A Rose By Any Other Name, or Whatever Happened to All Those 419A(f)(6) Providers?

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For years promoters of life insurance companies and agents have tried to find ways of claiming that the premiums paid by business owners were tax deductible. This allowed them to sell policies at a "discount".

The problem became especially bad a few years ago with all of the outlandish claims about how §§419A(f)(5) and 419A(f)(6) exempted employers from any tax deduction limits. Many other inaccurate statements were made as well, until the IRS finally put a stop to such assertions by issuing regulations and naming such plans as "potentially abusive tax shelters" (or "listed transactions") that needed to be disclosed and registered. This appeared to put an end to the scourge of such scurrilous promoters, as such plans began to disappear from the landscape.

And what happened to all the providers that were peddling §§419A(f)(5) and (6) life insurance plans a couple of years ago? We recently found the answer: most of them found a new life as promoters of so-called "419(e)" welfare benefit plans.

We recently reviewed several §419(e) plans, and it appears that many of them are nothing more than recycled §419A(f)(5) and §419A(f)(6) plans.

The "Tax Guide" written by one vendor's attorney is illustrative: he confuses the difference between a "multi-employer trust" (a Taft-Hartley, collectively-bargained plan), a "multiple-employer trust" (a plan with more than one unrelated employer) and a "10-or-more employer trust" (a plan seeking to comply with IRC §419A(f)(6)).

Background: Section 419 of the Internal Revenue Code

Section 419 was added to the Internal Revenue Code ("IRC") in 1984 to curb abuses in welfare benefit plan tax deductions. §419(a) does not authorize tax deductions, but provides as follows: "Contributions paid or accrued by an employer to a welfare benefit fund * * * shall not be deductible under this chapter * * *.". It simply limits the amount that would be deductible under another IRC section to the "qualified cost for the taxable year". (§419(b))

Section 419(e) of the IRC defines a "welfare benefit fund" as "any fund-- (A) which is part of a plan of an employer, and (B) through which the employer provides welfare benefits to employees or their beneficiaries." It also defines the term "fund", but excludes from that definition "amounts held by an insurance company pursuant to an insurance contract" under conditions described.

None of the vendors provides an analysis under §419(e) as to whether or not the life insurance policies they promote are to be included or excluded from the definition of a "fund". In fact, such policies will be included and therefore subject to the limitations of §§419 and 419A.

Errors Commonly Made

Materials from the various plans commonly make several mistakes in their analyses:

1. They claim not to be required to comply with IRC §505 non-discrimination requirements. While it is true that §505 specifically lists "organizations described in paragraph (9) or (20) of section 501(c)", IRC §4976 imposes a 100% excise tax on any "post-retirement medical benefit or life insurance benefit provided with respect to a key employee" * * * "unless the plan meets the requirements of section 505(b) with respect to such benefit (*whether or not such requirements apply to such plan*)." (Italics added) Failure to comply with §505(b) means that the plan will never be able to distribute an insurance policy to a key employee without the 100% penalty!

2. Vendors commonly assert that contributions to their plan are tax deductible because they fall within the limitations imposed under IRC §419; however, §419 is simply a limitation on tax deductions. Providers must cite the section of the IRC under which contributions to their plan would be tax-deductible. Many fail to do so. Others claim that the deductions are ordinary and necessary business expense under §162, citing Regs. §1.162-10 in error: there is no mention in that section of life insurance or a death benefit as a welfare benefit.

3. The reason that promoters fail to cite a section of the IRC to support a tax deduction is because, once such section is cited, it becomes apparent that their method of covering only selected key and highly-compensated employees for participation in the plan fails to comply with IRC §414(t) requirements relative to coverage of controlled groups and affiliated service groups.

4. Life insurance premiums could be treated as W-2 wages and deducted under §162 to the extent they were reasonable. Other than that, however, **no section of the Internal Revenue Code authorizes tax deductions for a discriminatory life insurance arrangement**. IRC §264(a) provides that "[n]o deduction shall be allowed for * * * [p]remiums on any life insurance policy * * * if the taxpayer is directly or indirectly a beneficiary under the policy." As was made clear in the *Neonatology* case (*Neonatology Associates v. Commissioner*, 115 TC 5, 2000), the appropriate treatment of employer-paid life insurance premiums under a putative welfare benefit plan is under §79, which comes with its own nondiscrimination requirements.

5. Some plans claim to impute income for current protection under the PS 58 rules. However, PS58 treatment is available only to qualified retirement plans and split-dollar plans. [Note: none of the 419(e) plans claim to comply with the split-dollar regulations.] Income is imputed under Table I to participants under Group-Term Life Insurance plans that comply with §79. This issue is addressed in footnotes 17 and 18 of the *Neonatology* case.

