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Cc:
Subject: FW: Revised Background document

I'm forwarding the revised version sent to on 1/15. I don't know it this is what the agents will get – may still be working on this, but I wanted you to have this.

ATTACHMENT 1: REDACTED

ATTACHMENT 2

<u>Background</u>

I. Welfare Benefit Plans and Funds

Sections 419 and 419A of the Internal Revenue Code govern the deduction of contributions to a welfare benefit *fund* (defined in § 419(e)).

Not all employer welfare benefit *plans* are funded. A "plan" is an arrangement, usually pursuant to a written document, under which an employer provides welfare benefits to employees. Some employers prefer to pay the cost of providing employee benefits under a welfare benefit plan out of the general assets of the business. This type of arrangement is often referred to as an "unfunded plan."

This document is concerned solely with arrangements which claim to be funded welfare benefit plans ("funded plans"), in other words, to include a welfare benefit fund within the meaning of § 419(e).

Sections 419 and 419A are discussed in detail below under "II. General Rules for the Employer's Deductions for its Contributions to a Welfare Benefit Fund."

A. Welfare Benefit Arrangements

1. Self-Insured and Fully Insured Plans

a. Unfunded Plans

Unfunded plans can be insured or self-insured, or a combination. When an unfunded plan is self-insured, the employer pays the benefit amount, typically out of the general assets of the company. Using health benefits as an example, the employer would reimburse the provider (e.g., the doctor or pharmacy) or the participant, in whole or in part, for the cost of a doctor's visit or a drug prescription. Typically, a third-party administrator would determine and pay claims on the employer's behalf.

Other unfunded plans are fully insured. They provide benefits through health insurance, life insurance, and/or disability insurance. With these types of plans the employer pays (again, typically out of its general assets), the insurance premiums, in whole or in part, for policies that cover the employee participants. The insurance company then pays the benefits to the participants. Some plans may be self-insured with respect to some benefits and fully insured with respect to others.

b. Funded Plans

An employer may establish a welfare benefit fund, as defined in § 419(e), in order to set aside assets to pay benefits under a welfare benefit plan. A welfare benefit fund is usually a trust, typically either a taxable trust or a Voluntary Employees' Beneficiary Association (VEBA) within the meaning of § 501(c)(9). In the case of self-insured plans, the employer will contribute to the fund amounts that will be used to pay benefits directly to the provider (again, typically the doctor or pharmacy) or the participant. For fully insured plans, the employer will contribute amounts to the fund that will be used by the fund to pay for insurance premiums.

2. "Single Employer Plans"

While the Code does not contain the term "single employer plan," the term is often used to refer to a plan under which there is only one participating employer and the employer's contributions are used only for benefits for its own employees (and related administrative costs). Assuming that the fund associated with the single employer welfare benefit plan is a welfare benefit fund within the meaning of § 419(e), an employer's deductions for contributions to the fund will be governed by the limits of §§ 419 and 419A.

The deduction limitations of §§ 419 and 419A apply to welfare benefit funds, generally. As discussed below, certain welfare benefit funds may qualify for an exception to these limits, thus allowing employers to take larger deductions for their contributions to these funds.

3. 10 or more Employer Plans ("§ 419A(f)(6) plans" or "(f)(6) plans")

In certain circumstances, several employers might participate together in one plan to provide welfare benefits to their employees. Employers belonging to trade associations, for example, may establish a welfare benefit fund which is part of a "10 or more employer plan" within the meaning of § 419A(f)(6). In such a plan, the relationship of the employer to the welfare benefit fund is more similar to the relationship of an insured to an insurer, than an employer to a single employer fund. See H.R. Rep. No. 98-961, 98th Cong., 2d Sess., 1159 (1984-3 C.B. (Vol. 2) 1, 413).

Employers that participate in a welfare benefit fund which meets the requirements of § 419A(f)(6) and the regulations thereunder may be able to deduct the amount of their contribution to a welfare benefit fund under the plan without reference to the general deduction limits of §§ 419 and 419A. (However, other Code provisions might limit or bar the deduction.) The § 419A(f)(6) exception to the deduction limits of §§ 419 and 419A applies only to contributions to a welfare benefit fund which is part of a 10 or more employer plan to which more than one employer contributes and to which no employer normally contributes more than 10 percent of the total contributions contributed to the plan by all employers. Furthermore, the exception applies only if the plan does not maintain experience-rating arrangements with respect to individual employers.

4. Collectively Bargained Funds ("§ 419A(f)(5)(A) plans" or "(f)(5) plans")
(Welfare Benefit Funds Which Are Part of a Collectively Bargained Plan)

Section 419A(f)(5)(A) provides an exception to the deduction limits of §§ 419 and 419A for contributions to a separate welfare benefit fund under a collective bargaining agreement (i.e., a welfare benefit fund which is part of a plan determined by a collective bargaining agreement). The § 419A(f)(5)(A) exception is based in part on the premises that (1) the contribution amounts agreed to in a collective bargaining setting will not be excessive because of the arms' length negotiations between employee representatives and one or more employers that is inherent in a true collective bargaining process; and (2) if the contributions amounts are not excessive, then the employer's claimed deductions for the contributions will not be excessive. See S. Rep. No. 313, 99th Cong., 2nd Sess. 1010 (1986), 1986-3 C.B. (Vol. 3) 1, 1010. Part III. C.1., below, provides more information on the requirements of § 419A(f)(5)(A) and § 1.419A-2T.

