DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Number: **201410037**
Release Date: 3/7/2014

Date: December 11, 2013

UIL: 501.09-00; 511.00-00

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

X =
Y =
Z =
State A =
Year =
Date =
Trust =

Dear :

We have considered your letter dated October 23, 2012, in which you request rulings on the application of §§ 501(c)(9) and 511 of the Internal Revenue Code (the "Code") to your plan to distribute your assets upon your dissolution.

Facts

You represent that you are a self-insured trust recognized as exempt under § 501(a) of the Code as an organization described in § 501(c)(9) as a Voluntary Employees' Beneficiary Association ("VEBA").

You provide medical and dental plan benefits to employees of your participating tax-exempt members/employers (individually referred to herein as the "Employer" and collectively as the "Employers"). All claims for benefits are paid from your funds, subject to certain reinsurance agreements for large claims. The Employers consist of X, Y, and Z, all of which are tax-exempt entities. All of the Employers are located in State A.

Due to several significant claims and a relatively low number of employees served, your ability to provide cost-effective benefits is deteriorating. In order to maintain necessary reserves, you have had to increase premiums higher than those typically assessed by other providers offering similar plans (but who service many more customers). Furthermore, the cost to you of complying with future regulatory mandates would be high compared to providers offering similar plans. Consequently, your board of trustees has voted to terminate the Trust at the end of the

Year plan year. You anticipate having excess assets upon termination.

Your Trust Agreement states the following:

> Upon termination of this Trust Agreement, the Trust Board shall promptly wind up the affairs of the Trust . . . . With respect to any other form of termination, any and all money and assets remaining in the Trust, after the payment of expenses, shall be used for the continuance of benefits provided by then existing [medical and dental plans], until such money and assets have been exhausted, unless some other disposition is required under the applicable laws. In no event shall any of the remaining money or assets be paid to or be recoverable by any Participating Municipality.

Your proposal to handle excess assets upon the termination of your medical and dental plans at the end of Year is to enter into an agreement with the Employers (the "Plan") that would contain the following provisions:

- The fund balance of the Trust would be used only to continue to provide participant-employees of Employers in the Trust as of [Date], [Year], with medical and dental benefits after termination, until the fund balance is exhausted. No Employer would have a legal right to a reversion of assets, either under the Internal Revenue Code or under the agreement with the Trust.

- Employers must use their allocated share of the Trust fund balance for the following purposes:
  - Obtain group medical or dental insurance plan coverage, as applicable, for employees of the Employer; or
  - Provide self-insured medical or dental benefits through a third-party administrator for employees of the Employer.

- The Employer must submit information to the Trust about each group insurance plan or self-insured plan providing sick or accident benefits. Upon verifying that the group insurance plan or self-insured plan would provide sick or accident benefits for the participant-employees of the Employer, the Trust would draw a check in the name of the group plan insurer or third-party administrator participant plan, and mail the check directly to the insurer or third-party administrator.

- Employers will be required to agree that benefit plan arrangements paid for with the Trust's fund balance may not provide disproportionate benefits for officers or highly-paid employees of each Employer.

- Each Employer must acknowledge that the IRS may audit the Employer to ensure that the Employer applied its share of the fund balance to pay benefits consistent with the terms of the agreement.

- The party providing group medical or dental insurance plan coverage, or acting as the third-party administrator of a self-insured plan, would be required to agree that any monies paid to such group insurer or third-party administrator by the Trust could not revert to the Employer.

- Any failure to comply with the terms of the agreement would cause the Employer to forfeit any right to application of its share of the fund balance.

After payment of all administrative expenses and claims of the Trust, the Trust's fund balance would be allocated among Employers on the following basis:

- By line of coverage (i.e. medical and dental) using total contributions by all Employers over the last five years of the Trust as the denominator, and total contributions by Employers for each line of coverage over the last five years of the Trust as the numerator.

- Determine each Employer's share of the fund balance per line of coverage using total contributions by all Employers during the last five years as the denominator, and the Employer's total contributions during that period as the numerator.

- If an Employer does not provide medical or dental benefits after termination of the Trust, or fails to meet the conditions of participation under the termination agreement, that Employer's share would be allocated among other Employers on a pro-rata basis, based on their total contributions to the Trust for such benefits over the past five years.

Rulings Requested

You have requested the following rulings:

1. Adopting and implementing the Plan will not adversely affect your tax-exempt status as an organization described in § 501(c)(9) of the Code.

2. Adopting and implementing the Plan will not cause you to incur unrelated business income tax under § 511 of the Code.

Law

Section 501(c)(9) of the Code provides for the exemption from federal income tax of voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

Section 1.501(c)(9)-1 of the Income Tax Regulations provides that for an organization to be described in § 501(c)(9), it must be an employees' association; membership in the association must be voluntary; the organization must provide for the payment of life, sick, accident, or other benefits to its members; and there can be no inurement (other than by payment of permitted benefits) to the benefit of any private shareholder or individual.

Section 1.501(c)(9)-3(c) defines "sick and accident benefits" for purposes of § 501(c)(9) as amounts furnished to or on behalf of a member or a member's dependents in the event of illness or injury to a member or a member's dependent. Such benefits may be provided through reimbursement to a member or a member's dependent for amounts expended because of illness or personal injury, or through the payment of premiums to a medical benefit or health insurance program.

Section 1.501(c)(9)-4(a) provides, generally, that no part of the net earnings of an employees' association may inure to the benefit of any private shareholder or individual other than through the payment of benefits permitted by § 1.501(c)(9)-3.

