

N. PREPAID LEGAL PLANS UNDER IRC 120 AND 501(c)(20)

Introduction

This topic provides a discussion of new IRC 501(c)(20) and 120. This also updates the topic in the 1978 EOATRI textbook. Included as attachments following this discussion are a copy of the proposed regulations published in the Federal Register on July 14, 1978, and a copy of a suggested representative determination letter recognizing exemption to an organization under IRC 501(c)(20). An extract of the parts of Form 1024 applicable to prepaid legal plans is also included as an attachment.

1. Background and General Requirements

Before the Tax Reform Act of 1976 (P.L. 94-455, 1976-3 (Vol. 1) C.B. 1) one could argue, under IRC 61, that an employee had to pay tax on either (1) his share of employer contributions to a group legal services plan, or (2) the value of legal services or reimbursements received by the employee under the plan. IRC 120, added by section 2134 of the TRA, provides that an employee need not include in income either (1) his share of employer contributions to a qualified group legal services plan, or (2) the value of legal services or reimbursements received under the plan. A qualified plan must be a separate written plan for the exclusive benefit of an employer's employees or their spouses and dependents. The only benefits the plan may provide are personal legal services.

IRC 120 is similar to the Code provisions affecting contributions by employers to accident and health plans. IRC 106 provides that gross income does not include contributions by the employer to accident or health plans to provide compensation (through insurance or otherwise) to employees for personal injuries or sickness, while IRC 105 provides that gross income does not include three categories of medical benefits received by employees as a result of employer contributions. As a further requirement, qualified legal services plans must be non-discriminatory with respect to enrollment and benefits. These requirements have been "borrowed" in part from the employee plan requirements under IRC 401. However, they are much more limited in scope.

New IRC 501(c)(20) was added to provide tax exemption for trusts formed as part of qualified group legal services plans. A trust may not be exempt under IRC 501(c)(20) if it provides for other than personal legal services. In other words,

to qualify under IRC 501(c)(20), a trust may not also provide for other benefits commonly provided for by IRC 501(c)(9) organizations.

2. Notice Provision and Issuance of Determination Letters

One of the first problems encountered was the notice provision of IRC 120(c)(4). This section provides:

The plan shall give notice to the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for recognition of the status of a qualified group legal services plan.

Proposed Regs. 1.120(c)(4)-1, published July 14, 1978, provide that such notice will be in the form of an application for recognition of a plan's status as a qualified group legal services plan, thus requiring approval or denial by the Service. Schedules L and M have been added to the Form 1024 so that this form may be used as an application for not only IRC 501(c)(20) trusts but also IRC 120 plans. Section 2134(e) of the TRA provides a transitional rule for plans in existence on June 4, 1976. Once this transitional period lapses, however, these plans will have to file the Form 1024. It should be noted, however, that the Form 1024 need not be submitted prior to 90 days after the day on which regulations under IRC 120(c)(4) become final.

MS 77G-21 provides that key District Directors may issue determination letters under IRC 120 and IRC 501(c)(20) if the issues are clear under the statute. Denials under either section entitle the plan or trust to the usual administrative appeals. As for filing requirements, IRC 501(c)(20) trusts use the Form 990, while IRC 120 plans file the Form 5500.

Even though it was the intent of Congress to promote prepaid legal services plans and thereby increase the availability of legal services to lower- and middle-income taxpayers, new IRC 120 applies only to employer plans for the benefit of employees, and not other prepaid legal services plans. For these other plans, there is a remote possibility of exemption under one of the provisions of IRC 501(c). For a discussion of these possibilities, see Tax Policies in Relation to Nonbusiness Legal Expenses and Prepaid Legal Services, 26 Amer. U.L. Rev. 451 (1977). In the recent past, the Service has extended IRC 501(c)(3) status to prepaid legal services plans only so long as they remain in an experimental stage. Once the feasibility of offering such plans has been adequately researched, presumably these plans will no longer qualify as scientific research organizations under IRC 501(c)(3).

