

Fox & Lalonde

Retirement & Welfare Benefits
Consulting, Design & Administration
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HealthCare Annuity Plus® WBP

Single Employer VEBA & IRC §419(e)

Questions and Answers

1. What is a Single Employer Welfare Benefit Plan?

A Single Employer VEBA or an IRC §419(e) Welfare Benefit Plan (WBP) is a plan that has been established by one employer for the benefit of its employees. A welfare benefit plan can provide for the payment of life, sickness, accident or other benefits to its members or their dependent or designated beneficiaries.

A welfare benefit plan is formed as a trust; generally it is either self-trusted or the Plan Sponsor will appoint a trustee. A Third Party Administrator (TPA) provides all administrative functions. Contributions to WBPs are tax deductible. WBPs enjoy tax deferred or tax advantaged growth. WBP benefits, in most plans, are received tax free by plan beneficiaries, either as a death benefit or medical reimbursement.

2. What Benefits Will A WBP Provide?

Our WBP plans may provide the following benefits:

I. Pre-retirement

Long Term Care Benefits
Accidental Death & Dismemberment Benefits
Temporary and Long-term Disability Benefits*
Death Benefits

II. Post-retirement

Medical Benefits **
Death benefits

*Disability limits: up to 75% of earnings, plus lump sum of 5X pay - max. \$40 million/participant);

** A tax free medical reimbursement fund of upto \$562,500 single/\$1.125 million joint beneficiaries

Note: Some WBPs provide Severance Benefits. Due to deferred compensation concerns, which may cause plan disqualification we do not recommend this benefit for most non-publicly held entities.

3. What is an IRC §419(e) WBP?

An IRC §419(e) WBP is a welfare benefit plan which is defined in IRC §419:

- §419(e): Provides the operating rules and definitions for a welfare benefit plan;
- §419(a): Allows a deduction for the annual employer contributions into a WBP.
- §419(c)(1): Defines the deductible contribution as being the "qualified direct cost" of the benefits provided.

4. What is a VEBA WBP?

A VEBA is a “voluntary employees’ beneficiary association” as defined in IRC §501(c)(9). A VEBA must provide for the “payment of life, sick, accident or other benefits to members of such association or their dependents or designated beneficiaries...”

The general rule, as set out by the Department of Treasury in 26 CFR §1.501 (c)(9)-1, tracks the statute and describes the four conditions that a plan must satisfy to qualify as a tax-exempt VEBA:

- The organization is an employees’ association.
- Membership in the association is voluntary.
- The organization provides for payment of life, sickness, accident or other benefits to its members or beneficiaries, and substantially all of its operations are in furtherance of providing such benefits, and
- No part of the net earnings of the organization inures, other than by the payment of the benefits referred to in (c), to the benefit of any shareholder or individual.

5. What is the difference between a VEBA and an IRC §419(e) WBP?

The main differences between a VEBA and an IRC §419(e) WBP is:

- A VEBA is an IRC §501(c)(9) tax deferred trust;
- An IRC §419(e) WBP is a taxable trust.

Our **HealthCare Annuity Plus® WBP VEBA** is designed with the *option* to be fully funded with either fixed or indexed annuities.

6. Is a WBP Subject to the IRS Rules for Qualified Retirement Plans?

A WBP is not a qualified retirement plan subject to the rules of IRC §401. A WBP that provides post-retirement medical benefits, however, must coordinate its contributions for key employees with any contributions made to a defined contribution qualified retirement plan. IRC §415(c)(2) annual addition limits apply to the combined contribution(s).

7. Is a WBP Subject to the Rules of ERISA?

A welfare benefit plan that receives employer contributions and covers common-law employees is subject to Title 1 of ERISA (the Employee Retirement Income Security Act of 1974). Under these rules, the employer must prepare a Summary Plan Description, to be filed with the Department of Labor and distributed to the plan participants. Additionally, the trustee must generally file IRS Forms 5500 annually, to report on the financial aspects of a plan. The trustee of a WBP is subject to all of the fiduciary, disclosure and reporting rules of ERISA.

