419/VEBA Plans and Phantom/Imputed Income

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Imputed Income to Employees

As you may already know, life insurance premium payments paid for by an employer for benefit on an employee in excess of $50,000 a year are treated as imputed income to the employee.

If you've ever heard a marketer of 419 plans give a sale's presentation, you probably missed the quick comment where the presenter said that employees have to recognize a modest amount of "economic benefit" if they receive death benefit coverage from the plan. The above statement made by the marketer is code for "the client will have to recognize sometime sizable imputed/phantom income each year for the economic value of the death benefit exceeding $50,000." As you will see, this expense is not insignificant as a client nears 55-65 years old.

Calculating Imputed Income

The amount of income the employee has to recapture is calculated by dividing the amount of life insurance that is in excess of $50,000 by $1000 and then multiplying that by the premiums shown in the table below. The cost of the life insurance is calculated on a month-by-month basis. For example:

1. Enter the uniform premium table at the individual insured's attained age on the last day of the taxable year.

2. Multiply this cost per $1,000 table rate by the number of thousands of taxable life insurance benefit (amount in excess of $50,000).

3. Subtract monthly employee contributions, if any.

4. Total each month's calculations to determine the reportable taxable income for the tax year, which is referred to as *imputed or phantom income*.

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*Uniform Premiums for $1,000 of Group Term Life Insurance Protection** Rates Applicable to Cost of Group Term Life Insurance Provided After June 30, 1999

5-Year Age Bracket	Cost Per $1,000 of Protection for One-Month Period
Under 25	$0.05
25 to 29	.06
30 to 34	.08
35 to 39	.09
40 to 44	.10
45 to 49	.15
50 to 54	.23
55 to 59	.43
60 to 64	.66
65 to 69	$1.27
70 and above	2.06

*In using the previous table, the age of the employee is his/her attained age on the last day of his/her taxable year.

When a client is younger, this recapture cost is not as significant. However, when a client nears age 55-65 the cost becomes significant.

<u>Let's look at an example</u>:

Dr. Smith, age X, earns $600,000 a year and has three (3) employees. Dr. Smith funds a single employer VEBA; and after the TPA does the calculations based on the annual contributions to the trust, the trust will purchase a $2,550,000 death benefit on Dr. Smith's life.

What is the economic benefit or the imputed/phantom income that Dr. Smith must recapture with his new VEBA plan? The answer depends on the client's age.

At ages 45-49 the imputed income would be $4,500 each year.

At ages 50-54 the imputed income would be $6,900 each year.

At ages 55-59 the imputed income would be $12,900 each year.

At ages 60-64 the imputed income would be $19,800 each year.

At ages 65-69 the imputed income would be $38,100 each year.

At ages 70+ the imputed income would be $61,800 each year.

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What the above numbers tell us is that depending on the age of the client, the imputed income can be very different. The younger your clients are when they use a 419/VEBA plan, the less imputed income they will have.

How long does an employee have to recapture the imputed/phantom income?

This seems to be the million-dollar question. Depending on who you ask, you will receive different answers. The following are the three answers commonly given in the industry.

1) An employee does not have to recapture any imputed income (I do not subscribe to this).

2) An employee only has to recapture imputed income in years when the company is making a contribution to the 419/VEBA trust. (This is the answer from most legal departments supporting 419/VEBA administrators).

3) An employer has to recapture imputed income every year the employee works for the employer and has death benefit coverage. (This is the most conservative approach which is not subscribed to by most in the industry).

We are not even going to discuss number one above. We can find no credibility to this position.

As indicated above, most in the industry subscribes to number two above. You can be certain that if the IRS ever looks at this issue they will subscribe to number three above. The thought behind number three is fairly simple. Just ask yourself the following simple questions: Does the employee receive an economic benefit when an employer purchases life insurance on the life of the employee? The answer is absolutely. Is that economic benefit different for the employee just because the employer is no longer making a contribution to the trust? This is a good question with no definitive answer.

<u>Let's look at two different examples</u>:

1) Assume Dr. Smith setup a single employer VEBA where the VEBA trust buys a $2,550,000 life insurance policy on Dr. Smith's life and where the medical practice makes contributions to the VEBA for ten-years. The trust in turn also pays premiums for 10-years to have a "paid-up" life insurance policy. In years 11 until Dr. Smith retires, the medical practice no longer makes contributions to the trust and the trust no longer pays premiums into the policy.