Congress apparently is also concerned as to whether these plans are viable. The new legislation requires a study by the Departments of Labor and Treasury regarding the desirability and feasibility of continuing these tax incentives, with a report due in 1980. See section 2134(d) of the Tax Reform Act of 1976, P.L. 94-455, 1976-3 C.B. (Vol. 1) 404. Also see Joint Committee Explanation, 1976-3 C.B. (Vol. 2) 683.

ATTACHMENT 1

PROPOSED REGULATIONS ON PREPAID LEGAL PLANS

Published July 14, 1978

[4830-01]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

[26 CFR Part 1]

[LR-217-76]

**APPLICATION FOR RECOGNITION AS A
QUALIFIED GROUP LEGAL SERVICES PLAN**

Proposed Rulemaking

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to notice of application for recognition of the status of a qualified group legal services plan. Provisions relating to group legal services plans were added to the tax law by the Tax Reform Act of 1976. The regulations would provide guidance by which a group legal services plan may apply to the Internal Revenue Service for recognition of its status as a qualified plan and would primarily affect administrators or sponsors of group legal services plans.

DATE: Written comments and requests for a public hearing must be delivered or mailed by September 12, 1978. The amendments are proposed to be effective for notices of application for recognition of the status of a qualified group legal services plan submitted after adoption of the amendments.

ADDRESS: Send comments and requests for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T:LR-217-76, Washington, D.C. 20224.

FOR FURTHER INFORMATION CONTACT:

Richard L. Johnson of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, D.C. 20224, Attention: CC:LR:T:LR-217-76, 202-566-3287 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 120(c)(4) of the Internal Revenue Code of 1954. These amendments are proposed to conform the regulations to one provision of section 2134 of the Tax Reform Act of 1976 (90 Stat. 1926), and are to be issued under the authority contained in sections 120(c)(4) and 7805 of the Internal Revenue code of 1954 (90 Stat. 1926 and 68A Stat. 917; 26 U.S.C. 120(c)(4) and 7805).

PREPAID LEGAL SERVICES

Section 120 was added to the Internal Revenue Code of 1954 by the Tax Reform Act of 1976. The new section excludes from the gross income of an employee, or the employee's spouse or dependents, amounts contributed on their behalf by an employer to a qualified group legal services plan. Benefits received under the plan are also excluded from the gross income of the recipient. The benefits may be either personal legal services provided under the plan directly to a participant, or reimbursement under the plan for personal legal services otherwise obtained.

REQUIREMENT FOR NOTICE

Section 120(c)(4) provides that in order to be a qualified group legal services plan, the plan must give notice to the Secretary of the Treasury that it is applying for recognition of its status as a qualified plan. The notice must be filed on Form 1024, Application for Recognition of Exemption Under Section 501(a) or for Determination Under Section 120, with the accompanying Schedule L. In general, a plan must file the notice before the end of its first plan year in order to be regarded as a qualified plan from the beginning of the first plan year. If the notice is filed after the end of the first plan year, a plan will be a qualified plan (if it otherwise satisfies the requirements for qualification) from the date on which the notice is filed. However, if the notice is filed any time before the 91st day after the amendments proposed by this document are adopted, the plan will be a qualified plan (if it otherwise satisfies the requirements for qualification) from the date of adoption of the plan.

PLANS IN EXISTENCE ON JUNE 4, 1976

A written group legal services plan in existence on June 4, 1976, will be deemed a qualified plan until at least April 2, 1977, whether or not a notice of application is filed for the plan. If the plan is maintained pursuant to a collective bargaining agreement in effect on October 4, 1976, this period of deemed qualification will extend until the agreement terminates, but not beyond

December 31, 1981. In order for a plan to be a qualified plan for any period after the period of deemed qualification, a notice of application must be filed under these regulations. Although a plan in existence on June 4, 1976, need not file a notice of application to be a qualified plan for the period of deemed qualification, the plan is not relieved of any other filing requirements, including any requirement for an annual information return.

