Abusive Welfare Benefit and Retirement Plans Can Lead to Severe Penalties for Accountants

By Lance Wallach

Accountants who are unaware of recent developments are likely to encounter a nightmarish scenario that may play out something like this: you sign a client's tax return that claims a tax deduction for participation in a "welfare benefit plan". A few years pass, and nothing happens. Then, on audit, the deductions are disallowed and your client is hit with back taxes, penalties, and interest. He discovers that he may be looking at a large penalty for not disclosing his participation in the plan to the IRS.

Naturally, at this point, your client wants out of the plan. But he discovers that he cannot get the money that he has contributed out of the plan. He finds that the money is being used by the plan sponsor to fight the IRS; his money is being used to defend a plan that he no longer wants to be in. This is claimed to be legal. Or he may even find that the money is simply gone, that it has been stolen or otherwise misappropriated.

And now you find that you are a "material advisor" with respect to your client's participation in the plan. Like your client, you were supposed to disclose your role here; in your case, as a "material advisor". You also may be looking at a large penalty for failing to disclose.

If you think this could never happen to you, think again.

Welfare benefit plans are a creation of and are sanctioned by Section 419 of the Internal Revenue Code. There are single employer plans and multiple employer plans; the latter rely mostly on IRC Section 419A (f) (6) (in the most common cases where there are ten or more employers as part of the same plan). The 419A(f)(6) plans are, and perhaps always were, generally regarded as abusive, and were substantially curtailed in recent years by harsh IRS regulation. Amazingly, however, they refuse to totally die, and are still being marketed. These plans are called listed transactions (more on that later).

While the principle purpose of this article is to discuss the current state of the welfare benefit plan, and everything outside of this paragraph will do just that, it is perhaps worth noting that welfare benefit plans are not the only subject of current IRS scrutiny and/or regulation. The Section 412(i) defined benefit plan, for example, is such a target that a task force has been formed internally solely to audit 412(i) plans. Many of them are being deemed listed transactions, many of the plans are being involuntarily terminated, and back taxes, penalties, and interest are being assessed. Not surprisingly, all of this has resulted in considerable litigation.

Single employer welfare benefit plans are now more popular than multiple employer plans. All welfare benefit plans tend to share certain characteristics, however. They tend to be marketed most frequently by insurance agents and financial planners, and sometimes by accountants and attorneys. Prospects tend to be professionals and profitable small businesses. The most attractive selling point is the ability to claim large tax deductions and remove money tax free. Life insurance tends to be the funding vehicle. Often cheap term insurance is purchased for rank and file workers and some form of permanent coverage (universal life, variable life, etc., for the owners and key employees. But many times workers are completely left out of the plan. For businesses looking to do as little as possible for workers, a selling point is that the great majority of benefits,

in most cases, eventually go to the owners. This type of discrimination was recently addressed by IRS Notice 2007-84, which disallowed tax deductions and penalties with respect to welfare benefit plans that discriminate. If done correctly, the plans can accomplish things like facilitating estate planning, business succession, and asset protection. But the promised tax deduction is usually the sizzle that sells the steak.

In October of 2007, welfare benefit plans were affected by IRS rulings. The two most important developments were Revenue Ruling 2007-65, which declared, in essence, that premiums paid inside of a welfare benefit plan for cash value life insurance were not tax deductible, and Notice 2007-83, which identified the trust within welfare benefit plans involving cash value life insurance policies, AND substantially similar arrangements, as listed transactions. In other words, in essence, not only are premiums paid for cash value life insurance policies in welfare benefit plans not tax deductible, but, and far more importantly, the plans themselves are now listed transactions. This, in turn, means that most welfare benefit plans are now listed transactions, because most feature cash value life insurance. This designation creates disclosure obligations with absurdly harsh penalties both for failure to disclose or incorrectly or incompletely disclosing, as we shall soon see.

A listed transaction, basically, is any transaction identified as such by specific IRS guidance OR any transaction substantially similar to the specifically identified transaction. Participants in listed transaction must file Form 8886 with both the Service and the Office of Tax Shelter Analysis. Failure to timely and completely file leads to penalties of $100,000 for individuals and $200,000 for corporate taxpayers.

The practitioner has filing requirements, also, which can lead to equally severe penalties, if the practitioner qualifies as a "material advisor" with respect to one of these transactions. What is a material advisor? Basically, someone who gives advice, sells, or otherwise plays a significant part in the promotion, sale, or paperwork with respect to a taxpayer's participation in a listed transaction. Put simply, from an accountant's standpoint, you must give advice, the client must do it, and you must satisfy a certain income threshold with respect to the transaction, usually $10,000. The accountant who signs a return taking a tax deduction with respect to the transaction is surely a material advisor, if the income threshold is met.

A problem is that many accountants are not even aware of these plans. Often it is discovered when preparing the client's tax return, at which point the client expects you to allow the deduction and sign the return, since the client was sold a tax deduction. Or worse yet, the deduction may already have been disallowed on audit. The point is that, far too frequently, the practitioner does not even discover a client's involvement in a listed transaction until too much damage has already been done. This is often the case if the contribution has already been made, as it usually has, and irretrievably so if the deductions have already been disallowed on audit. And added to all of this is the distaste that most professionals must have for all of these policing types of duties, to say nothing of the difficulties that are created with clients and, probably, the loss of some clients.

The material advisor must file Form 8918 describing her exact role in the client's participation in the transaction. Failure to file can lead to penalties imposed on the advisor that are as severe as those imposed on taxpayers ($100,000 for individuals and $200,000 for corporations) who fail to file Form 8886. The accountant may escape material advisor status by not meeting the $10,000 income threshold. A problem, however, is the accountant who is paid $10,000 in the aggregate by the client, but not that much specifically with respect to the listed transaction. Does such a person satisfy the income threshold? The author and his associates have discussed this point, among others, directly with IRS personnel who actually wrote published guidance in this area. The best we have been able to get is a declaration that any test that would be applied to the

determination of any of these issues would have to consider all surrounding facts and circumstances. This would be unlikely to yield any general rules, for each situation has its own facts and circumstances.

Another section that the practitioner, or at least the prudent one, should be aware of, largely apart from what has been discussed so far in this article, is Section 6701, entitled "penalties for aiding and abetting understatement of tax liability." This penalty is imposed upon those who assist in, procure, or advise while knowing or having reason to believe that the subject matter will be used in connection with any material matter arising under the tax laws and who know that the use thereof would result in the understatement of another person's tax liability. The penalty may be applied separately to each occurrence, and it is $1,000 if an individual is the taxpayer and $10,000 for a corporate taxpayer.

Three (3) definitions are now in order, which will hopefully help to clarify any confusion that may exist in the reader's mind. A "material advisor" is any person who provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and who directly or indirectly derives gross income in excess of a certain threshold amount. More on threshold soon, but the most common one is $10,000 for listed transactions. A "reportable transaction", basically, is any transaction which has been deemed to have a potential for tax avoidance or evasion. That is pretty broad, and the reader should consult the regulations under section 6011 for more on this. Finally, a "listed transaction" is a reportable transaction which is identical or substantially similar to a transaction specifically identified as a tax avoidance transaction.

As for threshold amounts, in the case of reportable transactions, it is $50,000, if substantially all tax benefits are provided to natural persons, and $250,000 in other cases. Natural person is construed most broadly, generally ignoring trusts, corporations, and other such entities. For listed transactions, the numbers are $10,000 (previously discussed) and $25,000.

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