

412i, 419, Captive Insurance and Section 79 Plans; Buyer Beware

The IRS has been attacking all 419 welfare benefit plans, many 412i retirement plans, captive insurance plans with life insurance in them, and Section 79 plans. IRS is aggressively auditing various plans and calling them “listed transactions,” “abusive tax shelters,” or “reportable transactions,” participation in any of which must be disclosed to the Service. The result has been IRS audits, disallowances, and huge fines for not properly reporting under IRC 6707A.

In a recent Tax Court Case, *Curcio v. Commissioner* (TC Memo 2010-115), the Tax Court ruled that an investment in an employee welfare benefit plan marketed under the name “Benistar” was a listed transaction. It was substantially similar to the transaction described in IRS Notice 95-34. A subsequent case, *McGehee Family Clinic*, largely followed *Curcio*, though it was technically decided on other grounds. The parties stipulated to be bound by *Curcio* regarding whether the amounts paid by *McGehee* in connection with the Benistar 419 Plan and Trust were deductible. *Curcio* did not appear to have been decided yet at the time *McGehee* was argued. The *McGehee* opinion (Case No.

10-102) (United States Tax Court, September 15, 2010) does contain an exhaustive analysis and discussion of virtually all of the relevant issues. Taxpayers and their representatives

should be aware that the Service has disallowed deductions for contributions to these arrangements. The IRS is cracking down on small business owners who participate in tax reduction insurance plans and the brokers who sold them. Some of these plans include defined benefit retirement plans, IRAs, or even 401(k) plans with life insurance.

In order to fully grasp the severity of the situation, you have to understand Notice 95-34. It was issued in response to trust arrangements that were sold to companies designed to provide deduct-

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ible benefits, such as life insurance, disability and severance pay benefits. The promoters of these arrangements claimed that all employer contributions were tax-deductible when paid. They relied on the 10-or-more-employer exemption from the IRC § 419 limits. They claimed that that permissible tax deductions were unlimited in amount.

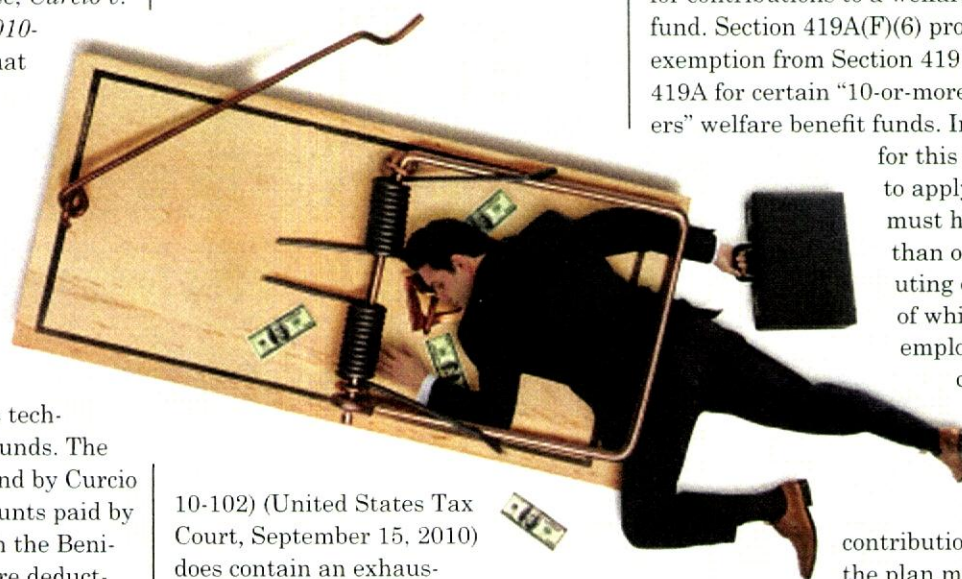
In general, contributions to a welfare benefit fund are not fully deductible when paid. Sections 419 and 419A impose strict limits on the amount of tax-deductible prefunding permitted for contributions to a welfare benefit fund. Section 419A(F)(6) provides an exemption from Section 419 and Section 419A for certain “10-or-more-employers” welfare benefit funds. In general,

for this exemption to apply, the fund must have more than one contributing employer, of which no single employer can

contribute more than 10% of the total

contributions. Also, the plan must not be experience-rated

with respect to individual employers. According to the Notice, these ar-



rangements typically involve an investment in variable life or universal life insurance contracts on the lives of the covered employees. The problem is that the employer contributions are large relative to the cost of the amount of term insurance that would be required to provide the death benefits under the arrangement. Also, the trust administrator can cash in or withdraw the cash value of the insurance policies to get cash to pay benefits other than death benefits. The plans are often designed to determine an employer's contributions or its employees' benefits based on a way that insulates the employer to a significant extent from the experience of other subscribing employers. In general, the contributions and claimed tax deductions tend to be disproportionate to the economic realities of the arrangements.