COMMENTS AND REQUESTS FOR A PUBLIC HEARING

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably six copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the FEDERAL REGISTER.

DRAFTING INFORMATION

The principal author of these proposed regulations was Richard Johnson of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

PROPOSED AMENDMENTS TO THE REGULATIONS

It is proposed to amend 26 CFR part 1 by adding a new Section 1.120(c)(4)-1 as follows:

Section 1.120(c)(4)-1 Notice of application for recognition of status of qualified group legal services plan.

(a) *In general.* In order for a plan to be a qualified group legal services plan for purposes of the exclusion from gross income provided by section 120(a), the plan must give notice to the Internal Revenue Service that it is applying for recognition of its status as a qualified plan. Paragraph (b) of this section describes how the notice is to be filed for the plan. Paragraph (c) of this section describes the action that the Internal Revenue Service will take in response to the notice submitted for the plan. Paragraph (d) of this section describes the period of plan qualification.

(b) *Filing of notice--(1) In general.* A notice of application for recognition of the status of a qualified group legal services plan must be filed with the key district director of internal revenue as described in Section 601.201(n). The notice must be filed on Form 1024, Application for Recognition of Exemption Under

Section 501(a) or for Determination Under Section 120, with the accompanying schedule L, and must contain the information required by the form and any accompanying instructions. The form may be filed by either the employer sponsoring the plan or the person administering an employer-adopted plan. See paragraph (a) of this section for special rules and definitions relating to information required to be filed on schedule L.

(2) *Plans to which more than one employer contributes; multiple filings required.* Except in the case of a plan to which subparagraph (3) of this paragraph applies, if more than one employer contributes to a plan, information required to be filed on schedule L which relates to employees of a contributing employer must be filed separately, for each contributing employer. Accordingly, a separate schedule L must be filed for the plan for each contributing employer after the employer adopts the plan. Information required to be filed on schedule L which does not relate to the employees of a contributing employer need be filed only once, and need not be repeated on each schedule L filed for the plan.

(3) *Plans to which more than one employer contributes for which no multiple filings required.* If a plan to which more than one employer contributes is a plan to which this subparagraph applies, only one schedule L is required to be filed for the plan, regardless of the number of employers who contribute to the plan. A separate schedule L is not required for each contributing employer. Information required by schedule L that relates to employees of contributing employers is required only for those employers who adopt the plan before the date the schedule L is filed for the plan. A schedule L need not be filed with respect to employers who thereafter adopt the plan. In general, this subparagraph applies to any plan that is maintained pursuant to a collective bargaining agreement between employee representatives and more than one employer who is required by the plan instrument or other agreement to contribute to the plan with respect to employees (or their spouses or dependents) participating in the plan. This subparagraph does not apply, however, if all employers required to contribute to the plan are corporations which are members of a controlled group of corporations within the meaning of section 1563(a), determined without regard to section 1563(e)(3)(C). If all employers required to contribute to the plan are corporations which are members of such a controlled group, the filing requirements described in subparagraph (2) of this paragraph apply, notwithstanding that the plan is maintained pursuant to a collective bargaining agreement.

(c) *Internal Revenue Service action on notice of application for recognition.* The Internal Revenue Service will issue to the person submitting form 1024 and schedule L a ruling or determination letter stating that the plan is or is not a qualified group legal services plan. For general procedural rules, see Section 601.201(a) through (n), as that section relates to rulings and determination letters.

