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Multiple Employer Welfare Benefit Plans Require Planning and Risk Evaluation

To maximize the benefits of these plans, employers must evaluate taxable status, investment risks, and current case law on deferred compensation features.

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Multiple employer welfare benefit plans have become increasingly popular in recent years. They provide both significant benefits to employees, including those outside the highly compensated group, and advantages to the employer in the form of tax deductions and risk sharing. The multiple employer welfare benefit trust—unlike a qualified plan—is not itself a tax-exempt entity, so careful planning in design, administration, and plan investments is essential.

SUITABLE INVESTMENTS

Due to the taxable nature of multiple employer welfare benefit trusts, they are often funded with tax-exempt investments such as municipal bonds and whole, variable, and universal life insurance policies.[1] Even with tax-exempt investment vehicles, however, some income taxes are likely to be incurred. For example, many states tax the interest on municipal bonds issued by other jurisdictions.

Planning for optimal investment. There is no requirement, however, that multiple employer welfare benefit trusts be funded with tax-advantaged investments. Consequently, stocks, bonds, and other traditional investments can be used. Nevertheless, to minimize income taxes, employers may want to make investments that provide long-term capital appreciation potential with relatively small dividends or interest streams; more assets resulting from tax savings will be at work for a longer time to build up the employer's fund.

The plan administrator or independent trustee overseeing the plan may determine that a particular investment is not suitable for the plan or otherwise may refuse an investment in exercising its administrative powers or fiduciary duty. For example, some plans will not accept stocks that are not publicly traded on a major market or municipal bonds rated less than AA. Similarly, some plans restrict insurance investments to those in companies that are at least AA-rated or meet certain standards for the insurance company's investment portfolio.

TAXATION OF BENEFITS

As employer contributions are made annually or periodically, to a multiple employer welfare benefit trust, the employees are taxed on the "P.S. 58" costs or one-year term rate for any life insurance held on their lives.[2] The calculated costs are included on the employees' Forms W-2 or 1099-R for any year in which a contribution is made.

Death benefits. The death benefits provided are analogous to the insurance risk element in qualified or split-dollar insurance plans. By having the employee either contribute this cost or pay the related income tax on it, the employer is assured that the resulting death benefit is income tax free.[3]

Severance benefits. These benefits are taxable in the year received. They are subject to withholding for

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federal and state income taxes, as well as Social Security and Medicaid taxes, and federal and state unemployment contributions.

Disguised deferred compensation. It is critical that severance benefits not be construed as disguised deferred compensation. The distinction may rest on whether the severance benefit is payable by reason of termination events not foreseeable or controlled by the employee, or in all events. There is little justification, however, for the position that withdrawal distributions from a plan terminated for valid business reasons are deferred compensation. Officers, directors, executives, and shareholder-employees may have legitimate reasons, whether business or financial, for terminating welfare benefit plans. Such distributions, however, are subject to income tax in the year received. Although it is possible that some type of rollover may be authorized in the future, there is no direct support for the rollover of welfare benefit withdrawal distributions at this time.

Other requirements. The nontaxability of contributions made on behalf of employees is predicated on compliance with the multiple employer trust exception and related statutes. In addition, the benefits held by the trust must be nontransferable and subject to a substantial risk of forfeiture. Section 83 and the Regulations thereunder provide that funds set aside in trust for the benefit of employees and exempt from claims of the employer's creditors are taxable to the employee on whose account the funds were transferred, as soon as the employee's interest in the property is not subject to a substantial risk of forfeiture.[4]

To meet this standard, plans generally provide that death benefits are forfeited on disability, termination for cause, dismissal without cause, retirement, and other events. Similarly, severance benefits may be forfeited at death, retirement, termination, and voluntary withdrawal without reasonable cause. Some plans marketed to closely held businesses have attempted to remove or greatly minimize these risks of forfeiture. Unfortunately, this requirement is part of the price of having a viable plan. Welfare benefits are not intended to be paid with absolute certainty to all employees and in all events. As a result, aggressive plans without material risks of forfeiture should be avoided.

STATUS IN THE COMPENSATION AND BENEFITS HIERARCHY

Multiple employer welfare benefit plans can fill several niches in compensation and benefits packages. These plans are available to corporations, S corporations, partnerships, and LLCs. Currently, the vast majority of employers (large and small) that are considering a multiple employer welfare benefit plan have already implemented significant benefit plans. These employers typically have some form of qualified pension plan (usually a profit sharing plan or 401(k) plan) already in place. In addition, most have adopted group-term life insurance, health insurance, and wage-continuation plans. The purpose of the multiple employer welfare benefit plan for these employers is to provide ancillary benefits.

