The 419(e) Plan: Reports of Its Death Have Been Greatly Exaggerated

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Abstract: *In Revenue Ruling 2007-65, issued in October 2007, the IRS effectively prohibited the deduction for contributions to welfare benefit plans (sometimes called Sec. 419(e) plans) for preretirement death benefits when funded with any life insurance, including term insurance. In a widely misunderstood Notice issued on the same day (Notice 2007-84), the Service effectively permitted deductions for contributions to 419(e) plans providing postretirement medical and death benefits even when funded with cash value life insurance. Also on that day the Service released a second Notice (Notice 2007-83). Notice 2007-83 declared 419(e) plans that generate deductions for contributions for preretirement benefits funded with cash value life insurance as listed transactions. Yet those plans providing only postretirement benefits—even when funded with cash value life insurance—are not listed transactions. This article dissects these pronouncements and describes what is right, what is wrong, what can still be done, and what should be avoided when dealing with Sec. 419(e) plans. The answers will surprise those who think 419(e) plans are no longer available.*

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It is not unusual these days to hear statements such as "all 419(e) plans (also known as single employer welfare benefit plans) are illegal and abusive tax shelters and contributions made to such plans are not deductible."

Those making such statements, however, may not have had a chance to closely read Revenue Ruling 2007-65 and two concurrent Notices that the Internal Revenue Service issued in October 2007 or, having read them, failed to grasp their nuances. Frankly, this is understandable. The legal minutiae of welfare benefit plans is fully understood by relatively few practitioners in the country. Furthermore the guidance is convoluted enough to cause a reader without sufficient exposure to this area of the law to jump to simplistic conclusions.

Unless you immerse yourself in it to the exclusion of everything else you do to earn a living you may have no way to navigate this area. There are even advance marketing attorneys at a few major insurance companies who share this predicament. This article will explain why informed advisors and insurance companies disagree with the statement posed above.

Like much of the guidance springing forth from the Service, we learn both what the Service considers inappropriate and what it considers valid. As such, it is bad news for some and a validating roadmap for others. (Of course, as always the guidance is the Service's unilateral position and subject to legal challenge, but for the purpose of this article the author will accept the Service's position as defensible, if not correct. See Appendix.)

In a nutshell, the Service has stated the following:

- Regarding single employer 419(e) plans that offer preretirement benefits (such as preretirement death benefits):

    - No deduction is permitted for the cost of the preretirement benefit if it is funded with any life insurance.
    - It is a listed transaction if the insurance is a cash value policy.
- Regarding single employer 419(e) plans that offer postretirement benefits (such as postretirement medical and death benefits):
    - The deduction is permitted for the cost of the postretirement benefit even if it is funded with life insurance, including cash value insurance.
    - It is *not* a listed transaction even if the insurance is a cash value policy if this is the only benefit offered or for which a deduction is claimed.

What Can't Be Done and Why

Revenue Ruling 2007-65[1] describes an employer in two scenarios in which the company, through a welfare benefit fund, offers its active employees welfare benefits. In one case the plan offers a preretirement death benefit funded with the proceeds of a cash value life insurance policy, and in the other the plan offers a preretirement disability benefit funded with the cash value within a cash value life insurance policy. In both cases the contributions to the plan by the employer are deemed to be nondeductible. A cursory reading of the ruling leads to the inescapable conclusion that no contribution to a welfare benefit plan with this design is deductible. But, as with anything this intricate, the cursory reading is misleading.

Secs. 419 and 419A, working in tandem, effectively permit and limit a deduction for certain contributions to a welfare benefit plan that offers a variety of benefits, including death, medical, disability, severance, education, day care, and others. Often the plan is set up as an irrevocable trust and the contributions may not revert to the company; other times it may be set aside among company assets. In calculating the deduction we are directed to a complicated set of rules that inform us that not all amounts contributed are necessarily deductible just because a check is written. Among these rules is one that states that the contribution must fit into the definition of "qualified cost." Qualified cost is broken down into different components, mainly "qualified direct cost" (QDC) and "additions to qualified asset account" (QAA). A contribution will be tested against each component (each of which has its own set of rules) and will be deductible if it fits into at least one.

QDC may best be thought of as the contribution for current benefits, i.e. benefits the employee is enjoying during the year provided. This would include current life insurance protection. It is defined as, among other things, the aggregate amount (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided during the year if such benefits were provided directly by the employer [Sec. 419(c)(3)(A)].

