INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 08, 2004

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-116814-04

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

VEBA Trust =

Bank O =

Bank P =

Bank Q =

Consultant R =

Consultant S	=
Law Firm T	=
Life Company U	=
v	=
x	=
z	=
Actuary W	=
State A	=
State B	=
Month D	=
Month E	=
Month F	=
Month H	=
Month L	=
Month M	=
Month N	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=

Year 8 =

Year 9 =
Year 10 =

Year 11 =

Year 12 =

ISSUES:

(1) Whether § 264(a)(1) of the Internal Revenue Code prevents Taxpayer from deducting contributions to a Voluntary Employees Benefit Association Trust (VEBA Trust or VEBA) that are used to purchase life insurance policies, the proceeds from which are used by the VEBA Trust to fund certain post-retirement benefits provided by Taxpayer to its employees?

(2) Whether Taxpayer is "directly or indirectly a beneficiary" of the life insurance policies purchased by the VEBA Trust within the meaning of § 264(a)(1)?

(3) Whether § 419 allows a deduction for Taxpayer's contributions to the VEBA Trust to provide a reserve fund for post-retirement medical and life insurance benefits when such reserve funds are invested by the VEBA Trust in life insurance contracts on employees of Taxpayer?

CONCLUSIONS:

(1) We found no agency, conduit, or other relationship to attribute the premium payments of the VEBA to Taxpayer. Therefore, Taxpayer is not viewed as paying insurance premiums within the meaning of § 1.264-1(a) of the Income Tax Regulations. Accordingly, § 264(a)(1) does not prevent Taxpayer from deducting contributions to a VEBA Trust that are used to purchase life insurance policies, the proceeds of which are used by the VEBA Trust to fund certain post-retirement benefits provide by Taxpayer to its employees.

(2) Because we have concluded under ISSUE 1 that § 264(a)(1) does not apply to Taxpayer in the present case, an examination of this second requirement is unnecessary. Accordingly, no opinion is expressed on this issue.

(3) In view of the conclusion under ISSUE 1, no opinion is expressed on this issue.

FACTS:

Taxpayer is a State A corporation engaged in a variety of businesses. Taxpayer maintains a group medical plan and a self-funded death benefit plan (hereinafter the Plan) for employees, retired employees and their dependents. Prior to the establishment of the Voluntary Employees' Beneficiary Association (VEBA), the Plan was maintained as a direct obligation of Taxpayer with benefit payments made from the general assets of Taxpayer. With the establishment of the VEBA Trust, Taxpayer remains obligated for benefits under the Plan but with benefit payments made from the funds of the VEBA Trust.

Taxpayer states that the Plan is an employee welfare benefit plan subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Section 3(1) of ERISA, 29 U.S.C. § 1002(1). ERISA and State A Corporation Law impose fiduciary responsibilities for employee benefit plans.

In Month M of Year 1, the Board established the Employee Benefits Administrative Committee (Administrative Committee) and the Employee Benefits Investment Committee (Investment Committee) in order to carry out its fiduciary responsibilities.

The duties of the Administrative Committee include developing, implementing and periodically reviewing procedures necessary to ensure that all of Taxpayer's ERISA employee benefit plans are being administered in accordance with the terms of each plan and applicable law. The duties of the investment committee include developing investment guidelines for funded benefit plan assets and monitoring the performance of plan investments.

Each committee could, in turn, delegate specific duties and functions to groups within Taxpayer. In the present case, Human Resources was delegated the responsibility to administer all welfare plans. The Corporate Treasurer was given the responsibility of administering the investment of fund assets. Even though these two committees consist of employees of Taxpayer, these delegated duties and functions are performed solely in the best interests of the Plan participants as required by ERISA.

Since the Plan's inception, it has undergone numerous amendments. In Years 2 and 3, benefit levels under the Plan were reduced. In Years 4, 5 and 7, amendments further changed the levels of benefits provided under the Plan.

Accounting for (corporate) liabilities necessarily generated to provide the benefits under discussion had been under consideration by the Financial Accounting Standards Board (FASB) since 1979. In 1988, FASB first proposed what was ultimately to become Statement of Financial Accounting Standard No. 106 (SFAS 106). As eventually adopted, SFAS 106 required that an employer's financial statements report existing non-pension, post-retirement benefit obligations. However, it also provided that any non-pension, post-retirement benefits obligation could be offset with the value of the so-called "plan assets."

Prior to SFAS 106's adoption, obligations for Taxpayer's post-retirement welfare benefits were not pre-funded. Taxpayer recognized the cost of these benefits as they were paid.

In December of 1990, SFAS 106 was issued in final form and defines "plan assets" as "assets … that have been segregated and restricted (usually in a trust) to provide for post-retirement benefits." Plan assets include contributions by employers and by participants in a contributory plan and amounts earned on invested funds, less benefits, taxes, and other expenses incurred. Also, plan assets cannot be withdrawn by an employer except in situations where they exceed plan obligations and the employer has taken certain steps to satisfy those obligations. Amounts held in a VEBA can be considered plan assets and thus satisfy the requirements of SFAS 106.

