LESSON 5

VEBA AWARENESS

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INTRODUCTION

The term VEBA is an acronym for a Voluntary Employees' Beneficiary Association. A VEBA is an exempt trust which is used as a vehicle to fund certain employee welfare benefits, most notably, health care. A VEBA can be

established by employees, labor organizations or employers. Our principal focus is on VEBA's established by employers. Actually our principal focus isn't on VEBA's at all, rather, it is on employers who take deductions for contributions to VEBA's they established.

The IRC section 419 and 419A/VEBA area has been included as a specialty area under the Industry Specialization Program (VEBA ISP). Issue Specialists not only advise agents on current issue identification and development but are also charged with the responsibility of keeping abreast of emerging issues and meeting with both internal and external stakeholders. See Appendix I.

In very basic terms, an employer is allowed a deduction for contributions to VEBA's for the purpose of funding the payment of its employee welfare benefits. This deduction is controlled by IRC sections 419 and 419A. We are concerned about employer deductions of VEBA contributions because we have uncovered a substantial amount of abuse in this area; primarily, the acceleration of the timing of deductions. This may not sound all that significant (i.e., a "timing" adjustment) but it is for a number of reasons.

The primary reason timing is significant is because sections 419 and 419A were enacted by Congress for the specific purpose of establishing the proper timing of deductions for contributions to welfare benefit funds. In other words, Congress determined that timing in this area was important enough to be statutorily controlled. Furthermore, the ability to control the timing of a deduction in this area is financially significant to employers because of the dollar amounts involved. In fact, many benefit consultants market the ability to accelerate the timing of deductions as a means of reducing the ultimate cost to the employer. The cost of providing employee welfare benefits is very substantial and it is rising at a rate which exceeds the general rate of inflation. A major American automotive manufacturer has stated that the single most expensive cost component of their motor vehicles is the cost of providing medical benefits to their active and retired employees. Given the relative dollar amounts involved, the ability to control the timing of a deduction, from the employer's perspective, is financially significant and therefore subject to potentially improper manipulation.

OBJECTIVES

At the end of this module, you should be able to:

1. Recognize issues involving VEBA deductions.

2. Identify resources available to resolve VEBA issues.

BACKGROUND

Until recently, the provision of employee welfare benefits (such as medical, dental, disability, and life insurance) by an employer was taken for granted by most American workers. Skyrocketing medical costs, combined with the effect of Financial Accounting Standards Board Statement Number 106, have had a major impact on the provision of this type of benefit by employers. Some companies are requiring employees to share the cost of these benefits. Other companies are reducing or eliminating medical insurance and other benefits for their retirees. Many companies have turned to self-insurance of certain benefits, especially medical coverage, in an attempt to control or reduce their costs. Finally, the proposals to institute a flat tax system or to reform health care to extend medical insurance to all Americans will have an impact depending on how Congress decides to implement the changes.

Financial Accounting Standard Number 106 deals with employers' accounting for post-retirement benefits other than pensions, most notably medical benefits. This Statement has heightened the attention paid by employers to the cost of providing employee welfare benefits. This Statement, which was issued in December of 1990, and became mandatory for most employers for fiscal years beginning after December 15, 1992, requires most employers to accrue the expected cost of post-retirement benefits other than pensions during the years that the employee renders services rather than on a pay-as-you-go basis. This Statement does not require the actual funding of benefits, just the current recognition of the future expense. Expense recognition creates an unfunded liability on the employer's balance sheet.

Within limits, sections 419(b) & 419A(c)(2) allow a deduction to companies who decide to fund post-retirement medical and life insurance reserves in a welfare benefit fund, such as a VEBA. The tax provision does not allow a deduction for an accrual of this liability; rather, the amounts must be actually paid to the fund.

Even though FAS 106 and section 419A(c)(2) deal, in essence, with the same expense component the computations involved are very different. The most significant difference between the two is that FAS 106 requires that inflation be included in the computation whereas section 419A(c)(2) forbids inclusion of inflation in the calculation of any post-retirement medical reserve.

Although FAS 106 does not address the tax deduction allowable to the employer, it may have an indirect effect on the amounts claimed as a deduction by giving employers an incentive to prefund larger amounts of post-retirement welfare benefits than they would have in the absence of the book accrual requirement. This happens because FAS 106 permits an employer to offset the liabilities accrued on its balance sheets for post-retirement welfare benefits by the amount of any assets that have been set apart from its general assets, e.g., in a VEBA trust, and dedicated solely to the payment of those post-retirement benefits. Employers making contributions to prefund these benefits will, it can be expected, seek to deduct those contributions under section 419A(c)(2).

WHY WOULD A COMPANY USE A VEBA TRUST?

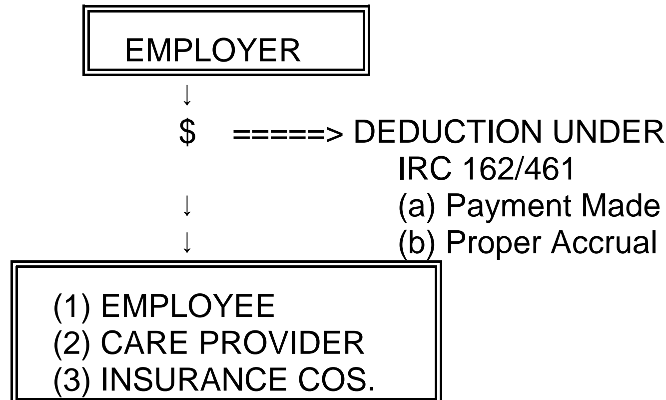
As you may already be aware, this area of tax law is significantly different from other areas that a large case agent encounters. It deals with the deduction of employee benefits which are routed through an exempt organization and governed by new sections of law with little or no formal guidance available through normal research sources. As a result, before getting into any specifics on the law, it is helpful to quickly touch upon some basic concepts involved in this area. This module is obviously not designed to turn the reader into an expert.

Rather, its purpose is to give the reader a basic understanding of the general nature of the types of issues involved in the VEBA area, why the issues may exist, and what to do if it turns out that you have an issue on one of your cases.

DEDUCTION WITHOUT THE USE OF A TRUST

To understand why an employer would consider using a trust to provide employee benefits, it is helpful to first review the basic mechanics of a deduction in situations where no funding vehicle is used. An employer's deduction for the expense of providing welfare benefits to its employees is taken under IRC sections 162 and 461 at the time the employer pays (or properly accrues) the expense liability. The lead case in this area is General Dynamics Corporation v. United States, 481 U.S. 239 (1987). These costs may be paid to the

employee, the care provider, or an insurance company. They may also be paid through a third party benefit administrator. This can be illustrated as follows:



FUNDING OF WELFARE BENEFIT OBLIGATIONS

Employers may decide to fund their obligations to provide welfare benefits through the use of a trust. An irrevocable welfare benefit trust created by an employer can place assets beyond the reach of the creditors of the employer and can provide employees with some assurance that assets will be available to pay the promised benefits.

It is important, at this point, to distinguish between an employer's welfare benefit "plan" and a "trust" through which it may be funded.

Welfare Benefit Plan.

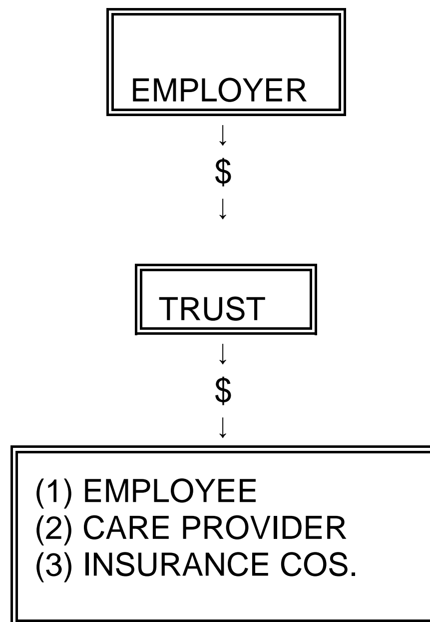
The "plan" is a program of benefits promised to employees. It is normally embodied in a written plan document. In most cases, Title I of the Employee Retirement Income Security Act (ERISA) requires the employer to prepare a "summary plan description" explaining the essential features of the plan and to furnish a copy of this summary plan description to each employee. The plan sponsor is required to file a Form 5500 [Annual Return/Report of Employee Benefit Plan (with 100 or more participants)] which reflects, among other things, the financial activities relating to the plan.

Welfare Benefit Trust.

The "trust" is the employer's vehicle for funding its obligation under a plan or

plans. It is normally established by a written trust instrument naming the employer as the settlor of the trust, appointing a trustee, and describing the powers and duties of the trustee. An employer may decide to fund some, or all, of the benefits under its plan through one or more trusts. If it does so, the trust instrument will set forth the benefits that the trustee will pay out of the trust fund and the employer will be responsible for paying other plan benefits, either directly or through a different trust. A trust may also cover more than one plan, e.g., a medical plan and a disability plan. The trustee is required to file either a Form 1041 [U.S. Fiduciary Income Tax Return] for taxable trusts, or a Form 990 [Return of Organization Exempt from Income Tax] for exempt trusts.

The flow of money, when a trust is interposed in the payment stream, can be illustrated as follows:



DEDUCTION WITH THE USE OF TRUST

Prior to the enactment of sections 419 and 419A, with certain limits, the timing of a deduction could generally be accelerated to the point when the contribution was paid or accrued to the trust, irrespective of when the actual benefit was paid

out to the employees. The ability to control the timing (and correspondingly the amount) of the deduction was one of the prime advantages associated with the use of a trust. Furthermore, if the trust qualified for exemption as a VEBA then its investment earnings were tax free.