A collectively bargained fund may involve only one employer (i.e. a variant of a welfare benefit fund maintained as part of a single employer plan for which contributions are deducted under §§ 419 and 419A) or, as suggested above, multiple employers; in this document the term "collectively bargained fund" will refer to a fund maintained pursuant to a collective bargaining agreement, which meets the requirements of § 419A(f)(5)(A), and with respect to which the contributing employer or employers claim a deduction for contributions under § 419A(f)(5)(A).

B. Welfare Benefit Funds

1. May be Exempt or Non-Exempt

A welfare benefit fund may be “any trust, corporation, or other organization not exempt from the tax imposed by [Chapter 1 of the Code]” which meets the requirements of § 419(e). See § 419(e)(3)(B). Non-exempt trusts are sometimes used to fund benefit arrangements.

A welfare benefit fund also may be a Voluntary Employees’ Beneficiary Association (VEBA), described in § 501(c)(9), or, less commonly, a § 501(c)(7) or 501(c)(17) organization. See § 419(e)(3)(A). VEBAs are commonly used to fund benefit arrangements. However, 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 whether the plan funded by the trust is truly a welfare benefit plan, to whether the benefits paid to participants are taxable, or to whether the employer may take a deduction for contributions to the trust under §§ 419 and 419A. Furthermore, the earnings of a VEBA are not necessarily exempt from income tax, because VEBAs are subject to Unrelated Business Income Tax (UBIT) under § 512(a)(3).

2. Accounts with an Insurance Company

If you encounter a situation in which a taxpayer claims that an account or an arrangement with an insurance company constitutes a welfare benefit fund within the meaning of § 419(e)(3)(C), please contact a technical advisor or your local field counsel.

II. General Rules for an Employer’s Deductions for its Contributions to a Welfare Benefit Fund under §§ 419 and 419A

The deduction limits imposed by §§ 419 and 419A apply to contributions paid or accrued with respect to a welfare benefit fund after December 31, 1985. Prior to that date, the amount of a deduction for contributions paid to a welfare benefit fund was controlled solely by § 162.[1]

A. Section 162

An employer which does not maintain a funded welfare benefit plan but rather pays for benefits directly from its general assets (whether through benefit payments, premium payments or both) typically will claim a deduction for its contribution payments under § 162. Section 162(a) allows a deduction for all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business. A taxpayer must meet five requirements in order to deduct an expense under this section. The taxpayer must prove that the item claimed as a deductible business expense: (1) was paid or incurred during the taxable year; (2) was for carrying on a

1 The enactment of § 419 placed new statutory limits on the amount of the deduction allowable to an employer in a given taxable year for contributions to a welfare benefit fund and, further, changed the timing of the deduction for accrual basis taxpayers from the general rules of § 461.

trade or business; (3) was an expense; (4) was a necessary expense; and (5) was an ordinary expense. Commissioner v. Lincoln Savings & Loan Assoc., 403 U.S. 345, 352 (1971); T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581, 587 (1993).

Prior to the effective date of §§ 419 and 419A, an employer which maintained a funded welfare benefit arrangement typically would claim a deduction for the amount of its contribution to the fund under § 162, whether or not the entire amount was determined actuarially to be necessary or, in fact, was used, to provide employee benefits in the taxable year the contribution was made.

Sections 419 and 419A were enacted as part of the Deficit Reduction Act of 1984 (DEFRA). Sections 419 and 419A imposed strict limits on the deduction of contributions in excess of the current year's costs. Congress's purpose in enacting §§ 419 and 419A, generally, was to restrict an employer's deduction for contributions to a welfare benefit fund to amounts reasonably and actuarially necessary to satisfy expenses incurred in the year the deduction is taken. The exceptions which Congress provided to this rule are very narrow and strictly defined for the funding of certain nondiscriminatory postretirement benefits.

Contributions must be "otherwise deductible" in order to be deductible under § 404 or 419. Therefore, meeting the requirements of § 162, among other Code sections, is still a precondition for deductions claimed under § 419. It is also a precondition for deductions claimed under § 404 which governs deductions for deferred compensation payments.

B. Sections 419 and 419A

1. Overview

Under **§ 419**, the employer's deduction for contributions to a welfare benefit fund for a taxable year is limited to:

1) an amount necessary to provide benefits for that year (**qualified direct cost**),
plus
2) an addition to a **qualified asset account**, up to an **account limit** determined under **§ 419A**
minus
3) the fund's after-tax income.

2. Qualified Direct Cost

Section 419(c)(3) provides that a fund's Qualified Direct Cost is the aggregate amount that would have been allowable as a deduction to the employer for the taxable year for plan benefits includible in the employees' incomes for the year (or which would have been includible but for an exclusion) if (a) the employer had been a cash basis taxpayer and (b) the employer had provided the benefits directly.

As stated above, a welfare benefit fund's qualified direct cost does not include amounts that an employer would not be able to deduct if it had provided the benefit directly (instead of through the fund). This is an important point when dealing with arrangements which have paid premiums on cash value life insurance policies.