Shortly after FASB first proposed what ultimately become SFAS 106, Taxpayer began developing a non-actuarial model to determine the financial impact of the proposed FASB accounting changes. Taxpayer, through the use of its actuaries and auditors, reviewed the proposed model.

Taxpayer considered alternative plan design changes and reviewed the projected financial impact of SFAS 106. As set forth above, SFAS 106 allowed for qualified offsetting assets.

Taxpayer concluded that, without offsetting assets, its financial statements would bear the full impact of SFAS 106. As such, liabilities would significantly increase and earnings per share would significantly decrease. The implementation of a funding plan would reduce the rate of increase of this liability and would also reduce the negative impact on earnings per share. Taxpayer determined that a funding plan would minimize the need to further reduce costs though the additional shifting of costs to retirees or through elimination of post-retirement welfare benefits altogether.

In Year 6, Taxpayer adopted SFAS 106 and reported an actuarially determined transaction obligation of approximately x dollars.

In Year 4, in anticipation of adopting SFAS 106, Taxpayer initiated a process to solicit and evaluate various options for funding its projected post-retirement welfare benefits. From Year 4 to Year 6, Taxpayer's treasury staff reviewed many proposals for funding those benefits.

In late Year 5, a formal task force developed a set of objectives for funding/financing which were approved by senior management. These were reaffirmed in the summer of Year 6 and the summer/fall of Year 7. The objectives were: (1) offset to SFAS 106 liability and expense, (2) contributions to be tax deductible, (3) cash flow thrown off to eventually pay benefits, and (4) retain flexibility in plan design.

In Month D of Year 6, Taxpayer solicited funding proposals to offset the anticipated SFAS 106 liability from several brokers.

In Month E of Year 6, Consultant R responded to Taxpayer's solicitations. In discussing the possibility of using a VEBA, the following was pointed out in Consultant R's proposal:

> The most likely investments for the VEBA are marketable securities and permanent life insurance. Since VEBA income is subject to unrelated business income tax under IRC §§ 511 and 512, permanent life insurance can produce significantly higher *after-tax* returns than marketable securities. Therefore, [Consultant R] recommends permanent life insurance as a VEBA investment to the extent that short-term liquidity needs can be met.

In Month L of Year 7, the task force recommended that the funding proposal submitted by Consultant R to Taxpayer's Board be accepted.

The proposal to fund the post-retirement welfare benefits designed by Consultant R incorporated a number of elements. Generally, Consultant R's proposal would establish a trust to fund those benefits. The trust together with the plan would constitute a VEBA under § 501(c)(9) of the Code. The VEBA Trust would purchase life insurance policies on the lives of certain key employees of Taxpayer. The trust-owned life insurance would be the primary investment of the VEBA's reserves for the benefits. Beginning in Year 8, Taxpayer would sufficiently fund the VEBA reserve so that the combination of the VEBA Trust contributions and VEBA Trust earnings would eventually offset the liability created by the SFAS 106 benefits accrual.

Consultant R's proposal also stated that the life insurance cash values would accumulate on a deferred tax basis and, as pointed out above, would not (in Consultant R's view) be subject to the unrelated business income tax (UBIT) under §§ 511-512. The tax deferred earnings from the policies would ultimately be paid to the VEBA as tax free benefits under § 101(a).

To maximize investment results, the VEBA Trust would use individual variable life insurance contracts and would hold the life insurance policies of each insured to mortality (the death of the individual insured employee). Further, according to the proposal, Taxpayer's contributions to the VEBA Trust would be deductible. The proposal projected that this would generate cash flow sufficient to pay for the non-pension, post-retirement benefits.

A formal presentation of the proposed funding arrangement for the SFAS 106 liability was made to Taxpayer's Board in Month L of Year 7. The Board approved the arrangement as recommended above.

To implement the funding arrangement, in Month N of Year 7, the Taxpayer's Board through resolution, appointed Bank O as the trustee of the VEBA Trust (Trustee). The Board appointed Taxpayer's Vice-President and Treasurer as a Fiduciary for the Plan and to authorize him to execute the VEBA Trust document. The Board also resolved that Taxpayer's Administrative Committee would direct the Trustee in all matters pertaining to the investment of the funds in the VEBA Trust.

The issuer of the policies would be Life Company U, a State B corporation licensed to conduct life insurance business in State A. The policies purchased would be individual variable life insurance contracts. The v employees were asked to voluntarily sign consents. These consents were secured during Month N of Year 7.

In authorizing the Trustee to apply for life insurance on their lives, the employees, through the consents, acknowledged that Taxpayer had decided to pre-fund a portion of its non-pension, post-retirement benefits through the VEBA Trust. The employees also acknowledged that they would not receive any direct benefit from these policies and that all proceeds would be used to pay the non-pension, post-retirement benefits.

