N. VEBAS: NONDISCRIMINATION RULES AND UNRELATED BUSINESS INCOME TAX

1. Introduction

VEBAs are once again in the throes of change. The safe harbor guidelines issued in 1987 and revised in 1988 have permitted us to work many of the previously suspended cases. However, with the effective date of IRC 89, the rules have changed again and we still have insufficient regulations. Taxpayers' lack of understanding of the rules embodied in IRC 512, 419, and 419A means that unrelated business income of VEBAs is probably unreported or underreported.

2. VEBAS as History

What is now IRC 501(c)(9) was enacted in 1928. Proposed regulations were first published on January 23, 1969. These were withdrawn, and new proposed regulations were published on July 17, 1980. Final regulations were published on January 8, 1981 (T.D. 7750). The CPE text for 1982 contains an excellent discussion of the final regulations and includes a complete copy of T.D. 7750.

The arrival of some degree of certainty with respect to VEBAs in 1981 made them much more popular with employers and practitioners alike as a means of funding employee welfare benefits. At that time, employer contributions to VEBAs were subject only to the "reasonable and necessary" test of IRC 162. Consequently, some prefunding of benefits was possible. Furthermore, there were no specific limits on the funds a VEBA could accumulate as long as the funds were set aside for the payment of permissible benefits.

At about the same time, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) lowered the dollar limits on the annual contributions that could be made to qualified pension plans and the benefits that could be paid out of them. In some cases, plans were required to increase benefits for rank-and-file employees. Employers and practitioners realized that VEBAs could be used to some extent to recoup deductions lost in qualified plans after TEFRA.

As a result, there was a tremendous increase in the number of VEBA applications. Employers saw an opportunity to obtain in some respects the financial benefits associated with providing a qualified pension plan without many of the restrictions applicable to such plans. Our handling of this flood of cases was hampered by the lack of specific guidance on many issues. For example, Reg. 1.501(c)(9)-2(a)(2) prohibits discrimination in favor of "officers, shareholders, or highly compensated employees of an employer. . . ." but nowhere provides a definition of "highly compensated employee". Many VEBAs were created in which benefits were provided only to a single shareholder-employee, or to a very small group of employees in which the owner of the employer received a dominant share of the benefits. Ultimately, a list of major problem areas was published in the Internal Revenue Manual (IRM 7664.31(8)), with instructions to send all cases presenting these issues to the National Office.

Congress became very concerned about the problem of excessive employer contributions to VEBAs, prefunding of benefits and the consequent mismatching of income and expenses. Prior to the Tax Reform Act of 1984, some prefunding of welfare benefits was possible. At the same time, many employers were claiming deductions for large contributions to welfare benefit plans made long before any benefits were actually received by employees. In the Tax Reform Act of 1984, Congress amended IRC 512 and created new IRC 505, 419, and 419A primarily to address the funding problem, but also to provide some specific rules for addressing the discrimination issue. IRC 4976 was also enacted to provide effective penalties for certain discriminatory benefits and for reversion of funds to the employer from welfare benefit plans.

With the enactment of these Code sections work was begun on regulations. It was decided to issue guidance under IRC 505 in the form of questions and answers, the "Q's & A's". Whereas previously only some VEBAs required National Office consideration, on March 13, 1985, a memorandum was sent to all ARCs (Examination) requiring all VEBAs to be sent to the National Office. Initially, some attempts were made to continue working these cases in the National Office, but it soon became clear that this would not be done without guidance under IRC 505, which became effective on January 1, 1985. Nearly all applications under IRC 501(c)(9) were suspended in early 1985 and on December 2, 1985 the Service formally announced that all applications for exemption under IRC 501(c)(9) containing issues under IRC 505 could be suspended until rules or regulations under IRC 505 were published. Effectively, this meant that favorable rulings or determination letters would be issued only to collectively bargained plans. Denials were still issued in cases not involving the discrimination provisions of IRC 505, e.g. where impermissible types of benefits were provided.

Unfortunately, before much progress was made on the Q's & A's, Congress changed the rules again by enacting IRC 89. This time, the concerns were that the

Code contained a bewildering variety of discrimination provisions for different types of benefits and that the existing provisions were not strict enough in some cases. There was also a determination that employers should be encouraged to provide basic health care benefits for more of their employees. The Tax Reform Act of 1986, enacted October 22, 1986, created new IRC 89 and made significant changes to IRC 505. The Technical and Miscellaneous Revenue Act of 1988 also made significant changes to anti-discrimination rules with respect to VEBAS.

Because IRC 89 would take effect January 1, 1989 at the latest, work on the Q's & A's stopped. It appeared that unless some action was taken, VEBAs would continue to be suspended for several more years. This situation was causing administrative problems both for the Service and for taxpayers. Because of the Service's desire to provide prompt guidance to taxpayers, it was decided to issue guidance in the VEBA area in the form of "safe harbor guidelines" published in the IRM. These guidelines were issued August 28, 1987 and were the subject of extensive discussion in the 1988 CPE text. Minor revisions and corrections to the safe harbor guidelines were issued May 18, 1988. Training was provided to field personnel and both the key districts and the National Office began processing VEBA applications once again. Currently, the only cases which should be referred to the National Office are those which do not meet the safe harbor guidelines, are not willing to amend their plans to comply, and cannot be denied exemption for some other reason.