Cutting to the chase, the ruling concludes that the contribution used to buy life insurance is not deductible as QDC under this provision since the company would not have been permitted a deduction for life insurance premiums it paid had it been the beneficiary of the policy directly rather than through the plan, even if the policy were held in an irrevocable trust.

It reached that conclusion by a novel interpretation of the legislative history of Section 419, in particular the definition of QDC. As stated in the ruling:

> In its explanation of "qualified direct cost," the legislative history of §419 states that the rules in other Code sections that generally limit deductions if an employer provides the plan benefits directly are "passed through" to limit deductions with respect to fund contributions. An example of this limitation is given for fund expenditures for insurance that would not have been deductible under §264 if made directly by the employer. [T]hus, no deductions are available to the employer with respect to such expenditures. *[cite omitted]* Section 264(a)(1) provides that no deduction is allowable for premiums on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract.[2]

Thus, according to the Service, Sec. 264(a)(1) prohibits an employer, when calculating its deduction for welfare benefit plan contributions, from including in the QDC portion of the calculation the life insurance premiums paid by the plan if the plan or an employee is a beneficiary of the insurance, because the employer is deemed to be indirectly the beneficiary of this policy. Based on this rationale, the employer in both scenarios is precluded from deducting anything for its contribution to the extent it is part of QDC.

The holding in the ruling is not limited to premiums for cash value life insurance but covers any life insurance used in this context. While the facts of the ruling specifically involve cash value life insurance, if the Sec. 264(a)(1) argument is valid, then it is valid for all life insurance, individual and group term included. There is nothing in Sec. 264 to limit this holding to cash value life insurance. In fact, the Service says as much: "The conclusions...are the same...regardless of the type of life insurance policy." Thus, every employer in the country taking a deduction under Sec. 419 for premiums for preretirement life insurance benefits as a component of QDC can no longer do so according to the Service.

What Can Be Done and Why

Ignoring what one thinks of this conclusion (remember the premise of this article is that the Service's position is defensible), there is still the other part of the qualified cost calculation, the QAA. If a contribution is attributable to QAA then it is still deductible even if it would not be deductible as part of QDC. As stated in the ruling, after concluding that the employer could not deduct the contribution used to pay premium as a part of QDC, the Service reminds us that "…some of [the employer's] contribution amounts may be deductible as qualified cost in the taxable year as an addition to a qualified asset account…."[3]

If QDC corresponds to contributions for current benefits, QAA relates to contributions to fund future costs—both benefits that have been incurred but as yet unpaid and a reserve for benefits that may be incurred in the future. The best example of the latter is postretirement benefits, such as postretirement medical and death benefits. Among the several rules defining the proper amount, the overarching rule is that the amount of reserves added to QAA will be deductible if the amount is reasonable and actuarially necessary. Of particular note is that Sec. 264(a)(1) *does not* apply in calculating QAA. The legislative history of Sec. 419 on which the Service relied in applying Sec. 264(a)(1) to QDC is irrelevant in calculating QAA. The Service readily acknowledges as much in the ruling.

At the same time that Revenue Ruling 2007-65 was released so too was Notice 2007-84,[4] which all but blesses postretirement medical and death benefit plans as supporting deductible contributions even when funded with life insurance. Notice 2007-84 is a fascinating read as much for what it says as for what it does not say. Yet when all is said and done it, in fact, says nothing that is not already known.

What it says is that appropriately calculated contributions to properly organized and operated 419 plans are deductible:

> Businesses often maintain welfare benefit funds that comport with the intent of §§ 419 and 419A and do in fact provide meaningful medical and life insurance benefits to retirees on a nondiscriminatory basis, and make substantial contributions to those welfare benefit funds that are fully deductible. *Such welfare benefit funds are outside the scope of this notice.* (emphasis added)[5]

Furthermore, the Service takes the opportunity to caution practitioners and taxpayers that, as with any other tax planning, there is a right way and a wrong way to approach it. The right way is to use actuarially reasonable assumptions, to operate the plan in a nondiscriminatory manner, and to otherwise comply with the many mandates within Secs. 419 and 419A. The wrong ways, according to the Service, include

- using actuarial assumptions that are not reasonable
- structuring the plan so that only a few employees (primarily the employees who are also owners of the business) will ever receive those benefits
- structuring the plan so that the owner will receive a substantial portion of excess assets not needed to pay the original benefits, perhaps through the use of "loans" to the owners
- amending the plan to provide benefits other than the plan's original postretirement medical or life insurance benefits
- terminating the plan prior to the payment of the postretirement benefits so that the owners and other key employees will receive, directly or indirectly, all or a substantial portion of the assets held by the trust

Analogous guidance—"do it right"—could have been issued about anything that crosses a practitioner's desk on any given day, including IRAs, ILITs, and the home mortgage deduction, to name just a few.

