PART XII: WELFARE BENEFIT FUNDS

3963. May an employer deduct contributions to a welfare benefit fund to provide medical, disability, and life insurance benefits, including post-retirement medical and death benefits, for employees and independent contractors?

The deduction of contributions paid by an employer to a fund under a plan to provide benefits to employees and their beneficiaries generally is limited. These limits also apply to contributions to provide benefits for independent contractors and their beneficiaries.[1]

As a general rule, the limits apply to contributions to any fund that is part of an employer plan, or a method or arrangement having the effect of a plan, and through which the employer provides welfare benefits to employees or their beneficiaries. A welfare benefit is rather cryptically defined as any benefit other than one subject to the deduction rules applicable to property transferred in connection with performance of services (so-called "IRC Section 83 property") and qualified and nonqualified deferred compensation. For tax purposes, this kind of fund is called a welfare benefit fund.[2]

A welfare benefit fund can be (1) any tax-exempt organization that is a voluntary employees' beneficiary association ("VEBA"), a trust providing for payment of supplemental unemployment compensation benefits ("SUB"), a qualified group legal services organization ("GLSO") (although the tax exemption for GLSOs is not available in taxable years beginning after June 30, 1992), or a social club, or (2) any taxable organization that is a corporation, a trust, or other organization.[3]

Certain accounts held by an insurance company for an employer also will be considered welfare benefit funds.[4]

Amounts held by an insurance company are not considered a fund subject to the limit if they are held pursuant to a contract that is (1) a life insurance contract covering the life of an officer, employee, or any person financially interested in any trade or business carried on by a policyholder if the policyholder is directly or indirectly a beneficiary, or (2) not guaranteed renewable and the only payments other than insurance protection to which the employer or employees are entitled are experience-rated refunds or policy dividends that are not guaranteed and that are determined by factors other than the amount of welfare benefits paid to or on behalf of employees or their beneficiaries. The experience refund or policy dividend in (2) also must be treated by an employer as paid or accrued in the taxable year in which the policy year ends.[5]

An employer's ability to contribute to a welfare benefit fund with respect to certain retiree health liabilities may be limited if the employer has made a qualified transfer of excess pension assets to a 401(h) retiree health account.[6]

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1. See IRC Secs. 419(a), 419(b), 419(g).
2. IRC Secs. 419(e)(1), 419(e)(2).
3. IRC Secs. 419(e)(3), 120(e).
4. See IRC Sec. 419(e)(3)(C); TRA '86, Sec. 1851(a)(8)(B); Temp. Treas. Reg. §1.419-1T, A-3(c); Ann. 86-45, 1986-15 IRB 52.
5. IRC Sec. 419(e)(4).
6. IRC Sec. 420(d)(2).

In addition, setting assets aside in a welfare benefit fund to pay for retiree health liabilities may limit an employer's ability to make a qualified transfer of excess pension assets to a 401(h) retiree health account (Q 3756).[1] The rules permitting transfers to 401(h) accounts apply for taxable years beginning before January 1, 2022.[2] Details of the coordination of benefits between an IRC Section 401(h) account and a VEBA have been explained by the IRS.[3]

3964. When may an employer deduct contributions to a welfare benefit fund?

Contributions paid or accrued by an employer to a welfare benefit fund generally will be deductible when paid to the fund, if they are otherwise deductible, subject to the limit discussed in Q 3965.[4] If contributions paid by an employer during a taxable year exceed the deduction limit, the excess is treated as paid to the fund in the next taxable year.[5]

3965. What is the limit on the amount an employer may deduct for contributions to a welfare benefit fund to provide disability, medical, death, and other benefits to employees and independent contractors?

Qualified Cost

An amount, otherwise deductible, that is contributed by an employer to a welfare benefit fund may be deducted up to the fund's qualified cost for the taxable year of the fund that ends with or within the employer's taxable year.[6] A fund's qualified cost for any taxable year generally is its (1) qualified direct cost for that taxable year, plus (2) any additions to a qualified asset account for that taxable year to the extent the additions do not cause the account to exceed its account limit for the taxable year, minus (3) the fund's after-tax income for the taxable year.[7] The deductible amount may be reduced further by additional rules.[8]

To determine whether a company's contributions to a proposed trust to fund postretirement medical benefits for union retirees under a plan would be treated as not exceeding the trust's qualified cost under IRC Section 419(b) and IRC Section 419(c) and would be deductible without regard to the limits of IRC Section 419A(b) and IRC Section 419A(c), the IRS determined that if the amount of the contribution satisfies the requirements of IRC Section 419, the deduction of the amount generally is not limited by IRC Section 162.

If a contribution is such that the assets exceed the amount needed to provide postretirement benefits to all current and future retirees from current active employees, that is, the present value of future benefits, then the contribution fails to satisfy the requirements of IRC Section 162.[9]

1. IRC Sec. 420(e)(1)(B).
2. IRC Sec. 420(b)(4).
3. See Let. Rul. 9834037.
4. IRC Sec. 419(a).
5. IRC Sec. 419(d).
6. IRC Secs. 419(a), 419(b); Temp. Treas. Regs. §§1.419-1T, A-1, 1.419-1T, A-4.
7. IRC Secs. 419(c)(1), 419(c)(2), 419A(b); Temp. Treas. Reg. §1.419-1T, A-5(a).
8. See Temp. Treas. Reg. §1.419-1T, A-5(b).
9. Let. Rul. 199945066.

When the taxable year of a fund is different from the taxable year of an employer, special rules determine the deduction limit for the taxable year of the employer in which the fund is established and for the employer's next taxable year.[1] Special rules also require contributions made after the close of a fund's taxable year but during the employer's taxable year to be treated as an amount in the fund as of the last taxable year of the fund that relates to the taxable year of the employer.[2] Accordingly, an employer with a differing tax year than its welfare benefit trust cannot accelerate its deduction for its contribution to the trust to an earlier tax year by making its contribution after the end of the trust's tax year but before the end of the employer's tax year and, therefore, prefunding the trust for benefits to be provided in the following tax year.[3]

A fund's qualified direct cost for a taxable year generally is the amount, including administrative expenses, that a cash basis employer with the same taxable year as the fund could deduct had it provided the benefits directly instead of through an intermediary fund. Rules limiting the deduction for benefits provided directly by an employer apply even though the benefits are provided through a fund. The benefit is considered provided in the year the benefit is includable in income by the employee or would be includable except for IRC provisions excluding the benefit from income.[4]

A qualified asset account is an account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, supplemental unemployment benefits ("SUB"), severance pay benefits, or life insurance benefits including any other death benefits.[5] The account limit on a qualified asset account for a taxable year generally is the amount reasonably and actuarially necessary to fund claims incurred but unpaid as of the close of the fund's taxable year for the benefits, as well as the administrative costs with respect to those claims.[6]

In one case, the Tax Court concluded that assets actually must be set aside for the payment of future long-term disability benefits that were incurred but unpaid; thus, an employer could not deduct contributions for the benefits where the employer had failed to accumulate the necessary assets in a VEBA trust.

The Sixth Circuit Court of Appeals determined that the Tax Court had erroneously interpreted the term "set aside" in IRC Section 419A(a) as having the same meaning as the term "reserve" in IRC Section 419A(c)(2). The Sixth Circuit held that an employer has set aside assets for purposes of IRC Section 419A(a) when it has made an irrevocable contribution to a welfare benefit fund providing those benefits specified in IRC Section 419A(a).[7]

In other words, "set aside" with respect to an account for disability, medical, supplemental unemployment, severance, or life insurance benefits under IRC Section 419A(a) has a different, less restrictive meaning than "reserve" as it applies to an account for postretirement medical

1. See Temp. Treas. Reg. §1.419-1T, A-7.
2. See Temp Treas. Reg. §1.419-1T, A-5(b).
3. *Square D Co. v. Comm.*, 109 TC 200 (1997).
4. IRC Sec. 419(c)(3); Temp. Treas. Regs. §§1.419-1T, A-6(a), 1.419-1T, A-6(c).
5. IRC Sec. 419A(a).
6. IRC Sec. 419A(c)(1).
7. *Parker-Hannifin Corp. v. Comm.*, TC Memo 1996-337, *aff'd in part*, *rev'd in part*, 139 F.3d 1090 (6th Cir. 1998).

or life insurance benefits.[1] Apparently, the amount reasonably and actuarially necessary to fund incurred but unpaid claims in a fully insured plan is zero.[2]

Under certain circumstances, the account limit also may include an amount to fund, over their working lives, postretirement medical or life insurance benefits including any other death benefit to be provided to covered employees.[3] The reserve may not be included in the account limit, however, unless such a reserve actually is established and funded, that is, unless assets actually are accumulated in the fund to cover postretirement obligations.[4]

The present value of projected postretirement medical benefits for employees who are retired at the time a reserve is created may be deducted in the year the reserve is created. The Tax Court has approved the use of the individual level premium cost method to compute the reserve and rejected the use of the aggregate cost method.[5]

The IRS privately ruled that where a company's VEBA intended to purchase a retiree health insurance policy to fund retiree benefits under the VEBA:

(1) the VEBA would not be taxed on any income from the policy;

(2) the company would not be required to recognize any income on the amount of the policy; and

(3) the benefit payments under the policy to the VEBA would be excluded from the VEBA's gross income.[6]

Whether deductions may be claimed under IRC Section 419A(c)(2) turns on the intent of the employer at the time that the reserve is established.[7] A reserve for postretirement benefits is not required to be segregated from the general assets of the fund into a separate account.[8]

One special rule provides that certain employee pay-all VEBAs have no account limits.[9] Another special rule provides that welfare benefit funds under collective bargaining agreements have no account limits.[10] Certain arrangements purportedly qualifying as collectively-bargained welfare benefit funds excepted from the account limits of IRC Sections 419 and 419A have been identified as listed transactions (Q 3975).[11]

1. Internal Revenue Service Exempt Organizations Continuing Professional Education Text for Fiscal Year 1999, Chapter F, Voluntary Employees' Beneficiary Associations.
2. See Let. Rul. 9325050.
3. See IRC Secs. 419A(c)(2), 419A(e)(1).
4. *General Signal Corp. v. Comm.*, 103 TC 216 (1994), *aff'd*, 142 F.3d 546 (2nd Cir. 1998); *Parker-Hannifin Corp. v. Comm.*, TC Memo 1996-337, *aff'd in part*, *rev'd in part*, 139 F.3d 1090 (6th Cir. 1998). See also *Square D Co. v. Comm.*, 109 TC 200 (1997); IRS CCA 201040018.
5. *Wells Fargo v. Comm.*, 120 TC 69 (2003).
6. Let. Rul. 200404055.
7. *General Signal Corp. v. Comm.*, 142 F.3d 546 (2nd Cir. 1998).
8. See *General Signal Corp. v. Comm.*, 103 TC 216 (1994) (agreeing in dicta with IRS attorneys' argument that a postretirement reserve need not be maintained in a separate account), *aff'd*, 142 F.3d 546 (2nd Cir. 1998); *Parker-Hannifin Corp. v. Comm.*, 139 F.3d 1090 (6th. Cir. 1998).
9. IRC Sec. 419A(f)(5)(B).
10. IRC Sec. 419A(f)(5)(A); see Temp. Treas. Reg. §1.419A-2T, A-2.
11. Notice 2003-24, 2003-18 IRB 853.