8. Are Plan Sponsor Annual Contributions to Both a WBP and a Qualified Retirement Plan Tax Deductible?

Both are fully tax deductible subject to the IRC §415(c)(2) annual addition limitations, which apply to the combined contribution(s) for key employees, if there is an existing defined contribution qualified plan e.g. 401(k) Profit Sharing.

Plan Sponsors who want both benefits funded currently may adopt a qualified retirement plan prospectively that is not subject to IRC §415(c)(2).

9. Can a Sole Proprietorship or Single Member LLC Adopt a WBP?

A Single Member LLC may adopt a WBP if it elects to be taxed as a corporation; Form 8832. A sole proprietor cannot adopt a WBP.

10. What Type of Business Should Consider a WBP?

A profitable business (C Corporation, S Corporation, partnership, or LLC), that is seeking a tax deductible way to:

- Retain and reward good employees, key employees and other highly compensated employees in direct proportion to their company service and overall contributions to the company's bottom line ("golden handcuffs").
- Provide additional pre-retirement and post-retirement life and health benefits to its employees, including key and highly compensated employees, as well as, owner employees.

11. Is a WBP subject to non-discrimination rules?

The non-discriminatory rules under IRC §505(b) apply to all VEBA benefits and all post-retirement benefits of an IRC §419(e) WBP.

It should be noted that eligibility for WBP inclusion can be more restrictive than a qualified retirement plan. Additionally *benefit entitlement* can be limited to employees who actually reach retirement age and have a stipulated number of years in either or both service and plan participation.

12. Can a WBP Secure an IRS Approval Letter of Tax-Exempt Status?

A VEBA WBP routinely applies for and receives an IRS favorable letter of determination of its IRC §501(c)(9) tax exempt status. An IRC §419(e) WBP does not file for tax exempt status; it is a taxable trust which by design is funded by tax advantaged financial instruments.

WBPs which directly or indirectly use cash value life insurance to fund plan benefits should file IRS Form 8886 in order to avoid potential listed transaction penalties.

13. Does the IRS Approval Letter Guarantee Tax Deductibility?

This is a common misconception. An IRS Approval Letter *does not* have any impact on the deductibility of the plan. Tax deductibility is the consequence of the applicability of the appropriate IRC sections and actual plan operations to a specific WBP.

The actuarial validation provided by the plans Administrative Service Provider (TPA) is, however, critical to the tax deductibility process.

14. What is the Plan Contribution deadline for Tax Deductibility?

A Plan contribution that is made by the last day of the calendar year, or the last day of the employer's fiscal year if other than the calendar year, is deductible in that year. This result assumes that the employer reports its income on the cash basis.

In the event that the employer reports on the accrual basis, the contribution is deductible provided all necessary documentation is completed by the last day of the year, and the Plan contribution is made no later than 75 days after the end of the fiscal year (plus extensions).

The adoption agreement and all other ancillary documents must be completed, executed and forwarded to the plan trustee by the last day of the employer's year.

15. What is the Funding Method Used for WBP Death Benefits?

The death benefit is generally provided by one year group term life insurance. Post October 17, 2007 WBP Sponsors using cash value life insurance directly or indirectly to fund plan benefits must consider the IRS concern and guidance issued at that time, as follows:

IRS Notice 2007-84; 2007-45 IRB 1 October 17, 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 §§ 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.”

16. What Happens Upon the Death of a Participant?

The death benefit from the insurance policy on the deceased participant's life is paid to the WBP trustee who, in turn, distributes the proceeds to the beneficiary or beneficiaries designated by the participant.

17. Are Plan Death Benefits Received Tax Free?

IRC §101(a) provides an income tax exclusion for benefits payable under a life insurance contract because of the death of the insured. A plan participant is required to report the annual economic benefit of the plans death benefit as taxable income, IRC §79 Table I. Failure to report the Table I income would result in the inclusion of the policy's proceeds in taxable income.

18. Are Plan Death Benefits Subject to Estate Tax?

Insurance is taxable for estate tax purposes, provided that the insured possessed any incidents of ownership, or had the right to designate the beneficiary of the policy.

An irrevocable assignment of plan death benefits for group life insurance is an estate planning option that would typically remove life insurance proceeds from the taxable estate. Independent legal counsel should be consulted in this regard.