WHY CONGRESS CHANGED THE LAW

The new Code sections were enacted in 1984 and effective for contributions made after December 31, 1985. The legislative history of these sections shows that they were remedial in that Congress intended them to stop certain abuses that had developed in this area. Specifically, Congress concluded that the favorable tax treatment of employers who use welfare funds under the prior law was "inappropriate" and that deductions for contributions to these funds should be limited to prevent employers from taking deductions far in advance of when the actual benefits are paid. Congress noted that the substantial amount of advance funding in employee welfare benefits funds resulted in an unacceptable tax burden for those taxpayers who did not use such funds.

Since 1986, the deductibility of employer contributions made to a trust fund established to provide employee welfare benefits is governed by sections 419 and 419A. These sections apply to any deduction for contributions to a "welfare benefit fund." Most funds are organized as trusts. Although the limits imposed by these sections apply to employer contributions to any welfare benefit fund, whether or not the fund itself is a tax exempt VEBA, most employers take advantage of the tax benefits available to VEBAs when they establish a welfare benefit fund. Accordingly, the discussion in the following portions of this module will focus on the application of the benefit limits to VEBA contributions. It should be noted, however, that the same deduction limits apply to contributions to other types of welfare benefit funds, such as taxable trusts.

WHAT IS A "WELFARE BENEFIT"?

This is a basic term in the employee benefit field but it may not be familiar to large case agents. It is defined, for purposes of sections 419 and 419A, as any employee benefit other than certain retirement benefits and certain transfers in connection with the performance of services taxable under section 83. The most important categories of welfare benefits are medical benefits, dental benefits, life insurance benefits, sick and accident benefits, disability benefits, supplemental unemployment benefits and severance pay. Some welfare benefit funds also provide other benefits such as vacation pay, child care facilities, and job

readjustment allowances, but these are relatively minor items.

EXEMPT ORGANIZATION ASPECTS

A trust used to provide welfare benefits may be exempt from income taxation as a VEBA under the provisions of section 501(a) if certain requirements are met, most notably the requirements set forth in the Regulations that underlie section 501(c)(9) and the nondiscrimination requirements of section 505(b). A VEBA must provide notice to the IRS that it is claiming exemption from tax. This notice is given by applying for recognition of exempt status under section 501(c)(9). The application is made on Form 1024 [Application for Recognition of Exemption Under Section 501(a)], which should be mailed to the District Director for the Key District in which the principal office of the association is located. If the applicant satisfies the requirements of the statute, the Key District Director will issue a determination letter stating that the applicant qualifies for the exemption sought.

It should be noted that the deduction limits of section 419 and 419A are applicable irrespective of whether or not the trust qualifies for exemption.

Finally, it is possible for a VEBA, even though it is generally exempt from taxation, to be subject to income taxation in certain circumstances. In some cases, a VEBA, unlike charities, can be subject to unrelated business income tax (UBIT) on its investment income. This liability arises because section 512(a)(3)(E) limits the amount that a VEBA can set aside for its exempt purposes. In these situations, the trustee must file a Form 990-T [Exempt Organization Business Income Tax Return] in addition to the normal Form 990 filing requirements. These returns must be filed within four and one-half months after the close of the taxable year of the fund.

WHO EXAMINES VEBA DEDUCTION ISSUES?

Sections 419 and 419A control the deductibility of employer contributions to welfare benefit funds. In this module we are focusing on the most common type of a welfare benefit fund, a VEBA, which is an exempt organization. To complicate matters even more, the specific expense item is for an employee benefit which is paid under the provisions of an employee benefit plan. The obvious question that arises is: who should be examining this area: Examination, Exempt Organizations, or Employee Plans? The answer is: Any of the above, depending on the district or regional policy in regard to the examination and coordination of employer audits in this area. Of course, there are certain

functional lines which must be recognized and respected by whomever is assigned the VEBA contribution issue.

As far as sections 419 and 419A are concerned, the primary focus is on the employer's deduction. As a result, there is absolutely no problem with having the CEP audit team examine the contribution issue. However, if the CEP agent is going to examine the deduction for the VEBA contribution, there are a couple of points to keep in mind.

Initially, as you will learn later in this module, the statute uses the "qualified cost" of the trust as its upper limit on the employer deduction. This means that certain records of the VEBA trust (e.g., Forms 990 and 990T) must be looked at by the CEP agent in order to determine if the employer complied with the statute. We have developed a pro-forma IDR which requests the basic information needed to see if the employer complied with sections 419 and 419A. See Appendix C. This request for information from the trust does not mean that the CEP agent is auditing the trust itself, and this point should be made explicitly clear to the employer and the trustee. Of course, the more detail a CEP agent requests from the trust the closer the agent comes to the line which separates this type of activity from an "examination" of the trust itself. As a result, if the CEP agent believes it is necessary to request more detail from the trustee, the agent should consult with their local EP/EO function to ensure that they do not inadvertently cross this line.

Secondly, one of the more common sections 419 and 419A issues involves the actuarial computations involved in calculating the post-retirement medical and life insurance reserves. This, of course, goes well beyond the knowledge and experience levels of most CEP agents. In this regard, the Service has actuaries available for consultation. The consultation can be on a very informal basis. As you will learn later in this module there is a focus training textbook in regard to the VEBA area. This book has the names, addresses and telephone numbers of all of the Service's actuaries.

Finally, the CEP agent's review of trust information and the CEP audit adjustment could result in potential exempt organization issues. If this is the case, it should be recognized that these issues can only be addressed by an exempt organization agent. At this point agents must contact their local EP/EO function to see what action should be taken (e.g., referral, etc.). The most common example of when this would occur is when the CEP adjustment is a result of a change in the allowable "qualified asset account limit", which will be

discussed later in this module. This change results in the potential for unrelated business tax under sections 511 and 512 for the VEBA. Timeliness of coordination in this respect will be important since there are obviously statute of limitation problems associated with the assessment of this tax.

HOW DO YOU KNOW IF YOUR TAXPAYER USES A VEBA?

The simplest answer, of course, is to ask them. However, there are several other ways to determine if they do or to verify their response.

The starting point is Form 5500 [Annual Return/Report of Employee Benefit Plan (with 100 or more participants)]. This form is required to be filed under ERISA by the sponsoring employer. It reflects details of the specific employee benefit "plan". This form must be requested as part of all CEP examinations. The form has a question on line 6 of page 1 which asks if the plan is a "welfare benefit" plan or a "pension benefit" plan. For those plans that are designated as "welfare benefit plans", you can ask if the employer uses a VEBA trust (or any other type of a trust) as a funding vehicle. If necessary you can ask to see copies of the plan’s "summary plan description". These should indicate if the employer used a trust as a funding vehicle for the plan benefits and, if so, the name and address of the trustee.

If a VEBA is used, ask for copies of Form 990 [Return of Organization Exempt from Tax] which is required to be filed by the trustee. At the top of Form 990 there is a location for the category of section 501(c) under which the trust is exempt. A VEBA is exempt under section 501(c)(9).

Finally, the ISP Team has a database of all VEBA trusts in existence as of 1991 and 1993. This listing is based on information obtained from the Forms 990 filed by the VEBA trustees. Using the addresses listed on the 990’s the listing is broken down by region and district. The names and employer identification numbers listed are those of the VEBA Trust and not of the employer. However, with most VEBA’s established by single employers, the name of the corporate employer is usually found within the name of the trust - e.g., the XYZ Company Employee Welfare Benefit Trust. As a result it is fairly easy to locate trusts established by a single corporate employer. Copies of the 1991 listing has been provided to each Regional ISP Coordinator and the database has been uploaded on the Des Moines ISP Bulletin Board, which can be accessed by any district ISP coordinator. We are in the process of disseminating the 1993 information. If there are any problems in obtaining information from the list, you can contact the

Issue Specialist at (716) 551-3031, Ext. 197.

WHERE WOULD A VEBA CONTRIBUTION BE REFLECTED?

Form 1120

Page 1.

The corporate deduction for employee benefits is normally found on line 25 of a Form 1120. However, this will not specify whether or not the employer used a VEBA trust as a funding vehicle for the payment of these costs. Furthermore, any portions of employee benefits which are capitalized under Section 263A by the employer would not be included in any amount listed on this line.

Schedule M.

If the tax treatment for employee welfare benefits differed from the financial accounting treatment, then there should be a Schedule M item reflecting this difference. The existence and accuracy of the Schedule M disclosure is, of course, at the control of the taxpayer.

Financial Statements.

If an employer prefunded employee welfare benefits and had not expensed this cost on its financial statements, then there would be a "prepaid expense" recognized as an asset on the financial balance sheet and a disclosure should be made under "deferred taxes" reflecting the tax effect of the timing differences. If there is a disclosure in the deferred tax area it will usually state that it is the result of a contribution to a VEBA. There may also be a disclosure in the footnotes to the financial statements in the "employee benefits" section. FAS 106 requires elaborate disclosure of an employer's obligation to provide post-retirement employee benefits and the costs of these benefits.

In regard to the differences between tax and financial treatment of contributions to a VEBA it should be noted that FAS 106 has an impact. Although there are profound differences between FAS 106 and section 419A(c)(2) in regard to the computation of post-retirement medical and life insurance reserves, it is possible that the interaction between the two could result in an offsetting of any Schedule M differences. Keep in mind that FAS 106 deals with accruals; the funding of this obligation is optional. GAAP prior to FAS 106 (i.e., FAS 87) allowed the

employer the option of voluntarily using accrual accounting for post-retirement benefits other than pensions. Section 419A(c)(2) does not permit deductions for mere accruals, i.e., actual prefunding of the benefits is required.

