Audit Technique Guide – Supplemental Unemployment Benefit Trusts – IRC Section 501(c)(17)

Introduction

These guidelines offer examination techniques for identifying and developing issues commonly encountered during an IRC Section 501(c)(17) trust audit.

These guidelines give specific aid for IRC Section 501(c)(17) trust audits but are not all inclusive. The purpose is to add to the guidelines in:

- IRM 4.75.10, Exempt Organization Pre-Audit Procedures
- IRM 4.75.11, On Site Examination Guidelines
- IRM 4.75.12, Required Filing Checks
- IRM 4.75.13, Issue Development

The intent isn't to restrict identifying issues or using audit techniques not included here.

Background Information

IRC Section 501(c)(17) exempts from federal income tax a trust(s) that is a part of a plan that offers supplemental unemployment compensation benefits (SUB) if it meets the requirements of:

- IRC Section 501(c)(17)(A)(i)
- IRC Section 501(c)(17)(A)(ii)
- IRC Section 501(c)(17)(A)(iii)

Permissible Employee Benefits

An IRC Section 501(c)(17) trust must offer Supplemental Unemployment Benefit(s) (SUB) to employees and it must be its primary purpose. It may offer sick and accident benefits but only if they are subordinate to unemployment compensation benefits.

An IRC Section 501(c)(17) trust can't offer death, vacation, or retirement benefits.

An IRC Section 501(c)(17) trust must pay benefits only if an employee's involuntary separation from employment results from:

- A reduction in work force
- Discontinuing a plant or operation
- Similar conditions

Audit Guidelines: Permissible Employee Benefits

Review the trust instrument and plan document to verify the:

- Plan offers SUB and subordinate sick and accident benefits.
- Trust Instrument binds the trustees to act consistent with the plan provisions.
- Trust's corpus and income were used to satisfy all liabilities to covered employees before any other purpose.

Review minutes, publications, and a sample of claims filed to:

- Verify that sick and accident benefits are subordinate to SUB.
- Verify the plan pays for SUB only for an involuntary separation.
- Determine whether the plan offers any prohibited death or retirement benefits.

Review disbursement journals and supporting documents (such as invoices and cancelled checks) for any disbursement other than allowable benefits and administrative expenses, such as:

- Payment of a death, vacation, or retirement benefit.
- Benefits paid to the employee for other than an involuntary separation.
- Distributions to employees of funds for contributions in excess of the maximum funding allowed.

Non-Discrimination Provisions

SUB plans must meet certain nondiscrimination conditions. They must not discriminate in favor of highly compensated employees (HCEs). Neither the classification under which benefits are paid nor the benefits may discriminate in favor of HCEs. See IRC Section 414(q) for the definition of HCE.

If benefits paid to HCEs bear a larger ratio to their compensation than benefits to lower paid employees, the plan doesn't qualify. Benefits paid on a uniform ratio qualify.

Audit Guidelines: Non-discrimination Provisions

Review the plan document to learn how the benefits are determined.

Review disbursements journals and supporting documents for:

- Indications of discrimination in the payment benefits.
- Any disparity in the ratio of compensation to benefits paid.
- Any disparity in paying benefits to HCEs.

Example: Paying sick and accident benefits solely to HCEs would be discriminatory.

Prohibited Transactions Under IRC Section 503(b)

IRC 503(b) prohibits trusts exempt under IRC Section 501(c)(17) from engaging in certain transactions. In general, these relate to preferential treatment for prohibited parties. See Treas. Reg. 1.503(b)-1.

Note: Neither the IRC nor regulations use the term "prohibited party." The term in this manual references a specific set of entities listed in Treas. Reg. 1.503(b)-1(a).

Examples of prohibited transactions by the trust and prohibited parties appear in the table below:

Prohibited Transaction:	Prohibited Party:
Lend any part of its income or corpus, without receiving adequate security and a reasonable rate of interest to a prohibited party.	The creator of that organization (if a trust).
Pay any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services rendered, to a prohibited party.	A person who substantially contributed to that organization.
Make any part of its services available on a preferential basis to a prohibited party.	A member of the family (as defined in IRC Section 267(c)(4)) of an individual who is the creator of that trust or who has substantially contributed to that organization.
Makes any substantial purchase of securities or any other property for more than adequate consideration in money or money's worth from a prohibited party.	A corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all

Sell any substantial part of its securities or other property for less than an adequate consideration in money or money's worth to a prohibited party.	classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.
Engage in any other transaction which results in a substantial diversion of its income or corpus to a prohibited party.	

Audit Guidelines: Prohibited Transactions Under IRC Section 503(b)

Review books and records to identify transactions prohibited under IRC Section 503(b).

Analyze the following potential issues if a prohibited party is involved:

- Assets' acquisitions or dispositions at above or below fair market value
- Unusual disbursements
- Salary not commensurate to employee's duties
- Income from low-yield investments
- Accounts, notes, and mortgages payable without proper collateral or a reasonable interest rate or both

Unrelated Business Income

Trusts exempt under IRC Section 501(c)(17) are subject to the unrelated business income tax (UBIT) provisions in IRC Section 512(a)(3).

If the trust exceeds the IRC Section 419A(c)(3) account limit at the end of the taxable year, the excess is taxed under IRC Section 512(a)(3)(E). The SUB's account limit is 75 percent of the average annual qualified direct costs for SUB for any of the immediately preceding seven years.

Audit Guidelines: Unrelated Business Income

Review cash receipts to identify any unusual income sources. Analyze income from any source other than members, employers, or investments to determine if it's subject to the UBIT.

Determine if the employer contributions exceed the deduction limitations in IRC Section 419(c) and IRC Section 419A. UBIT and excise tax may apply as allowed by the Deficit Reduction Act of 1984, P.L. 98-369.