Internal Revenue Service

memorandum

CC:EBEO - FREV-116260-97
Br4/JLaufer

date: MAR 16 1998

to: Director, Employee Plans Division CP:E:EP

from: Assistant Chief Counsel (Employee Benefits and Exempt Organizations) CC:EBEO

subject: [redacted]

This responds to your memorandum of August 22, 1997, to Sarah Hall Ingram, requesting our assistance on issues raised in a Technical Assistance Memorandum you are preparing involving the application of sections 419, 419A, and 512 to two trusts maintained by [redacted] (Company).

Facts

Company maintains one trust (the Long Term Disability Trust) through which it provides long-term disability benefits to its employees, and also maintains another trust (the Medical Benefits Trust) through which it provides medical benefits to its employees. Both the Long Term Disability Trust and the Medical Benefits Trust qualify for tax-exempt status as voluntary employees' beneficiary associations (VEBAs) under section 501(c)(9) of the Code. The assets of one trust cannot be used to pay benefits of the other trust

The taxable year of each trust is the calendar year. For the years [redacted] and [redacted] the assets of the Long-Term Disability Trust at year end exceeded the qualified asset account limit of section 419A. The Medical Benefits Trust had no assets at the end of the [redacted] taxable year, and that trust's assets at the end of [redacted] were less than the qualified asset account limit. When the VEBAs filed income tax returns for [redacted] and [redacted] the trusts were not aggregated for purposes of computing unrelated business taxable income (UBTI). Accordingly, the Long-Term Disability Trust paid unrelated business income tax (UBIT) on assets over that trust's account limit. The Medical Benefits Trust paid no UBIT for taxable years [redacted] and [redacted]

In [redacted] the VEBAs filed amended Forms 990-T for [redacted] and [redacted] seeking a refund of the UBIT paid with respect to the Long-Term Disability Trust. The basis for the refund request was that Company was permissively aggregating the two funds in accordance

with section 419A(h)(1)(B) of the Code for purposes of computing UBIT under section 512(a)(3).

Issues

(1) Does the permissive aggregation provision of section 419A(h)(1)(B) apply for purposes of computing UBIT under section 512(a)(3)?

(2) If the Corporation is entitled to elect to permissively aggregate the two trusts for purposes of computing UBIT for a taxable year, may that election be made on an amended return submitted subsequent to the due date of the tax return for that taxable year?

Law

Section 419(a) of the Code 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) of the Code 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) of the Code defines the qualified cost as equal to 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 taxable year.

Section 419A(a) of the Code 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) of the Code 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) of the Code 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) of the Code 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 512(a)(3) and regulation §1.512(a)-5T, Q&A-3 provide rules for calculating the exempt function income and UBTI of a VEBA.

Section 511(b) of the Code imposes a tax on the unrelated business taxable income (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)(A) of the Code provides that, in the case of an organization described in section 501(c)(9), the term "unrelated business taxable income" (UBTI) 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).

Temporary Regulation §1.512(a)-5T, Q&A-3(b) provides that the UBTI of a VEBA for a taxable year generally will equal the lesser of two amounts:

(1) The income of the VEBA for the taxable year (excluding member contributions); or

(2) The excess of the total amount set aside as of the close of the taxable year (including member contributions) over the qualified asset account limit (calculated without regard to the otherwise permitted reserve for postretirement medical benefits) for the taxable year.

Analysis

Issue One: Does the permissive aggregation provision of section 419A(h)(1)(B) apply for purposes of computing UBTI under section 512(a)(3), and is the aggregation of the VEBAs in this case inconsistent with the purposes of subpart D and section 512?

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

However, the legislative history of DEFRA, under which section 419 was enacted, suggests that an employer should be able to 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 in computing UBTI, 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 under section 419A(h)(1)(B) for purposes of calculating UBTI under section 512(a)(3).

[redacted]

Because both of the trusts qualify as VEBAs under section 501(c)(9), the determination of the UBTI must be made in accordance with the special rules provided under section 512(a)(3), including the limitation on setasides contained in section 512(a)(3)(E). This limitation, in turn, is dependent upon the calculation of the account limit under section 419A. If the election to permissively aggregate the trusts in accordance with section 419A(h) for purposes of calculating UBIT was timely made, the requirements of section 512(a)(3) would be applied to the combined funds. Accordingly, in order to determine the amount of income subject to unrelated business

---

[redacted]

income tax under section 511, exempt function income and UBTI under section 512(a)(3) would be computed by applying the account limit calculated by treating the combined VEBAs as one.

In this case, that account limit is equal to the sum of the account limits calculated separately for each of the VEBAs.[2]

Issue 2: May the election to permissively aggregate the two VEBAs for purposes of computing UBIT for a taxable year be made on an amended return submitted subsequent to the due date of the tax return for that year?

Section 419A(h) is silent about the time for making an election to aggregate VEBAs for purposes of computing UBIT, and no regulations have been published prescribing the method or time for making such an election. See generally Treasury temporary regulation §301.9100-6T, which provides for the time and manner of making certain elections under DEFRA. Nor has the Service issued any other guidance relating to an election under section 419A(h).

Although often regulations or other guidance provide that an election under a specified section of the Code must be made by the due date (including extensions thereof) of the tax return for the first taxable year for which the election is to be effective, other election deadlines are also set forth in the Code, and there is no generally applicable guidance that provides a default

[redacted]

rule in a case (such as this) where there is no published guidance prescribing the method or time for making an election. Moreover, published guidance with respect to certain types of elections permits the election to be revoked. See, e.g., Treas. regulation §301.9100-7T(a)(4)(iii), which specifies that an election made under section 311(d)(2) of TRA '86 is freely revocable.

In the absence of any statutory or regulatory guidance on the time and manner for making an election under section 419A(h), we believe that the Service cannot effectively challenge an election under section 419A(h) that is made on a timely filed amended return.

In summary, we conclude that Company may elect to aggregate the trusts under section 419A(h) for purposes of computing UBTI under section 512(a)(3). Accordingly, UBTI for the combined trusts is computed by applying their combined account limits.

[redacted]

[redacted]
FREV-116260-97

If you have any questions regarding this memorandum, please call Janet Laufer at 622-6060.

MARY E. OPPENHEIMER
Assistant Chief Counsel

By: _____
Mark I. Schwimmer
Chief, Branch 4
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)