Rev. Rul. 2007-65, 2007-45 I.R.B. 949, provides that for purposes of determining the limitations on an employer's deduction for contributions to a welfare benefit fund under §§ 419 and 419A, premiums paid on cash value life insurance policies by the fund are not included in the fund's qualified direct cost whenever the fund (or the employer) is directly or indirectly a beneficiary under the policy within the meaning of § 264(a). This is because a fund's qualified direct cost does not include amounts that would not have been deductible if the employer had provided the benefit directly. In situations involving premiums paid by a fund for cash value life insurance policies, if the employer had provided the benefit directly (that is, if the employer had not set up a trust to obtain and hold the cash value life insurance policies, but instead had held the policies itself and paid the premiums itself) § 264(a) would have precluded the deduction for the premium payments. Thus, those premium payments are not included in the fund's qualified direct cost.

3. Qualified Asset Account Additions

A fund's **qualified asset account** consists of any **assets set aside** to provide for the payment of (1) disability benefits, (2) medical benefits, (3) supplemental unemployment compensation benefits or severance pay benefits, or (4) life insurance benefits.

Pursuant to § 419A(c)(1), the **account limit** for any qualified asset account for any taxable year is (subject to special rules for certain types of benefits) the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year), and administrative costs with respect to those claims. Note that the inclusion of amounts for claims "incurred but unpaid" when calculating the account limit would only apply in the case of self-insured plans. In cases where the plan is fully insured, the deduction could not exceed the current year's cost of providing insurance coverage to the participants (plus, if applicable, actuarially determined amounts contributed to a postretirement medical and/or life insurance reserve which meets the requirements of § 419A(c)(2), discussed below). Also, please note that, as discussed below, other Code sections may limit or bar the deduction of certain insurance premium payments.

Section 419A(c)(2) provides that the account limit for any taxable year may also include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis as necessary for post-retirement medical benefits to be provided to covered employees or post-retirement life insurance benefits to be provided to covered employees. Section 419A(e)(2) provides that life insurance benefits shall not be taken into account under § 419A(c)(2) to the extent the life insurance coverage for an employee exceeds $50,000. Section 419A(c)(2) provides that contributions to a post-retirement medical reserve is to be determined on the basis of current medical costs. Section 419A(d) requires separate accounts for key employees with respect to the post-retirement benefits, and § 419A(e)(1) requires that the post-retirement reserve be nondiscriminatory.

III. Certain Arrangements Claiming to Include Welfare Benefit Funds: Issues Which May Arise under §§ 419 and 419A

The following is not meant to be a complete list of the issues that can come up when dealing with arrangements claiming to be welfare benefit plans; the issues will vary depending on the facts of the particular arrangement. Below are some of the most common issues involving the rules under §§ 419 and 419A, particularly with respect to professional corporations and other small businesses.

Legal issues involving the rules of other Code sections are not addressed in detail here but are discussed under "IV. Service's Position." For example, if an arrangement claiming to be a welfare benefit fund is determined to be, in fact, a plan of deferred compensation, the rules of § 404(a)(5) (and, potentially, § 409A) would govern the deduction of contributions to the arrangement. The Service's position with respect to the timing of deductions to such a plan is explained under part IV.

The three issues in Sections A, B and C below generally involve the following questions:

1) Is the sole purpose of the arrangement to provide welfare benefits to employees?

a) If the answer is no, then §§ 419 and 419A won't govern the extent and timing of any deductions for contributions to the arrangement. Which Code sections will control the extent and timing of any deduction depends, of course, on what the arrangement is, in fact. (See A., below, and IV.)

b) If the answer is yes, then the question is whether the deductions for contributions are allowed by the rules under §§ 419 and 419A.

i) Were the employer's contributions to the fund used to pay cash value life insurance premiums? If yes, please see B., below.

ii) Were the employer's contributions to the fund used to pay premiums under a life insurance contract that is part of a split-dollar life insurance arrangement as defined in Treas. Reg. § 1.61-22? (Generally, a split-dollar life insurance arrangement is an arrangement between an owner (e.g., an employer or trust), and a non-owner (e.g., an employee or shareholder), to split the benefits of a life insurance contract.) If yes, please see IV.

iii) If the employer claims that it can deduct more than what §§ 419 and

419A allow because the arrangement it contributed to qualifies for an exception under § 419A(f)(5)(A) or § 419A(f)(6), see question 2 and Section C, below.

2) If the arrangement is determined to include a welfare benefit fund, and claims to be a collectively bargained plan under § 419A(f)(5)(A) or a 10 or more employer plan under § 419A(f)(6), does it truly qualify for the exception under which the contributing employers are claiming a deduction? (See Section C below.)

A. Certain Arrangements Claiming to Include a Welfare Benefit Fund under § 419(e) are Dividend or Deferred Compensation Arrangements

Certain arrangements claim to be a welfare benefit fund as defined in § 419(e) and to be subject to the rules of §§ 419 and 419A, when, in fact, they are primarily or in whole (1) disguised dividend arrangements, or (2) deferred compensation arrangements. The deduction, if any, for contributions to such arrangements is governed by Code sections other than §§ 419 and 419A. The Service's position on such arrangements is addressed in more detail under "IV. Service's Position." Please note that not only self-described single employer plans, but also purported 10 or more employer plans and purported collectively bargained plans may be, in fact, disguised dividend or deferred compensation arrangements.