The cautionary notes in this Notice, however, do not deny any deduction under these facts as did the ruling. While the explicit language of the Notice supports this conclusion, its silence speaks volumes. On the face of the Notice nothing is said about the underlying investments of the plan, including whether life insurance can be used as the investment. The Notice neither approves nor disapproves such an investment. Yet the failure to disapprove supports the ability to use life insurance as an investment. Certainly if the Service had an argument, including one based on Sec. 264(a), one might reasonably expect the Service to have made it. Inasmuch as the Service did not prove timid in issuing a blanket negative ruling relating to the computation of QDC, it presumably would have done the same relating to the computation of QAA if it could have. It did not.

If there are other aspects of life insurance that make it obnoxious as an investment within a welfare benefit plan while at the same time it is acceptable as an investment in a qualified plan, the Service has yet to explain this and had not tried to do so in Notice 2007-84. That neither this Notice nor any other directive addresses any negative aspects of using life insurance within a welfare benefit plan and explicitly praises well-structured welfare benefit plans leads to the conclusion that life insurance is a permissible investment in such a plan, at least until the Service tells us otherwise and can defend such a position. Until such time it is a valid interpretation that Notice 2007-84 is validation, if not express approval, of properly structured welfare benefit plans that provide postretirement medical benefits funded with cash value life insurance. On the same score, until such time there would seem to be no basis for a finding of deficiency or for taxpayer, preparer, or promoter penalties.

That the Service saw the need to issue such a Notice and use terminology that frightened many unfamiliar with the intricacies of Sec. 419 indicates that there are those who may be promoting plans that, to a greater or lesser extent, step over the line. If caution is needed, then caution is welcome. The Service cannot be faulted for alerting the tax community to problematic arrangements. However, the Service will have gone too far if its next step is to cast a net so wide as to bring down both valid and troublesome programs and thereby deny taxpayers—primarily the country's small businesses that foresee a need to provide for their employees' retirement needs in this environment of failing government resources—a way to achieve this goal.

What Is and Isn't a Listed Transaction

Any discussion of this guidance would be incomplete without mentioning the third of this trilogy of pronouncements. Notice 2007-83[6] declares as a listed transaction a 419 single employer plan that offers preretirement benefits funded with cash value life insurance and for which a deduction is taken (Figure 1). A Form 8886 must be filed by the employer and, if the employer is a pass-through entity, then presumably by its owners each year that there is a tax consequence arising from the plan. Furthermore, if the filing criteria are met, at least one person among the advisors and promoters to the taxpayer must file a Form 8918 as a material advisor and maintain a list of plans if that person otherwise falls within the definition of a material advisor.

