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Administration Budget Proposals Tighten Rules for 409A Violations, VEBA Funding and Indemnity Health Plans

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On March 28, the Biden Administration submitted its Fiscal Year 2023 budget proposals reflecting its budget and tax policy priorities, which could surface when Congress resumes work on budget reconciliation. While it is challenging to assess Congress' appetite for tackling tax increases at this point, the package proposes the following major changes:

- increase in the top corporate rate from 21% to 28%,
- increase in the top individual tax rate from 37% to 39.6%, and
- a 20% minimum income tax on households worth more than $100 million.

In addition to these high profile tax proposals, the accompanying 120-page Treasury "Green Book" includes three proposals potentially affecting the funding of post-retirement benefits, sanctions for Internal Revenue Code ("Code") section 409A violations, and the tax treatment of fixed indemnity health insurance policies. We comment briefly on these proposals – all of which would be effective for tax years after 2022 – below.

A. Withholding on 409A Nonqualified Deferred Compensation ("NQDC") Violations

Code section 409A imposes complex rules on the deferral and payment of nonqualified deferred compensation. Violations of the rules result in a 20% additional tax and interest being imposed on the affected employees.

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While the Green Book would not change the 409A rules themselves, the proposal would require employers to withhold the 20 percent additional income tax and additional interest tax on the NQDC included in an employee's income as a result of a 409A violation. As a result, IRS agents would have an easier time collecting the 409A penalties when violations are identified in a corporate tax audit. Under current law, the penalties are imposed on affected employees, which requires coordination with other parts of the IRS and no withholding is required.

Unfortunately, Treasury and IRS have yet to issue final regulations on how to calculate the income inclusion for 409A violations so this proposal will prove challenging to affected taxpayers. Nevertheless, the Congressional scorekeepers believe that imposing a withholding obligation on employers should enhance compliance – according to the Joint Committee on Taxation revenue table, this proposal is estimated to raise almost $7 billion over a 10-year budget period.

B. Tighten Rules for Funding Post-Retirement Benefits

Longstanding Code rules limit the ability of employers to pre-fund retiree health and life insurance benefits to a period based on "the working lives of the covered employees, actuarially determined on a level basis." The IRS has not issued any guidance on this determination, however. In its 2003 decision in *Wells Fargo v. Commissioner*, the Tax Court allowed a current deduction for the full amount necessary to fund the liability for already retired workers. 120 T.C. 69. Many employers have relied on this decision to pre-fund retiree medical benefits in VEBAs and insurance continuation funds.

The Green Book includes a proposal that generally would limit pre-funding of retiree benefits to the longer of (1) the working lives of the covered employees or (2) 10 years, unless the employer commits to maintaining the same level of benefits for 10 years. Accordingly, an employer could no longer pre-fund the entire liability for already retired employees in a single year on a currently deductible basis.

In support of the proposal, the general explanation (at page 108) states as follows:

> there is no specific prohibition against using the funds that are no longer needed to provide post-retirement benefits to instead provide other welfare benefits. Therefore, an employer can effectively accelerate deductions for welfare benefits provided to current employees by making a lump sum contribution to a reserve for retirees' future benefits in one year, eliminating or reducing those retiree benefits, and then in subsequent years directing those funds towards the cost of providing welfare benefits for current employees.

This explanation fails to recognize that an employer's ability to modify its retiree benefit provisions is regulated by ERISA and has been the subject of extensive litigation. Further, while there is no specific prohibition, the IRS currently has a "no-rule" policy on the ability of an employer to "repurpose" surplus retiree medical assets to pay other employee welfare benefits, such as active employee medical, without subjecting the employer to the reversion excise tax of Code section 4976.

C. Clarify Taxation of Fixed Indemnity Medical Policies

Some employers offer insured fixed indemnity benefits to their employees which pay fixed amounts for a specified medical event rather than benefits keyed to the actual cost of medical care.

The Green Book proposes to clarify that the exclusion under Code section 105(b) for payments from fixed indemnity policies is limited to the actual medical cost, and any excess benefits above those amounts are "wages" includible in the employee's income and subject to the standard wage withholding provisions. The proposal would not affect the treatment of benefits under policies purchased with employee after-tax dollars, however.

GROOM INSIGHT: The origin of these three disparate benefits proposals is puzzling. Except for the 409A withholding changes, it does not appear that raising revenue is their chief objective. Nevertheless, it is quite possible that one or more of them will find their way into a tax bill later this year.