1. Dividend Arrangements

a. Arrangements Involving the Use of Cash Value Life Insurance

In Neonatology Associates et al., v. Commissioner, 115 T.C. 43 (2000), aff'd. 299 F.3d 221 (3d Cir. 2002), a trust claimed to be a § 419(e) welfare benefit fund that provided current life insurance benefits (that is, a promise to pay an employee's beneficiary a death benefit should the employee die during the year, while employed with the employer). The Tax Court held, however, that most of the amounts contributed to the trust were disguised constructive dividends to the owner-employees. In Neonatology, the owner-employees of the business and the promoter of the arrangement expected and understood that most of the contributions would benefit the owner-employees. In affirming, the Third Circuit said that the artificially inflated premiums paid by the employers in that case were a creative bookkeeping ploy invented by insurance specialists to exploit what they thought were loopholes in the tax laws. The Third Circuit further stated that the payments were so far in excess of the cost of the annual insurance protection that they could not plausibly qualify as ordinary and necessary business expenses under § 162(a).

Similarly, in V.R. DeAngelis, MDPC & R.T. Domingo, MDPC v. Commissioner, T.C. Memo 2007-360, the Tax Court ruled that an arrangement that was marketed as, and designed to appear as, a welfare benefit plan providing death and severance benefits, through which the employer's owner-employees obtained "cash-laden" life insurance policies was nothing more than a subterfuge to pay surplus cash to the owner-employees. The Tax Court stated that while employers are not generally prohibited from funding term life insurance for their employees and deducting the premiums on that insurance as a business expense under § 162(a), employees are not allowed to disguise their investments in life insurance as deductible benefit plan expenses when those investments accumulate cash value for the benefit of the employees personally.

Questions

1) Did the employer pay artificially high insurance premiums, in excess of the cost of current life insurance protection, under the arrangement?

2) Do the owner-employees and other key employees report only small amount of income with respect to the life insurance coverage and contributions for it, which are out of proportion to the substantial amounts of money contributed by the employer on their behalf?

3) Can a covered employee have a cash value policy covering the employee's life transferred to him or her – i.e. can an employee get at the cash value in that policy? Or, can a covered employee convert or exchange a policy without cash value, either for a policy with cash value, or for a policy without cash value but for which the premiums are not based on the employee's age at the date of the conversion or exchange?

If the answers to one or more of the above questions are yes, then it is likely that the arrangement is not an employee welfare benefit fund, but is an arrangement used to disguise investments in life insurance as deductible benefit-plan expenses when those investments accumulate cash value for owner-employees personally.

If the employer does not establish that the payments to the arrangement are anything other than a nondeductible distribution of cash for the benefit of the owner-employee(s) (and, if applicable, other key employees), then the plan may be simply a disguised dividend arrangement, i.e. a means of distributing corporate earning and profits to the owner-employee in the guise of providing "employee benefits." It is a subterfuge to accumulate surplus corporate cash in the life insurance policy for the owner-employee's ultimate use and benefit. If the payments are deemed to be distributions of earnings and profits to covered owner-employee(s), then they are not deductible to the employer. See Neonatology Associates et al., v. Commissioner, 115 T.C. 43 (2000), aff'd. 299 F.3d 221 (3d Cir. 2002); V.R. DeAngelis, MDPC & R.T. Domingo, MDPC v. Commissioner, T.C. Memo 2007-360.

b. Other Disguised Dividend Arrangements

The above is not an exclusive description of disguised dividend arrangements and is not meant to suggest that such arrangements are limited to purported benefit plans involving cash value life insurance. A determination of whether an arrangement is, in fact, a method to collect and distribute corporate earning and profits under the pretext of funding and providing welfare benefits is made based on the facts of the particular case.

For example, Notice 2007-84, 2007-45 I.R.B. 963, informs taxpayers of the Service's intent to challenge certain promoted trust arrangements claiming to provide nondiscriminatory post-retirement medical benefits and post-retirement life insurance benefits which, in operation, benefit primarily the owners or other key employees of the business. These purported welfare benefit arrangements typically are sold to small businesses and other closely held businesses as a way to for the owners to provide post-retirement medical benefits, post-retirement life insurance, and cash and other property to themselves and, perhaps, other key employees of the business, on a tax-favored basis through the use of a trust.

The amount of the employer's deduction for contributions to one of these arrangements is often based on a calculation of a post-retirement reserve associated with each of the plan participants – i.e. each of the employer's employees. However, while the calculation of the employer's contributions and deductions may be based on the actuarial assumption that all the business' employees will eventually receive post-retirement benefits under the arrangement, it is unlikely, in many situations, that the rank and file employees of the small business will remain in the business's employ until retirement or will retire from that business. The calculation also may be based on other actuarial assumptions that either are not reasonable or are not permitted to be reflected in the reserve calculations for purposes of §§ 419 and 419A.

While in such arrangements the trust frequently uses the employer's contributions to purchase cash value life insurance policies on the lives of employees who are owners of the business and, sometimes, on the lives of other key employees, this is not always the case. Other methods for funneling corporate earning and profits to the owners may include: (1) amending the plan to provide benefits other than the plan's original post-retirement medical or life insurance benefits at a time when the owners and perhaps other key employees will be the primary beneficiaries; (2) terminating the plan prior to the payment of the post-retirement benefits at a time and using a method of asset allocation that provides the owners and key employees, directly or indirectly, all or a substantial portion of the assets held by the trust.

2. Deferred Compensation Arrangements

If it is found that payments to a purported welfare benefit plan or arrangement are part of a compensatory arrangement, rather than a distribution of earnings and profits (above), and the sole purpose is not the provision of welfare benefits, then the arrangement is a non-qualified plan of deferred compensation.