3. <u>Unresolved Issues Under IRC 501(c)(9)</u>

IRC 501(c)(9) and the regulations thereunder remain unchanged, although there are some unresolved problems, chiefly in the area of determining whether an employment-related common bond exists.

A. <u>Geographic Locale</u>

As discussed in the 1988 CPE VEBA article, it continues to be our position that VEBAs composed of several unaffiliated employers must be in the same line of business and share the same geographic locale, such as a single state or consolidated metropolitan statistical area (CMSA). We are not acceding to the decision in <u>Water Quality Association Employees' Benefit Corporation v. U.S.</u>, 795 F.2d 1303 (1986), in which the 7th Circuit Court of Appeals held that the "geographic locale" restriction in the regulations had no basis in the statute. Thus, we will continue to enforce this restriction in all circuits other than the 7th Circuit. The rationale for our position is twofold -- to prevent nationwide 501(c)(6) organizations from using VEBAs to avoid the imposition of unrelated business tax on their insurance programs and to prevent insurance companies from using VEBAs as tax-exempt vehicles to market insurance throughout the country in a manner that would undermine those provisions of the Code covering the income tax treatment of insurance companies.

We have begun to receive cases in which an otherwise nationwide VEBA is split into as many as 50 separate entities to comply with our position. We currently have under study the possibility of establishing a prototype or master plan procedure similar to that used in Employee Plans.

B. Line of Business

The issue of what constitutes a "line of business" for purposes of Reg. 1.501(c)(9)-2(a)(1) was considered in GCM 39299. In that case, a trade association described in IRC 501(c)(6) established a trust to provide various benefits to employees of the member-employers. Any member-employer engaged in a business described in Major Group numbers 40-49 of the Standard Industrial Classification (SIC) could participate in the trust.

Citing National Muffler Dealers Association, Inc. v. United States, 440 U.S. 472 (1979), and United States v. Continental Can Co., 378 U.S. 441 (1969), the GCM concluded that the term "line of business" means either an entire industry or all components of an industry within a geographic area. "Industry" was defined to mean either a group of businesses competing in the same market or "... an aggregate of enterprises employing similar production and marketing facilities and producing products having markedly similar characteristics."

The SIC is published by the Office of Management and Budget as a means of categorizing businesses according to the type of economic activity in which they are engaged. All business primarily engaged in the same type of economic activity, as defined by the principal products produced or services rendered, are grouped in the same 4-digit industrial code. The 4-digit industries are gathered into 3-digit "Industry Groups," which are divided into 2-digit "Major Groups." The "Major Groups" are classified into eleven "Economic Divisions." Economic Division E, which consists of Major Groups 40-49, is entitled "Transportation, Communication, Electric, Gas and Sanitary Services" and includes 70 distinct 4-digit industries including railroads, taxicabs, school buses, warehousing and storage, air transport, telephone communication, television broadcasting, and natural gas transmission.

The GCM concluded that while entities comprising a 4-digit industry or even a 3-digit Industry Group might be in the "same line of business", Economic Division E could not be so described because employers do not use similar production or marketing facilities, do not produce products or provide services having markedly similar characteristics, and do not compete in the same markets. Therefore, the employees of these employers do not share an employment related common bond within the meaning of the regulations.

C. <u>Employment Related Common Bond - Facts and Circumstances</u>

Reg. 1.501(c)(9)-2(a)(1) provides that a VEBA's membership must "consist of individuals who become entitled to participate by reason of their being employees and whose eligibility for membership is defined by reference to objective standards that constitute an employment-related common bond among such individuals." A number of examples are then given:

a. a common employer;

b. affiliated employers;

c. coverage under one or more collective bargaining agreements;

d. membership in a labor union; and

e. employers in the same line of business and same geographic locale.

The section then states "whether a group of individuals is defined by reference to a permissible standard or standards is a question to be determined with regard to all the facts and circumstances, taking into account the guidelines set forth in this paragraph." Thus, the examples enumerated in this section are neither exhaustive nor exclusive. Below are two examples where a facts and circumstances approach would be appropriate.

> **<u>Example 1</u>** A VEBA is established to provide benefits to employees of several banks in four states. Each of the participating banks was owned, prior to his death, by O. Each of the banks is now owned by either M or N who are brothers and who are the sons of O. There is an employment-related common bond.

<u>Example 2</u> Assume the same facts in Example 1 except that controlling interests in some of the participating banks are owned by Corporation X. Corporation X is owned by M, N, and other persons related to M and N. There is an employment-related common bond.

D. <u>Termination</u>

On occasion, a new VEBA may be formed out of one or more pre-existing VEBAs as a result of a merger of employers or of unions, or as a result of a termination of an existing plan. Where the surviving organization seeks recognition as an organization described in IRC 501(c)(9) as a result of such a merger, termination, or change in affiliation, IRM 7664.31:(9)(b) requires that the application be forwarded to the National Office. However, this does not apply to VEBAs that simply terminate, where no new VEBA is created, no funds are transferred to another VEBA, or no merger occurs. Such terminations should be handled in the key district office, in the same manner that all other terminations are handled.

4. <u>Discrimination Rules</u>

A. <u>Introduction</u>

IRC 505(a) requires that organizations described in IRC 501(c)(9) meet certain nondiscrimination requirements set forth in IRC 505(b) in order to obtain exemption. IRC 505(b)(3) provides that if nondiscrimination rules are provided by some other Code section, those other rules will be used. Discrimination rules for supplemental unemployment benefits are found in IRC 501(c)(17). IRC 120 provides discrimination rules for group legal services, IRC 127 for educational assistance, and IRC 129 for dependent care assistance.

