

Part I

Section 419.—Treatment of Funded Welfare Benefit Plans

26 CFR § 1.419-1T: Treatment of welfare benefit funds.

(Also, §§ 264, 7805; § 301.7805-1.)

Rev. Rul. 2007-65

ISSUES

(1) For purposes of determining the limitations on an employer's deduction for contributions to a welfare benefit fund under §§ 419 and 419A of the Internal Revenue Code (the "Code"), are premiums on cash value life insurance policies paid by the fund included in the fund's qualified direct cost if the benefit provided through the fund is life insurance coverage?

(2) For purposes of determining the limitations on an employer's deduction for contributions to a welfare benefit fund under §§ 419 and 419A, are premiums on cash value life insurance policies paid by the fund included in the fund's qualified direct cost if the benefit provided through the fund is other than life insurance coverage?

FACTS

Situation 1. Employer C maintains an employer-financed life insurance plan for the benefit of its employees. The life insurance provided to C's employees under the plan satisfies the definition of group-term life insurance for purposes of § 79 and is provided through a taxable trust. The plan does not provide permanent benefits within the meaning of § 1.79-0 of the Income Tax Regulations. The plan, which is not maintained pursuant to a collective bargaining agreement, provides that C will provide a stated amount of life insurance coverage for each employee while the employee is actively employed by C. No other benefits are provided to the employees under the plan or from the trust. The trustee has obtained a cash value life insurance policy on the life of each employee, where the amount of the death benefit under each policy equals the amount of the death benefit payable under the plan to the employee's beneficiary and the death benefit proceeds under each policy are payable to the beneficiary designated by the employee. The trust has retained all other policy rights. During the year, C contributes to the trust an amount equal to the aggregate premiums due on the life insurance policies payable by the trustee. The trust has no administrative expenses and no after-tax income (within the meaning of § 419(c)(4)) for the year. The taxable year for both C and the trust is the calendar year, and C uses the accrual method of accounting.

Situation 2. The facts are the same as in Situation 1 except that, instead of group-term life insurance, the plan provides disability benefits to C's employees if they become disabled while they are actively employed by C. The trust is the owner and the

named beneficiary of the life insurance policies held by the trust, which are intended to accumulate value to pay the disability benefits. The employees have no interest in the life insurance policies. During the taxable year, the trust distributed \$x of disability benefits with respect to claims incurred during the year (and there were no benefits paid during the year with respect to any claims incurred in prior years).

LAW

Section 419 prescribes limits on the amount of deductions for contributions paid or accrued by an employer to a welfare benefit fund. The term “welfare benefit fund” is defined in § 419(e)(1) to mean any fund that is part of a plan of an employer, and through which the employer provides welfare benefits to employees or their beneficiaries. Section 419(e)(2) defines “welfare benefit” as any benefit other than a benefit with respect to which § 83(h), § 404 (determined without regard to § 404(b)(2)), or § 404A applies. Under § 419(e)(3), a “fund” is any organization described in § 501(c)(7), (9), (17) or (20); any trust, corporation, or other organization not exempt from tax imposed by chapter 1, subtitle A of the Code; or, to the extent provided in regulations, any account held for an employer by any person (other than amounts described in § 419(e)(4)).

Under § 419(a) and (b), an employer’s contributions to a welfare benefit fund are deductible in the taxable year in which paid but only if they would otherwise be deductible under Chapter 1 of the Code, and the amount of the deduction is limited to the welfare benefit fund’s qualified cost for the taxable year. Pursuant to § 419(d), if the amount of the contributions paid by the employer during any taxable year to a welfare

benefit fund exceeds this deduction limit, the excess is treated as an amount paid by the employer to the fund during the succeeding taxable year.

The term “qualified cost” is defined in § 419(c)(1) to generally mean, with respect to any taxable year, the sum of (i) the qualified direct cost for that taxable year, and (ii) any addition to a qualified asset account for the taxable year (but only to the extent the addition does not exceed the limit on the additions to the account under § 419A(b)). Under § 419(c)(2), the fund’s qualified cost must be reduced by the fund’s after-tax income for the taxable year (as defined in § 419(c)(4)). Under § 419(c)(5), no item may be taken into account more than once in determining the qualified cost of any welfare benefit fund.