The DOL has released criteria for determining when a plan is established and maintained under a collective bargaining agreement for purposes of the exception from the multiple employer welfare arrangement ("MEWA") rules under ERISA.[1]

Maintenance of a separate welfare benefit fund for union employees is required. A fund for union employees must not only be separate from the employer and its creditors, but must also be "distinct and apart from any funds provided for non-collectively bargained employees."[2]

A fund's after-tax income generally is the fund's gross income, including employee contributions but excluding employer contributions, reduced by allowable deductions directly connected with production of gross income and by the tax on the income.[3]

Employer contributions that are not deductible in one year because they exceed the limit on allowable deductions are carried over and treated as contributed in the next year.[4]

Special rules apply if a welfare benefit fund is part of a ten or more employer plan (Q 3975).

Account Limit

Claims are incurred only on the occurrence of an event entitling the employee to benefits, such as a medical expense, a separation, a disability, or a death. The allowable reserve includes amounts for claims estimated to have been incurred but that have not yet been reported, as well as those claims that have been reported but have not yet been paid.[5]

Incurred but unpaid claims include the present value of a future stream of payments under a long-term disability or death claim, using reasonable actuarial assumptions.[6] The report of the Senate committee (TRA '86) notes that no more than twelve months of disability benefits may be deemed incurred with respect to a short term disability expected to last more than five months.[7]

The account limit to fund disability claims that have been incurred, but remain unpaid, may not take into account disability benefits to the extent they are payable at an annual rate in excess of (1) the lower of 75 percent of the individual's average high three years of compensation or (2) the dollar limit on an annual benefit of a defined benefit plan ($210,000 in 2013 and 2014, up from $200,000 in 2012).[8] In applying this limit, all welfare benefit funds of the employer are treated as one fund.[9]

The account limit with respect to reserves set aside to provide postretirement medical or life insurance benefits may not take into account life insurance benefits in excess of $50,000, except to the extent a higher amount may be provided tax-free under grandfathering provisions

1. See Labor Reg. §2510.3-40; 68 Fed. Reg. 17471 (4-9-2003).
2. *Parker-Hannifin Corp. v. Comm.*, 139 F.3d 1090 (6th Cir. 1998). But see Let. Ruls. 200137066, 199945066.
3. IRC Sec. 419(c)(4).
4. IRC Sec. 419(d).
5. H.R. Conf. Rep. 861 (TRA '84), 98th Cong., 2d Sess. 1156, *reprinted in* 1984-3 CB (vol. 2) 410.
6. See *id.*
7. S. Rep. No. 313, 99th Cong., 2d Sess. 1006, *reprinted in* 1986-3 CB (vol. 3) 1006.
8. IRC Sec. 419A(c)(4)(A); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
9. IRC Sec. 419A(h)(1)(A).

of Section 79 for certain individuals.[1] For this purpose, all welfare benefit funds of an employer are treated as one.[2] In funding for postretirement medical benefits, current cost assumptions must be used; future inflation may not be assumed.[3]

The account limit generally may not include a reserve to provide postretirement medical or death benefits under a plan that fails to meet nondiscriminatory benefit requirements (Q 3972).[4] If postretirement benefits are provided for key employees, see Q 3971.

Unless there is an actuarial certification of the account limit by a qualified actuary, the account limit for a taxable year may not exceed certain safe harbor limits.[5] The IRC's reference to safe harbor limits here is potentially confusing because these limits are not true safe harbors.[6] That is, the safe harbor limits do not establish a minimal reserve level or account limit that an employer can automatically fund on a currently deductible basis. An employer claiming an account limit equal to or less than the applicable safe harbor limit or limits still must show that its claimed reserve satisfies the generally applicable restrictions of IRC Section 419A. That is, the claimed reserve still must be reasonably and actuarially necessary to pay incurred but unpaid claims plus administrative costs.[7]

Any reserve for postretirement medical or life insurance benefits must be determined actuarially on a level basis to fund the postretirement benefits over the working lives of covered employees. Claiming an account limit at or below the applicable safe harbor limit or limits simply relieves the employer of the obligation to obtain an actuarial certification justifying its reserve computations.[8] Actuarial valuation reports do not constitute an actuarial certification for purposes of IRC Section 419A.[9]

The safe harbor limit for any taxable year for short term disability claims is 17.5 percent of the qualified direct costs other than insurance premiums for short term disability benefits for the immediately preceding taxable year.[10]

The safe harbor limit for any taxable year for long-term disability or life insurance benefits is to be prescribed by regulations.[11]

The safe harbor limit for any taxable year for medical claims is 35 percent of the qualified direct costs other than insurance premiums for medical benefits for the immediately preceding taxable year.[12] The TRA '84 conference report explains that insurance premiums may not

1. IRC Sec. 419A(e)(2); TRA '86, Sec. 1851(a)(3)(B), as amended by TAMRA '88 Sec. 1018(t)(2)(D).
2. IRC Sec. 419A(h).
3. IRC Sec. 419A(c)(2).
4. See IRC Sec. 419A(e)(1); TRA '86 Sec. 1851(a)(3)(B), as amended by TAMRA '88 Sec. 1018(t)(2)(D).
5. See IRC Sec. 419A(c)(5)(A); H.R. Conf. Rep. 861 (TRA '84), above, *reprinted in* 1984-3 CB (vol. 2) 412.
6. See *General Signal Corp. v. Comm.*, 103 TC 216 (1994), *aff'd*, 142 F.3d 546 (2nd Cir. 1998); *Square D Co. v. Comm.*, 109 TC 200 (1997); TAMs 9818001, 9446002, 9334002.
7. See, e.g., Let. Rul. 9818001.
8. See *General Signal*, above; *Square D Co.*, above; H.R. Conf. Rep. No. 861, above, *reprinted in* 1984-3 CB (vol. 2) 412.
9. Let. Rul. 9818001.
10. IRC Sec. 419A(c)(5)(B)(i).
11. IRC Sec. 419A(c)(5)(B)(iv).
12. IRC Sec. 419A(c)(5)(B)(ii).

be taken into account because the conferees did not intend that a fund be used as a vehicle for prepayment of insurance premiums for current benefits.[1]

3966. What is the additional reserve for medical benefits of bona fide association plans?

For tax years beginning after December 31, 2006, an applicable account limit for any taxable year may include a reserve in an amount not to exceed 35 percent of the sum of the qualified direct costs and the change in claims incurred but unpaid for such taxable year with respect to medical benefits other than post-retirement medical benefits. For this purpose, applicable account limit means an account limit for a qualified asset account with respect to medical benefits provided through a plan maintained by a bona fide association as defined in Section 2791(d)(3) of the Public Health Service Act.[2]

In determining an employer's deduction, no item may be taken into account more than once.[3]

3967. How do supplemental unemployment compensation ("SUB") and severance pay benefits apply in the context of a welfare benefit fund?

Where contributions are made to a fund to provide supplemental unemployment compensation ("SUB") or severance pay benefits, the account limit for SUB or severance pay benefits is 75 percent of the average qualified direct costs for any two of the immediately preceding seven taxable years, as selected by the fund.[4] If the benefit to any individual is payable at an annual rate in excess of 150 percent of the IRC Section 415 dollar limit on contributions to defined contribution plans, the excess cannot be taken into account in determining the account limit.[5] In applying this latter limit, all welfare benefit funds of the employer are treated as one fund.[6] Treasury regulations are to provide an interim limit for new SUB or severance pay plans that do not cover key employees.[7]

The safe harbor limit for SUB or severance pay benefits is the amount as determined above.[8]

For an explanation of how certain severance benefits are treated in light of the deferred compensation rules set forth in IRC Section 409(A), see Q 3986.

3968. How do the aggregation rules apply to welfare benefit funds?

An employer must treat all of its welfare benefit funds as one fund for certain purposes.[9] For other purposes, an employer may elect to treat two or more of its funds as one.[10] An election to aggregate must be consistent for deduction and nondiscrimination purposes

1. H.R. Conf. Rep. 861, above, *reprinted in* 1984-3 CB (vol. 2) 412.
2. 42 USC 300gg-91(d)(3). IRC Sec. 419A(c)(6), as added by PPA 2006.
3. IRC Sec. 419(c)(5).
4. IRC Sec. 419A(c)(3)(A).
5. IRC Sec. 419A(c)(4)(B).
6. IRC Sec. 419A(h)(1)(A).
7. IRC Sec. 419A(c)(3)(B).
8. IRC Sec. 419A(c)(5)(B)(iii).
9. IRC Sec. 419A(h)(1)(A).
10. IRC Sec. 419A(h)(1)(B).

(Q 3972, Q 3981).[1] There are aggregation rules similar to those of IRC Section 414 for controlled groups of corporations, employers under common control, and affiliated service groups and there are rules similar to the employee leasing rules.[2]

3969. What are the tax consequences to an employer and to a welfare benefit fund if the employer contributes excess amounts to the fund?

First, the deduction for the excess contribution is disallowed currently, although the excess contribution may be carried over and may be deductible in a later year. This carryover appears to be unlimited in time.[3]

Second, the fund's income-based tax liability may be increased. If contributions are made to a tax-exempt fund, the fund's liability for unrelated business income tax (UBTI) may increase. Thus, to the extent that excess contributions reduce any difference between the qualified asset account and the qualified asset account limit, which is calculated with some modification, the excess contributions will limit a fund's ability to protect some of its income from treatment as UBTI. In addition, excessive contributions to a fund ultimately may increase the fund's earnings, which may cause an increased exposure to UBTI (Q 3970).

Third, any increase in a fund's after-tax income, including employee contributions but not employer contributions, reduces the amount the employer can deduct (Q 3965). Thus, the IRC forces the fund's earnings to be used to provide benefits. The amount of tax imposed on an employer attributable to income of the fund is treated as a contribution to the fund as of the last day of the employer's taxable year. The amount of tax is treated as a tax on the fund for purposes of determining the fund's after-tax income.

Finally, efforts to retrieve excessive contributions may be costly because the IRC imposes an excise tax of 100 percent on any portion of a fund that reverts to the benefit of an employer to the extent it is attributable to deductible contributions (Q 3973).[4] It is not clear whether efforts to retrieve excessive contributions to a voluntary employees' beneficiary association ("VEBA") would violate the prohibition against private inurement (Q 3981).

