H. HARBOR LIGHTS--NONDISCRIMINATION RULES FOR IRC 501(c)(9) VEBAs

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1. Introduction

A. Purpose of Article

Since 1928 voluntary employees' beneficiary associations (VEBAs) have been included in the Internal Revenue Code as a tax-exempt category. But, it was only after final regulations applicable to VEBAs under IRC 501(c)(9) were issued by T.D. 7750 on January 8, 1981, that renewed interest was shown by employers in using VEBAs to fund employee welfare benefits. One area that continues to prove difficult is the application of non-discrimination rules to VEBAs.

This article discusses the nondiscrimination safe harbor guidelines applicable to VEBAs. It also reviews cafeteria plans under IRC 125. [We would like to emphasize that exemption applications submitted by VEBAs that provide benefits under a cafeteria plan do not have to be referred to the National Office for processing.] Finally, it discusses the latest development in the geographic locale requirement as it applies to multiple employer VEBAs.

B. Background

In general, the final regulations under IRC 501(c)(9) prohibit a VEBA from establishing criteria for eligibility for membership or benefits that favor officers, shareholders, or highly compensated personnel of an employer by either limiting benefits to these individuals or by providing disproportionate benefits to them in relation to benefits provided to other members of the VEBA. IRC 505(a), added as part of the Deficit Reduction Act of 1984, provides that a VEBA described in IRC 501(c)(9), unless it is a collectively bargained plan, is not exempt from tax under IRC 501(a) unless it is part of a plan that meets the nondiscrimination requirements of IRC 505(b). IRC 505(b)(1) bars discriminatory classifications and discriminatory benefits in favor of highly compensated individuals.

There are no final regulations under IRC 505(b). However, even without regulations, IRC 505(b)(1) prohibits discrimination in favor of highly compensated individuals with respect to eligibility for benefits, including the terms and conditions upon which each benefit is offered. In 1987, safe harbor guidelines were made part of IRM 7751-935, Exempt Organizations Handbook, so that the Service could process tax exempt status for VEBAs without waiting for the publication of regulations under IRC 505(b). If the safe harbor guidelines are satisfied, Reg. 1.501(c)(9)-2(a)(2) and Reg. 1.501(c)(9)-4(b) regarding eligibility for benefits or membership in favor of officers, shareholders, or highly compensated individuals of an employer will also be presumed to be met.

We should note that IRC 89, enacted by the Tax Reform Act of 1986 to apply to certain medical and group-term life insurance benefits, was repealed in 1989 before it became effective.

2. <u>In General</u>

A. <u>What Rules Apply?</u>

The safe harbor guidelines apply to benefits covered by IRC 505(b), which include life, disability, severance, insured medical, unemployment compensation and vacation/sick leave benefits. IRC 505(b)(3) provides that where another provision of Chapter 1 of the Code provides nondiscrimination rules for a benefit, the rules of that provision are substituted for the rules of IRC 505(b)(1) in determining if IRC 505(b) is satisfied. Therefore, while the safe harbor guidelines apply to the above noted benefits covered by IRC 505(b), the following benefits are tested for nondiscrimination under nondiscrimination rules provided by another Code section.

(1) Group term life insurance benefits are tested under IRC 79(d);

(2) self-insured medical benefits are tested under IRC 105(h);

(3) qualified group legal service plan benefits are tested under IRC 120(c);

(4) educational assistance benefits are tested under IRC 127(b); and

(5) dependent care assistance benefits are tested under IRC 129(d).

These other nondiscrimination provisions are discussed in Chapter 900 of IRM 7751.

B. Practical Application

A VEBA that otherwise meets all the requirements of IRC 501(c)(9), but does not meet the nondiscrimination safe harbor guidelines, will be given the opportunity to amend its plan to conform to the nondiscrimination safe harbor for each benefit. If the VEBA does not agree to amend its plan to conform to the safe harbor guidelines, the plan should be reviewed to determine whether it is discriminatory under IRC 505(b) and whether there are any disproportionate benefits within the meaning of Reg. 1.501(c)(9)-2(a)(2), or any impermissible restrictions within the meaning of Reg. 1.501(c)(9)-4(b). If so, an adverse determination may be issued based on the fact that the VEBA has a discriminatory benefit, or it has either a disproportionate benefit or an impermissible restriction. This approach also applies to situations where a VEBA's plan provides for benefits that are tested for nondiscrimination under Code sections other than IRC 505(b)(1).

If the VEBA agrees to amend its plan to conform to the safe harbor guidelines, the only issue left is whether the determination letter will be retroactive or prospective in application. If the VEBA has not paid any benefits, it would be eligible for retroactive exemption to the date of its formation, as in the following example:

> **Example (1)** A VEBA funded a plan that provided, among other benefits, educational benefits for all of the employer's highly compensated individuals, but to none of the employer's other employees. This benefit is discriminatory and does not meet the safe harbor guidelines. Under the circumstances, the VEBA agrees to amend the benefit by either having the VEBA provide the educational benefits to all employees, or by funding the benefit outside of the VEBA. All the other benefits come within the safe harbor guidelines. The VEBA furnishes documentation that no highly compensated individual has, as yet, received any educational benefit. Thus, exemption may be retroactive.

