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419(e) Welfare Benefit Plans

Due to the rising cost of health care and the fact that people are living longer into retirement, many individuals find that their retirement savings is depleted sooner than expected. A qualified retirement plan alone may not adequately meet all the needs of retirees. A welfare benefit plan offering post-retirement medical benefits, however, may be able to provide the funds necessary to pay for rising health care costs and thus alleviate the possible burden on the individual's retirement savings.

For many years welfare benefit plans have been used as a tool by employers to provide employees with attractive benefits. The employer's primary goal in offering welfare benefits, such as post-retirement medical, is to promote employee loyalty. Employees have an overwhelming need for post-retirement benefits and are more likely to remain with an employer offering a welfare benefit plan. A welfare benefit plan can offer employees valuable medical benefits while at the same time reducing employee turnover for the employer.

What is a 419(e) plan?

A 419(e) plan is a type of funded welfare benefit plan. A welfare benefit plan is "funded" when assets are set aside to provide current and/or future employee welfare benefits in either: (1) a taxable entity, such as a trust or a separate corporation, or (2) various tax-exempt organizations. The requirements of these funded welfare benefit plans are detailed under Internal Revenue Code (IRC) Sections 419 and 419A, hence they are often referred to as 419 plans. In order for the employer to receive a deduction for contributions to these plans, the requirements of these sections must be met. 419(e) plans are funded welfare benefit plans offered by a single employer, as opposed to multiple-employer or union 419A plans.

What benefits may be provided by a 419(e) plan?

A 419(e) plan may provide pre- and post-retirement welfare benefits such as medical, disability, severance pay, or life insurance death benefits.¹ A 419(e) plan may not, however, provide retirement income. They are not qualified plans, nor are they a substitute or supplement to a qualified plan or a non-qualified deferred compensation plan.

Do all 419(e) plans provide the same benefits?

No. Each plan may provide different welfare benefits; however, in order to be approved by Pacific Life and Pacific Life & Annuity, all plans that offer a pre-retirement death benefit must also offer a post-retirement medical benefit.²

Are contributions to the 419(e) plan deductible?

Contributions to a 419(e) plan are deductible by the employer to the extent they do not exceed the plan's "qualified cost." The "qualified cost" is comprised of two components: the qualified direct cost and any additions to a qualified asset account. The qualified direct cost ("QDC") can be thought of as the costs for current employee welfare benefits. The additions to a qualified asset account ("QAA") generally represent the amount necessary to fund a reserve for post-retirement benefits.³ Therefore, the employer can normally deduct contributions that are used to not only pay

for current benefits (QDC), but also to fund a reserve for post-retirement benefits (QAA).

If the plan provides a pre-retirement death benefit, the cost for the current benefit is the current cost of life insurance protection. Although one may reasonably conclude that this cost should be deductible as a QDC, the IRS has taken a different approach. In Revenue Ruling 2007-65 the IRS states that the cost of current life insurance protection does not qualify as a QDC and is not deductible by the employer. The IRS reaches this conclusion by asserting that the employer is directly or indirectly a beneficiary of the life insurance policy even though it is held inside a trust and even if the employer has no reversionary right. If the employer is directly or indirectly a beneficiary of the life insurance policy the employer may not deduct the life insurance premiums.⁴ Therefore, according to the Revenue Ruling 2007-65, employers are not permitted to take a deduction for contributions to the 419(e) plan to the extent those contributions pertain to current life insurance benefits; the QDC is zero. Accordingly, if the only benefit provided by the plan is a current life insurance benefit, such as in a death benefit only plan ("DBO"), no portion of the life insurance premium is deductible.

If the plan also provides a post-retirement benefit it may be possible to deduct some portion of the contribution to the plan. As mentioned above, contributions to a 419(e) plan are deductible as either a QDC for current benefits or a QAA for a reserve for future benefits. While the revenue ruling does state that the QDC is zero when life insurance is used, it may be possible to still receive a deduction for permitted contributions to fund the QAA for post-retirement benefits, such as medical benefits. The revenue ruling, however, does not specifically address whether or not the employer may take a deduction for funding the post-retirement medical reserve if the plan is using a cash value life insurance policy to help provide the benefits. Taxpayers should consult their legal and tax advisors before taking any deduction for contributions to a 419(e) plan.