The term “qualified direct cost” is generally defined in § 419(c)(3)(A) to mean, with respect to any taxable year, the aggregate amount (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided during the year if (i) such benefits were provided directly by the employer, and (ii) the employer used the cash receipts and disbursements method of accounting. Under § 419(c)(3)(B), a benefit is treated for this purpose as provided when that benefit would be includible in the gross income of the employee if provided directly by the employer (or would be so includible but for a provision of chapter 1 of the Code excluding the benefit from gross income).

The term “qualified asset account” is defined in § 419A(a) to mean any account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, supplemental unemployment compensation benefits or severance pay

benefits, or life insurance benefits. Pursuant to § 419A(b), no additions to any qualified asset account may be taken into account under § 419(c)(1)(B) to the extent that the addition would result in the amount in the account exceeding the account limit specified in § 419A(c).

Section 419A(c)(1) provides that the account limit for any qualified asset account for any taxable year is generally the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits referred to in § 419A(a), and administrative costs with respect to those claims. Section 419A(c)(2) allows an additional limited reserve for certain post-retirement medical and post-retirement life insurance benefits to be provided to covered employees. Section 419A(c)(3) through (c)(6) and § 419A(d) and (e) specify additional rules with regard to the account limit under §419A(c).

Under Q&A-6(a) of § 1.419-1T of the Temporary Income Tax Regulations, the qualified direct cost of a welfare benefit fund for any taxable year of the fund is the aggregate amount that would have been allowable as a deduction to the employer for benefits provided by the fund during the year (including insurance coverage for the year) if (i) those benefits were provided directly by the employer and (ii) the employer used the cash receipts and disbursements method of accounting and had the same taxable year as the fund. In this regard, a benefit is treated as provided when the benefit would be includible in the gross income of the employee if provided directly by the employer (or would be so includible but for a provision excluding it from gross income). Under Q&A-6(c) of § 1.419-1T, the qualified direct cost of a welfare benefit

fund does not include expenditures by the fund that would not have been deductible if they had been made directly by the employer. As an example of such an expenditure, the regulations provide that a fund's purchase of land for an employee recreational facility will not be treated as a qualified direct cost, noting that the purchase would not have been deductible under § 263 if made directly by the employer. Q&A-6(c) of § 1.419-1T also refers to §§ 264 and 274.

In its explanation of "qualified direct cost," the legislative history of § 419 states that the rules in other Code sections that generally limit deductions if an employer provides the plan benefits directly are "passed through" to limit deductions with respect to fund contributions. An example of this limitation is given for fund expenditures for insurance that would not have been deductible under § 264 if made directly by the employer. "[T]hus, no deductions are available to the employer with respect to such expenditures." H.R. Rep. No. 432, 98th Cong., 2d Sess. at 1277-78 (1984).

Section 264(a)(1) provides that no deduction is allowable for premiums on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract.

Pursuant to § 61(a)(1), except as otherwise provided, gross income means all income from whatever source derived, including compensation for services, including fees, commissions, fringe benefits, and similar items. Gross income includes the value of any economic benefit conferred on an employee by his or her employer, whatever the form or mode by which it is effected. Commissioner v. Smith, 324 U.S. 177, 181 (1945), 1945 C.B. 49, 51. Accordingly, if an employer pays premiums on a life insurance policy

that it owns and the death benefits are payable to an employee's beneficiaries, the value of the economic benefits provided to the employee, including the cost of current life insurance protection, is includible in the employee's gross income annually. This is true even if the employee only has rights with respect to all or a portion of the death proceeds and the employer retains all other rights and benefits under the policy. See, e.g., Genshaft v. Commissioner, 64 T.C. 282, 290 (1975), acq., 1976-2 C.B. 2; Frost v. Commissioner, 52 T.C. 89, 96 (1969). Special rules apply under § 1.61-22 for a split-dollar life insurance arrangement, as that term is defined in § 1.61-22(b), that is entered into or materially modified after September 17, 2003.

Section 79 generally provides an exclusion from an employee's gross income for the cost of group-term life insurance on the employee's life provided under a policy carried directly or indirectly by his or her employer (or employers), but only to the extent that the cost does not exceed the cost of \$50,000 of coverage.