If the VEBA has actually paid out benefits, it may only receive prospective exemption effective the date the plan is amended to conform to the safe harbor guidelines, as illustrated by the following example:

> **Example (2)** The same facts as in Example (1), except the VEBA has actually funded educational benefits for some of the employer's highly compensated individuals. Exemption may only be prospective from the date that the VEBA's plan is amended to provide educational benefits to all employees, or from the date the benefit is removed from the plan and is funded outside of the VEBA.

If the VEBA has paid out benefits that are de minimis, it may receive exemption retroactive to its date of formation. The term "de minimis" has reference to inconsequential amounts both in dollar value and as a percentage of total benefits.

C. <u>Highly Compensated</u>

The nondiscrimination rules were enacted to ensure that highly compensated individuals are not favored over other employees. IRC 505(b)(5) and IRC 414(q) generally define the term "highly compensated individual" for taxable years beginning after December 31, 1987, to include employees who at any time during the year (or preceding year):

(1) were five percent owners;

(2) had compensation from the employer in excess of $75,000 (adjusted for inflation);

(3) were in the top twenty percent of employees in compensation and had compensation in excess of $50,000 (adjusted for inflation); or

(4) were officers of the employer and received compensation in excess of 50 percent of the amount in effect under IRC 415(b)(1)(A) (adjusted for inflation for the taxable year or preceding year).

The IRC 415(b)(1)(A) amount is $90,000 or 100 percent of the individual's average compensation for a high three year period, whichever is less. Under IRC 414(q)(5)(B) if for any year no officer of the employer exceeds the income ceiling then the highest paid officer of the employer for that year is treated as having exceeded the income ceiling. Therefore, there is always at least one highly compensated individual. A notice is published yearly in the Internal Revenue Bulletin providing inflation adjustment figures. For example, Notice 94-6, 1994-5 I.R.B. 18, announces the IRC 415(b)(1)(A) amount at $118,800 effective January 1, 1994.

D. Related Plans and Employers

Under IRC 505(b)(4) an employer may elect to treat two or more of its plans as one plan for purposes of the nondiscrimination rules. In other words, an employer may be able to demonstrate that the benefits provided by a VEBA are not discriminatory in favor of the highly compensated by electing to treat several plans as if they were one plan for nondiscrimination testing purposes.

In addition, for purposes of the safe harbor guidelines, two or more related employers are treated as a single employer. The term "related employers" includes employers subject to single-employer treatment under the aggregation rules of IRC 414(b), (c) and (m), such as the same controlled group of corporations. However, a plan that provides benefits for employees of two or more unrelated employers will satisfy the safe harbor guidelines only if the plan is nondiscriminatory under the guidelines as applied separately to employees of each unrelated employer.

E. Excluded Employees

The following employees may be excluded in testing for discrimination pursuant to IRC 505(b)(2):

(1) employees with less than three years of service;

(2) employees under the age of 21;

(3) seasonal[1] and less than half-time employees.[2]

[1] "Seasonal employee" is not defined in IRC 505(b)(2). An employee is generally deemed seasonal if employed for less than 6 months, but all the facts and circumstances can be considered.

[2] "Less than half-time employee" is not defined in IRC 505(b)(2). Since IRC 89 was repealed, less than half-time does not necessarily mean employees who work less than 17 1/2 hours per week. It means employees who work less than half-time by reference to the normal work week established by an employer.

(4) employees covered by a collective bargaining agreement; and,

(5) certain nonresident alien employees.

3. Safe Harbor Guidelines

A. Overview

The safe harbor guidelines set forth in IRM 7751-935 provide for the application of nondiscrimination rules under IRC 505(b). The safe harbor guidelines are divided into two major categories: (1) rules for income replacement benefits, and (2) rules for non-income replacement benefits.

Non-income replacement benefits include any benefit that is not a substitute for wages during a period of interruption or impairment of earning power. Non-income replacement benefits include:

(1) Health and accident;

(2) vacation facilities;

(3) child care assistance and facilities;

(4) recreational activities and facilities; and

(5) education and training expenses.

An income replacement benefit is a benefit that is designed to protect against a contingency that interrupts earning power. Income replacement benefits include:

(1) Life insurance;

(2) disability;

(3) severance;

(4) supplemental unemployment compensation; and

(5) sick or vacation pay.

B. <u>The Guidelines</u>

(1) <u>In General - Non-Income Replacement Benefits</u>

The nondiscrimination safe harbor guidelines for non-income replacement benefits require that benefits be offered to participants in equal amounts and under equal eligibility requirements, terms and conditions, and without regard to salary level, position, or ownership interest in the employer. (As will be discussed later, the guidelines for income replacement benefits allow such benefits to vary as a uniform percentage of compensation, so that salary level is a permissible determining condition for the amount of a benefit provided to employees.) Generally, "highly compensated" individuals may not receive better VEBA funded benefits than are made available to all "rank and file" employees. This is the case even though another type of benefit is offered exclusively to other employees.

