I. VEBA UPDATE

1. Introduction

VEBAs remain in a state of flux, as the repeal of IRC 89 returns us to the situation that existed prior to the enactment of that provision. VEBAs must be tested for discrimination using the rules of section 505(b), but no regulations have been issued with respect to section 505(b). This article will discuss some of these discrimination issues, as well as other 501(c)(9) issues. See also the articles on VEBAs in the 1982 and 1989 CPE texts.

2. Definition of "Employment-Related Common Bond"

Reg. 1.501(c)(9)-2(a)(1) requires that an "employment-related common bond" exist among the employee-members of an association in order for it to be described in IRC 501(c)(9). The regulations go on to list several examples of a permissible common bond, and conclude by stating that the existence of such a bond must be determined based on all the facts and circumstances.

One of the examples given, and the one that has generated the greatest controversy, is that of employers in the same line of business in the same geographic locale.

Line of Business

The issue of what constitutes a "line of business" for purposes of Reg. 1.501(c)(9)-2(a)(1) was considered in GCM 39299 and discussed in the 1989 CPE text. In that case, a trade association described in IRC 501(c)(6) established a trust to provide various benefits to employees of the member-employers.

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

> "an aggregate of enterprises employing similar production and marketing facilities and producing products having markedly similar characteristics."

VEBAs established by trade associations frequently present the problem of participation by "affiliate" members, usually firms having some sort of business relationship with the "regular" members. For example, in a VEBA for the home building industry in a particular state, potential affiliate members included public utilities, attorneys, real estate agents, local governments, and suppliers to the industry. Despite the existence of some sort of business relationship, these firms are not in the home building industry. Lacking additional facts and circumstances in their favor, there is not a sufficient employment-related common bond to support exemption.

Geographic Locale

The term "geographic locale" has also been the subject of debate. As discussed in previous CPE articles, the Service's position has been that an area no broader than a single state or consolidated metropolitan statistical area is contemplated by this term. The Service is not following the decision in Water Quality Association Employees' Benefit Corporation v. U.S., 795 F. 2d 1303 (1986), which held that the "geographic locale" restriction had no basis in the statute.

Reg. 1.501(c)(9)-2(a)(1) provides that a VEBA's membership must "consist of individuals who become entitled to participate by reason of their being employees and whose eligibility for membership is defined by reference to objective standards that constitute an employment-related common bond among such individuals." A number of examples are then given. The section then states "whether a group of individuals is defined by reference to a permissible standard or standards is a question to be determined with regard to all the facts and circumstances, taking into account the guidelines set forth in this paragraph." Thus, the examples enumerated in this section of the regulations are neither exhaustive nor exclusive.

Cases involving franchises or some degree of common ownership may indicate an employment-related common bond even though none of the enumerated examples in the regulations apply. For example, an association of otherwise unrelated independent religious schools which shared a common educational philosophy established a VEBA for employees of its members. The association required member schools to meet certain standards in order to continue as members. Member schools participated in many common activities such as curriculum development. Professional employees frequently transferred among member schools. Benefits and seniority were entirely portable. Under these circumstances an employment-related common bond does exist.

Factors that indicate the presence of an employment related common bond include:

1. Some degree of common ownership, although not rising to the level of common control. 2. Limitation to a geographic area not necessarily limited to a single state or metropolitan area. An example of this would be the panhandle area of West Virginia along with portions of Ohio and Pennsylvania.

2. Some degree of supervision or oversight by a common "parent" organization, even though no common ownership is involved. Many franchise arrangements would fall into this category.

3. Public perception that the businesses are part of a single organization. This would also apply to many franchise arrangements.

3. Life Insurance

Reg. 1.501(c)(9)-3(b) provides that life benefits are permissible VEBA benefits, but must generally consist of current protection. The right to convert to individual coverage on termination of eligibility for coverage under the VEBA is also permissible. This means, as a general rule, that VEBAs providing life insurance must do so using term coverage; they may not provide whole-life coverage or any type of "permanent" benefit (except for so-called "group-permanent" coverage as described in the regulations under IRC 79). A "permanent benefit" is defined in Reg. 1.79-0 to be "an economic value extending beyond one policy year (for example, a paid-up or cash surrender value) that is provided under a life insurance policy."

