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Tax Deductibility of Unpaid Employee Welfare Benefit Claims

When is the expense of Incurred But Not Reported (IBNR) claims Deductible?

The rules governing the deductibility of Incurred But Not Reported Claims in an employee welfare benefit program are complex. This complexity has led benefits and accounting professionals of every stripe to offer differing interpretations to clients and employers. The purpose of this Position Paper is to clarify those rules and the circumstances under which employers may claim a deduction under self-funded health and welfare plans sponsored by *single* employers and *not subject to collective bargaining*.

The Paper addresses such key points as:

- An overview of the applicable sections of the Internal Revenue Code of 1986 (Code)
- A discussion of the tax issues including the applicability of cash versus accrual accounting methods
- Judicial interpretation of the "All Events" test before and after the advent of "Economic Performance"
- The inescapable grip of the General Dynamics decision
- Revenue Procedure 2008-52 (which appears to contradict in part the General Dynamics decision)
- The authors' conclusions about the tax issue and the Trust or Other Fund issue

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Overview

The rules governing the deductibility of Incurred But Not Reported Claims (IBNR) in an employee welfare benefit program are complex. The purpose of this Article is to clarify those rules and the circumstances under which employers may claim a deduction. [1]

- Sections 419 and 419A of the Code together limit deductible employer welfare benefit fund contributions (whether "paid or accrued") to the sum of:

  (1) the "qualified direct cost" for the taxable year, and

  (2) any addition to a "qualified asset account."

- Paragraph 419(a)(2) of the Code contains a clear limiting mandate that such contributions are deductible only in the taxable year "in which paid", leaving the authors with no doubt that *the deductibility of contributions to a funded welfare benefit plan is determined only on a cash accounting basis, even in the case of a taxpayer who is otherwise on an accrual basis of tax accounting.*

- "Qualified direct cost" is the amount of benefits expense (including administrative expenses) which the employer could have deducted during the taxable year if it was under the cash accounting method. In other words, it is the benefits paid during the year plus related paid expenses.

[1] *Plans with 10 or more participating employers (whether multiemployer or multiple employer) and collectively bargained plans with 50 or more participating employees are generally not subject to the rules relating to IBNR which are discussed in this Paper. See Internal Revenue Code § 419A(f)(5) and (6).*

- A "qualified asset account" is defined as any amount set aside for the payment of disability, medical, supplemental unemployment, severance or life insurance benefits. However, deductible contributions to a "qualified asset account" may not exceed the "account limit," which is defined as the sum of claims for such benefits which are incurred but unpaid (as of the end of the taxable year), plus any associated administrative costs for such claims. One component of claims incurred but unpaid is claims which are incurred but not reported to the plan by the end of the year. These are known in actuarial and accounting practice as "IBNR." Unlike unpaid claims incurred which have been reported, IBNR can only be estimated.

- The rules also limit the deduction to "actuarially necessary" amounts, and further provide that unless there is an actuarial certification, the deduction for additions to the qualified asset account is limited to specified percentages of "qualified direct cost." In the case of medical benefits it is up to 35% of qualified direct costs exclusive of insurance premiums, to the extent reasonably and actuarially necessary. (This so-called 35% "safe harbor" is more accurately characterized as an "unsafe harbor" as careful examination of IRS P.L.R. 9818001 will reveal.)

- These Internal Revenue Service ("IRS")-enforced rules allow additional deductible contributions to a "qualified asset account" for pre-funding certain post-retirement benefits. This paper does not discuss that aspect of these rules, nor to any significant extent, the tax treatment of "qualified direct cost." Instead, it focuses strictly on the deductibility of "IBNR" under both cash and accrual accounting theories. It also does not address the accounting of IBNR for financial reporting purposes, which may or may not differ based on generally accepted accounting principles ("GAAP") or other appropriate standards governing sound professional accounting practice.

The tax issue

- ### Theories on deductibility of IBNR in an unfunded setting

When the terms of a plan require all benefits to be paid from a trust or other welfare benefit fund, there is no question in our view that the employer can only deduct what it actually contributes to the fund by the end of the taxable year. *This includes IBNR estimated and certified by the actuary.*

Since the mandate of § 419 applies to contributions "paid or accrued" and since that rule clearly limits the deduction to amounts paid in that taxable year, the conclusion that it cannot be accrued merely for tax purposes seems irrefutable. In other words, an employer cannot claim the deduction for one taxable year (based only on accrual accounting rules) but actually contribute or pay it in a later year.

