

Internal Revenue Service

DEC 16 2001

Employee Plans Technical Advice Memorandum

200514022

Taxpayer's Name:

Taxpayer's Address:

SE.T. EP. RA. T. A1

Taxpayer's Identification Number: EIN:

Year Involved:

Taxpayer =

Fund =

Issues

- (1) Whether the Fund is a welfare benefit fund under the provisions of Section 419 of the Internal Revenue Code (the "Code").
- (2) Whether qualified direct costs under the provisions of section 419(c)(3) of the Code only includes claims that are either (a) funded through and paid directly to health care providers and employees by a welfare benefit fund set up by an employer or (b) paid directly to health care providers and employees by the employer from a corporate account and reimbursed by the welfare benefit fund pursuant to a reimbursement agreement entered into between the welfare benefit fund and the employer (i.e. benefits provided by the employer as an agent for the fund).
- (3) Whether an actuarial certification of a welfare benefit account limit under section 419A(c) of the Code can be based on the total expenditures of the welfare benefit fund and an employer or merely the total expenditures of the welfare benefit fund.

Facts

The Taxpayer is an accrual basis taxpayer with an October 1 to September 30 fiscal year.

Effective, [REDACTED] the Taxpayer and certain individuals (the "Trustees") entered into an agreement to establish a trust (the "Fund") to implement and form a part of certain employee benefit plans (the "Plans") previously adopted by the Taxpayer. The Plans are represented to be "employee welfare benefit plans" as defined in section 3(1) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The Plans are represented to provide life, sick, and accident, or other qualifying benefits described in section 1.501(c)(9)-3(b), (c), and (d) of the Treasury Regulations. The Fund received a letter dated March 9, 1992, determining its status as an organization described section 501(c)(9) of the Code.

Through [REDACTED] all payments for benefits provided by the Plans were made through the Fund either directly to health care providers or, in the case of (section 125 of the Code) flexible spending account benefits, to the employees. Through [REDACTED] the Taxpayer funded all benefits through the Fund, other than flexible spending account benefits that were funded by employee contributions.

Beginning [REDACTED] the Taxpayer changed the operation of the Fund. At that time, the Taxpayer began a process of funding the Fund only at year-end, in an amount estimated to be equal to the amount of claims incurred but unreported at year-end. (Employees continued to contribute to the Fund to fund the flexible spending account benefits). Also, beginning [REDACTED] all benefits provided by the Plans were paid directly by the Taxpayer (i.e. not through the Fund), other than benefits associated with the employees' flexible spending account plan.

Concurrent with the change in operation of the Fund, the Taxpayer and the Fund entered into an agreement that provided that the Fund would reimburse the Taxpayer and accept as a liability the debts and expenses of the Taxpayer associated with the Taxpayer's payment of medical expenses otherwise eligible for coverage under the Fund, to the full extent of its assets, when requested by the Taxpayer. (The Taxpayer represents that, in operation, the amounts contributed by the Taxpayer at the end of each year to the Fund are usually returned to the Taxpayer within the first two and one-half months of the following year as reimbursement for benefit payments paid directly by the Taxpayer in such following year.)

Law

Section 419(a) of the Code provides that contributions paid or accrued to a welfare benefit fund shall not be deductible under chapter 1, but if they would otherwise be deductible shall (subject to the limitation of subsection (b)) be deductible under section 419 for the taxable year when paid.

Section 419(b) of the Code provides that the amount of any deduction under subsection 419(a) for any taxable year shall not exceed the welfare benefit fund's qualified cost for the taxable year.

Section 419(c)(1) of the Code provides that for purposes of section 419(a), except as otherwise provided for in subsection 419(c), the term "qualified cost" means, with respect to any taxable year, the sum of the qualified direct cost for the taxable year and, subject to the limitations of section 419A(b) of the Code, any additions to a qualified asset account for the taxable year.

Section 419(c)(2) of the Code provides that in the case of any welfare benefit fund, the qualified cost for any taxable year shall be reduced by such fund's after-tax income for such taxable year.

Section 419(c)(3)(A) of the Code provides that the term "qualified direct cost" means, with respect to any taxable year, the aggregate amount (including administrative expenses) which would have been allowable as a deduction to the employer with respect to the benefits provided during the taxable year if such benefits were provided directly by the employer, and the employer used the cash receipts and disbursements method of accounting.

Section 419(c)(5) of the Code provides that no item may be taken into account more than once in determining the qualified cost of any welfare benefit fund.