However, a VEBA may purchase whole-life insurance policies on its individual employee-members as long as three conditions are met:

1. the policies are owned by the VEBA (not the employer and not the employee)

2. the policies are purchased through level premiums over the expected lives or working lives of the individuals; and

3. the accumulated cash reserves of the policies accrue to the VEBA. That is, the covered employees have no access to any cash or loan values.

Under these conditions, the employee-participants are receiving current protection only. The whole-life policies are being used by the VEBA simply as an investment.

A problem may arise, however, if a covered employee terminates employment and wishes to convert his or her group coverage to individual coverage. Because group-term life insurance coverage contains no investment features and the premiums are paid one year, or even one month, at a time, conversion does not result in the transfer of anything of economic value from the VEBA to the covered employee. The employee simply begins paying the required premiums.

In contrast, the transfer of a whole-life policy from the VEBA to an employee does involve the transfer of something of value. As long as premiums are paid, the cash value of a whole-life policy increases each year. In fact, with some policies, the cash values may increase to the point that no additional premiums are required; the investment earnings on the accumulated cash value are sufficient to pay the premiums. Reg. 1.501(c)(9)-4 provides that the disposition of property to a person for less than the greater of fair market value or cost (including indirect costs) constitutes prohibited inurement. Therefore, a VEBA cannot simply give a whole-life policy to a departing employee by allowing the employee to take over paying the premiums; the employee must purchase the policy from the VEBA. The amount paid must be the greater of fair market value or the VEBA's cost. In no case will the amount to be paid by the employee to the VEBA ever be less than the total premiums paid by the VEBA on that policy to date.

Use of single-premium life insurance policies by a VEBA would not be permitted; such an arrangement does not fall within the permitted category of whole-life policies described above because it is not funded by level premiums over the expected working life of the employee. Recent changes in the tax law have made single-premium policies less attractive from an investment perspective. Also, note that combination annuity/life insurance policies are not permissible VEBA benefits. Under such an arrangement, if the insured individual dies before age 65, the beneficiary receives a stated death benefit. If the insured individual, often referred to in the policy as the annuitant, reaches age 65, he or she receives an annuity. An annuity is not a permissible VEBA benefit. See Reg. 1.501(c)(9)-3(f).

As a general rule, life insurance proceeds payable by reason of the death of the insured are excluded from the gross income of the beneficiary by IRC 101. Premiums paid by an employer for up to $50,000 of group-term life insurance coverage are not taxed to the employee. The cost of coverage in excess of $50,000 is taxed to the employee, but the amount taxable is calculated from a table in Reg. 1.79-3(d)(2) (referred to as Table I) and may be less than the actual premium paid by the employer. The cost of permanent insurance, i.e. whole-life coverage, provided by an employer is taxable to the employee. The taxable amount is calculated using a formula contained in Reg. 1.79-1(d).

Premiums paid by the employer are generally deductible by the employer as a business expense, assuming that all other requirements for deductibility are met. Note that the limitations of IRC 419 generally do not apply to the direct purchase of an insurance contract by the employer.

The net result of these provisions may be to encourage employers to provide a benefit labelled term life insurance to their employees. This is especially true in the case of small, closely-held corporations, such as professional corporations where the employer and the employee are essentially the same person. Consider the following example.

A firm with two employees pays an annual premium of $200,000 for $1,500,000 of term coverage for each employee. Employee X (also the sole shareholder) is 63. Employee Y is 33. The amount to be included in X's income for the year is calculated as follows:

Total coverage provided (in 000's)	1,500
$ 50,000 exclusion	50
Taxable coverage	1,450
Table I amount	1.17
Taxable amount for one month	$1696.50
	12
Taxable amount for one year	$20,358

Similar calculations result in a taxable amount for Y of $1566 for the year.