The question remains - what if a welfare benefit plan is either completely self-funded (has no trust or other "fund"), or if the plan gives the employer the option of paying all or some benefits directly instead of through the trust or other fund? In that situation, can an accrual basis taxpayer simply accrue the liability for the IBNR and take the deduction for it, assuming it is otherwise properly determined and fixed by year end, even though it actually pays it in the *next* taxable year?

- ### Contrasting cash basis and accrual basis tax accounting

Section 446 of the Code recognizes two basic methods of accounting, commonly referred to by tax and accounting practitioners as the "cash" and "accrual" methods. There are two other sanctioned methods which, in reality, are merely a combined utilization of both.

Section 461 of the Code prescribes that the method of accounting to be used in determining deductibility of an item is the "method used by the taxpayer in computing taxable income."

Interestingly, neither section actually defines and distinguishes "cash" and "accrual" accounting methodology. That detail is found in IRS regulations interpreting these two sections.

IRS Regulation § 1.446-1(c)(1) provides the distinguishing definitions. In determining the deductibility of an expenditure under the cash method of accounting, the regulation states (in relevant part):

"Generally, under the cash receipts and disbursements method … Expenditures are to be deducted for the taxable year in which actually made…."

The accrual method of determining deductibility is defined (in relevant part) as follows:

"Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability."

The cash method, then, is quite straightforward: the deduction is taken only for the year in which it is paid. Accrual accounting, by contrast, presents three distinct elements, all of which must be met to allow for a deductible accrual:

- All events must have occurred which establish the fact of the liability ("all events" test)
- The amount of the liability can be determined with reasonable accuracy ("reasonably ascertainable amount" test)
- Economic performance has occurred regarding the liability ("economic performance" test)

The economic performance test was created by an amendment to § 461 of the Code made by the Revenue Act of 1987 (Public Law 100-203) which took effect in 1988 and which provides that the "all events test" shall not be considered met until "economic performance" occurs. This somewhat blurs the distinction between the tests as they are described in IRS regulations, but it would appear that the "all events" test can be met after economic performance occurs, but never before. As a practical matter, however, nothing can be deductible on an accrual basis until all three tests are met.

- Judicial interpretation of the "all events" test before the advent of "economic performance"

To reach an understanding of accrual accounting rules in the context of the treatment of IBNR, it is important to understand how the "all events" and "reasonably ascertainable amount" tests were applied by the federal judiciary prior to the addition of the "economic performance" test. Without question the most critical and relevant of these is the 1987 decision of the United States Supreme Court in *United States v. General Dynamics (481 U.S. 239)*. This case was decided before the time of the addition of the "economic performance" test. In fact, it was addressing a tax controversy involving the 1972 tax year - long before the new test entered the law. Consequently, the opinion offers no clear insight as to how the new addition to the accrual tax accounting rules might change the result, if at all.

In that case the taxpayer maintained a self-insured medical plan. It estimated its IBNR as of the end of taxable year 1972 and established a reserve account on its books in the amount of that estimate. The taxpayer did not initially claim the deduction for IBNR but later attempted to obtain a refund by filing an amended return which claimed an additional deduction for accrual of the IBNR reserve amount. The IRS denied the deduction, but the United States Court of Claims sustained it and the United States Court of Appeals for the Federal Circuit affirmed the Court of Claim's decision.

In the end, the U.S. Supreme Court reversed the decision and backed the IRS, disallowing the deduction. The Court reasoned that the claimed deduction failed the "all events" test. *It held that the last event which determined the fact of the liability was not the providing of the medical services, but the actual filing of a claim with the plan.*

What has changed today that might lead a court to attempt to conclude that *General Dynamics* is not or is no longer the governing rule on similar facts, or which might persuade the Supreme Court to reverse its own stand? One possibility would be to take the IBNR calculation beyond "mere estimate" by including a professional actuarial certification of the IBNR. Another might be to argue that the means of processing claims today is much different than it was in 1972, with significant electronic records being created at the point of service, making modern estimates more accurate and presumably lower, all other variables being fixed, except for a reduction in pending employee reimbursements. However, that would certainly be the aggressive position because it chooses to ignore the Court's clear statement that the "event" in question is not the providing of the medical service, but the filing of the claim (in whatever form filed).

The conservative position remains to follow *General Dynamics* and assume that the IRS will challenge such accrual deductions of unfunded IBNR amounts if it finds them and is likely to be supported in court.[2]

Does the advent of the "economic performance" rule change any of this? Or does it only make things worse for an accrual taxpayer attempting to deduct an unfunded IBNR liability?