Form 990

Form 990 reflects the financial information of the trust. This Form should reflect employer contributions under the heading of "program service revenue" on page 1. There is a detailed schedule provided in Part IV of the 990, which breaks out the various sources of this revenue. This schedule generally specifies the amounts contributed by the employer, the employees, etc. Form 990 will also reflect the fund’s expenses for providing welfare benefits and its beginning and ending balances.

In situations where the trust has a year end that is different from that of the employer, however, caution should be used in utilizing information from the Form 990. Remember that the VEBA’s year end balance will not reflect any employer contributions made after the VEBA’s year end. Many employers specifically allow the VEBA’s fund balance to be drawn down without being replenished before the VEBA’s year end in an effort to avoid the imposition of the unrelated business income tax. This tax is calculated, in part, by reference to year end fund balances. These employers make their contribution in the period between the VEBA and employer year end. This maneuver gives the illusion that the employer is not prefunding the VEBA since the VEBA’s year end balance is minimal.

WHAT TO DO IF YOUR COMPANY USES A VEBA?

1. Contact your District ISP Coordinator to find out if your District has any agents who received the VEBA focus training. Find out what your District policy is in regard to utilizing those individuals who did receive the training. This training was given to examination division and EP/EO agents in the summer of 1993.

2. If the CEP team will be examining the VEBA deduction, have your District ISP Coordinator download a copy of the VEBA focus training text, the VEBA audit issue guide, and the VEBA issue checksheet from the Des Moines ISP Bulletin Board. This material is in the Enable Word Processing format and includes a pro-forma IDR and a listing of recommended audit steps.

3. Issue the pro-forma IDR to obtain information needed to determine if there are any

potential issues. A hard copy of this is included in Appendix C of this module for your reference.

4. Contact Exempt Organization's Key District office that covers your District to determine what their policy is regarding referrals relating to any potential EO issues. This is important to do as early in the examination as possible so that the Form 990 and Form 990-T statutes are still open.

5. After the VEBA deduction issue is resolved, complete the VEBA checksheet and return it to the VEBA ISP Team. See discussion below in regard to the reasons why this checksheet is needed.

VEBA INFORMATION GATHERING PROJECT

There currently is a National Information Gathering Project relating to employers who use VEBA's. The Project Team includes members from the Office of Chief Counsel, Employee Plans and Exempt Organizations, the Examination Division, and Appeals.

Information Gathering Projects focus on a limited number of taxpayers in certain identifiable market segments. The objective of a Project is to determine the level of compliance with tax laws and, if noncompliance exists, to attempt to determine the reasons for the noncompliance. The VEBA checksheet is designed to collect information needed to make recommendations on ways to help reduce non-compliance in the future.

DEDUCTION LIMITS UNDER IRC 419 AND 419A

IRC sections 419 and 419A were added by the Tax Reform Act of 1984 and impose strict limits on the timing and on the amount of the deduction allowable to an employer for contributions to welfare benefit funds, including VEBAs. The new sections are applicable to employer tax years ending after December 31, 1985.

Deduction Limits.

There are three basic limitations on the deductibility of an employer's contribution to a welfare benefit fund:

(1) the fund's qualified cost,

(2) the actual contribution paid to the fund,
(3) the so-called "eat-up rule", which is applicable in certain cases where the fund balance is in excess of the account limit.

The employer's deduction is limited to the lowest of the three items. Any deduction disallowed as a result of the first or third limitation will give rise to a carryover of the disallowed contribution under the provisions of section 419(d). This carryover is treated as an amount paid by the employer in its succeeding year. Any deduction disallowed as a result of the second limit will not give rise to a carryover because the employer has never actually paid enough money over to the fund.

(1) QUALIFIED COST

Section 419(b) provides that the amount of any employer deduction under section 419 shall not exceed the fund's "qualified cost" for the taxable year. Qualified cost is composed of the "qualified direct cost" plus any addition to a "qualified asset account" (to the extent that the "account limit" is not exceeded). Finally, the qualified cost must be reduced by the fund's "after-tax income". The formula for qualified cost is therefore:

QUALIFIED DIRECT COST	=	cash-basis cost of current benefits paid by the fund;
+ ADDITION TO QUALIFIED ASSET ACCOUNT*	=	addition to reserves funded for (1) disability, (2) medical, (3) SUB or severance pay, and (4) life insurance benefits; [up to the account limit]
- AFTER-TAX INCOME	=	fund income less unrelated business income or other tax.
= QUALIFIED COST ============	=	maximum deduction

The statute provides that the employer's deduction cannot "exceed" the fund's qualified cost. In other words, the qualified cost represents the maximum limit or a "ceiling" for the employer's deduction under section 419. It is possible that an employer's deduction will be limited to a lesser amount, such as the actual contribution paid to the fund or an amount determined under the eat-up rule, as

explained below.

* Additions to a Qualified Asset Account

The amount includible in the qualified cost formula for prefunding reserves for future benefits is determined through "account limits" for each type of benefit specified in section 419A(a). These account limits are set forth in section 419A(c) as follows:

Benefit:	Account Limit under IRC 419A
1. Disability	- claims incurred but unpaid (c)(1), [limited further by (c)(4)(A)]
2. Medical	- claims incurred but unpaid (c)(1), - post-retirement benefits (c)(2)
3. SUB or severance pay	- claims incurred but unpaid (c)(1), [calculated in (c)(3) & limited further by (c)(4)(B)]
4. Life Insurance	- claims incurred but unpaid (c)(1), - post-retirement benefits (c)(2), [limited further by (e)(2)]

No addition to a qualified asset account may be taken into account in determining the qualified cost to the extent that it results in the amount in the account exceeding the account limit.

(2) CONTRIBUTIONS MUST BE PAID TO THE FUND

Section 419(a)(2) requires that employer contributions to a welfare benefit fund must actually be paid to the fund (rather than simply accrued) by the employer during its taxable year before a deduction can be taken. The contribution must be paid during the employer's taxable year (as opposed to the trust's year).

(3) THE "EAT-UP RULE"

Regulation section 1.419-1T Q&A-5(b)(1) is a transition rule. It provides that contributions to a welfare benefit fund during any taxable year of an employer beginning after December 31, 1985 are not deductible to the extent that they

cause the fund's balance to exceed the "qualified asset account limit" of the fund. This has been referred to as the "eat-up rule" since employer contributions and/or deductions are not allowed in situations where the trust remains overfunded after the new law went into effect, until the overfunding is "eaten-up" through the disallowance of deductions. The rule was designed to respond to employers who built up fund balances before the account limits of the new law took effect. It should be noted that there was an eighteen month delay between the date the law was enacted on July 18, 1984 and when it became effective. The eat-up rule further provides that once the deduction limits and/or the fund balances are brought in line, the rule is "turned-off" [subparagraph (b)(2)]. In cases where the employer's and the fund's year end differ, the rule provides that any contribution made after the fund's year end and before the employer's year end is treated as if it were actually in the fund at its year end.

CARRYOVER PROVISION

If employer contributions paid to the fund during the employer's taxable year would be otherwise deductible except that they exceed the allowable section 419 deduction limits, then the employer is allowed a carryover of the "excess" contributions to the employer's succeeding year. The carryover amount will be treated as an actual contribution made in the succeeding year. This carryforward is cumulative - i.e., it represents the cumulative total of any disallowed contributions. The total is reduced as the carryforwards are allowed as employer deductions up to the qualified cost in subsequent years. In this case, the employer is allowed a deduction in excess of its actual contribution to the fund for such years.

EXAMPLE (1):

If an employer contributes $100X in 1991 and the fund's 1991 qualified cost is only $80X, then the $20X which is disallowed would be considered as being contributed to the fund by the employer in 1992. The employer will be allowed a deduction in 1992 to the extent that this carryforward, plus the actual 1992 contributions, do not exceed the fund's 1992 qualified cost. If the 1992 qualified cost is exceeded another carryforward will be generated to 1993.

The carryover provisions are very significant from an examination standpoint

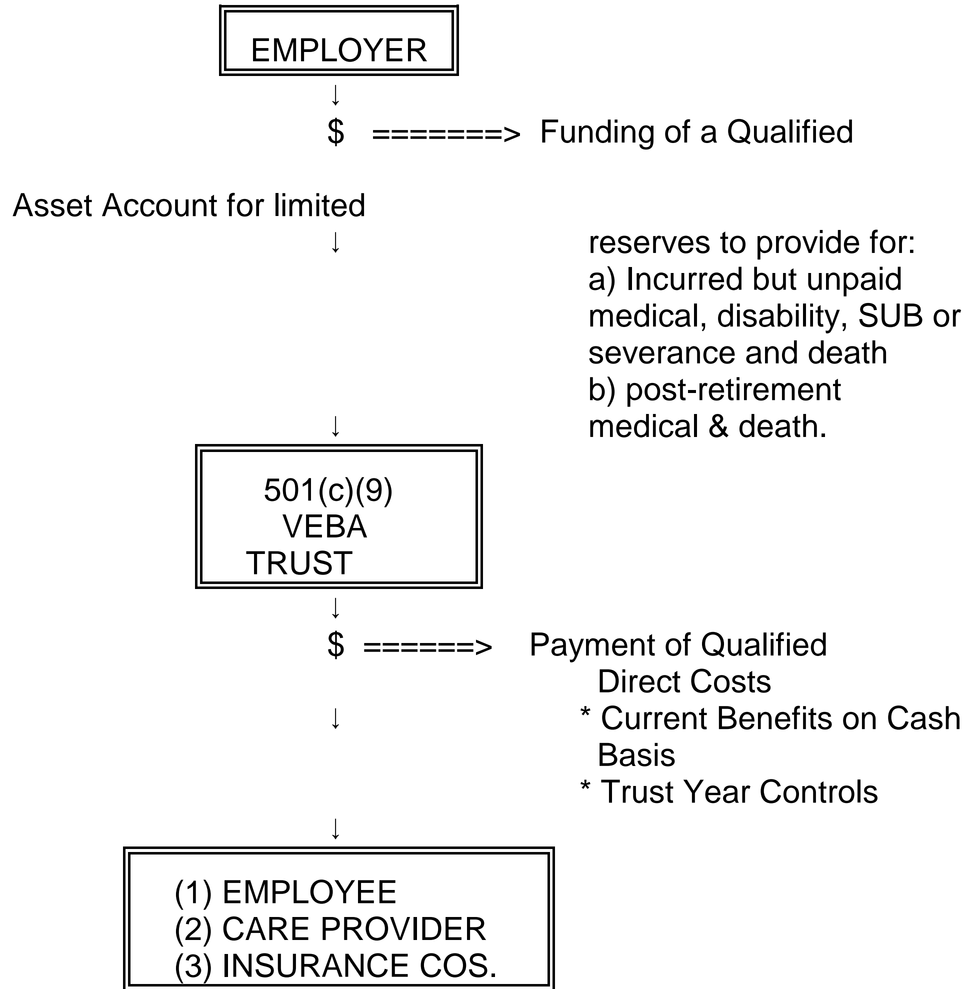
since the taxpayer will eventually be allowed a deduction for its VEBA contributions. The only question is in what tax period does section 419 permit the deduction. If the taxpayer has been continually deferring taxes by improperly prefunding their VEBA, then the rollout adjustment does not take place until the prefunding is brought down to the permissible level, which may be in the current unfiled tax period.