Severance benefits. For the typical employer described above, employees would have no severance benefit at all without a welfare benefit plan unless the event triggering severance was disability, falling within the employer's wage-continuation plan definition. The company otherwise may have no severance package, or it may have a limited severance benefit imposed by contract for only a few of the very highest-ranking executives. There is typically no severance benefit even for lower-level executives and upper-level managers, and it is rare to find any severance benefit for the rank-and-file employees. Moreover, short-term employees are perhaps in the worst position because they may not be vested in any but the most basic group-term life and health plans.

The severance benefit is a critical and tangible benefit to all employees otherwise not covered, and a good motivator for even short-term employees, who may see it as the only real benefit they are likely to actually receive. Accordingly, employees can receive a meaningful benefit to cover the many circumstances under which they can be terminated, including layoffs, elimination of positions, insolvency of the company, sale of the business, mergers, acquisitions, and changes in control.

Severance benefits also may remove the covered employees from government-sponsored unemployment and welfare benefits rolls. Arguably, the lowest-paid workers are most in need of such benefits, but all employees can receive a tangible and needed benefit.

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[1] Code Section 419A(g)(1). See also Handler, "Multiple Employer Welfare Benefit Plans Have Advantages for Employees and Executives," 3 JTEB 10 (May/Jun 1995).

[2] "P.S. 58" rates are published in Rev. Rul. 55-747, 1955-2 CB 228, and are used in computing the cost of pure life insurance protection taxable to employees under certain types of employee benefit plans.

[3] See Rev. Ruls. 64-328, 1964-2 CB 11; 66-110, 1966-1 CB 12; and 55-747, *supra* note 2.

[4] Reg. 1.83-3(e).

Death benefits. For a typical employer, death benefits provide supplemental benefits to the beneficiaries of its employees and are funded at least in part by life insurance. If employees are taxed on the P.S. 58 or one-year term cost associated with the life insurance policies, the proceeds paid to their beneficiaries will not be subject to income tax. Consequently, these benefits can be layered on top of group-term life, split-dollar life, and qualified plan life insurance, or other similar employee benefits.

This protection is valuable to the surviving families of deceased employees. It also provides additional capital and time for these families to react to the loss of income and benefits. It appears that death benefits provided under a welfare benefit plan would be particularly appropriate for companies involved in inherently dangerous activities, in which loss of employee lives and serious injuries are a statistical certainty.

The nature of potential welfare benefits available under a multiple employer plan determines their use as an ancillary benefits plan. Depending on the nature of the employer's business and employee base, however, these plans may provide more tangible and important benefits than those provided under other plans.

Risk sharing. From the employer's standpoint, the pooled nature of the multiple employer plan provides elements of risk sharing analogous to that provided by an insurance company. As a result, large and small employers alike can benefit from the forfeitures and favorable experience of other employers participating in the multiple employer plan. Thus, if a particular employer is underfunded due to adverse employee experience, poor investment results, or other reasons, the employer's account may be restored by the multiple employer trust. Moreover, the involvement of an independent plan fiduciary helps to assure employees and employers that the benefits specified under the plan will be provided in accordance with controlling plan documents and be potentially exempt from creditors of the employer and employees.

THE CURRENT TAX ENVIRONMENT

Many questions regarding the compliance of multiple employer welfare benefit plans and taxation of the related benefits remain unresolved. There is no question, however, that valid plans can be structured to serve the legitimate objectives that Congress sought to provide.

Severance pay issues. The most difficult tax issues involve severance pay benefits. As a result, employers that want to take a more conservative approach may prefer to exclude these benefits from plans until such issues are resolved or, alternatively, to carefully avoid any elements of deferred compensation in their severance plans. The unanswered questions and related tax risks are greatly diminished for large employers and small employers not controlled by owner-employees, since there are few opportunities for abuse and manipulation. Consequently, the multiple employer welfare benefit plan should work well in this context.

Small employers and aggressive plans. The welfare benefits sought to be provided, however, are equally beneficial to smaller companies and closely held businesses with owner-employees. Welfare benefits may be more important for small employers that have very limited benefit plans than to large and publicly held companies. The employees of these small businesses may be most in need of welfare benefits. Unfortunately, some plan sponsors market plans to closely held businesses as a means of deferring income taxes until distributions are made in the future, usually on a predetermined plan termination only several years into the plan's duration. Some plans attempt to water down the risks of forfeiture or otherwise circumvent the self-policing mechanisms Congress put in place. These aggressive plans have too many unnecessary risks and should be avoided. Employers participating in such plans attempt to obtain the benefits of the multiple employer trust exception without abiding by the restraints imposed by Congress. It is only a matter of time before this sort of abuse is remedied by the IRS, courts, or legislation.