> **Example (1)** Corporation X established a VEBA to provide health and accident benefits to its employees. X has two classes of employees: management and non-management. Management employees, comprised mainly of highly compensated individuals, are eligible to participate after 30 days of employment with X. The plan also provides that non-management employees are eligible to participate after 90 days of employment with X. Since the group with highly compensated individuals are eligible to participate within a shorter time than the other group, this plan offers its health and accident benefits on more favorable terms to its highly compensated individuals. The VEBA does not satisfy the safe harbor guidelines for IRC 501(c)(9) exemption.

> **Example (2)** Assume the same facts as in Example (1) except that all eligible non-management members of the VEBA are covered under a collective bargaining agreement and health and accident benefits were the subject of good faith bargaining with the employer. A VEBA may exclude employees covered under this collective bargaining agreement. Hence, the only group under consideration is the group comprised of

management employees. Since, the 30-day waiting period is uniform among the highly compensated individuals of that group and the other members of that group, the VEBA does not offer its health and accident benefits upon more favorable terms to highly compensated individuals than to other employees.

Example (3) Assume the same facts as in Example (1), except that in addition to the health and accident benefits, the VEBA also provides education and training benefits solely to its non-management employees. Even though the VEBA offers education and training benefits exclusively to non-management employees, the health and accident benefit is discriminatory in favor of X's highly compensated individuals, and the nondiscrimination safe harbor is not met.

Example (4) Employer C creates a VEBA to provide education and training benefits to its employees. The VEBA's plan grouped employees into Class one and Class two employees. All Class one employees are highly compensated. Under the plan, a Class one employee is entitled to receive education and training benefits upon the employee's request. A Class two employee is entitled to receive education and training benefits if his position is eliminated. Since a highly compensated individual is entitled to receive education and training benefits under more favorable conditions, the terms of the benefit discriminate in favor of the highly compensated.

(2) <u>Income Replacement Benefits - The Uniform To Compensation Rule</u>

An income replacement benefit will not be considered discriminatory merely because the benefit bears a uniform relationship to compensation pursuant to IRC 505(b)(1). Income replacement benefits usually are provided as a fraction or multiple of employees' compensation. The following examples illustrate this provision.

Example (1) Corporation C created a VEBA to provide a life benefit, other than a group-term life benefit described in IRC 79, to all its employees. C has 447 employees, 27 of whom are highly compensated. Under the policy issued to the VEBA, the employee's beneficiaries receive upon the employee's death 300% of the employee's annual earnings at death. Since the amount of the life benefit is a percentage of annual earnings and the percentage is uniform for all employees, the benefit bears a uniform relationship to compensation. Even though the amount of life benefit which each highly compensated individual would receive is higher than that which other employees would receive, the life benefit is not discriminatory because it bears a uniform relationship to compensation.

Example (2) The facts are the same as in Example (1), except that employees are categorized into four classes depending on salary. Employees who earn between $75,000 and $100,000 belonged to class one, employees who earn between $50,000 and $75,000 belong to class two, employees who earn between $25,000 and $50,000 belong to class three, and employees who earn less than $25,000 belong to class four. Upon an employee's death, class one employees receive 300 percent of $100,000, class two employees receive 300 percent of $75,000, class three employees receive 300 percent of $50,000, and class four employees receive 300 percent of $25,000. Compensation determines the class and employee life benefit. Since the benefit is only roughly offered as a uniform percentage of compensation based on compensation categories, all of the facts and circumstances will have to be considered to determine whether the life benefits are nondiscriminatory.

(3) <u>Excluded Employees - The Ratio Test</u>

For purposes of the safe harbor guidelines, a plan does not have to make a particular benefit available to all employees under an eligibility classification (even aside from those employees who are otherwise excluded pursuant to IRC

505(b)(2) above). However, if the benefit is not made available to all employees, the ratio of highly compensated individuals eligible to receive the benefit compared to the total number of highly compensated individuals (who are not otherwise excluded from consideration under IRC 505(b)(2)) may not exceed the ratio of lower paid employees eligible to receive the benefit compared to the total number of lower paid employees (who are not otherwise excluded from consideration under IRC 505(b)(2)).

Example The following chart sets forth an employer's work force where a particular benefit is offered <u>only</u> to managers and drivers who are over 21 years of age and who have over three years of service with the employer.

	Highly Compensated Employees	**Lower Paid Employees**
Employees under 3 years service	**1**	**21**
Employees under 21	**1**	**15**
Drivers (over 21 / 3 years service)	**10**	**42**
Managers (over 21 / 3 years service)	**7**	**3**
Employees (over 21 / 3 years service)	**1**	**37**

Because employees under 21 years of age or with less than 3 years of service may be excluded from consideration, the work force that must be taken into consideration in this example is comprised only of the drivers, managers, and other employees who are over 21 and have at least three years of service. In this case, the number of highly compensated individuals eligible to receive the benefit (17) when compared to the total number of highly compensated individuals not excluded from consideration (18) yields a ratio of 17/18 or 94.4% The number of eligible lower paid employees (45) when compared to the total number of lower paid employees not excluded from consideration (82) yields a ratio of 45/82 or 54.9% Because the ratio of eligible highly compensated individuals (94.4%) exceeds the comparable ratio of lower paid eligible employees (54.9%), the plan does not meet the ratio test under the nondiscrimination safe harbor guidelines with respect to the benefit.