2) Assume the same example, except instead of only paying premiums for ten-years, assume that the medical practice makes contributions to the VEBA for 25-years an in turn the trust pays premiums for 25-years. How will that change things?

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If you believe the economic benefit comes from the business making contributions to the trust, not from the actual policy coverage, then you would subscribe to the notion that in years when the business does not make a contribution to the VEBA (and in turn the VEBA pays a life premium that year), Dr. Smith does not have to recapture imputed income for having life insurance coverage.

If you believe the economic benefit comes from the actual life insurance coverage, not from the contributions to the plan by the employer, then in years 11 until retirement, Dr. Smith should have to recapture imputed income for having life insurance coverage (provided by the employer through the 419/VEBA trust).

Let's look at the numbers for Dr. Smith assuming the IRS wins and number three above is used to calculate the imputed income.

Assume Dr. Smith is 45 years old.
Let's assume Dr. Smith dies when he is age 69. How much phantom income did he have to recapture until his death at age 69 (assuming he was working at age 69 like many doctors)? $411,500.

Unfortunately, there is no definitive answer on this issue. Advisors who counsel their clients to use the accounting methods for the second scenario can take some comfort in the fact that nearly all of the law firms supporting 419/VEBA trusts take that position.

There are many areas in the "advanced" tax fields where we do not have definitive answers to certain questions. All you can do is surround yourself with people you trust who know the subject matter and give full disclosure to the client. If you opt for number two where the employee only recaptures imputed/phantom income in years when a contribution is made by the employer, the hope is that if the IRS challenges the issue, by showing due diligence and good faith, if the IRS were to win, the client would simply have to pay taxes on the undeclared imputed income (hopefully no penalties and interest).

A practical planning discussion

It won't shock you but games can be played with this topic. What if an employer took a very large deduction in year one to fund a 419/VEBA plan and then never made another contribution? Due to the fact that most will not want the life insurance policy purchased to become a Modified Endowment Contract (MEC), the premiums paid into a cash value life policy purchased in a plan needs to be paid over 5-7 years to maximize the cash value of the policy and minimize the death benefit/internal expenses of the life policy.

The trust could accept the employer contribution in year one, pay the first year's life insurance premium and place the remaining money in a savings account which would be used over the next 4-6 years to pay future premiums. Technically speaking, the company only made a contribution for one year to the plan and if you follow the logic of

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number two, the employees who received coverage would only have to recapture phantom income for the death benefit coverage in year one. The employees would not have to recapture income in years 2-6 when other premium payments are being made by the trust or any year thereafter when the trust is done paying premiums.

What CWPP™ and CAPP™ advisors want to know is what does the Wealth Preservation Institute recommend?

Our position is that until the IRS challenges or Congress issues regulations on this issue, the number accounting procedures should be used. The position is defendable and reasonable for a client to take when dealing with the recapture/phantom income issue.

Practice pointer

This allows for some very interesting planning opportunities for advisors looking to help clients purchase life insurance in a trust that will be 100% deductible and will pass income and estate tax free. If a client can fund over a short period of time the contributions needed to fund a "paid-up" life insurance policy where the beneficiary designation is irrevocable, a client will many times be much better off using a 419/VEBA plan to purchase the life insurance vs. gifting money to an irrevocable life insurance trust.

Side Note: **Medical benefits**

A 419e or single employer VEBA that offers clients medical benefits is another story. There are no imputed income issues to deal with. I like the sale of such plans when we can be open and up front with the expenses and the benefits. Nearly all clients will have post-retirement medical costs which are usually paid for with after-tax dollars. This is expensive and painful. With a 419e or single employer VEBA, the client can take a current income-tax deduction for expenses through the business; and the medical benefits can come out completely tax-free if used for listed medical benefits without having to worry about imputed income.

Summary

Hopefully this additional material has given you insight into the sometimes cloudy world of 419 and VEBA planning.

For now, just know that the table 1 costs of insurance that the client has to recapture in a 419 or VEBA plan are not always insignificant and should not be overlooked when pitching the concept to a client. Full disclosure is always the best avenue to take, and we recommend it highly when you pitch these plans to your clients. Finally, if your clients are only interested in current and post-retirement medical benefits, the issues discussed in this summary are not an issue.

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