***Wellons* and deferred compensation characteristics.** An indication of future regulation can be found in a recent Tax Court case that examined welfare benefits in a different context, prior to enactment of the Section 419 and 419A funding limits of DRA '84. Accordingly, this case does not involve a plan meeting the requirements of Section 419A(f)(6).

In *Harry A. Wellons, Jr., M.D.S.C.*,[5] the Seventh Circuit upheld the Tax Court's decision disallowing the taxpayer's deduction for contributions to a severance pay plan. The vast majority of benefits were attributable to the controlling shareholder and his spouse. Although the taxpayer's plan provided some elements of a welfare benefit plan, it more closely resembled a deferred compensation plan. Benefits were determined, in part, based on years of service and were not payable until

[5] 31 F.3d 569 (CA-7, 1994), *aff'g* TCM 1992-704.

the completion of five years of service. Forfeiture of benefits occurred only in limited circumstances and benefits were payable to all employees in almost all situations. The court disallowed the tax deduction based on the elements of deferred compensation. This decision is more restrictive than many earlier cases[6] and is inconsistent with DOL Regulations specifically exempting certain severance plans.[7]

It appears that the taxpayer in *Wellons* was doing exactly what Sections 419 and 419A were enacted to prohibit, with none of the safeguards and restrictions required under the Section 419A(f)(6) exception. The facts of *Wellons* are unique and somewhat extreme. In addition, the case involved an early employee benefit trust that may be subject to requirements and restrictions not applicable to a non-exempt multiple employer trust. Thus, *Wellons* may have little or no application to taxable multiple employer welfare benefit trusts. If it was not clear before *Wellons*, however, it should be clear now that well-designed plans should not have any elements of deferred compensation.

Pending cases. To date, the Service has been reluctant to issue private letter rulings, and there have been no cases decided under Section 419A(f)(6). At least two cases are pending in the Tax Court, however, in which the IRS disallowed a portion of the deductions taken by closely held businesses for contributions to a non-exempt multiple employer trust.[8] These cases, however, may be limited by their facts and provide no meaningful support or guidance for multiple employer welfare benefit plans. The issuance of Regulations by the Service would go a long way toward curbing the current abuses and assisting taxpayers in complying with the complicated labor and tax provisions that control these plans.

It is likely that the IRS will treat multiple employer welfare plans like many of the qualified plans in use in the late 1970s. Over the next five to ten years, court decisions and Regulations may slowly frame the parameters of plans meeting the Section 419A(f)(6) exception; these plans have been authorized only since 1984.

IRS Notice. The Service formally announced its position for the first time in a brief notice issued on 5/17/95 (*Notice* 95-34, 1995-23 IRB 10). The Notice indicated four theories of possible attack: (1) disguised deferred compensation, (2) "separate" plans, (3) experience-rated arrangements, and (4) nondeductible prepaid expenses. Not coincidentally, these theories were used in IRS Appeals proceedings leading up to Tax Court cases against the government.

The primary issue in those proceedings was whether the subject plan used experience rating. This issue is likely to be the central thrust of the IRS argument in Tax Court. The definition advanced by the Service is extraordinary in that it is in direct conflict with definitions previously adopted by the Supreme Court, those used in the insurance industry, and those adopted by professional actuaries. The Service would like to prohibit the practice of maintaining separate accounting for each participating employer. This requirement, however, was not contemplated by Congress and would effectively frustrate congressional intent. The IRS should have an uphill battle in selling its newly expressed definition of experience rating to the courts.

VARIATIONS ON THE THEME

Although most multiple employer welfare benefit plans are structured as taxable trusts, they can also be structured as nontaxable trusts under the Voluntary Employees' Beneficiary Association (VEBA) rules.[9] VEBA status and a favorable determination letter provide only limited benefits, however. More importantly, the VEBA rules carry additional restrictions that can make it more difficult to provide welfare benefits without additional tax hurdles.

Disadvantages of VEBAs. If the Service determines that a VEBA trust is being administered in a discriminatory manner with respect to any individual employer participant, the tax-exempt status of the trust will be terminated. Moreover, the prohibited inurement and anti-discrimination requirements of the VEBA Regulations are applied separately to each employer in a multiple employer VEBA trust. Therefore, if even one employer fails to satisfy these requirements, the entire trust will lose its nontaxable status under Section 501(c)(9).[10]

Small businesses. The VEBA is also not particularly useful for small businesses with a limited number of employees. When a majority of the aggregate benefits under a VEBA inure to the benefit of prohibited group employees, the plan may fail the prohibited inurement standard and its tax-exempt status will be terminated.[11] Many small businesses with few employees simply will not be able to meet this requirement mathematically.