- The "economic performance" test

The concept of "economic performance" is a relatively new wrinkle to traditional accrual tax accounting. This third prong of the requirements for a deductible accrual is found at § 461(h) of the Code. As previously stated, it modifies the "all events" test by stipulating that "all events" cannot occur earlier than the date economic performance occurs. However, in order to avoid the adverse impact of *General Dynamics*, the accrual taxpayer needs something to cause the "all events" test to be met earlier.

One does not have to conduct an in-depth analysis of how the "economic performance" test might change things to realize that it can only delay satisfaction of the "all events" test, not accelerate it as the accrual taxpayer needs, leaving the accrual camp's position hollow. [3]

Nevertheless, in the interest of thoroughness and a search for truth that leaves no stone unturned, we shall examine how the IRS interprets § 461(h) of the Code as it applies to employee benefit plans. IRS Regulation § 1.461-4 is dedicated solely to outlining the parameters of economic performance.

Subparagraph (d)(2)(i) states the following general rule as to when economic performance occurs with respect to the performance of services for the taxpayer (employer) by another person (employee):

(i) In general…if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided."

This part of the regulations (the "General Rule"), read alone, can reasonably be interpreted as saying that economic performance can have occurred with respect to IBNR by the close of the taxable year to which it pertains since, presumably, the IBNR will relate to and be compensation (generally tax-free) for employees for services performed in that year. That reading would give partial support to the ability of an accrual basis employer to be able to deduct the IBNR for that year without actually contributing it (assuming the *General Dynamics* ruling presented no bar to meeting the "all events" test by that date). However, Subparagraph (d)(2)(iii) muddies the waters by saying the following about when economic performance occurs with respect to employee benefits:

"…Except as otherwise provided in any Internal Revenue regulation, revenue procedure, or revenue ruling, the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under § 404 (employer contributions to a plan of deferred compensation), § 404A (certain foreign deferred compensation plans), and § 419 (welfare benefit funds). See § 1.461-1(a)(2)(iii)(D)."

Is this rule (the "Special Rule") meant to override the General Rule for economic performance? Clearly, §§ 404 and 404A of the Code deal with deferred compensation plans and have no relevance to the IBNR of an employee welfare benefit plan. The only other "otherwise

[2]*At least this is what we would have concluded before September 8, 2008, the date the IRS issued Revenue Procedure 2008-52, which is discussed at some length later in this Paper. Now such a conservative approach may no longer be completely necessary because the IRS has clarified when it will accept the IBNR deductions of accrual basis taxpayers. Nevertheless, the conservative approach of funding the IBNR by the end of the taxable year remains viable and safe.*

[3]*Again, before September 8, 2008, after which time it rings virtually true except for §263A of the Code.*

deductible" authorization is § 419 of the Code, which, as we have already concluded, places all taxpayers, including accrual taxpayers, effectively on a cash basis for purposes of funding a welfare plan. So, was the IRS by the Special Rule trying to say that whether an accrual taxpayer's plan is self-funded or funded, its deduction for any employee welfare benefit plan cost (and not just IBNR) is available only in the year it is actually paid or contributed? Or was it addressing only funded plans with self-funded or partially self-funded plans being under the General Rule for the self-funded portion? At least arguably it is the latter, with the effect under either interpretation being that the employer's economic performance may be deemed to have occurred at the time it makes a deductible contribution to a fund, regardless of when the services to which the contributions relate were performed.

This also leaves at least some wiggle room for those who contend that if the plan is unfunded the Special Rule has no application. An accrual basis taxpayer might be able to support an argument that economic performance occurred in the year before the year it is actually paid if it is on account of services performed in the earlier year.

This is the closest we can come to constructing the kind of argument the accrual proponents may have been attempting to make. Perhaps they were confusing "economic performance" with the "all events" test, concluding that satisfaction of the former is satisfaction of the latter?

In our view that would be a clear misreading of both the statute and the regulations. However, if the intended interpretation of the regulations is that the Special Rule applies to unfunded arrangements of accrual taxpayers as well as funded ones, it would appear that it should be the death blow to any IBNR accrual arguments because there would be no way to accelerate economic performance to the earlier year absent an actual contribution to a fund.

Thus, the interpretation we would favor is that the Special Rule for benefit plans is intended to override the General Rule for all employee benefit plans.