(4) <u>Proportionality Test</u>

A VEBA that offers a particular benefit under terms or conditions that favor employee classifications that contain a significantly greater percentage of highly compensated individuals when compared to the total number of participants in the plan fails the safe harbor guidelines.

> **Example** Corporation W established a VEBA to provide disability benefits to its employees. W has 207 employees, 16 of whom are highly compensated. The plan provides for two classes of employees: salaried employees and hourly employees. 25 employees are classified as salaried, while 182 are hourly employees. All 16 highly compensated individuals are salaried employees. The plan provides that salaried employees are eligible to participate after 30 days of employment with X and hourly employees are eligible to participate after 90 days of employment with X. The ratio of highly compensated individuals in the salaried employee's group to the total number of salaried employees is 16/25 or 64 percent. The ratio of highly compensated individuals to the total employee population is 16/207 or 8 percent. Since, the plan offers the disability benefits under terms that favor salaried employees and the salaried employee classification contains a significantly greater percentage of highly compensated individuals when compared to the total number of participants in the plan, the plan fails the safe harbor guidelines.

(5) Best Benefit Test - Used In Conjunction With Proportionality Test

The ratio test is used to determine whether the eligibility requirements for a particular benefit are nondiscriminatory. The proportionality test is used to determine whether terms and conditions for a particular benefit are nondiscriminatory. If not discriminatory in eligibility for benefits (that is, all employees are covered other than "excluded employees" per IRC 505(b)(2)), but the plan contains certain additional terms and conditions that cause some employees to receive a benefit that differs in quantity or quality from that received by others, then the "best benefit test" can be used as an approach to rescue a plan that otherwise fails the proportionality test.

The best benefit refers to a particular benefit that is provided to all employees but under more favorable terms or conditions to a favored group of employees. It is a "working rule." It was previously described in the 1990 EO CPE at page 170 as a reasonable approach where the percentage of highly compensated employees in the most favored group is less than 50 percent, the plan should meet the safe harbor guidelines and be considered nondiscriminatory.

> **Example (1)** A VEBA funds medical benefits for all of the employees of F except part-time and seasonal employees. All the eligible employees of F can participate in the medical benefit plan under the same terms and conditions with the following exception. The medical benefits are divided into two classes. The Class 1 medical benefits are available to management employees. Class 1 medical benefits provide for dependent/spouse coverage and the employer pays 100 percent of the insurance premiums. The Class 2 medical benefits are available to non-management employees. Class 2 medical benefits provide solely for employee coverage and the employer pays 100 percent of the insurance premium. If Class 2 employees want dependent/spouse coverage, they must pay the entire insurance premium for this additional benefit. The employee census reflects that F employs 340 employees of which 100 are management and 240 are non-management. Of the 100 management employees, 20 are highly compensated individuals. Under the proportionality test, the ratio of highly compensated individuals in the management group to the total number of management employees is 20/100 or 20 percent. The ratio of highly compensated individuals to the total number of employees is 20/340 or 5 percent. Therefore, the proportionality test is not satisfied. However, since all employees (other than those excluded under IRC 505(b)(2)) are eligible to participate in the medical benefit plan, the "best benefit test" is applicable. Only 20 percent (20/100) of the employees eligible for the best medical benefit are highly compensated. Since the percentage of eligible employees participating in the best benefit who are highly compensated is less than 50

percent, the plan meets the safe harbor guidelines pursuant to the "best benefit test."

Example (2) C, a janitorial company, establishes a VEBA to provide short-term disability benefits to its employees. Eligibility for benefits is limited to the proprietor of the business, managers, secretaries, and janitors. C has 20 employees consisting of 1 proprietor, 2 managers, 1 secretary, and 16 janitors. Assume that the proprietor and the two managers are highly compensated individuals. Eligibility for benefits is further limited to full-time employees, which is defined as employees who regularly work at least 30 hours each week. The proprietor and all other employees except janitors work at least 40 hours each week. Eight janitors work 30 or more hours a week; four janitors work between 20 and 30 hours each week; and four work less than 20 hours each week. The work force to consider is comprised of 16 employees: 1 proprietor, 2 managers, 1 secretary, and 12 janitors who work at least 20 hours each week. Since the plan excludes certain employees, other than employees described in IRC 505(b)(2), the ratio test is applied. The number of highly compensated individuals eligible to receive the benefit is 3 and the total number of highly compensated individuals is 3. this yields a ratio of 3/3 or 100 percent. The number of eligible lower compensated employees is 9 (1 secretary and 8 janitors since 4 are not eligible under the plan because they work between 20 to 30 hours per week) and the total number of lower compensated employees other than those permitted to be excluded is 13 (12 janitors and 1 secretary). This yields a ratio of 9/13 or 69 percent. Pursuant to the ratio test, V's short term disability benefit does not pass the safe harbor guidelines. The best benefit test is unavailable since <u>not all</u> employees, other than employees who may be excluded under IRC 505(b)(2), are eligible to receive benefits.