The intended result is that the Corporation, owned 100% by X, takes an annual deduction of $200,000. When X dies, his beneficiary gets $1,500,000 tax free. In the meantime, X must only pay tax on an additional $20,358 of income each year. This particular policy is a so-called "guaranteed to issue" policy with no health requirements. Given X's age, he might find it difficult to purchase such a large amount of insurance in any other way. Thus, this "insurance" product appears to serve as an estate planning tool to provide liquidity to the estate of X. In this situation, it should also be noted that the accuracy of the plan administrator's statements regarding the purpose and ultimate destination of the extremely large premiums is uncertain. Furthermore, an examination of the employer corporation might result in the disallowance of all or a portion of the $200,000 premium deduction because it fails the "ordinary, reasonable, and necessary" test of IRC 162. Such a plan would not qualify under IRC 501(c)(9) as a tax exempt VEBA because it appears to be an estate planning tool for X rather than an association for the benefit of employees.

VEBAs providing life insurance in which the premiums paid seem unusually high in relation to the type and amount of insurance provided should be closely examined to determine if they may be serving some purpose other than that permitted for a VEBA or if there may be some ancillary provision or benefits provided outside the VEBA such as the ability to borrow against the policy or to convert to a whole-life policy or annuity.

4. Severance Pay

Reg. 1.501(c)(9)-3(e) permits VEBAs to provide severance benefits under a severance pay play within the meaning of 29 CFR 2510.3-2(b). These regulations are ERISA regulations whose purpose is to exclude severance pay plans with certain characteristics from the definition of a pension plan. Among other things, these regulations require that payments not be contingent, directly or indirectly, upon the employee's retiring.

Some VEBAs provide severance benefits that are payable upon termination of employment for any reason (other than termination for cause). Often, retirement will be specifically listed as one of the events which will trigger payment of severance benefits. Our position has generally been that such a provision is not permissible for a VEBA.

In New York Post Co. v. Commissioner, 40 T.C. 82 (1963), the Tax Court considered an employee benefit plan under which "severance pay" was payable not only upon dismissal or discharge, but also at death or upon retirement. The court held that this so-called severance pay was deferred compensation for which the deduction was governed by IRC 404 of the Code. It distinguished the benefit from "dismissal wages" on the ground that the benefit was payable not merely upon involuntary termination of employment, but also upon death or voluntary termination after satisfaction of the age or service requirement. The court held that the benefits were in the nature of retirement benefits, and that their labeling as "severance pay" was thus irrelevant.

VEBAs which include severance pay plans that will pay benefits upon retirement should be required to amend their plans to delete retirement as an event triggering the payment of severance benefits. If the plan provides that benefits will be paid upon termination "for any reason" an amendment will also be necessary to preclude the payment of benefits upon retirement. "Severance pay" that is payable upon death, although not "dismissal wages", would be viewed as a death benefit and therefore a permissible VEBA benefit. See Reg. 1.501(c)(9)-3(b).

5. <u>Bankruptcy and Collective Bargaining Agreements</u>

Several cases have arisen involving the establishment of VEBAs to fund benefits for retirees of bankrupt corporations which had, until bankruptcy, provided retiree medical coverage out of current earnings. Generally such cases involve the allocation of a portion of the corporation's assets to a fund to be used to provide some level of medical benefits to retirees who were promised continuing medical coverage as part of their retirement package. When a VEBA is used to fund such an arrangement, several questions arise:

1. Are retirees considered "employees" for purposes of IRC 501(c)(9) and the regulations thereunder?

2. Does providing benefits solely to retirees constitute the provision of retirement benefits?

3. To what extent is the VEBA subject to the account limits of IRC 419A?

Reg. 1.501(c)(9)-2(b) defines "employee" for purposes of IRC 501(c)(9) to include "an individual who became entitled to membership in the association by reason of being or having been an employee" and goes on to specifically mention retirement as an event that does not change a person's classification as an employee. Thus, if an individual was a bona fide employee prior to retirement, he/she is still an employee for purposes of IRC 501(c)(9) after retirement.