In Month N of Year 7, Consultant R received a legal opinion from the T Law Firm. Among other things, the opinion concluded that certain senior employees would qualify as "key employees" for purposes of the "insurable interest" provisions of State A law. The memo also opined that the VEBA Trust would succeed to Taxpayer's insurable interest in these employees. Additionally, T Law Firm's legal opinion pointed out the following:

> The trustee of the VEBA, [Bank P], will have powers and responsibilities that are largely "ministerial," i.e., [Taxpayer] will exercise control over the VEBA to the extent consistent with State A and federal law.

In Month E of Year 8, the VEBA Trust Agreement was executed between Taxpayer and Bank P (as successor to Bank O).

The Assistant Secretary for Taxpayer certified that as of Month N of Year 7 certain resolutions were adopted by the Board. First, Bank P was appointed the Trustee for Taxpayer's VEBA. Second, Taxpayer's Vice-President and Treasurer was appointed Named Fiduciary of Taxpayer's Plans. He was also authorized to execute the VEBA trust documents between Taxpayer and Bank P. Third, the Administrative Committee was authorized to direct Bank P in all administrative matters pertaining to the VEBA and payment of the non-pension, post-retirement benefits. Finally, the Investment Committee was authorized to direct the Trustee in all investment matters pertaining to the VEBA.

Consultant R sent Taxpayer's Vice-President and Treasurer a letter advising him, in his capacity as the named fiduciary, among other things, that Consultant R would receive sales commissions on the premiums. Also Life Company U had agreed to impose no surrender charges during the first five years of the contracts.

Taxpayer's Vice-President and Treasurer, as Named Fiduciary, wrote to Life Company U designating Life Company U as investment manager of the assets held that funded the non-pension, post-retirement benefits of Taxpayer's plan.

In Month F of Year 8, applications for insurance in the names of individual employees of Taxpayer were submitted to Life Company U. The application for insurance included the following elements: (1) 70% of the net premiums were to be invested in stock; 30% in bonds; (2) the owner of the policy was to be Bank P as Trustee; (3) premiums were to be billed annually; and (4) the beneficiary of the policy was to be Bank P.

Taxpayer applied for tax-exempt status for the VEBA Trust in Month M of Year 9 and the VEBA Trust was granted tax-exempt status under § 501(c)(9) in Month H of Year 10.

The deductions claimed by Taxpayer in each of the first five taxable years of the VEBA Trust's existence consisted of essentially two elements: actual cash expenditures for benefits and a z dollar contribution to the Post Retirement Medical and Life Insurance Benefits Reserve.

The annual premium for the life insurance policies was z dollars. In each of its tax Years 8 though 12, Taxpayer made an actual cash contribution to the VEBA Trust of z dollars. These contributions were, in turn, immediately used by the VEBA Trust to pay the premiums on the life insurance policies.

On an annual basis, Consultant R or Consultant S would send a letter to Taxpayer's Director, Benefits Finance, enclosing the life insurance premium notice for the VEBA policies. The letter instructed Taxpayer to remit the premium to the Trustee. The Trustee was then to wire transfer the funds to a designated Life Company U account. In a subsequent letter, Taxpayer directed the Trustee to wire transfer the premium payments to the designated Life Company U account at Bank Q.

Actuary W determined the account limit for the reserve for post-retirement medical and life benefits as of the end of Years 8, 9, 10, 11 and 12. It is our understanding for the purposes of this technical advice that the account limit was determined correctly under the rules of § 419A(c)(2) of the Code, that the contributions made each year did not cause the amount in the qualified asset account to exceed the account limit for that year, and that there is no issue with regard to Taxpayer's contributions exceeding the qualified cost. Taxpayer claimed a deduction each year for the amounts contributed. During those years the account grew significantly.

The examining agent proposes to deny Taxpayer's claimed deduction of the annual z dollar amounts paid to the VEBA to fund the post-retirement medical and life benefits reserve. Inter alia, the examining agent contends that the contributions made by Taxpayer to the VEBA Trust were intended and did pay annual premiums on life insurance policies which implicates § 264(a)(1) (dealing with certain amounts paid in connection with life insurance contracts) in such a way that causes the amounts paid by Taxpayer to the VEBA to not be deductible.

Taxpayer, inter alia, urges that the examining agent is inappropriately focusing on the fact that Bank P, is a directed trustee, receiving its instructions with respect to investment and administrative matters from Taxpayer (or from committees, departments, or employees of Taxpayer). Taxpayer argues that it is error to view Taxpayer's control over the VEBA as somehow transforming the VEBA Trust's investment in life insurance policies as an investment by Taxpayer in life insurance policies. Taxpayer, thus, urges that the form of transactions with the VEBA Trust have substance and that § 264(a)(1) is not implicated because Taxpayer made a deductible contribution to the VEBA Trust and the VEBA Trust, as a separate entity, purchased the life insurance contracts.

LAW

Section 162(a) of the Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162-10 of the Income Tax Regulations provides, generally, that amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, are deductible under § 162 if they are ordinary and necessary expenses of the trade or business. However, §1.162-10T of the regulations provides, at Q&A-2, that § 419 shall govern the deduction of contributions paid or accrued by an employer with respect to a welfare benefit fund after December 31, 1985, in taxable years of employers ending after that date.

