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Multiple Employer Welfare Benefit Plans Have Advantages for Employees and Executives

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Multiple Employer Welfare Benefit Plans Have Advantages for Employees and Executives

These plans have increased in recent years as qualified plan benefits, welfare benefits, and fringe benefits have become more expensive and elusive for both employers and employees.

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As employers have struggled to provide deductible tangible benefits to rank-and-file employees and executives, they are increasingly turning to multiple employer welfare benefit plans.

KEY EMPLOYEE BENEFITS

Benefits provided under a multiple employer welfare benefit plan typically include medical, death, or severance benefits, or any combination of these.

Welfare benefits. These are benefits other than pension or retirement benefits that are similar to life, sick, and accident benefits intended to either safeguard or improve the health of an employee or the employee's dependents, or protect against events that interrupt or impair an employee's earning power.[1]

Death benefits. These are payable only on the death of an employee who is still in "employee" status, i.e., post-retirement death benefits cannot be paid to former employees in retirement status. Although death benefits are generally paid to all covered employees, some plans limit the ability of "control persons" to participate beyond the later of age 70½ or ten years of participation. Control persons may be deemed to include director-employees and owner-employees who control business decisions of sponsoring employer enterprises.

Calculation. Death benefits are determined when the employee first becomes a participant in the plan, in accordance with the adoption agreement of the sponsoring employer. The employer may change the death benefit by amending the adoption agreement, but only prospectively. The multiple used to calculate the death benefit should be uniform for all employees, except that a lower multiple may be adopted for control persons or highly compensated employees (HCEs); some plans, however, specify a minimum death benefit for all covered employees. In addition, lower death benefit multiples may be provided for employees who are deemed substandard risks by insurance companies due to factors such as lifestyle or poor health.

Objectives. Death benefits are designed to provide assistance to families or beneficiaries of employees who die during their working career. This is precisely the type of contingency that a welfare benefit is designed to meet, reducing the burden on surviving family members and on the public, which can use funds from government welfare programs to benefit others. It is probable that the direct subsidy of these tax incentives, provided under the Code and administered by the private sector, is significantly more cost-efficient and timely than similar benefits administered through the large federal and state government welfare bureaucracy. Accordingly, the death benefit can be used to replace lost income, or pay funeral expenses for families who lose a wage earner. Statistically, this benefit may be somewhat remote for most employees but can still be critically important to families who experience a sudden, unexpected death.

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It is perhaps most significant to rank-and-file employees at or near the poverty level who may own no life insurance other than employer-provided (e.g., group-term life) insurance. Privately purchased life insurance may be an unaffordable luxury for many workers.

Medical benefits. These are traditional benefits for health care, typically designed to supplement group health care benefits in place. Low-income employees may be able to deduct related medical expenses paid, resulting in a partially or fully nontaxable employee benefit. Middle- and high-income employees, however, may be able to deduct only a portion of the medical expenses paid with respect to these benefits, resulting in a partially or fully taxable benefit. This is due to the classification of health care expenditures or "medical expenses" as itemized deductions subject to limitations based on adjusted gross income for tax purposes. Consequently, the higher the employee's income, the higher the medical expenses must be to overcome the limitation and obtain a deduction.

Severance pay. Severance pay benefits are provided on termination of employment. Terminations may be caused by numerous events for legitimate business purposes, including layoffs, shut-downs, terminations other than for cause, permanent disability, voluntary withdrawals with reasonable cause, company-wide reductions in force, and similar events dictated by the routine business necessities in any enterprise. Severance is typically not payable in the event of death, dismissal for cause, normal retirement, or continued employment after a specified forfeiture age. Severance benefits can never be paid based merely on the passage of time.

Severance benefits provide supplemental income benefits to bridge the period between termination of employment and obtaining new employment, to defray burdensome expenses incurred personally after termination, and to enhance the employee's standard of living after termination. Accordingly, this is the most tangible and perhaps the most needed benefit provided. It is extremely helpful to both rank-and-file employees who may have few reserves on which to rely, and to managers and executives who typically will have an extended period of unemployment before finding a replacement position.

