Abusive Insurance, Welfare Benefit, and Retirement Plans

By Lance Wallach

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The IRS has various task forces auditing all section 419, section 412(i), and other plans that tend to be abusive. These plans are sold by most insurance agents. The IRS is looking to raise money and is not looking to correct plans or help taxpayers. The fines for being in a listed, abusive, or similar transaction are up to $200,000 per year (section 6707A), unless you report on yourself. The IRS calls accountants, attorneys, and insurance agents ''material advisers'' and also fines them the same amount, again unless the client's participation in the transaction is reported. An accountant is a material adviser if he signs the return or gives advice and gets paid. More details can be found on http://www.irs.gov and http://www.vebaplan.com.

Bruce Hink, who has given me written permission to use his name and circumstances, is a perfect example of what the IRS is doing to unsuspecting business owners. What follows is a story about how the IRS fined him $200,000 a year for being in what they called a listed transaction. Listed transactions can be found at www.irs-.gov. Also involved are what the IRS calls abusive plans or what it refers to as substantially similar. Substantially similar to is very difficult to understand, but the IRS seems to be saying ''if it looks like some other listed transaction, the fines apply.'' Also, I believe that the accountant who signed the tax return and the insurance agent who sold the retirement plan will each be fined $200,000 as material advisers. We have received many calls for help from accountants, attorneys, business owners, and insurance agents in similar situations. Don't think this will happen to you? It is happening to a lot of accountants and business owners, because most of these so-called listed, abusive, or substantially similar plans are being sold by insurance agents.

Recently I came across the case of Hink, a small-business owner who is facing $400,000 in IRS penalties for 2004 and 2005 because of his participation in a section 412(i) plan. (The penalties were assessed under section 6707A.)

In 2002 an insurance agent representing a 100-year-old, well-established insurance company suggested the owner start a pension plan. The owner was given a portfolio of information from the insurance company, which was given to the company's outside CPA to review and give an opinion on. The CPA gave the plan the green light and the plan was started.

Contributions were made in 2003. The plan administrator came out with amendments to the plan, based on new IRS guidelines, in October 2004.

The business owner's insurance agent disappeared in May 2005, before implementing the new guidelines from the administrator with the insurance company. The business owner was left with a refund check from the insurance company, a deduction claim on his 2004 tax return that had not been applied, and no agent.

It took six months of making calls to the insurance company to get a new insurance agent assigned. By then, the IRS had started an examination of the pension plan. Asking advice from the CPA and a local attorney (who had no previous experience in these cases) made matters worse, with a ''big name'' law firm being recommended and over $30,000 in additional legal fees being billed in three months.

To make a long story short, the audit stretched on for over 2½ years to examine a 2-year-old pension with four participants and $178,000 in contributions.

During the audit, no funds went to the insurance company, which was awaiting formal IRS approval on restructuring the plan as a traditional defined benefit plan, which the administrator had suggested and the IRS had indicated would be acceptable. The $90,000 in 2005 contributions was put into the company's retirement bank account along with the 2004 contributions.

In March 2008 the business owner received a private e-mail apology from the IRS agent who headed the examination, saying that her hands were tied and that she used to believe she was correcting problems and helping taxpayers and not hurting people.

The IRS denied any appeal and ruled in October 2008 the $400,000 penalty would stand. The IRS fine for being in a listed, abusive, or similar transaction is $200,000 per year for corporations or $100,000 per year for unincorporated entities. The material adviser fine is $200,000 if you are incorporated or $100,000 if you are not.

Could you or one of your clients be next?

To this point, I have focused, generally, on the horrors of running afoul of the IRS by participating in a listed transaction, which includes various types of transactions and the various fines that can be imposed on business owners and their advisers who participate in, sell, or advise on these transactions. I happened to use, as an example, someone in a section 412 plan, which was deemed to be a listed transaction, pointing out the truly doleful consequences the person has suffered. Others who fall into this trap, even unwittingly, can suffer the same fate.

Now let's go into more detail about section 412(i) plans. This is important because these defined benefit plans are popular and because few people think of retirement plans as tax shelters or listed transactions. People therefore may get into serious trouble in this area unwittingly, out of ignorance of the law, and, for the same reason, may fail to take necessary and appropriate precautions.

The IRS has warned against section 412(i) defined benefit pension plans, named for the former code section governing them. It warned against trust arrangements it deems abusive, some of which may be regarded as listed transactions. Falling into that category can result in taxpayers having to disclose the participation under pain of penalties, potentially reaching $100,000 for individuals and $200,000 for other taxpayers. Targets also include some retirement plans.

One reason for the harsh treatment of some 412(i) plans is their discrimination in favor of owners and key, highly compensated employees. Also, the IRS does not consider the promised tax relief proportionate to the economic realities of the transactions. In general, IRS auditors divide audited plans into those they consider noncompliant and others they consider abusive. While the alternatives available to the sponsor of a noncompliant plan are problematic, it is frequently an option to keep the plan alive in some form while simultaneously hoping to minimize the financial fallout from penalties.

