Part III -- Administrative, Procedural, and Miscellaneous

Tax Problems Raised by Certain Trust Arrangements Seeking to Qualify for Exception for Collectively Bargained Welfare Benefit Funds under § 419A(f)(5)

Notice 2003-24

The Internal Revenue Service and the Treasury Department have become aware of certain arrangements purporting to qualify as collectively-bargained welfare benefit funds excepted from the account limits of § 419 and § 419A of the Internal Revenue Code. This notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This notice also identifies some purported collectively bargained arrangements as listed transactions and alerts taxpayers, their representatives, and organizers or sellers of these transactions to certain responsibilities that may arise from participating in these transactions.

In general, contributions to a welfare benefit fund are deductible when paid, but only if they qualify as ordinary and necessary business expenses of the taxpayer and only to the extent allowable under § 419 and § 419A of the Code. Those sections impose strict limits on the deduction for contributions in excess of current costs. An exception to some of the limits is provided under § 419A(f)(5) for contributions to a separate welfare benefit fund under a collective bargaining agreement. The exception is based in part on the premise that deductions in such a setting will not be excessive because of the arms' length negotiations between adversary parties inherent in the collective bargaining process. See S. Rep. No. 313, 99th Cong., 2nd Sess. 1010 (1986), 1986-3 C.B. (Vol. 3) 1, 1010.

Section 1.419A-2T, Q&A-2, of the Income Tax Regulations sets out a number of requirements that a fund must meet in order to qualify as a welfare benefit fund under a collective bargaining agreement for purposes of § 419A(f)(5) of the Code. One of those requirements is that the benefits provided through the fund were the subject of arms-length negotiations between employee representatives and one or more employers. Another requirement is that the circumstances surrounding a collective bargaining agreement must evidence good faith bargaining between adverse parties over the welfare benefits to be provided through the fund.

Section 7701(a)(46) of the Code provides, in part, that an agreement will not be treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and one or more employers. When this language was added to the Code in 1986, the Committee on Ways and Means reported that some promoters of tax avoidance arrangements were entering into arrangements with employers under which, superficially, the employer and its employees were represented by agents in collective bargaining. The Committee noted that the named bargaining agent for the employees may have obtained a ruling by the Internal Revenue Service that the agent is exempt from tax as a labor organization. Even so, the Committee noted, no good faith bargaining occurred under this type of arrangement because the bargaining agent for the employees merely acts in concert with the named bargaining agent for the employer. The Committee Report states:

> The committee believes that these arrangements are, in fact, designed for no material purpose other than the improper exploitation of provisions that are appropriate only for legitimate collectively bargained plans. The committee wishes to make clear that it does not regard such an arrangement as the product of good faith bargaining and that it does not consider an entity to be an employee representative merely because of its status for tax exemption or a determination by the Internal Revenue Service with respect to that status.

H.R. Rep. No. 426, 99th Cong., 1st Sess. 760 (1986), 1986-3 C.B. (Vol. 2) 1, 760.

A number of business owners have been approached about arrangements that purportedly allow the business to take a current tax deduction for all contributions to a welfare benefit fund. Prior to this contact, these businesses typically have had no involvement with labor organizations or other aspects of the collective bargaining process. The promoters of these arrangements rely on § 419A(f)(5), claiming that the benefits are provided under a collective bargaining agreement. The individual or company promoting the arrangement typically arranges for an organization (sometimes referred to as a management group) to act on the business's behalf in bargaining with an employee representative over benefits to be provided to some or all of the employees of the business (including employees who are also owners of the business) and over certain other terms. While its name may include the word "union," the employee representative is often established specifically for the purpose of the welfare benefit arrangement that is being promoted. In other cases, the employee representative may be affiliated with an established union.

These arrangements usually require large employer contributions relative to the amount actually needed to provide the current coverage for the welfare benefits under the arrangement. Typically, benefits that are provided or expected to be provided to employees who are also owners are more favorable than the benefits provided to employees who are not owners. For example, if death benefit protection is being provided, owners may be covered by cash value life insurance policies (and entitled to certain benefits resulting from amounts accumulating under those policies) while other employees receive only term insurance coverage or other less valuable coverage than that provided to the owners.

In some of the arrangements, participants can access funds by obtaining a loan from the trust. While the plan documents may indicate that the loans are available only for unanticipated future events, in reality, most owners will be able to obtain a loan without regard to whether those events occur.

Often, the arrangement will operate to allow the owner or owners to benefit from any contributions to the trust in excess of amounts actually used to provide coverage to other employees.

In general, these arrangements and other similar arrangements do not satisfy the requirements of § 419A(f)(5) of the Code and do not provide the tax deductions claimed by their promoters. For example, if an employer (or its agent) bargains for benefits to be provided to employees, including the owner or owners of that employer, and the benefits to be provided to an owner are more favorable than those provided to other employees, the circumstances of that bargaining process strongly indicate a lack of the good faith bargaining required to satisfy the conditions for the § 419A(f)(5) exception. Further, even if the stated benefits for an owner are not more favorable than those for other employees (e.g., all benefits are based on a uniform percentage of compensation), the facts and circumstances of the particular arrangement or the bargaining process may indicate that the good faith bargaining requirement, or another requirement to be treated as a collective bargaining agreement for purposes of § 419A(f)(5), has not been met.