ANALYSIS

In Situation 1, the trust is a welfare benefit fund within the meaning of § 419(e). The qualified direct cost of the trust for the year involved is the aggregate amount (including administrative expenses) that would have been allowable as a deduction to C for the benefit provided by the trust during the year (current life insurance coverage) if the life insurance coverage had been provided directly by C, and if C had used the cash receipts and disbursements method of accounting. Under § 419(c)(3)(B), the life insurance coverage is treated as provided when it would be includible in the gross income of the employee if provided directly by the employer (or would be so includible

absent the exclusion from gross income provided under § 79). Absent the § 79 exclusion, the cost of the current life insurance protection provided to C's employees for part or all of a year is includible in the employees' incomes for that year.

If C had provided the current life insurance coverage directly (that is, if C had not interposed a trust to obtain and hold the cash value life insurance policies, but instead had held the policies and paid the premiums itself), C would have retained ownership rights in each of the policies, including the right to withdraw funds from a policy's cash value or to surrender the policy for cash. As a result, C would have been, directly or indirectly, a beneficiary under the policies. Thus, § 264(a) would have precluded any deduction by C with respect to the premium payments if C had owned the policies directly. See Rev. Rul. 70-148, 1970-1 C.B. 60.

Under § 419(c)(3) and Q&A-6(c) of § 1.419-1T, the qualified direct cost of a welfare benefit fund does not include expenditures by the fund that would not have been deductible if they had been made directly by the employer. Accordingly, the trust's qualified direct cost for the taxable year in Situation 1 does not include any amounts for premiums on the cash value life insurance policies paid by the trust. Further, because all the benefits provided by the plan are fully insured, no amounts are reasonably and actuarially necessary to fund claims incurred but unpaid for purposes of the account limit under § 419A(c)(1). Thus, the qualified cost is zero and no portion of C's contributions is deductible under § 419 for the taxable year.

The conclusions for Situation 1 are the same regardless of whether the plan benefits are provided through a taxable trust, an exempt VEBA described in § 501(c)(9),

or any other type of welfare benefit fund as defined in § 419(e). Also, the conclusions for Situation 1 are the same regardless of whether the death proceeds are payable from the insurance company directly to the beneficiaries designated by the employees, or are payable to the trust or plan for the benefit of the employees' beneficiaries. Additionally, the conclusions for Situation 1 are the same regardless of the number or amount of premiums, and regardless of the type of life insurance policy. Thus, the conclusions would apply, for example, to a variable policy, to a policy with level premiums payable to age 65, or to any other life insurance policy, if the trust is directly or indirectly a beneficiary under the policy. Further, the same rule applies if the employer, rather than the welfare benefit fund, is directly or indirectly a beneficiary under the policy.

The conclusion for Situation 1 that no deduction is allowable with respect to the premium amounts would be the same if the plan were an arrangement subject to the regulations for split-dollar life insurance arrangements. See § 1.61-22 for the rules for split-dollar life insurance arrangements, including § 1.61-22(c)(1)(iii)(C) (providing that the employer is treated as the owner of a life insurance policy if the owner is a welfare benefit fund within the meaning of § 419(e)(1)); and § 1.61-22(f)(2)(ii) (concerning the nondeductibility of premium amounts by the employer under a split-dollar arrangement).

In Situation 2, the qualified direct cost of the trust for the taxable year is the aggregate amount (including administrative expenses) that would have been allowable as a deduction to C for the uninsured disability benefits provided by the trust during the year if the disability benefits had been provided directly by C, and if C had used the cash receipts and disbursements method of accounting. In this regard, the disability

benefits are treated as provided when they would be includible in the gross income of the employees if provided directly by C (or would be includible in income absent a provision of the Code excluding them from income).