Reg. 1.501(c)(9)-3(f) describes various types of nonqualifying benefits, including any benefit that is similar to a pension or annuity payable at the time of retirement. Thus, if medical benefits provided solely to retirees are considered a retirement benefit, exemption under IRC 501(c)(9) would be precluded. A benefit is considered similar to a pension or annuity if it becomes payable by reason of the passage of time, rather than as the result of an unanticipated event. Thus, if the coverage provided is merely a continuation of benefits provided prior to retirement, the benefits are not retirement benefits and are permissible. For this requirement to be met coverage must be equal to or less than pre-retirement medical coverage.

Of the greatest practical concern to retiree groups is the applicability of IRCs 512(a)(3)(E) and 419A to these plans. Typically, the plan is funded with a single large payment as part of the bankruptcy settlement with creditors. If the plan is subject to the set-aside limits of IRC 512, most of its investment income will be taxable, drastically reducing the amount available for the provision of benefits. Because the bankruptcy settlement is the result of negotiation among the various creditor groups and because the retirees are usually represented by a retirees' committee which bargains for the benefits for its members, these arrangements can be viewed as collectively bargained even if no traditional labor unions are involved. IRC 419A(f)(5) states that the account limits do not apply to collectively bargained plans. Therefore, all of such a plan's investment income may be validly set aside for the payment of benefits, thus escaping taxation as unrelated business income. This ruling was made available to the public as PLR 8943009. *(**NOTE**: private letter rulings are directed only to the organization that receives them; they cannot be used or cited as precedent.)*

6. IRC 89 and Other Discrimination Issues

Almost since the moment of its enactment in section 1151 of the Tax Reform Act of 1986, IRC 89 was the subject of intense criticism by the business community. Section 1011B(a)(27)(C) of the Technical and Miscellaneous Revenue Act of 1988 amended IRC 505(a)(1) to provide that failure to meet the requirements of IRC 89 will not preclude exemption. As a result, there were no discrimination tests to be applied in the case of VEBAs providing only life and medical benefits.

Section 528 of H. R. 2989, the bill providing the Service's budget for fiscal 1990, stated that "No monies appropriated by this Act may be used to implement or enforce section 1151 of the Tax Reform Act of 1986 or the amendments made by such section." That provision has now been made moot: as part of the legislation increasing the national debt limit, IRC 89 was repealed on November 9, 1989. The legislation specifically reinstates the pre-1986 nondiscrimination rules, as though IRC 89 and related statutes had never been enacted. Therefore, we must again test VEBAs for discrimination under the rules of IRC 505 and related Code sections. This means we will once again be applying the safe harbor guidelines in the IRM to all VEBA benefits.

IRC 89(k) provided certain qualification requirements for VEBAs, including requirements that the plan be in writing, be intended for the exclusive benefit of employees, etc. Even though that section has been repealed, similar requirements appear in the temporary regulations under IRC 505(c). Reg. 1.505(c)-1T, A-3, requires that the terms and conditions of eligibility for membership and the terms and conditions of eligibility for benefits must be set forth. This information may be contained in either the organizational instrument for the entity or in a separate plan document. Insurance policies, if used, must be submitted. The benefits provided must be sufficiently described so that each benefit is definitely determinable. A benefit is definitely determinable if the amount of the benefit, its duration, and the persons eligible to receive it are ascertainable from the plan document or other instrument.

7. Disability Benefits

Not all VEBA benefits are subject to nondiscrimination rules found in some other section of the Code. Disability benefits, insured medical benefits, severance pay, and vacation pay are subject instead to the rules under IRC 505.

Disability benefits may be either long-term (LTD) or short-term (STD). STD benefits commonly have a one day (for accidents) or one week (for illness) waiting period before benefits begin. The benefits are fairly low, and are usually set at a percentage of compensation with a dollar maximum, e.g. 50% of weekly compensation up to a maximum weekly benefit of $150. Benefits usually continue for six months, although some plans pay benefits for a shorter period. LTD benefits commonly have a six month waiting period before benefits begin. A typical plan would call for benefits equal to 60% of monthly compensation, with a maximum benefit of $3000 per month. LTD benefits are commonly offset by Social Security disability benefits, as well as other disability benefits.

