DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
CHIEF COUNSEL

CC:TEGE:EB:HW LDMasano
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MEMORANDUM FOR ROBERT FONTENROSE
T:EO:RA:G MANAGER, EO TECHNICAL GUIDANCE &
QUALITY ASSURANCE

FROM: Janet Laufer
Senior Technician Reviewer, Qualified Plans Branch 1
Associate Chief Counsel/Division Counsel
(Tax Exempt & Government Entities)

SUBJECT: [redacted] VEBA Trust

This memorandum responds to your request for Technical Advice concerning whether [redacted] and its subsidiary, [redacted] can elect to aggregate, in accordance with § 419A(h) of the Internal Revenue Code, two welfare benefit funds for purposes of computing unrelated business taxable income (UBTI), where one fund is a voluntary employee benefits association (VEBA) exempt under section 501(c)(9) and the other is not. As described in the following paragraphs, we believe that whether aggregation between any two welfare benefit funds under § 419A(h) is permissible in any given case is a question of fact. Generally, aggregation between a VEBA and a non-exempt welfare benefit fund would be permissible if the aggregation is not inconsistent with sections 419, 419A, or 512. In this case, we believe that aggregation is not inconsistent with those sections and so is permissible.

[redacted] is a wholly owned subsidiary of [redacted] is the sponsor of a VEBA which has been recognized as exempt under § 501(c)(9) (the [redacted] VEBA). [redacted] welfare benefit plans include [redacted] and [redacted] Both of these plans are funded through the [redacted] VEBA. [redacted] maintains other welfare benefit funds that have not been recognized as exempt under § 501(c)(9). The welfare benefit funds maintained by [redacted] include a retired lives reserve for life insurance benefits, the [redacted]

For the tax year ending [redacted] [redacted] VEBA (including the retiree life insurance plan which is the major plan funded through the VEBA) initially calculated its unrelated business income tax liability without aggregating its accounts with any other of the welfare funds maintained by [redacted] The funds held in reserve in the VEBA's qualified asset account as defined in § 419A(b) substantially exceeded the

account limit set forth in § 419A(c)(1) and were taxed pursuant to the provisions of § 512(a)(3). [redacted] did not aggregate its accounts. However, [redacted] did not pay deemed unrelated income tax under section 419A(g) on the [redacted] because the qualified asset account limit was not exceeded for that welfare benefit fund.

In order to reduce the [redacted] VEBA's tax liability for the tax year, [redacted] filed amended returns for [redacted] In those amended returns, it elected to "permissively aggregate" the [redacted] VEBA and the [redacted] under § 419(h)(1)(B) and to recompute the unrelated business income tax (UBIT). This aggregation eliminated the UBIT owed by the VEBA with regard to the [redacted] for [redacted]

Section 419(a) provides that contributions paid or accrued by an employer to a welfare benefit fund (e.g., a VEBA) shall not be deductible under chapter 1 of the Code but, if they would otherwise be deductible, they shall be deductible under section 419 in the taxable year when paid, subject to the limitation contained in section 419(b).

Section 419(b) provides that the deduction allowable under section 419(a) shall not exceed the qualified cost of the welfare benefit fund for the taxable year.

Section 419(c) defines the term "qualified cost" as the sum of the qualified direct cost for the taxable year as defined under section 419(c)(3), plus the amount of any addition to a qualified asset account for the taxable year, subject to the limit contained in section 419A(b), less the after-tax income of the welfare benefit fund for the taxable year.

Section 419A(a) defines the term "qualified asset account" as any account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits.

Section 419A(b) states that no addition to a qualified asset account may be taken into account in determining the limit on the amount deductible under section 419(c) to the extent that the addition increases the amount in the account above the account limit described in section 419A(c).

Section 419A(c) sets the account limits applicable to each of the types of benefits listed in section 419A(a). In general, the account limit for each benefit is the amount reasonably and actuarially necessary to fund the claims incurred but unpaid at the close of the taxable year and the administrative costs associated with those claims. In addition, under section 419A(c)(2) of the Code, the account limit may include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis to fund the amount necessary for the payment of post-retirement medical and life insurance benefits under the plan.