19. Are WBP Assets Creditor Proof?

The employer has no ownership or other interest in assets that may be in the WBP trust and under the terms of the WBP the employer has no right to have any assets revert to it. Therefore, any assets of the WBP should not be subject to the employer's creditors. Similarly, the participants have no current interest in any funds in the hands of the WBP's trust.

20. What are some of the Non-tax Advantages of either a VEBA or an IRC §419(e) WBP?

- Cost effective: All plans that provide post-retirement benefits may limit *benefit entitlements* to plan participants who actually reach a stipulated retirement age and fulfill a minimum number of years of participation and/or service e.g. 10 years, 15 years, etc.
- Retain and Reward Key personnel and long term employees: VEBAs and IRC §419(e) WBP plan design can help *retain and reward* valued employees (*golden handcuffs*), as well as, marginalize the plan cost for non-productive, short term human resources.
- Up to \$50,000 of Group term life insurance can be provided income tax free to each participant of a non-discriminatory plan.

21. What is the consequence if the *current economic benefit* e.g. the life insurance premium for amounts in excess of \$50,000, the DI premium, etc. of a VEBA or 419 plan benefit if is not reported currently by the participant for income tax purposes?

The benefit is taxable.

22. Does a Plan Participant's gross income include ER contributions to a Welfare Benefit Plan for AD&D, DI and/or LTC for the Employee participant, Employee's spouse or legal dependents?

Definitively **no** if the plan Sponsor is a C Corp. The rules change for owner/ee's in pass-thru organizations, but may still be either fully or partially non-inclusive. Also, note the taxability of LTC premiums above the age based limits in IRC Sec. 213(d)(10). See Q&A Appendix for additional details.

23. Are *benefits* received from plans included in employees' gross income?

Medical benefits received from a WBP are not includable as income to the participant. IRC §7702B, IRC §104(a)(3) refer to benefits received from an employer sponsored LTC policy being as being excluded from income. The taxability of disability income or death benefits depends on whether or not the premium paid by the WBP or the attributable term insurance cost for life benefits in excess of \$50,000 was included in the Employee's taxable income for the respective year.

24. A VEBA or IRC §419(e) WBP has multiple participants none of which (other than the owner) meet the eligibility requirements for service and otherwise that are necessary to receive a post-retirement benefit. The business has a downturn, downsizes or ceases to operate, people are laid off or quit (prior to meeting a benefit entitlement age), etc. – what happens?

The owner's benefits would be paid by the plan; the balance of assets, if any, would depend on the facts and circumstances of each individual case.

25-27. IRC §419A mandates that contributions used to fund post-retirement medical benefits for Key Employees be treated as an annual addition made to a defined contribution plan for purposes of IRC §415(c)(2) limitations. Questions:

- **Is the contribution offset to the D/C or the IRC §419(e)?** The DC
- **Is the issue a *contribution* offset or simply a *limitation on deductibility* in a given year?** It is a contribution offset.
- **Does the IRC §415(c)(2) annual addition limitation apply to a stand alone WBP?** No

28. With regard to #25-27 above is there a danger of penalties or disqualification for either the defined contribution or welfare benefit plans?

There is a 10% penalty for excess contributions above the IRC §415(c)(2) annual addition limit; if not corrected the penalty goes to 100%; if subsequently not corrected the DC would be disqualified.

29. How does a credit for past service liability factor in re: offsets in #25-27 above? For example, the contribution for past service liability attributed to the owner is \$250,000, what is my deduction "limit" for the current taxable year?

It counts. There would be no DC contribution for the year(s) in question.

HealthCare Annuity Plus® WBP

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Questions and Answers Appendix Deductibility by the Business Entity and Related Plan Participant Income Tax Issues

Fox & Lalonde's HealthCare Annuity Plus® WBP Single Employer VEBA & IRC §419(e) Welfare Benefit Plans (WBPs) make available the following benefits:

I. Pre-retirement: death, disability, accidental death & dismemberment and long term care benefits. Generally it is assumed that the plan will pay/deduct the appropriate premiums for insurance policies that will provide the benefits.

II. Post-retirement: medical and death benefits. An actuarially calculated post-retirement medical "sum" is available to plan participants, as well as, optionally spouses and/or dependents of plan participants.

Plan sponsors may choose which benefits to provide.