3970. What income of a tax-exempt welfare benefit fund is taxable as unrelated business taxable income?

A tax-exempt welfare benefit fund is subject to a tax on its unrelated business taxable income ("UBTI"); a corporate fund is taxed at corporate rates and a trust at rates applicable to trusts.[5] Income less certain deductions from an unrelated trade or business regularly carried on by the organization is taxable. Other income of a tax-exempt organization, excluding member

1. H.R. Conf. Rep. 861, above, *reprinted in* 1984-3 CB (vol. 2) 413.
2. IRC Sec. 419A(h)(2).
3. See IRC Sec. 419(d).
4. IRC Sec. 4976.
5. IRC Sec. 511. See, e.g., *Sherwin-Williams Co. Employee Health Plan Trust v. U.S.*, 2005-1 USTC ¶50,286 (6th Cir. 2005), *aff'g*, 2002-2 USTC ¶50,271 (ND Ohio 2002).

contributions and certain deductions, is taxable except to the extent it is set aside for certain purposes and, at least in some cases, within certain limits.[1]

A VEBA or SUB may protect income from treatment as UBTI by setting it aside for the payment of life, sick, accident, or other benefits and reasonable, directly connected administrative costs.[2] The amount that may be so protected is expressly limited to the amount that may be set aside without causing the total assets set aside for such purposes to exceed the fund's account limit (Q 3965) for the taxable year.[3] This limitation applies to a fund that is part of a ten or more employer plan. In determining the account limit for this purpose, a reserve for postretirement medical benefits generally may not be taken into consideration.[4] Income in excess of the amount properly set aside is taxable as unrelated business income. To the extent the account limit already is satisfied, a fund's income cannot be set aside tax-free.

If any amount attributable to income set aside tax-free is used for any purpose other than one entitling the set-aside to tax-free treatment, the amount generally will be treated as UBTI.[5]

Special rules apply where there are existing reserves set aside as of the close of the last plan year ending before July 18, 1984, or, if greater, on July 18, 1984, to provide postretirement medical or life insurance benefits.[6]

In *Sherwin-Williams Co. Employee Health Plan Trust v. Comm.*, the Sixth Circuit Court of Appeals reversed the Tax Court and held that the IRC Section 512(a)(3)(E)(i) limit on accumulating set-aside income does not apply to income that was set aside and spent on the reasonable costs of administering health care benefits under IRC Section 512(a)(3)(B) over the course of the year. Instead, the limit is on the amount of income that is still set aside at the end of the year. The Sixth Circuit reasoned that the limit does not apply to such spent income because that income is exempt function income, which is not subject to tax under IRC Section 512(a)(3)(A).[7]

The IRS did not acquiesce in the decision, but did recognize its precedential effect on other cases appealed to the Sixth Circuit. Therefore, with respect to cases within the Sixth Circuit, the IRS announced that it will follow the *Sherwin-Williams* decision if the opinion cannot be meaningfully distinguished.[8]

Distinguishing *Sherwin-Williams* on its facts, and also disagreeing with the Sixth Circuit's legal interpretation of the limit set forth in IRC Section 512(a)(3)(E)(i), the Court of Federal Claims held in *CNG Transmission Management VEBA v. United States* that a VEBA may not avoid the limit on exempt function income merely by allocating investment income to the payment of welfare benefits during the course of the tax year.[9] Affirming the lower court's ruling, the Court

1. IRC Sec. 512(a)(3).
2. IRC Sec. 512(a)(3)(B)(ii).
3. IRC Sec. 512(a)(3)(E)(i).
4. IRC Sec. 512(a)(3)(E)(ii).
5. IRC Sec. 512(a)(3)(B). But see Let. Ruls. 200126035, 200126034, 200023052, 9401033, 9147059.
6. See IRC Sec. 512(a)(3)(E)(ii); Temp. Treas. Reg. §1.512(a)-5T, A-4.
7. *Sherwin-Williams Co. Employee Health Plan Trust v. Comm.*, 330 F.3d 449 (6th Cir. 2003), rev'g, 115 TC 440 (2000).
8. See Action on Decision 2005-2 (released 9-12-2005) at www.irs.gov/pub/irs-aod/aod200502.pdf.
9. *CNG Transmission Management VEBA v. United States*, 84 Fed. Cl. 327(2008).

of Appeals for the Federal Circuit flatly rejected CNG's argument that its investment income could not have resulted in any account overage because it had spent all of its investment income on member benefits during the course of the tax year. In the view of the appellate court, money is fungible. Therefore, CNG could not avoid taxation by claiming that it had spent money from investment income, rather than money from some other source, on member benefits. Furthermore, the appellate court held that there is no requirement in Section 512(a)(3)(E)(i) that a VEBA's investment income can result in a year-end account overage only to the extent that the actual dollars in the account at year end are traceable to income made on investments.[1] The Court of Federal Claims continues to follow *CNG*.[2]

In technical advice, the IRS stated that all income of a VEBA, other than income from an existing reserve, is included in computing the UBTI of a VEBA even though the VEBA consists of four separate claims reserves that are accounted for separately.

In computing UBTI, income from tax-exempt bonds is not treated as exempt function income of a VEBA. That income affects the amount of assets available to pay benefits and, thus, may indirectly affect the computation of UBTI.

Finally, amounts set aside in existing reserves and additional reserves for postretirement medical or life insurance benefits are taken into account in accordance with Treasury Regulation Sections 1.512(a)-5T, Q&A-4(a) and 1.512(a)-5T, Q&A-4(d) when computing the UBTI of a VEBA.[3] In other technical advice, the IRS determined that an employer could aggregate two welfare benefit funds, such as a VEBA and a non-tax exempt welfare benefit fund, for the purpose of computing UBTI.[4]

The set aside limitation does not apply to any funds to which substantially all contributions are made by employers that were tax-exempt throughout the five taxable year period ending with the taxable year in which the contributions are made.[5] Because they have no account limits, welfare benefit funds under collective bargaining agreements and certain employee pay-all VEBAs, namely those with at least fifty employees and in which no employee is entitled to a refund other than one based on the experience of the entire fund, are not subject to the IRC's express set-aside limitation.

3971. What special rules apply if postretirement medical or life insurance benefits are provided to a key employee through a welfare benefit fund?

Separate Account Required

In the first year a reserve for postretirement medical or life insurance benefits including any other death benefits is taken into account in determining the applicable account limit (Q 3965), a separate account must be established for any medical or life insurance benefits provided after

1. *CNG Transmission Management VEBA v. United States*, 588 F.3d 1376 (CA Fed. Cir. 2009).
2. *Northrop Corp. Emple. Ins. Ben. Plans*, 99 Fed. Cl. 1 (June 28, 2011), aff'd, 467 Fed. Appx. 886 (Fed. Cir. 2012), *cert. denied*, 133 S. Ct. 756 (2012).
3. TAM 199932050.
4. TAM 200317036.
5. IRC Sec. 512(a)(3)(E)(iii).

retirement with respect to a key employee. The separate account must be maintained for all subsequent taxable years. Medical or life insurance benefits provided with respect to an employee after retirement must be paid from that separate account only.[1]

A key employee is one who at any time during the plan year or any preceding plan year is or was a key employee (Q 3828) as defined for top-heavy qualified retirement plans.[2] A separate account is to include amounts contributed to the plan with respect to service after the employee becomes a key employee as well as a reasonable allocation, determined under applicable regulations, of amounts contributed on his or her behalf before the individual became a key employee.[3]

Annual Additions

Any amount allocated to an account of a key employee for postretirement medical benefits must be counted as an annual addition for purposes of the IRC Section 415 dollar limit, but not for determining the percentage of compensation, as if it were a contribution to a qualified defined contribution plan; all welfare benefit funds of the employer are treated as one fund for this purpose.[4]

Therefore, the amount allocated to a key employee's account can have a significant effect on the qualification of any pension, profit sharing, or stock bonus plan in which the employee is a participant. Presumably, amounts allocated for periods before the employee became a key employee can be disregarded.

3972. Must a welfare benefit fund providing postretirement life insurance or medical benefits meet nondiscrimination requirements?

The current status on the tax treatment of these benefits is awaiting regulatory guidance under IRC Section 9815 (effective in 2014 or after a regulation is adopted).[5]

Prior to the passage of health care reform legislation, the following applied:

A reserve for postretirement benefits generally may not be included in determining a fund's qualified asset account limit if the plan of which the fund is a part is discriminatory with respect to those benefits; thus, in effect, a deduction is not available for contributions to prefund discriminatory benefits.[6]

A plan is discriminatory with respect to postretirement medical or life insurance benefits including any other death benefits unless it meets the nondiscrimination requirements, if any, specifically applicable to the benefit it provides or, if none, satisfies the following two requirements: (1) each class of these benefits must be provided under a classification of employees that is set forth in the plan and that is found by the IRS not to be discriminatory in favor of highly

1. IRC Sec. 419A(d)(1).
2. IRC Sec. 419A(d)(3).
3. H.R. Conf. Rep. 861 (TRA '84), 98th Cong., 2d Sess. 1157, *reprinted in* 1984-3 CB (vol.2) 411.
4. IRC Secs. 419A(d)(2), 419A(h)(1)(A).
5. Notice 2011-1.
6. IRC Sec. 419A(e)(1).

compensated individuals, and (2) the benefits provided under each class of benefits must not discriminate in favor of highly compensated individuals.[1] These nondiscrimination requirements also apply to VEBAs (Q 3981).

3973. What is the penalty for providing certain disqualified benefits through a welfare benefit fund?

An employer will be subject to a tax equal to 100 percent of:

(1) any postretirement medical or life insurance benefit including any other death benefit provided to a key employee other than from a separate account, if a separate account was required (Q 3971);

(2) any postretirement medical or life insurance benefit including any other death benefit provided with respect to an individual in whose favor discrimination is prohibited unless the plan is nondiscriminatory (Q 3972, Q 3981) with respect to this benefit, or

(3) any portion of the fund reverting to the benefit of the employer that is attributable to contributions that were deductible in the current or any prior year.[2]

One exception provides that postretirement medical or life insurance benefits charged against amounts in a reserve up to the greater of the amount in the reserve as of the close of the last plan year ending before July 18, 1984, or on July 18, 1984, or charged against the income on such amounts are not subject to the tax referred to in (1) and (2) above.[3]

Another exception provides that certain welfare benefit funds maintained pursuant to collective bargaining agreements are not subject to the tax described in (2) above.[4]

A loan by a VEBA to its members' employer is not necessarily a prohibited reversion, but any such transaction will be carefully reviewed to determine whether it is a genuine, commercially viable loan.[5]

3974. Must a tax-exempt welfare benefit fund apply for recognition of its tax-exempt status?

Yes.

A VEBA or SUB must give notice to the IRS, in the manner required in the regulations that it is applying for recognition of its tax-exempt status.[6] An organization that fails to provide the required notice will not be tax-exempt until it gives notice. Requirements for giving notice are set forth in Temporary Treasury Regulation Section 1.505(c)-1T.

1. IRC Secs. 419A(e)(1), 505(b).
2. IRC Sec. 4976.
3. IRC Sec. 4976(b)(4).
4. IRC Sec. 4976(b)(2).
5. See GCM 39884 (10-29-92).
6. IRC Sec. 505(c).