Section 419 generally controls the timing and amount of an employer's deductions for contributions made to a welfare benefit fund. Section 404(a) provides the deduction rules for employers' contributions to stock bonus, pension, profit-sharing, or annuity plans, as well as the deduction rules for compensation paid to any employee under a plan deferring the receipt of that compensation.

Unfunded deferred benefits are treated the same as deferred compensation, under § 404(b)(2). If the deferred benefits are provided through a *funded* welfare benefit plan, however, then § 419 generally controls the deduction. (See §§ 402(b)(2)(B) and 419(e)(2)(B) of the Code.) In determining whether § 419 or § 404 applies, the primary question is whether the arrangement has any features of a deferred compensation plan, or whether it is solely a welfare benefit fund. See Wellons v. Commissioner, 31 F. 3d 569, 571 (7^{th} Cir. 1994), aff'g T.C. Memo 1992-704 (taxable years before effective date of § 402(b)(2)(B)).

The facts of an arrangement may raise the question of whether it is a funded welfare benefit plan or a deferred compensation plan, i.e. whether § 419 or § 404 applies to the employer's deductions. The Code does not define a "plan deferring the receipt of compensation." However, the regulations provide that an arrangement defers the receipt of compensation or benefits to the extent that, under it, an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. Treas. Reg. § 1.404(b)–1T Q&A 2 (a). Deferred compensation arrangements can take many forms and can even have characteristics similar to welfare benefit funds.

Questions

1) Does the arrangement mainly provide cash or other benefits to a covered employee more than a brief period of time after the end of the employer's taxable year in which the employee performed the services that created the employee's right to that compensation or those benefits, *regardless* of whether there was an unforeseen event (contingency) of the type that would normally trigger such payments from a welfare benefit fund?

2) Has the employer contributed amounts to the arrangement that far exceed the cost of providing the current year's benefits for the covered employees?

If the answer to one or both questions is yes, then the arrangement may be a deferred compensation plan. If the arrangement is a deferred compensation plan, then § 404(a)(5) governs the employer's deduction and the employer must show that it has met the requirements that section. Under § 404(a)(5), an employer can deduct its contribution to a non-qualified deferred compensation plan only in the year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan. However, if the plan does not maintain a separate account for each employee, then no deduction is allowed at all. Further, amounts are deductible under § 404(a)(5) only if they would otherwise be deductible.

If the employer has not established (1) that the payments to the plan are includible in the Employee's gross income in the year at issue;[2] (2) that separate accounts were

2 The inclusion of amounts in the Shareholder-Employee's gross income with respect to the arrangement is governed by § 402(b).

maintained for each employee[3]; or (3) that amounts contributed are otherwise deductible, then the employer's payments to the plan are not deductible under § 404(a)(5).

B. Arrangements Claiming to be Funded Welfare Benefit Plans under § 419(e) which hold Cash Value Life Insurance Policies

Even in cases where an arrangement is determined to be a welfare benefit fund within the meaning of § 419(e), the rules of §§ 419 and 419A may bar the deduction of contribution amounts.

As stated above, Rev. Rul. 2007-65, 2007-45 I.R.B. 949, provides that the premiums paid on cash value life insurance policies are not included in the fund's qualified direct cost under § 419(c)(3) if the fund is **directly or indirectly a beneficiary under the policy** within the meaning of § 264(a). Examples include, but are not limited to, plans under which the fund is the owner of the policy, and, plans under which the covered participant owns the policy but has assigned the proceeds of the cash value policy to the fund, in whole or in part.

This is because a fund's qualified direct cost does not include amounts that would not have been deductible if the employer had provided the benefit directly. In situations involving premiums paid by a fund for cash value life insurance policies which benefit, directly or indirectly, the fund, if the employer had held the policies and paid the premiums itself, § 264(a) would have precluded the deduction for the premium payments. Thus, those premium payments are not included in the fund's qualified direct cost under § 419(c)(3), and, accordingly, are not deductible under § 419.

C. Issues with Certain Arrangements Claiming to Meet the Requirements of the § 419A(f)(5)(A) or § 419A(f)(6) Exception to the General Deduction Limits of §§ 419 and 419A

Further to the issues described above, certain arrangements claim to be collectively bargained plans or 10 or more employer plans which meet the requirements of the exception to the deduction limits of §§ 419 and 419A provided by, respectively, § 419A(f)(5)(A) or § 419A(f)(6). These arrangements and their participating employers claim that deductions for contributions are governed solely by the rules of § 162.

1. Certain Arrangements Which Claim to be "maintained pursuant to a collective bargaining agreement" Within the Meaning of § 419A(f)(5)(A)

3 See § 404(a)(5); Treas. Reg. § 1.404(a)–12(b)(3). Such accounts must be sufficiently separate and independent to qualify as separate shares under § 663(c). The general test for separate and independent shares under § 663(c) is "whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created." Treas. Reg. § 1.663(c)–3(a). In addition to meeting the "separate share" rule, the trust must meet the "separate account" rule of § 404(a)(5). "Separate accounts," as used in § 404(a)(5), requires separate accounts maintained on the books and records of the trust. Wigutow v. Commissioner, T. C. Memo. 1983-620.

As explained above, § 419A(f)(5)(A) provides an exception to the deduction limits of §§ 419 and 419A for contributions to a separate welfare benefit fund under a collective bargaining agreement. The § 419A(f)(5)(A) exception is based in part on the premise that deductions for contribution amounts agreed to in a collective bargaining 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 Regulations sets out several 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)(A) of the Code. One requirement 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.

