironically, at a time when the insurance industry is best suited to address the fears of an aging population about paying for medical care, advisors have shied away from promoting fully-insured welfare benefit plans. In fact, there has been a



drumbeat of doom in the insurance industry decrying the demise of welfare benefit plans funded with life insurance. The primary reason for the distress is a series of guidance published by the Internal Revenue Service (the "IRS") in October 2007—Notice 2007-83, Notice 2007-84 and Rev. Rul. 2007-65 (collectively the "IRS Guidance").

The purpose of this article is to dispel the myth that life insurance can no longer be used to fund a welfare benefit plan. While the IRS Guidance has had the chilling effect that the IRS intended, it did not change the substantive

law regarding welfare benefit plans. A welfare benefit plan is still the best and, perhaps, the only vehicle through which an employer can provide legitimate welfare benefits to its employees on a tax-deductible basis. In addition, life insurance is still a viable funding mechanism for such benefits.

Trust Arrangements and Listed Transactions

In my opinion, the most important of the IRS Guidance is Notice 2007-83, which designates certain “trust arrangements” as “listed transactions” under Section 6011 of the Code. While it appears that Notice 2007-83 has scared advisors from recommending legitimate welfare benefit transactions, it is important to recognize that the Notice is not directed to all welfare benefit plans, but only to those plans that the IRS finds abusive. In the news release accompanying the IRS Guidance, the IRS says:

- There are many legitimate welfare benefit funds that provide benefits, such as health insurance and life insurance, to employees and retirees.
- The guidance targets specific abuses involving a limited group of arrangements that claim to be welfare benefit funds.

Thus, we are left with two questions. The first is which “trust arrangements” are abusive and, as a result, considered “listed transactions” by the IRS? The second is what does it mean that an arrangement has been designated a listed transaction?

In Notice 2007-83, the IRS says that it “intends to challenge the claimed tax benefits for the above-described transactions.” (emphasis added) Taking the IRS at its word, this guidance should mean that the IRS will not challenge transactions not described in the Notice.

The transactions described in the Notice are welfare benefit plans, funded with cash-value life insurance contracts that provide *current* benefits to *active* employees only.

The plan and trust documents indicate that the plan provides benefits such as *current* death benefit protection, self-insured disability benefits, and/or self-insured severance benefits to covered employees (including those employees who are also owners of the business), and that the benefits are payable while the employee is actively employed by the employer. The employer’s contributions are often based on premiums charged for cash value life insurance policies. For example, contributions may be based on premiums

that would be charged for whole life policies. *As a result, the arrangements often require large employer contributions relative to the actual cost of the benefits currently provided under the plan.* (emphasis added)

Furthermore, contributions in excess of the cost of the plan’s current benefits accumulate in the policy’s cash value for the purpose of making cash distributions to the owner of the business at a later date.

It is anticipated that after a number of years the plan will be terminated and the cash value life insurance policies, cash, or other property held by the trust will be distributed to the employees who are plan participants at the time of the termination. While a small amount may be distributed to employees who are not owners of the business, the timing of the plan termination and the methods used to allocate the remaining assets are structured so that the business owners and other key employees will receive, directly or indirectly, all or a substantial portion of the assets held by the trust.

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, and, in Notice 2007-84, the IRS affirms that post-retirement life insurance and medical reimbursement benefits are legitimate benefits that can be funded on a tax-deductible basis.

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. 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 for the post-retirement benefits to be provided to the covered employees.

Unlike a plan that provides post-retirement benefits, a plan that provides current benefits to active employees only is not entitled to maintain a reserve. However, a cash-value insurance policy, by definition, has a reserve. The policy’s reserve is its accumulation account, which holds assets in excess of the cost of the plan’s current benefits.

We now have the answer to the first question asked in this article. Arrangements that permit larger contributions than the cost of the plan’s benefits are abusive. Welfare benefit plans that provide current benefits to active employees only, but are funded with cash-value insurance permit such excess contributions. As a result, we would expect such trust arrangements to be designated as listed transactions for purposes of Section 1.6011-4(b)(2) of the Treasury regulations.

Unfortunately, while Notice 2007-83 defines the problem in narrow terms, the Notice has been interpreted by some as painting in very broad strokes. The Notice designates any transaction that has each of four elements a “listed transaction.” The element that has caused the most consternation in the insurance industry is the following:

The employer has taken a deduction for contributions for benefits under the plan (**other than post-retirement medical benefits or post-retirement life insurance benefits**) that is greater than the sum of the following amounts:

- a. For uninsured benefits, such as self-insured disability or self-insured severance, the amount is equal to the fund's qualified cost for the taxable year. The fund's qualified cost is the sum of claims actually incurred and paid during the year, plus a reserve for claims incurred, but not paid, during the year, plus claims paid during the year, but incurred during a previous year, as long as no deduction was taken for such claims, plus administrative expenses in connection therewith.
- b. For insured benefits, such as life insurance, the amount is equal to insurance premiums paid during the taxable year, plus insurance premiums paid in prior taxable years that are properly allocable to the current year, plus administrative expenses in connection therewith, as long as the insurance policy does not accumulate value either within or outside the policy.
- c. For taxable years ending after November 5, 2007, the sum of the foregoing amounts equals zero. For taxable years ending prior to November 5, 2007, this amount equals the greater of the amount reported on an employee's W-2 or 1099 or the cost of insurance element of the policy purchased.