(6) <u>$150,000 Limit</u>

No employee may receive a benefit which is based upon a level of compensation that exceeds $150,000. Two things are important here: 1) This amount is adjusted for inflation (see Notice 94-6, supra.); 2) this rule does not say that an employee who earns more than the amount in effect for the year may not participate in a VEBA. Instead it says that the benefit may not be based on an amount that exceeds $150,000. So, an employee who earns more than $150,000 may participate in a VEBA if the benefit is based on an amount that does not exceed $150,000. This provision which is contained in IRC 505(b)(7) specifically does not apply to determining whether the nondiscrimination requirements of IRC 79(d) applicable to group-term life insurance benefits are met.

> **Example** Corporation C created a VEBA to provide severance benefits to its employees. C has 25 employees, including A and B who are the only highly compensated individuals in the plan. A and B earn $200,000 and $185,000 in annual compensation, respectively. The plan provides that upon severance, each employee would receive as a benefit two times annual compensation. Since the plan does not limit the amount of the severance benefits to two times the $150,000 amount including annual inflation adjustments, the plan is not considered to have met the requirement of IRC 505(b) even though the severance benefit bears a uniform relationship to compensation.

C. More Examples

(1) Benefit Varies With Seniority

An income replacement benefit is not offered as a uniform percentage of compensation if the percentage upon which the benefit is based increases with the participant's length of service with the employer. However, if highly compensated individuals are not disproportionately represented in the groups with the longest period(s) of service, the benefit may nevertheless be provided under a formula that takes years of service into consideration.

> **Example** Corporation C created a VEBA to provide a life benefit, other than a group-term life benefit under IRC 79, to its employees. C has 447 employees, 27 of whom are highly compensated. Under the policy issued

to the VEBA, if an employee remains in C's services for at least 20 years, the employee's beneficiary receives upon the employee's death 300 percent of the employee's annual earnings at death. Of the 27 highly compensated individuals, 10 have been with C for at least 20 years. Of the 420 lower paid employees, 200 have been with C for at least 20 years. Although the amount of life benefit is a uniform percentage of annual earnings, eligibility is based on length of service. Thus, the life benefit must be tested to determine whether it discriminates based on eligibility in favor of highly compensated individuals who comprise 20-year employees. Under the ratio test, the fraction for the highly compensated is 10/27 or 37 percent; whereas, the fraction for the lower paid is 200/420 or 47.6 percent. In this situation, the ratio test is satisfied since length of service does not result in a life benefit that discriminates in favor of highly compensated individuals.

(2) Benefit to Compensation Ratio Differs

An income replacement benefit is discriminatory if the amount of benefit offered to any highly compensated individual bears a larger ratio to that individual's compensation than the average benefit offered to other employees bears to their average compensation. This test compares the proportion of each highly compensated individual's actual benefit to his actual compensation against the proportion of the average benefit of all other employees to their average compensation. Each highly compensated individual must be tested to determine if any of them received a benefit which has a larger ratio to their compensation than the average benefit offered to other employees bears to their average compensation.

Example 1 Corporation C established a VEBA to provide severance benefits to its employees. C's employees include K, R, and S who are highly compensated individuals. K, R, and S otherwise are not related to each other. R received $80,000 from C in compensation in 1993; K received $85,000 from C in compensation in the same year; and S received $60,000 in compensation in the same year. The average compensation of other employees excluding K, R, and S for 1993 was $30,000. The plan provides that upon involuntary termination, officers and directors of C would receive $10,000 and all other employees would receive $7,500. To determine whether the plan is discriminatory in favor of K, R, or S, we must test the average benefit/average compensation that all other employees receive from the plan against the actual benefit/actual compensation that <u>each</u> highly compensated person receives from the plan. The ratio of the average benefit to the average compensation for other employees is 7,500/$30,000 or 25%. For K, the ratio of the severance benefit to his compensation is $10,000/$75,000 or 13.3%; for R, the ratio is $10,000/$80,000 or 12.5%; and for S the ratio is $10,000/60,000 or 17%. Since the benefit offered to K, R, or S does not bear a larger ratio to their compensation than the average benefit offered to other employees bears to their average compensation, this benefit is not discriminatory.

Example (2) Assume the facts as in Example (1), except that the plan provides that upon involuntary termination officers and directors of C receive $15,000 and all other employees receive $7,000. To determine whether the plan is discriminatory in favor of K, R, or S, we must test the average benefit/average compensation that all other employees receive from the plan against the actual benefit/actual compensation that <u>each</u> highly compensated person receives from the plan. The ratio of the average benefit to the average compensation for other employees is 7,000/$30,000 or 23.3%. For K, the ratio of the severance benefit to his compensation is $15,000/$75,000 or 20%; for R, the ratio is $15,000/$80,000 or 18.75%; and for S the ratio is $15,000/60,000 or 25%. The ratio of the actual benefit/actual compensation of S is higher than the average benefit/average compensation for all other employees. Hence, the severance benefit discriminates in favor of S, a highly compensated individual. This is so even though this benefit does not discriminate in favor of K or R.

D. Specific Benefits

The following discussion highlights some benefit areas in which application of the nondiscrimination rules are unclear.