Section 1.501(c)(9)-4(d) provides that it will not constitute prohibited inurement if, on termination of a plan established by an employer and funded through an association described in § 501(c)(9), any assets remaining in the association, after satisfaction of all liabilities to existing beneficiaries of the plan, are applied to provide, either directly or through the purchase of insurance, life, sick, accident or other benefits within the meaning of § 1.501(c)(9)-3 pursuant to criteria that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees of the employer.

Section 511 imposes a tax on the unrelated business taxable income of organizations described in § 501(c)(9).

Section 512(a)(3)(A) provides that, in the case of an organization described in § 501(c)(9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income) less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with modifications.

Section 512(a)(3)(B)(ii) provides that in the case of an organization described in paragraph (9), (17) or (20) of § 501(c), "exempt function income" includes all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to § 512(a)(1)), which is set-aside to provide for the payment of life, sick, accident, or other benefits, including reasonable costs of administration directly connected with its exempt purpose.

Section 512(a)(3)(E) provides that, generally, for organizations described in paragraph (9), (17) or (20) of § 501(c), a set-aside may be taken into account under subparagraph (B) only to the extent that such set-aside does not result in an amount of assets set aside in excess of the account limit determined under § 419A (without regard to subsection (f)(6) thereof) for the taxable year (not taking into account any reserve described in § 419A(c)(2)(A) for post-retirement medical benefits).

Section 512(a)(3)(E)(iii) provides that subparagraph 512(a)(3)(E) does not apply to an organization if substantially all of the contributions to such organization are made by employers who were exempt from tax under Chapter 1 of the Code throughout the 5-taxable year period ending with the table year in which the contributions are made.

Analysis

First, you have requested a ruling on whether the adoption and implementation of the Plan will adversely affect your tax-exempt status as an organization described under § 501(c)(9). Pursuant to § 1.501(c)(9)-4(a), a voluntary employees' beneficiary association will jeopardize its exempt status under § 501(c)(9) if any part of its net earnings inures to the benefit of any private shareholder or individual other than through the payment of benefits permitted by § 1.501(c)(9)-3. Pursuant to § 1.501(c)(9)-4(d), it will not constitute prohibited inurement if, on termination of a plan established by an employer and funded through an association described in § 501(c)(9), any assets remaining in the association, after satisfaction of all liabilities to existing beneficiaries of the plan, are applied to provide, either directly or through the purchase of insurance, life, sick, accident or other benefits within the meaning of § 1.501(c)(9)-3 pursuant to criteria that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees of the employer.

You represent that, after you terminate the Trust and pay administrative expenses and liabilities, the remaining fund balance of the Trust will be used to make pre-payments on group plans or to the self-insured plan's third-party administrator that would benefit the Employers' participant-employees of the VEBA. The Employers would not receive distributions of cash or other assets under the Plan. Instead, you would send checks directly to the Employer's group plan or third-party administrator providing benefits as described in § 1.501(c)(9)-3(c). These checks would be drawn only after you verify information regarding the group plan or self-insured plan and its cost.

In order for an Employer to receive an allocable share of the fund balance, it must agree to, and comply with, the terms of the Plan. The Plan provides that the fund balance of the Trust will be used only to continue to provide participant-employees of Employers in the Trust as of Date, Year, with § 501(c)(9) benefits after termination until the fund balance is exhausted, and that no Employer will have a legal right to a reversion of assets. Employers will be required to agree that benefit plan arrangements paid for with the Trust's fund balance may not provide disproportionate benefits for officers or highly paid employees of the Employer. Further, the party providing group medical or dental insurance plan coverage, or acting as the third-party administrator of a self insured plan, would be required to agree that any monies paid to such group insurer or third-party administrator by the Trust could never revert to the Employer. Thus, because you will use the fund balance to pre-pay the group plan insurers or third-party administrators secured by the Employers to provide medical and dental benefits permitted under § 501(c)(9) of the Code with no disproportionate benefit inuring to any person, and because none of the Trust's assets will revert back to any Employer, we conclude that this transaction will not jeopardize your tax-exempt status under § 501(c)(9).

Second, you have requested a ruling on whether the transfers will result in liability for unrelated business income tax under § 511. The transfers described above will not, in and of themselves, result in unrelated business income tax under § 511.

The unrelated business taxable income of a VEBA is determined pursuant to § 512, including § 512(a)(3)(E) and Treasury regulation §1.512(a)-5T. However, pursuant to § 512(a)(3)(E)(iii), §

512(a)(3)(E) does not apply to a VEBA such as the Trust if substantially all of the contributions to the VEBA are made by employers who were exempt from tax under Chapter 1 of the Code throughout the 5-taxable year period ending with the taxable year in which the contributions are made. You represent that the contributing employers, X, Y, and Z are tax exempt entities, and that substantially all of the contributions to Trust are made by employers who were exempt from tax under Chapter 1 of the Code throughout the 5-taxable year period ending with the taxable year in which the contributions are made. Accordingly, unrelated business taxable income of Trust is computed without regard to § 512(a)(3)(E).

Rulings

Based on the information submitted, we rule as follows:

1. Adopting and implementing the Plan will not adversely affect your tax-exempt status as an organization described in § 501(c)(9) of the Code.

2. Adopting and implementing the Plan will not, in and of itself, cause you to incur unrelated business income tax under § 511 of the Code.

This ruling will be made available for public inspection under § 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose.* A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Steven Grodnitzky
Manager, Exempt Organizations
Technical Group 1

Enclosure
Notice 437