Part III. -- Administrative, Procedural and Miscellaneous

Abusive Trust Arrangements Utilizing Cash Value Life Insurance Policies Purportedly to Provide Welfare Benefits

Notice 2007-83

The Internal Revenue Service (IRS) and Treasury Department are aware of certain trust arrangements claiming to be welfare benefit funds and involving cash value life insurance policies that are being promoted to and used by taxpayers to improperly claim federal income and employment tax benefits. This notice informs taxpayers and their representatives that the tax benefits claimed for these arrangements are not allowable for federal tax purposes. This notice also alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies certain transactions using trust arrangements involving cash value life insurance policies, and substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 6111 and 6112 of the Internal Revenue Code. This notice further alerts persons involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

Concurrently with this notice, the IRS is publishing Rev. Rul. 2007-65 (concluding that for purposes of deductions allowable to an employer under § 419, a welfare benefit fund's qualified direct cost does not include premium amounts for cash value life insurance policies paid by the fund, whenever the fund is directly or indirectly a beneficiary under the policy within the meaning of § 264(a)), and Notice 2007-84 (describing trust arrangements involving purported welfare benefit funds that, in form, provide post-retirement medical and life insurance benefits to employees on a nondiscriminatory basis but, in operation, result in the owner or owners receiving all or a substantial portion of the post-retirement and other benefits, and all or a substantial portion of any assets distributed from the trust).

BACKGROUND

1. Promoted Arrangements

Trust arrangements utilizing cash value life insurance policies and purporting to provide welfare benefits to active employees are being promoted to small businesses and other closely held businesses as a way to provide cash and other property to the owners of the business on a tax-favored basis. The arrangements are sometimes referred to by persons advocating their use as “single employer plans” and sometimes as “419(e) plans.” Those advocates claim that the employers' contributions to the trust are deductible under §§ 419 and 419A as qualified cost, but that there is not a corresponding inclusion in the owner's income.

A promoted trust arrangement may be structured either as a taxable trust or a tax-exempt trust, i.e., a voluntary employees' beneficiary association (VEBA) that has received a determination letter from the IRS that it is described in § 501(c)(9). The plan and the 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.

Under these arrangements, the trustee uses the employer's contributions to the trust to purchase life insurance policies. The trustee typically purchases cash value life insurance policies on the lives of the employees who are owners of the business (and sometimes other key employees), while purchasing term life insurance policies on the lives of the other employees covered under the plan.

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.

Those advocating the use of these plans often claim that the employer is allowed a deduction under § 419(c)(3) for its contributions when the trustee uses those contributions to pay premiums on the cash value life insurance policies, while at the same time claiming that nothing is includible in the owner's gross income as a result of the contributions (or, if amounts are includible, they are significantly less than the premiums paid on the cash value life insurance policies). They may also claim that nothing is includible in the income of the business owner or other key employee as a result of the transfer of a cash value life insurance policy from the trust to the employee, asserting that the employee has purchased the policy when, in fact, any amounts the owner or other key employee paid for the policy may be significantly less than the fair market value of the policy. Some of the plans are structured so that the owner or other key employee is the named owner of the life insurance policy from the plan's inception, with the employee assigning all or a portion of the death proceeds to the trust. Advocates of these arrangements may claim that no income inclusion is required because there is no transfer of the policy itself from the trust to the employees.

2. Intent to Challenge Transactions

The IRS intends to challenge the claimed tax benefits for the above-described transactions for various reasons. 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. *See* Neonatology Associates v. Commissioner, 299 F.3d 221 (3d Cir. 2002). Depending on the facts and circumstances of a particular arrangement, the arrangement may properly be characterized as a plan deferring the receipt of compensation for purposes of § 404(a)(5), resulting in the application of the rules under § 404(a)(5) governing the timing of any otherwise available deductions. *See* Wellons v. Commissioner, 31 F.3d 569 (7th Cir. 1994). In addition, an arrangement may properly be characterized as a nonqualified deferred compensation plan for purposes of § 409A. Application of § 409A may result in immediate inclusion of income and additional taxes to the employee, as well as income tax withholding liabilities to the employer. The facts and circumstances of a particular arrangement may result in it coming within the definition of a split-dollar life insurance arrangement, so that the tax consequences to the employer and the employees are subject to the rules governing those types of arrangements, including potentially § 409A. Under the economic benefit regime of the split-dollar life insurance arrangement rules set forth in § 1.61-22, the employee must include in income the full value of the economic benefits provided to the employee under the arrangement for the taxable year without a corresponding employer deduction.