Under the facts of Situation 2, the trust paid \$x during the year with respect to disability benefits incurred during the year (and no benefits were paid with respect to any claims incurred in prior years). These disability benefits are includible in an employee's income under § 105(a) when the benefits are received by the employee. If Employer C had used the cash receipts and disbursements method of accounting, and if C had provided the uninsured disability benefits directly (that is, if C had not interposed a trust to provide the disability benefits, but instead had paid the disability benefits to the employees itself), C would have been allowed a deduction for the year for the \$x actually paid during the year. Thus, the fund's qualified direct cost for the year with respect to the benefits under the plan is \$x. Furthermore, if C had purchased the cash value life insurance policies directly to accumulate assets to pay the uninsured disability benefits, § 264(a) would have precluded any deduction by C with respect to the premium payments because C would have retained ownership rights in the policies. Thus, the premium amounts paid by the trust are not included in the fund's qualified direct cost under § 419(c)(3). However, some of C's contribution amounts may be deductible as qualified cost in the taxable year as an addition to a qualified asset account for disability claims incurred but unpaid as of the close of the taxable year, but only if the amounts are otherwise deductible, and only to the extent they are reasonably

and actuarially necessary to fund incurred but unpaid claims and satisfy the requirements of § 419A(c)(4) and (c)(5).

The conclusions for Situation 2 are the same regardless of whether the plan benefits are provided through a taxable trust, an exempt VEBA described in § 501(c)(9), or any other type of welfare benefit fund as defined in § 419(e). Additionally, the conclusions for Situation 2 are the same regardless of the type of assets, if any, purchased by the trustee to fund the disability benefits (other than the purchase of disability insurance to the extent the premiums paid for the insurance would otherwise be deductible by the employer if the employer had purchased it directly and the employer used the cash receipts and disbursement method of accounting). The conclusion for Situation 2 that the qualified direct cost does not include any amounts paid for life insurance premiums would be the same if the benefit or benefits provided under the plan were uninsured medical or severance benefits, or any other type of uninsured benefit.

HOLDINGS

(1) For purposes of determining the limitations on an employer's deduction for contributions to a welfare benefit fund under §§ 419 and 419A, if the benefit provided through the fund is life insurance coverage, premiums paid on cash value life insurance policies by the fund are not included in the fund's qualified direct cost whenever the fund is directly or indirectly a beneficiary under the policy within the meaning of § 264(a).

(2) For purposes of determining the limitations on an employer's deduction for contributions to a welfare benefit fund under §§ 419 and 419A, if the benefit provided

through the fund is other than life insurance coverage, premiums paid on cash value life insurance policies by the fund are not included in the fund's qualified direct cost whenever the fund is directly or indirectly a beneficiary under the policy within the meaning of § 264(a). However, the fund's qualified direct cost includes amounts paid as welfare benefits by the fund during the taxable year for claims incurred during the year.

PROSPECTIVE APPLICATION

Pursuant to the authority contained in § 7805(b)(8) and § 301.7805-1 of the Procedure and Administration Regulations, with respect to Holding (1) the Commissioner has determined that for any taxable year of an employer ending before November 5, 2007, if a deduction is otherwise allowable, then to the extent set forth in the following paragraph, a deduction for contributions to a welfare benefit fund under an arrangement that is not subject to the regulations applicable to split-dollar life insurance arrangements will not be disallowed under § 419(b) and (c)(3) merely because the deduction would have been disallowed under § 264 had the employer provided the benefits directly.

In the case of an employer with a taxable year that is the calendar year, the amount of the deduction that will not be disallowed for a taxable year is the portion of the amounts that are otherwise disallowed under this revenue ruling that were reported (or would have been reported but for the exclusion under § 79) by the employer as the cost of insurance on each employee's Forms W-2 (or Forms 1099) for that year. In the case of an employer with a taxable year other than the calendar year, the deduction that

will not be disallowed for a taxable year is the reported (and excluded) amounts described in the previous sentence that are properly allocable to the employer's taxable year. In either case, these amounts are to be determined without regard to any amendment to any Form W-2 or Form 1099 made after October 17, 2007.

REFERENCE TO LISTED TRANSACTIONS NOTICE

Some of the arrangements described in this revenue ruling and substantially similar arrangements (as well as certain other arrangements utilizing cash value life insurance policies for which an employer has deducted amounts as contributions to a welfare benefit fund) may be transactions that have been designated as listed transactions. See Notice 2007-83, this Bulletin. If a transaction is designated as a listed transaction, affected persons may be subject to additional penalties and disclosure responsibilities.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Betty J. Clary of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities) and Larry Isaacs of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact Betty J. Clary at (202) 622-6080 (not a toll-free call) or Larry Isaacs at RetirementPlanQuestions@irs.gov.