What are the typical requirements for a pre-retirement death benefit?

There are various methods an employer may use to determine the amount of death benefit protection offered by the plan. Generally, 419(e) plans may discriminate as to this benefit and not only offer it to select key employees, but also offer death benefits of various sizes to the different key employees. 419(e) plans that are also Voluntary Employee Benefit Arrangements (VEBAs)⁵, however, must not discriminate when it comes to pre-retirement death benefits. One example of a nondiscriminatory death benefit formula is one that is offered to all employees as a multiple of compensation; it is similar, if not identical, to a group term benefit.

Does the employee incur any cost for this death benefit coverage?

Yes. The covered employee needs to include in his or her taxable income the cost of current life insurance protection, also known as the reportable economic benefit or "REB." This is measured by either the Table 2001 rates, or if the plan qualifies as a group term design under IRC Sec. 79, the cost of life insurance protection is measured by the Table I rates and the employee can exclude the first \$50,000 of coverage. If the cost of life insurance protection is reported, and the employee dies prior to normal retirement age, the employee's beneficiary will receive the death benefit free from income taxation.⁶

Is the life insurance death benefit subject to estate taxes?

Yes, but the employee could possibly avoid estate taxes⁷ if he or she irrevocably elects to name his or her irrevocable life insurance trust (ILIT) as beneficiary of the death benefit and survives three years following that election.⁸

If the employee does not die prior to retirement, what happens to the life insurance policy?

If the plan does not offer a post-retirement death benefit, once the employee retires, the death benefit ceases. If the employee wishes to continue the life insurance coverage the plan may allow the employee to purchase the policy for its fair market value. Clients should consult their tax and legal advisors prior to any purchase of a life insurance policy from the 419(e) plan. Careful consideration should be given to the fair market value of the policy. The IRS has stated that it

intends to challenge the value of any property, including life insurance, transferred from the plan if the property is not properly valued.⁹ If the participant does not wish to purchase the policy, or the plan does not allow for such a purchase, the plan may instead surrender the policy for its cash surrender value.

May a 419(e) plan offer post-retirement death benefits?

Some plans do allow for post-retirement death benefits, but these plans generally limit the death benefit to \$50,000. This is because 419(e) plans may only create a reserve to fund post-retirement death benefit of \$50,000 of coverage.¹⁰ Unlike pre-retirement death benefits, however, the reserve fund for post-retirement death benefits may not discriminate in favor of highly compensated employees.¹¹

Will Pacific Life and Pacific Life & Annuity allow their products to be used in a plan that only provides a pre-retirement death benefit?

No. Pacific Life and Pacific Life & Annuity have never allowed their cash value products to be used in death benefit only ("DBO") 419(e) plans. It is difficult to justify the use of a cash value policy in a DBO plan. In a DBO plan, the employer cannot deduct the contribution used to pay the life insurance premiums.¹² A DBO is also likely to be a listed transaction.¹³ Pacific Life and Pacific Life & Annuity will only allow their cash value life insurance policies to be used in plans that provide a post-retirement medical benefit.

What are the typical requirements for a post-retirement medical benefit?

Unlike pre-retirement death benefits, the 419(e) plan may not discriminate in favor of highly compensated employees when it comes to post-retirement medical benefits.¹⁴ Additionally, although the plan may in form look nondiscriminatory, it must in fact operate in a nondiscriminatory manner. The plan may not be operated in such a way as to primarily benefit the owners or other key employees.¹⁵

As mentioned previously, an employer can fund a reserve in a 419(e) plan to provide post-retirement medical benefits and may be able to deduct the costs necessary to build that fund. This reserve and the potentially deductible contributions are actuarially determined on a level basis and are based upon reasonable actuarial assumptions as to the estimated costs of post-retirement medical benefits (using current year values) and the expected year of retirement.

