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STUDY
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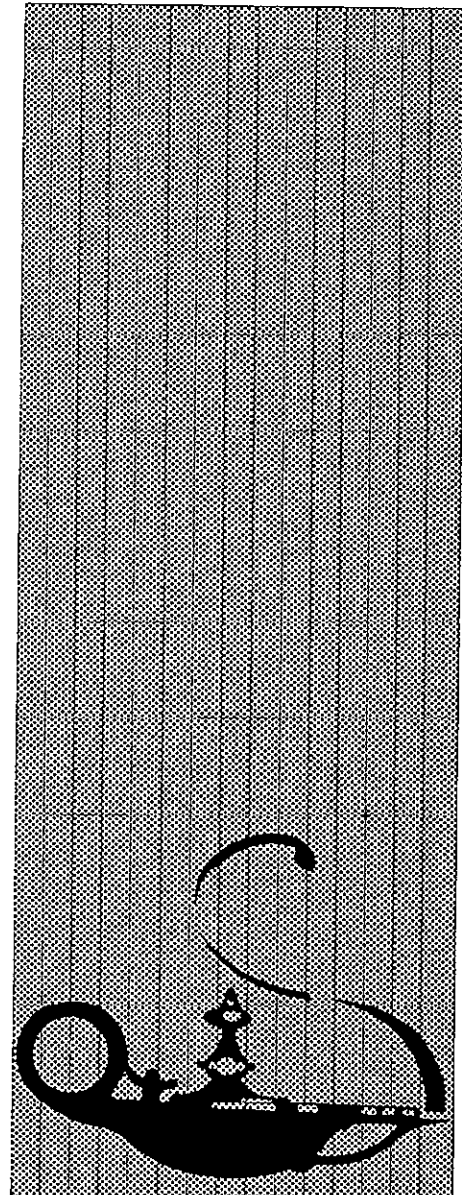
**Uses of Insurance in
Estate and Tax Planning**

May 31-June 2, 2001
Chicago, Illinois

Volume I

SF59

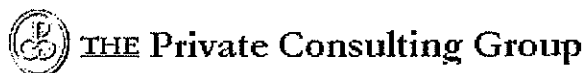
Handler and Thornhill, "Welfare Benefit Plans: Current Trends and Legislative Proposals," SF59, ALI-ABA, 255, Uses of Insurance in Estate and Tax Planning Course Book (2001)



AMERICAN LAW INSTITUTE-AMERICAN BAR ASSOCIATION
COMMITTEE ON CONTINUING PROFESSIONAL EDUCATION

**WELFARE BENEFIT PLANS
CURRENT TRENDS
AND
LEGISLATIVE PROPOSALS**

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SECTION ONE

I. Overview and Background

a. Legislative History:

- 1) Traditionally, welfare benefits have been used to provide welfare benefits to employees, with a current deduction for employers without current taxation to employees.
- 2) The early rules allowed employers to overfund or prefund substantial benefits, obtain a large deduction, and thereby mismatch the income and its related deduction.
- 3) In response to perceived abuse, Congress enacted Code Secs. 419 and 419A.
- 4) These sections limited deductions to the cost of current welfare benefits determined as if the employer provided the benefits directly, plus an amount sufficient to cover accrued, but unpaid, welfare claims incurred.
- 5) Congress determined that collective bargaining plans and multiple employer benefit plans were not subject to the perceived abuses, and enacted Code Sec. 419A(f)(6).
- 6) These plans are not subject to the funding limitations imposed by Code Secs. 419 and 419A.

b. Qualifications:

- 1) 10 or more employer plan:
 - (i) The trust must be made up of 10 or more employers; and

- (ii) No employer can *normally* contribute more than 10% of the total contributed to the plan by all employers.
 - (iii) This approach is designed to ensure that no one employer can control the trust and its assets.
- 2) Experience rating
- (i) A qualifying trust cannot practice experience rating.
 - (ii) Although the Code does not define this term, it is generally understood to mean that the plan cannot maintain experience rating arrangements with respect to individual employers relative to other employers in the group.
 - (iii) The related Committee Reports on Code Sec. 419A(f)(6) indicate that a participating employer's relationship to the plan should be similar to that of an insured to an insurer.
 - (iv) In group life and health insurance, the term means that the determination of an employer's liability is based solely on the actual historical experience of that employer.
 - (v) The Supreme Court of the United States has defined the term as "the cost of insurance to the group as based on that group's claims experience, rather than actuarial tables." 477 U.S. 105 (1986).
 - (vi) Congress included this prohibition against experience rating to lessen employer's incentive to overfund their plan.
 - (vii) Experience rating is one of the major issues of contention with the IRS, which has adopted an extremely expansive view.
- c. Constraints:
- 1) By including the constraints on contributions and experience rating, Congress sought to create a self-policing program where overfunded reserves would be strongly discouraged.
 - 2) The presence and possibility of forfeiting overfunded reserves provides further incentive to avoid overfunding.