Section 264(a)(1) of the Code provides that no deduction shall be allowed 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.

Section 1.264-1(a) of the regulations provides, in part, that premiums paid by a taxpayer on a life insurance policy are not deductible from the taxpayer's gross income, even though they would otherwise be deductible as trade or business expenses, if they are paid on a life insurance policy covering the life of any officer or employee of the taxpayer, or any person (including the taxpayer) who is financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary of the policy.

Section 419(a) of the Code provides that contributions paid or accrued by an employer to a welfare benefit fund –

(1) shall not be deductible under this chapter, but

(2) if they would be otherwise be deductible, shall (subject to the limitation of subsection (b)) be deductible under this section for the taxable year in which paid.

Section 419(b) of the Code provides that the amount of the deduction allowable under § 419(a)(2) for any taxable year shall not exceed the welfare benefit fund's qualified cost for the taxable year.

Section 419(c) provides, in relevant part, that for purposes of § 419 -

(1) IN GENERAL. - Except as otherwise provided in § 419(c), the term "qualified cost" means, with respect to any taxable year, the sum of –

(A) the qualified direct cost for such taxable year, and

(B) subject to the limitation of § 419A(b), any addition to a qualified asset account for the taxable year.

(2) REDUCTION FOR FUNDS AFTER-TAX INCOME. - In the case of any welfare benefit fund, the qualified cost for any taxable year shall be reduced by the fund's after-tax income for the taxable year.

(3) QUALIFIED DIRECT COST.-

(A) IN GENERAL. – The term "qualified direct cost" means, with respect to any taxable year, the aggregate amount (including administrative expenses) which would have been allowable as a deduction to the employer with respect to the benefits provided during the taxable year, if-

(i) such benefits were provided directly by the employer, and

(ii) the employer used the cash receipts and disbursements method of accounting.

(B) TIME WHEN BENEFITS PROVIDED. – For purposes of subparagraph (A), a benefit shall be treated as provided when the benefit would be includible in the gross income of the employee if provided directly by the employer (or would be so includible but for any provision of this chapter excluding such benefit from gross income).

Section 419A(a) provides that the term “qualified asset account” means any account consisting of assets set aside for the payment of disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits.

Section 419A(b) provides that no addition to any qualified asset account may be taken into account under §419(c)(1)(B) to the extent the addition results in the amount in the account exceeding the account limit.

Section 419A(c)(1) provides that the account limit for any qualified asset account for any taxable year is generally the amount reasonable and actuarially necessary to fund claims incurred but unpaid (as of the close of the taxable year) for benefits referred to in § 419A(a), and administrative costs with respect to those claims.

Section 419A(c)(2) provides that the account limit for any taxable year may include an additional reserve for post-retirement medical and life insurance benefits. The additional reserve must be funded over the working lives of the covered employees and actuarially determined on a level basis (using assumptions that are reasonable in the aggregate) as necessary for those benefits.

ANALYSIS

ISSUE 1

Overview

Section 264(a)(1) and § 1.264-1(a) require that the taxpayer to whom the section is potentially applicable must have paid the insurance premiums. If the taxpayer has paid the premiums, then the next issue is whether the taxpayer is a direct or indirect beneficiary of the insurance proceeds. We understand that the question being asked in ISSUE 1 is whether Taxpayer’s payment of contributions constitutes the payment of premiums within the meaning of § 264. In this case Taxpayer did not pay the premiums to the insurance company. A separate taxpayer, the VEBA, paid the premiums. Thus, our first task is to analyze on what basis the action of the VEBA can be attributed to Taxpayer and transform the VEBA investment into a Taxpayer investment.

The examining agent, in applying § 264 to deny any deduction to Taxpayer for its contributions to the VEBA, argues that Taxpayer’s payments come within the scope of § 264(a)(1) and/or that the contributions were part of an overall plan to buy insurance with the VEBA acting as a conduit for Taxpayer. In general, the examining agent’s basis for denying the Taxpayer’s deductions under § 264 is that (1) Taxpayer’s contributions to the VEBA were part of Taxpayer’s plan to invest in life insurance through the VEBA, or (2) Taxpayer controlled the VEBA, or (3) the VEBA Trust should be treated as a conduit for purposes of § 264.

The examining agent points to the following actions by Taxpayer prior to establishing the VEBA as evidence of Taxpayer's control over the VEBA: Taxpayer's stated purpose in establishing the VEBA was to discharge its liabilities to its retirees; Taxpayer's accounting treatment of the contributions and VEBA income was to offset the Taxpayer's SFAS 106 liabilities; Taxpayer's intention was to direct the VEBA Trustee as to administrative and investment decisions; Taxpayer intended to fund some of the benefit obligations with life insurance and controlled this decision, in part, by obtaining "Consents to Insure" from the insured employees prior to the establishment of the VEBA.