In Notice 2007-83, the IRS targets plans that permit "large contributions relative to the cost of the plan's benefits." However, there are benefit professionals who believe that the Notice goes well beyond this point. They have written that the Notice designates any plan funded with cash-value life insurance as a listed transaction. They do not believe that it matters that the plan also provides post-retirement benefits or that the plan does not permit contributions in excess of the cost of the plan's benefits. For them, if the employer takes a deduction for the cost of the plan's current benefits, the plan is a listed transaction.

In my opinion, this interpretation of the Notice is overly broad, but for purposes of this article I will assume that it is correct. Of course, even under this broad interpretation of the Notice, plans funded with something other than cash-value insurance, such as a combination of term insurance and an annuity, should not be listed transactions. In addition, as long as the employer does not take a deduction for the cost of current benefits, a plan funded with cash-value insurance should not be a listed transaction. But, the question for this article is what does it mean that a plan is a listed transaction? It does not mean that the employer will not be allowed a deduction for the cost of the plan's pre-retirement death benefit. Whether a particular taxpayer is entitled to a deduction for a particular transaction depends upon the facts and circumstances of the taxpayer and the facts and circumstances of the transaction. Deductions are uniquely fact-specific. A taxpayer may be entitled to a deduction, even though the transaction generating the deduction has been designated a listed transaction by the IRS.

Congress gave the IRS the right to designate listed transactions in Section 6011 of the Code. However, Section 6011 is not substantive law. It is a notice provision. It simply requires a taxpayer participating in a listed transaction to disclose its participation in the transaction to the IRS, so the IRS can decide whether to seek more information about the transaction. The IRS said as much in the preamble to the Treasury regulations under Section 6011:

The Treasury Department and the IRS are concerned about the proliferation of corporate tax shelters. These temporary regulations are intended to provide the Service with early notification of large corporate transactions with characteristics that may be indicative of such tax shelter activity.

Disclosure and Deductibility

Whether a taxpayer is entitled to a deduction for a particular transaction depends not upon the disclosure provisions of Section 6011, but upon the substantive law governing that transaction. The substantive law of welfare benefit plans is found in Sections 419, 419A and 162 of the Code. What does that law say?

An employer can deduct contributions to a welfare benefit fund if they are ordinary and necessary business expenses.¹ Amounts paid by the employer for welfare benefits are deductible under Section 162(a) of the Code.² Death and medical reimbursement benefits are welfare benefits, and insurance premiums are ordinary and necessary business expenses.³

The employer's deduction is limited to the fund's qualified cost for the plan year.⁴ The qualified cost is the sum of the qualified direct cost and an addition to a qualified asset account, as long as the amount in the qualified asset account does not exceed the fund's account limit for the year.⁵ The qualified direct cost is the amount actually paid by the employer for benefits during the year.⁶ For pre-retirement death benefits, the qualified direct cost is the term cost of insurance.⁷

A fund's qualified asset account includes assets set aside to pay life insurance and medical benefits.⁸ It includes money for claims incurred during the taxable year, but not paid until the following year.⁹ It can also include a reserve funded over



1 IRC Sections 419(a) and 162(a)
 2 Treas. Reg. Section 1.162-10(a)
 3 Moser, Schneider, Booth and Neonatology

4 IRC Section 419(b)
 5 IRC Section 419(c)(1)
 6 IRC Section 419(c)(3)


7 Neonatology
 8 IRC Section 419A(a)
 9 IRC Section 419A(c)(1)

the working lives of the employer's employees on a level basis to provide post-retirement death and medical reimbursement benefits.¹⁰ In addition, the employer may deduct administrative expenses associated with the benefits.

To illustrate the foregoing, assume that an employer desires to provide pre-retirement death and post-retirement medical reimbursement benefits to its employees. For ease of illustration, assume that the employer has one employee who is age 55 at plan adoption and that normal retirement age is 65. Further, assume that the pre-retirement death benefit is \$2,000,000 and the post-retirement medical reimbursement benefit is \$500,000. If we assume that the cost of term insurance at age 55 is \$2.00 per \$1,000, then, under Section 419(c)(3) of the Code, the qualified direct cost of the plan's pre-retirement death benefit is \$4,000, and this amount is deductible by the employer, irrespective of the type of insurance policy purchased by the plan. In addition, if we ignore interest, the level funding of the post-retirement medical reimbursement benefit is \$50,000 per year, and, under Section 419A(c)(2) of the Code, this amount can be paid into the plan's reserve and is tax-deductible, irrespective whether the reserve is maintained in an annuity, the cash-value of a permanent insurance policy or some other investment. The employer can also deduct administrative expenses in connection with the benefits, which include insurance company expenses associated with the policy.

An employer funding its plan with cash-value insurance may be required to attach a disclosure statement to its tax return if it deducts the cost of the plan's pre-retirement death benefit, which, in the example above, is \$4,000. However, Notice 2007-83, which some think imposes the disclosure obligation, cannot override the provisions of the Code that govern contributions to a welfare benefit fund and provide a deduction for those contributions. The IRS acknowledges as much in the following excerpt from Notice 2007-84 when it says:

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 sections 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.

As a benefits, tax, insurance or accounting advisor, a welfare benefit plan is the best way to protect your clients' retirement security by setting aside funds to pay for quality medical care after retirement. As long as a plan provides legitimate welfare benefits on a non-discriminatory basis, it can be funded with life insurance contracts on a tax-deductible basis. The amount of the deduction is determined under Sections 419 and 419A of the Code, and nothing in Notice 2007-83 says otherwise. 

In Notice 2007-83, the IRS targets plans that permit "large contributions relative to the cost of the plan's benefits."



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