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) amended IRC 505(a)(1) to state that failure to meet the requirements of IRC 89 will not preclude exemption for plans including benefits to which IRC 89 applies. Instead, an excise tax will be imposed on the employer. IRC 89 applies, generally, to medical and group-term life insurance benefits. It is not yet clear what discrimination rules will apply with respect to VEBAs providing these types of benefits.

B. Excluded Employees

For purposes of testing discrimination, certain categories of employees can be excluded from consideration. These categories of employees are enumerated in IRC 89(h). This does not mean that a plan is required to exclude these employees or that only these employees can be excluded. It means only that when testing for discrimination these employees can be ignored. The exclusions are:

(1) Employees who have not completed 1 year of service (or in the case of core benefits under a health plan, 6 months of service).

(2) Employees who normally work less than 17 1/2 hours per week.

(3) Employees who normally work during not more than 6 months during any year.

(4) Employees who have not attained age 21.

(5) Employees who are included in a unit of employees covered by a good faith collective bargaining agreement

(6) Employees who are nonresident aliens and who receive no earned income from the employer which constitutes income from sources within the United States

(7) Employees who are students working for the school, college, or university they attend if core health coverage is made available to them (added by TAMRA)

Prior to the enactment of IRC 89, it was arguable whether an employer could, without adverse consequences, have different waiting periods for different groups of employees as long as all the waiting periods were less than 3 years. IRC 89(h)(2) makes it clear, however, that excluding the employees listed above when testing for discrimination is permissible only if the exclusions are the same for all categories of employees.

Example 3 A plan provides for a waiting period for life insurance coverage of six months for hourly employees and three months for salaried employees. All highly compensated employees are classified as salaried employees. For purposes of testing for discrimination, only those employees with less than three months of service could be excluded from consideration.

All such exclusions (except the one for nonresident aliens) must apply to all plans of the employer of the same type. There is also a special rule for multi-employer plans. In applying exclusions (A), (B), (C), and (D) to other plans of the employer, multiemployer plans are ignored. This special rule does not apply if the employer contributes to the multiemployer plan on behalf of individuals performing professional services for the employer.

It is permissible to have different waiting periods for core and noncore health benefits. It is also permissible to provide proportionately reduced health benefits to employees who work less than 30 hours per week. See IRC 89(j)(5).

The term "core health benefits" is not defined in the statute. However the Conference Report for the Tax Reform Act of 1986 explains that noncore benefits consist of coverage for dental, vision, psychological and orthodontia expenses and elective cosmetic surgery. Core health benefits are therefore basic medical benefits other than the items mentioned in the previous sentence. See 1986-3 C.B. Vol. 4, p. 519. A different definition of "core health benefits" is used for COBRA purposes. See Prop. Reg. 1.162-26 Q&A 25.

C. Other Definitions and Special Rules

IRC 89(i) describes the types of plans to which IRC 89 applies. These are accident or health plans within the meaning of IRC 105(e) and group term life insurance plans within the meaning of IRC 79. IRC 105(e) describes amounts received under an accident or health plan for employees and amounts received from a sickness and disability fund for employees maintained under the law of a State or the District of Columbia.

An employer may elect to treat three other types of plans as statutory employee benefit plans. These are:

1. Qualified group legal services plans described in IRC 120(b);

2. Educational assistance programs described in IRC 127(b); and

3. Dependent care assistance programs described in IRC 129(d).

If an employer elects to do this and the plan meets the requirements of IRC 89, then the plan is treated as meeting the nondiscrimination requirements imposed by those other Code sections, except for the percentage limitations of IRCs 120(c)(3), 127(b)(3), and 129(d)(4).

IRC 89(k) sets forth some other requirements that a plan must meet if benefits are not to be taxable to employees. In addition, TAMRA of 1988 added IRC 89(k)(5) which provides that a plan to which IRC 505 applies must meet the requirements of IRC 89(k)(1) or exemption is precluded. IRC 89(k)(1) requires that:

(A) the plan be in writing,

(B) the employees' rights under such plan are legally enforceable,

(C) employees are provided reasonable notification of benefits available in the plan,

(D) the plan is maintained for the exclusive benefit of employees, and

(E) the plan was established with the intention of being maintained for an indefinite period of time.

D. Discrimination Rules -- IRC 505

1. Introduction

IRC 505(a)(1) provides that an organization otherwise described in IRC 501(c)(9) or 501(c)(20) is not exempt unless it meets the requirements of IRC 505(b)(2). As originally enacted in 1984, IRC 505(a)(2) excepted from these requirements

> "any organization which is part of a plan maintained pursuant to 1 or more collective bargaining agreements between 1 or more employee organizations and 1 or more employers."

The Tax Reform Act of 1986 amended this to read:

> "any organization which is part of a plan maintained pursuant to an agreement between employee representatives and 1 or more employers if the Secretary finds that such agreement is a collective bargaining agreement and that such plan was the subject of good faith bargaining between such employee representatives and such employer or employers."

The reason for this change was Congress' concern about the proliferation of so-called "collective bargaining agreements" between employers and organizations "representing" highly compensated employees of the employer. See p. 760, House Report 99-426.