- The inescapable grip of g*eneral dynamics*

At least before September 8, 2008 when the IRS issued Revenue Procedure 2008-52, discussed below, even if those who might have argued in favor of economic performance occurring by the end of the year to which the IBNR pertains for accrual taxpayers maintaining unfunded plans, this favorable reading would have done nothing to satisfy the long-standing "all events" test, and the rather high hurdle presented by the *General Dynamics* decision. The Supreme Court clearly said the "event" is the submission of the claim, not the providing of the service for which the claim will be paid. That will occur in the year after the year in which they wish to accrue the IBNR liability. This was the fatal flaw in the position of the accrual proponents that before Revenue Procedure 2008-52 reduced all their other probable arguments to little more than an obtuse academic exercise. Their surmised arguments, viewed most favorably to them, at best got them only two-thirds of the way there (reasonably ascertainable in amount with economic performance having occurred). However, this is not a case of two out of three being not bad. Rather, it is a case of not being good enough.

We chose to concede the "reasonably ascertainable in amount" portion of the test for accrual, not only because we believe IBNR is reasonably ascertainable in amount in most cases, but because we were attempting to address the probable arguments of the accrual proponents in the light most favorable to them. Nevertheless, the rest of the likely argument would seem to lead only into darkness.

Again, we could have ended the inquiry there and concluded for a second time that before September 8, 2008 there was no sound and unassailable legal basis for the argument that it is possible for IBNR to be properly deducted by an accrual basis taxpayer in a year earlier than the year it is paid to some fund or directly in benefits. Nevertheless, in the same spirit of thoroughness we pressed on with a search for any regulations, rulings, procedures or other authorities which might create an "except as otherwise provided" scenario.

Recall that IRS regulation § 1.461-4 referred us to *§ 1.461-1(a)(2)(iii)(D).* Well, that reference reads:

Except as otherwise provided in any Internal Revenue regulation, revenue procedure, or revenue ruling, the economic performance requirement of § 461(h) and the regulations thereunder is satisfied to the extent that any amount is otherwise deductible under § 404 (employer contributions to a plan of deferred compensation), § 404A (certain foreign deferred compensation plans), or § 419 (welfare benefit funds). See § 1.461-4(d)(2)(iii).

Certainly, there is no "except as otherwise provided" to be found there. It says exactly the same thing as the first regulation reference (except adding the reference to § 461(h) of the Code), and loops us right back to the same regulation that referred us there. So, we searched on---and have found nothing more.

- The curious case of revenue procedure 2008-52

On September 8, 2008, the IRS did something rather astonishing - it issued Revenue Procedure 2008-52 (IRB 2008-36). In subsection 19.01 of the Appendix to that Revenue Procedure, the IRS authorized a new automatically allowable change of accounting method for certain accrual taxpayers who had not been claiming deductions for year-end IBNR. In clause (1)(a)(i) of that subsection, the IRS decrees as follows:

(A) If the taxpayer has a liability to pay an employee for medical expenses incurred by the employee, the taxpayer will treat the liability as incurred in the taxable year in which the employee files the claim with the employer. See United States v. General Dynamics Corp., 481 U.S. 239 (1987), 1987-2 C.B. 134.

(B) If the taxpayer has a liability to pay a 3rd party for medical services provided to its employees, the taxpayer will treat the liability as incurred in the taxable year in which the services are provided.

With this, the IRS completely changed what seemed to be the clear law on the deductibility of IBNR by accrual taxpayers. In one Solomon-like act, the IRS effectively divided the IBNR baby into two parts: the part that will reflect direct reimbursements to employees and the part that will be directly paid to third-party providers. It follows *General Dynamics* on the former, continuing the ban on accruing the portion of IBNR that reflects amounts to be paid as reimbursements to employees. However, it tosses aside *General Dynamics* on the latter, permitting that part to be accrued for the taxable year it arises and can be estimated.

Naturally, we find vindication in this Revenue Procedure to the extent it acknowledges that this is a change in the government's position and that the conclusions we had originally intended to publish (the inability to accrue IBNR for tax purposes without contributing the amount to a welfare benefit fund) were absolutely correct under then-existing law and guidance. However, we find it a little troubling that the IRS now virtually abandons the position it long ago successfully fought for before the U.S. Supreme Court.

Now it appears to sanction an accrual basis taxpayer simply accruing the portion of IBNR that will be paid to third-parties without bothering with a fund if it satisfies the other requirements spelled out in this Revenue Procedure. In almost every case this will be 90% or more of the IBNR.