Section 419(e)(1) of the Code provides that for purposes of section 419, the term "welfare benefit fund" means any fund which 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) of the Code provides that for purposes of section 419, the term "welfare benefit" means any benefit other than a benefit with respect to which section 83(h) applies, section 404 applies (without regard to section 404(b)(2)), or section 404A applies.

Section 419(e)(3) of the Code provides that for purposes of section 419 the term "fund" means any organization described in paragraph (7), (9), (17), or (20) of section 501(c), any trust, corporation, or other organization not exempt from tax imposed by chapter 1, and to the extent provided in regulations, any account held for an employer by any person.

Section 419A(a) of the Code provides that for purposes of subpart D and section 512, the term "qualified asset account" means any account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits.

Section 419A(b) of the Code provides that no addition to any qualified asset account may be taken into account under section 419(c)(1) to the extent such addition results in an amount exceeding the account limit.

Section 419A(c)(1) provides that, except as otherwise provided in subsection 419A(c), the account limit for any qualified asset account for any taxable year is the amount reasonably and actuarially necessary to fund the claims incurred but unpaid (as of the close of such taxable year) for benefits referred to in subsection 419A(a) and administrative costs with respect to such claims.

Section 419A(c)(5)(A) of the Code provides that unless there is an actuarial certification of the account limit determined under subsection 419A(c) for any taxable year, the account limit for such taxable year shall not exceed the sum of the safe harbor limits for such taxable year.

Section 419A(c)(5)(B)(ii) of the Code provides that, in the case of medical benefits, the safe harbor limit for any taxable year is 35 percent of the qualified direct costs (other than insurance premiums) for the immediately preceding taxable with respect to medical benefits.

Section 501(c)(9) of the Code provides that voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual, are organizations referred to in subsection 501(a).

Q & A -6(a) of section 1.419-1T of the regulations provides, in part, the following example of a qualified direct cost:

If a calendar year welfare benefit fund pays an insurance company in July 1986 the full premium for coverage of its current employees under a term health insurance policy for the twelve month period ending June 30, 1987, the insurance company will be treated as provided by the fund over such twelve month period. Accordingly, only the portion of the premium for coverage during 1986 will be treated as a "qualified direct cost" of the fund for 1986, the remaining portion of the premium will be treated as a "qualified direct cost" of the fund for 1987.

Q & A-6(a) of section 1.419-1T of the regulations further provides that the "qualified direct cost" for a taxable year includes the administrative expenses incurred by the welfare benefit fund in delivering the benefits for the year.

Q & A-6(c) of section 1.419-1T of the regulations provides that 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. For example, a fund's purchase of land in a year for an employee recreational facility will not be treated as a qualified direct cost because, if made directly by the employer, the purchase would not have been deductible under section 263.

Analysis - Issue 1.

The Fund has been determined to be an organization described in paragraph (9) of section 501(c) of the Code. The Fund is part of a plan of the Taxpayer through which the Taxpayer provides welfare benefits to its employees or their beneficiaries. Therefore, the requirements of section 419(e) are satisfied and the Fund is a welfare benefit fund within the meaning of section 419(e).

Analysis - Issue 2.

Section 419(c)(3) of the Code provides, in part, that the term "qualified direct cost" means the amount that would have been allowable as a deduction to the employer with respect to the *benefits provided during the taxable year* if such benefits were provided by the employer (italics added). In the instant case, the issue is whether the italicized fragment of the preceding sentence refers merely to benefits provided by the welfare benefit fund (including benefits that are provided by the employer as an agent for the fund) or could be taken to mean benefits provided by either the fund or the employer.

In this regard, if it were to be inferred that the italicized fragment above could be taken to also include benefits provided by the employer, it would then be necessary (to avoid taking items into account more than once) to infer additional language in section 419(c)(3) providing that if such benefits provided during the taxable year were provided by the employer, such benefits would only fit within the meaning of qualified direct costs if the employer did not take a deduction for such benefits. Clearly, the more straightforward interpretation of section 419(c)(3) is that the fragment "benefits provided during the taxable year" refers only to benefits provided by a welfare benefit fund and thus, qualified direct costs are limited to costs paid directly by a welfare benefit fund (including benefits that are provided by the employer as an agent for the fund).