EXAMPLE (2):

An employer is allowed to prefund its VEBA for incurred but unpaid claims in the amount of $25X for 1992. The employer actually prefunded in the amount of $100X. The $75X which is disallowed upon audit during 1994 was still in the fund at the end of 1993. In order for the employer to take advantage of the carryforward it would have to reduce its VEBA contributions starting in 1994. Of course, the employer would be allowed a deduction only up to the amount of the 1994 qualified cost.

EFFECT OF IRC 419 AND 419A

The effect of sections 419 and 419A on the deduction of employer contributions can be roughly illustrated as follows:



The deduction cannot exceed the qualified cost of the fund (as reduced by after-tax income). In determining the qualified cost, section 419(c)(5) provides that no amount can be taken into account more than once. There is a further limitation, in certain cases, if the fund balance exceeds the allowable "account limit." And the deduction can never exceed the amount actually paid to the fund.

LIFE AFTER IRC 419 AND 419A

The examination of employer deductions for contributions to VEBA's under the new law has shown that there is still a major problem with the acceleration of the timing of deductions. In some cases, taxpayers are simply not following the explicit requirements of the new law. In other cases, taxpayers are following the advice of a small group of benefits consultants, attorneys, and actuaries who are interpreting the new law in a very aggressive way that allows taxpayers to continue to prefund their VEBAs in a manner which the Service believes is inconsistent with the requirements of sections 419 and 419A.

Agents in several districts have made, or are proposing, substantial adjustments to disallow excessive VEBA deductions arising either from ignorance of the sections 419 and 419A limits or from taxpayer positions that the Service believes are insupportable.

As is discussed in more detail in Appendix E, the Tax Court has completely upheld the Service's position in the first two cases decided dealing with sections 419 and 419A. General Signal Corporation v. Commissioner 103 TC 216 (1994), aff'd __F.3d __(2d Cir. 1998), and National Presto Industries v. Commissioner 104 TC 559 (1995).

APPENDIX A

CURRENT AUDIT ISSUES

The audit issues in the IRC 419 and 419A/VEBA area, as they apply to the deduction taken for employer contributions, currently fall in the following areas:

(1) DEFINITIONAL:

(a) Does IRC 419 and 419A apply?
   (i) is there a "welfare benefit fund"?
   (ii) does the 10 or more employer exception under IRC 419A(f)(6) apply?

(b) Is the employer deduction not subject to the account limits because of the special rule for a separate welfare fund under a collective bargaining agreement under IRC 419A(f)(5)? **

(2) MECHANICAL:

Are the following components correctly calculated?

(a) existing excess reserves [IRC 419A(f)(7)];
(b) qualified direct costs [IRC 419(c)(3)];
(c) after-tax income [IRC 419(c)(4)];
(d) additions to a qualified asset account for:
   - claims incurred but unpaid [IRC 419A(c)(1)]**
   - post-retirement medical and life insurance reserves [IRC 419A(c)(2]; **
(e) qualified cost [IRC 419(c)]?

(3) LIMITATIONAL:

Was the deduction limited to the lowest of:

(a) the fund’s qualified cost [IRC 419(b)];
(b) the actual contribution paid [IRC 419(a)(2)];
(c) the limit calculated under the eat-up rule [IRC 1.419-1T Q&A-5(b)(1)]?

** Discussed in more detail below:

POST-RETIREMENT RESERVES

As could probably be expected, most of the disputes center on the limit on additions to a reserve for post-retirement medical or life insurance benefits under section 419A(c)(2).

This section allows the inclusion of a contribution to fund a reserve for post-retirement medical and life insurance benefits as long as it is:

(1) actuarially determined on a level basis;
(2) uses assumptions which are reasonable in the aggregate and which do not include inflation; and,
(3) funded over the working lives of covered employees.

In applying section 419A(c)(2) the actuary determines the amount of money needed to fund the benefits the plan promises to pay a retired employee over their retired life. This will depend on the type of benefit (i.e., medical, life insurance or death benefit), the cost of providing the benefit, and the time over which the benefit is to be provided. Any projections for future costs of medical benefits must be made on a year-to-year basis using current costs as the standard. The total cost to fund the promised benefits is then discounted (using reasonable interest assumptions) to a present value which is allocated (on a level basis) over the remaining working lives of the covered employees.

Full Funding for Current Retirees?

The major audit issue in the section 419A(c)(2) area involves the employer's attempt to deduct a contribution for the entire present value of post-retirement benefits for current retirees in the initial year the reserve is established. This is sometimes referred to by actuaries as full or terminal funding.

The National Office has informally indicated that the funding of a post-retirement reserve for current retirees is permissible, as long as the reserve is funded over the remaining working lifetimes of the current (i.e., active) employees and based upon an actuarial determination on a level basis (using assumptions reasonable in the aggregate). Furthermore, the remaining working lifetime for current employees cannot be reduced by factoring in a zero life for current retirees. To fund for current retirees in any other manner (such as, full funding of the entire present value of benefits for current retirees) would violate one or more of these requirements and is therefore not

permissible.

This issue was presented to the Tax Court in General Signal v. Commissioner, 103 T.C. 216 (1994), aff'd __F.3d__ (2d Cir. 19978), and again in Parker-Hannifin v. Commissioner, 72 T.C.M. 191 (1996), aff'd in part and rev'd in part __F3d.__ (6th Cir. 1998). In both cases, however, since the Court determined that no post-retirement reserve existed, it was not required to rule on the issue. See Appendix E for details.

INCURRED BUT UNPAID CLAIMS (IBUCs)

Section 419A(c) provides the account limit for any qualified asset account. Subsection (c)(1) provides, in general, that the account limit is the amount reasonably and actuarially necessary to fund the amount of claims which are incurred but unpaid at the close of the taxable year. The account limit includes any administrative costs associated with these claims. This section applies only to funds which are self-insured in the provision of their benefits since the account limit cannot include amounts set aside for the payment of insurance premiums.

Actuarial Certification and the Safe Harbor Limits

The necessity of having an actuarial certification of the amount of IBUCs is limited by section 419A(c)(5) through the establishment of certain "safe harbor" limits which are expressed in percentage terms. If the amount of IBUCs is less than or equal to the sum of the safe harbor limits, no actuarial certification is required. However, there still is a requirement to substantiate that the reserve amount is a reasonable estimate of the actual incurred but unpaid claim expense. The only safe harbor being provided is from having to incur the expense of obtaining an actuarial certification. (See General Signal v. Commissioner 103 TC 216 (1994)) aff'd __F.3d __(2d Cir. 1998).

The majority of audit issues in regard to IBUCs relates to the taxpayer's use of a safe harbor percentage as the minimum deductible amount without any attempt to establish that this amount is reasonable. The safe harbor percentages are: 17.5% for short-term disabilities and 35.0% for medical benefits. Each safe harbor percentage is multiplied times the prior year's QDC (not including any insurance premiums) for that particular expense component.

SPECIAL RULE FOR COLLECTIVE BARGAINING AGREEMENTS

Section 419A(f)(5) was amended by the Tax Reform Act of 1986 to provide that no account limits shall apply in the case of "any qualified asset account under a separate

welfare benefit fund ... under a collective bargaining agreement". (Emphasis added.) The Committee Reports for the Act explain that the provision "permanently exempts collectively bargained VEBAs from the account limits applicable to welfare benefit funds without regard to any Treasury regulations providing special account limits for such funds. Thus, employer contributions to such VEBAs are deductible and earnings on assets of such VEBAs are tax exempt."

Prior to its amendment, section 419A(f)(5) provided that the Secretary was to issue regulations providing "special account limits" in the case of any qualified asset account under a welfare benefit fund "maintained pursuant to a collective bargaining agreement." Treasury Regulation section 1.419A-2T Q&A-1, adopted July 1, 1985, provides that the section 419 and 419A account limits do not apply to collectively bargained funds until final regulations are issued. The 1986 Act eliminated the need for final regulations.

