Notice 95-34

Tax Problems Raised by Certain Trust Arrangement Seeking to Qualify for Exemption from Section 419

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[*1] Taxpayers and their representatives have inquired as to whether certain trust arrangements qualify as multiple employer welfare benefit funds exempt from the limits of section 419 and *section 419A of the Internal Revenue Code*. The Service is issuing this Notice to alert taxpayers and their representatives to some of the significant tax problems that may be raised by these arrangements.

In general, contributions to a welfare benefit fund are deductible when paid, but only if they qualify as ordinary and necessary business expenses of the taxpayer and only to the extent allowable under section 419 and section 419A of the Code. Those sections impose strict limits on the amount of tax-deductible prefunding permitted for contributions to a welfare benefit fund.

Section 419A(f)(6) provides an exemption from section 419 and section 419A for certain welfare benefit funds. In general, for this exemption to apply, an employer normally cannot contribute more than 10 percent of the total contributions, and the plan must not be experience rated with respect to individual employers. The legislative history states that the exemption under section 419A(f)(6) is provided because "the relationship [*2] of a participating employer to [such a] plan often is similar to the relationship of an insured to an insurer." Even if the 10 percent contribution limit is satisfied, the exemption does not apply to a plan that is experience rated with respect to individual employers, because the "employer's interest with respect to such a plan is more similar to the relationship of an employer to a fund than an insured to an insurer." H.R. Rep. No. 98-861, 98th Cong., 2d Sess., 1159 *(1984-3 C.B. (Vol. 2) 1, 413).*

In recent years a number of promoters have offered trust arrangements that they claim satisfy the requirements for the 10-or-more-employer plan exemption and that are used to provide benefits such as life insurance, disability, and severance pay benefits. Promoters of these arrangements claim that all employer contributions are tax-deductible when paid, relying on the 10-or-more-employer exemption from the section 419 limits and on the fact that they have enrolled at least 10 employers in their multiple employer trusts.

These arrangements typically are invested in variable life or universal life insurance contracts on the lives of the covered employees, but require large employer contributions [*3] relative to the cost of the amount of term insurance that would be required to provide the death benefits under the arrangement. The trust owns the insurance contracts. The trust administrator may obtain the cash to pay benefits, other than death benefits, by such means as cashing in or withdrawing the cash value of the insurance policies. Although, in some plans, benefits may appear to be contingent on the occurrence of unanticipated future events, in reality, most participants and their beneficiaries will receive their benefits.

The trusts often maintain separate accounting of the assets attributable to the contributions made by each subscribing employer. Benefits are sometimes related to the amounts allocated to the employees of the participant's employer. For example, severance and disability benefits may be subject to reduction if the assets derived from an employer's contributions are insufficient to fund all benefits promised to that employer's employees. In other cases, an employer's contributions are related to the claims experience of its employees. Thus, pursuant to formal or informal arrangements or practices, a particular employer's contributions or its employees' benefits [*4] may be determined in a way that insulates the employer to a significant extent from the experience of other subscribing employers.

In general, these arrangements and other similar arrangements do not satisfy the requirements of the section 419A(f)(6) exemption and do not provide the tax deductions claimed by their promoters for any one of several reasons, including the following:

1) The arrangements may actually be providing deferred compensation. This is an especially important consideration in arrangements similar to that in *Wellons v. Commissioner, 31 F.3d 569 (7th Cir. 1994),* aff'g, *64 T.C.M. (CCH) 1498 (1992),* where the courts held that an arrangement purporting to be a severance pay plan was actually deferred compensation. If the plan is a nonqualified plan of deferred compensation, deductions for contributions will be governed by section 404(a)(5), and contributions to the trust may, in some cases, be includible in employees' income under section 402(b). Section 404(a)(5) provides that contributions to a nonqualified plan of deferred compensation are deductible when amounts attributable to the contributions are includible in the employees' income, and that deductions are [*5] allowed only if separate accounts are maintained for each employee.

2) The arrangements may be, in fact, separate plans maintained for each employer. As separate plans, they do not qualify for the 10-or-more employer plan exemption in section 419A(f)(6).

3) The arrangements may be experience rated with respect to individual employers in form or operation. This is because, among other things, the trust maintains, formally or informally, separate accounting for each employer and the employers have reason to expect that, at least for the most part, their contributions will benefit only their own employees. Arrangements that are experience rated with respect to individual employers do not qualify for the exemption in section 419A(f)(6).

4) Even if the arrangements qualify for the exemption in section 419A(f)(6), employer contributions to the arrangements may represent prepaid expenses that are nondeductible under other sections of the Internal Revenue Code.

Taxpayers and their representatives should be aware that the Service has disallowed deductions for contributions to these arrangements and is asserting the positions discussed above in litigation.

Finally, in response to questions [*6] raised by taxpayers and their representatives, we note that the Service has never issued a letter ruling approving the deductibility of contributions to a welfare benefit fund under section 419A(f)(6). Although a trust used to provide benefits under an arrangement of the type discussed in this Notice may have received a determination letter stating that the trust is exempt under section 501(c)(9), a letter of this type does not address the tax deductibility of contributions to such a trust.