The agent points to the following provisions in the Trust Agreement to demonstrate that the powers and responsibilities of the Trustee were "ministerial," with Taxpayer (either directly or through its Investment Committee) exercising de facto control: Taxpayer's Investment Committee's right to direct the Trustee as to fund investments and the direction to the Trustee to follow such direction insofar as possible; specific language in the Agreement stating that the Investment Committee may direct the Trustee to maintain life insurance contracts on the lives of employees covered under the Plan, with the Trustee as owner of the contracts; the Trustee's power to exercise rights and perform obligations under the insurance contracts are subject to direction from the Investment Committee; a provision stating that the exercise of the Trustee's authority and discretion shall be consistent with the funding policy of the Plan, as certified by the Plan Administrator; Taxpayer's right to remove a Trustee; and Taxpayer's right to terminate the Trust and to use any remaining assets for benefits first for employees covered under the Plan and then for other employees of Taxpayer.

The agent notes that after the VEBA was established, Taxpayer (through the Investment Committee) directed the Trustee that annual contributions to the VEBA would be specifically used, and were in fact used, to pay premiums on life insurance contracts on the v employees that Taxpayer had previously selected. Taxpayer also directed the Trustee to apply for and maintain contracts of life insurance on the lives of employees selected by Taxpayer. Further, the agent contends that each year Taxpayer controlled the VEBA's ability to invest independently by contributing only enough to satisfy the premiums due at the time the contributions were made.

The revenue agent cites to Glassner v. Commissioner, 43 T.C. 713 (1965), aff'd per curiam, 360 F.2d 33 (3^{rd} Cir. 1966), cert. denied, 385 U.S. 819 (1966); Neonatology Associates, P.A., et al v. Commissioner, 115 T.C. 43 (2000), aff'd, 299 F. 3d 221 (3^{rd} Cir. 2002); and General Signal Corporation v. Commissioner, 103 T.C. 216 (1994), aff'd, 142 F.3d 546 (2d Cir. 1998), as authority that § 264(a)(1) applies to disallow Taxpayer's deduction, even though Taxpayer did not directly pay the premium amounts to the insurance company.

Glassner

In the Glassner case, § 264 was held to apply to a taxpayer (debtor) even though the taxpayer did not pay the premiums for the life insurance contracts directly to the life insurance companies.

Glassner had a law practice and he was also president and managing officer of three corporations. The three corporations as well as Glassner borrowed funds from two individuals. Glassner guaranteed the loans of the three corporations. The three corporations went out of business without repaying the two individuals.

Glassner in order to secure his indebtedness executed two separate agreements with each of the individual creditors in which he agreed to obtain life insurance, and fund the premiums thereon, and designate each individual as beneficiary of the respective life insurance policies. Glassner made payments to each of the individual lenders and to the extent that Glassner's payments to them were insufficient the lenders paid the cost of the premiums out of their own funds. (One of the lenders opened a bank account for the express purpose of receiving Glassner's deposits and applying them toward the life insurance policies of which that lender was a beneficiary.) Glassner's motivation for entering into these agreements was so he could continue to practice law. He testified that he could not have continued the unobstructed practice of law without satisfying the lenders' demands for security.

The Tax Court stated that the issue for their decision was whether Glassner was "directly or indirectly" benefited by the premium payments he made, within the meaning of § 264(a)(1). The Court noted that while Glassner did not pay the premiums directly to the insurance companies and there was contribution toward payment by the creditors, the Tax Court considered some earlier (creditor) decisions dealing with the "directly or indirectly" benefited part of the statute to be controlling (such as Jefferson v. Helvering, 121 F.2d 16 (C.A.D.C. 1941), aff'g. 40 B.T.A. 274 (1939)[1] where the taxpayer actually paid the life insurance premiums to the insurance company). The Tax Court noted that not only did Glassner agree in writing to obtain policies and pay the premiums thereon, but he testified that he was aware that the sums he remitted were being used to pay the premiums on the life insurance policies. As to whether Glassner was directly or indirectly benefited by the policies, the Tax Court noted that he was benefited by his ability to practice law unobstructed by the demands of the creditors. In addition,

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[1] In Jefferson v. Helvering, the taxpayer was a salesman who as a member of a partnership acted as a selling agent for two mills. The mills needed further financing and the creditors desired some additional guaranty of their accounts. The taxpayer's sales position was in jeopardy as the dissolution of the partnership, his chief source of livelihood, was being considered. Accordingly, taxpayer in 1931 named the partnership the beneficiary of four insurance policies to secure his guaranty of the obligation of the two mills. The taxpayer paid the premiums on the five policies in 1935 and deducted the premiums on his tax return. The taxpayer urged that as he ceased being a beneficiary of the policy and as he was taking these actions to preserve his source of livelihood as a salesman the premium payments are deductible. The court concluded under the predecessor statute to § 264 applied because the taxpayer had a potential benefit from the policies (e.g., the mills could pay enough of their debts such that the value of the policies exceed the unpaid portion of the debt by the mills or by the taxpayer). Accordingly, the court concluded that taxpayer was unable to deduct the amounts taxpayer paid as insurance premiums.