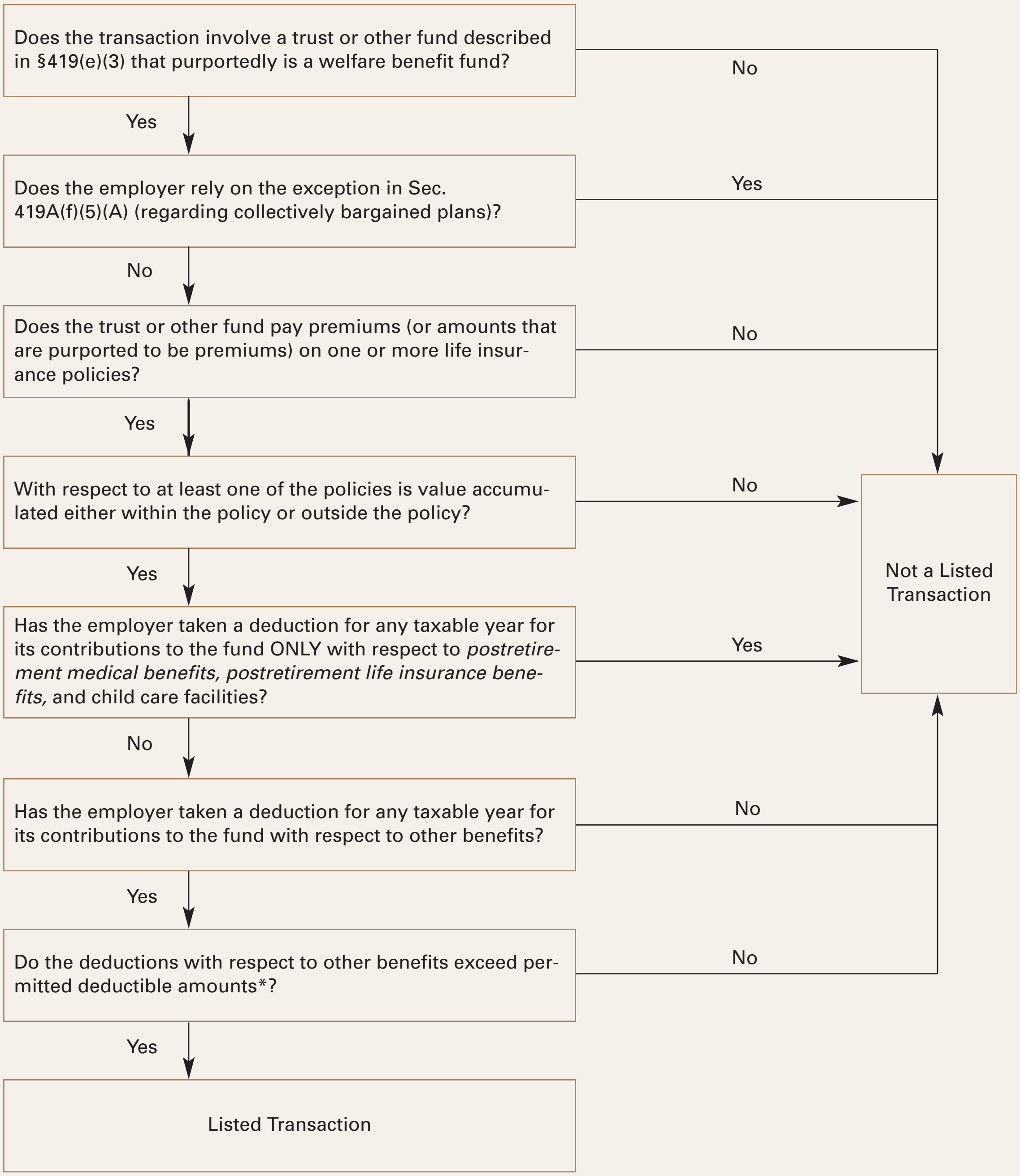
It is interesting to note that, whereas Revenue Ruling 2007-65 denies the deduction when funded by *any* type of life insurance policy (not just cash value policies), Notice 2007-83 defines as a listed transaction a welfare benefit plan with *only* cash value policies. Thus, if any one of four requirements (a single-employer plan, preretirement benefit, cash value insurance, and the deduction) is not present, the plan is not a listed transaction (Figure 1).

As indicated in both this Notice and Notice 2007-84, a plan that provides only postretirement benefits is not a listed transaction. This Notice employs an elaborate calculation to determine the side of the line on which the plan lands. In operation, the calculation compares the deduction actually taken for a list of expenditures with the deduction that is permitted for such list. If the actual deduction exceeds the permissible one, it is a listed transaction. In running that calculation, permissible deductions include administrative expenses but not much else. Of particular note is that the "reasonable and actuarially necessary" contribution for postretirement benefits is explicitly omitted from the "actual deduction" side of the equation. In other words, if the only benefit offered is a postretirement benefit and the only deduction taken is for an actuarially proper amount, the "actual" side of the equation is zero and does not exceed the "permissible" side of the equation. Hence the plan is not a listed transaction.