Treasury Regulation section 1.419A-2T Q&A-2 defined "welfare benefit fund maintained pursuant to a collective bargaining agreement" to mean, among other things, that the collective bargaining agreement must cover at least 50 percent of the employees eligible to receive benefits under the fund. For funds not in existence on July 1, 1985, the percentage is increased from 50 to 90 percent. Furthermore, even where these requirements have been met, only the portion of the fund attributable to employees covered by the collective bargaining agreement, and from which benefits for such employees are provided, is considered to be maintained pursuant to a collective bargaining agreement. At this time, there are no operational details as to when the percentage determinations are to be made (i.e., beginning of the year, end of the year, etc.) and as to how to allocate the portion of the fund attributable to the employees covered by the collective bargaining agreement.

While the 1986 Tax Reform Act's amendment of section 419A(f)(5) was subsequent to the promulgation of the temporary regulations, the regulations have not been withdrawn, and to the extent that they go to matters other than account limits, may provide guidance.

One of the issues present in Parker-Hannifin v. Commissioner involves the special rule for collective bargaining agreements. See Appendix E for further details.

The National Office has issued a Technical Advice Memorandum (Number 9215002 11-15-91) and a Letter Ruling (Number 9213029 12-31-91) on this issue. According to the TAM a trust set up as a VEBA to fund health insurance and other welfare benefits

that had been negotiated as part of an arm's-length collective bargaining agreement was a separate welfare benefit fund maintained pursuant to a collective bargaining agreement, even though the collective bargaining agreement did not specify the funding mechanism for the required benefits. Therefore, the VEBA was maintained pursuant to a collective bargaining agreement under IRC section 419A and was not subject to the account limits of section 419. The National Office found that although the regulations require that the benefits of a collectively bargained plan be the subject of arm's-length negotiations, the regulations do not require that the funding mechanism for providing those benefits must also be the subject of genuine bargaining between adverse parties.

APPENDIX B

EXAMPLE OF A VEBA DEDUCTION ISSUE

You are examining the 9012 and 9112 corporate returns for the XYZ Company and Subsidiaries. The Company had a $50,000,000 NOL in 9012 which it carried back and fully utilized in 8712. The company established a VEBA trust on November 1, 1990 to provide employee medical benefits to its active and retired employees. The trust has a November 30th year end. The Form 990 for the 9011 states that it was a short period return for one month. There was no investment income during this one month period. For simplicity, assume that the medical benefits are provided through the purchase of insurance policies and that no employee contribution is required. During 9012 XYZ paid and deducted medical insurance premiums in the amount of $44,000,000. On December 31, 1990 XYZ contributed $45,000,000 to the VEBA.

Review

Before continuing with the example, its helpful to remember certain provisions of sections 419 and 419A. These sections were enacted to prevent deductions for the prefunding of welfare benefit funds, with the exception of certain limited reserves. On the surface, the VEBA in this example does not appear to have any prefunding problem as of November 30, 1990 - i.e., it has a $0 fund balance. Under section 419A(c)(1) the VEBA in this example would not be allowed a reserve for incurred but unpaid claims since it is not self-insured. The VEBA, however, would be allowed to set aside a limited amount of reserves for post-retirement medical benefits under section 419A(c)(2).

You issue an IDR to XYZ in regard to their 9012 VEBA deduction. In response, XYZ provides you with a copy of a certified actuarial report from Consulting Actuaries Ltd. This report purportedly calculates the account limit for post-retirement medical benefits under section 419A(c)(2) as follows:

Active Employees:	10,000
Working Life Expectancy:	20 years (average)
Current Retirees:	2,500

Present Value of Future Payments for Post-Retirement Benefits:

Active Employees:	$55,000,000

Current Retirees:	40,500,000

Funding Amortization:

Active Employees:	$ 4,500,000 per year/20 years
Current Retirees:	40,500,000 per year/1 year

Account Limit:	$45,000,000
	======

The $4,500,000 for active employees represents an actuarially computed annual amortization of the $55,000,000 present value spread over the remaining average working life expectancy of 20 years, using a 5.25% interest factor.

The $40,500,000 for current retirees represents the full amortization of the entire present value of the future benefit payments.

The report from Consulting Actuaries contains a caveat which states that the issue of tax deductibility of any contribution is subject to the opinion of your tax counsel.

Based on this report, XYZ calculated its allowable VEBA contribution for 9012 as follows:

$ -0-	Qualified Direct Costs
45,000,000	Addition to Qualified Asset Account [post-retirement medical reserves]
(-0-)	After-Tax Income of the VEBA

$45,000,000	Qualified Cost for 9011
======	

During VEBA year ended November 30, 1991, the VEBA earned $1,000,000 in investment income and paid out $46,000,000 in medical insurance premiums. XYZ did not make another contribution to the VEBA before November 30, 1991. Since the VEBA received no contributions from XYZ, it used the only available source of funds - i.e., the amount which the employer had contributed in December of 1990 to allegedly fund a reserve for post-retirement medical benefits plus investment earnings, to pay for the current benefits. The VEBA's fund balance at its 9011 year end was again $0.

On December 31, 1991, XYZ contributed another $45,000,000 to the VEBA. XYZ deducted this amount, claiming that it equaled the VEBA's qualified costs for the VEBA's year ended November 30, 1991 - i.e., qualified direct costs of $46,000,000 for insurance premiums paid less the after-tax income of $1,000,000. XYZ made no further contribution to the post-retirement reserve.

XYZ's deductions for its employee medical benefits for 9012 and 9112 are as follows:

$44,000,000	9012 insurance premiums
45,000,000	12/31/90 VEBA contribution

$89,000,000	9012 deduction
======	
$45,000,000	12/31/91 VEBA contribution

$45,000,000	9112 deduction
======	

You issue a second IDR to XYZ requesting more information including details relating to any consulting fees which XYZ may have paid in regard to its decision to establish the VEBA. XYZ provides you with a contract between it and VEBA Promoters, Inc. and a proposal that provides XYZ with specific details on how to set-up a VEBA and prefund it exactly as XYZ had done.

The proposal stated that one of the goals of prefunding the VEBA in the outlined manner was to allow XYZ a current deduction for the next year's medical insurance premiums. The proposal stated that this was particularly attractive to XYZ in 1990 since XYZ anticipated having a NOL which could be carried back to 1987 when the effective federal tax rate was 40%. The contract stated that the specific details were confidential and not to be revealed to anyone. The contract provided that XYZ would pay VEBA Promoters, Inc. 5% of the tax deferral realized by XYZ as a result of the VEBA deduction. This deferral would be calculated at the 40% rate because of the NOL carryback.

Your review of the subsequent year tax return indicates that the company made no contribution to the VEBA in 9212. The company indicated that it never notified its employees of the contribution to allegedly fund the post-retirement reserve nor did it disclose this fact in its financial statements. XYZ did disclose in its financials that there

was a tax timing difference as a result of differences between tax deductions and book expenses relating to VEBA contributions.

Needless to say, the Service disagrees with some of the "interpretations" of sections 419 and 419A which are required to make the above scenario work. In General Signal v. Commissioner 103 TC 216 (1994), aff'd __F.3d __ (2d Cir. 1998), the Tax Court, relying on a fact pattern with many similarities to the one in this example, upheld the Service's disallowance of the full amount of the addition to the qualified asset account for post-retirement medical and life insurance benefits. The Court ruled that the statute requires the accumulation of assets and the funding of benefits. See Appendix E for more details.

Based on the General Signal decision you propose the following adjustment:

(For ease of presentation, the deduction limits calculated below only reflect the qualified cost calculation. This is the operational limit in this case.)

Employer year ------>	9012	9112
Deduction per return:	$45,000,000	$45,000,000
Deduction per exam: [a]	-0-[1]	45,000,000
	-------------	-------------
Adjustment Required:	$45,000,000	$ -0-
	======	======

[a] Deduction per examination calculated as follows:

VEBA year --------->	9011	9111
Qualified direct cost:	$ -0-	$46,000,000
Addition to QAA:		
- active employees:	$ -0-	$ -0-
- retired employees:	$ -0-	$ -0-
After-tax income:	(-0-)	(1,000,000)

[1] The $44,000,000 in medical insurance premiums paid directly by XYZ in 9012 are allowed in full and not taken into consideration.

	------------	-------------
Qualified Cost:	$ -0-	$45,000,000
	======	======

UNAGREED CASE ALTERNATIVE POSITION: MISCALCULATED RESERVE

This position assumes that a reserve was determined to meet the "funded" requirements. This position argues that the amount of the post-retirement reserve is not in conformance with the statute since the current retiree calculation was based upon full or terminal funding. In other words, this is not deemed to meet the statutory requirement that post-retirement benefits be funded over the "working lives of the covered employees" on a "level basis" using assumptions that are "reasonable in the aggregate."
In the alternative position for 9112, the taxpayer is allowed a deduction which exceeds its actual contribution because of the $37,200,000 carryforward from the 9012 adjustment.

Employer year ------>	9012	9112
Deduction per return:	$45,000,000	$45,000,000
Deduction per exam: [b]	7,800,000[2]	52,800,000
	-------------	--------------
Adjustment Required:	$37,200,000	$(7,800,000)
	======	======

[b] Deduction per examination calculated as follows:

VEBA year --------->	9011	9111
Qualified direct cost:	$ -0-	$46,000,000
Addition to QAA: [c]		

[2] The $44,000,000 in medical insurance premiums paid directly by XYZ in 9012 are allowed in full and not taken into consideration.

- active employees:	$ 4,500,000	$ 4,500,000
- retired employees:	$ 3,300,000	$ 3,300,000
After-tax income:	(-0-)	(1,000,000)
	-------------	-------------
Qualified Cost:	$ 7,800,000	$52,800,000
	======	======

[c] Calculated by amortizing the present value of future payments over a 20 year period using an interest factor of 5.25%. The amounts for 9111 represent the allowable additions. The actual account limit would be $9,000,000 for actives and $6,600,000 for retirees. [Note: These amounts are rough calculations for illustrative purposes only. IRS actuaries would do the actual calculations in an actual examination.]