2. <u>Discrimination Rules</u>

IRC 505(b)(1) provides that each class of benefits under the plan must be provided under a classification of employees which is specified in the plan and which is not discriminatory in favor of highly compensated employees. In the case of each class of benefits, the benefits provided cannot be discriminatory in favor of highly compensated employees. Thus, neither the eligibility rules nor the actual benefits provided can be discriminatory in favor of highly compensated employees.

There is a special exception for life, disability, severance, and supplemental unemployment benefits; they can be provided as a uniform percentage of compensation. The inclusion of this exception in the statute implies that, absent this provision, such benefits would be discriminatory.

IRC 505(b)(2)provides that when testing for discrimination, employees excludable under IRC 89(h) can be excluded for purposes of IRC 505. The specific exclusions were discussed earlier. Remember that the exclusions must be the same for all employees, or this exception does not apply.

IRC 505(b)(3)provides that, with respect to particular benefits, if some other Code section provides nondiscrimination rules for a particular type of benefit, then those nondiscrimination rules are used and IRC 505(b)(1) does not apply. Discrimination rules for life insurance, health (medical) benefits, group legal services, educational assistance, and dependent care assistance were discussed earlier. Supplemental unemployment compensation benefits are tested for discrimination under IRC 501(c)(17), using the IRC 414(q) definition of highly compensated employees. All other benefits, including disability, severance pay, vacation pay, and vacation facilities are tested for discrimination under IRC 505(b)(1).

3. Aggregation Rules

Employers frequently have different plans for different groups of employees. These differences may result from different collective bargaining agreements, acquisition of businesses, industry practice, or a variety of other factors. IRC 505(b)(4) provides aggregation rules. The employer may elect to treat 2 or more plans as 1 plan for purposes of testing for discrimination.

A different problem arises with groups of related employers.

> **Example 4** An employer, X Corp, creates a wholly-owned subsidiary, Y Corp. All officers and highly-compensated employees are employed by X. All other employees are employed by Y. Both X and Y set up VEBAs for their employees, but the X VEBA provides significantly better benefits than the Y VEBA. Can the X VEBA qualify for exemption under IRC 501(c)(9)?

In dealing with related employers such as X and Y, the rules in IRCs 414(b), (c), (m), and (n) apply. This means, generally, that employers described in those Code sections will be treated as one employer for purposes of testing for discrimination. IRC 414(b) refers to employees of a controlled group of corporations within the meaning of IRC 1563(a). These are generally parent-subsidiary or brother-sister groups of corporations. Thus, for purposes of the previous example, X and Y would be treated as a single employer. IRC 414(c) refers to employees of partnerships and proprietorships which are under common control.

IRC 414(m) discusses affiliated service groups. These are groups of organizations linked by some degree of common ownership in which some members of the group perform services for other members of the group.

> **Example 5** Corporation X is operating a group medical practice with 10 doctors. All physician employees of X are highly-compensated employees of X. All non-physician employees (nurses, office personnel, etc.) are employees of another corporation, Y. Y's only function is to provide services to X. 20% of Y is owned by one of the highly-compensated doctors of X. X and Y are therefore members of

an affiliated service group and will be treated as one employer for purposes of testing discrimination.

IRC 414(n) discusses leased employees. For purposes of testing discrimination under IRC 89, leased employees are treated as employees of the business for whom they provide services. However, benefits provided to leased employees by their nominal employers (the leasing organization) are treated as being provided by the employer for whom the employees are providing services.

4. <u>Highly Compensated Individuals</u>

IRC 505(b)(5) provides that indetermining whether an individual is highly compensated, rules similar to the rules under IRC 414(q) will be used. IRC 414(q) defines "highly compensated employee" to mean any employee who, during the year or the preceding year --

(A) was at any time a 5% owner,

(B) received compensation from the employer in excess of $75,000,

(C) received compensation from the employer in excess of $ 50,000 and was in the top 20% of employees (ranked on the basis of compensation), or

(D) was at any time an officer and received compensation greater than 150% of the amount in effect under IRC 415(c)(1)(A). For 1988, this means officers earning more than $ 45,000 per year.

TAMRA provides that the dollar amounts in (B) and (C) will be indexed for inflation in the same way as the IRC 415(d) limit. IRC 414(q) includes numerous other provisions used in determining who is highly compensated, but these are the basic rules.

TAMRA also provides a simplified method for determining highly compensated employees. An employer who maintains significant business activities in at least two significantly separate geographic areas may elect to treat all employees earning more than $50,000 per year as highly compensated employees. This would relieve the employer from the need to determine who is in the top 20% of employees when ranked by compensation.

5. Unrelated Business Income of VEBAS

A. Introduction

In 1984, Congress was chiefly concerned with the deduction/taxation mismatch. Prior to the Tax Reform Act of 1984, some prefunding of welfare benefits was possible. At the same time, many employers were claiming deductions for large contributions to welfare benefit plans made long before any benefits were actually received by employees. This, combined with the availability of tax exemption for VEBAs, provided tax treatment similar to that provided for qualified pension plans, but with far fewer restrictions.

Therefore, IRC 419 and 419A provided that, as a general rule, employers should not be permitted a current deduction for welfare benefits that may be provided in the future. Instead, employers should generally be permitted to deduct employer contributions to a welfare benefit fund on the same basis as if the employer had provided the benefits directly to the employees. Reasonable levels of reserves are permitted for certain self-funded insurance-type benefits -- life, medical, disability, severance pay, and supplemental unemployment compensation benefits. It was the intent of Congress to limit the definition of "disability" to serious physical or mental impairments which cause an inability to perform a substantial portion of the duties of an individual's ordinary employment. See General Explanation of the Tax Reform Act of 1984, p. 783.