III. Questions:

Can any business entity sponsor a welfare benefit plan (WBP) and tax deduct the annual cost?

Depending on the type of business entity/Plan Sponsor *does the plan participant experience a different tax result* i.e. inclusion of part or all of the benefits' cost in the plan participant's current taxable income? In other words just what is the impact on individual plan participants with respect to contributions made in any particular year?

This Appendix's purpose is to examine these questions. It will detail the participant's current inclusion in taxable income as to type of business entity (C Corp, S Corp, LLC, LLP, partnerships) and the type of benefit provided (pre-retirement death, disability, AD&D and LTC; post-retirement medical and death).

Sole Proprietors

It is generally agreed that a sole proprietor cannot have a tax deductible welfare benefit plan.

C Corp – 100% deductible, only term life insurance cost pass thru for benefits in excess \$50,000.

S Corp – 100% deductible w/certain modifications and clarifications; term life insurance cost pass thru for death benefits in excess of \$50,000.

With regard to **health insurance premiums**, IRC §1372 treats more than 2% shareholders of S corporations as if they were partners in a partnership for fringe benefit purposes. The IRS explained the income tax treatment of health insurance provided by an S corporation to a more than 2% shareholder in *Rev. Rul. 91-26 and Announcement 92-16*.

The health insurance premiums paid by the corporation are deductible by the corporation but includible in the shareholder's gross income and are to be reported on his Form W-2 each year (although the shareholder may be able to deduct a portion of these amounts on his personal income tax return).

S Corp (con't)

IRC §162(l) allows the more than 2% shareholder to deduct health insurance premiums paid by the corporation for the corporation's health insurance on his personal income tax return up to the amount of his "earned income" from the S corporation. For this purpose, the more than 2% shareholder's wages from the S corporation are treated as his "earned income."

The **long-term care insurance premiums** that may be taken into account in determining the overall health insurance premium deduction under IRC §162(l) allowed for a self-employed individual are limited to eligible long-term care premiums, as defined in IRC §213(d)(10) and limited to the amounts set forth in that provision as increased for inflation. **Important Note: Owner employees are not however subject to the 7.5% of AGI itemization requirement.**

The IRS has informally taken the position that the above income tax treatment applies only if the health insurance is sponsored by the corporation — it does not apply to personal health insurance obtained by the S corporation's shareholder.

IRS Chief Counsel Advice 200524001 (that may not be cited as precedent) provided that a sole proprietor who purchases health insurance in his own individual name, rather than in the name of his business, has established a health plan with respect to his business and may, therefore, deduct the insurance premiums under IRC §162(l), but only to the extent that the premiums do not exceed his earned income from the business with respect to which the insurance was purchased.

When taxpayers tried to extend the logic of that advice to S corporations, the IRS issued a "headliner" on its website on May 15, 2006 in which the IRS stated that: (i) an S corporation has not established a health insurance plan itself when an S corporation shareholder purchases health insurance in his own name, (ii) because the S corporation has not established a fringe benefit plan, *Code section 1372* is not triggered, (iii) as a result, the S corporation shareholder is not treated as a partner of a partnership, and (iv) therefore, IRC §162(l) is not available to allow an income tax deduction by the S corporation shareholder for the health insurance premiums.

LLCs - The income tax treatment of the members of a limited liability company (LLC) depends on how the LLC is taxed.

If the LLC has only one owner, it will automatically be treated as if it were a sole proprietorship, unless an election is made to be treated as a corporation. *Treasury Regulations Section 301.7701-2(a)* provides: *A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.*

So, the sole member of an LLC would be treated as a sole proprietor (see discussion above) unless an election has been made to treat the LLC as a corporation. Such an election is made using *Form 8832, Entity Classification Election*.

If the LLC has two or more owners, it will automatically be considered to be a partnership unless an election is made to be treated as a corporation. A limited liability partnership (LLP) is going to be taxed as a partnership unless an election is made to treat the LLP as an association that is taxed as a corporation. Certain state laws recognize LLPs only for the practice of specific professions e.g. accountancy, architecture, and law.

Planning Note: A management company established as a C Corp may compliment an established pass thru business entity and provide an effective benefit and tax planning dynamic.