3975. What exception applies to a welfare benefit fund that is part of a ten or more employer plan?

IRC Sections 419 and 419A do not apply to a welfare benefit fund that is part of a ten or more employer plan that does not maintain experience rating arrangements with respect to individual employers. A ten or more employer plan is one to which more than one employer contributes, and to which no employer normally contributes more than 10 percent of the total contributions made under the plan by all employers.[1]

A variety of multi-employer plans have been marketed to take advantage of the ten or more employer plan exception; some of these plans were very aggressive and did not qualify for the exception. In 1995, the IRS claimed to have uncovered significant tax problems in multi-employer arrangements and warned taxpayers that arrangements claiming to qualify for the multi-employer plan exception may suffer from various defects, including:

(1) The arrangements actually may be providing deferred compensation rather than welfare benefits. This issue seems to arise most often in connection with plans purporting to provide severance benefits;[2]

(2) The arrangements in fact may be separate plans maintained for each employer although nominally linked together as part of multi-employer arrangements; and

(3) The arrangements may be experience-rated with respect to individual employers in form or operation because, among other things, the trusts may maintain, formally or informally, separate accounts for each employer and the employers may have reason to expect that their contributions will benefit only their employees.[3]

The IRS successfully argued before the Tax Court points (2) and (3) with respect to the multi-employer plan in question in *Booth v. Comm*.[4] The Tax Court held that the multi-employer plan did not fall within the scope of IRC Section 419A(f)(6)(A) because the plan was an aggregation of separate welfare benefit plans each having an experience-rating arrangement with the related employer.

The Tax Court stated, "We interpret the word 'plan' to mean that there must be a single pool of funds for use by the group as a whole (i.e., to pay the claims of all participants), and we interpret the phrase '10 or more employer plan' to mean that 10 or more employers must contribute to this single pool. We do not interpret the statutory language to include a program like the instant one where multiple employers have contributed funds to an independent party to hold in separate accounts until disbursed primarily for the benefit of the contributing employer's employees in accordance with unique terms established by that employer."[5] As a result, the deductions of the employers participating in the plan were subject to the deduction limitations of IRC Sections 419 and 419A.

1. IRC Sec. 419A(f)(6).
2. See, e.g., *Wellons v. Comm.*, 31 F.3d 569, 94-2 USTC ¶50,402 (7th Cir. 1994), *aff'g*, TC Memo 1992-704 (severance pay arrangement is more akin to deferred compensation plan than welfare benefit plan where five years of service must be given before benefits accrue, benefit amount is linked to level of compensation and length of service, and benefits can be paid at virtually any termination of employment).
3. See Notice 95-34, 1995-1 CB 309.
4. 108 TC 524 (1997).
5. *Id.* at 571.

In *Neonatology Assoc., P.A., et al. v. Comm.*,[1] the Tax Court denied deductions for the portion of VEBA contributions in excess of the cost of current year (term) life insurance under IRC Section 162. Contributions to a welfare benefit fund can be deducted only in the amount (Q 3965) and at the time permitted by IRC Section 419 (Q 3964), but they also must satisfy the requirements of IRC Section 162 or IRC Section 212.[2]

In this case, the two VEBAs were structured so that each employer established and contributed to its own plan. The premiums on the underlying insurance policies were substantially greater than the cost of conventional term life insurance because they funded both the costs of term life insurance and credits that would be applied to conversion universal life policies of individual insureds. Policyholders generally could withdraw any earned amount or borrow against their policies without any out-of-pocket costs.

The Tax Court in *Neonatology* determined that the VEBAs were not designed, marketed, purchased, or sold as a means for an employer to provide welfare benefits to its employees. The Tax Court held that the VEBAs were primarily vehicles that were designed and served in operation to distribute surplus cash surreptitiously in the form of excess contributions from the medical corporations for the employee/owners' ultimate use and benefit. Although the plans provided term life insurance to the employee/owners, the excess contributions were not attributable to that current year protection. The Tax Court further held that the excess contributions were constructive distributions of cash to the employee/owners that did not constitute deductible ordinary and necessary business expenses under IRC Section 162(a).[3]

In 2009, the IRS released a lengthy background document that outlined the issues and patterns its agents would look for during audits of welfare benefit plans with respect to uncovering disguised dividend arrangements, for example as in the *Neonatology* and *DeAngelis* cases, as well as disguised deferred compensation arrangements.[4] In the audit guidance, the IRS advises its agents to place a particularly sharp focus on arrangements using cash value life insurance policies and includes several questions that agents will use to identify abusive arrangements.

Definitions

The term benefits or other amounts payable includes all amounts payable or distributable or that otherwise will be provided directly or indirectly to employers, to employees or their beneficiaries, or to another fund as a result of a spin-off or transfer, regardless of the form of the payment or distribution (i.e., whether provided as welfare benefits, cash, dividends, credits, rebates of contributions, property, promises to pay, or otherwise).[5]

Benefits experience of an employer or of an employee or a group of employers or employees means the benefits and other amounts incurred, paid, or distributed or otherwise provided,

1. 115 TC 43 (2000) (19 consolidated cases), *aff'd*, 299 F.3d 221 (3d Cir. 2002).
2. See IRC Sec. 419(a), Temp. Treas. Reg. §1.419-1T, A-10.
3. See also *DeAngelis et al. v. Comm.*, TC Memo. 2007-360, *aff'd*, 574 F.3d 789 (2d Cir. 2009), citing *Neonatology; Curcio v. Comm.*, 2012 U.S. App. LEXIS 16645 (2d Cir. 2012).
4. See Revised Background Document No. 200931049 (Release Date 7-31-2009).
5. Treas. Reg. §1.419A(f)(6)-1(d)(1).

directly or indirectly, including to another fund as a result of a spin-off or transfer, with respect to the employer regardless of the form of payment or distribution.[1]

The overall experience of an employer or group of employers is the balance that would have accumulated in a welfare benefit fund if that employer were the only employer providing benefits under the plan.

The overall experience of an employee is the balance that would have accumulated in a welfare benefit fund if that employee were the only employee being provided benefits under the plan. Overall experience as of any date may be either a positive or a negative number.[2]

The term employer means the employer whose employees are participating in the plan and those employers required to be aggregated under IRC Sections 414(b), 414(c), or 414(m).[3] Rating group means a group of participating employers that includes the employer or a group of employees covered under the plan that includes one or more employees or that employer.[4]

A plan provides a fixed welfare benefit package, that is, fixed welfare benefits for a fixed coverage period for a fixed cost, if it: (1) defines one or more welfare benefits, each of which has a fixed amount that does not depend on the amount or type of assets held by the fund, (2) specifies fixed contributions to provide for those welfare benefits, and (3) specifies a coverage period during which the plan agrees to provide specified welfare benefits subject to the payment of the specified contributions by the employer.[5] For the treatment of actuarial gains or losses, see Treasury Regulation Section 1.419A(f)(6)-1(d)(5)(ii).

Plan administrator is defined the same as in Treasury Regulation Section 1.414(g)-1.[6] The plan administrator of a plan that is intended to be a ten or more employer plan described in IRC Section 419A(f)(6) is required to maintain permanent records and other documentary evidence sufficient to substantiate that the plan satisfies the requirements of IRC Section 419A(f)(6) and the regulations.[7]

3976. What are the circumstances that will cause the IRS to classify a multi-employer welfare benefit plan as a listed transaction? What is the penalty that applies for this classification?

Certain trust arrangements under Notice 95-34[8] that are purported to qualify as multiple employer plans exempt from the IRC Section 419 and IRC Section 419A limits have been classified by the IRS as listed transactions.[9]

Reportable transaction means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under IRC

1. Treas. Reg. §1.419A(f)(6)-1(d)(2).
2. Treas. Reg. §1.419A(f)(6)-1(d)(3).
3. Treas. Reg. §1.419A(f)(6)-1(d)(4).
4. Treas. Reg. §1.419A(f)(6)-1(b)(4)(iii).
5. Treas. Reg. §1.419A(f)(6)-1(d)(5)(i).
6. Treas. Reg. §1.419A(f)(6)-1(a)(2).
7. Treas. Reg. §1.419A(f)(6)-1(e).
8. 1995-1 CB 309.
9. See Notice 2009-59; 2009-2 CB 170.

Section 6011, the transaction is of a type that the IRS determines as having a potential for tax avoidance or evasion.[1] One category of reportable transactions is a listed transaction, that is, a transaction that is the same as, or substantially similar to, one of the types of transactions that the IRS has determined to be a tax avoidance transaction and has identified as such by notice, regulation, or other form of published guidance.[2] For guidance on the penalty assessed under IRC Section 6707A, see T.D. 9550.[3]

The maximum penalty for failing to disclose a listed transaction is $100,000 (with a minimum penalty of $5,000) in the case of a natural person and $200,000 (with a $10,000 minimum) in any other case.[4] A 20 percent penalty applies when a taxpayer has a reportable transaction understatement attributable to a listed transaction.[5] A 30 percent penalty applies to undisclosed listed transactions.[6] Guidance on the penalty assessed under IRC Section 6662A is provided in Notice 2005-12.[7]

For other tax shelter provisions, see IRC Section 6111 (disclosure of reportable transactions by material advisors), IRC Section 6112 (list maintenance requirements for material advisors) and IRC Section 6502(c) (statute of limitations). T.D. 9350[8] discusses modifications to the rules relating to the disclosure of reportable transactions affecting taxpayers and material advisors; T.D. 9351[9] discusses modifications to the rules relating to the disclosure of reportable transactions by material advisors; and T.D. 9352[10] discusses modifications to the rules relating to list maintenance requirements for material advisors. For additional guidance on material advisor reporting and exceptions to tax shelter reportable transactions, see Notice 2004-80.[11] For the final regulations outlining the requirements applicable to tax shelters, see TD 9046.[12] For the final requirements for tax shelter opinion letters, see TD 9165.[13]

3977. What regulations govern the exception for a welfare benefit fund that is part of a ten or more employer plan?

A valid ten or more employer plan is a single plan:

(1) to which more than one employer contributes,

(2) to which no employer normally contributes more than 10 percent of the total contributions of all employers under the plan, and

(3) that does not maintain an experience-rating arrangement with respect to any individual employer.[14]

1. IRC Section 6707A(c)(1).
2. IRC Sec. 6707A(c)(2). See Treas. Reg. §1.6011-4(b)(2). Notice 2009-59; 2009-2 CB 170.
3. 2011-2 CB 785.
4. IRC Sec. 6707A.
5. IRC Secs. 6662A(a), 6662A(b).
6. IRC Sec. 6662A(c).
7. 2005-7 IRB 494; see also IRS News Release IR-2005-10 (1-19-2005).
8. 72 Fed. Reg. 43146 (8-3-2007).
9. 72 Fed. Reg. 43157 (8-3-2007).
10. 72 Fed. Reg. 43154 (8-3-2007).
11. 2004-50 IRB 963 clarified and modified by, Notice 2005-17, 2005-8 IRB 606, and Notice 2005-22, 2005-12 IRB 756. See also Rev. Proc. 2008-20, 2008-20 IRB 980.
12. 68 Fed. Reg. 10161 (3-4-2003).
13. 2005-1 CB 357, modified by 2005-1 CB 996.
14. Treas. Reg. §1.419A(f)(6)-1(a)(1).