(1) Health and Accident Benefits

The term "health and accident benefits" refers to both insured medical benefits (medical benefits provided under a group insurance policy such as a Blue Cross/Blue Shield policy) and self-funded medical benefits (medical benefits funded directly by the employer). The general rule for non-income replacement benefits, as previously noted, is that health and accident benefits must be offered to participants (other than those that may be excluded under IRC 505(b)(2) such as part time employees) in equal amounts and under equal terms, eligibility requirements, and conditions, and without regard to salary level, position, or ownership interest in the employer. If a plan does not make non-income replacement benefits available equally to all employees, it may, nevertheless, satisfy the safe harbor guidelines if the ratio of highly compensated individuals eligible for the benefit to all highly compensated individuals is not greater than the ratio of lower compensated individuals eligible for the benefit to all lower paid employees.

Example (1) A VEBA provides all an employer's employees, including owners, officers and highly compensated individuals, with the same medical, dental, and prescription benefits. In this case, the VEBA satisfies the safe harbor guideline.

Example (2) A VEBA provides all an employer's employees, including owners, officers, and highly compensated individuals, with the same medical, dental, prescription and weekly disability benefits. The owners, officers and highly compensated individuals are salaried. All other employees are hourly. The employer contributes 100 percent of the cost of premiums for its salaried employees for the enumerated benefits, but it requires its hourly employees to pay 50 percent of the cost of their premiums. The VEBA does not satisfy the general rule under the safe harbor guidelines because the benefits are not offered under equal terms and without regard to salary level, position, or ownership interest. The different conditions and terms would not satisfy the proportionality test since the ratio of highly compensated individuals in the salaried group to the total number of salaried employees is 100 percent; whereas, the ratio of highly compensated individuals to the total employee population would be less than 100 percent. Moreover, the best benefit test would not be satisfied since more than 50 percent of those eligible employees receiving the best benefit are highly compensated individuals.

(2) Insured Medical Benefits

IRC 505(b) and the nondiscrimination safe harbor guidelines are applicable to all insured health and accident benefits, such as medical benefits, dental benefits, prescription benefits, optical benefits, and medical reimbursement benefits. Insured benefits include those where the VEBA purchases commercial insurance to pay for the benefit coverage rather than provide for self-insurance. All participating employees must be offered the same health/medical benefits under the same terms and conditions. The following example involves insured medical benefits under the safe harbor guidelines.

Example A VEBA funded medical benefits by purchasing insurance for the employees of X. The employee census shows that X has 299 employees. Of this number, 6 were excluded because of time-in-service requirements (Less than 3 years service), and 15 were excluded because they worked part-time. 278 of X's employees are eligible to participate in the VEBA. The VEBA represents that 174 employees participate in the medical plan, and that 104 employees do not participate in the medical plan because they either do not want coverage, or are covered under their spouse's plan. Thus, all eligible employees, excluding the 104 individuals who declined coverage, participate in the medical plan. The VEBA meets the safe harbor guidelines.

In the above example, all eligible employees received or were offered the same health benefits under the same terms and conditions. The fact that certain eligible employees elected out of the health care coverage does not adversely affect the VEBA. This is typical of most VEBA insured health benefit plans. <u>If</u> there is a question as to whether the elections were voluntary, information should be obtained concerning how employees elect health care coverage, including a copy of the form used to elect coverage; a copy of the policy purchased by the VEBA; and a copy of any other documents that describe restrictions on employee participation. If such information demonstrates that the elections were voluntary, the safe harbor guidelines are met.

(3) <u>Self-Insured Medical Reimbursement Benefits</u>

Many employers partly or fully self-insure medical care benefits. Self-insured medical reimbursement benefits are subject to the nondiscrimination rules of IRC 105(h) rather than IRC 505(b)(1). Thus, the safe-harbor guidelines do not apply.

The eligibility requirements for self-insured medical reimbursement benefits are contained in Reg. 1.105-11(c)(2). Specifically, (a) the plan must actually cover at least 70 percent of all employees; (b) at least 70 percent of employees must be eligible for coverage of which at least 80 percent must actually be covered; or (c) the classification test of Reg. 1.105-11(c)(2)(ii) must be satisfied that demonstrates that the plan is not discriminatory in favor of highly compensated individuals.

Employees described in Reg. 1.105-11(c)(2)(iii) may be excluded from consideration without violating the nondiscrimination requirement. The excluded employees include (a) employees who have not completed 3 years of service; (b) employees who are less than 25 years old; (c) part-time employees who work less than 35 hours per week; (d) employees covered by a collectively bargained agreement; (e) and nonresident aliens.

Reg. 1.105-11(c)(3) provides that the nondiscriminatory benefit requirements will not be met unless all benefits provided for highly compensated participants (or their dependents) are provided for all other participants (or their dependents) on the same basis. Reg. 1.105-11(c)(3)(i) provides that:

> **"all the benefits available for the dependents of employees who are highly compensated individuals must be available on the same basis for the dependents of all other employees who are**

participants. A plan that provides optional benefits to participants will be treated as providing a single benefit with respect to the benefits covered by the option provided that (A) all eligible participants may elect any of the benefits covered by the option and (B) there are either no required employee contributions or the required employee contributions are the same amount."