II. Key Employee Benefits

- a. Welfare Benefits – in general:
- 1) These are benefits, other than pension or retirement benefits, that are similar to life, sick, and accident benefits intended to either safeguard or improve the health of an employee's dependents, or protect against events that interrupt or impair an employee's earning power.
 - 2) Benefits provided under a multiple employer welfare benefit plan typically include medical, death, or severance benefits, or any combination of these.

- b. **Death Benefits:**
 - 1) The amount of death benefit is determined when the employee first becomes a participant in the plan – according to the adoption agreement of the sponsoring employer.
 - 2) The amount is generally based on a multiple of the participating employee's wage income (typically, 1 to 20 times their last W-2 wages).
 - 3) The amount of the death benefit may be changed by the employer, but only prospectively.
 - 4) The multiple used to calculate the death benefit should be uniform for all employees, except lower multiples can be adopted for highly compensated employees or employees deemed substandard risks by insurance companies.

- c. **Medical Benefits:**
 - 1) These are generally included to supplement group health care benefits that are already in place.
 - 2) Low income employees may be able to deduct related medical expenses paid, resulting in a partially or fully nontaxable employee benefit.
 - 3) Middle and high income employees, however, may be able to deduct only a portion of the medical expenses paid with respect to such benefits. This is because of the limitations based on AGI that are inherent with medical deductions.

- d. **Severance Pay Benefits:**
 - 1) These benefits are provided upon termination of employment.
 - 2) They are designed to provide a financial bridge between termination and obtaining new employment.
 - 3) The benefits generally range from a small percentage of average annual compensation up to a maximum of two times average annual compensation.
 - 4) Terminations can be caused by numerous events for legitimate business purposes, including layoffs, shut-downs, permanent disability, voluntary withdrawals with reasonable cause, company wide reductions in force, and other routine business reasons.
 - 5) Severance is not typically payable in the event of death, dismissal for cause, normal retirement, or continued employment after a specified forfeiture age.
 - 6) Furthermore, it is never payable merely for passage of time.

- e. **Asset Security:**
 - 1) These plans also serve as an asset protection measure, protecting plan funds from creditors of the employers and employees.

III. Employer Contributions

a. Deductibility:

- 1) In addition to qualification under Code Sec. 419A(f)(6), plans must also satisfy the requirements of Code Secs. 404(a), 404(d), and 162(a) to qualify for current income tax deduction.
- 2) The critical inquiry is whether the contributions fall under a deferred compensation or welfare benefit plan.
 - (i) Under a deferred compensation plan, Code Secs. 404(a) and (d) apply and the contributions will not be fully deductible.
 - (ii) Under a welfare benefit plan, Code Sec. 404(b)(2)(B) may apply so that the contributions are deductible.
 - (iii) This issue is important because the IRS has consistently maintained that Code Sec. 419A(f)(6) plans are, in substance, deferred compensation plans.

b. Parameters:

- 1) There are no specific guidelines regarding the maximum amount that can be deducted; however, the expense must qualify as an ordinary and necessary expense within the employer's industry under Code Sec. 162.
- 2) In one case, the Tax Court went so far as to allow the prefunding of the entire projected benefit in one year to qualify as an ordinary and necessary expense under Code Sec. 162, even though the contribution was not actuarially determined and the vast majority of benefits inured to the benefit of the controlling shareholder. *Moser*, TCM 1989-142.

IV. IRS Position

a. The IRS formally announced its position for the first time in Notice 95-34. This provided four theories of possible attack.

b. The payments are disguised deferred compensation:

- 1) The IRS has consistently maintained that contributions to a Code Sec. 419A(f)(6) plan are not deductible because it is deferred compensation.
- 2) The IRS has maintained it is deferred compensation because of the virtual certainty that the benefits will be provided in one form or another.
- 3) The courts, however, have acknowledged that many plans not subject to Code Sec. 404 have some elements of deferred compensation. *Greensboro Pathology Associates P.A. v. United States*, 698 F.2d 1196.
- 4) Furthermore, there is no single determinative factor; rather, all factors must be considered to determine which Code Sec. applies.