At the same time, limits were imposed on the extent to which a tax-exempt entity such as a VEBA could accumulate income on a tax-favored basis and the types of benefits for which funds could be accumulated. Prior law did not specifically limit the amount of income that could be set aside, but the Service's position has always been that any such setasides must be reasonable in amount and duration. Accordingly, limits were imposed on the amounts that may be set aside on a tax-exempt basis. Tax-free reserves are not allowed at all except with respect to self-funded life (including post-retirement life), medical, disability, severance pay, and supplemental unemployment compensation benefits. Reserves for most of these are limited to claims incurred but unpaid as of the end of the year. However, reserves for post-retirement life and post-retirement medical benefits may be accumulated over the working lives of covered employees. Additional reserves for long-term disability benefits are also allowed to fund the future stream of benefit payments to a currently disabled employee.

B. IRC 512

IRC 512(a)(3)(A) provides the first basic rule for the taxation of VEBAs. All gross income (less directly connected expenses) is taxable except exempt function income. Gross income is defined by IRC 61 to mean all income from whatever source derived, except as otherwise provided. IRC 103 provides that gross income does not include interest on state and local bonds. Therefore, if a VEBA's investment income is received exclusively from interest on municipal bonds, it will have no unrelated business income. Because of the new limits on accumulation of reserves by VEBAs, some commentators are suggesting that VEBAs invest their reserves exclusively in these instruments.

IRC 512(a)(3)(B) defines exempt function income as amounts paid by members as consideration for providing the members with services, etc., in furtherance of the organization's exempt purposes. Reg. 1.512(a)-5T Q&A 3(b) provides that for purposes of this definition, member contributions include both employee contributions and employer contributions.

Exempt function income also includes all income which is set aside to provide for the payment of life, sick, accident, or other benefits, including reasonable costs of administration. However, income from an unrelated trade or business regularly carried on by the organization cannot be set aside. For this purpose, income from an unrelated trade or business is computed using the general rules of IRC 512(a)(1).

Generally, a VEBA will include a provision in its governing instrument stating that all of its income and assets will be used for the payment of benefits and administrative costs. Such a provision is adequate for creating a setaside up to the allowable limits established by IRC 512(a)(3)(E) (discussed below). All income earned by the VEBA is then considered set aside for the payment of benefits. If reserves exceed the allowable account limit established by IRC 419A, any investment income will be considered unrelated business income. This is consistent with the legislative history of IRC 512(a)(3)(B), which indicates that investment income is an integral part of the exempt insurance function of a VEBA. See S.REP. No. 91-552, 1969-3 C.B. 470. For a more extensive discussion of this issue, see IRM 7751, section 9(11)0.

If amounts previously set aside for the payment of benefits or administrative costs are used for some other purpose, the amounts so used are included in unrelated business taxable income for the year in which they are used.

> **<u>Example 6</u>** In 1989 a VEBA uses funds previously set aside from investment income to purchase an office building for $500,000. Fifty percent of the building will be used by the VEBA in carrying out its exempt functions. The remainder of the building will be leased to commercial tenants. In 1989, the VEBA must include $250,000 in unrelated business income because the amount was withdrawn from setaside funds and not used to provide benefits or to pay reasonable administrative costs.

When a VEBA terminates, Reg. 1.501(c)(9)-4(d) permits the distribution of remaining assets to member employees. Such a distribution does not constitute withdrawal from a setaside, and would not result in unrelated business taxable income to the VEBA.

It must be emphasized that exempt function expenditures, i.e. payment of benefits and administrative costs, cannot be deducted from investment income in determining a VEBA's unrelated business taxable income. However, if the account limit determined under IRC 419A is such that actual reserves at the end of a given tax year are less than or equal to permitted reserves, investment income earned and expended for benefits within the year is treated as having first been set aside and then expended for the payment of benefits.

> **<u>Example 7</u>** In 1988 a VEBA which provides self-funded medical benefits has a reserve at the beginning of the year of $50,000. Expenditures for benefits during the year are $75,000. Investment income for the year is $5,000 and employer contributions are $20,000. Assume that the allowable reserve at the end of 1988 is $30,000 and that the actual reserve at the end of 1988 is -0-. The investment income is deemed to have been first set aside and then expended for benefits. Thus, there will be no unrelated business income in 1988.

IRC 512(a)(3)(E) limits the amounts that can be validly set aside. Effective for taxable years ending after 12/31/85, setasides for payments of benefits are valid only if the setaside does not result in an amount of assets set aside in excess of the account limit determined under IRC 419A. While plans that involve ten or more employers are not subject to the employer deduction limits of IRC 419, they cannot hold reserves beyond the limits imposed by IRC 419A without subjecting their investment income to the tax on unrelated business income.

Reg. 1.512(a)-5T Q&A 3(b) provides that the unrelated business taxable income of a VEBA generally will equal the lesser of two amounts:

1. the income of the VEBA for the taxable year (excluding member and employer contributions); or

2. the excess of the total amount set aside as of the close of the taxable year over the qualified asset account limit.

Thus, if there is no investment income or other non-member income, there will be no tax because #1 will equal zero and will thus be less than #2.

IRC 512(a)(3)(E)(iii) provides that these new rules for computing unrelated business income do not apply if substantially all of the contributions to the organization were made by employers who were exempt from federal income tax throughout the period of 5 taxable years ending with the taxable year in which the contributions are made.