Final point: A carryover of the disallowed contributions to 9212 would be allowed in the amount of $45,000,000 for the primary issue and $29,400,000 for the alternative issue.

APPENDIX C

SAMPLE INFORMATION DOCUMENT REQUEST

Our records indicate (You have indicated) that your company has established a Voluntary Employees' Beneficiary Association (VEBA) trust under Internal Revenue Code Section 501(c)(9) as a funding vehicle for the payment of certain employee welfare benefits. IRC sections 419 and 419A control the deductibility of employer contributions to welfare benefit funds, such as a VEBA. In order to determine whether any deduction you have taken is in conformity with the requirements of these sections, we need to look at certain information. It should be understood that any questions concerning the VEBA trust relate to your deduction for contributions. This does NOT constitute an examination of the VEBA trust. Please provide the following information, as applicable:

(01) Copy of Form 1024 [Application for Recognition of Exemption under Section 501(a)].

(02) Copies of any correspondence with the Internal Revenue Service concerning this application for exemption. This should include copies of response(s) to any IRS correspondence.

(03) Copies of the VEBA trust agreement(s), together with any amendments.

(04) Copies of all Forms 5500 (Annual Return of Employee Benefit Plan), Forms 990 (Return of Organization Exempt from Income Tax), and Forms 990-T (Exempt Organization Business Income Tax Return), as applicable, filed for the years ending in 1984 through the present date.

(05) Copies of any and all audited reports of independent public accountants relating to the VEBA trust for the years ending in 1984 through the present date.

(06) Break-down of all contributions (i.e., payments) made by your company(ies) to the VEBA trust for the years under examination - i.e., entity, date, check number, dollar amount and the account(s) to which they were posted.

(07) Break-down of the deductions taken on your Form 1120 in regard to your VEBA expenses for the years under examination - i.e., under what expense category were they deducted, amount deducted per year, amount of VEBA contribution allocated to

inventory at year's end, Schedule M reconciliations, etc.

(08) Were any of your contributions to the VEBA for expenses which would not be incurred by the VEBA trust until the subsequent tax period? If the answer is yes, please provide complete details in this regard - i.e., expense category, dollar amounts, how your contribution to prefund this expense was determined, etc.

(09) Details, together with back-up substantiation, relating to VEBA trust expenses for any claims for incurred but unpaid expenses at year end for the years ending in 1984 through the present date. This should include copies of any actuarial reports, claim run-outs, lag analyses, etc.

(10) Break-down of the specific expense components (i.e, medical, disability, life insurance, etc.) together with their total costs for the VEBA trust for the years the company is under examination.

(11) Were any of these expenses financed through premiums paid to outside insurance companies? If the answer is yes...

- please provide a break-down for these expenses detailing the specific coverage(s) provided, insurance company name(s), total expense per year.

- do any of these policies pass any of the risks associated with payment of claims through to the VEBA or the company? If so, could I have the details on these policies - i.e., when did they start, copies of the policies, how are the premiums determined, schedule of claims paid, estimate of incurred but unpaid claims at year's end, etc.

(12) Were any of the benefits provided through your VEBA trust paid pursuant to a collective bargaining agreement? If the answer is yes...

- please provide details on the specific benefits which were paid - i.e., expense category, dollar amounts, etc.
- total number of employees eligible to receive benefits provided by the VEBA for each year under examination.

- total number of employees eligible to receive benefits provided by the VEBA who are covered by the collective bargaining agreement for each year under examination.
- please provide a copy of the relevant collective bargaining agreement(s) in effect for the years under examination.
- was a separate VEBA trust established for the provision of the benefits provided to the employees covered by the collective bargaining agreements?

(13) Were any of your contributions to the VEBA made to fund a post-retirement medical or life insurance reserve? If so, please provide copies of any and all actuarial computations and assumptions regarding the calculation on the amount of your contribution and/or deduction.

(14) Copy of any calculations used to determine the IRC sections 419/419A qualified cost deduction limitation for the years under examination.

APPENDIX D

SIGNIFICANT ISSUES:

As part of the Industry Specialization Program, the VEBA area has identified 4 issues under the title of "Significant Issues". Significant Issues present a unique opportunity for taxpayers to get involved early with the Service to share ideas and information on these issues. This process could result in the early elimination of issues, clarification of law, regulations, rulings or procedures, or better framed issues where professional disagreement exists.

There currently are no Coordinated Issues in the IRC 419 and 419A area.

Additions to Qualified Asset Account Reserves:

(a) Whether taxpayers have properly established and funded qualified asset account reserves under the provisions of IRC section 419A. [General Signal Corporation & Subsidiaries v. Commissioner 103 TC 216 (1994), aff'd __F.3d __ (2d Cir. 1998)]

(b) Whether taxpayers have properly applied the provisions of IRC section 419A(c)(2) in computing the addition to their qualified asset account reserve for post-retirement medical and life insurance reserves, especially in the case of employees who have already retired at the time the reserve is established.

Limits for Claims Incurred But Unpaid:

Whether taxpayers have properly applied the provisions of IRC section 419A(c)(5) in determining their IRC section 419A(c)(1) qualified asset account limits for claims incurred but unpaid. [General Signal Corporation & Subsidiaries v. Commissioner 103 TC 216 (1994), aff'd __F.3d __(2d Cir. 1998)]

Deductions Limited by Balances Accumulated Before 419 Effective Date

Whether taxpayers have properly limited the deduction of contributions under IRC sections 419 and 419A as a result of welfare benefit fund balances accumulated before the effective date of these sections. Specifically, that the increase in the account limit under IRC section 419A(f)(7) has been correctly calculated for the years under examination. Further, that the provisions of Temporary Regulations section 1.419-IT

Q&A-5(b)(1) have been applied to reduce the deductions otherwise allowable to the extent necessary to absorb any fund balance in excess of the account limit under IRC section 419A. [National Presto Industries, Inc. & Subsidiary Corporations v.Commissioner 104 TC 559 (1995); General Signal Corporation & Subsidiaries v. Commissioner 103 TC 216 (1994), aff'd __F.3d __(2d Cir. 1998)]

10 or More Employer Plans

Whether taxpayers have properly determined that the exception provided by IRC section 419A(f)(6) applied in their situation. Specifically, whether or not their plan is a welfare benefit plan or a non-qualified plan of deferred compensation. Further, if their plan is a welfare benefit plan, whether or not their plan maintains experience-rated arrangements with respect to individual employers. [Notice 95-34, IR Bulletin No. 1995-23]

APPENDIX E

VEBA TAX COURT LITIGATION

General Signal Corporation v. Commissioner
103 TC 216 (1994)

In December of 1985, General Signal established a VEBA to prefund its subsequent year's employee medical and other welfare benefits pursuant to a recommendation from the consulting firm of Dolgin & Associates. In 1986 and 1987, General Signal deducted yearend VEBA contributions of $39,067,195 and $40,204,000, respectively. The majority of these contributions represented alleged reserves for post-retirement medical and life insurance.

A. Post-Retirement Medical and Life Insurance Reserve

IRC section 419A(c)(2) effectively allows a deduction for a reserve "funded" over the working lives of covered employees as necessary to provide for post-retirement medical and life insurance benefits. The Service disallowed General Signal's deduction for this reserve because its contribution was never intended to, and in fact never did, "fund" such a reserve. As a result, the allowable addition to the qualified asset account limit for this component was zero. General Signal argued that the Service was taking the "simplistic position that the words (of the statute) mean what they purport to say." General Signal argued that this section simply provided a method of calculating the underlying liability of this component of the account limit.

The Tax Court agreed with the Service, stating that this section required the establishment of a funded reserve before an amount can be included in the account limit. The Court ruled that the language of this section

> suggests that Congress intended to allow **the accumulation of funds** over the working lives of employees for the purpose of providing postretirement benefits. This interpretation is supported by repeated references in the legislative history to the accumulation of reserves for the purposes of funding postretirement benefits... . Additionally, the legislative history also establishes that Congress intended to "prevent employers from taking premature deductions for expenses which have not yet been incurred". Thus, both the plain language of the provision and the legislative history fully demonstrate that (General Signal's) interpretation of section 419A(c)(2) is erroneous. 103 T.C. at 243-44.

The Court found that General Signal's interpretation would

> clearly allow the taking of premature deductions for expenses that have not been incurred. (General Signal's) contributions to the VEBA Trust were intended to, and primarily did, satisfy claims of active employees in the year following the year of contribution. (General Signal) did not, and never intended to, accumulate funds in the VEBA Trust so that postretirement benefits would be funded upon the retirement of its employees. 103 T.C. at 243.

The Court decided that the Service's interpretation of this section was not only reasonable, but that "this interpretation is necessary to accomplish the intent of Congress to prevent the premature deduction of expenses which have not been incurred." 103 T.C. at 247.

Some of the facts and circumstances cited by the Tax Court were:

(1) General Signal had established the VEBA Trust as a tool for annually prefunding the benefit payments it expected to come due in the subsequent year, as evidenced by the following facts:

> a) General Signal had actually purchased the idea from a benefit consulting firm (Dolgin & Associates) for the specific purpose of funding employee benefits "in a unique manner which will result in a significant tax reduction... ." Dolgin specifically recommended that post-retirement reserve contributions be used to pay the subsequent year's benefits, primarily for active employees. In fact, Dolgin emphasized that the advantage of its idea was that General Signal would "be prefunding the VEBA only for amounts that would have to be paid to employees during the next year regardless of whether the VEBA is established."
>
> b) Internal memoranda prepared by General Signal's executives during the years at issue confirmed the fact that General Signal viewed its prefunding contributions as "estimates of the following year's cash disbursements for employee and retiree benefit payments."
>
> c) The VEBA Trust used the contributions consistently with this purpose.