Lack of other tangible benefits. A significant number of rank-and-file employees are likely to terminate employment with their present employer prior to reaching normal retirement age. It appears that this national trend is escalating and employee turnover is increasing. Moreover, many of these employees will be terminated or sever employment after only a short time, before they would vest in or be entitled to any benefits under a qualified pension plan. Such short-term employees may view qualified pension benefits as illusory because they know they are not likely to be employed long enough to vest and, therefore, will receive no benefit whatsoever. For these employees, the severance benefit may be the only tangible benefit they are likely to receive. Executives and managers who have been subjected to the massive reductions in force (RIFs) and corporate restructurings of the 1990s are also likely to view severance pay as a real and tangible benefit.

Employer contributions. Employer contributions to a plan are generally determined annually by the employer and the plan actuary, based on the benefit levels targeted by the employer and on the employee census. Death benefits are typically based on a percentage of average annual compensation for some period prior to the date of death. These percentages vary plan by plan but typically range between 100% and 1000% of average annual compensation. Thus, the employer may target funding the death benefit from one to ten times annual compensation. Severance benefits may range from a small percentage of average annual compensation up to a maximum of two times average annual compensation. This upward limitation is contained in DOL Reg. 2510.3-2(b)(1)(ii) and appears to be shared by most plans.

> **For employees who leave an employer within a short time, severance pay may be the only tangible benefit they receive.**

Severance benefits may be calculated using a percentage-of-compensation or money-purchase method. To determine the severance benefit under the percentage-of-compensation method, the employee's compensation for the calendar year preceding termination is multiplied by a percentage. For purposes of this calculation, the maximum total benefit is limited to 200% of compensation for the 12-month period preceding termination.

Money-purchase method. Alternatively, severance benefits can be calculated under the money-purchase method by dividing an employee's compensation at the time of severance by the total compensation of the employer

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[1] Reg. 1.501(c)(9)-3(d).

group. The resulting percentage is multiplied by the total severance account balance to determine the severance benefit. The benefit formula generally applies to all employees, except that a more restrictive formula may apply to HCEs. Payments to HCEs may be reduced to the extent that, at the time of termination, the trust account attributable to the employer's group of employees is insufficient to fund the severance pay benefits for all members of the group. Moreover, a vesting schedule that can be elected by a participating employer may further limit severance benefits.

Under the multiple employer trust exception, a plan cannot maintain experience-rated arrangements with respect to individual employers.

LEGISLATIVE BACKGROUND

Welfare benefit plans have traditionally been used to provide welfare benefits to employees, with a current deduction for employers, and without current taxation to the employees. The early rules allowed employers to overfund or prefund substantial benefits for future periods, obtain a large income tax deduction, and thereby mismatch the timing of income and deductions without risk of losing the prefunded or overfunded contributions. In these plans, the employer often had total control over assets in the plan, benefits could be paid in a discriminatory manner in favor of HCEs, and the employer could receive a reversion of the overfunded contributions. Consequently, these plans could function as a form of deferred compensation for officers, executives, and professionals.

In response to these perceived abuses, Congress enacted Code Sections 419 and 419A under DRA '84. These sections limited deductions to the cost of current welfare benefits determined as if the employer provided the benefits directly, plus an amount sufficient to cover accrued but unpaid welfare claims incurred. In addition, Code Section 4976 imposed a 100% excise tax on extreme abuses defined as "disqualified benefits." Disqualified benefits include reversions to the employer and discriminatory post-retirement death and medical payments. These deduction limitations and the potential excise tax effectively preclude use of a welfare plan as a deferred compensation arrangement.

MULTIPLE EMPLOYER WELFARE BENEFIT TRUST EXCEPTION

Congress determined that a multiple employer benefit plan with risks of forfeiture would not be subject to the perceived past abuses, and it enacted the exception in Section 419A(f)(6).[2] In addition, Congress enacted several safe harbor provisions, which may reflect congressional recognition that welfare benefits are significant and meaningful benefits that should be available in a nondiscriminatory manner. Employer contributions to a welfare benefit plan that is part of a multiple employer plan and trust established under Section 419A(f)(6) (exception for ten-or-more employer plans) are not subject to the funding limitations imposed by Sections 419 and 419A.[3]

To qualify under the ten-or-more employer plan exception, the trust must be made up of ten or more employers, and no employer can normally contribute more than 10% of the total contributed to the plan by all employers. This structure was intended to remove the ability of any one employer (or small group) to control the trust and its assets. In enacting Sections 419 and 419A, Congress was attempting to prevent employers from taking premature deductions for expenses not yet incurred, apparently concluding that this was not a problem in the ten-or-more employer plan context.