Glassner's estate indebtedness would be reduced by the proceeds of the policies and if he managed to pay off the indebtedness, the policies would revert to him. Thus, the Tax Court concluded that any of the above considerations constituted a direct or indirect benefit within the meaning of § 264(a)(1). On the other hand, Glassner cannot correctly be cited for authority that § 264 applies broadly to situations where taxpayer did not pay the premium to the insurance company. The courts considering Glassner, without going through an agency or conduit legal analysis, assumed that for all practical purposes Glassner paid the premium.[2] Thus, Glassner is a "directly or indirectly benefited" case and not a "who" paid the premium case. Furthermore, Glassner is clearly distinguishable factually from the situation presented involving a legally separate § 501(c)(9) VEBA Trust subject to ERISA. The facts are also distinguishable because Glassner had a specific obligation to obtain life insurance, whereas Taxpayer did not; nor did Taxpayer have an obligation to contribute any amounts to the fund.

Neonatology

The Neonatology decision applies to three consolidated cases, all involving deductions taken by businesses for contributions made to a purported VEBA pursuant to separate purported welfare benefit plans. Two of the businesses were corporations, while the third was a sole proprietorship. The sole proprietorship plan participants were Dr. Lo (the proprietor), Dr. Lo's wife (who was an employee), and Edward Lo (also an employee). The Court found that Dr. Lo's participation in the plan was inconsistent with the plan terms.

The only benefit provided to participants under the VEBA plan was current-year (term) life insurance payable at a specified multiple of compensation. Each business contributed amounts to the VEBA that were grossly in excess of the cost of the current-year insurance. The VEBA would then use the contributions to purchase group insurance policies or group annuities. The contracts insuring the business owners allowed the insured, at no cost, to convert the policy when he or she left the plan to a life insurance policy with cash values that could be accessed through withdrawals or borrowing. The conversion right associated with the contracts insuring the employees who were not owners did not include the right to any cash values.

The Court found that the corporations' plans were designed primarily to distribute the excess contribution amounts for the use and benefit of the owners, rather than to provide welfare benefits to employees. The Court held that the contributions in excess of what was needed to provide current life insurance protection were disguised dividends to the shareholders/employees and were not deductible by the corporations.

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[2] In addition, we note that the Eleventh Circuit in Carbine v. Commissioner, 777 F2d 662, 666 (11th Cir. 1985) in summarizing the Glassner case described the taxpayer in that case as obtaining the insurance and paying the premiums. ("In Glassner, the taxpayer, in order to secure his indebtedness, obtained life insurance, paid the premiums thereon, designated his creditors as beneficiaries, and gave his creditors exclusive control over the policies.")

With respect to the sole proprietorship, the Court concluded that because Dr. Lo was neither an employee nor an individual eligible to participate in the plan, the contributions on his behalf served no legitimate business purpose and, hence, were not ordinary and necessary business expenses deductible under § 162. As to the other two participants in that plan, the Court held that § 264(a)(1) prevented the Schedule C deduction for amounts paid for their term life insurance policies because it found that Dr. Lo was "directly or indirectly a beneficiary" of the policies insuring those participants, even though the plan was the named beneficiary of those policies. For purposes of making this determination, the Court viewed the business, a sole proprietorship, as an alter ego of Dr. Lo, the sole proprietor. The Court reasoned that in the event of the death of one of the participants, the face value of the policy would be paid to the plan, for which Dr. Lo was a beneficiary. The insurance proceeds could be used by the Plan to pay the premiums on Dr. Lo's policy and the policy of the other participant, thus satisfying the obligation of the business to do so. The Court did not specifically address the issue of whether Dr. Lo had paid the premiums for purposes of § 264(a)(1) of the Code and § 1.264-1(a) of the regulations, rather than the so-called VEBA Trust.

The examining agent apparently sees the Neonatology decision as authority for concluding that the fact that the VEBA, not Taxpayer, actually paid the premiums on the life insurance policies should be ignored for purposes of § 264(a)(1), i.e., the fact that Taxpayer's contributions were intended to and did pay premiums on life insurance purchased by the VEBA to fund Taxpayer's benefit obligations is enough to deny the deduction under § 264.

Several things distinguish the corporate taxpayer and its Plan in the case under examination from the sole proprietorship taxpayer and his plan in the Neonatology decision. The primary purpose of the Plan in the instant case is, undisputedly, to provide welfare benefits to employees, while the primary purpose of the plans in Neonatology was to distribute amounts that were contributed to the trust to the owners. Further, Taxpayer here is a corporation. Because Dr. Lo did business as a sole proprietorship, the Tax Court viewed the business as his alter ego. While the Court was silent on this issue, the Court may have reasoned that the trust set up for Dr. Lo and his employees was merely a conduit for distributing money from the business to its owner and should not be viewed as a separate entity for purposes of § 264. As discussed in detail below, the VEBA Trust here is not such a conduit for Taxpayer. Therefore, in view of the lack of specific language by the Court on this, and in view of the differences as to the type of taxpayer and the type of plan involved in Neonatology, we do not believe that this case provides authority for the proposition that Taxpayer, rather than the VEBA, should be treated as paying the premium amounts for purposes of § 264(a)(1) of the Code or § 1.264-1(a) of the regulations. Nor do we believe that this case provides authority for the proposition that, merely because Taxpayer's contributions were used by the Trustee to purchase life insurance, Taxpayer's contributions to the VEBA were premium payments for purposes of § 264(a)(1).