To qualify as a valid ten or more employer plan, a plan also must satisfy certain compliance requirements. It must be maintained pursuant to a written document that: (1) requires the plan administrator to maintain records sufficient for the IRS or any participating employer to readily verify the plan's compliance with the requirements of IRC Section 419A(f)(6) and Treasury Regulation Section 1.419A(f)(6)-1(a)(2), and (2) provides the IRS and each participating employer with the right on written request to the plan administrator to inspect and copy all of these records.[1]

To qualify as a valid ten or more employer plan, a plan must satisfy the requirements of the regulations in both form and operation.[2] The term "plan" includes the totality of the arrangement and all related facts and circumstances, including any related insurance contracts. Thus, all agreements and understandings, including promotional materials, policy illustrations, and the terms of any insurance contracts, will be taken into account in determining whether the requirements are satisfied in form and in operation.[3]

Special Rules

Treatment of insurance contracts. Insurance contracts generally will be treated as assets of the fund. Thus, the value of the insurance contracts including non-guaranteed elements is included in the value of the fund, and amounts paid between the fund and the insurance company are disregarded, except to the extent they generate gains or losses, as explained below.[4]

Payments to and from an insurance company. Payments from a participating employer or its employees to an insurance company with respect to insurance contracts will be treated as contributions made to the fund. Amounts paid under the arrangement from an insurance company will be treated as payments from the fund.[5]

Gains and losses from insurance contracts. As of any date, if the sum of benefits paid by an insurer and the value of the insurance contract including non-guaranteed elements is greater than the cumulative premiums paid to the insurer, the excess is treated as a gain to the fund. As of any date, if the cumulative premiums paid to the insurer are greater than the sum of the benefits paid by the insurer and the value of the insurance contract including non-guaranteed elements, the excess is treated as a loss to the fund.[6]

Treatment of flexible contribution arrangements. Solely for purposes of determining the cost of coverage under a plan, if contributions for any period can vary with respect to a benefit package, the IRS may treat the employer as contributing the minimum amount that would maintain the coverage for that period.[7]

1. Treas. Reg. §1.419A(f)(6)-1(a)(2).
2. Treas. Reg. §1.419A(f)(6)-1(a)(3)(i).
3. Treas. Reg. §1.419A(f)(6)-1(a)(3)(ii).
4. Treas. Reg. §1.419A(f)(6)-1(b)(4)(i)(A).
5. Treas. Reg. §1.419A(f)(6)-1(b)(4)(i)(B).
6. Treas. Reg. §1.419A(f)(6)-1(b)(4)(i)(C).
7. Treas. Reg. §1.419A(f)(6)-1(b)(4)(ii).

Experience-rating by group of employers (or employees). A plan will not be treated as maintaining an experience-rating arrangement with respect to an individual employer merely because the cost of coverage under the plan is based, in whole or in part, on the benefits experience or the overall experience of a rating group provided that no employer normally contributes more than 10 percent of all contributions with respect to that rating group.[1]

3978. What is an experience-rating arrangement and what are the results if a welfare benefit plan is found to maintain such an arrangement?

A plan maintains an experience-rating arrangement with respect to an individual employer if, for any period, the relationship of contributions under the plan to the benefits or other amounts payable under the plan, that is, the cost of coverage, is or can be expected to be based, in whole or in part, on the benefits experience or the overall experience of that employer or one or more employees of that employer.[2] According to the IRS, this determination is not intended to be purely a computational one, although actual numbers often can be used to demonstrate the existence of an experience-rating arrangement.[3]

For these purposes, an employer's contributions include all contributions made by or on behalf of the employer or the employer's employees. The prohibition against experience-rating applies under all circumstances, including employer withdrawals and plan terminations.[4]

An example of a plan that maintains an experience-rating arrangement with respect to an individual employer is a plan that entitles the employer to, or for which the employer can expect, a reduction in future contributions if that employer's overall experience is positive or an increase in future contributions if that employer's overall benefits experience is negative.[5]

Another example of a plan that maintains an experience-rating arrangement with respect to an individual employer is a plan under which benefits for an employer's employees are or can be expected to be increased if that employer's overall experience is positive or decreased if that employer's overall experience is negative.[6]

Use of insurance contracts. The IRS recognizes that if whole life insurance contracts or other insurance contracts that provide for level premiums or otherwise generate a savings element are purchased under an arrangement, the economic values reflected under those contracts, including cash values, reserves, conversion credits, high dividend rates, or the right to continue coverage at a premium that is lower than the premium that would apply in the absence of that savings element, reflect the overall experience of the employers and employees who participate under the plan.[7]

The IRS also states that neither IRC Section 419A(f)(6) nor the regulations govern the investments of a welfare benefit fund, including investments by a trust in cash value policies. Instead, the IRS is concerned with the economic relationship between a fund and participating employers, and whether the pass-through of premiums based on the insurance contracts associated with an

1. Treas. Reg. §1.419A(f)(6)-1(b)(4)(iii).
2. Treas. Reg. §1.419A(f)(6)-1(b)(1).
3. Preamble, TD 9079, 68 Fed. Reg. 42254, 42256 (7-17-2003).
4. Treas. Reg. §1.419A(f)(6)-1(b)(1).
5. Treas. Reg. §1.419A(f)(6)-1(b)(2).
6. Treas. Reg. §1.419A(f)(6)-1(b)(3).
7. Preamble, TD 9079, 68 Fed. Reg. 42254, 42256 (7-17-2003).

employer's employees has the effect of creating experience-rating arrangements with respect to individual employers. Furthermore, the IRS believes that the exception is still viable for many life and health benefit arrangements that are self-insured in accordance with ERISA or state law.[1]

3979. What characteristics indicate a plan is not a ten or more employer plan?

The presence of any of the characteristics listed below generally indicates that the plan is *not* a ten or more employer plan under IRC Section 419A(f)(6). It is important to note that a plan's lack of all of the following characteristics does not create any inference that it is a ten or more employer plan described in IRC Section 419A(f)(6).[2] The characteristics are as follows:

(1) Allocation of plan assets. Assets of the plan or fund are allocated to a specific employer or employers through separate accounting of contributions and expenditures for individual employers, or otherwise.[3]

(2) Differential pricing. The amount charged under the plan is not the same for all the participating employers, and those differences are not merely reflective of differences in current risk or rating factors that are commonly taken into account in manual rates used by insurers (such as current age, gender, geographic locale, number of covered dependents, and benefit terms) for the particular benefit or benefits being provided.[4]

(3) No fixed welfare benefit package. The plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed cost.[5]

(4) Unreasonably high cost. The plan provides for fixed welfare benefits for a fixed coverage period for a fixed cost, but that cost is unreasonably high for the covered risk for the plan as a whole.[6]

(5) Nonstandard benefit triggers. The plan provides for benefits (or other amounts payable) that can be paid, distributed, transferred or otherwise provided from a fund that is part of a plan by reason of any event other than the illness, personal injury, or death of an employee or family member, or the employee's involuntary separation from employment. For example, a plan exhibits this characteristic if the plan provides for the payment of benefits to an employer's employees on the occasion of the employer's withdrawal from the plan. A plan will not be treated as having this characteristic merely because upon cessation of participation in the plan, an employee is provided with the right to convert coverage under a group life insurance contract to coverage under an individual life insurance contract without demonstrating evidence of insurability, but only if there is an additional economic value association with the conversion right.[7]

1. Preamble, TD 9079, 68 Fed. Reg. 42254, 42257 (7-17-2003).
2. Treas. Reg. §1.419A(f)(6)-1(c)(1).
3. Treas. Reg. §1.419A(f)(6)-1(c)(2).
4. Treas. Reg. §1.419A(f)(6)-1(c)(3).
5. Treas. Reg. §1.419A(f)(6)-1(c)(4).
6. Treas. Reg. §1.419A(f)(6)-1(c)(5).
7. Treas. Reg. §1.419A(f)(6)-1(c)(6).

For examples of arrangements classified as experience-rating arrangements, see Treasury Regulation Section 1.419A(f)(6)-1(f).

3980. What is an abusive 419(e) plan, and how is it taxed?

A 419(e) plan is a welfare benefit fund that is sponsored by an employer to provide welfare benefits to its employees. When a 419(e) plan meets all of the IRC's requirements, the employer's contributions are fully deductible with no taxation to the employee then or when benefits are provided. When these plans operate consistently with the IRC, they generally are unattractive to smaller employers.[1] These plans may involve a taxable welfare benefit fund or a tax-exempt VEBA (Q 3981). Different deduction limits apply to 10 or more employer plans (Q 3975) and collectively bargained plans (Q 3965).

Abusive Arrangements in Single Employer Plans

The IRS cautions taxpayers about participating in certain trust arrangements being sold to professional corporations and other small businesses as welfare benefit funds.[2] Some of the arrangements have been identified as listed transactions (see Notice 2007-83, IR 2007-170, below).

Revenue Ruling 2007-65 addresses situations where an arrangement is considered a welfare benefit fund, but the employer's deduction for its contributions to the fund is denied in whole or part for premiums paid by the trust on cash value life insurance policies.[3] For purposes of determining the limitations on an employer's deduction for contributions to a welfare benefit fund under Section 419 and Section 419A, the IRS concluded that regardless of whether the benefit provided through the fund is life insurance coverage, premiums paid on cash value life insurance policies by the fund are not included in the fund's qualified direct cost whenever the fund is directly or indirectly a beneficiary under the policy within the meaning of Section 264(a). The fund's qualified direct cost includes amounts paid as welfare benefits by the fund during the taxable year for claims incurred during the year.[4]

Some of the arrangements described above and substantially similar arrangements, as well as certain other arrangements using cash value life insurance policies for which an employer has deducted amounts as contributions to a welfare benefit fund, may be transactions that have been designated as listed transactions. If a transaction is designated as a listed transaction, affected persons may be subject to additional penalties and disclosure responsibilities (Q 3975).

The IRS has identified certain trust arrangements involving cash value life insurance policies and substantially similar arrangements as listed transactions.[5] If a transaction is designated as a listed transaction, affected persons have disclosure obligations and may be subject to applicable penalties.

1. See IRC Section 419(e).
2. IRS News Release IR-2007-170 (10-17-2007).
3. Rev. Rul. 2007-65, 2007-45 IRB 949.
4. IRC Section 264(a) provides that no deduction is allowable for premiums on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract.
5. Notice 2007-83, 2007-45 IRB 960.

The IRS cautions taxpayers that the tax treatment of trusts that, in form, provide post-retirement medical and life insurance benefits to owners and other key employees may vary from the treatment claimed.[1] The IRS may issue further guidance to address these arrangements, and taxpayers should not assume that the guidance will be applied prospectively only.

The IRS and Treasury released a warning on certain trust arrangements being sold as welfare benefit plans to professional employers and small employers. The announcement discussed certain welfare plan arrangements using life insurance contracts that constitute listed transactions.

