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Do 419 Plans Deliver The Tax Savings Promised?

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Wall Street's greatest bond trader used to say, "In the gap between perception and reality, there is money to be made."

There exists such a gap between perception and reality in the area of Employee Welfare Benefit Plans (EWBPs) or § 419A (f)(6) plans. Welfare Benefit Plans deserve a careful review to see how they might best serve your clients.

A common question is can welfare benefit plans deliver the tax savings promised? The answer is "yes" — if they are properly drafted and are in compliance with the Internal Revenue Code.

EWBPs have been in existence since 1929. Today, literally thousands of public and private corporations have EWBPs. These plans include, but are not limited to:

- severance benefits,
- disability benefits,
- life insurance benefits, and
- health benefits.

EWBPs have become even more popular as of late. The attraction for the business owner, highly-paid professional or executive is a current tax deduction and the ability to preserve more of his or her wealth.

The issue isn't if EWBPs work. After all, Congress, through various pieces of legislation over the years, has authorized and recognized welfare benefits plans in order to insure the welfare of employees. Rather, the issue for a closely-held business considering an EWBP is what is required to be in compliance.

Most plan sponsors have the business taxpayer join a master trust that is written and administered under strict guidelines. The drafting of the plan documents is critical to being either in or out of compliance.

Generally, C corporations, sub-chapter S corporations, limited liability corporations and general partnerships (subject to certain conditions) can provide these benefits as a tax-deductible benefit plan of the business. Participation must cover at least two participants of the company. If one owner owns more than 50 percent of the business, a non-owner employee must be included. However, a plan can be limited to two 50 percent owners, or minority owners.

Moreover, an EWBP should have a plan design that revolves around the death benefit provided. The best approach would be to have benefits, in general, limited to 15 times W-2 for the death benefit provided and 30 percent of W-2 for contributions made, or a flat death benefit with premium limited to W-2 income.

The plan design can be changed in two ways: 1) benefits can be raised or lowered and 2) the overall design can be adjusted as long as these changes are reflected in an amendment to the adoption agreement. Therefore, case design and product selection are critical to meeting expectations of all parties.

419 Plans + Compliance = Peace-Of-Mind

Recently, it was reported that a pending tax court case — *North Carolina Power v. Comm'r.* — had settled in favor of the taxpayer. The same judge is considering a similar case — *Wells Fargo v. Comm'r* — which is expected to reach settlement by the end of June. In addition, further IRS regulations and guidance are expected by the end of the summer.

Legislation proposed under the Clinton 2000-01 budget and the African Trade Bill have attempted to modify 419A(f)(6) plans but thus far have not made their way into law. There seems to be a general misunderstanding of EWBPs increasing the chances of an IRS audit based on compliance with the Tax Promoter Registration rules. This is generally not the case, really only to the extent it reduced the taxpayer's federal income tax liability by more than $1 million in one year or more than $2 million in any continuation of years, according to § 6700 and § 6662(e).

Furthermore, attorneys Stephen Leimberg (www.leimberg.com) and John G. Simmons (who was published in "The Practical Tax Lawyer," Summer 2000 issue) have written separate articles on 419A(f)(6) plans. It's highly recommended that any plan considered by an attorney or tax professional meets their additional, well-thought-out guidelines.

Qualifications

Frequently, this author has discovered that legal and tax professionals have great discomfort with EWBPs in general. The problem, however, is not universal to EWBPs, but unique to a particular fact situation — as seen in the *Booth* case.

The IRS in *Booth* attacked the prime plans on the following grounds:

- the plan was experience rated;
- the plan was not a single plan;
- the plan was a deferred compensation plan, not a welfare benefit plan;
- the plan contained no substantial risk of forfeiture; and
- plan participants did not include PS 58 costs in annual income.

These are all issues that can — and must — be carefully considered when considering an EWBP.

In order to qualify as a welfare benefit plan under § 419A(f)(6), the plan cannot be experience rated and it must be a single plan (not a collection of plans). Also, it can in no way appear to be a deferred compensation benefit.

The results of *Booth* are not surprising given that the plan failed to be in compliance with the law. Most commentators feel that the prime plans under the lead case known as *Booth* violated the "Pig Rule." (Pigs get fat, hogs get slaughtered.)

Failure to be in compliance generally means: 1) the employer loses its § 162 ordinary and necessary *current* business deduction until such time as the employee picks up the income, or 2) the employer is limited to lower deductions for § 419 and 419A contributions limits. Therefore, oversimplified plan design and implementation is critical to getting the desired results.

Attorneys and tax professionals do, however, face an imposing task in discerning which of the dozen-plus EWBPs being

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marketed to the closely-held business currently best meets the definition of being in compliance with all relevant issues. Moreover, roughly a dozen life insurance companies are approved carriers for use in these plans — some offering better results than others.