Discrimination with respect to STD benefits usually arises in circumstances where some employees receive STD benefits and some receive a more generous sick pay plan that pays 100% of salary, with no waiting period. If highly-compensated employees make up more than half of the group receiving the sick pay benefit, and if sick pay is funded through the VEBA, exemption is precluded. If, on the other hand, the sick pay benefit is provided by the employer directly to the employees without passing through the VEBA, there is no basis for denying exemption to the VEBA.

Discrimination problems can arise with respect to eligibility requirements, benefit amounts, waiting periods, duration of payments, offsets, and other factors, such as the definition of disability.

Often, LTD plans are limited to salaried employees. If they are funded entirely by employee contributions, a favorable ruling is probably appropriate, since the plan is not employer funded. If the employer pays all or part of the cost, further inquiry is necessary. A reasonable approach would be to determine what percentage of eligible employees are highly compensated employees (within the meaning of IRC 414(q)). If the percentage is less than 50%, the plan should be considered nondiscriminatory as to eligibility.

If differences exist with respect to the amount of benefit, duration, or waiting periods, an analysis similar to that described in the preceding paragraph should be carried out with respect to the group receiving the best benefit. If the percentage of highly compensated employees in the most favored group is less than fifty percent, then the plan should be considered nondiscriminatory as to benefits.

Finally, some LTD plans provide different definitions of disability for different groups of employees. Typically, the definition of "totally disabled" for rank and file employees will be something similar to "unable to perform his regular work or any other work for which he is reasonably fitted by training or experience." The definition of "totally disabled" for the group that includes all of the highly compensated employees will be something similar to "unable to perform his regular work." Unless at least 50% of the favored group consists of non-highly compensated employees this is discrimination in favor of highly compensated employees and precludes exemption under IRC 501(c)(9).

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1990 UPDATE

Editor's Note: In late 1990 the IRS updated each topic that came out in early 1990 in its Exempt Organizations Continuing Professional Education Technical Instruction Program textbook for 1990. As a result, what you have already read contains the topic as it was set forth in early 1990; what you are about to read is the 1990 update to that topic. We believe combining each text topic with its update will both improve and speed your research.

I. VEBA UPDATE

1. Court Cases

In Lima Surgical Associates, Inc. Voluntary Employees' Beneficiary Plan Trust v. U.S., No. 72-86T (June 15, 1990), the Court of Claims found in favor of the government's position that the VEBA in question did not qualify for exemption under section 501(c)(9) of the Code. In this case, the trust provided severance benefits to seven employees of a medical practice, three of whom were the doctors who were the sole shareholders of the employer corporation. Benefits were payable upon termination of employment for any reason other than death or termination for cause. The trust was created subsequent to the termination of the employer's pension plan. Benefits were based on a combination of compensation and years of service, with the three doctors entitled to 95% of the benefits. Benefits were actually paid to one (non-physician) employee upon her retirement. A bank was named as trustee of the Trust, but the employer (and therefore the physician-shareholders) retained ultimate control over all operations of the Trust.

The Service, in denying exemption to the Trust, relied on three grounds, all of which were sustained by the Court. First, the Court held that the "control test" of Reg. 1.501(c)(9)-2(c)(3) was not satisfied because the employer, not the bank trustee, actually controlled the Trust. Furthermore, the Trust could not be deemed to be controlled by the employees as an employee welfare benefit plan under ERISA section 3(1) because it was in fact a pension plan. It is important to note that the provisions in the Trust which caused the Court to conclude that the employer controlled the Trust are standard provisions found in most VEBA trust instruments.

The second ground for denial of exemption was the nature of the benefits themselves. Because the benefits could be payable upon retirement, the Court concluded that the ERISA definition of a "severance pay benefit" at 29 CFR 2510.3-2(b) was not met. The Court stated that "any payment that is necessitated by the employee's retirement, be it voluntary or mandatory, does not qualify for treatment as a severance benefit...."

The third ground for denial was inurement. The Service had used the usual limited membership VEBA rationale in denying exemption. That is, a dominant share of the benefits (95%) would be paid to the three highly compensated shareholder-employees who controlled the employer. The Court, on the other hand, held that the benefits were clearly not based on a uniform percentage of compensation because length of service was also a factor in the benefit calculation. The Court therefore concluded that the plan provided for disproportionate benefits to highly compensated employees, resulting in inurement to the shareholder employees.