In 2009, the IRS released a lengthy background document that outlines the issues and patterns its agents will look for during audits of welfare benefit plans with respect to uncovering disguised dividend arrangements, for example, as in the *Neonatology* and *DeAngelis* cases (Q 3975), as well as disguised deferred compensation arrangements.[2] In the audit guidance, the IRS advises its agents to place a particularly sharp focus on arrangements using cash value life insurance policies and includes several questions that agents will use to identify abusive arrangements.

3981. What is a 501(c)(9) trust ("VEBA")?

A Voluntary Employees' Beneficiary Association ("VEBA") is a tax-exempt entity created to fund life, sick, accident, or certain other benefits (Q 3986) for members, their dependents, or their designated beneficiaries. A VEBA may be established by an employer or through collective bargaining. A trust created to provide benefits to one employee does not qualify as an employees' association for purposes of exemption from federal income tax under IRC Section 501(c)(9).[3] Some of the requirements for tax-exempt VEBA status include:

(1) Membership eligibility (Q 3982);

(2) Nondiscrimination (Q 3983);

(3) Entities and individuals entitled to maintain control over the VEBA (Q 3984); and

(4) Prohibition on inurement of earnings for the benefit of private shareholders or individuals (Q 3985).

3982. What are the membership eligibility restrictions that apply to a 501(c)(9) trust ("VEBA")?

Membership in a VEBA generally must be limited to employees, including certain former employees.[4] Membership may include some non-employees, as long as they share an employment-related bond with the employee-members and as long as at least 90 percent of the members are employees.[5]

1. Notice 2007-84, 2007-45 IRB 963.
2. See Revised Background Document 200931049 (Release Date 7-31-2009).
3. Rev. Rul. 85-199, 1985-2 CB 163.
4. See Treas. Regs. §§1.501(c)(9)-2(a)(1), 1.501(c)(9)-2(b)(2), 1.501(c)(9)-2(b)(3).
5. Treas. Reg. §1.501(c)(9)-2(a)(1); GCM 39834 (12-26-90). See, e.g., Let. Rul. 200137066.

Eligibility for membership must be defined by reference to objective standards that constitute an employment-related common bond. A common bond could be a common employer or common coverage under a collective bargaining agreement.[1] The IRS believes that employees whose only connection is that their employers are engaged in the same line of business will have the requisite common bond only if their employers are in the same geographic locale.[2] The IRS sticks to this position despite *Water Quality Assoc'n Employees' Benefit Corp. v. U.S.*,[3] which held a geographic locale restriction invalid.[4]

Currently, the IRS believes that an area is a single geographic locale if it does not exceed the boundaries of three contiguous states. The IRS also believes that larger areas can be considered a single geographic locale under appropriate facts and circumstances.[5]

Membership may be limited by objective criteria reasonably related to employment, such as a limitation based on a reasonable minimum period of service or a requirement that members be full time employees. Any criteria used to restrict membership may not be used to limit membership to officers, shareholders, or highly compensated employees.[6]

3983. What nondiscrimination requirements apply to a 501(c)(9) trust ("VEBA")?

Although eligibility for membership and benefits generally may be restricted by objective conditions, any objective criteria used to restrict eligibility for membership or for benefits may not limit membership or benefits to officers, shareholders, or highly compensated employees of a contributing employer and may not entitle any of that prohibited group to disproportionate benefits.[7] A plan will not run afoul of the prohibition against disproportionate benefits by basing life or disability income benefits on a uniform percentage of compensation.[8] In the context of associations with a small number of members receiving disparate levels of compensation, general counsel memoranda have concluded that severance benefits may be based on a uniform percentage of compensation; these memoranda also have concluded that severance benefits may be based on length of service requirements as long as those requirements do not limit benefits to members of the prohibited group.[9]

If by virtue of basing death and disability benefits on uniform percentages of compensation or by basing severance benefits on a percentage of compensation and determining that percentage by reference to length of service, (1) an association provides a dominant share of benefits to a member of a prohibited group, (2) the association provides that on termination of the association members will be entitled to their allocable share of the association's assets and (3) the member of the prohibited group effectively controls the association, the association may violate the prohibition against inurement.[10] For further important information, see the inurement discussion

1. Treas. Reg. §1.501(c)(9)-2(a)(1).
2. See, e.g., GCM 39817 (5-9-90).
3. 795 F.2d 1303 (7th Cir. 1986).
4. See, e.g., the preamble to Prop. Treas. Reg. §1.501(c)(9)-2(d), 57 Fed. Reg. 34886 (8-7-92).
5. See Treas. Reg. §1.501(c)(9)-2(d).
6. Treas. Reg. §1.501(c)(9)-2(a)(2).
7. Treas. Reg. §1.501(c)(9)-2(a)(2)(i).
8. Treas. Regs. §§1.501(c)(9)-2(a)(2)(ii)(F), 1.501(c)(9)-2(a)(2)(ii)(G).
9. GCMs 39818 (5-10-90), 39300 (10-30-84).
10. See *id*. See also GCM 39801 (10-26-89).

in Q 3985, especially the references to the *Lima Surgical* litigation. Courts have pointed to the basing of severance benefits on both level of compensation and length of service in ruling that benefits really were impermissible retirement benefits.[1]

A VEBA generally will not be tax-exempt unless the plan meets the nondiscrimination rules applicable to the particular benefits provided or, if none, the following nondiscrimination requirements: (1) each class of benefits under the plan must be provided under a classification of employees that is set forth in the plan and that is found by the IRS not to be discriminatory in favor of employees who are highly compensated individuals, and (2) benefits provided under each class of benefits must not discriminate in favor of employees who are highly compensated individuals.[2] IRC Section 505(a)(2) provides an exception for certain collectively bargained VEBAs.[3]

A highly compensated individual is similar to a highly compensated employee for qualified plan purposes (Q 3827).

To apply the nondiscrimination standards, certain employees may be excluded from consideration.[4] For purposes of testing for discrimination, an employer may elect to treat two or more plans as one plan.[5] An election to aggregate must be consistent for deduction and discrimination purposes (Q 3965).[6]

Employers related under the common control, controlled group, and affiliated service group aggregation rules (Q 3830, Q 3832) must be treated as a single employer, and the employee leasing provision, other than the safe harbor rule, must be applied (Q 3826).[7]

A life insurance, disability, severance, or supplemental unemployment compensation benefit is not considered discriminatory merely because the benefits bear a uniform relationship to total (or basic, or regular rate of) compensation of employees covered by the plan.[8]

A plan generally will not satisfy the nondiscrimination requirements of IRC Section 505(b) unless the annual compensation of each employee taken into consideration for any year does not exceed $260,000 in 2014 (up from $255,000 in 2013).[9] This limit does not apply in determining whether the nondiscrimination rules of IRC Section 79 are met.[10]

If a VEBA plan provides postretirement medical or group term life insurance benefits, see Q 3971 and Q 3972.

1. See *Lima Surgical Assoc., Inc. v. U.S.*, 20 Cl. Ct. 674, 90-1 USTC ¶50,329 (U.S. Claims Court 1990), *aff'd*, 944 F.2d 885, 91-2 USTC ¶50,473 (Fed. Cir. 1991). See Q 3989.
2. See IRC Secs. 505(a)(1), 505(b)(1).
3. See Let. Ruls. 200119064, 199920044 (VEBA maintained pursuant to a collective bargaining agreement, which was the subject of good faith bargaining between the company and the union, not subject to the nondiscrimination requirements).
4. See IRC Sec. 505(b)(2); H.R. Conf. Rep. 861 (TRA '84), 98th Cong., 2d Sess. 1164, *reprinted in* 1984-3 CB (vol. 2) 418; the General Explanation of TRA '84, p. 800.
5. IRC Sec. 505(b)(4).
6. H.R. Conf. Rep. 861 (TRA '84), above, *reprinted in* 1984-3 CB (vol. 2) 413.
7. IRC Secs. 414(n)(3)(C), 414(t).
8. IRC Sec. 505(b)(1).
9. IRC Sec. 401(a)(17)); Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
10. IRC Sec. 505(b)(7).

3984. Who may control a 501(c)(9) trust ("VEBA") in order for it to maintain its tax-exempt status?

The association must be controlled by (1) its membership, that is, by its participants, (2) independent trustees, or (3) trustees, some of whom are designated by or on behalf of members.[1] Requisite control was held lacking where trustees were appointed by a self-perpetuating board of directors, new members of which were appointed by current members from among a group only indirectly selected by employees.[2] A bank may not necessarily be considered an independent trustee.[3]

3985. What is the prohibition on inurement of earnings to private individuals that is applicable to a 501(c)(9) trust ("VEBA")?

Except in payment of permissible benefits, no part of the earnings of a VEBA may inure to the benefit of any private shareholder or individual.[4] A return of excess insurance premiums to the payor, based on mortality or morbidity experience, is not prohibited.[5] In addition, the refund of contributions to an employer, which had been paid after a collective bargaining agreement had ended but during the pendency of a labor dispute with a union, did not constitute inurement.[6]

On termination of a plan, there is no prohibited inurement if, after satisfaction of all liabilities to existing beneficiaries, remaining assets are applied to provide permitted benefits pursuant to criteria that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees.

A distribution to members on dissolution of a VEBA made on an objective and reasonable basis not resulting in unequal payments to similarly situated employees or disproportionate distributions to officers, shareholders, or highly compensated employees will not be prohibited inurement.