Are post-retirement medical benefits taxable to the covered employee?

No. All eligible medical costs paid for by the 419(e) plan are paid free of income tax.¹⁶ If in retirement, the covered employee incurs some medical costs and the plan either pays for these costs or reimburses the employee, the employee is not taxed.

If the participant dies during retirement, do his or her heirs receive any medical benefits?

Generally, no. Once the participant dies, the medical benefit ceases. Any unused medical benefits are forfeited. An heir may only receive medical benefits if they are also covered by the plan. For example, some plans may cover the participant, the participant's spouse, and his or her dependents. If a plan offers such a benefit it must be made available to other participants on a nondiscriminatory basis.

How does a VEBA compare to other 419(e) plans?

Like all 419(e) plans, a Voluntary Employee Benefit Association (VEBA), is a welfare benefit plan. It differs, however, from a typical 419(e) plan in two important aspects. First, a VEBA is a tax-exempt trust. Secondly, all benefits offered by VEBAs must be offered on a nondiscriminatory basis. A VEBA may not offer pre-retirement benefits, such as life insurance death benefits, to a select few individuals. Pacific Life and Pacific Life & Annuity do allow their products to be used in approved VEBA 419(e) plans. Please contact your Pacific Life or Pacific Life & Annuity Marketing

Representative for more information about the approved VEBA providers.

Does the existence of a 419(e) plan impact the employer's ability to fund a qualified retirement plan?

Possibly. If the employer offers a key employee¹⁷ both a defined contribution qualified plan retirement benefit and a 419(e) post-retirement medical benefit, the employer's deductible contributions to the qualified plan may be impacted.¹⁸ Contributions to the 419(e) plan to fund a post-retirement medical benefit reserve for key employees are treated as annual additions to the defined contribution qualified plan. As such, contributions to the 419(e) plan reduce the amount of deductible annual contributions that can be made to the defined contribution plan. For example, if an employer contributes \$25,000 in 2008 to fund a 419(e) post-retirement medical benefit reserve for a key employee, the employer may only be able to deduct a contribution of \$21,000¹⁹ to a profit-sharing plan for that same key employee. If, however, the employer offers a key employee a retirement benefit from a defined benefit qualified plan, the contributions to the 419(e) plan do not offset the contributions to the defined benefit plan.

If the client owns more than one business, can a 419(e) plan be established in only one of those businesses?

419(e) plans must follow the same control group and affiliated service group tests as qualified retirement plans.²⁰ These tests require that all the employees who are either under common control, or who are part of an affiliated service group, be treated as if they are employed by a single employer. While the 419(e) plan may be established in only one of those businesses, it may have to cover the employees of the other businesses as well. Clients in a multiple entity setting should contact their employee benefits counsel to determine the effect of the control group or affiliated service group tests in their particular situation.

Is the employer able to terminate the 419(e) plan if the financial situation changes?

If the employer is no longer able to maintain the 419(e) plan, it may be terminated. All welfare benefit plans are intended to be permanent. Some plans, but not all, do allow the employer the right to terminate the plan if financial situations dictate such a drastic measure. Once the plan is terminated, the assets are distributed to the participants on a pro-rata basis.²¹ Unlike the pre-retirement death benefits or the post-retirement medical benefits, these termination distributions are income taxable to the participants.

The right to terminate a plan must not be used to operate the plan as a disguised deferred compensation arrangement. Operating a plan in such a manner would violate both ERISA and IRC Sec. 409A and may result in not only disqualification of the plan but also penalty taxes for both the employer and the participant. Deciding to terminate the plan should only be done after the employer has consulted with its employee benefits counsel and an independent legal and tax advisor to determine if a termination is appropriate and the legal and tax ramifications that may follow such a decision.

Which Pacific Life and Pacific Life & Annuity life insurance products may be used inside a 419(e) plan?