The term "highly compensated individuals" is defined in Reg. 1.105-11(d). The term "highly compensated individuals" includes individuals who are (a) the 5 highest paid officers of the employer; (b) 10 percent shareholders in the employer; and (c) are in the highest paid 25 percent of the employer's employees.
non-income

The following are examples involving the nondiscrimination rules for benefits under IRC 105:

> **Example (1)** A VEBA provides self-funded medical benefits for Q's employees. The medical benefits fall into four classes: (1) single, (2) single with dependent, (3) married with spouse, and (4) family. Q has four categories of employees: (1) officers, (2) managers, (3) clerical and, (4) factory. All employees receive class 1 (single) medical benefits under the same terms and conditions. All employees are provided class 1 benefits. But, medical benefits classes 2, 3, and 4 are offered under different terms and conditions to the various employee classifications (officers, managers, clerical and factory). The members of the officer's classification are provided class 2, 3. and 4 dependent medical benefits. But, the managers, clerical and factory classifications must pay the premium amounts for the difference in cost between class 1 benefits and class 2, 3, or 4 benefits. The plan is discriminatory under IRC 105(h) in favor of the highly compensated since they receive a preferential benefit based on their classification.
>
> **Example (2)** R operates facilities in 21 states. All the businesses covered by the VEBA are wholly owned by R. The employee census shows that R has 3497

employees and that 2739 participate in medical and dental benefits. The VEBA funds self-insured Medical and Dental benefits. The VEBA represents that there were 69 part-time employees and 689 who elected not to be covered. Because IRC 105(h) permits the exclusion of part-time employees and because employees may elect not to participate in VEBA funded benefits, the VEBA meets the nondiscrimination rules under IRC 105(h).

(4) Vacation Facilities

Vacation facilities are tested for nondiscrimination under IRC 505(b) and the safe harbor guidelines. Sometimes a time-in service factor operates so that the terms or conditions of the plan provide a greater benefit for highly compensated individuals than for lower paid employees. The following provide examples of this situation.

Example A vacation facility benefit is provided by a VEBA on a preferential basis to employees of X who have been employed by X for at least 10 years. X has 20 employees, of whom 5 are highly compensated. All of X's highly compensated individuals have been employed by X for 10 years or more. Only one of X's other employees has at least 10 years of service. This benefit does not meet the nondiscrimination safe harbor guidelines since highly compensated individuals are disproportionately represented in the group with the longer period of service. In this case, the ratio test is failed because the ratio of highly compensated individuals eligible for the benefit to total highly compensated individuals is 5/5 or 100 percent; whereas, the ratio of lower paid employees eligible for the benefit to total lower paid employees is 1/15 or 6.67 percent. The best benefit test is not applicable because the benefit is not offered to all employees.

(5) Dependent Care Assistance and Facilities

A dependent care assistance and facilities program involves the provision of facilities or the reimbursement of a portion of the employees' day care expenses for dependents. These benefits must be provided on a basis that does not discriminate in favor of highly compensated individual as tested under IRC 129.

(6) Education Assistance Program

An education assistance program involves the provision by an employer of courses of instruction for employees or the payment by an employer of an employee's expenses incurred for education such as tuition, fees, books, supplies, and equipment. These benefits must be provided on a basis that does not discriminate in favor of highly compensated individuals as tested under IRC 127.

(7) Recreational Activities and Facilities

Included in the term "other benefits" under Reg. 1.501(c)(9)-3(d) are subsidizing recreational activities like bowling, golf, softball, baseball and tennis. In addition, some employers may have an exercise facility on site. If funded through a VEBA, these recreational benefits and facilities must be provided on a nondiscriminatory basis under IRC 505(b). Therefore, the safe harbor guidelines apply.

4. Cafeteria Plans

A. Overview

Recently, we have seen an increase in the number of VEBAs that provide benefits through cafeteria plans. This part of the article provides an overview of cafeteria plans, summarizes the requirements for a cafeteria plan, and provides a discussion of how cafeteria plans should be handled for qualification purposes under IRC 501(c)(9).

Congress enacted IRC 125, in part, to permit employees to use salary reduction methods to pay for welfare benefits and to tailor benefits to their needs. Benefits consisting of group-term life insurance, health or accident coverage, qualified group legal services (prior to June 30, 1992), and dependent care assistance may be provided through a cafeteria plan described in IRC 125. Because cash or deferred savings arrangements can also be provided through a cafeteria plan, but are not permitted benefits under IRC 501(c)(9), this type of benefit may not be funded through a VEBA. Moreover, pursuant to Rev. Proc. 94-4, 1994-1 I.R.B. 90 at Sec. 8.07, the Service will not rule on whether a cafeteria plan satisfies the requirements of IRC 125. Nevertheless, benefits provided by a cafeteria plan that are otherwise permitted under IRC 501(c)(9) may be funded through a VEBA.

B. Definition of a Cafeteria Plan

IRC 125 provides that no amount is included in the income of an employee merely because the employee may choose among benefits in a cafeteria plan. In general, a cafeteria plan is a plan that offers participants a choice between cash and one or more qualified benefits. Other requirements for a cafeteria plan include: only employees may participate, the plan must operate under a written plan; and the plan may not permit employees to change their elected benefits during the same period in which they selected the benefits.