If a welfare benefit fund is not exempt from income tax, e.g. a VEBA whose exemption has been revoked, the deemed unrelated income of the fund is includible in the gross income of the employer who maintains the fund. The deemed unrelated income is the amount of unrelated business income the fund would have if it were exempt. It is unclear how this provision would apply in the case of funds involving more than one employer, i.e. how the unrelated business income would be allocated among the participating employers. One possible method would be to make the allocation based on employer contributions.

C. <u>IRCs 419 and 419A</u>

IRC 419 limits employer deductions for contributions to welfare benefit funds and defines certain terms. It can apply even if there is not a separate legal entity; exempt status is irrelevant. Except for definitions and possible referrals to Exam Division, the Exempt Organizations function is not directly concerned with IRC 419.

IRC 419 defines qualified direct cost to mean the aggregate amount (including administrative expenses) which would have been allowable as a deduction to the employer if the benefits were provided directly by the employer and the employer used the cash receipts and disbursements method. In the case of fully insured benefits, this means the amount that would have been allowable as a deduction to the employer if the employer paid the premiums directly. Note that if payments by the employer cover periods lying in more than one taxable year, the payments must be prorated when determining qualified direct cost. For example, if a calendar year welfare benefit fund pays an insurance company in July 1986 the full premium for coverage of it current employees under a term health insurance policy for the twelve month period ending June 30, 1987, the insurance coverage will be treated as provided by the fund over such twelve month period. Only the portion of the premium for coverage during 1986 will be treated as a qualified direct cost for 1986; the remainder will be treated as a qualified direct cost of the fund for 1987. See Reg. 1.419-1T Q&A 6.

IRC 419A defines "qualified asset account" and sets limits on additions to such accounts for purposes of IRC 419 and IRC 512.

IRC 419A(a) defines qualified asset account to mean assets set aside to provide for the payment of disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits. Assets cannot be set aside for future years with respect to any other type of benefits, e.g. vacation pay or child care, without incurring tax on the investment income earned.

IRC 419A(c)(1) sets forth the general rule that the account limit is the amount reasonably and actuarially necessary to fund <u>claims incurred but unpaid</u> (emphasis added) plus administrative costs with respect to such claims. Claims incurred but unpaid include both claims incurred but unreported and claims reported but unpaid. This limitation is designed to reflect the general policy that a deduction is not to be allowed with respect to an item of expense before the expense has been incurred. A claim is incurred only when an event has occurred that entitles an employee to the benefit. For example, in the case of a plan providing life insurance benefits, a claim is incurred upon the death of a covered employee. In the case of a self-funded medical plan, a claim is incurred when a covered employee has received a service and, thus, incurred an expense covered by the plan. Insurance premiums are not to be regarded as claims incurred but unpaid. See <u>General Explanation of the Tax Reform Act of 1984</u>, pp. 782-783.

IRC 419A(c)(2) provides that additional reserves are allowed for post-retirement life and medical benefits. This is because such benefits are generally funded over the expected working lives of covered employees. That is, funds are gradually accumulated so that when an employee retires, funds are available to provide the desired coverage. However, the amount of the reserve must be actuarially determined.

IRC 419A(c)(5) provides that unless there is an actuarial certification of the account limit, the allowable account limit may not exceed the sum of the safe harbor limits for each benefit provided. Even if the safe harbor level is not exceeded, the taxpayer must be able to show that the amount is reasonable. Thus, these are not safe harbors in the traditional sense of the term. See General Explanation of the Tax Reform Act of 1984, p. 786. Remember that the actuarial certification referred to here is an actuarial estimate of claims incurred during the plan year, but not yet paid. It is not an actuarial estimate of future funding needs as discussed in the previous paragraph. In addition to requiring that actuarial assumptions must be reasonable, the regulations may also require specific interest rate and mortality assumptions to be used.

D. "Safe Harbor" Limits

The safe harbor account limit varies depending on the type of benefit provided. For SUB and severance pay plans, the account limit is equal to 75% of the average annual qualified direct costs for any 2 of the preceding 7 tax years. Of course, a new plan with no direct cost history would have some difficulty in using this standard. Therefore, for new plans with no key employee participants, the account limit is to be set by regulations. In determining qualified direct costs for such a plan, IRC 419A(c)(3)(B) provides that benefits payable to any one individual at an annual rate of more than 150% of the IRC 415(c)(1)(A) limit are not taken into account. Thus, benefits payable to an employee at an annual rate of more than $45,000 (for 1988) are disregarded in calculating qualified direct cost.

For short term disability benefits, the "safe harbor" limit is 17.5% of qualified direct costs, disregarding any qualified direct costs that consist of insurance premiums.

For medical benefits, the "safe harbor" limit is 35% of qualified direct costs. Again, insurance premiums are specifically excluded from the calculation.

For life insurance and long-term disability benefits, the safe harbor limit is to be established by regulations. In determining qualified direct costs for long-term disability benefits, benefits payable to an individual are taken into account only to the extent that they don't exceed the lesser of 75% of the employee's average compensation for his high three years, or the limitation in effect under IRC 415(b)(1)(A) ($90,000 in 1988). An amount necessary to fund a stream of future payments to a currently disabled employee can be set aside currently if the amount is supported by an actuarial determination. If the disability is long-term it must have existed for at least five months and be expected to continue for a total of at least twelve months. A short-term disability must have existed for at least two weeks. With respect to short-term disabilities, a maximum of twelve months of benefit payments can be deemed to have been incurred. See General Explanation of the Tax Reform Act of 1984, p. 783.