In addition, assets held in an EWBP are generally creditor proof. To illustrate the importance of this, consider this — in 2001, 257 public companies representing $258 billion of assets found themselves forced into bankruptcy. Also, the average business owner has in excess of 90 percent of his or her net worth tied up in the business. Thus, the benefit of taking some of one's assets off the table is becoming increasingly clear.

Where do § 419 plans fit? These plans fit where the employee/employer has a need for tax deductible life insurance for estate planning, buy-sell planning, income replacement or securing bank financing, and so forth.

Life insurance, like health insurance, looks better when it is tax deductible. Most businesses would never think of missing this business tax deduction for health insurance premiums, but generally miss it for life insurance benefits via EWBPs under § 419A(f)(6).

There are a myriad of key considerations in evaluating which sponsor's EWBP is the right one for you. As a rule of thumb, a closely-held business considering a EWBP will want a *death benefit only* (DBO) plan for peace of mind.

Compliance

The following issues are critical to being in compliance for a death benefit only plan under a § 419A(f)(6) plan.

Does the employer contribution qualify under code § 162(a) as an ordinary and necessary expense in trade or business? Reg 1.162-10(a) provides: "Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits … or sickness, accident, hospitalization, medical expense, … welfare, or <u>similar benefit</u> are deductible under § 162(a) if they are ordinary and necessary expenses of a trade or business."

A qualifying EWBP must qualify as a § 162(a) deduction and not be limited by code 419A limits or superseded by 404(a) or 83(h). Section 404(a)(5) basically states that the employer contribution is not deductible until the year included in the employee's gross income. However, this does not apply to a qualifying EWBP. Code § 83(h) doesn't apply for plans that qualify as an employee benefit plan described in Reg. § 1.162-10(a).

Notice 95-34 offers further direction, along with somewhat overlapping guidance from Judge David Laro's nine-point test in *Booth* and the three-point test in the *Neonatology* cases, which provide the following:

- The plan must be a single plan, not a collection of separate plans, in order to qualify for § 419A(f)(6) treatment
- No one employer should contribute more than 10 percent of total contributions.
- The trust must be a single plan with 10 or more employers.
- All assets of all plans must ultimately be available to pay all claims under the plan, and there must be cross liability among various employer groups for "true risk sharing." This shouldn't cause a problem if the plan is a death benefit only plan with contributions based on levelized mortality charges over the working life of an employee. Since a death benefit only plan has no cash or cash value in the actual trust, it can never resemble a deferred compensation plan.
- There can be no experience rating, which means an employer typically cannot receive anything back based upon experience. Code § 419A(f)(6)(A) prohibits experience rating as to any individual employer
- There are no deferred compensation benefits or anything that can be considered deferred compensation. It is a good idea in closely-held business situation not to have a severance plan in an EWBP while providing a life insurance benefit. This could look as if the owner might one day fire himself around the time his retirement age arrives in order to gain access to the severance plan assets. There should be nothing that allows a shifting of wealth.
- There must be no prepaid expenses. An actuary report should support all expenses. Attorneys and tax professionals should use an actuary to "safe harbor" what the levelized contribution should be over an employee's working life.
- An employee should have no expectation of receiving anything other than a death benefit only from the EWBP. It is recommended that attorneys and tax professionals avoid plans with springing cash values and fancy trust exchanges at retirement, or those that convert cash value into other benefits, such as paid-up medical or disability coverage.
- At least one commentator recommends not terminating any existing retirement plans while implementing an EWBP, which ensures that no one plan replaces another plan.
- A taxpayer and/or business should not be the trustee or the administrator of plan. There should be no unilateral ability to change benefits. Termination by itself, however, doesn't appear to be a problem.
- The taxpayer should have an independent advisor's tax opinion to rely upon in order to provide the taxpayer substantial authority for the EWBP. Senators Grassley and Baucus have a bill pending (SB2498, known as the "Tax Shelter Transparency Act," introduced May 9, 2002) that looks for substantial authority for benefit, as well as compliance with corporate disclosure rules. In addition, the taxpayer should believe more likely than not that the EWBP qualifies within the IRS code.
- To be safe and prudent, the real purpose of the EWBP should be a death benefit only plan.
- Covered employees should either be part of a select group of management or a highly-compensated employee qualifying for the "Top Hat" exemption contained in DOL Reg. 2520.104-24
- Death benefits should either be: 1) a multiple of eligible employee compensation or 2) a flat dollar amount for everyone covered. The portion of the death benefit attributable to the EWB trust should be reflected in taxes due by the employee based on the lower of the government tables or the lowest term costs of the insurance company providing the policy.

Welfare benefit plans can deliver the tax savings promised — if they are properly drafted and are in compliance with the Internal Revenue Code. EWBPs deserve a careful review to see how they might best serve your clients. As Yogi Berra said, "You can observe a lot just by looking."

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