(2) In its financial statements, General Signal made no disclosure of the funding of any reserve for post-retirement medical or life insurance benefits. Financial Accounting Standard No. 81 requires the disclosure of its accounting and "funding" policies for post-retirement health care and life insurance benefits.

(3) General Signal made no disclosure to its employees or their unions of the funding, establishment or maintenance of any reserve for post-retirement medical or life insurance benefits.

(4) The projected budget estimates prepared by the VEBA Trust for the years at issue and submitted to the Service as part of its Form 1024 Application for Recognition of Exemption in January of 1987, showed only minimal amounts of surpluses and did not reflect the existence of any reserves whatsoever.

The Court cited the above facts in support of its conclusion that General Signal did not, and never intended to, fund a post-retirement reserve. However, the Court did not establish a test requiring all (or any) of the specific facts present in this case as necessary for such a conclusion. Obviously, there are other fact patterns which could support the same conclusion.

The Tax Court's decision with respect to this issue was affirmed by the Second Circuit Court of Appeals in General Signal Corporation v. Commissioner, aff'd __F.3d __(2d Cir. 1998). The Second Circuit stated that whether deductions may be claimed under section 419A(c)(2) turned on the intent of General Signal in establishing its reserve. The Court stated that, as General Signal had conceded that it was never intended that any portion of any VEBA contribution would be spent in any particular way, other than to provide permitted benefits, no deduction could be claimed under section 419A(c)(2).

Proper Actuarial Calculation of the Post-Retirement Reserve

The Service also argued that General Signal's calculation of the amount of its alleged reserve for post-retirement medical and life insurance benefits did not comply with the statute's requirement that it be "funded over the working lives of the covered employees and actuarially determined on a level basis (using assumptions that are reasonable in the aggregate)... ." General Signal included the full present value of its benefit liability for current retirees in its calculations. This component amounted to between 80% and 90% of the entire reserve calculation. A major portion of the actual trial consisted of expert actuarial testimony on this question and both the Service and General Signal devoted a substantial proportion of their briefs to arguments supporting their respective

positions.

The Tax Court ruled, however, that since General Signal "has failed the minimum requirement of establishing a funded reserve..." it was not required to decide issues related to the proper actuarial calculations required under section 419A(c)(2).

In its opening and reply briefs, the Service argued that the actuarial calculations required by section 419A(c)(2) did not allow for the immediate inclusion of any prior liabilities. General Signal's actuarial calculations had amortized the past service liability with respect to active employees over their working lives, while immediately amortizing the retiree liability. The Service argued that the statute required amortization of all benefit liabilities, including those for current retirees, over the working lives of the covered employees (in this case, 15 years). The briefs submitted to the Court are now a matter of public record in this case. Given that there is little other public guidance in this area, these briefs are a very useful source of information for taxpayers and Service personnel.

B. Incurred But Unpaid Claims

The section 419A(c)(1) account limit also includes "the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of such taxable year)". Section 419A(c)(5)(A) provides that unless there is actuarial certification with respect to an account limit, the account limit may not exceed certain "safe harbor" limits.
For medical benefits the safe harbor is 35% of the qualified direct costs (other than insurance premiums) for the immediately preceding taxable year.

General Signal provided the Court with a calculation of the amount of incurred but unpaid claims using the 35% safe harbor for medical benefits (excluding insurance premiums). The Service argued that General Signal had not only used the wrong years in calculating the safe harbor amounts but, more importantly, had failed to show that the amount calculated by using this percentage was "reasonably necessary" to fund claims incurred but unpaid. The Tax Court agreed with the Service ruling that:

> While titled "Safe Harbor Limits", section 419A(c)(5)(B) does not allow a taxpayer to automatically claim 35 percent of its prior year's qualified direct costs as the amount of incurred but unpaid claims. Rather, the statute merely allows a taxpayer to claim amounts at or below this threshold without obtaining an actuarial certification.

The Court referred to the legislative history of this section noting that it specifically stated that "(e)ven if the safe harbors are satisfied, the taxpayer is to show that the reserves ... are reasonable." In other words, while no amount can be claimed in excess of the safe harbor amount without an actuarial certification, amounts claimed at or below this figure are not automatically allowable. The taxpayer must still support such amounts as being reasonable through substantiating documentation.

National Presto Industries Inc. v. Commissioner
104 T.C. 559 (1995)

National Presto established a VEBA Trust to provide for its employee medical and other welfare benefits. For the taxable year ending December 31, 1984, the VEBA Trust reported assets of $2,408,732, which included an account receivable from National Presto in the amount of $2,388,824. The question presented to the Tax Court was whether this receivable constitutes "assets set aside" for purposes of IRC section 419A(f)(7). This section provides a special transitional rule for the first 4 taxable years ending after December 31, 1985. This rule applies to a welfare benefit fund which, as of July 18, 1984, had assets set aside for purposes of providing certain employee benefits. The transitional rule permits the account limit to be increased by the applicable percentage of any "existing excess reserves". For the taxable year ending December 31, 1987, the applicable percentage is 60%.

Temporary Regulation section 1.419-1T Q&A-5(b)(1) provides that a taxpayer may deduct contributions made to a welfare benefit fund only to the extent that the contribution does not cause the fund to have assets at the end of the taxable year in excess of its account limit, as adjusted by section 419A(f)(7). At the close of the 1987 taxable year the VEBA's assets exceeded its account limit (before adjustment by section 419A(f)(7)) by $745,975. Unless it were entitled to include the account receivable of $2.39 million in its transitional rule calculations, National Presto's deduction for 1987 would be reduced by $745,975.

The Tax Court fully upheld the Service's position that the account receivable could not be considered in applying the transitional rule. The Court, citing General Signal, ruled that "mere liability does not create a funded reserve; a funded reserve connotes the accumulation of assets and the funding of benefits. ... Similarly, we do not think that a

’liability’ created by a mere bookkeeping entry constitutes an asset that can be set aside for purposes of section 419A(f)(7)." As a result, the transitional rule calculations (not counting the receivable) did not result in an increase in the account limit.

The phrase "assets set aside" also appears in the section 419A(a) definition of qualified asset account. National Presto gains added significance if its definition of "assets set aside" can be extended to the same term used in a different subsection. See Parker-Hannifin below.

Parker-Hannifin Corporation v. Commissioner
72 T.C.M. 191 (1996), aff’d

Parker-Hannifin has a fiscal year ending June 30th. On June 30, 1987, Parker-Hannifin established a VEBA Trust to provide for its employee medical, dental, disability and life insurance benefits. On that same date Parker-Hannifin made a $42 million contribution to its VEBA. The Service disallowed the portion of the contribution that related to the alleged reserves for post-retirement medical and life insurance benefits, long-term disability and benefits provided pursuant to collective bargaining agreements.

The questions presented to the Court were: whether the alleged reserves are properly includible in the account limit (i.e., did the contribution fund the reserves); if so, whether Parker-Hannifin had actuarial certifications for the portions that exceed the safe-harbor limits; if so, whether the calculation of the amount of the reserves for post-retirement and long-term disability was proper; and finally, whether the contribution relating to the benefits provided under collective bargaining agreements was made to a separate welfare benefit fund.

The Tax Court ruled in favor of the Commissioner on all of the issues. The Sixth Circuit subsequently affirmed the Tax Court as to two of the issues but reversed as to the long-term disability issue. Parker-Hannifin Corp. v. Commissioner, __F.3d__ (6th Cir. 1998). As to the long-term disability issue, the Sixth Circuit ruled that, unlike post-retirement benefits under section 419A(c)(2), contributions for long-term disability benefits need only be “set aside” under section 419A(a) and a separate reserve need not be created. The Sixth Circuit concluded that assets are “set aside” when the taxpayer makes an irrevocable contribution to a welfare benefit fund which provides those benefits specified in section 419A(a).

Connecticut Mutual Life Insurance Co. v. Commissioner
106 T.C. 445 (1996)

This case involved a pre-section 419 contribution to a VEBA. In December, 1985, Connecticut Mutual established a VEBA Trust to provide for its employee holiday pay. On or about that same date, Connecticut Mutual made a $20 million contribution to its VEBA to prefund its holiday pay for many years into the future. The Service disallowed the full amount of this deduction.

The questions presented to the Court were: whether the contribution was an ordinary and necessary business expense under section 162(a); whether the contribution satisfies the all-events test under section 461(a); and whether the contribution clearly reflects income under section 446(b). The Court rules that the contribution was not an ordinary and necessary business expense under section 162(a) and denied the deduction.

Harry A. Wellons v. Commissioner
7th Circuit Court of Appeals
31 F.3d 569 (1994)

This case predates section 419, however, it still has precedential value for any case which claims to be excepted from the limitations of sections 419 and 419A - e.g., 10 or more employer plans.

Dr. Harry Wellons, Jr. established a severance pay plan for his employees in 1983. Wellons contributed $194,000 in 1984, and again in 1985, to a VEBA trust established as a funding vehicle for this plan. Wellons deducted these contributions as a section 162 business expense. The Service disallowed the deduction on the grounds that the payments were made to a non-qualified deferred compensation plan governed by section 404(a)(5). The Tax Court agreed with the Service, ruling that the deductions could not be taken until the severance benefits were actually paid to the employee. Wellons appealed to the 7th Circuit.

The 7th Circuit Court of Appeals upheld the Tax Court decision, finding that on "its face the Wellons' plan seems more akin to a pension plan than to a plan providing benefits corresponding to those listed alongside 'welfare' benefits... ." The Court stated that the key distinguishing feature was that analogous welfare benefits (such as, dismissal wages) operated more as insurance in case of a contingent event rather than as, in the case of the Wellons plan, a "guarantee of income upon a certain event."