(d) *Period of plan qualification--(1) In general.* In the case of a favorable determination, the plan will be considered a qualified group legal services plan. If a schedule L required to be filed by or on behalf of an employer is filed before--

- (i) The end of the first plan year (as defined in the plan),
- (ii) The end of the plan year within which the employer adopts the plan, or
- (iii) (A date 91 days after this section is published in the FEDERAL REGISTER as a final regulation),

the period of plan qualifications with respect to the employer will begin on the date the plan is adopted by the employer (or, if later, January 1, 1977). If the schedule L is not filed before the latest of the dates described in subdivisions (i), (ii), and (iii), the period of plan qualification with respect to the employer will begin on the date of filing. If no schedule L is required to be filed by or on behalf of an employer (see paragraph (b)(3) of this section), the period of plan qualification with respect to the employer will begin on the date the plan is adopted by the employer (or, if later, January 1, 1977). However, if a plan is materially modified to conform to the requirements of section 120 either before or after a schedule L is filed, the period of plan qualification will not include any period before the effective date of the modifications.

(2) *Plans in existence on June 4, 1976.* (i) Notwithstanding paragraph (d)(1) of this section, a written group legal services plan providing for employer contributions which was in existence on June 4, 1976, will be considered a qualified group legal services plan for the period January 1, 1977, through April 2, 1977. However, if the plan is maintained pursuant to one or more agreements which were in effect on October 4, 1976, and which the Secretary of Labor finds to be collective bargaining agreements, the period of deemed qualification will extend beyond April 2, 1977, and end on the date on which the last of the collective bargaining agreements relating to the plan terminates. Extensions of a bargaining agreement which are agreed to after October 4, 1976, are to be disregarded. The period of deemed qualification for a plan maintained pursuant to a collective bargaining agreement will not, however, extend beyond December 31, 1981.

(ii) A written group legal services plan will be considered to have been in existence on June 4, 1976, if on or before that date the plan was reduced to writing and adopted by one or more employers. No amounts need have been contributed under the plan as of June 4, 1976.

(e) *Definitions and special rules--(1) Applicability.* The definitions and special rules in this paragraph apply with respect to information required to be filed on schedule L accompanying form 1024.

(2) *Employee.*--(i) The term "employee" includes an individual who is an employee within the meaning of section 410(e)(1) (relation to self-employed individuals).

(ii) An individual who owns the entire interest in an unincorporated trade or business is treated as his own employee.

(iii) Each partner who is an employee within the meaning of section 401(c)(1) is treated as an employee of the partnership.

(3) *Officer.* An officer is an individual who is an officer within the meaning of regulations prescribed under 414(c).

(4) *Shareholder.* The term "shareholder" includes an individual who is a shareholder as determined by the attribution rules under section 1563(d) and (e), without regard to section 1563(e)(3)(C).

(5) *Self-employed.* An individual is "self-employed" if he is self-employed within the meaning of section 401(c)(1).

(6) *Highly compensated.* The term "highly compensated" has the same meaning for purposes of the information required by schedule L, as for purposes of section 410(b)(1)(B).

(f) *Effective date.* This section is effective for notices of application for recognition of the status of a qualified group legal services plan submitted after (date of publication of this section as a final regulation).

JEROME KURTZ,
Commissioner of
Internal Revenue.

ATTACHMENT 2

SUGGESTED SAMPLE DETERMINATION LETTER RECOGNIZING EXEMPTION TO AN ORGANIZATION UNDER IRC 501(c)(20)

Dear Applicant:

We have considered your application for recognition of exemption from Federal income tax under section 501(c)(20) of the Internal Revenue Code of 1954.

The information submitted indicates that you were formed as a trust on July 1, 1977, for the purpose of providing prepaid legal services for participating employees. You were established by

You administer a group prepaid legal services plan for the benefit of active members, apprentices, retirees, and staff of certain visiting members of the international union, and their spouses and dependent children. All eligible employees are entitled to the same benefits.

The plan provides the cost of up to ten hours of legal consultations per year from a designated attorney. The plan also provides for the first twenty-five hours of office work per client per year and for up to seventy-five hours of court and/or administrative hearing representation for any one client in a given year.

The plan is maintained under the collective bargaining agreement effective July 1, 1977, between _____ and _____, which incorporates your trust instrument. The plan is supported by employer contributions at the rate of 10 cents per hour worked under the collective bargaining agreement.