- 5) Factors supporting the deductibility of contributions to a multiple employer plan are:
 - (i) The qualification as a welfare plan;
 - (ii) Funding obligations not predicated on employer earnings;
 - (iii) Lack of benefit increases after full vesting based on employment longevity;
 - (iv) The potential for forfeiture of benefits;
 - (v) Lack of discrimination in the provision of benefits to eligible employees; and,
 - (vi) Plan benefits are not a current salary substitute.
- c. Separate plans
 - 1) The IRS has consistently maintained that Code Sec. 419A(f)(6) plans are an aggregation of separate plans with a common administrator, and that they are NOT a single plan.
 - 2) This position, however, frustrates legislative intent.
- d. Experience rated arrangements
 - 1) The definition advanced by the IRS is in direct conflict with the definitions previously adopted by the Supreme Court, those used in the insurance industry, and those adopted by insurance actuaries.
 - 2) The IRS would like to prohibit the practice of maintaining separate accounting for each participating employer.
- e. The payments are nondeductible prepaid expenses.

V. Related Cases

- a. *Booth v. Commissioner*
 - 1) The Tax Court addressed the issue of “experience-rated arrangements” in *Booth v. Commissioner*, 108 T.C. 524 (1997).
 - 2) The *Booth* case involved a multiple-employer welfare benefit plan which was intended to be organized under Code Sec. 419A(f)(6). The subject plan provided welfare benefits to participating employees in the form of death benefits and severance benefits.
 - 3) According to the Court, the use of the term “experience-rated arrangement” was intentionally used by Congress to encompass more than the traditional concept of experience-rating. In *Booth*, participating employees could look only to the assets of their employer group for the payment of benefits. In the event that these assets were insufficient to meet the required benefit payments, benefits were reduced according to a formula set forth in the plan’s trust agreement. As a result, the Court found “experience-rating arrangements” present because, among

other reasons, benefits could be reduced in the event that a particular employer's contributions were insufficient to fund the required benefits for its employees.

- 4) This is distinguishable from a validly implemented plan that makes assets of all employers available to any employer group in the plan. Therefore, benefits of a participating employee will not be reduced if their employer group funding is insufficient.
- b. *Neonatology Associates, P.A. et al v. Commissioner*, 115 TC No. 5 (2000).
- 1) The IRS has cited this case to try and establish that Code Sec. 419A(f)(6) plans should be disqualified as deferred compensation arrangements.
 - 2) This case involved three separate, but similar, plans that were sold as Voluntary Employer Benefit Associations ("VEBAs").
 - 3) The court held that neither of these plans qualified as a VEBA or a Code Sec. 419A(f)(6) plan; note that the plans were not intended to be Code Sec. 419A(f)(6) plans.
 - 4) However, the egregious facts of this case make it clear that it has no impact on a validly implemented multiple employer welfare benefit plan; the IRS application of this case will not withstand Tax Court scrutiny.
 - 5) These plans failed to meet the qualifications of a Code Sec. 419A(f)(6) plan. They did not adhere to the 10-or-more employer requirement, and they maintained an experience rating arrangement, under any definition of the term.

SECTION TWO

Legislative Developments and Proposals

I. Treasury Proposal

- a. Introduced by Clinton Administration, but was not passed.
- b. Sought to eliminate life insurance as a funding vehicle.
- c. Sought to eliminate withdrawals by employers.
- d. This proposal was rejected two times by Congress; however, it ultimately made its way into tax legislation that was vetoed by President Clinton.
- e. Current administration has made it clear that it intends to curb abuses in the area, but is committed to the platform.

II. Pennsylvania Letter

- a. This proposal was presented by Senator Rick Santorum of Pennsylvania to the Department of the Treasury.

- b. Key issues:
- 1) Modification of definition of a 10 or more employer plan.
 - (i) Add anti-discrimination language similar to Code Sec. 505(b).
 - (ii) Requires plan to receive a favorable determination from the Secretary.
 - (iii) Prohibits inclusion of severance benefits in the plan.
 - 2) Clarification of experience rating
 - (i) This defines an experience-rated plan as one which determines contributions by individual employers on the basis of actual gain or loss experience.
 - (ii) This shall not include a "guaranteed benefit plan," which means a plan the benefits of which are funded with insurance contracts or are otherwise determinable and payable to a participant without reference to, or limitation by, the amount of contributions to the plan attributable to any contributing employer.
 - 3) Includes a provision that the rules on tax shelters do not apply.
 - 4) Forces Code Sec. 419A(f)(6) plans onto a new hybrid VEBA structure.