If, based on the facts and circumstances, an arrangement described above is properly characterized as a welfare benefit fund for purposes of §§ 419 and 419A (rather than a dividend arrangement, a plan deferring the receipt of compensation, or a split-dollar life insurance arrangement), an employer is allowed a deduction for contributions to the trust or other welfare benefit fund only to the extent allowed under §§ 419 and 419A. Under §§ 419 and 419A, no deduction is allowed with respect to premiums paid for life insurance coverage provided to current employees if the welfare benefit fund or the employer is directly or indirectly a beneficiary under the life insurance policy within the meaning of § 264(a). In the promoted arrangements discussed above, the trust typically retains rights in the life insurance policies and is directly or indirectly a beneficiary under the policies, so that no deduction is allowed with respect to the life insurance premiums. *See* Situation 1 in Rev. Rul. 2007-65. Further, any deduction with respect to uninsured benefits (for example, uninsured medical, disability, or severance benefits) is not based on the premiums paid on the life insurance policies, but is generally limited to claims incurred and paid during the year.[1] *See* Situation 2 in Rev. Rul. 2007-65. Thus, contrary to the claims made by persons advocating the use of the arrangements discussed above, premiums on cash value life insurance policies paid through the trust are not a justification for claiming a deduction under §§ 419 and 419A.

[1] Limited deductions are allowable under §§ 419 and 419A for additions to certain reserves, including a reserve for claims incurred but unpaid as of the close of a taxable year.

Moreover, in appropriate cases, the IRS intends to challenge the value claimed by the taxpayer for property distributed from the trust, including cash value life insurance policies.

The above conclusions apply whether the trust used to provide the plan benefits is a taxable trust or a VEBA. While the trust may have received a determination letter stating the trust is exempt under § 501(c)(9), a letter of this type does not address the tax deductibility of contributions to the trust with respect to the employer nor the income inclusion with respect to the employees.

The IRS has previously identified certain other transactions that claim to be welfare benefit funds as listed transactions, concluding that the tax benefits claimed to be generated by these transactions are not allowable for federal income tax purposes. Notice 2003-24, 2003-1 C.B. 853, describes certain transactions purporting to meet the exception under § 419A(f)(5) for collectively bargained plans and identifies those and substantially similar transactions as listed transactions, and Notice 95-34, 1995-1 C.B. 309, describes transactions that purport to meet the 10-or-more employer plan exception under § 419A(f)(6). The transactions described in Notice 95-34 and substantially similar transactions have also been identified as listed transactions. See Notice 2004-67, 2004-2 C.B. 600.

LISTED TRANSACTIONS

1. Transactions Identified As Listed Transactions

Any transaction that has all of the following elements, and any transaction that is substantially similar to such a transaction, are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) and §§ 6111 and 6112, effective October 17, 2007, the date this notice is released to the public.

(1) The transaction involves a trust or other fund described in § 419(e)(3) that is purportedly a welfare benefit fund.

(2) For determining the portion of its contributions to the trust or other fund that are currently deductible the employer does not rely on the exception in § 419A(f)(5)(A) (regarding collectively bargained plans).

(3) The trust or other fund pays premiums (or amounts that are purported to be premiums) on one or more life insurance policies and, with respect to at least one of the policies, value is accumulated either:

(a) within the policy (for example, a cash value life insurance policy); or

(b) outside the policy (for example, in a side fund or through an agreement outside the policy allowing the policy to be converted to or exchanged for a policy which will, at some point in time, have accumulated value based on the purported premiums paid on the original policy).

(4) The employer has taken a deduction for any taxable year for its contributions to the fund with respect to benefits provided under the plan (other than post-retirement medical benefits, post-retirement life insurance benefits, and child care facilities) that is greater than the sum of the following amounts:

(a) With respect to any uninsured benefits provided under the plan,

(i) an amount equal to claims that were both incurred and paid during the taxable year; plus

(ii) the limited reserves allowable under § 419A(c)(1) or (c)(3), as applicable; plus

(iii) amounts paid during the taxable year to satisfy claims incurred in a prior taxable year (but only to the extent that no deduction was taken for such amounts in a prior year); plus

(iv) amounts paid during the taxable year or a prior taxable year for administrative expenses with respect to uninsured benefits and that are properly allocable to the taxable year (but only to the extent that no deduction was taken for such amounts in a prior year).

(b) With respect to any insured benefits provided under the plan,

(i) insurance premiums paid during the taxable year that are properly allocable to the taxable year (other than premiums paid with respect to a policy described in (3)(a) or (b) above); plus

(ii) insurance premiums paid in prior taxable years that are properly allocable to the taxable year (other than premiums paid with respect to a policy described in (3)(a) or (b) above); plus

(iii) amounts paid during the taxable year or a prior taxable year for administrative expenses with respect to insured benefits and that are properly allocable to the taxable year (but only to the extent that no deduction was taken for such amounts in a prior year).