The Service has encountered arrangements which purport to be collectively bargained plans but do not meet the requirements of § 419A(f)(5)(A). In determining whether there was a valid collective bargaining agreement, the examiner should review whether there were bona fide arm's length negotiations between adverse parties. There must also be a valid employee representative negotiating with the employer.

All facts and circumstances must be examined to determine if there is a valid collective bargaining agreement. Below are some indicators which, if present in a particular arrangement, suggest that an arrangement is <u>not</u> maintained pursuant to a bona fide collective bargaining agreement.

- The owner(s) of the employer picks the union.
- The employer decides who is in the bargaining unit covered by the collective bargaining agreement.
- The bargaining unit includes officers and the owner's family members, while other employees are excluded from the bargaining unit.
- The union makes no effort to organize the remaining employees.
- There is no evidence that the non-owner-employees had any say over who would be their employee representative.
- The owner initiated contact with the union.
- There is no union presence at the workplace.
- The union makes no effort to enforce the provisions of the collective bargaining agreement.
- The initial contact with the union is through an insurance agent.
- The employee representative allows the shareholder-employee(s) to receive substantially bigger benefits than the rank and file employees.
- The Employer provided other benefits than those provided in the contract. For example, the Employer provides benefits to its employees, such as

health insurance and retirement benefits, even though the contract does not provide for these benefits.
- There is no evidence of negotiations between the Employer and the union.

See Notice 2003-24 for further information.

2. Certain Arrangements Which Claim to be "10 or more" Plans Within the Meaning of § 419A(f)(6)

As explained above, the § 419A(f)(6) exception to the deduction limits of §§ 419 and 419A applies only to contributions to a welfare benefit fund which is part of a 10 or more employer plan (1) to which more than one employer contributes and (2) to which no employer normally contributes more than 10 percent of the total contributions contributed to the plan by all employers. Furthermore, the exception applies only if the plan does not maintain experience-rating arrangements with respect to individual employers.

The legislative history of the Deficit Reduction Act of 1984, which enacted §§ 419 and 419A, states that the exception provided by § 419A(f)(6) was provided because "the relationship of a participating employer to [such a] plan often is similar to the relationship of an insured to an insurer." Even if the 10 percent contribution limit is satisfied, the exemption does not apply to a plan that is experience-rated with respect to individual employers, because the "employer's interest with respect to such a plan is more similar to the relationship of an employer to a fund than an insured to an insurer." H.R. Rep. No. 98-961, 98th Cong., 2d Sess., 1159 (1984-3 D.B. (Vol. 2) 1, 413). A plan does not meet the requirements of § 419A(f)(6) unless 10 or more employers contribute to a single pool of funds, and that single pool of funds is for the use of the group of employers as a whole (*e.g.* to pay the claims of all employees covered under the plan). Booth et al v. Commissioner, 108 T.C. 524 (1997).

The Service has uncovered arrangements which claim to be valid 10 or more plans but which, in fact, do not meet the requirements of § 419A(f)(6). Typically, such arrangements provide separate accounting with respect to the contributions and earnings of the individual employers, and/or provide experience-rating with respect to the claims of the individual employers' employees. Benefits are sometimes related to the amounts allocated to the employees of a participant's employer. Whether by formal agreement or informal practices, in these arrangements, a particular employer's contributions or its employees' benefits are determined and tracked in a way that insulates the individual employers to a significant degree from the claims experience of other participating employers. Thus, in such arrangements, the relationship of the employer to the arrangement is more like an employer to its own fund, than an insured party to an insurer. See § 1.419A(f)(6)-1 for further information.

Arrangements that are the same as or substantially similar to the claimed 10 or more employer plans were originally identified as listed transactions in Notice 2000-15, 2000-1 C.B. 826. Taxpayers participating in listed transactions are required to disclose that participation in accordance with § 1.6011-4 (or, depending on when the transaction was entered into, § 1.6011-4T). The American Jobs Creation Act added a monetary penalty for the failure to disclose. This penalty is found in § 6707A, which applies to returns and statements that are due after the date of enactment, October 22, 2004 – i.e., generally, 2004 returns

Many purported 10 or more employer plans have terminated and the participating employers either have directed that assets allocable to their contributions be distributed to covered employees (often for a nominal fee), or have transferred these assets to a "single employer plan."

D. Issues With Purported 10 or More Employer or Collectively Bargained Plans Which Terminate, then Distribute Assets to Covered Employees or Transfer Assets to a Single Employer Plan

Some arrangements claim to have transformed from a 10 or more or collectively bargained plan to an arrangement in which each employer has its own single employer plan (SEP). In other cases, a purported 10 or more or collectively bargained plan was terminated and assets allocated to individual employers were transferred to a second arrangement, often administered by the same entity as that which administered the first arrangement, or a related entity.

This means that amounts that were deducted in past years as contributions to a 10 or more employer or collectively bargained plan, and earnings on those amounts (generally via the transfer of the cash value insurance policies purchased with the employer contributions), are put into a single employer plan. If the amounts that were previously deducted had been contributed to the single employer plan originally, the deduction would have been limited under §§ 419 and 419A. This brings the tax benefit rule into play. (This is discussed further under IV., below.)