The provisions of section 419A(h) contain rules for mandatory and permissive aggregation relating to welfare benefit funds maintained by the same employer. Section 419A(h)(1)(A) requires that all welfare benefit funds of an employer must be treated as one fund in applying certain limits imposed by section 419A. This aggregation requirement applies to the following statutory provisions: First, all welfare benefit funds of an employer must be aggregated in calculating the limit imposed by section 419A(c)(4)(A) on the amount of disability benefits payable to an individual and in calculating the limit imposed by section 419A(c)(4)(B) on the amount of SUB or severance pay benefits payable to any individual that may be taken into account in determining the qualified asset account limit under section 419A(c) applicable to disability, SUB, or severance pay benefits; second, all welfare benefit funds of an employer must be aggregated in applying section 419A(d)(2) to determine the amount to be treated as an annual addition to a defined contribution plan for a key employee arising out of an allocation to a separate account for post-retirement medical or life insurance benefits payable to that key employee. Finally, all welfare benefit funds of an employer must be aggregated in applying section 419A(e)(2), which imposes a limit of $50,000 on the aggregate amount of post-retirement life insurance provided to any employee that may be taken into account in calculating the amount of the reserve that the employer may fund over the working lives of the covered participants in accordance with section 419A(c)(2).

Section 419A(h)(1)(B) permits an employer, at its election, to treat two or more of its welfare benefit funds as one fund for any purpose (other than with respect to the provisions for which the mandatory aggregation rules apply) to the extent that this treatment is not inconsistent with the purposes of section 419, section 419A, or section 512.

Section 419A(g) requires that in the case of any welfare benefit fund which is not an organization described in paragraph (7), (9), (17), or (20) of section 501(c), the employer shall include in gross income for any taxable year an amount equal to such fund's deemed unrelated income for the fund's taxable year ending within the employer's taxable year. "Deemed unrelated income" is defined as the amount which would have been its unrelated business taxable income (UBTI) under section 512 (a)(3) if such fund were an organization described in section 501(c)(7), (9), (17), or (20).

Section 511(b) imposes a tax on the UBTI, as defined in section 512 of the Code, of every trust which is exempt from tax under section 501(a) and which, if it were not for such exemption, would be subject to taxation under subchapter J (relating to estates, trusts, beneficiaries, and decedents).

Section 512(a)(3) and regulation section 1.512(a)-5T, Q&A- 3 provide rules for calculating the exempt function income and UBTI of a VEBA.

Section 512(a)(3)(A) provides that, in the case of an organization described in section 501(c)(9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter that are directly connected with the production of the gross income (excluding exempt function income). Both the gross income and the deductions taken into account under this paragraph are computed with certain modifications provided in section 512(b), relating to net operating losses and charitable contributions.

Section 512(a)(3)(B) defines the term "exempt function income" as used in section 512(a)(3)(A) as the gross income from dues, fees, charges or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. The term also includes all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization) that is set aside to provide for the payment of life, sick, accident or other benefits.

Section 512(a)(3)(E) of the Code provides that, in the case of certain types of exempt organizations, including VEBAs, no amount set aside to provide for the payment of life, sick, accident or other benefits may be taken into account under section 512(a)(3)(B)(ii) to the extent that the aggregate amount set aside for these purposes exceeds the account limit determined under section 419A, reduced by any reserve for post-retirement benefits described in section 419A(c)(2)(A).

The calculation of UBTI (or deemed unrelated income) with respect to a welfare benefit fund is not among the calculations expressly subject to mandatory aggregation under section 419A(h)(1)(A). No regulations have been published prescribing specific methods of calculating UBTI or deemed UBTI in a case in which the same employer contributes to two or more welfare benefit funds covering its employees.

The legislative history of the Deficit Reduction Act of 1984 (DEFRA), under which section 419 was initially enacted, suggests that an employer could elect permissive aggregation of two welfare benefit funds for purposes of computing UBTI under section 512(a)(3)(A). While the legislative history does not specifically address permissive aggregation of VEBAs or a VEBA and a non-exempt welfare benefit fund in computing UBTI and deemed unrelated income, it does address permissive aggregation of non-exempt welfare benefit funds in computing deemed unrelated income of the fund under section 419A(g)(2). Specifically, the conference report on DEFRA states: "In determining deemed unrelated income, at the election of the employer, 2 or more non-exempt welfare benefit funds of the employer may be treated as a single fund." H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1163 (1984). Since deemed unrelated income of a welfare benefit fund is defined in section 419A(g)(2) as the amount that would have been the fund's UBTI under section 512(a)(3) if the fund were a VEBA, and

there is no indication that a different aggregation rule was intended for non-exempt welfare benefit funds than for VEBAs, we infer that Congress was assuming that an employer could elect to aggregate two or more VEBAs or one or more VEBAs and one or more non-exempt funds under section 419A(h)(1)(B) for purposes of calculating UBTI under section 512(a)(3). Additionally, a position that VEBAs could not be involved in permissive aggregation under section 419A(h)(1)(B) would be difficult to reconcile with the requirement of section 419A(h)(1)(A) for mandatory aggregation in certain specified circumstances for all welfare benefit funds of an employer (which we interpret as including VEBAs through which the employer funds employee welfare benefits).