Pacific Life and Pacific Life & Annuity only allow their universal life and variable universal life insurance policies to be placed inside a 419(e) plan. Pacific Life's and Pacific Life & Annuity's whole life policies (Flex XIV, Flex Protector, and Flex Pro-NY) may not be used inside a 419(e) plan. A 419(e) plan requires greater premium flexibility than that offered by whole life insurance. If an employee leaves the company prior to reaching normal retirement age, that employee forfeits his or her post-retirement medical benefit. This would obviously impact the amount required to fund a post-retirement reserve fund for remaining employees and could possibly affect the amount available to pay the life insurance policy premiums.

What type of 419(e) designs may not use Pacific Life's or Pacific Life & Annuity's life insurance policies?

Pacific Life and Pacific Life & Annuity do not allow their products to be used in connection with either a multiple-employer 419A plan or a union 419A plan.²² Only single-employer 419(e) plans that are offered by approved providers may use Pacific Life or Pacific Life & Annuity life insurance policies. As mentioned above, these plans must offer both a pre-retirement death benefit and a post-retirement medical benefit.

Additionally, Pacific Life and Pacific Life & Annuity do not allow their products to be used in a 419(e) design that contemplates using elements of reverse split dollar. In the typical reverse split dollar design, the participant owns a life insurance policy and endorses some or all of the net-amount-at-risk to the 419 plan. Following Notice 2002-59 and the final split dollar regulations, such a design may subject the participant to income taxation of the entire premium amount rather than simply the cost of current life insurance protection. Such a design may also incur a loss of deduction for the contributions pursuant to Rev. Rul. 2007-65.

Are 419(e) plans listed transactions?

Possibly. Notice 2007-83 states that plans with the following four elements, and plans that are substantially similar, are listed transactions:

- The transaction is a welfare benefit fund under IRC Sec. 419(e)(3).
- The plan is not a collectively bargained plan under IRC Sec. 41A(f)(5)(A).
- Premiums are paid on one or more cash value life insurance policies.
- The employer has taken deductions for contributions to the plan (**other than post-retirement medical benefits or post-retirement life insurance benefits**) that are greater than the claims for the current year plus administrative expenses. If a cash value life insurance policy is used for plan years after November 5, 2007, the deductible cost of life insurance protection is zero. Prior to November 5, 2007, the Notice does allow some deduction for the cost of life insurance protection.

Most, if not all, 419(e) plans funded with cash value life insurance will have the first three elements. The fourth element will exist in those 419(e) plans where the employer has attempted to deduct excessive contributions, such as the cost of current life insurance protection beyond November 5, 2007. It therefore appears that a 419(e) plan may not be a listed transaction if the employer limits its deductions to the cost to provide the post-retirement medical and post-retirement life insurance benefits. Taxpayers should consult their own independent legal advisors for assistance in this area.

The listed transaction issue is not prospective only. Existing plans may be listed transactions based upon deductions taken in past plan years. Taxpayers currently participating in a 419(e) plan should contact the plan administrator for more information regarding their specific plan.

Listed transactions have certain reporting requirements for the taxpayer (Form 8886) and listing requirement for the promoters (Form 8918). Severe penalties may be assessed if the listed transaction requirements are not met.

Are there any additional requirements that must be met before placing a Pacific Life or Pacific Life & Annuity policy inside a 419(e) plan?

Yes. Pacific Life and Pacific Life & Annuity require that the client sign a Disclosure and Acknowledgment form prior to placing a policy inside a 419(e) plan. The form notifies the client of some of the important issues raised in 419(e) plans.

Who is the ideal candidate for a 419(e) plan?

Any employer who wants to provide a welfare benefit to its employees may find a 419(e) plan attractive. A small business owner or a family business owner may find these plans especially attractive because the overall cost to provide the benefits would be less, but there is no limit on the size of the company. These plans can be offered by virtually any business entity, with the only exception being a sole proprietor.

How does an employer establish a 419(e) plan?

The first step in establishing a 419(e) plan would be to contact a plan provider. Pacific Life and Pacific Life & Annuity, as providers of product only, do not design 419(e) plans. Pacific Life and Pacific Life & Annuity do not endorse any particular plan; however, some plans have met our requirements and are authorized to use Pacific Life's or Pacific Life & Annuity's life insurance products in their plan. Please contact your Pacific Life or Pacific Life & Annuity Marketing Representative for more information about the approved providers.