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6 See, e.g., Greensboro Pathology Associates, P.A., 698 F.2d 1196 (CA-FC, 1982), and Grant-Jacoby Inc., 73 TC 700 (1980).

7 DOL Reg. 2510.3-2(b)(1).

8 Young & Young, Ltd. (Docket No. 5754-94), and Traegde (Docket No. 5893-94).

9 Section 501(c)(9).

10 GCM 39284, 9/14/84.

11 GCM 39300, 10/30/84; GCM 39801, 10/26/89.

Unrelated business income. VEBAs are also subject to tax on their unrelated trade or business income. Even though a VEBA trust may satisfy the requirements of the multiple employer trust exception in Section 419A(f)(6), income earned on plan assets in excess of the limitations on overfunding in Sections 419 and 419A may be deemed exempt function income and thus will be taxed as unrelated business income. Further, the tax-exempt nature of a VEBA trust has no bearing on the deductibility of employer contributions and the taxation of employers for which contributions are made or benefits are paid.

Collective bargaining group. Section 419A(f)(5)(A) authorizes another welfare benefit plan exception to Sections 419 and 419A exclusively for collective bargaining groups. It may be useful for unions seeking to provide benefits to its members under a valid collective bargaining agreement with an employer. This provision, however, provides no relief for rank-and-file non-union employees who may be in greater need of benefits, and does not apply to executives and most professionals.

FINANCIAL AND ESTATE PLANNING

Multiple employer welfare benefit plans can be used by individual employers to accomplish several legitimate financial and estate planning objectives.

Financial planning. Plan assets that can ultimately be used to benefit employees are not taxed to employees at the time of contribution and the earnings on such investments are taxed to the trust. Thus, the income taxes of any employee ultimately receiving a benefit are deferred.

Second, plan assets in which an employee has a vested interest are subject to substantial risk of forfeiture. Even for shareholder-employees, there can be no reversion of plan assets. Moreover, benefits can be paid by the independent trustee only to qualifying employees in accordance with plan documents on a triggering event such as death or termination of employment. As a result, these assets are outside the reach of employers and employees, and should also be outside the reach of creditors. In this regard, multiple employer welfare benefit plans may serve an asset preservation planning function for businesses and employees.

Death taxes and estate planning. Death benefits funded with life insurance may be able to pass to beneficiaries free of estate and inheritance taxes. These death benefits payable from a plan are generally included in the employee's gross estate unless the employee (1) had no incidents of ownership in the life insurance policy owned by the plan and (2) did not retain a reversionary interest in the policy.

Incidents of ownership. An incident of ownership includes the right to change a beneficiary.[12] The only incident of ownership that an employee will initially have under these plans is the right to change a beneficiary. By making an irrevocable beneficiary designation and surviving at least three years from the date of the beneficiary designation, the death benefits should escape estate taxation under Section 2035(d)(2), which captures insurance transfers made within three years of death.

Reversionary interest. If the employee retains a reversionary interest in the policies, the value of the death benefit is includable in the decedent employee's gross estate even if the employee had no incidents of ownership in the policy. Such a reversionary interest must exceed 5% of the value of the policy immediately before the death of a decedent. This reversionary interest will not exist if, immediately before the decedent's death, some other person possesses the power to obtain the cash surrender value alone and in all events.[13] In these plans, the power to obtain the cash value of a policy rests solely with the independent corporate trustee acting under the direction of the plan administrator or contract administrator. Thus, the employee will not have a reversionary interest under Section 2042(2) and the proceeds should be excluded from the estate. In this regard, estate taxation of the insurance policy held in the multiple employer trust subject to an irrevocable beneficiary designation is analogous to life insurance subject to a split-dollar plan held by an irrevocable life insurance trust or family limited partnership.

CONCLUSION

Participating employers in multiple employer welfare benefit plans can receive current deductions for payment of actuarially determined contributions to a multiple employer trust, which has elements of both risk sharing and diversification. Such features can be further enhanced by including life insurance in the trust's investment portfolio. Employees can derive additional benefits from the asset protection attributes of the plan and by removing the projected death benefits from their taxable estates. A well-designed multiple employer welfare benefit plan can provide needed benefits as one component of an employee benefits package and serve as an excellent vehicle for compensation planning. ■

[12] Reg. 20.2042-1(c)(2).
[13] Section 2042(2).