



MEMORANDUM

TO: Raymond G. Ankner, Chairman
Richard A. Whitbeck, President

FROM: Jeffrey I. Bleiweis, Vice President and General Counsel

RE: IRS Notice 2007-83, Notice 2007-84 and Rev. Rul. 2007-65

DATE: October 19, 2007

Sections 419 and 419A of the Internal Revenue Code set forth rules under which employers are permitted to make currently deductible contributions to welfare benefit funds in order to provide their retirees with medical and life insurance benefits. Businesses often maintain welfare benefit funds that comport with the intent of sections 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.

With those words, the Internal Revenue Service (the “IRS”) finally made good on its long-standing promise to provide guidance regarding the tax treatment of an employer’s contributions to a single-employer welfare benefit fund. That language is the better part of the first paragraph of Notice 2007-84, which, along with Notice 2007-83 and Rev. Rul. 2007-65, was released by the IRS on October 17, 2007.

A. Notice 2007-83

While Notice 2007-83 may be less important to CJA than Notice 2007-84, it will be discussed first, because it is likely to have a greater impact on the welfare benefit plan market.

The purpose of Notice 2007-83 is to identify certain transactions as listed transactions under section 6011 of the Code. The transactions targeted by Notice 2007-83 are single-employer welfare benefit plans that provide current benefits, such as life insurance, self-insured disability and self-insured severance benefits, to active employees only. The Notice says that such plans are often funded with cash-value life insurance, even though they do not provide post-retirement benefits and, as a result, are not entitled to fund a reserve. Because an employer’s contributions may be based upon premiums for cash-value insurance, such plans:

. . . often require large employer contributions relative to the actual cost of the benefits currently provided under the plan.

Because such plans do not provide post-retirement benefits, the cash value generated by the employer's excess contributions do not fund any benefit provided by the plan. The Notice says that, as a result, the employer expects to terminate the plan and distribute cash to the participants; the bulk of which will be paid to the owners or key employees of the plan sponsor.

Not every single-employer plan is a listed transaction. As noted above, the IRS is concerned with plans that purport to fund current benefits with cash-value insurance. In addition, a transaction will be a listed transaction, as defined in Notice 2007-83, only if it has each and every one of the following characteristics:

1. The funding mechanism for the plan must be a trust or other fund described in section 419(e)(3) of the Code.
2. The plan is not collectively-bargained.
3. Premiums paid by the fund accumulate value either within or outside the policy.
4. The employer has taken a deduction for contributions for benefits under the plan (**other than post-retirement medical benefits or post-retirement life insurance benefits**) that is greater than the amount calculated in accordance with the formula provided in the Notice.
 - a. For uninsured benefits, such as self-insured disability or self-insured severance, the limitation is equal to the fund's qualified cost for the taxable year. The fund's qualified cost is the sum of claims actually incurred and paid during the year, plus a reserve for claims incurred, but not paid, during the year, plus claims paid during the year, but incurred during a previous taxable year, plus administrative expenses in connection therewith.
 - b. For insured benefits, such as life insurance, the limitation is equal to the fund's qualified direct cost for the taxable year. An insured plan cannot have a qualified asset account, because there can be no claims incurred during the taxable year, but unpaid before the end of the year, and a plan that provides no post-retirement benefits cannot have a reserve. The fund's qualified direct cost is equal to premiums paid for insurance, as long as the policy or plan does not accumulate value either within or outside of the policy. In other words, the qualified direct cost of an insured, pre-retirement death benefit plan is limited to the cost of term insurance.

- c. For taxable years ending after November 5, 2007, no part of the premiums paid for cash value policies will be deductible. However, for taxable years ending prior to November 5, 2007, an employer may deduct the greater of the amount reported on an employee's W-2 or 1099 or the cost of insurance element of the policy purchased.