Experience rating. Although the IRS has not defined experience rating for purposes of the Section 419A(f)(6) exception, it is generally understood to mean that the plan cannot maintain experience rating arrangements with respect to individual employers relative to other employers in the group. The Committee Reports on Section 419A(f)(6) indicated that a participating employer's relationship to the plan should be similar to that of an insured to an insurer.[4]

In group life and group health insurance, experience rating means that the determination of an employer's liability is based solely on the actual historical experience of that employer. It includes the practice of adjusting premiums

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[2] The rationale behind this exception was stated as follows:

"The exclusion is provided because, under such plan, the relationship of a participating employer to the plan is often similar to the relationship of an insured to an insurer ... however, a plan is not exempt from the deduction limits if the liability of any employer who maintains the plan is determined on the basis of experience rating because the employer's interest with respect to such a plan is more similar to the relationship of an employer to a fund than an insured to an insurer." H. Rep't No. 98-861, 98th Cong., 2d Sess. 1159 (1984), 1984-3 CB (Vol. 2) 1159.

[3] This exception for any welfare benefit fund that is part of a ten-or-more-employer plan does not apply to any plan that maintains experience-rating arrangements with respect to individual employers.

[4] Note 2, *supra*.

to reflect the difference between the anticipated and the actual cost of benefits. The Supreme Court has defined experience rating as determining "the cost of insurance to the group [as] based on that group's claims experience, rather than general actuarial tables."[5] To determine if a plan used experience rating, the way in which deviations from projected experience affected the contributions of employers is examined. In an experience-rated plan, experience gains result in lower contribution obligations to employers while experience losses produce higher contributions.

Congress did not want multiple employer plans to use experience rating because it would give employers an incentive to overfund plans and, in turn, increase the possibility of a reversion to the employer. Thus, to qualify for the multiple employer trust exception, a plan (in addition to the above requirements) also must not maintain experience-rated arrangements with respect to individual employers.

Employer contributions. Employer contributions to a multiple employer welfare benefit plan cannot be based on either retrospective or prospective experience rating. Consequently, the employer's annual contribution should be determined actuarially, targeted to meet the benefit levels adopted by the employer. The plan actuary should apply the same assumptions regarding interest rates, turnover, and other factors to all participating employers in the plan. The plan actuary cannot differentiate among the assumptions and actuarial methods used because of the actual experience of a participating employer. Employees with higher incomes generally will be entitled to greater benefits from the plan than employees with lower incomes. Similarly, the plan actuary cannot engage in retroactive experience rating because the forfeitures and experience gains of the trust are commingled and may be used to fund the experience losses of other employee groups in the plan.

Shortfalls. There is currently no requirement that participating employers make up any shortfall resulting from insufficient contributions on the part of some employers to pay the targeted severance benefits to their terminated employees. Although forfeitures and experience gains may be used to meet shortfalls experienced by one or more employers, participating employees bear the risk of loss when insufficient assets are available to pay the targeted severance benefits. Some plans, however, commingle all plan assets in addition to forfeitures and experience gains, which then can be used to fund shortfalls.

Constraints. By imposing restraints and certain mechanisms, Congress believed that welfare benefit plans would become self-policing and the establishment of overfunded reserves would be strongly discouraged. By limiting an employer's contribution to 10% of the trust, no single employer can control the trust or exert undue influence over the independent trustee, plan administrator, or plan actuary. The mere presence of an independent trustee assures some measure of compliance with the exception due to the fiduciary duties placed on the trustee and the related threat of litigation.

Third-party trustee. The independent third-party trustee relationship with the employer is similar to the arm's-length relationship between an insurance company and an insured. Insureds are not motivated to pay excessive insurance premiums to obtain deductions because the insurance company can retain any portion of the premium not used to pay benefits. Similarly, an employer will not be

Tax risks increase for businesses with fewer owners because shareholder-employee participants have greater control.

motivated to overfund welfare benefit contributions to a Section 419A(f)(6) multiple employer trust because any contributions not used to meet projected benefits will be forfeited to other employers in the trust.