[redacted] However, the facts and circumstances of any aggregation must indicate that such aggregation is not inconsistent with sections 419, 419A, and 512. [redacted]

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One specific argument you made against permissive aggregation between VEBAs is that, for purposes of section 512, two non-VEBA exempt organizations cannot agree to consolidate their unrelated income or expenses to achieve a better tax result even if they are controlled by a common parent exempt organization. Although consolidation under subchapter A, of chapter 6 of the Code is generally not permissible for exempt organizations, VEBAs do not present similar multi-tiered corporate structure issues that other exempt-organizations present. Additionally, section 512 of the Code treats VEBAs differently than other exempt organizations for the purpose of determining UBTI. Accordingly, we believe the general prohibition against consolidation of income for exempt organizations should not prevent permissive aggregation involving a VEBA under section 419A(h). This conclusion has been coordinated with James Brokaw, Branch Chief of CC:TEGE:EOEG:EO2, and Mike Blumenfeld of that branch.

Another argument you make against VEBAs being permitted to aggregate for UBTI determination is that, unlike nonexempt welfare benefit funds, VEBAs are entities, independent from the employer. You argue that VEBAs are employee-controlled, not employer-controlled organizations like nonexempt welfare benefit funds, so the employer should not be able to make an election under section 419A(h)(1)(B) to aggregate a VEBA with other welfare benefit funds (including other VEBAs). To support this argument you point to the requirement in section 1.501(c)(9)-2 of the regulations that VEBAs be controlled by the membership, independent trustees, or persons who exercise control on behalf of the membership. Section 1.501(c)(9)-2(c)(4), example (1) of the regulations, states that a VEBA created and substantially funded by

an employer that also permits some of the trustees to be picked by the employer and some by the collective bargaining unit would satisfy the membership control requirement. This is not much different than a nonexempt welfare benefit fund. In most cases involving a private sector employer, Title I of ERISA would apply and would require that the welfare benefit plan and any related trust be administered by trustees and other plan fiduciaries who are charged with ensuring that plan assets not inure to the benefit of an employer and are held for the exclusive purpose of providing benefits to plan participants and beneficiaries. Even where ERISA does not apply, common law trust principles and/or state trust law would require plan fiduciaries act independently of the employer in making decisions such as whether to aggregate welfare benefit funds for purposes of computing UBTI or deemed unrelated income. You also argue that because exempt VEBAs are distinct from the employer unlike nonexempt welfare benefit plans, VEBA trustees would be subject to fiduciary duties that would not allow them to use one VEBA to benefit another VEBA. However, both with VEBAs and non-exempt trusts, trustees and other plan fiduciaries would be subject to the same duties and dilemmas. Accordingly, we do not think that the requirement that a VEBA be independent from an employer should prevent permissive aggregation under section 419A(h)(1)(B) of a VEBA with a non-exempt trust.

Because section 419A(h) states aggregation of welfare benefit funds is permissible unless it is inconsistent with sections 419, 419A or 512, the presumption is that aggregation is permissible and the taxpayer need not justify the decision to aggregate. To disallow permissive aggregation, therefore, there must be specific facts in a particular case that demonstrate an inconsistency with sections 419, 419A, or 512. The underlying purpose of section 512 (as it relates to UBIT for VEBAs) and section 419A(g) (as it relates to "deemed unrelated income" for non-exempt welfare benefit funds) is to set reasonable limits on the extent to which a VEBA may accumulate income tax free. The underlying purpose of sections 419 and 419A generally is to prevent deductions taken far in advance of when benefits are paid, resulting in excessive accumulation of funds. *See* H.R. Rep. No. 432, 98th Cong., 2nd Sess., pt.2, at 1275, 1291 (1984). Where permissive aggregation in any case conflicts with these purposes, it should not be permitted.

In this case, [redacted] elected to "permissively aggregate" the [redacted] VEBA and the [redacted] under § 419(h)(1)(B) and to recompute the unrelated business income tax (UBIT). Both the [redacted] VEBA and the [redacted] fund retiree life benefits. [redacted] elected to aggregate similar types of reserves in two different welfare benefit plans offering the same type of benefits. This aggregation does not allow excess accumulation of income in either the [redacted] VEBA or the [redacted] it simply combines accounting figures for tax computation. Accordingly, such aggregation is not inconsistent with sections 419, 419A, or 512 and, therefore, aggregation should be permitted.

One issue you raised in your assistance request is the administrative problems that would result if after aggregating an exempt and nonexempt welfare benefit fund, there is remaining UBTI. How this UBTI would be allocated among the aggregated welfare benefit funds is unclear. In this case, however, no UBTI remained after aggregation and, therefore, this issue need not be addressed at this point.

If you have any questions regarding this memorandum, please call me at (202) 622- 3361 or Lorianne Masano at (202) 622-3281.