In Uniformed Services Benefit Association v. U.S., No. 88-0234CV-W-6 (W.D. Mo. Jan. 3, 1990), the District Court for the Western District of Missouri upheld the Government's position and ruled that a VEBA's purchase of an office building more than twice as large as it needed resulted in unrelated business taxable income. To make this purchase, the VEBA used funds previously set aside for the payment of benefits. At the time of the purchase in 1978, the VEBA used only 25% of the space in the building and rented the remainder to unrelated tenants. At the same time, the VEBA purchased additional computer capacity which that year exceeded its needs by 8%. The District Court agreed with the principle expressed in Cotter and Co. v. U.S., 765 F.2d 1102 (Fed Cir. 1985) that reasonable provision for anticipated growth should not be penalized, but concluded that the VEBA's purchase of excess office space which was not absorbed ten years after purchase did not fall within the realm of that principle. The VEBA was therefore liable for tax on the amount expended to purchase the excess office space. The Court determined that the "excess" should be determined by comparing the funds actually expended to the lowest price at which the VEBA could have purchased space that came close to meeting its criteria. However, the Court also ruled that the VEBA was entitled to a refund on the tax assessed on the marginal amount of excess computer capacity.

2. GCMs

On May 9, 1990 the Service released GCM 39817. The GCM concluded that an area encompassing an entire state may be viewed as a qualifying "geographic locale" for purposes of section 1.501(c)(9)-2(a)(1) of the regulations. The GCM also expressly declined to consider whether worker's compensation could be considered an "other benefit" under section 1.501(c)(9)-3(d), concluding instead that ". . . the mere existence of worker's compensation alone does not warrant denial of exemption to an otherwise qualified VEBA." The payment of a "de minimis" or insubstantial amount of worker's compensation does not warrant denial of exemption to an otherwise qualified IRC 501(c)(9) trust.

On May 10, 1990 the Service released GCM 39818. The GCM concluded that the inurement prohibition under section 501(c)(9) precludes the granting of exemption to an organization which provides a dominant share of aggregate benefits to a single highly compensated owner-employee where that same owner-employee maintains effective control over the VEBA. Under these circumstances, distribution of assets upon termination of the VEBA would constitute nonqualifying deferred compensation benefits.

3. Proposed Legislation

A VEBA that provides for the payment of life, sick, accident, or other similar benefits to its members, their dependents, or designated beneficiaries may qualify for exemption from income taxation if certain requirements are met. Under the regulations, one of these requirements is that the members have an employment-related common bond determined by reference to objective standards. Employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to have an employment-related common bond. The Internal Revenue Service has taken the position that the geographic locale requirement is not met if membership in a VEBA is available on a multi-state basis to employees whose sole common bond is their employment with unaffiliated employers that are members of a trade association (unless the multi-state area is a single metropolitan area or similarly restricted geographic locale). See the extensive discussion of this issue in the 1989 CPE text. Proposed legislation now under consideration would eliminate the geographic locale restriction contained in the regulations.

Present law imposes limits on the deductibility of contributions to certain welfare benefit funds, including VEBAs. These limitations generally do not apply to VEBAs which are part of a 10-or-more employer plan. A 10-or-more employer plan is defined as a plan to which more than 1 employer contributes and to which no employer normally contributes more than 10 percent of the total annual contributions under the plan.

In general, income set aside by a VEBA to provide for the payment of life, sick, accident, or certain other benefits generally is subject to tax as unrelated business income to the extent that such amounts exceed the account limits established by section 419A of the Code or the amount necessary to meet the costs of providing current coverage and for permissible adjustments for existing excess reserves. The limit on permissible set-asides applies without regard to whether or not the VEBA is a 10-or-more employer VEBA. Proposed legislation now under consideration would change the definition of a 10-or-more employer plan. Under the proposal, the 10-percent contribution limit would be increased to 25-percent if the plan had more than 15 contributing employers. Finally, 10-or-more employer plans would not be subject to the rule treating excess set-asides as unrelated business taxable income.

Both of these changes would be effective for years beginning after December 31, 1989.