Section 501(c)(20) of the Code provides for the exemption from Federal income tax of organizations or trusts created or organized in the United States, the exclusive function of which is to form part of a qualified group legal services plan or plans, within the meaning of section 120.

Section 120(b) of the Code states that a qualified group legal services plan is a separate written plan of an employer for the exclusive benefit of his employees or their spouses or dependents to provide such employees, spouses, or dependents with specified benefits consisting of personal legal services through prepayment of, or provision in advance for, legal fees in whole or in part by the employer if the plan meets the requirements of subsection (c).

According to section 120(c) of the Code, the following requirements must exist for qualification as a qualified legal services plan: (1) contributions or benefits provided under the plan must not discriminate in favor of employees who are shareholders, officers, self-employed, or highly compensated; (2) the plan must benefit employees who are eligible under a classification set up by the employer and ruled nondiscriminatory; (3) there must be a 25 percent contribution limitation on amounts contributed during the year and paid to shareholders owning more than five percent of the stock or the capital or profits interest of the employer; (4) the service must be notified that the plan is applying for recognition of status as a qualified group legal services plan, and (5) amounts contributed under the plan must be paid to designated recipients, including organizations and trusts exempt under section 501(c)(20).

The information submitted indicates that you were created in the United States and that your exclusive function is to form part of a qualified group legal services plan, within the meaning of section 120.

The information submitted also indicates that your legal services plan is a separate written plan of an employer, _____, for the exclusive benefit of active members, apprentices, retirees, and staff of _____, and certain visiting members of the international union. The plan provides such employees, their spouses and dependents with specified benefits consisting of personal legal service through prepayment of, or provision in advance for, legal fees in whole or in part by the employer. Additionally, the information submitted indicates that the plan satisfies the requirements of section 120(c) of the Code.

Accordingly, based upon the information submitted, we rule as follows:

1. _____ Legal Fund is exempt from Federal income tax under section 501(c)(2) of the Code.

2. _____ Legal Fund benefit plan is a qualified group legal services plan within the meaning of section 120 of the Code. Accordingly, gross income of covered employees, their spouses, or their dependents does not include (1) amounts contributed by the employer on behalf of an employee, his spouse, or his dependents, or (2) the value of legal services provided or amounts paid for legal services.

These rulings are effective for taxable years beginning after December 31, 1976.

This ruling is conditioned on the understanding that you will not participate in any group legal services plans unless such plans are qualified group legal services plans as defined in section 120 of the Code.

Unless specifically excepted, you are liable for taxes under the Federal Insurance Contributions Act (social security taxes) on remuneration of \$50 or more to each of your employees during a calendar quarter, and, unless excepted, you are also liable for tax under the Federal Unemployment Tax Act on remuneration of \$50 or more to each of your employees during a calendar quarter if, during the current or preceding calendar year, you have one or more employees at any time in each of 20 calendar weeks or pay wages of \$1,500 or more in any calendar quarter. If you have any questions about excise, employment, or other Federal taxes, please address them to your key District Director.

If your purposes, character, or method of operation is changed, you should let your key District Director know so he can consider the affect of the change on your exempt status. Also, you must inform him of all changes in your name and address.

You are required to file Form 990, Return of Organization Exempt From Income Tax, only if your gross receipts each year are normally more than \$10,000. If a return is required, it must be filed by the 15th day of the fifth month after the end of your annual accounting period. The law imposes a penalty of \$10 a day, up to a maximum of \$5,000, for failure to file the return on time.

You are not required to file Federal income tax returns unless you are subject to the tax on unrelated business income under section 511 of the Code. If you are subject to this tax, you must file an income tax return on Form 990-T. In this letter we are not determining whether any of your present or proposed activities are unrelated trade or business as defined in section 513 of the Code.

Please use your employer identification number on all returns you file and in all correspondence with the Internal Revenue Service.

We are informing your key District Director of this action. You should keep this ruling in your permanent records.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter.

Thank you for your cooperation.

Sincerely yours,

[Attachment 3 not shown here]