However, the accrual basis taxpayer cannot accrue it all, and must forgo the deduction for so much of the IBNR which consists of amounts estimated to be payable directly as reimbursements to employees unless it contributes that portion to a trust fund by the last day of the taxable year. So, to take full advantage of this new rule, the actuary must now make two separate estimates for each category of IBNR.

As if this action were not strange enough, the IRS further divided the Revenue Procedure's applicability by qualifying this rule for taxpayers who are manufacturers, wholesalers or retailers, or who are engaged in any business that makes, buys or sells goods to produce income. Those businesses are required to capitalize certain costs under § 263A of the Code rather than treat them as currently deductible expenses.

Although the language in § 19.01(1)(a)(ii) of the Appendix to Revenue Procedure 2008-52 is somewhat convoluted, it appears the IRS is trying to say that those taxpayers must treat

IBNR as part of the costs of the acquisition of either depreciable property (i.e. capital assets) or inventory, to the extent properly allocable to the acquisition or creation of such property under other IRS regulations relating to accounting for inventory and depreciable property. The exact manner in which these particular kinds of businesses may be required to capitalize IBNR rather than accrue a current deduction for it is beyond the scope of this paper. However, it would appear that only service businesses fully benefit from the new IRS position on accrual of IBNR. In effect, the IRS giveth and the IRS taketh away. We encourage employers who are not service businesses to consult with their tax accountants on the exact treatment of IBNR after Rev. Rul. 2008-52. It does appear, however, that at least to the extent IBNR is attributable to labor that was a direct cost of such production or acquisition, it may have to be capitalized or treated as part of inventory cost (meaning the deduction is taken over a period of years under the depreciation rules, or as part of the cost of goods sold under the inventory rules).

We are not at all certain what drove the IRS to allow this change. We have grave doubts that the IRS can overrule the Supreme Court in this manner without a change in the underlying law the highest court in the land was construing. However, we are not constitutional scholars and leave that part of the discussion to such lofty thinkers. The practical matter is this: the IRS will allow an accrual taxpayer whose business is providing services to deduct part of the IBNR without funding it, and who is going to challenge them for allowing such a deduction? Answer: nobody. Who even has legal standing to challenge such a ruling? Answer: we doubt anybody.

- Our conclusion regarding the tax issue

For all the reasons outlined above, the authors and others within and outside this firm believe that before September 8, 2008, there was no sound basis for deducting IBNR for any taxable year before the year in which it was paid to some fund, even by an accrual basis taxpayer.

On and after that date this remains our conclusion for the portion that will consist of claim reimbursements to employees. By definition, IBNR is only an estimate, not a payment as yet made directly to plan participants or third-party providers.

Other practitioners may have disagreed with our view as it existed before September 8, 2008. Unfortunately, we are unable to fully assess and address whatever the counterarguments of such practitioners might have been, beyond what we have speculated, because we have found no contrary writings of any kind (except for the Deloitte & Touche *Washington Bulletin* of April 13, 2009 which post-dates Revenue Procedure 2008-52).

We attempted to construct a hypothetical counterargument to support an opposing position, but concluded that a strong and credible counterargument could not be made and that the accrual camp's position was at that time highly suspect and subject to IRS attack.

See § 19.01(a)(1)(b) of the Appendix to Revenue Procedure 2008-52 ("Amounts Taken into Account"). Under § 263A of the Code, even an allocable portion of indirect labor costs may have to be attributed to acquisition cost of capital assets or inventory.

Certainly, at a minimum, the use of a fund and contribution of the IBNR to that fund by the end of the taxable year to which it related was before then the only safe approach for assuring an earlier year deduction of all IBNR that could withstand any assault. Although the rules governing the deductibility of IBNR are somewhat complex, they were quite clear (at least before September 8, 2008) and left little room for doubt. If nothing else, by Revenue Procedure 2008-52 the IRS has mooted the debate, at least to the extent of what that agency will allow.

Sponsors of health and welfare plans will want to work closely with their accounting firms to ensure strict compliance with the requirements of the Code. Accrual basis taxpayers, in particular, need to pay special attention to Revenue Procedure 2008-52. IBNR can materially affect the balance sheet and it is in the best interest of plan sponsors to take full advantage of the deductibility of this expense.

The conclusions we have reached also drive us to seek an answer to yet another question: "What kind of "fund" can be used to deduct the part of IBNR that cannot be accrued?" The remainder of this paper will address that question, as well as other advantages for the use of trust funds by self-funded plans.