Assets of a VEBA may not be distributable to contributing employers on dissolution, either under the trust document or by operation of law, unless the distribution is applied to provide permissible benefits in a manner that does not result in disproportionate benefits for officers, shareholders, or highly compensated employees of the employers.[7]

A transfer of assets from a VEBA to a separate nonexempt trust resulting from the termination of a sick leave/severance plan component of the VEBA and then to a bank account to be

1. Treas. Reg. §1.501(c)(9)-2(c)(3).
2. *American Assn. of Christian Schools v. U.S.*, 663 F. Supp. 275, 87-1 USTC ¶9328 (M.D. Ala. 1987), *aff'd*, 850 F.2d 1510, 88-2 USTC ¶9452 (11th Cir. 1988).
3. See *Lima Surgical Assoc., Inc. v. U.S.*, 20 Cl. Ct. 674, 90-1 USTC ¶50,329 (U.S. Claims Court 1990), *aff'd on other grounds*, 944 F.2d 885, 91-2 USTC ¶50,473 (Fed. Cir. 1991).
4. Treas. Regs. §§1.501(c)(9)-1(d), 1.501(c)(9)-4(a).
5. Treas. Reg. §1.501(c)(9)-4(c); Let. Rul. 9006051. See also Let. Rul. 9214030 (the rebate of excess insurance premiums to professional associations whose members contributed premiums to the VEBA for disability protection and agreed that any excess funds in the VEBA could go to the professional associations was not prohibited inurement as long as the professional associations could use the money to provide VEBA benefits to their members).
6. Let. Rul. 199930040.
7. Treas. Reg. §1.501(c)(9)-4(d).

distributed to employees who participated in the terminated trust was not considered prohibited inurement as funds apparently were used to pay qualifying Section 501(c)(9) benefits.[1]

In terminating a VEBA, use of the assets in a postretirement medical reserve to pay health care claims of employees who had retired prior to the effective date of the VEBA did not constitute prohibited inurement or a reversion of plan assets to the employer because the use of the reserves for an additional class of retirees was consistent with the purpose of the reserve.[2]

The termination of the life insurance portion (the retiree life plan) of a welfare benefit plan that was a non-exempt trust and the subsequent transfer to a VEBA of the assets remaining after the purchase of individual paid-up policies to satisfy the obligation of the retiree life plan and the subsequent use of those remaining assets to provide payment of permitted benefits other than life insurance did not result in prohibited inurement to the employer.[3]

Where an employer intended to reactivate a previously inactive VEBA by using the remaining assets to purchase one or more insurance policies that would provide accidental death, disability, and long-term care benefits to current employees and then terminate the VEBA on exhaustion of such assets, the proposed use of the net assets would not affect the tax-exempt status, that is, there was no prohibited inurement, because the assets would be used to provide benefits contemplated by IRC Section 501(c)(9).[4]

A general counsel memorandum concluded that a transfer of assets from an employer's VEBA to a 401(h) arrangement under a qualified pension plan of the same employer, providing retiree health benefits, would result in inurement of earnings from the VEBA to the employer, inasmuch as a 401(h) arrangement is required to provide for return to the employer of assets remaining in the account after satisfaction of all liabilities under the plan (Q 3839).[5]

The transfer of excess assets from a terminating VEBA to a successor VEBA to fund permissible VEBA benefits for the employer's employees generally should not result in prohibited inurement.[6]

The transfer of a terminated VEBA's remaining assets to an exempt educational trust fund did not result in prohibited inurement.[7] No inurement resulted from the termination of a VEBA and transfer of assets back to its original tax-exempt sponsor, which had operated as a charity hospital and was operating as a charity only, because the assets were to be distributed by the charity for charitable purposes, with the remaining assets to be distributed to the charity's former employees who were currently working for the new hospital.[8]

1. TAM 9647001.
2. Let. Rul. 9720034.
3. Let. Rul. 9740024.
4. See Let. Rul. 9446036, Treas. Reg. §1.501(c)(9)-4(d).
5. GCM 39785 (3-24-89).
6. See, e.g., Let. Ruls. 200122051, 200122047 (assets transferred from a terminated VEBA to another VEBA would be used to provide permissible welfare benefits in a nondiscriminatory manner, a common employment-related bond was present, and the transfer was not being used to avoid any of the statutory VEBA requirements). In each situation, the IRS ruled that the transfer did not result in inurement or trigger excise tax. See also Let. Ruls. 200024054, 200009051, 9812035, 9551007, 9505019, 9438017, 9414011, 9322041, 9115035, and 9014065.
7. Let. Rul. 200136028.
8. Let. Rul. 200003054.

The termination of a VEBA and distribution of remaining assets to a 501(c)(3) private foundation did not result in a reversion because the foundation was not an employer with respect to the trust, nor was it an organization that otherwise was merely an alter ego of the employer; instead, the foundation was a charitable organization whose assets were dedicated to charitable purposes and that could not be used for the private benefit of the employer.[1]

The substitution of a successor company for the original company in a VEBA trust document did not constitute prohibited inurement.[2]

The IRS has indicated tax-exempt status may be denied where principal shareholders receive a dominant share of aggregate benefits and effectively control the organization.[3]

In administrative proceedings prior to litigation in the *Lima Surgical* case, the IRS found a violation of the inurement proscription because the owner-employees were entitled to a dominant share of severance benefits and controlled the corporation. The court found a violation of the prohibition against private inurement because the dominant benefits were based on both level of compensation and length of service but did not explicitly analyze whether owner-employees also effectively controlled the plan trust.[4] On appeal, the circuit court did not address the lower court's inurement ruling, but the IRS conceded that the arrangement did not violate the prohibition against inurement.[5]

The IRS disqualified a VEBA because it failed to satisfy the requirement of no prohibited inurement. The IRS concluded that the plan, in substance, was not adopted or operated as an employee benefit plan, but was merely a separate fund controlled by the controlling family for the primary benefit of two members of the controlling family, with the incidental coverage of other employees of the corporation being merely a cost of attempting to secure tax-exempt status.[6]

In another disqualification due to prohibited inurement, the IRS privately ruled that the trust was established for the personal and private benefit of the company president and his wife, the universal life policies in the plan were not eligible for inclusion in a Section 501(c)(9) trust because they allowed for periodic payments and loans, and the trust was disqualified because it was not controlled by an independent trustee as required in the Treasury regulations.[7]

A loan from a VEBA to its members' employer might violate the prohibition against private inurement.[8]

1. Let. Rul. 199908054.
2. Let. Rul. 200041035.
3. See, e.g., GCMs 39818 (5-10-90), 39801 (10-26-89), 39300 (10-30-84).
4. 20 Cl. Ct. 674, 90-1 USTC ¶50,329, at pp. 84,145-84,146.
5. 944 F. 2d 895, 91-2 USTC ¶50,473, at p. 89,800.
6. Let. Rul. 200836041.
7. Let. Rul. 200950049.
8. See GCM 39884 (10-29-92) (whether loan violated prohibition was not an issue in the memorandum, but IRS noted that the loan might have been a sham transaction for employer's benefit and was "tainted by the type of economic domination by a controlling person … that [has been] found to constitute private inurement").

3986. What benefits can a 501(c)(9) trust ("VEBA") provide?

A VEBA trust may provide for the payment of life, sick, accident, or other benefits to members, their dependents or their designated beneficiaries. A dependent can be, among others, a spouse, a child of the member or the member's spouse who is a minor or a student for income tax dependent exemption purposes, or any other minor child residing with the member.[1] Provision of an insubstantial or de minimis amount of impermissible benefits will not disqualify an arrangement from tax-exempt VEBA status.[2]

A life benefit is one payable by reason of the death of a member or dependent; it may be provided directly or through insurance. It generally must consist of current protection, but it may include a permanent benefit as defined in, and subject to the conditions in, regulations under Section 79 (Q 237, Q 238).[3] In addition, the IRS has indicated that life benefits may be provided through employer-funded whole-life policies that are not group-permanent policies under IRC Section 79 if:

(1) the policies are owned by a VEBA,

(2) the policies are purchased through level premiums over the expected lives or working lives of the individual members, and

(3) the accumulated cash reserves accrue to a VEBA.[4]

The purchase of individual whole life insurance by VEBAs funding ERISA plans may violate ERISA.[5]

A reserve for future retirees' life insurance held by a postretirement trust was found to provide an impermissible benefit similar to deferred compensation and the trust was not tax-exempt under 501(c)(9).[6]

Also, consider the conference report to TRA '84, which admonishes that a plan providing medical or life insurance benefits exclusively for retirees would be considered a deferred compensation plan rather than a welfare benefit plan.[7]

The payment of self-funded, paid-up life insurance constituted a qualifying benefit for purposes of IRC Section 501(c)(9) regardless of how self-funded, paid-up life insurance was characterized under state law where (1) payment of the benefit only came due on the occurrence of an unanticipated event (i.e., the death of the insured) and protected a member and the member's family or beneficiary against a contingency that interrupted or impaired the member's

1. Treas. Reg. §1.501(c)(9)-3(a).
2. See, e.g., GCM 39817 (5-9-90); TAM 9139003.
3. Treas. Reg. §1.501(c)(9)-3(b).
4. GCM 39440 (11-7-85).
5. Compare *Reich v. Lancaster*, 55 F.3d 1034 (5th Cir. 1995), *aff'g*, 843 F. Supp. 194 (N.D. Tex. 1993) (purchases of individual whole life insurance by self-funded welfare benefit plan violated various provisions of ERISA) with *Reich v. McDonough*, Civ. Action No. 91-12025 H (D. Mass. Dec. 10, 1993) (in part recognizing that individual whole life insurance can be an appropriate investment for ERISA plans).
6. Let. Rul. dated May 25, 1982.
7. H.R. Conf. Rep. 861, 98th Cong., 2d Sess. 1157, *reprinted* in 1984-3 CB (vol. 2) 411. But consider Let. Rul. 9151027 (Q 3963).

earning power, and (2) it was clear that unlike an annuity or retirement benefit, the self-funded, paid-up life insurance benefit was not payable merely by reason of passage of time.[1]

Sick and accident benefits may be reimbursement for medical expenses. They may be amounts paid in lieu of income during a period a member is unable to work because of sickness or injury. Sick benefits include benefits designed to safeguard or improve the health of members and their dependents. They may be provided directly, through payment of premiums to an insurance company, or to another program providing medical services.[2]

Home health care benefits provided under a VEBA qualified as medical care benefits and, thus, were excludable from gross income.[3] Supplemental medical benefits qualified as sick and accident benefits.[4] Reimbursement of union members' health insurance premiums constituted a permitted benefit where benefits would be paid only as reimbursement for health premiums, and under no circumstances could employees take the contributions as unrestricted cash.[5]

Paid sick days and short term disability wage replacement benefits have been considered sick and accident benefits.[6] Health benefits provided by a VEBA to nondependent, nonspousal domestic partners of participants did not adversely affect the VEBA's tax-exempt status because the coverage and benefits would constitute no more than a de minimis amount of the VEBA's total benefits under Treasury Regulation Section 1.501(c)(9)-3(a).[7]

Other benefits are limited to those similar to life, sick or accident benefits. A benefit is similar if it is intended to safeguard or improve the health of a member or a member's dependents or if it protects against a contingency that interrupts or impairs a member's earning power.[8] The IRS understands a contingency to be an unanticipated event beyond the control of the beneficiary.[9]

Other benefits may include vacation benefits, child care facilities, supplemental unemployment compensation benefits, severance benefits (but see Q 3987), and education benefits.[10]

Holiday pay and paid personal days have been considered other benefits.[11] Social, recreational, and cultural benefits provided to retirees, designed to promote their physical, mental or emotional well-being or to provide them with information relating to retirement and asset management, constituted permissible benefits.[12]

Other benefits do not include, among other things, any benefit that is similar to a pension or annuity payable at the time of mandatory or voluntary retirement, or a benefit that is similar to a benefit provided under a stock bonus or profit-sharing plan. In other words, other benefits

1. Let. Rul. 199930040.
2. Treas. Reg. §1.501(c)(9)-3(c).
3. Let. Rul. 200028007.
4. Let. Rul. 200003053.
5. Let. Rul. 199902016.
6. See TAM 9126004.
7. Let. Rul. 200108010.
8. Treas. Reg. §1.501(c)(9)-3(d).
9. See GCM 39879 (9-15-92).
10. Treas. Reg. §1.501(c)(9)-3(e).
11. See TAM 9126004.
12. Let. Rul. 9802038.

do not include deferred compensation payable by reason of the passage of time rather than because of an unanticipated event.[1]