General Signal

The examining agent cites to General Signal, supra, as support for the argument that Taxpayer's deduction is precluded by § 264(a)(1). The General Signal decision addresses the meaning of the term "reserve" for purposes of § 419A(c)(2) of the Code -- specifically, whether that provision requires that funds contributed to a reserve for post-retirement benefits be intended actually to accumulate for those benefits. The taxpayer in that case had argued that § 419A(c)(2) allows the deduction even if the contributions are spendable on benefits other than the post-retirement benefits. The Tax Court held that contributions to a reserve are deductible only where they are intended to actually accumulate for the purpose of funding the post-retirement benefits. In making its determination, the Court relied heavily on the plain language used in § 419A(c)(2) to determine the meaning of "reserve," and found that the plain language was supported by the legislative history.

The General Signal holding is not helpful to our analysis of the issue here. The plain language of § 264(a)(1) does not inherently address the "intent" issue presented here, i.e. , whether contributions paid to a VEBA by an employer, which the employer intends will be used by the VEBA to purchase life insurance contracts, are treated as premiums paid by an employer for purposes of that Code provision. While the employer's intent in making the contribution may be one relevant factor in that determination, it is not, by itself, determinative.

Fiduciary Functions and Obligations

The VEBA in the present case was established for the purpose of providing medical and life insurance benefits for active employees and retirees of Taxpayer under Taxpayer's Plan. Taxpayer states, and the examining agent does not dispute, that the Plan is an employee welfare benefit plan subject to the provisions of Title I of ERISA. ERISA imposes fiduciary responsibilities on various parties associated with the Plan.

According to the examining agent, consideration of the ERISA fiduciary provisions is not appropriate for determining whether § 264(a)(1) precludes Taxpayer's tax deductions. As support, the agent directs us to Carman v. Parsons, 789 F.2d 1532 (11^{th} Cir. 1986) (involving the immunity of a vacation fund trust and its trustees from ERISA liability when complying with an IRS levy, by virtue of § 6332 of the Code). The plaintiff in that case, a plan participant, had argued that the trustees, by transferring funds to the IRS, violated his rights under ERISA. The Court held that the trustees were immune from liability under ERISA by virtue of § 6332.

The agent contends that the Carman case demonstrates that the Commissioner, in administering the tax law, is not limited by ERISA -- that tax compliance, not fiduciary duty is at issue here. We do not agree. Unlike the situation in Carman where the ERISA statute directly contravened the plain language of § 6332, here the ERISA provisions are being considered merely to shed light on the relationship of Taxpayer and the Trustee, not to limit or to contravene the tax law.

The agent also directs us to language in the Third Circuit Court of Appeals opinion in the Neonatology case, supra, where the taxpayer had argued that the purported VEBA programs were subject to ERISA and, accordingly, the Court could only consider the written plan documents in determining whether excess contribution amounts were ordinary and necessary business expenses for purposes of § 162 of the Code. While declining to determine whether the plan was, in fact, subject to ERISA, the Court nevertheless noted that under well-established tax principles a court is not limited to plan documents in determining the tax consequences of a transaction. The Court cited to a number of cases involving the substance-over-form doctrine and noted in a footnote that the Tax Court had found that the form of the VEBA in that case was not reflective of its genuine substance. 299 F.3d 221, 231.

In that same case, the taxpayer arguing that the Tax Court had erred in determining that the excess contributions constituted dividends rather than compensation, relied on non-tax ERISA jurisprudence for the proposition that payments made pursuant to an employee benefit plan are necessarily compensatory. The Court of Appeals stated that the plain language of § 419(a)(2) of the Code explicitly contemplates situations where contributions to a welfare benefit fund are not deductible (deduction allowed only if they would otherwise be deductible). "To read otherwise inexplicably creates a shelter loophole by allowing taxpayers to transform disbursements into deductible business expenses merely by funneling them through the ERISA plan." Id. at 232. The Court, at 232, further stated:

> We recognize that is axiomatic that taxpayers lawfully may arrange their affairs to keep taxes as low as possible. Nevertheless, at the same time the law imposes certain threshold duties which a taxpayer may not shirk simply by manipulating figures or maneuvering assets to conceal their real character. (Footnote omitted.)