The sponsor of an abusive plan can expect to be treated more harshly than participants. Although in some situations something can be salvaged, the possibility is definitely on the table of having to treat the plan as if it never existed, which of course triggers the full extent of back taxes, penalties, and interest on all contributions that were made — not to mention leaving behind no retirement plan whatsoever.

Another plan the IRS is auditing is the section 419 plan. A few listed transactions concern relatively common employee benefit plans the IRS has deemed tax avoidance schemes or otherwise abusive. Perhaps some of the most likely to crop up, especially in small-business returns, are arrangements purporting to allow deductibility of premiums paid for life insurance under a welfare benefit plan or section 419 plan. These plans have been sold by most insurance agents and insurance companies.

Some of these abusive employee benefit plans are represented as satisfying section 419, which sets limits on purposes and balances of ''qualified asset accounts'' for the benefits, although the plans purport to offer deductibility of contributions without any corresponding income. Others attempt to take advantage of exceptions to qualified asset account limits, such as sham union plans that try to exploit the exception for separate welfare benefit funds under collective bargaining agreements provided by section 419A(f)(5). Others try to take advantage of exceptions for plans serving 10 or more employers, once popular under section 419A(f)(6). More recently, one may encounter plans relying on section 419(e) and, perhaps, defined benefit section 412(i) pension plans.

Sections 419 and 419A were added to the code by the Deficit Reduction Act of 1984 in an attempt to end employers' acceleration of deductions for plan contributions. But it wasn't long before plan promoters found an end run around the new code sections. An industry developed in what came to be known as 10-or-more-employer plans.

The IRS steadily added these abusive plans to its designations of listed transactions. With Revenue Ruling 90-105, it warned against deducting some plan contributions attributable to compensation earned by plan participants after the end of the tax year. Purported exceptions to limits of sections 419 and 419A claimed by 10-or-more-employer benefit funds were likewise proscribed in Notice 95-34 (*Doc 95-5046*, *95 TNT 98-11*). Both positions were designated as listed transactions in 2000.

At that point, where did all those promoters go? Evidence indicates many are now promoting plans purporting to comply with section 419(e). They are calling a life insurance plan a welfare benefit plan (or fund), somewhat as they once did, and promoting the plan as a vehicle to obtain large tax deductions. The only substantial difference is that these are now single-employer plans. And again, the IRS has tried to rein them in, reminding taxpayers that listed transactions include those substantially similar to any that are specifically described and so designated.

On October 17, 2007, the IRS issued Notices 2007-83 (*Doc 2007-23225*, *2007 TNT 202-6*) and 2007-84 (*Doc 2007-23220*, *2007 TNT 202-5*). In the former, the IRS identified some trust arrangements involving cash value life insurance policies, and substantially similar arrangements, as listed transactions. The latter similarly warned against some postretirement medical and life insurance benefit arrangements, saying they might be subject to ''alternative tax treatment.'' The IRS at the same time issued related Rev. Rul. 2007-65 (*Doc 2007-23226*, *2007 TNT 202-7*) to address situations in which an arrangement is considered a welfare benefit fund but the employer's deduction for its contributions to the fund is denied in whole or in part for premiums paid by the trust on cash value life insurance policies. It states that a welfare benefit fund's qualified direct cost under section 419 does not include premium amounts paid by the fund for cash value life insurance policies if the fund is directly or indirectly a beneficiary under the policy, as determined under section 264(a).

Notice 2007-83 targets promoted arrangements under which the fund trustee purchases cash value insurance policies on the lives of a business's employee/owners, and sometimes key employees, while purchasing term insurance policies on the lives of other employees covered under the plan. These plans anticipate being terminated and anticipate that the cash value policies will be distributed to the owners or key employees, with little distributed to other employees. The promoters claim that the insurance premiums are currently deductible by the business and that the distributed insurance policies are virtually tax free to the owners. The ruling makes it clear that, going forward, a business under most circumstances cannot deduct the cost of premiums paid through a welfare benefit plan for cash value life insurance on the lives of its employees.

Should a client approach you with one of these plans, be especially cautious, for both of you. Advise your client to check out the promoter very carefully. Make it clear that the government has the names of all former section 419A(f)(6) promoters and, therefore, will be scrutinizing the promoter carefully if the promoter was once active in that area, as many current section 419(e) (welfare benefit fund or plan) promoters were. This makes an audit of your client more likely and far riskier.

It is worth noting that listed transactions are subject to a regulatory scheme applicable only to them, entirely separate from Circular 230 requirements, regulations, and sanctions. Participation in such a transaction must be disclosed on a tax return, and the penalties for failure to disclose are severe — up to $100,000 for individuals and $200,000 for corporations. The penalties apply to both taxpayers and practitioners. And the problem with disclosure, of course, is that it is apt to trigger an audit, in which case even if the listed transaction were to pass muster, something else may not.