Plans that provide medical and death benefits, but that require participants to contribute a portion of the cost, may violate Treasury Regulation Section 1.501(c)(9)-3(f).[2]

A benefit payable by reason of death may be settled in the form of an annuity to the beneficiary.[3]

3987. What requirements apply to a 501(c)(9) trust ("VEBA") that provides severance pay arrangements?

IRC Section 409A creates requirements governing whether and when employees are to be taxed on deferred compensation. Under the general rule, if a nonqualified deferred compensation plan fails to meet certain requirements regarding distributions, acceleration of benefits, and interest on tax liability payments (Q 3533) or is not operated in accordance with such requirements, all compensation deferred under the plan for the taxable year and all preceding taxable years is includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.[4]

Plans providing for severance pay, or for separation pay, as it officially is labeled by the IRS, are not excluded from the definition of nonqualified deferred compensation plan (unlike bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefits).[5] Final 409A regulations state that a separation pay plan does not provide for a deferral of compensation to the extent the plan is:

(1) a collectively bargained separation pay plan;

(2) separation pay due to an involuntary separation from service or participation in a window program;

(3) a foreign separation pay plan; or

(4) a reimbursement or certain other separation payments.[6]

A plan that provides separation pay only due to an involuntary separation does not provide for a deferral of compensation under 409A if the plan meets the following requirements:

1. Treas. Reg. §1.501(c)(9)-3(f). See also *Lima Surgical Assoc., Inc. v. U.S.*, 20 Cl. Ct. 674, 90-1 USTC ¶50,329 (U.S. Claims Court 1990) (severance benefits based on length of service and level of compensation and payable upon retirement were impermissible deferred compensation), *aff'd*, 944 F.2d 885, 91-2 USTC ¶50,473 (Fed. Cir. 1991); Let. Rul. 9249027 (severance benefits payable upon any voluntary or involuntary termination, including retirement, are deferred compensation or retirement benefits and are not qualifying other benefits). Compare *Wellons v. Comm.*, 31 F.3d 569, 94-2 USTC ¶50,402 (7th Cir. 1994)(severance pay arrangement is more akin to deferred compensation plan than welfare benefit plan where five years of service must be given before benefits accrue, benefit amount is linked to level of compensation and length of service, and benefits can be paid at virtually any termination of employment), *aff'g*, TC Memo 1992-704.
2. See *Internal Revenue Service Exempt Organizations Continuing Professional Education Text for Fiscal Year 1999*, Chapter F, Voluntary Employees' Beneficiary Associations.
3. Treas. Reg. §1.501(c)(9)-3(b).
4. IRC Sec. 409A(a)(1).
5. See IRC Sec. 409A(d). See also Treas. Regs. §§1.409A-1(a)(5), 1.409A-1(b)(9)(i).
6. See Treas. Regs. §§1.409A-1(b)(9)(ii), 1.409A-1(b)(9)(iii), 1.409A-1(b)(9)(iv), 1.409A-1(b)(9)(v). See also Treas. Regs. §§1.409A-1(m), 1.409A-1(n).

(1) The separation pay does not exceed two times the lesser of (x) the sum of the employee's annualized compensation based on the annual pay rate for services provided to the employer for the taxable year preceding the taxable year in which the employee had a separation from service, or (y) the maximum amount that may be taken into account under a qualified plan under IRC Section 401(a)(17) ($260,000 in 2014, up from $255,000 in 2013) for the year in which the employee had a separation from service;[1] and

(2) The plan provides that the separation pay must be paid no later than the last day of the second taxable year following the taxable year in which the separation from service occurred.[2]

A window program is a program established by an employer, in connection with an impending separation from service, to provide separation pay where it is made available by the employer for a limited period of time (no longer than twelve months) to employees who separate from service during that period or to service providers who separate from service during the period under specified circumstances.[3]

Final regulations became effective April 17, 2007, with transition relief extended to December 31, 2008.[4] For further explanation of IRC Section 409A, see Q 3533.

3988. Are an employer's contributions to a 501(c)(9) trust ("VEBA") deductible?

As a general rule, contributions to an employer-funded VEBA are deductible to the extent contributions to an employee welfare benefit fund are deductible (Q 3963 to Q 3969).[5]

3989. How are contributions to and benefits payable under 501(c)(9) trusts ("VEBAs") taxed to participants?

Contributions

Whether an employer's contributions to a VEBA to provide particular benefits are taxable to participants would seem to be determined under generally applicable tax rules. The presence of the VEBA would not seem to require special treatment. For example, the IRS has privately ruled that employer contributions to trusts providing accident and health benefits are excludable from participants' gross income as provided in IRC Section 106.[6]

Similarly, whether contributions to a VEBA are wages for FICA, FUTA, and federal income tax withholding purposes generally is determined under the FICA, FUTA, and withholding rules applicable to the kind of benefit or kinds of benefits at issue.[7]

1. Notice 2012-67 (Dec. 10, 2012); IR-2013-86 (Oct. 31, 2013).
2. Treas. Reg. §1.409A-1(b)(9)(iii).
3. Treas. Reg. §1.409A-1(b)(9)(vi).
4. See Notice 2007-86, 2007-46 IRB 990.
5. See, e.g, *National Presto Indus., Inc. v. Comm.*, 104 TC 559 (1995); Let. Ruls. 9401033, 9351042, 9322041.
6. See e.g., Let. Ruls. 9513007, 9340054, 9151017, 9046023, 8534048, 8507024, 8445019.
7. See e.g., Let. Ruls. 9340054, 8824030, 8534048.

Planning Point: Rules governing the taxation of employer-owned life insurance (i.e., COLI) were enacted under PPA 2006.[1] Whether these rules might apply to a VEBA, if the VEBA were considered to be engaged in a trade or business, is unclear.

Benefits

Both cash and noncash benefits provided through the association are included in or excluded from income under general tax rules. They are not given special tax treatment simply because they are provided by a 501(c)(9) association.[2]

Medical expense benefits and dismemberment and disability benefits appear to be tax-free or taxable to the participant under rules applicable to employer-provided health insurance (Q 315, Q 317) to the extent such benefits are attributable to employer contributions. These benefits appear to be excludable from gross income to the extent allowed under the rules applicable to personal health insurance (Q 324) to the extent they are attributable to participant contributions.[3]

Fully insured group term life insurance coverage provided by an employer through a VEBA has been privately ruled to be excludable from the employee's gross income to the extent permitted by IRC Section 79 (Q 229).[4]

Fully insured group term life insurance coverage provided by employees to themselves through a VEBA has been considered not to be subject to the inclusion rules of IRC Section 79 where the insurance is not carried directly or indirectly by the employer.[5]

Employees who purchased fully insured group term life insurance for their dependents through a VEBA were not required to include the cost of that coverage in their income as a fringe benefit where the employer's involvement with the arrangement was limited to providing reimbursed administrative services and the insurance was arranged and financed on an after-tax basis entirely by the employees.[6]

Fully insured group term life insurance death benefits payable by reason of an employee's death are excludable under IRC Section 101(a), at least where the benefits are paid directly from the insurance company to the beneficiary.[7]

After "extensive study," the IRS announced it would issue rulings on whether a death benefit under self-insured life insurance provided through a 501(c)(9) trust will be tax-exempt under IRC Section 101(a).[8]

1. See IRC Sec. 101(j), as discussed in Q 263.
2. Treas. Reg. §1.501(c)(9)-6.
3. See, e.g., Let. Ruls. 9340054, 9151017, 9046023, 8534048, 8507024, 8445019, 8352022, 8344069. See also Let. Rul. 199930015 (long term disability coverage purchased under either of two options would be attributable to employee contributions for purposes of IRC Section 104(a)(3); accordingly, if union employees could be treated as a separate class of employees, the long term disability benefits received by participants in new plans created under two different options would be excludable from participants' gross income under IRC Section 104(a)(3)).
4. See Let. Ruls. 8302034, 8248108, 8226062, 8225147.
5. See Let. Ruls. 9549029, 8906023.
6. See Let. Ruls. 9549029, 9151033.
7. See Let. Ruls. 8507024, 8352022, 8248108, 8226062, 8225147.
8. Rev. Proc. 90-3, 1990-1 CB 402. See, e.g., Let. Rul. 199921036 (general and accidental death benefits paid by a self-insured VEBA constituted amounts received under a life insurance contract and, therefore, were excludable from gross income under IRC Section 101(a); the arrangement was found to possess the requisite risk-shifting and risk-distributing elements necessary to establish the existence of a life insurance arrangement under *Helvering v. LeGierse*, 312 U.S. 531 (1941)). See also Let. Rul. 200002030.

Uninsured death benefits payable under a private plan created under federal law constituted amounts received under a life insurance contract and were excludable from gross income under IRC Section 101(a).[1]

Reimbursement of health insurance premiums under a collectively bargained Retiree Premium Reimbursement Plan would be excludable from gross income of members under IRC Section 106.[2]

Whether benefits provided through a VEBA are wages for FICA, FUTA, and federal income tax withholding purposes generally is determined under the FICA, FUTA, and withholding rules applicable to the kind of benefit or kinds of benefits at issue.[3]

Rebates and Termination Distributions

The IRS has privately ruled that payments made by a company to its employees from its general assets to reimburse employees for excess pre-tax and after-tax contributions to a VEBA were wages for FICA, FUTA, and income tax withholding purposes. If the employer had made the payments on behalf of the VEBA and then received reimbursement from the VEBA, the portion of the rebate attributable to employee after-tax contributions would have escaped that treatment.[4]

Participants in an employee pay-all VEBA who were receiving disability benefits were not required to recognize income when, on termination of the VEBA, they received disability insurance policies purchased with VEBA assets providing precisely the same benefits. Further, disability benefits under the policies were ruled excludable from income under IRC Section 104(a)(3) to the extent that disability benefits from the VEBA were excludable under that section.[5]

On the termination of employee pay-all VEBAs and the distribution of their assets in cash, all participants were considered to have received income to the extent the distributions exceeded their contributions; those who had taken deductions for their contributions were considered to have received additional income in the amount of any contributions for which they had taken a deduction that reduced their tax liability in earlier years.[6] Where the distributions did not exceed the employees' contributions, the distributions were not wages for FICA or FUTA purposes.[7]

1. Let. Rul. 9840040 (as corrected by Let. Rul. 199903026).
2. Let. Rul. 199902016.
3. See e.g., Let. Ruls. 200043007, 9340054, 8824030, 8534048.
4. Let. Rul. 9203033.
5. E.g., Let. Ruls. 9244035, 9219016, 9219014, 9219013.
6. Let. Ruls. 9147059, 9039009. See also 200023052.
7. Let. Rul. 9039009. Compare *Sheet Metal Workers Local 141 Supplemental Unemployment Benefit Trust Fund v. U.S.*, 64 F.3d 245 (6th Cir. 1995) (distributions at termination of supplemental unemployment benefit fund of amounts representing earnings on contributions to the fund were wages for FICA and FUTA purposes where the distributions derived solely from employer contributions and where eligibility for distribution payments was based on satisfaction of work requirements or their equivalents).