Forfeitures. The presence of forfeitures strongly discourages funding in excess of the amount needed to pay the employee benefits, because an employer is not likely to trade a relatively small tax deduction for a real dollar loss of its funds to other employers in the trust. The proscription against experience rating also serves to create the relationship between the employer and the trust similar to that of an insured to an insurer. In the same way that insurers in some situations are limited in charging premiums based on the insured's experience, the trust cannot modify contribution levels either prospectively or retroactively based on an employer's experience. Similar to insurance industry practices, the employees of participating employers receive the benefits and incur the burdens of favorable or unfavorable experience. A participating employer should not derive the benefit or incur the detriment of the investment experience of the trust or the

[5] American Bar Endowment, 477 U.S. 105 (1986).

employment experience of the participating employers' employees.

A multiple employer welfare benefit plan that seeks to circumvent mechanisms enacted by Congress to prevent abuse is not likely to qualify for the Section 419A(f)(6) exception and should be avoided. Although the multiple employer benefit trust is a statutory trust, it is not an exempt trust and its income is not treated like that of a qualified plan. The earnings of these trusts are taxable for both federal and state income tax purposes.

The IRS may find that any element of deferred compensation results in a deferred compensation plan, not a welfare benefit plan.

TAX DEDUCTION

In addition to qualification under the multiple employer trust exception, plans also must satisfy the requirements of Code Sections 404(a), 404(d), and 162(a). For contributions to a plan to qualify for current income tax deductions, a plan must provide welfare benefits through a welfare benefit fund.

Welfare plan vs. deferred compensation plan. The critical inquiry is whether the contributions fall under a deferred compensation or welfare benefit plan. Under a deferred compensation plan, Sections 404(a) and (d) apply and the contributions will not be fully deductible. Under a welfare benefit plan, Section 404(b)(2)(B) may apply so that the contributions are deductible.

ERISA definitions. "Employee welfare benefit plan" is defined in ERISA Section 3(1).[6] ERISA Section 3(2) also defines employee pension benefit plans as programs that provide retirement income to employees or result in a deferred termination of covered employment. In its definition, ERISA specifically provides for the Secretary of Labor to establish Regulations that exempt certain categories from its coverage, including severance pay arrangements. DOL Reg. 2510.3-2(b)(1) identifies certain programs that are not pension plans under ERISA. These programs specifically include severance benefits paid at termination, provided the payments (1) are not contingent on retirement; (2) do not exceed twice the employee's annual compensation; and (3) are completed within 24 months of termination or 24 months after the employee reaches normal retirement age. Viable plans have been designed to fall squarely within these guidelines and thus should not be employee pension benefit plans.

Case law. In interpreting the distinction between welfare benefit plans and deferred compensation plans, the courts have acknowledged that many plans not subject to Code Section 404 have some elements of deferred compensation.[7] The opinions point out that plans falling within Code Section 162 (ordinary and necessary business expenses) have certain characteristics not present among plans governed by Section 404.[8]

There is no single determinative factor; rather, all factors must be considered in determining which Code section applies. Factors supporting the existence of a multiple employer plan and the deductibility of related contributions include qualification as a welfare plan, funding obligations not predicated on employer earnings, lack of benefit increases after full vesting based on employment longevity, lack of discrimination in the provision of benefits to eligible employees, and plan benefits that are not a current salary substitute (disguised deferred compensation). Plans should be administered independently in accordance with the plan documents and be served by an independent trustee. Moreover, the employer must lose control over funds contributed to the plan and have no possibility of obtaining those funds (reversion).

The right of shareholder-employees to benefit from the plan should not disqualify payments to a plan, provided that an individual shareholder-employee does not manipulate the severance date to effect a deferred compensation arrangement.[9] Moreover, that an employer retains the right to terminate a welfare benefit plan without any right to receive a reversion of trust assets should not result in any benefit to the employer or undermine the status of a plan.[10]

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[6] Under ERISA Section 3(1), an "employee welfare benefit plan" is any plan, fund, or program that was previously or subsequently established or maintained by an employer, employee organization, or both, to the extent that such plan, fund, or program was established or is maintained to provide for its participants or their beneficiaries, through the purchase of insurance or otherwise: (1) medical, surgical, or hospital care benefits; benefits in the event of sickness, accident, disability, death, or unemployment; vacation benefits; apprenticeship or other training programs; day care centers; scholarship funds; or prepaid legal services; or (2) any benefit described in Section 302(c) of the Labor Management Relations Act, 1947 (other than pensions on retirement or death, and insurance to provide such pensions).

[7] See, e.g., Greensboro Pathology Associates, P.A., 698 F.2d 1196 (CA-F.C., 1982).