The Taxpayer's argument in Neonatology was that the Court could not go beyond consideration of ERISA in determining the nature of the transaction in issue. We do not read the Third Circuit's opinion as precluding consideration of ERISA as part of the factual landscape. Instead we read the opinion as emphasizing the principle that in determining tax liability all relevant facts and circumstances should be considered. In this case, we are trying to determine whether Taxpayer's contributions to the VEBA were, in substance, the payment of premiums. There is no dispute here that the Plan is subject to ERISA and no suggestion that Taxpayer has, in any way, breached its fiduciary duties under ERISA. Accordingly, the following ERISA provisions are relevant for determining the issue in this case.

Pursuant to ERISA Section 403(a), all assets of an employee welfare benefit plan must generally be held in trust by one or more trustees named in either the trust or the plan instrument. Subject to very limited exceptions, the assets of a plan can never inure to the benefit of any employer, but must be held for the exclusive purposes of providing benefits to participants and defraying reasonable expenses of administering the plan. ERISA Section 403(c)(1).

In general, an ERISA trustee has exclusive authority and discretion to manage and control the plan assets. However, the plan can expressly subject the trustees to the direction of a named fiduciary, and the plan can delegate to one or more investment managers the authority to manage, acquire, or dispose of plan assets. Thus, ERISA permits a plan to have financial institutions as "directed trustees" that have no discretionary investment authority and take their investment directions from other fiduciaries.

ERISA imposes fiduciary responsibilities for employee benefit plans. Section (3)(21)(A) provides that, generally, a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. The term also includes a person designated by a named fiduciary to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan, pursuant to ERISA Section 405(c)(1)(B). A fiduciary is required to discharge his duties with respect to a plan solely in the interests of the participants and beneficiaries. ERISA Section 404(a)(1).

ERISA contemplates that a person can act in two capacities with respect to a plan. However, ERISA requires that the fiduciary with two hats wear only one at a time, and wear the fiduciary hat when making fiduciary decisions. See Pegram v. Herdrich, 530 U.S. 211, 225 (2000); Hughes Aircraft Co. v. Jacobson, 525 U.S. 432, 443-444 (1999). See also, Phillips v. Amoco Oil Co., 799 F. 2d 1464, 1471 (11th Cir. 1986) (an employer can act in a dual capacity as both a fiduciary to the plan and as employer, and the employer can act in accordance with its interests as employer when not administering the plan or investing its assets); Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982), cert. denied, 459 U.S. 1069 (1992) (corporate executives who serve as trustees to a plan do not violate their duties with respect to a plan by taking action which, after careful and impartial investigation, they reasonably conclude best promotes the interests of participants and beneficiaries simply because the action incidentally benefits the corporation; however, their decisions must be made with an eye single to the interests of the participants and beneficiaries); In re Enron Corporation Securities, Derivative & "ERISA" Litigation, 284 F. Supp. 2d 511, 546, 550, 551 (D.C. S.D. Texas 2003) (an ERISA trustee may wear many hats, although only one at a time, and may have financial interests that are adverse to the interests of the beneficiaries but in the best interest of the company; however, when making fiduciary decisions, a fiduciary may wear only his fiduciary hat).

The examining agent and Taxpayer agree that Taxpayer, its Board, and its employees on the various Committees all come within the ERISA definition of "fiduciary". As ERISA fiduciaries, they are required to discharge their duties with respect to the Plan solely in the interests of the VEBA participants and beneficiaries. Thus, Taxpayer, the Board, the Investment Committee and all other Plan fiduciaries are required to perform their duties with respect to the plan independently of Taxpayer's interests.

In view of the fiduciary functions discussed above, we believe that Taxpayer, its Board, and the Investment Committee, in exercising control over the VEBA and in directing the Trustee to purchase the life insurance policies, were acting in their fiduciary capacities. Acting in that capacity, they could act and provide direction only in the best interest of the VEBA participants. To operate the VEBA as a mere conduit for Taxpayer's benefit would violate their duties and obligations under ERISA. Thus, absent some showing of violation of the fiduciary principles, we can find no agency, conduit, or other relationship that would equate Taxpayer's contributing amounts to the VEBA to the payment of premiums. Therefore, Taxpayer is not viewed as paying insurance premiums within the meaning of § 1.264-1(a) of the Income Tax Regulations.

Accordingly, § 264(a)(1) does not prevent Taxpayer from deducting contributions to a VEBA Trust that are used to purchase life insurance policies, the proceeds of which are used by the VEBA Trust to fund certain post-retirement benefits provide by Taxpayer to its employees.

ISSUE 2

Since we have concluded that § 264(a)(1) does not apply to Taxpayer in the present case because the premiums were not paid by Taxpayer, an examination of whether Taxpayer is directly or indirectly a beneficiary under the life insurance contracts is unnecessary. Accordingly, no opinion is expressed on this issue.

ISSUE 3

As we understand ISSUE 3, the question asked is whether a deduction would be allowed under § 419(a)(2) of the Code even if the deductions were precluded under § 264(a)(1). We have concluded in ISSUE 1 above Taxpayer's deduction is not precluded under § 264(a)(1). Accordingly, no opinion is expressed on this issue.

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.