It should be obvious that CJA's prototype, single-employer plan is not a listed transaction. While CJA's plans may be funded with cash-value insurance or term insurance and an annuity that accumulates value outside the insurance policy, CJA's plans provide both pre-retirement and post-retirement benefits. That means that, unlike the plans described in Notice 2007-83, CJA's plans are entitled to establish a qualified asset account to fund such post-retirement benefits. In addition, CJA's prototype plan does not have each of the foregoing characteristics set forth in the Notice. Specifically, an employer's contribution to its plan will not exceed the amount calculated in accordance with the formula set forth in no. 4 above. In addition, the highlighted language, which is taken verbatim from the Notice, means that IRS has expressly acknowledged that an employer can deduct the cost of post-retirement death and medical benefits.

B. Rev. Rul. 2007-65

Rev. Rul. 2007-65 must be read in tandem with Notice 2007-83. It illustrates the application of the principles set forth in the Notice.

In Rev. Rul. 2007-65, the IRS describes two fact situations. In the first, an employer provides pre-retirement death benefit protection to its active employees through a welfare benefit fund. No other benefits are provided. In the second, the employer provides self-insured disability benefits to its active employees through a welfare benefit fund. Again, no other benefits are provided. In both cases, the trust obtains a cash-value life insurance policy to fund the benefits. The revenue ruling asks whether the premiums for the cash-value life insurance policy are included in the fund's qualified direct cost for the taxable year of the fund.

In answering the question, the IRS first reviews the law relating to welfare benefit funds. The IRS says that an employer's contribution to a welfare benefit fund is deductible under sections 419 and 419A of the Code, but only if the contribution is otherwise deductible under another section of the Code and only to the extent permitted by section 419(b). Section 419(b) provides that an employer's deduction is limited to the fund's qualified cost for the taxable year. The term "qualified cost" is defined in section 419(c)(1) as the sum of the fund's qualified direct cost and an addition to a qualified asset account, as long the amount in the qualified asset account does not exceed the fund's account limit for the taxable year. The fund's qualified direct cost for the taxable year is defined in section 419(c)(3)(A) as the amount that would have been allowable as a deduction to the employer if the employer had provided such benefits directly, and the employer used the cash receipts and disbursements method of accounting.

The term “qualified asset account” is defined in section 419A(a) to mean assets set aside to pay life, medical, disability, supplemental unemployment or severance benefits. The account limit for a fund’s qualified asset account is generally limited to the amount required to pay claims incurred during the fund’s taxable year, but unpaid before the end of such year, and administrative expenses attributable thereto. In addition, a fund’s account limit can include a reserve for post-retirement death and medical reimbursement benefits.

The IRS then discusses each fact situation. In situation 1, the IRS says that the amount that would have been deductible to the employer, if the pre-retirement death benefit had been provided directly by the employer, is equal to the cost of current insurance protection. This would equal the term premium or the cost of insurance element of the policy obtained by the fund. Therefore, the qualified direct cost of the fund is the current cost of insurance, which is significantly less than the premiums paid for a cash-value insurance policy.

In situation 2, the IRS says that the amount that would have been deductible to the employer, if the disability benefits had been provided directly by the employer, is equal to the disability benefits actually paid to employees during the taxable year of the fund. Therefore, the qualified direct cost of the fund is the amount actually paid to employees.

So far, the holding in the revenue ruling comports with the Neonatology and Booth cases and the general understanding of the issue. However, the IRS does something clever and unexpected in Rev. Rul. 2007-65 to deny the employer any deduction in both fact situations. The IRS says that, if the employer had purchased a cash-value policy directly, instead of interposing a welfare benefit fund, the employer would have owned the policy and all of the ownership rights in the policy. Among the rights retained by the employer would be the right to withdraw or otherwise use the cash value of the policy. As a result, the employer is directly or indirectly a beneficiary of the policy. Section 264(a) of the Code precludes a taxpayer from taking any deduction for the cost of an insurance policy where the taxpayer is a beneficiary of the policy. Since section 419 says that a contribution to a welfare benefit fund is deductible only if it is deductible under another section of the Code, and section 264(a) precludes such a deduction, the employers in both fact situations are denied any deduction for their contributions to their funds.