APPENDIX F

THE "10 OR MORE EMPLOYER" EXCEPTION TO SECTIONS 419 AND 419A

Section 419A(f)(6) provides an exemption from the deduction limitations of sections 419 and 419A for contributions to a plan to which 10 or more employers contribute, if no one employer normally makes more than 10% of the total contributions, and if the plan does not maintain "experience rating" arrangements with respect to individual employers.
A number of plans have been discovered in recent years that are designed to use the 10 or more employer exception as a vehicle for funding large amounts of life insurance, disability and severance pay benefits. These plans are being promoted actively on a nationwide basis by a number of promoters and under a variety of names. The plans generally target small, closely-held corporations with significant amounts of taxable income and a limited number of employees.

The basic idea behind arrangements of this nature is to establish a benefit plan that allegedly is an employee welfare benefit plan, but which is not subject to the limitations of sections 419 and 419A. These arrangements purport to also escape the deduction limits of section 404 (relating to certain deferred compensation arrangements). This latter factor has taken on added importance given the stringent limitations on deductions for highly compensated key employees. As a result, promoters have marketed programs of this nature as attractive alternatives to qualified retirement plans. This is significant because one of the reasons sections 419 and 419A were added to the Internal Revenue Code was because of Congressional concern that welfare benefit funds were being utilized to defer compensation or otherwise accumulate, on a tax deferred basis, amounts for later distribution to highly compensated professional employees of closely-held companies.

Initially, it appeared that most promoters utilized VEBAs as the funding vehicle for providing the promised benefits. It now appears, however, that promoters are also using taxable trusts as funding vehicles. Using a taxable trust means that benefits can be weighted heavily in favor of the owner or majority shareholder of the business since discrimination is not a concern.

The Tax Court rules in Booth v. Commissioner, 108 T.C. 524 (1997), that the arrangements in that case represented separate plans as opposed to a single “10-or-more employer” plan and also concluded that the plan maintained experience rating arrangements with respect to individual employers.

The Service has issued Notice 95-34 (reprinted below) in an effort to provide guidance

in this area. The North Florida District, in cooperation with the ISP team, is in the process of writing an MSSP guide relating to this issue.

NOTICE 95-34 (1995-1 C.B. 309)

Tax Problems Raised by Certain Trust Arrangements Seeking to Qualify for Exemption from Section 419.

Taxpayers and their representatives have inquired as to whether certain trust arrangements qualify as multiple employer welfare benefit funds exempt from the limits of section 419 and section 419A of the Internal Revenue Code. The Service is issuing this Notice to alert taxpayers and their representatives to some of the significant tax problems that may be raised by these arrangements.

In general, contributions to a welfare benefit fund are deductible when paid, but only if they qualify as ordinary and necessary business expenses of the taxpayer and only to the extent allowable under section 419 and section 419A of the Code. Those sections impose strict limits on the amount of tax-deductible prefunding permitted for contributions to a welfare benefit fund.

Section 419A(f)(6) provides an exemption from section 419 and section 419A for certain welfare benefit funds. In general, for this exemption to apply, an employer normally cannot contribute more than 10 percent of the total contributions, and the plan must not be experience rated with respect to individual employers. The legislative history states that the exemption under section 419A(f)(6) is provided because "the relationship of a participating employer to [such a] plan often is similar to the relationship of an insured to an insurer." Even if the 10 percent contribution limit is satisfied, the exemption does not apply to a plan that is experience rated with respect to individual employers, because the "employer’s interest with respect to such a plan is more similar to the relationship of an employer to a fund than an insured to an insurer." H.R. Rep. No.98-861, 98th Cong., 2d Sess., 1159 (1984-3 C.B. (Vol.2) 1,413).

In recent years a number of promoters have offered trust arrangements that they claim satisfy the requirements for the 10-or-more-employer plan exemption and that are used to provide benefits such as life insurance, disability, and severance pay benefits. Promoters of these arrangements claim that all employer contributions are tax-deductible when paid, relying on the 10-or-more-employer exemption from the section 419 limits and on the fact that they have enrolled at least 10 employers in their multiple employer trusts.

These arrangements typically are invested in variable life or universal life insurance contracts on the lives of the covered employees, but require large employer contributions relative to the cost of the amount of term insurance that would be required to provide the death benefits under the arrangement. The trust owns the insurance contracts. The trust administrator may obtain the cash to pay benefits, other than death benefits, by such means as cashing in or withdrawing the cash value of the insurance policies.

Although, in some plans, benefits may appear to be contingent on the occurrence of unanticipated future events, in reality, most participants and their beneficiaries will receive their benefits.

The trusts often maintain separate accounting of the assets attributable to the contributions made by each subscribing employer. Benefits are sometimes related to the amounts allocated to the employees of the participant's employer. For example, severance and disability benefits may be subject to reduction if the assets derived from an employer's contributions are insufficient to fund all benefits promised to that employer's employees. In other cases, an employer's contributions are related to the claims experience of its employees. Thus, pursuant to formal or informal arrangements or practices, a particular employer's contributions or its employees' benefits may be determined in a way that insulates the employer to a significant extent from the experience of other subscribing employers.

In general, these arrangements and other similar arrangements do not satisfy the requirements of the section 419A(f)(6) exemption and do not provide the tax deductions claimed by their promoters for any one of several reasons, including the following:

1) The arrangements may actually be providing deferred compensation. This is an especially important consideration in arrangements similar to that in Wellons v. Commissioner, 31 F.3d 569 (7th Cir. 1994), aff'g, 64 T.C.M. (CCH) 1498 (1992), where the courts held that an arrangement purporting to be a severance pay plan was actually deferred compensation. If the plan is a nonqualified plan of deferred compensation, deductions for contributions will be governed by section 404(a)(5), and contributions to the trust may, in some cases, be includible in employees' income under section 402(b). Section 404(a)(5) provides that contributions to a nonqualified plan of deferred compensation are deductible when amounts attributable to the contributions are includible in the employees' income, and that deductions are allowed only if separate accounts are maintained for each employee.

2) The arrangements may be, in fact, separate plans maintained for each employer. As

separate plans, they do not qualify for the 10-or-more-employer plan exemption in section 419A(f)(6).

3) The arrangements may be experience rated with respect to individual employers in form or operation. This is because, among other things, the trust maintains, formally or informally, separate accounting for each employer and the employers have reason to expect that, at least for the most part, their contributions will benefit only their own employees. Arrangements that are experience rated with respect to individual employers do not qualify for the exemption in section 419A(f)(6).

4) Even if the arrangements qualify for the exemption in section 419A(f)(6), employer contributions to the arrangements may represent prepaid expenses that are nondeductible under other sections of the Internal Revenue Code.

Taxpayers and their representatives should be aware that the Service has disallowed deductions for contributions to these arrangements and is asserting the positions discussed above in litigation.

Finally, in response to questions raised by taxpayers and their representatives, we note that the Service has never issued a letter ruling approving the deductibility of contributions to a welfare benefit fund under section 419A(f)(6). Although a trust used to provide benefits under an arrangement of the type discussed in this Notice may have received a determination letter stating that the trust is exempt under section 501(c)(9), a letter of this type does not address the tax deductibility of contributions to such a trust.

APPENDIX G

VACATION PAY FUNDING THROUGH VEBA's

IRC section 463, which permitted employers to deduct additions to a reserve for vacation pay, was repealed by the Revenue Act of 1987. As a result, for tax years beginning after 1987, the deduction for vacation pay is generally limited to the amount earned during the year to the extent that:

(1) the amount is paid to employees during the year, or
(2) the amount is vested as of the last day of the tax year and is paid to employees within 2 1/2 months after the end of the year.

Some employers have deducted vacation pay accruals to VEBAs. These employers make a contribution to a VEBA during the 2 1/2 month period after the employers year end. This, they argue, satisfies the statutory requirements for deductibility. The employees do not actually receive their vacation pay until some time after the VEBA contribution. In most cases, the employer uses its normal payroll procedures to pay the vacation amounts to its employees and the employer is reimbursed by the VEBA.

Agents have challenged this deduction. The primary argument is that section 419 controls and it does not allow a deduction for any accruals to welfare benefit funds. Section 419(a)(2) provides that contributions are deductible for the taxable year in which they are paid to the fund. In other words, no accruals are allowable.

An alternative position should be taken in situations of this nature. This is because there is a mutually exclusive relationship between section 419 and section 404. Section 419 governs the timing of employer deductions for contributions to employee welfare benefit funds, whereas, section 404 governs the timing of employer deductions relating to certain deferred compensation arrangements. By definition, a welfare benefit fund does not include one which provides benefits to which section 404 applies (determined without regard to section 404(b)(2)). Conversely, section 404(b)(2)(A) does not apply to any benefit provided through a section 419(e) welfare benefit fund.

As a result, assuming section 419 is not controlling, the alternative argument for disallowing the vacation pay accrual is this: Temporary Regulation sections 1.404(b)-1T Q&A-2(b)(1) and 1.404(b)-1T Q&A-2(c) clearly require that the compensation must be "received by the employee on or before the end of the applicable 2 1/2 month period." While the contributions paid to the VEBA, in this situation, constitute the "funding" of such benefits, they do not constitute actual "receipt" by the employee. The

legislative history for the final version of Revenue Act of 1987 refers only to amounts "paid to employees" within the 2 1/2 month period. This is significant because this version specifically deleted the phrase "funded amounts that vest" from its description of the 2 1/2 month rule. The Temporary Regulations are consistent with this revision.

APPENDIX I

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