The trust or other "fund" issue

- What the code says

As reasoned above, in order for at least part of IBNR reflecting participant and beneficiary reimbursements to be deductible for a taxable year before the taxable year the underlying claims are paid, the contributions representing that portion of properly estimated IBNR must be paid to a "welfare benefit fund" by the last day of such taxable year. Paragraph 419(e)(3) of the Code and the applicable regulations under that section define "fund" as any tax-exempt organization exempt from tax under IRC §§ 501(c)(7), (9), (17) or (20), any taxable trust or taxable corporation not exempt from federal income tax or certain arrangements with insurance companies. Such arrangements are limited to retired lives reserves, premium stabilization reserves, separate accounts in conjunction with "administrative services only" funding vehicles or non-cancellable experience-rated contracts with provision for refunds, credits or additional benefits in the event of favorable experience.

- What ERISA says

Section 403 of Employee Income Retirement Security Act of 1974 ("ERISA") provides that all employee welfare benefit plan assets must be held in trust, except for insurance policies or assets of an insurance company. The exceptions from a trust requirement under ERISA are narrower than those allowed under § 419 of the Code. In the case of a plan covering self-employed individuals, certain custodial accounts can be used.

As we have seen, in order to deduct IBNR by the close of the taxable year for which it is determined, it must be contributed to a "fund" by the last day of such year. This means that the employer must by then both identify specific assets and transfer them to the control of the plan.

The clear and long-held stance of the U.S. Department of Labor is that once plan assets are identified to the plan, subject to the exceptions stated in the previous paragraph, they must be held in trust. In Advisory Opinion 92-24A, for example, the Department stated as follows:

"*Apart from participant contributions, applying ordinary notions of property rights, the assets of a welfare plan generally include any property, tangible or intangible, in which the plan has a beneficial ownership interest. The identification of plan assets therefore requires consideration of any contract or other legal instrument involving the plan, as well as the actions and representations of the parties involved. For example, a welfare plan generally will have a beneficial interest in particular assets if the employer establishes a trust on behalf of the plan, sets up a separate account with a bank or other third party in the name of the plan, or specifically indicates in the plan documents or instruments that separately maintained funds belong to the plan. ….*"

- Our conclusions regarding the trust or other fund issue

Once such assets are identified in the plan, the Advisory Opinion (and several others issued over the years) concludes that they must be held in trust. Consequently, while the broader definition of "fund" used in the Code might permit deductibility of amounts paid to other types of "funds" as described in IRS regulations, the plan will not be in full compliance with the labor law requirements of Title I of ERISA unless that fund is in the form of a trust. In fact, failure to place the amounts in a true trust fund (or one of the alternative arrangements allowed by ERISA) would be a breach of ERISA's fiduciary duty rules which could subject the plan fiduciaries to personal liability for any losses realized by the plan or its participants and beneficiaries resulting from the failure to place the amounts in a trust fund. As a practical matter, any employee welfare benefit plan is effectively required to have a trust (or a custodial account in the case of certain plans benefitting self-employed individuals) in order to pre-fund IBNR on a deductible basis, unless it is paying those amounts to an insurance company.

The many other advantages of funding medical benefits through a trust fund

Despite the possibility that certain accrual basis taxpayers may now be able to deduct at least part of IBNR without actually contributing it to a trust or other fund by the last day of the taxable year, we continue to see many advantages for funding IBNR (and all plan benefits for that matter) through a trust. These are just some of the advantages we see:

- No need to divide IBNR into two parts. All IBNR, whether eventually payable to third parties or directly to employees, may be deducted for the year contributed.
- The associated liability for all IBNR is off the employer's balance sheet (to the extent the trust has assets).
- The assets in the trust become assets of the plan rather than assets of the employer, providing better protection for employee benefits in the event of employer bankruptcy.
- Placing the assets in the hands of a trustee reduces the employer's potential fiduciary burdens (and liabilities) under ERISA if it is not the trustee.
- The deductibility of <u>all</u> IBNR will be protected by statute and case law, and not simply partial deductibility protected by an IRS procedural declaration that can be withdrawn on little or no notice.

We would add as a final comment that employers need to understand that not establishing a trust fund does not avoid the need to obtain an actuarial certification of the IBNR. Whether the deduction will be supported by an actual contribution to a fund, or simply by accruing the liability on the employer's books, the deduction must be supported by calculations performed by a professional actuary in order to be able to withstand IRS scrutiny.

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