Of course, Notice 2007-83, as with all listed transactions, refers to plans "substantially similar" to the one described in the notice (arguably an unconstitutionally vague phrase), and the penalties for making a wrong choice in this regard are

FIGURE 1

Determining If a Welfare Benefit Plan Is a Listed Transaction



*Permitted deductible amounts are (i) an amount equal to claims that were both incurred and paid during the taxable year, plus (ii) the limited reserves allowable under Sec. 419A(c)(1) or (c)(3), as applicable, plus (iii) amounts paid during the taxable year to satisfy claims incurred in a prior taxable year (but only to the extent that no deduction was taken for such amounts in a prior year), plus (iv) amounts paid during the taxable year or a prior taxable year for administrative expenses with respect to uninsured benefits and that are properly allocable to the taxable year (but only to the extent that no deduction was taken for such amounts in a prior year).

quite intimidating. One should be able to comfortably conclude that a plan offering only postretirement medical benefits funded with cash value life insurance is not substantially similar to the listed preretirement plan, especially since the computation is so specific; yet every taxpayer must consider the need to file the Form 8886 when employing any 419 plan.

Conclusion

Change is always a challenge, especially when change is fomented by the Internal Revenue Service. Revenue Ruling 2007-65 and these two Notices require practitioners to review actions that we previously did not have reason to question. That these IRS pronouncements are questionable and obscure and many who profess expertise fail to understand them further compounds the challenge. Prudent employers considering welfare benefits plans would be well advised to consult with truly knowledgeable advisors. Today, we take a step in the direction of clarity. ■

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(1) 2007-45 IRB 949.
(2) 2007-45 IRB at 950.
(3) 2007-45 IRB at 951.
(4) 2007-45 IRB 960.
(5) 2007-45 IRB 963.
(6) 2007-45 IRB 960.

APPENDIX

Why Revenue Ruling 2007-65 Is Wrong

Curiously, and in what may be the first public or private pronouncement to take this position, the Service takes a false tautological leap in Revenue Ruling 2007-65: the irrevocable trust as policyowner equals the employer as policyowner equals the employer as beneficiary…

> If [the employer] had provided the current life insurance coverage directly (that is, if [the employer] had not interposed a trust to obtain and hold the cash value life insurance policies, but instead had held the policies and paid the premiums itself), [the employer] would have retained ownership rights in each of the policies, including the right to withdraw funds from a policy's cash value or to surrender the policy for cash. As a result, [it] would have been, directly or indirectly, a beneficiary under the policies.*

Even if this declaration is accepted as true—that the employer would have been the beneficiary if a trust had not been interposed—the fact remains that there had been an irrevocable trust interposed. Once that fact is established it would be hard to imagine a court permitting the Service to assume the fact away to bootstrap its argument. If there is a valid irrevocable trust that owns and is the beneficiary of the policy, and an employee's estate is the beneficiary of the plan, the employer has no nexus to the policy. Under a properly crafted welfare benefit trust none of the funds will revert to the employer, the employer may not withdraw funds from the policy's cash value, and the employer may not surrender the policies for cash. The employer is neither the beneficiary of, nor has any ownership rights in, the policy within the terms of Sec. 264(a)(1). Furthermore, even the ruling that the Service cites to support this proposition (Revenue Ruling 70-148) is inapposite as is any other existing precedent on which the Service might try to rely.** That earlier ruling involved the purchase of life insurance policies by the employer itself directly rather than through an irrevocable trust, which retained the right to surrender the policies and receive the cash values; based on these rights the ruling deemed the employer to be an indirect beneficiary under the policies within the meaning of Sec. 264(a)(1). Yet that 1970 ruling, inasmuch as the employer held the ownership rights directly, does not support the holding in Revenue Ruling 2007-65, which attempts to apply it to an irrevocable trust where the employer has neither control over nor reversionary interest in the trust funds. Not even the Service seems to agree with itself; in TAM 200511015 just three years ago the Service found no agency, conduit, or other relationship to attribute to the employer premium payments made by a VEBA trust for insurance policies. The employer was not prevented under Sec. 264(a)(1) from deducting its contributions to the VEBA trust that were in turn used to purchase the life insurance policies.

*2007-45 IRB at 951.
**Rev. Rul. 70-148, 1970-1 CB 60; Rev. Rul. 66-203, 1966-2 CB 104; *Wilcox Inv. Co. v. Comm'r,* 3 TC 458 (1944); *Brock, Jr. v. Comm'r,* 44 TCM 128 (1982). See Zaritsky and Leimberg, *Tax Planning with Life Insurance,* ¶7.02[2][a].