III. Industry proposal

- a. Main issues:
- 1) Clarification of experience rating
 - (i) This proposes that a plan is not experience rated as long as at all times, all plan assets are available as a single, undivided pool to provide benefits to the covered employees of all individual employers participating in the plan.
 - (ii) This was the definition that was applied in *Booth v. Commissioner*, 108 TC 524 (1997).
 - 2) Anti-discrimination rules
 - (i) Participation must be available to any employee meeting the following standards:
 - a. Age 21,
 - b. 1,000 hours of service annually, and
 - c. one year of service.
 - (ii) All benefit formulas must provide a uniform multiple of compensation to all participants.
 - (iii) Each employer plan must benefit at least one non-owner employee for each two owner-employees who benefit.
 - (iv) The trust as a whole must benefit at least three non-owner employees for every owner-employee that benefits.
 - 3) Limitations on annual deduction:
 - (i) Death benefits

1. If term insurance, the annual term insurance premium;
 2. If whole life insurance, the level annual premium to normal retirement age; or,
 3. If universal life, the guideline annual premium as defined in IRC Code Sec. 7702.
- (ii) Severance benefits
1. Reasonable actuarial principles to purchase the level benefit stated in the plan document; but,
 2. No prefunding of the benefit in excess of the amount needed to fund the current benefit amount would be permitted.
- (iii) Medical, health, disability benefits
1. An amount required to pay an insurance company premium; or,
 2. In the case of a self-funded plan, amounts needed to cover the anticipated liability; but, such contributions would be forfeited to the trust if the employer plan participants die or terminate prior to payment of these benefits.
- 4) Effective date rule
- (i) The new rules would be effective as of the date of enactment, but
 - (ii) Benefits earned as of the date of enactment would be **grandfathered** in at their existing level and previous deductions would be **grandfathered** if the plans are brought into compliance within 24 months of enactment.

IV. Recent Proposals

- a. A recent proposal provides that Medical Savings Accounts (“MSAs”) under Code Sec. 220 can be offered through a multiple welfare benefit plan.
- b. Furthermore, it provides that Code Secs. 419A(f)(5) and 419A(f)(6) trusts offering MSAs in addition to other welfare benefits will be income tax exempt.

SECTION THREE

How are they being used?

I. Current gaps in coverage:

- a. Many Americans, particularly rank-and-file employees, have grossly insufficient life insurance, medical benefits, disability benefits, and long-term care.
- b. As a result, Congress is slowly moving toward privatization of welfare benefits (e.g., profit-sharing §401(k), MSAs (§220), simple plans, proposed individual social security retirement account (“SSRSs”), etc.).

II. Benefits provided:

- a. Welfare benefit plans seek to fill some of the gaps in coverage.
- b. Initially, most plans offered death benefits and severance benefits.
- c. Currently, the following benefits are regularly offered through Code Sec. 419A(f)(6) plans.
 - 1) Death benefits,
 - 2) Severance benefits,
 - 3) Disability benefits,
 - 4) Health benefits,
 - 5) Major medical benefits, and
 - 6) Long-term care benefits.

III. Funding – suitable investments:

- a. Stocks, bonds, and securities.
- b. Life insurance contracts:
 - 1) Whole life insurance,
 - 2) Universal life insurance,
 - 3) Variable life insurance,
 - 4) Term life insurance, and
 - 5) Second-to-die life insurance (only if both insureds are employees).
- c. Municipal bonds.
- d. Cash and cash equivalents.

IV. Financial and Estate planning fits:

- a. Executive compensation and employee benefit plan for worker and his or her family.
- b. Asset preservation planning – plan assets are generally exempt from creditors of employee and employer.
- c. Estate planning – death benefits can be paid to an irrevocable life insurance trust, a family limited partnership, or a family limited liability company and kept out of the decedent's estate.
- d. Provides liquidity to survivors.
- e. Provides emergency cash flow to terminated employees in the event of shut-down, reduction in force, lay-off, merger, etc.
- f. Can provide golden hand-cuffs for executive and rank-and-file employees.
- g. Income tax planning – contributions to the trust are deductible to the employer and not taxable to the employee until payout of a benefit.

LIST OF SELECTED ARTICLES

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