New Version of 419 Plans: An Impending Train Wreck

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SYNOPSIS: While properly designed 419 Plans have thrived after the IRS attack on DBO Plans two years ago, some new plans may appear compliant but in fact violate IRS guidance.

In the old serial movies, when the hero saw the train heading for a booby trapped section of track he would race fearlessly to the track switch and divert the train from certain doom just in the nick of time. Sometimes tax lawyers, CPAs and other advisors need to do the same to try to keep consumers of tax advice from the proverbial train wreck, albeit without the rousing music, the horse and the grateful beauty.

While it is a fact that employers can make deductible contributions to certain welfare benefit plans, often called 419(e) Plans, using cash value life insurance as a vehicle to fund post-retirement medical benefits,[2] it is also generally understood that the IRS has taken a position in Revenue Ruling 2007-65 that no contribution to a 419(e) Plan used to acquire life insurance that provides a pre-retirement death benefit can be deducted.[3] The train destined for certain doom in this instance is those uninformed taxpayers who are participating in plans that “creatively” interpret the revenue ruling. Specifically these plans promise death benefits funded by term insurance or cash value insurance and for which the term cost is deducted. Unless those with the right information divert that train these taxpayers are destined for disaster.

BACKGROUND

Prior to October, 2007 it was generally accepted that welfare benefit plans could offer a variety of benefits, including pre-retirement death benefits, all of which could be funded with contributions that would be used to acquire cash value life insurance policies. One popular plan design, which would offer an array of post-retirement medical benefits to a company's qualifying employees, is sometimes referred to as a post-retirement medical benefit plan ("PRMB"). As this plan is governed by ERISA, there are specific non-discrimination, participation and funding requirements. By using a cash value life insurance policy as a funding mechanism the assets in the plan, which had been contributed on a tax deductible basis, can grow tax free and be distributed to participants free of income tax under specific circumstances. In its purest form this type of plan would not offer any death benefits. Instead, the life insurance owned in the Plan would pay proceeds which would be to be retained by the plan; these insurance proceeds within the plan might then be used to fund medical benefits into the future.

At the other end of the spectrum another popular plan design would offer only death benefits, colloquially termed a Death Benefit Only, or DBO, Plan. These plans might offer a pre-retirement death benefit funded by any type of insurance, term or cash value. Not being subject to ERISA these plans were not subject to many of the rules governing the PRMB plan, including the non-discrimination and funding rules. Finally there were plan designs that offered a hybrid version of these two plans. These plans offered both the pre-retirement death benefit and the post-retirement medical benefit, using a variety of life insurance policies.

In October, 2007 the IRS issued a revenue ruling and two notices (Rev. Rul. 2007-65, Notice 2007-83 and Notice 2007-84). These directives have been to subject of several articles, some of which have been insightful and accurate. For an extended description and interpretation of this guidance see Neufeld, "The 419(e) Plan: Reports of its Death Have Been Greatly Exaggerated," *Journal of Financial Service Professionals*, Oct. 2008, page 56. In a nutshell this guidance stated that it was the IRS' view that no contribution that funded death benefits payable by life insurance, whether the plan was a DBO or a hybrid, is deductible, based on IRC section 264(a)(1). The argument is that the company that sets up a welfare benefit plan providing death benefits funded with life insurance, even if through an irrevocable trust, is indirectly the beneficiary of the life insurance.[4] As such, section 264(a)(1) prevents the company from deducting any part of the contribution. The life insurance policy in the IRS' example is a cash value policy.

Relying more on alchemy than science, some taxpayers might be employing a plan that seem on its face to satisfy the IRS' concerns with cash value life insurance by measuring itself only against the specific facts in the ruling. However these are truly still in violation of the ruling and present impending doom since it ignores the actual holding.

THE APPROACHING TRAIN WRECK

Remarkably, when faced with clear, if arguably wrong, IRS guidance, some still find programs that ignore such guidance. The argument for such programs proceeds as follows: since the facts of the ruling address only a cash value life insurance policy a company may sponsor and fund a 419(e) plan that provides death benefits funded by a term policy and deduct all of the premium or fund it with a cash value policy and deduct that portion of the premium that equates to the term cost.

This is not even arguably an accurate interpretation of the IRS guidance. While it sounds plausible to those without a technical background those who purport to be tax advisors should know better. The IRS' position is not limited to the specific facts of the ruling; just because they illustrate the case with a cash value life insurance policy does not mean the holding is limited to cash value insurance. In fact the IRS says as much: "The conclusions . . . are the same . . . regardless of the type of life insurance policy."[5]

To appreciate this one must appreciate section 264(a). Section 264(a) does not distinguish between term insurance or cash value insurance. It makes the straight forward statement that if a company is directly or indirectly the beneficiary of a life insurance policy the premiums it pays are not deductible. As the IRS' rationale in the guidance is based on this provision then it is inescapably the IRS' position that no contribution used to acquire term insurance or cash value insurance is deductible when policy proceeds is used to pay death benefits.

In a pre-October 2007 world this mistake might have led only to a tax deficiency and some minor penalties. In a post-October, 2007 world if a cash value policy is employed and the term equivalent portion is deducted this can now expose taxpayers and advisors to massive penalties for engaging in a listed transaction if they fail to adequately disclose the transaction. If those buying this scheme are convinced they can do it, it is safe to guess that they might also be convinced that this is not a listed transaction, and fail to adequately disclose, thereby exposing themselves to hundreds of thousands of dollars in penalties.

WHAT CAN YOU DO FOR YOUR CLIENTS

1. Divert your clients away from plans offering death benefits through life insurance where the contributions are being deducted from the company's taxes. If they wish to use a welfare benefit plan they should be directed to the safer PRMB plans.

2. If your clients insist on going into such a plan try to dissuade them from taking the deduction for the term portion that funds the death benefit.

3. If your clients insist on going into the plan and deducting the term equivalent portion of a cash value policy they should be sure to file the Form 8886 notifying the IRS that they are engaged in a listed transaction. In addition you should file the Form 8918 notifying the IRS that you are a material advisor to a client that has engaged in a listed transaction if in fact you are a material advisor. Failure to do either will result in penalties that can reach $200,000 per year for the client and other penalties for you.

SUMMARY

Sometimes all that stands between our clients and certain disaster is an advisor who is astute and alert. Be that hero to your clients by diverting them away from 419(e) Plans that offer pre-retirement death benefits and purport to do so on a tax deductible basis, at least until the IRS is proven wrong in a court.

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[2] Notice 2007-84, 2007-45 IRB 960

[3] Rev. Rul. 2007-65, 2007-45 IRB 949

[4] There are valid arguments that the IRS position is wrong and would be overruled if subject to legal challenge. See Neufeld, "The 419(e) Plan: Reports of its Death Have Been Greatly Exaggerated," *Journal of Financial Service Professionals*, Oct. 2008, at page 61. Until then this is the IRS position and clients need to make informed decisions prior to choosing to take the opposite position.

[5] Rev. Rul. 2007-65, 2007-45 IRB 949