Moreover, the examples incorporated in Q & A-6(a) and (c) of section 1.419-1T of the regulations each exemplify the meaning of qualified direct cost by way of expenditures paid by a welfare benefit fund. It is only with reference to administrative expenses (in paragraph (a)) that qualified direct costs are described in terms of expenses "incurred" (as opposed to paid). However, even in that instance the reference is with regard to "*delivering* the benefits during the year" (italics added). Therefore, Q & A-6 of section 1.419-1T also supports the conclusion that qualified direct costs are limited to costs paid directly by a welfare benefit fund (including benefits that are provided by the employer as an agent for the fund).

Thus, in the instant case, qualified direct costs would generally not include payments of benefits made directly by the employer during the final nine and one-half months of the year (i.e. payments for which the employer is not reimbursed by the fund). Under the double-counting prohibition of section 419(c)(5), qualified direct costs might also not include reimbursement payments made by the fund to the employer in the first two and one-half months of the year if those payments are viewed as depleting the qualified asset account additions which were deducted in the prior year. The safe harbor limit of section 419A(c)(5)(B)(ii) would therefore be zero (35 percent of zero is zero). Even if those reimbursement payments do give rise to qualified direct costs, 35 percent of those payments would still be less than the account limit that is needed to support a deduction of the year-end contributions.

Analysis - Issue 3

Section 419A(c)(1) of the Code provides that except as otherwise provided in that subsection, the account limit for any qualified asset account for any taxable year is the amount reasonably and actuarially necessary to fund claims incurred but unpaid (and administrative costs with respect to such claims). Section 419A(c)(5)(A) provides that, without actuarial certification, the account limit of a qualified asset account may not exceed the safe harbor limit for the taxable year. Section 419A(c)(5)(B)(ii) provides that in the case of medical benefits, the safe harbor limit is 35 percent of the qualified direct costs (other than insurance premiums) for the immediately preceding taxable year with respect to medical benefits.

In the situation where there is actuarial certification, however, section 419A(c)(1) provides that the limit is the amount reasonably and actuarially necessary to fund claims incurred but unpaid. Thus, the limit is merely based on an estimate of the liability of the welfare benefit fund at the end of the taxable year. Generally, an actuary would estimate this liability by studying historical patterns of claims paid in years subsequent to the years in which such claims were incurred. The fact that a sponsoring employer may have, in the past, voluntarily paid claims for which a welfare benefit fund had liability does not alter this conclusion.

For example, consider two funds (Fund A and Fund B), in which the respective fund actuaries correctly estimated, for each, incurred but unreported claims of \$500 as of the end of 2003 due (it turned out) to unreported claims of \$250 on December 22, 2003, and December 26, 2003. For each fund, the sponsoring employer (Employer A and Employer B) contributed an amount such that the balance of the fund was \$500 as of the close of business on December 31, 2003. In each fund the sponsoring employer made no other contributions subsequent to December 31, 2003, before December 31, 2004.

In Fund A, the first reported claims in 2004 were the unreported \$250 claims of December 22, 2003, and December 26, 2003. In Fund B, a claim of \$500 was incurred on January 1, 2004, and reported on January 2, 2004, before either of the unreported claims of \$250 of December 22, 2003, and December 26, 2003, were reported.

In Fund A after the incurred claims of December 22, 2003, and December 26, 2003, were paid the balance of the fund was zero. All subsequent claims in 2004 (i.e. for incidents incurred in 2004) were paid directly by Employer A.

In Fund B, after the incurred claim of January 1, 2004, was paid the balance of the fund was zero. All subsequent claims paid in 2004 (including the claims incurred on December 22, 2003, and December 26, 2003) were directly paid by Employer B.

In this example the respective actuaries for Funds A and B, each correctly estimated the incurred but unreported claims as of the end of 2003 for the respective funds. The fact that in Fund B the incurred but unreported claims at the end of 2003 were subsequently paid by Employer B directly and not by Fund B is immaterial.

Conclusions

- (1) The Fund is a welfare benefit fund under the provisions of section 419 of the Code.
- (2) Qualified direct costs under the provisions of section 419(c)(3) of the Code only includes claims that are either (a) funded through and paid directly to health care providers and employees by a welfare benefit fund set up by an employer or (b) paid directly to health care providers and employees by the employer from a corporate account and reimbursed by the welfare benefit fund pursuant to a reimbursement agreement entered into between the welfare benefit fund and the employer.
- (3) An actuarial certification of a welfare benefit account limit under section 419A(c) may be based on the total expenditures of the welfare benefit fund plus any additional expenditures by a sponsoring employer that would qualify as qualified direct costs if paid by the welfare benefit fund, but in either case only to the extent such expenditures are for claims paid in years subsequent to the years in which such claims were incurred.