6. Several of the plans claim to be exempt from ERISA. They appear to rely upon the ERISA Top-Hat exemption (applicable to deferred compensation plans). However, that only exempts a plan from certain ERISA requirements, not ERISA itself. It is instructive that none of the plans claiming exemption from ERISA has filed the Top-Hat notification with the Dept. of Labor.

7. Some of the plans offer severance benefits as a "welfare benefit", which approach has never been approved by the IRS. Other plans offer strategies for obtaining a cash benefit by terminating a single-employer trust. The distribution of a cash benefit is a form of deferred compensation, yet none of the plans offering such benefit complies with the

IRC §409A requirements applicable to such benefits.

8. Some vendors permit participation by employees who are self-employed, such as sole proprietors, partners or members of an LLC or LLP taxed as a partnership. This issue was also addressed in the *Neonatology* case where contributions on behalf of such persons were deemed to be dividends or personal payments rather than welfare benefit plan expenses.

[Note: bona fide employees of an LLC or LLP that has elected to be taxed as a corporation may participate in a plan.]

9. Most of the plans fail under §419 itself. §419(c) limits the current tax deduction to the "qualified cost", which includes the "qualified direct cost" and additions to a "qualified asset account" (subject to the limits of §419A(b)). Under Regs. §1.419-1T, A-6, "the "qualified direct cost" of a welfare benefit fund for any taxable year * * * is the aggregate amount which would have been allowable as a deduction to the employer for benefits provided by such fund during such year (including insurance coverage for such year) * * *." "Thus, for example, if a calendar year welfare benefit fund pays an insurance company * * * the full premium for coverage of its current employees under a term * * * insurance policy, * * * *only the portion of the premium for coverage during [the year] will be treated as a "qualified direct cost*" * * *." (Italics added)

Most vendors pretend that the whole or universal life insurance premium is an appropriate measurement of cost for Key Employees, and those plans that cover rank and file employees use current term insurance premiums as the appropriate measure of cost for such employees. This approach doesn't meet any set of nondiscrimination requirements applicable to such plans.

10. Some vendors claim that they are justified in providing a larger deduction than the amount required to pay term insurance costs for the current tax year, but, as cited above, the only justification under §419(e) itself is as additions to a qualified asset account and is subject to the limitations imposed by §419A. In addition, §419A adds several additional limitations to plans and contributions, including requirements that:

a. contributions be limited to a safe harbor amount or be certified by an actuary as to the amount of such contributions (§419A(c)(5));
b. actuarial assumptions be "reasonable in the aggregate" and that the actuary use a level annual cost method (§419A(c)(2));
c. benefits with respect to a Key Employee be segregated and their benefits can only be paid from such account (§419A(d));
d. the rules of subsections (b), (c), (m), and (n) of IRC section 414 shall apply to such plans (§419A(h)).
e. the plan comply with §505(b) nondiscrimination requirements (§419A(e)).

Circular 230 Issues

Circular 230 imposes many requirements on tax professionals with respect to tax shelter transactions. A tax practitioner can get into trouble in the promotion of such plans, in advising clients with respect to such transactions and in preparing tax returns. IRC §§6707 and 6707A add a new concept of "reportable transactions" and impose substantial penalties for failure to disclose participation in certain reportable transactions (including all listed transactions).

This is a veritable minefield for tax practitioners to negotiate carefully or avoid altogether. The advisor must exercise great caution and due diligence when presented with any potential contemplated tax reduction or avoidance transaction. Failure to disclose could subject taxpayers and their tax advisors to potentially Draconian penalties.

Summary

Key points of this article include:

- Practitioners need to be able to differentiate between a legitimate §419(e) plan and one that is legally inadequate when their client approaches them with respect to such plan or has the practitioner to prepare his return;
- Many plans incorrectly purport to be exempt from compliance with ERISA, IRC §§414, 505, 79, etc.
- Tax deductions must be claimed under an authorizing section of the IRC and are limited to the qualified direct cost and additions to a qualified asset account as certified by the plan's actuary.

Conclusion

Irresponsible vendors such as most of the promoters who previously promoted IRC §419A(f)(6) plans were responsible for the IRS's issuing restrictive regulations under that Section. Now many of the same individuals have elected simply to claim that a life insurance plan is a welfare benefit plan and therefore tax-deductible because it uses a single-employer trust rather than a "10-or-more-employer plan".

This is an open invitation to the IRS to issue new onerous Regulations and more indictments and legal actions against the unscrupulous promoters who feed off of the naivety of clients and the greed of life insurance companies who encourage and endorse (and even own) such plans.

The last line of defense of the innocent client is the accountant or attorney who is asked by a client to review such arrangement or prepare a tax return claiming a deduction for contributions to such a plan. Under these circumstances accountants and attorneys should be careful not to rely upon the materials made available by the plan vendors, but should review any proposed plan thoroughly, or refer the review to a specialist.

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