Benistar advertised that enrollees should expect the same type of tax benefits as listed in the transaction described in Notice 95-34. The advertising packet listed the following benefits of enrollment:

- Virtually unlimited deductions for the employer.
- Contributions could vary from year to year.
- Benefits could be provided to one or more key executives on a selective basis.
- No need to provide benefits to rank-and-file employees.
- Contributions to the plan were not limited by qualified plan rules and would not interfere with pension, profit sharing or 401(k) plans.
- Funds inside the plan would accumulate tax-free.
- Beneficiaries could receive death proceeds free of both income tax and estate tax.
- The program could be arranged for tax-free distribution at a later date.
- Funds in the plan were secure from the hands of creditors.

The Court said that the Benistar Plan was factually similar to the plans described in Notice 95-34 at all relevant times. In rendering its decision, the court heavily cited *Curcio*, in which the court also ruled in favor of the IRS. As noted in *Curcio*, the insurance policies, which were overwhelmingly variable or universal life policies, required large contributions compared to the cost of the

amount of term insurance that would be required to provide the death benefits under the arrangement. The Benistar Plan owned the insurance contracts.

Following *Curcio*, the Court held that the contributions to Benistar were not deductible under section 162(a) because participants could receive the value reflected in the underlying insurance policies purchased by Benistar. This is despite the fact that payment of benefits by Benistar seemed to be contingent upon an unanticipated event (the death of the insured while employed). As long as plan participants were willing to abide by Benistar's distribution policies, there was never a reason to forfeit a policy to the plan. In fact, in estimating life insurance rates, the taxpayers' expert in *Curcio* assumed that there would be no forfeitures, even though he admitted that an insurance company would generally assume a reasonable rate of policy lapses.

The McGehee Family Clinic had enrolled in the Benistar Plan in May 2001 and claimed deductions for contributions to it in 2002 and 2005. The returns did not include a Form 8886, Reportable Transaction Disclosure Statement, or similar disclosure.

The IRS disallowed the latter deduction and adjusted the 2004 return of shareholder Robert Prosser and his wife to include the \$50,000 payment to the plan. The IRS also assessed tax deficiencies and the enhanced 30% penalty totaling almost \$21,000 against the clinic and \$21,000 against the Prossers. The court ruled that the Prossers failed to prove a reasonable cause or good faith exception.

More You Should Know

- In recent years, some section 412(i) plans have been funded with life insurance using face amounts in excess of the maximum death benefit a qualified plan is permitted to pay. Ideally, the plan should limit the proceeds that could be paid as a death benefit in the event of a participant's death. Excess amounts would revert to the plan. Effective February 13, 2004, the purchase of excessive life insurance in any plan is considered a listed transaction if the face amount of the insurance exceeds the amount

that can be issued by \$100,000 or more and the employer has deducted the premiums for the insurance.

- By itself, A 412(i) plan is not a listed transaction; however, the IRS has a task force auditing 412i plans.
- An employer has not engaged in a listed transaction simply because it is a 412(i) plan.
- Just because a 412(i) plan was audited and sanctioned for certain items, does not necessarily mean the plan engaged in a listed transaction. Some 412(i) plans have been audited and sanctioned for issues not related to listed transactions.

Companies should carefully evaluate proposed investments in plans, such as the Benistar Plan. The claimed deductions will not be available and penalties will be assessed for lack of disclosure if the investment is similar to the investments described in Notice 95-34. In addition, under IRC 6707A, IRS fines participants a large amount of money for not properly disclosing their participation in listed, reportable or similar transactions; an issue that was not before the Tax Court in either *Curcio* or *McGehee*. The disclosure needs to be made for every year the participant is in a plan. The forms need to be filed properly even for years that no contributions are made. I have received numerous calls from participants who did disclose and still got fined because the forms were not filled in properly. A plan administrator told me that he helps hundreds of his participants file forms and they all still received very large IRS fines for not filling in the forms properly. □

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