TAX COURT RULES IN NEONATOLOGY ASSOCIATES CASE

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On July 31, 2000, Judge Laro of the Tax Court (who rendered the decision in the *Booth* case several months ago) handed down his decision in *Neonatology Associates, P.A., et. al. v. Commissioner of Internal Revenue*, 115 T.C. 5 (2000). And it wasn't favorable to the taxpayers.

The decision consolidates several cases involving IRS challenges to welfare benefit plan deductions under Section 162 of the Internal Revenue Code. In these cases physicians had adopted the Southern California (or New Jersey) Medical Profession Association VEBA and purchased life insurance policies. Each employer adopted a separate plan, and each purchased a group insurance contract or contracts. In each case, contributions to the Plan exceeded the amount required to pay the term insurance cost for the year.

Most employers purchased a type of insurance policy, called "continuous group" which was a term insurance policy coupled with a premium conversion account that permitted the policy to be converted to an individual universal life insurance contract. Some employers also purchased annuities.

The Tax Court ruled that under such arrangement, only the current term insurance cost was deductible for a year, and that additional amounts contributed amounted to a dividend to the owner of the employer corporation, or to nondeductible life insurance premium for a self-employed individual. The Tax Court also upheld the IRS in assessing the accuracy-related penalties for negligence or intentional disregard of rules or regulations determined under Section 6662(a) of the Internal Revenue Code.

The VEBAs in question, which the Tax Court called "deviously designed", were promoted by Barry Cohen, the late Stephen R. Ross and Donald S. Murphy. The life insurance product, which the Tax Court referred to as "speciously designed", was provided through A. A. Beavin (since replaced by CJA & Associates) and underwritten by Baltimore Life and Indianapolis Life Insurance Companies.

The Court points out several problems with the facts of these cases. None of the employers retained a CPA or Tax Attorney or other expert to advise them with respect to the tax treatment of their actions. The plans were not operated in accordance with the stated terms thereof.

The Court ruled that the continuous group insurance policy was, in fact, "* * * a universal life insurance policy consisting of two related policies. The first policy * * * is a group term life insurance policy * * *. The second policy * * * is an individual universal life insurance policy * * * referenced * * * as a "special conversion policy"."

Judge Laro noted that several of the policies had been converted, even though none of the taxpayers had complied with the 5 conditions for conversion set forth in the policy. He also noted that some of the witnesses had "consciously misrepresented material facts". In addition, some of the taxpayers had falsified plan records.

In differentiating this case from the *Booth* decision (*Booth v. Commissioner*, 108 T.C. 524 (1997)), Judge Laro pointed out that these plans included only life insurance benefits. He does not reach a decision as to whether these life insurance plans provide "welfare benefits" as in *Booth* where additional benefits were provided.

Although the taxpayers argued that their inclusion of "PS-58" amounts on forms W-2 was appropriate, the Tax Court in fact cites the regulations under Sections 72 and 79 for the rules "generally used to determine the cost of group term life insurance provided to employees * * *."

The Court did not accept the taxpayers' argument that the purchase of the insurance policy was a transfer for payment of compensation under Section 83 of the Code, and cited Section 264(a)(1) in holding that a self-employed individual may not obtain a tax deduction for the purchase of insurance for himself or for his spouse, since he was "directly or indirectly a beneficiary" of that policy.

Adding insult to injury, the Tax Court declared that "the record contains neither a credible statement by one or more of the individual petitioners to the effect that he or she saw or relied on a tax opinion letter, nor a tax opinion letter written by a competent, independent tax professional." He went on to express doubt "that such a tax opinion letter exists * * *."

Although this case does not provide much additional enlightenment about the taxation of welfare benefits, it does provide a perfect example of how **not** to structure a welfare benefit plan which seeks to comply with Section 419A(f)(6) of the Internal Revenue Code:

1. Don't falsify employment records.
2. Don't date documents back.
3. Don't refund contributions back from the trust to the employer which have been tax deducted.
4. Don't misrepresent material facts.
5. Don't use an individual plan.
6. Don't cover self-employed persons.
7. Don't permit non-employee spouses to participate in the plan.
8. Don't use "speciously designed" insurance policies.
9. Don't adopt a "deviously designed" plan.
10. Don't use the PS58 tables instead of following the regulations under Section 79.
11. Don't use a purported welfare benefit plan as a wealth transfer vehicle.
12. Don't adopt experience-rated plans.
13. Don't pay off medical societies or other legitimate organizations to obtain an endorsement;
14. Don't adopt a sophisticated tax planning strategy without consulting your tax adviser.

We applaud Judge Laro's seeing the arrangements for what they were and for reaching a correct decision. A review of the foregoing elements makes the differences between these plans and the Sterling Benefit Plan obvious.