C. Exemption Qualification

A cafeteria plan must meet a two-pronged nondiscrimination test. First, it must meet the nondiscrimination requirements applicable to each benefit so that the benefit is treated as nontaxable. Thus, the general nondiscrimination requirements under IRC 505(b) apply unless the benefit is subject to the nondiscrimination rules under some other section of the Code. For example, a dependent care assistance benefit must meet the rules in IRC 129(d), a self-insured medical expense reimbursement benefit must meet the rules in IRC 105(h), and a group-term life insurance benefit must meet the rules in IRC 79(d). Second, in addition to the nondiscrimination rules for each specific benefit, the cafeteria plan itself must also meet the nondiscrimination rules set forth in IRC 125. Meeting the IRC 125 rules ensures that amounts contributed to the plan are not treated as constructively received and, thereby, included as amounts of gross income.

Because the Service will not rule on the qualification of cafeteria plans under IRC 125, the following caveat should be included in exemption determination letters or rulings if benefits provided through a cafeteria plan are found to qualify under IRC 501(c)(9) and they otherwise satisfy the applicable nondiscrimination rules, other than IRC 125.

We are not making a determination, directly or indirectly, on whether the arrangement which you describe as a "cafeteria plan" meets the requirements of section 125 and other related sections of the Internal Revenue Code. Further, this determination is not to be construed by inference or otherwise as approving for purposes of exemption under section 501(c)(9), any other arrangement which purports to be a "Cafeteria Plan."

Example A VEBA provides medical, dental, and group-term life benefits for all full-time employees of S corporation. The VEBA has characterized the plan as a cafeteria plan. S has 54 employees of which 3 are highly compensated. The highly compensated individuals along with 35 other employees participate in the medical/dental plan and in the group-term life plan under terms that are nondiscriminatory in favor of the highly compensated individuals under the safe harbor guideline applicable to the medical/dental plan and under IRC 79(d). The remaining employees do not participate, however, they are covered by a collective bargaining agreement. The VEBA can be issued an exemption determination under IRC 501(c)(9) using the above-referenced special language.

5. Geographic Locale Requirement

A continuing issue under IRC 501(c)(9) is whether individuals employed by unrelated employers share an employment-related common bond sufficient to qualify the organization as a VEBA for purposes of IRC 501(c)(9). Reg. 1.501(c)(9)-2(a)(1) provides that employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to share an employment-related bond.

Employers engaged in business in the same state, Metropolitan Statistical Area (MSA), or Consolidated Metropolitan Statistical Area (CMSA), are engaged in business "in the same geographic locale" within the meaning of Reg. 1.501(c)(9)-2(a)(1) (a description of existing MSAs and CMSAs is published periodically by the Office of Management and Budget).

The restriction in Reg. 1.501(c)(9)-2(a)(1), limiting multiple employer trusts to the same geographic locale, was ruled invalid in Water Quality Employees' Benefit Corp. v. U.S., 795 F. 2d 1303 (7th Cir. 1986). However, the Service believes that the holding is in error. A notice of proposed rulemaking was published in the Federal Register Vol. 57, 153 on August 7, 1992, in which Reg. 1.501(c)(9)-2(a)(1) was revised by adding a paragraph (d) which further defines the term "geographic locale".

Reg. 1.501(c)(9)-2(d), as amended, provides for a three-state safe harbor. An area is considered a single geographic locale if it does not exceed the boundaries of three contiguous states. This includes three states which share a land or river border with one of the other, such as South Carolina, North Carolina, and Virginia. Also, Alaska and Hawaii are considered contiguous to California, Oregon, and Washington for purpose of these regulation. In addition, the Commissioner has authority to recognize an area that exceeds the three-state safe harbor if:

(i) It would not be economically feasible to establish one or more VEBAs to cover employees of employers engaged in the same line of business in fewer than three states and still be able to offer membership in a VEBA to all employees of employers in the covered states, and

(ii) Employment characteristics in that line of business, population characteristics, or other regional factors support the particular states included.

Below is an example of how to apply the revised "same geographic locale" requirements.

Example A VEBA that operates in 5 states funds medical, dental, life, AD&D and dependent care assistance benefits to employees of W, X, Y, and Z who work 20 hours per week (30 hours for the dental and medical plans). W, X, Y and Z share the same line of business. The medical, dental, and dependent care assistance benefits are funded through a cafeteria plan. W, X, Y, and Z have 361 employees, of whom 348 are covered. Those excluded worked less than 17 1/2 hours per week. The VEBA does not fund any other benefits through the cafeteria plan. All employees receive the same life and AD&D benefits. The employees who participate in the "cafeteria plan" benefits, may select the medical, dental, and dependent care assistance benefits that they need. Because the employees have a choice of medical, dental, and dependent care assistance benefits, it does not mean that the benefits are discriminatory. So long as each employee has the same kind of election, the benefits are not discriminatory and meets the safe harbor guidelines. Because the VEBA operates in 5 states, it does not meet the same geographic locale three-state safe harbor guideline. The VEBA may furnish information (1) to show that it is not economically feasible to form separate VEBAs, and (2) to describe specific employment characteristics in the line of business, population, or other regional factors to support an employment-related common bond among participants.