In some cases, the employer is given the option of having its assets in the arrangement (in a purported 10 or more employer plan, the assets allocated to the employer) distributed to covered employees. Typically, owner-employees receive cash-laden life insurance policies, however, other types of assets also might be distributed. Shareholder-owners might pay a nominal fee to receive a cash value life insurance policy or might pay an amount which, while not insignificant, is far below the policy's true fair market value. Such distributions result in income to the recipient employees, as discussed below.

IV. Service's Position

A. Employer's Deduction, Income

As described above, some arrangements claim to provide welfare benefits such as death and severance pay, but, in operation, distribute disguised dividends or deferred compensation in a manner designed to circumvent the applicable rules and regulations under the Code.

Further, an arrangement which is found to include a welfare benefit fund within the meaning of § 419(e) might also claim that the welfare benefit fund is under a collective bargaining agreement within the meaning of § 419A(f)(5)(A), or, that the plan is a 10 or more employer plan within the meaning of § 419A(f)(6). However, even if the arrangement meets the requirements of § 419(e), it might not meet the requirements of either the § 419A(f)(5)(A) or the § 419A(f)(6) exception to the general deduction limits of §§ 419 and 419A.

Similarly, a single employer plan which is found to include a welfare benefit fund within the meaning of § 419(e) might claim that contribution amounts used to pay premiums on cash value life insurance policies are deductible under § 419(c)(3) as part of the fund's qualified direct cost. However, although an arrangement might be found to include a welfare benefit fund within the meaning of § 419(e), premiums paid on cash value life insurance policies by the fund are not included in the fund's qualified direct cost whenever the fund is directly or indirectly a beneficiary under the policy within the meaning of § 264(a). See Rev. Rul. 2007-65.

If the employer's contributions to the fund were used to pay premiums under a life insurance contract that is part of a split-dollar life insurance arrangement as defined in Treas. Reg. § 1.61-22, then the regulations governing these arrangements may affect the timing of the employer's deduction for the contribution amounts. Generally, a split-dollar life insurance arrangement is an arrangement between an owner (e.g., an employer or trust), and a non-owner (e.g., an employee or shareholder), to split the benefits of a life insurance contract. If the arrangement was entered into after September 17, 2003, or "materially modified" after that date, the split-dollar life insurance arrangement rules of Treas. Reg. § 1.61-22 may apply. Treas. Reg. § 1.61-22(f)(2)(ii) provides that for the period prior to the transfer of the life insurance contract from the employer to the shareholder, no premium or other amount described in § 1.61-22(d) is deductible by the employer, except as otherwise provided in § 1.83-6(a)(5).[4]

Lastly, an employer which has assets allocable to contributions deducted under § 419A(f)(5)(A) or § 419A(f)(6) distributed, allocated or transferred to a single employer plan, will have income in the year of the effective date of the distribution, allocation or transfer.

1. <u>Employer Deductions for Contributions to Purported Collectively Bargained Plans and Purported 10 or more Employer Plans Which Do Not Meet the Requirements of § 419(e) or § 419A(f)(5)(A) / § 419A(f)(6)</u>

[4] If a split-dollar life insurance arrangement is entered into in connection with the performance of services, ownership of the life insurance contract will be attributed to the employer or service recipient if the named owner of the contract is a trust described in § 402(b), a welfare benefit fund described in § 419(e), or a trust that is treated as owned by the employer or service recipient under §§ 671 through 677. See Treas. Reg. § 1.61-22(c)(1)(iii).

- No deduction is allowed per § 162 because contributions are characterized as dividends to the shareholder-employee, resulting in dividend income to the shareholder-employee; or

- No deduction is allowed per § 404(a)(5); the arrangement is not a welfare benefit plan but a non-qualified deferred compensation plan which should be subject to the deduction rules of § 404 (a)(5). Deductions are only available under § 404(a)(5) when compensation income is included by the shareholder/employee. (Even then, the deduction may not be allowed because of the separate account rule in § 404(a)(5), or because of other Code provisions.)

- If the arrangement is found by the court to include a welfare benefit fund within the meaning of § 419(e), deductions are limited per §§ 419 and 419A because the arrangement does not meet the requirements of § 419A(f)(5)(A) or § 419A(f)(6), as applicable.

- Additionally, if the arrangement was entered into after September 17, 2003, or "materially modified" after that date, the split-dollar life insurance arrangement rules of Treas. Reg. § 1.61-22 may apply to any deduction by the employer until the policy is transferred to the employee. See Treas. Reg. § 1.61-22(f)(2).

2. Change from a Purported Collectively Bargained Plan or Purported 10 or More Employer Plan to a Single Employer ("419e") Plan is a Taxable Event

- Income Inclusion per Tax Benefit Rule: Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if an event occurs that is fundamentally inconsistent with the premise on which the deduction was initially based. See generally Hillsboro National Bank v. Commissioner and United States v. Bliss Dairy, Inc., 460 U.S. 370 (1983).

- The distribution of assets, or the allocation or transfer of assets to a single employer plan, are all events which are fundamentally inconsistent with the employer's premise for deducting its earlier contributions to the arrangement. The employer's premise for deducting plan contributions in those earlier years was that the arrangement (1) included a welfare benefit fund within the meaning of § 419(e) and (2) met the requirements of the § 419A(f)(5)(A) or § 419A(f)(6) exception to the general deduction limits.

- The adjustment is the lesser of: (1) the sum of the contributions to the arrangement deducted by the employer in prior years, less the sum of previous contributions that would have been deductible as contributions to the single employer plan; and (2) the value of the assets that were distributed, or transferred or allocated to the single employer plan on behalf of the employer on the effective date of the inconsistent event.