1. IRC Sec. 419A(a).
2. Plans may also provide a post-retirement death benefit. For information regarding the limitations of post-retirement death benefits please see the question below titled, "*May a 419(e) plan offer post-retirement death benefits?*"
3. IRC Secs. 419(c)(1); 419A(c)(2). The reserve amount may be actuarially determined using reasonable assumptions as to the estimated costs of post-retirement medical benefits (using current values) and the expected year of retirement.
4. IRC Sec. 264(a)(1).
5. For a discussion of VEBAs, please see the following question titled, "*How does a VEBA compare to other 419(e) plans?*"
6. For federal income tax purposes, life insurance death benefits generally pay income tax-free to beneficiaries pursuant to IRC Sec. 101(a)(1). In certain situations, however, life insurance death benefits may be partially or wholly taxable. Situations include, but are not limited to: the transfer of a life insurance policy for valuable consideration unless the transfer qualifies for an exception under IRC Sec. 101(a)(2) (i.e. the "transfer-for-value rule"); arrangements that lack an insurable interest based on state law; and an employer-owned policy unless the policy qualifies for an exception under IRC Sec. 101(j).
7. The federal estate tax exemption amount is \$2,000,000 in 2008 and increases to \$3,500,000 in 2009. The highest federal estate tax rate is 45% in 2008 and 2009. The federal estate tax will be repealed on 1/1/10 until 12/31/10. Beginning 2011, the federal estate tax will be reinstated with a federal estate tax exemption amount of \$1,000,000 and a maximum estate tax rate of 55%. Congress continues to discuss and consider legislation that, if passed, would permanently repeal or otherwise lessen the impact of the federal estate tax.
8. IRC Secs. 2042(1); 2035(a). Even with the irrevocable beneficiary election, the policy could remain in the employee's estate unless the plan is designed such that the employee does not retain any incidents of ownership over the policy.
9. Notice 2007-84.
10. IRC Sec. 419A(e)(2).
11. A highly compensated employee is defined as one who: (1) is a 5% owner, or (2) earns \$100,000 (in 2006, as indexed). IRC Sec. 419A(e)(1) applies the nondiscrimination rules of IRC Sec. 505(b). Plans may exclude employees who: (1) have not completed 3 years of service, (2) are under age 21, or (3) are less than half-time employees.
12. Rev. Rul. 2007-65. For deductibility of the contribution, please see the previous question titled, "*Are contributions to the 419(e) plan deductible?*"
13. Notice 2007-83. Please see the question titled, "*Are 419(e) Plans listed transactions?*" later in this white paper.
14. IRC Secs. 419A(e)(1); 505(b)(3); 105(h). Medical reserves must benefit: (1) at least 70% of all employees or 80% of those eligible if at least 70% of all employees are eligible, or (2) a classification of employees that the IRS has found to be nondiscriminatory. Plans may also exclude the employees listed in the previous footnote.
15. Notice 2007-84.
16. IRC Sec. 105(b).
17. A key employee is defined in IRC Sec. 416(i) as: (1) an officer earning more than \$150,000 a year (as indexed for 2008), or (2) a 5% owner of the employer, or (3) a 1% owner of the employer who earns more than \$150,000 (not indexed) a year.
18. IRC Sec. 419A(d)(2).
19. Total annual additions to defined contribution qualified plans are limited to \$46,000 in 2008. IRC Sec. 415(c).
20. IRC Secs. 419(h)(2); 414(c); 414(m).
21. In a pro-rata termination distribution, the assets in the plan are evenly divided up among the participants.
22. Multiple employer 419 plans and union 419 plans are also referred to as 419A(f)(6) and 419A(f)(5) plans, respectfully.

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Please note: This material is designed to provide general information in regard to the subject matter covered. Neither Pacific Life, Pacific Life & Annuity, nor their representatives offer legal or tax advice. Private legal counsel alone may be responsible and relied upon for those purposes.

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