Thus, in calculating the UBIT liability for a VEBA, separate calculations are necessary for each type of benefit provided in order to determine the amount of an allowable setaside. No setaside is permissible for the future provision of educational benefits, vacation pay, or any benefits other than those referred to above.

> **Example 8** A VEBA provides self-funded vacation pay, holiday pay, and sick pay benefits. It also provides medical benefits which are fully insured. Its account limit is $0. Vacation pay, holiday pay, and sick pay are not benefits for which set asides are permissible. Since the medical benefits are fully insured and insurance premiums are excluded from the calculation of qualified direct cost, the account limit for these benefits is also $0. Any investment income earned by this VEBA is therefore subject to tax.

E. Transition Rules

There are transition rules provided by IRC 419A(f)(7) which apply to the first four taxable years for which IRC 419A is effective. IRC 419A is effective generally for contributions paid or accrued after December 31, 1985, in taxable years ending after such date. Thus, for a calendar year VEBA the transition rules apply for the years ending December 31, 1986, 1987, 1988, and 1989. The transitional rule provides that the account limit during these four years will be increased by a percentage of any existing excess reserve as of the close of the first taxable year ending after July 18, 1984. The percentages are:

First taxable year 80%
Second taxable year 60%
Third taxable year 40%
Fourth taxable year 20%

The term "existing excess reserve" means the excess of:

the amount of assets set aside at the close of the first taxable year ending after July 18, 1984 for disability, medical, SUB, severance pay, or life insurance benefits

over:

the account limit determined for the taxable year (without regard to these transition rules).

Thus, the transition rules would not affect the calculation of the account limit in the previous example. The holiday, vacation, and sick pay benefits are not listed in IRC 419A(a). The medical benefits are fully insured and insurance premiums are not included in calculating the account limit. For purposes of the remaining examples, assume that 35% of qualified direct cost is in fact a reasonable estimate of claims incurred but unpaid.

Example 9 A calendar year VEBA provides self-funded medical benefits. Its reserve as of 12/31/84 was $150,000. Its qualified direct cost was $50,000 in 1985, $60,000 in 1986, $70,000 in 1987, and $80,000 in 1988. The account limit for each year is calculated as follows:

1986	(35% of $ 50,000)		$ 17,500
	12/31/84 reserve	$ 150,000	
	1986 account limit	17,500	
	Excess reserve	$ 132,500	
	Applicable percentage	80%	106,500
Adjusted account limit, 1986			$ 124,000
1987	(35% of $ 60,000)		$ 21,000
	12/31/84 reserve	$ 150,000	
	1987 account limit	21,000	
	Excess reserve	$ 129,000	
	Applicable percentage	60%	77,400
Adjusted account limit, 1987			$ 98,400

1988	(35% of $ 70,000)		$ 24,500
	12/31/84 reserve	$ 150,000	
	1988 account limit	24,500	
	Excess reserve	$ 125,500	
	Applicable percentage	40%	50,200
Adjusted account limit, 1988			$ 74,700
1989	(35% of $ 80,000)		$ 28,000
	12/31/84 reserve	$ 150,000	
	1989 account limit	28,000	
	Excess reserve	$ 122,000	
	Applicable percentage	20%	24,400
Adjusted account limit, 1989			$ 52,400

Example 10 Assume the same facts as in the previous example. In addition, assume that in 1988 the VEBA had investment income of $6,000, related expenses of $200, and a reserve at the end of the year of $100,000. Since the actual reserves ($100,000) exceed the account limit for 1988 ($74,700) by $25,300, no amount of investment income can be set aside. Therefore, the VEBA's unrelated business taxable income is $4800, taking into consideration the specific deduction of $1000 of IRC 512(b)(12).

Example 11 A calendar year VEBA provides self-funded medical benefits. On December 31, 1984 it had reserves of $100,000. For 1986 it had qualified direct costs of $50,000 and reserves of $50,000 at the end of the year. For 1987 it had investment income of $5,000, investment expenses of $500, and qualified direct costs of $50,000. Employer contributions were $6,500. Reserves at the end of the year were $10,000. What is the VEBA's unrelated business taxable income for 1987?

1987 account limit	(35% of $ 50,000)	$ 17,500
12/31/84 reserve	$ 100,000	
1987 account limit	17,000	
Excess reserve	82,500	
Applicable percentage	60%	49,000
Adjusted account limit		$ 67,000

Because the account limit ($ 67,000) exceeds the amount in the reserve ($ 10,000), all of the investment income can be set aside for the payment of benefits. Therefore, there is no unrelated business income tax liability for this VEBA for 1987.

Example 12 A calendar year VEBA provides self-funded medical benefits. On December 31, 1984 it had reserves of $100,000. For 1986 it had qualified direct costs of $50,000 and reserves of $50,000 at the end of the year. For 1987 it had investment income of $5,000, investment expenses of $500, and qualified direct costs of $50,000. Employer contributions were $105,500. Reserves at the end of the year were $110,000. What is the VEBA's unrelated business taxable income for 1987?