[8] See, e.g., Grant-Jacoby, Inc., 73 TC 700 (1980); Lima Surgical Associates, Inc. Voluntary Employees Beneficiary Association Plan Trust, 944 F.2d 885 (CA-F.C., 1991).

[9] See New York Post Corporation, 40 TC 882 (1963).

[10] Moser, TCM 1989-142.

Risk of manipulation. The tax risks are increased for businesses with fewer owners because shareholder-employee participants exercise greater control, making it difficult to prove that severance benefits are not deferred compensation and that substantial risks of forfeiture are tangible. To minimize the opportunity for manipulation, some plans preclude participation by shareholder-employees owning more than a stated percentage of employer stock. These limitations are artificial and may do little to prevent manipulation or curb abuse. A 100% shareholder that has an outside board of directors may have significantly less control and opportunity to manipulate a plan than a 1% shareholder who is the sole director. The determinative inquiry should be (1) what measure of control did the shareholder-employee actually exert, and (2) even if it were determined to be absolute control, was it used to bring about a deferred compensation plan or otherwise violate the requirements of Section 419A(f)(6)?

IRS focus. Challenges by the IRS under Code Section 404 are not as likely for large employers when no single executive, director, or shareholder-employee has the opportunity to manipulate the payment of plan benefits. Closely held corporations and partnerships with controlling owner-employees are more likely to be scrutinized simply because greater opportunity for abuse exists. These challenges will succeed or fail case by case.

Welfare benefit plans. A plan that meets the requirements of the Section 419A(f)(6) multiple employer trust exception and is not a deferred compensation plan under Sections 404(a) and (d) is not subject to the limitations of Sections 419 and 419A. Similarly, it is not subject to Section 83(h), which generally limits employer compensation-related deductions to the payment included in the employees' income.[11] Rather, the plan is a welfare benefit fund under Section 419(e), subject to Section 162 and Reg. 1.162-10(a) (deduction limited to reasonable compensation that is an ordinary and necessary business expense).

In setting this standard, courts have determined that when an expense results in the creation or enhancement of a separate and distinct asset owned by the taxpayer, the expense is not currently deductible.[12] The deductibility of an employer's contributions to a welfare benefit plan takes into account the degree of control that an employer retains over the plan and the degree to which the employees (rather than the employer) benefit. The retention by the employer of the rights to amend and terminate the plan is not sufficient to create a separate asset and invalidate the deduction.

In at least one case, the Tax Court went so far as to allow the prefunding of the entire projected benefit in one year to qualify as an ordinary and necessary expense under Section 162, even though the contribution was not actuarially determined and the vast majority of benefits inured to the benefit of the controlling shareholder-employees.[13] Similarly, the employer's deduction has been upheld when 85% of the severance benefits were paid for the benefit of controlling shareholders.[14] It appears that if a controlling shareholder participates in a plan as an employee and not as a shareholder, benefits payable on the shareholder's termination of employment are a severance benefit. The IRS has sometimes taken the position, however, that when any element of deferred compensation is present, the plan will be deemed a deferred compensation plan and not a welfare benefit plan.[15] All of the cases interpreting welfare benefits preceded Section 419A(f)(6), and many of them deal with tax-exempt VEBA rules, some of which are not applicable to taxable multiple-employer welfare benefit trusts.

CONCLUSION

Multiple employer welfare benefit plans can provide significant tangible benefits to employees of both large and small businesses. Additional Regulations or case law may be needed to curb current abuses and provide reasonable guidelines. Until then, plans should be approached with caution because some involve unnecessary risks and aggressive tax positions. The restrictions on qualified plans, greatly increased income tax rates, and expanded taxation of fringe benefits have enhanced the value and status of welfare benefits. Accordingly, employers establishing these plans can expect improved productivity and loyalty resulting from medical, death, and severance benefits. ■

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11 See Reg. 1.83-6(a)(3).

12 See Joel A. Schneider, M.D., S.C., TCM 1992-24.

13 Moser, *supra* note 10.

14 Greensboro Pathology Associates P.A., *supra* note 7.

15 See Harry A. Wellons, Jr., M.D., S.C., 31 F.3d 569 (CA-7, 1994), *aff'g* TCM 1992-704; see also "Deferred Compensation Characteristics Barred Cost Current Deduction," 2 JTEB 191 (Nov/Dec 1994) for further discussion of Wellons.