Taken together, Notice 2007-83 and Rev. Rul. 2007-65 may spell doom for pre-retirement benefit plans funded with cash value insurance. Notice 2007-83 says that such plans may be listed transactions, and a taxpayer, participating in such a plan, may be required to disclose its participation on its tax return. Rev. Rul. 2007-65 says that it may not even matter whether the transaction is a listed transaction, because the employer, participating in such a plan, is not entitled to deduct any portion of its contribution to the plan, even if the plan is treated as a welfare benefit plan. Rev. Rul. 2007-65 has no impact on deductions to CJA’s prototype single-employer welfare benefit plan, because CJA’s plan is not a pre-retirement plan only.

C. Notice 2007-84

In Notice 2007-84, the IRS acknowledges that employers sometimes provide post-retirement death and medical reimbursement benefits through welfare benefit funds. The IRS further acknowledges that employers make substantial contributions to these funds that are fully deductible. However, the IRS also says that it knows of plans that, for a number of reasons, may not comply with the requirements of sections 419 and 419A. The purpose of Notice 2007-84 is to alert taxpayers that it will challenge an employer's deduction for contributions to plans that do not provide legitimate and nondiscriminatory post-retirement benefits.

In Notice 2007-84, the IRS says that whether an employer is entitled to deduct its contributions to a plan to fund post-retirement benefits depends upon the facts and circumstances of the employer and its plan. In evaluating an employer's plan, the IRS will look at the following elements:

1. **Is the plan discriminatory?** Under section 419A(e)(1) of the Code, a post-retirement reserve may be taken into account only if the plan meets the nondiscrimination requirements of section 505(b) of the Code, even if those requirements would not otherwise apply to the plan. Section 505(b) contains the nondiscrimination requirements for a VEBA. This means that a plan, whether or not a VEBA, may not discriminate in favor of highly-compensated or key employees.
2. **Are the employer's contributions level funded?** Section 419A(c)(2) says that a welfare benefit fund may contain a reserve for post-retirement death and medical reimbursement benefits. However, contributions to the reserve are deductible only if the reserve is funded over the working lives of the covered employees and actuarially determined on a level basis, using assumptions that are reasonable in the aggregate. The IRS says that some plans use unreasonable assumptions by including the cost of benefits not likely to be paid.
3. **Are the employer's contributions based on current costs?** Section 419A(c)(2)(A) of the Code requires that the contribution to the reserve to fund post-retirement medical reimbursement benefits be determined on the basis of current medical costs.
4. **Does the employer actually intend that the reserve be used for post-retirement benefits?** Contributions to fund a reserve for post-retirement benefits are deductible under section 419A(c)(2) only if a reserve is actually created, and the employer actually intends to use the assets in the reserve to provide such post-retirement benefits.

CJA's prototype single-employer plan meets the requirements set forth in Notice 2007-84:

1. CJA's prototype plan is nondiscriminatory. It permits the exclusion of only those employees that may be excluded under section 505(b) of the Code – i.e. employees who have not attained the age of 21, employees who do not have 36 months of service, part-time employees and employees covered by a collective bargaining agreement.
2. Contributions to CJA's prototype plan are level funded over the working lives of the covered employees. The amount of an employer's contribution to the reserve is not inflated by unreasonable actuarial assumptions.
3. Contributions to CJA's prototype plan are based on current medical costs.
4. CJA's prototype plan provides for the creation of a reserve that is intended to be used for post-retirement benefits.

Notice 2007-83, Rev. Rul. 2007-84 and Notice 2007-84 do not signal the end of single-employer welfare benefit plans. To the contrary, they provide guidance to employers who desire to do such plans right. In the news release announcing the publication of Notice 2007-83, Rev. Rul. 2007-65 and Notice 2007-84, the IRS says as follows:

There are many legitimate welfare benefit funds that provide benefits, such as health insurance and life insurance, to employees and retirees.

In addition, in the same news release, Donald Korb, Chief Counsel for the IRS, is quoted as saying:

The guidance targets specific abuses involving a limited group of arrangements that claim to be welfare benefit funds.

Legitimate single-employer welfare benefit plans are outside the scope of the warnings.