In addition, an employer's deduction for contributions to the trust will be subject to the deduction limits of §§ 419 and 419A of the Code if it is not a "separate" welfare benefit fund under a collective bargaining agreement. Moreover, the deduction may be subject to or disallowed by other provisions of the Code. For example, depending on the facts and circumstances, the arrangement may actually be providing deferred compensation or a constructive dividend to an owner rather than welfare benefits. If the arrangement is providing deferred compensation, the employer's deduction for contributions to the trust is governed by § 404(a)(5) of the Code, rather than by §§ 419 and 419A. If the arrangement is providing a constructive dividend, to the extent of the constructive dividend, the contributions are not deductible at all.

Taxpayers and their representatives should be aware that the Service has disallowed deductions for contributions to these types of arrangements in the past and intends to do so in the future.

The Service would like to emphasize that the fact that a trust used to provide benefits under an arrangement may have received a determination letter stating that the trust is exempt under § 501(c)(9) of the Code has no relevance to the issues discussed in this Notice. A determination letter under § 501(c)(9) determines only the tax status of the trust. It does not determine the tax deductibility of contributions to such a trust, nor does it determine the taxation of the benefits provided through the fund to the participants. Also, as provided by regulations, even if a union has been recognized as exempt under § 501(c)(5), the Service nevertheless has the authority to determine whether there is a collective bargaining agreement under the Code. Regs. § 301.7701-17T.

Listed Transactions

The following arrangements, and any arrangement that is substantially similar to one of the following arrangements, are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and § 301.6111-2(b)(2) and § 301.6112-1(b)(2) of the Procedure and Administration Regulations. For purposes of determining whether an arrangement is a listed transaction described in this Notice, the term owner refers to a “key employee” as defined in § 416(i)(1) of the Code, other than an individual who is a key employee solely by reason of § 416(i)(1)(A)(i) (officers having annual compensation greater than a specified amount).

Any arrangement involving a purported collectively bargained welfare benefit fund is a listed transaction with respect to an employer if, in any year, the employer’s contributions with respect to any owner or owners of the employer, considered in the aggregate, are more than one-half of the employer’s total contributions, but only if there is at least one owner with respect to whom the employer’s contributions exceed $20,000. For this purpose, an employer’s contributions with respect to an owner means employer contributions used to fund the coverage or benefits for the owner, including any employer contributions used to pay premiums on an insurance contract covering the owner.

Any arrangement involving a purported collectively bargained welfare benefit fund is a listed transaction with respect to an employer if it provides more favorable coverage for an owner of the employer than for employees who are not owners. Even if the stated coverage under an arrangement is not more favorable for an owner, an arrangement provides more favorable coverage for an owner (and thus is a listed transaction) if it has any attributes that are likely to result in an owner actually receiving more favorable coverage or benefits than other employees, either during the term of the purported collective bargaining agreement or after the agreement has terminated. An arrangement that provides coverage based on a uniform percentage of each employee’s compensation will not be treated as providing more favorable coverage to an owner merely because the owner has higher coverage as a result of the owner’s higher compensation.

Some examples of purported collectively bargained arrangements that have attributes likely to result in an owner actually receiving more favorable coverage or benefits than other employees are as follows:

An arrangement providing death benefits based on a uniform multiple of compensation, if it can be expected that an owner will obtain other benefits, such as rights to accumulated amounts under the arrangement, that are not available on the same basis to other employees;

An arrangement allowing loans to participants under which it can be expected that an owner will be able to obtain the loans more readily, or on better terms, than the other employees;

An arrangement providing benefits only to participants who have completed a specified number of years of service with the employer, if it can be expected that one or more owners will be the only employees to satisfy the years-of-service requirement.

It should be noted that, independent of any classification as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2), and 301.6112-1(b)(2) of the regulations, arrangements that are the same as, or substantially similar to, the arrangements described in this notice may already be subject to the disclosure requirements of § 6011 of the Code, the tax shelter registration requirements of § 6111 or the list maintenance requirements of § 6112 (§§ 1.6011-4, 301.6111-1T, 301.6111-2, and 301.6112-1).

Persons who are required to satisfy the registration requirement of § 6111 of the Code with respect to the arrangements described in this notice and who fail to do so may be subject to the penalty under § 6707(a). Persons who are required to satisfy the list-keeping requirement of § 6112 with respect to the arrangements and who fail to do so may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in these arrangements or substantially similar arrangements, or, as applicable, on persons who participate in the promotion or reporting of these arrangements or substantially similar arrangements, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701. In addition to other penalties, any person who willfully attempts to evade or defeat tax by means of the arrangements described in this notice, or who willfully counsels or advises such evasion or defeat, may be guilty of a criminal offense under §§ 7201, 7203, 7206, or 7212(a) or other provisions of federal law.

Future Regulations

The Service is planning to publish proposed regulations under § 419A(f)(5) that will address, among other things, the "separate" fund requirement discussed above. The Service understands that there are bona fide collectively bargained welfare benefit plans that provide benefits to one or more employees who are not collectively bargained, and that some of these plans might not have maintained a separate and distinct fund for only the collectively bargained employees. The Treasury and the

Service request comments from the public regarding the "separate" fund requirement in advance of publishing the proposed regulations.

Those comments may be mailed to CC:PA:RU (Notice 2003-24), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, comments may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:RU (Notice 2003-24), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC, or submitted electronically to: *Notice.Comments@irscounsel.treas.gov*. Comments should be submitted no later than August 3, 2003. All comments will be available for public inspection and copying.

Drafting Information

The principal authors of this notice are Louis Leslie 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. Leslie at (202) 283-9888 (not a toll-free call) or Ms. Clary at (202) 622-6080 (not a toll-free call).