- If your case involves one or more open years prior to the conversion of a particular arrangement from a purported § 419A(f)(5)(A) or § 419A(f)(6) plan to a single employer plan, please contact a technical advisor or field counsel. Such cases generally have additional tax benefit rule issues that are beyond the scope of this document.

3. <u>Employer Deductions for Contributions to Single Employer Plans Which Do Not Meet the Requirements of § 419(e)</u>

- No deduction is allowed per § 162 because contributions are characterized as dividends to the shareholder-employee, resulting in dividend income to the shareholder-employee; or

- No deduction is allowed per § 404(a)(5); the arrangement is not a welfare benefit plan but a non-qualified deferred compensation plan which should be subject to the deduction rules of § 404 (a)(5). Deductions are only available under § 404(a)(5) when compensation income is included by the shareholder/employee. (Even then, the deduction may not be allowed because of the separate account rule in § 404(a)(5), or because of other Code provisions.)

- If the arrangement is found by the court to include a welfare benefit fund within the meaning of § 419(e), deductions are limited by §§ 419 and 419A. Contribution amounts used to pay premiums on cash value life insurance policies are not included in the fund's qualified direct cost whenever the fund is directly or indirectly a beneficiary under the policy within the meaning of § 264(a).

- Additionally, if the arrangement was entered into after September 17, 2003, or "materially modified" after that date, the split-dollar life insurance arrangement rules of Treas. Reg. § 1.61-22 may apply to deny any deduction to the employer until the policy is transferred to the employee. See Treas. Reg. § 1.61-22(f)(2).

B. <u>Income to Owner-Employee</u>

1. <u>Cost of Life Insurance Coverage</u>

- The cost of life insurance coverage provided to an employee under a life insurance contract is generally taxable under § 61. See, e.g., Treas. Regs. § 1.61-2(d)(2)(ii).

2. <u>Dividend Income or Deferred Compensation Income</u>

- If the arrangement is a disguised dividend arrangement rather than a bona fide welfare benefit plan, then the employer's contributions to the arrangement are corporate distributions and the shareholder-employee has dividend income under §§ 61 and 301. See also Neonatology v. Commissioner, 299 F. 3d 21 (3d Cir. 2002). A corporate distribution is taxed as a dividend to the recipient shareholder to the extent of the corporation's earning and profits.

- Alternatively, if the arrangement is a deferred compensation plan, the employee may have income under §§ 61 and 402(b). Section 402(b) sets forth rules applicable to beneficiaries of non-tax-exempt employees' trusts to which employers contribute amounts.

    - Section 402(b)(1) provides that contributions to an employees' trust made by an employer during a taxable year of the employer which ends with or within a taxable year of the trust for which the trust is not exempt from tax under § 501(a) shall be included in the gross income of the employee in accordance with § 83 (relating to property transferred in connection with performance of services), except that the value of the employee's interest in the trust shall be substituted for the fair market value of the property for purposes of applying such section.

    - Section 402(b)(2) provides that the amount actually distributed or made available to any distributee by a non-exempt employees' trust described in § 401(b)(1) shall be taxable to the distributee, in the taxable year in which so distributed or made available, under § 72 (relating to annuities), except that distributions of income of such trust before the annuity starting date (as defined in § 72(c)(4)) shall be included in the gross income of the employee without regard to § 72(e)(5) (relating to amounts not received as annuities).

    - Section 402(b)(4) provides special rules, applicable to highly compensated employees of certain trusts, that supersede the provisions of § 402(b)(1) and (2). For highly compensated employees, § 402(b)(4)(A) provides that if one of the reasons a trust is not exempt from tax under § 501(a) is the failure of the plan of which it is a part to meet the requirements of § 401(a)(26) or § 410(b), then such highly compensated employees shall, in lieu of the amounts determined under § 402(b)(1) or (b)(2), include in gross income for the taxable year with or within which the taxable year of the trust ends an amount equal to the vested accrued benefit of such employee (other than the employee's investment in the contract) as of the close of such taxable year of the trust.

3. Income from Receipt of Life Insurance Policy that is Part of a Split-dollar Life Insurance Arrangement

- Section 61 provides generally that, except as otherwise provided by law, gross income includes all income from whatever source derived. The concept of gross income encompasses accessions to wealth, clearly realized, over which taxpayers have complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

- In the context of purported welfare benefit arrangements, if an arrangement is a split-dollar life insurance arrangement as defined in Treas. Reg. § 1.61-22, then income inclusion to employees and shareholders is determined under the split-dollar regulations. In general, a split-dollar life insurance arrangement is an arrangement between an owner of a life insurance policy (e.g., an employer) and a non-owner of the policy (e.g., an employee or shareholder) to split the benefits of a life insurance contract. The split-dollar regulations apply only to split-dollar life insurance arrangements entered into after September 17, 2003, and to arrangements entered into before that date that are "materially modified" after that date. Treas. Reg. § 1.61-22(j).

- Treas. Reg. § 1.61-22 provides rules for taxation of a split-dollar life insurance arrangement for purposes of the federal income tax and certain other federal taxes. The non-owner must take into account the “full value of all economic benefits” reduced by any consideration paid (directly or indirectly) by the non-owner to the owner for those benefits. For most arrangements that are the subject of this report, the full value of all economic benefits includes the cost of the life insurance protection plus the policy’s cash value.