1987 account limit	(35% of $ 50,000)	$ 17,500
12/31/84 reserve	$ 100,000	
1987 account limit	17,500	
Excess reserve	82,500	
Applicable percentage	60%	49,500
Adjusted account limit		$ 67,000

Since the actual reserves ($ 110,000) exceed the adjusted account limit ($ 67,000) by $ 43,000, the VEBA cannot set aside its net investment income of $ 4500 and will have unrelated business taxable income of $ 3500, taking into consideration the specific deduction of $1000.

Example 13 A calendar year VEBA provides self-funded medical benefits. On December 31, 1984 it had reserves of $100,000. For 1986 it had qualified direct costs of $50,000 and reserves of $50,000 at the end of the year. For 1987 it had investment income of $5,000, investment expenses of $500, and qualified direct costs of $50,000. Employer contributions were $65,500. Reserves at the end of the year were $70,000. What is the VEBA's unrelated business taxable income for 1987?

1987 account limit	(35% of $ 50,000)	$ 17,500
12/31/84 reserve	$ 100,000	
1987 account limit	17,000	
Excess reserve	82,500	
Applicable percentage	60%	49,000
Adjusted account limit		$ 67,000

Because the actual reserve of $ 70,000 exceeds the adjusted account limit by $ 3000, $ 3000 of the interest income is taxable. Taking into consideration the specific deduction and an allocable share of the investment expenses, the VEBA's unrelated business taxable income is $1700.

F. Collectively Bargained Plans

Section 1.419A-2T A-1 of the temporary regulations has been largely rendered moot by the 1986 Act which amended IRC 419A(f)(5) to provide that there is no account limit for a separate welfare benefit fund under a collective bargaining agreement.

IRC 1.419A-2T A-2 defines when a welfare benefit fund is considered maintained pursuant to a collective bargaining agreement. Such a fund must be maintained pursuant to an agreement which the Secretary of Labor determines to be a collective bargaining agreement. Furthermore, the benefits provided through the fund must have been the subject of arms length negotiation between the employer and the employee representatives. The circumstances surrounding the agreement must evidence good faith bargaining between adverse parties over the welfare benefits to be provided through the fund. The agreement must also satisfy IRC 7701(a)(46) of the Code. That section requires that the term "employee representatives" shall not include any organization more than one-half of the members of which are employees who are owners, officers, or executives of the employer.

Some VEBAs provide benefits both to employees covered by a collective bargaining agreement and employees who are not. A welfare benefit fund is not considered to be maintained pursuant to a collective bargaining agreement unless at least 50 percent of the employees eligible to receive benefits are covered by the agreement. Furthermore, only the portion of the fund attributable to employees covered by a collective bargaining agreement is considered to be maintained pursuant to a collective bargaining agreement and thus exempt from the account limits.

> **<u>Example 14</u>** Corporation X established a VEBA in 1982 to provide medical benefits to its union and non-union employees. The same benefits are provided to all; X provides to non-union employees whatever benefits are bargained for by the union employees. X has 1000 employees, 600 of whom are covered by the collective bargaining agreement. Since 60% of the employees are covered by the collective bargaining agreement, the fund is considered to be maintained pursuant to a collective bargaining agreement. 60% of the fund is thus exempt from the account limits and also exempt from the limit on setasides of IRC 512(a)(3)(E). 60% of the fund could earn investment income without incurring any tax liability.

> **<u>Example 15</u>** Assume the same facts as in the previous example, except that only 400 of X's employees are covered by the collective bargaining agreement. In this case, the fund is not considered to be maintained pursuant to a collective bargaining agreement and no part of the fund is exempt from the account limit otherwise established by IRC 419A. To the extent that reserves exceed the applicable account limit, investment income will be fully taxable.

There is a special rule for new organizations. Pending the issuance of final regulations, a welfare benefit fund that was not in existence on July 1, 1985 must cover employees 90% of whom are covered by a collective bargaining agreement. Thus, in Example 14, above, if the VEBA were established in 1986, the fund would not be considered to be maintained pursuant to a collective bargaining agreement.

A welfare benefit fund will not be treated as a collectively bargained welfare benefit fund if, after July 1, 1985, the number of employees who are not covered by a collective bargaining agreement and are eligible to receive benefits under the fund increases by reason of an amendment, merger, or other action of the employer or the fund. See Reg. 1.419A-2T Q&A 2(4). This does not apply, however, to natural growth of the employer's work force.

6. <u>COBRA Considerations</u>

IRC 162(k) was enacted as part of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA). It requires employers to provide continuation of health care coverage for certain employees and beneficiaries. IRC 162(i)(2) denied an employer's deduction for health care costs if the employer maintained a noncomplying plan. TAMRA replaced the loss-of-deduction sanction with an excise tax in new IRC 4980B and moved the continuation coverage requirement from 162(k) to that new section. Generally, if an employee is terminated (except for gross misconduct), benefits must be available, at the employee's election, for as much as 18 months after the date of termination. Other qualifying events, such as death and divorce, require that benefits be available for up to 36 months after the triggering event. The coverage provided must be the same as provided to non-COBRA participants. In all cases, COBRA participants can be charged up to 102% of the cost of the benefits.

With respect to VEBAs, a question arises. Do COBRA participants share an employment-related common bond with other participants?

Reg. 1.501(c)(9)-2(b) defines "employee" for purposes of IRC 501(c)(9). This definition includes individuals who became entitled to membership by reason of having been an employee. Terminated employees are specifically mentioned. The definition also includes the surviving spouse and dependents of an employee. Therefore, it is our position that COBRA participants share an employment-related common bond with other VEBA participants.