(c) For taxable years ending prior to November 5, 2007, with respect to life insurance benefits provided through policies described in (3)(a) and (b) above, the greater of the following amounts:[2]

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[2] For taxable years ending on or after November 5, 2007, the amount under this (4)(c) is zero.

(i) in the case of an employer with a taxable year that is the calendar year, the aggregate amounts reported by the employer as the cost of insurance with respect to such policies on the employees' Forms W-2 (or Forms 1099) for that year, plus an amount equal to the amounts that would have been reportable on the employees' Forms W-2 for that year, but for the exclusion under section 79 (relating to the cost of up to $50,000 of coverage); or, in the case of an employer with a taxable year other than the calendar year, the portions of the aggregate amounts reported by the employer on the Forms W-2 (or Forms 1099) as described in (i), above, (or that would have been reported absent the exclusion under § 79) that are properly allocable to the employer's taxable year; and

(ii) with respect to each employee insured under a cash value life insurance policy, the aggregate cost of insurance charged under the policy or policies with respect to the amount of current life insurance coverage provided to the employee under the plan (but limited to the product of the current life insurance coverage under the plan multiplied by the current year's mortality rate provided in the higher of the 1980 or 2001 CSO Table).

(d) The additional reserve, if any, under § 419A(c)(6) (relating to medical benefits provided through a plan maintained by a bona fide association), but only to the extent amounts are not already included above in this paragraph (4), and only to the extent that no deduction was taken for such amounts in a prior taxable year.

2. Participation in the Listed Transactions

Whether a taxpayer has participated in the listed transaction described in this notice will be determined under § 1.6011-4(c)(3)(i)(A). However, an individual who is not the employer will be treated as a participant for a taxable year if, and only if the individual owns, directly or indirectly, 20 percent or more of an entity, other than a C corporation, that is a participant in the listed transaction for the taxable year. For this purpose, indirect ownership is determined under rules similar to the rules of § 318 but without regard to the family attribution rules of § 318(a)(1).

3. Disclosure, List Maintenance, and Registration Requirements; Penalties; Other Considerations

In general, if a taxpayer has participated in a listed transaction, the rules of § 1.6011-4(e) determine when a disclosure statement must be filed by the taxpayer. However, if, under § 1.6011-4(e), a taxpayer is required to file a disclosure statement with respect to the listed transaction described in this notice after October 17, 2007, and prior to January 15, 2008, that disclosure statement will be considered to be timely filed if the taxpayer alternatively files the disclosure statement with the Office of Tax Shelter Analysis (OTSA) by January 15, 2008.

Some transactions described in Notice 95-34 and substantially similar transactions may be identified as a listed transaction in this notice also. It should be noted that, independent of their classification as “listed transactions” for purposes of § 1.6011-4(b)(2) and §§ 6111 and 6112, transactions that are the same as, or substantially similar to, the transaction identified in this notice may already be subject to the requirements of §§ 6011, 6111, 6112, or the regulations thereunder. Persons required to disclose these transactions under § 1.6011-4 and who fail to do so may be subject to the penalty under § 6707A.[3] Persons required to disclose or register these transactions under § 6111 who have failed to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of investors under § 6112 who fail to do so (or who fail to provide such lists when requested by the IRS) may be subject to the penalty under § 6708(a).

In addition, the IRS may impose other penalties on persons involved in this transaction or substantially similar transactions (including the accuracy-related penalty under § 6662 or 6662A) and, as applicable, on persons who participate in the promotion or reporting of this transaction or substantially similar transactions (including the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701).

Further, under § 6501(c)(10), the period of limitations on assessment may be extended beyond the general three-year period of limitations for persons required to disclose transactions under § 1.6011-4 who fail to do so. See Rev. Proc. 2005-26, 2005-1 C.B. 965.

The IRS and the Treasury Department recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the types of transactions described in this notice. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action.

DRAFTING INFORMATION

The principal authors of this notice are Larry Isaacs 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. Isaacs at RetirementPlanQuestions@irs.gov or Ms. Clary at (202) 622-6080 (not a toll-free call).

[3] Section 6707A applies to returns and statements due after October 22, 2004. See Notice 2005-11, 2005-1 C.B. 493. The amount of the penalty under § 6707A with respect to a listed transaction is $100,000 in the case of a natural person and $200,000 in any other case.