F. SELECTED PROBLEMS OF VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS (VEBAs)

1. Introduction and History

The VEBA is a mutual association of employees providing certain specified benefits to its members or their designated beneficiaries. It may be funded by the employees or their employer. The VEBA has existed in the tax law since the Revenue Act of 1928 when it was given exempt status under section 101(16) of the Act. Exemption for this entity was re-enacted by the Revenue Acts of 1932, 1934, 1936, and 1938. The VEBA was incorporated into the 1939 Code as IRC 101(16) and subsequently into the 1954 Code (the present Code), as amended to date, as IRC 501(c)(9).

IRC 501(c)(9) exempts from federal income tax the voluntary employees' beneficiary association (VEBA) providing for the payment of life, sick, accident or other benefits to its members (or their dependents or designated beneficiaries) if no part of the net earnings inures (other than through such payments) to the benefit of any private shareholder or individual.

Any group of employees sharing an employment-related common bond may establish a VEBA. Also, an employer may, subject to certain fiduciary requirements, establish a VEBA on behalf of the employees. Funds in the possession of the VEBA are held in trust for the payment of benefits. Typical benefits are life, sick, accident, and medical benefits. Funds in the possession of the VEBA are not taxable, nor is interest earned on those funds usually taxable, however, the benefits provided to the employees may, or may not, be taxable depending upon the type of benefit. Although an employer making contributions to the VEBA would ordinarily receive a deduction under IRC 162 for amounts contributed, the employer would also receive a deduction if the benefits were paid directly to the employee by the employer as part of the fringe benefit package. The VEBA thus assures only a fund from which benefits may be paid directly, or out of which insurance premiums may be paid (in the case of benefits provided through insurance). There are, generally, no limitations on either the size of the entity or the amount of benefits that may be provided, only upon the type of benefits and the persons to whom benefits may be provided. This is also the situation with regard to other mutual associations, such as some fraternities, and social clubs.

Despite the age of the exemption provision (since 1928), no regulations were proposed until the late 1960's. These regulations engendered considerable comment and were substantially revised. Proposed regulations under IRC 501(c)(9) were first published in the Federal Register on January 23, 1969, and new revised proposed regulations on July 17, 1980. Final regulations under IRC 501(c)(9) were published in the Federal Register on January 7, 1981 (T. D. 7750).

The final regulations provided some fairly definite "affiliation rules" to ensure that organizations applying under the exemption provision were in fact associations of employees of the type intended to be exempted. There was also concern expressed that these rules were necessary to prevent circumvention of Code provisions which had been in the Code since the Revenue Act of 1950. Further, there was concern that insurance companies would attempt to circumvent Code provisions applicable to them through use of the VEBA in a multi-employer benefits plan. The regulations adequately dealt with these issues, except for some definitional problems. But the final regulations did not adequately address certain other issues such as discrimination against lesser-compensated employees, an area of great concern in the pension area, and dealt with extensively in the Employee Retirement Income Security Act of 1974 and amendments thereto (ERISA). However, the preamble to the new regulations does indicate that IRC 501(c)(9) organizations need not comply with anti-discrimination rules as stringent as those that apply to qualified pension trusts plans under IRC 401. The Final Regulations do provide that benefits may not be provided on a "disproportionate" basis to highly-compensated employees (similar to the "prohibited group" in the Employee Plans area) and that restrictions on eligibility for membership and benefits must be on a reasonable and objective basis. These determinations must be based in each instance on the facts and circumstances of the case.

These rather loose "anti-discrimination" rules under IRC 501(c)(9) coupled with changes in deferred compensation area have made VEBAs a more attractive vehicle to defer income tax and provide benefits. For years after 1982, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) significantly reduced the limit on the amount that an employer could contribute to a deferred compensation plan, and reduced the maximum benefit that could be paid.

2. Funding Problems

Unless VEBA benefits are to be provided through the purchase of commercial insurance, funding problems are inherent - a somewhat uncertain benefit is being promised at some uncertain future time, but it must be provided for currently. Proper funding is obviously a problem of great magnitude in the pension area and it took two significant pieces of legislation to correct it - ERISA to correct the problem of underfunding, i.e., promising benefits that could not be delivered; and TEFRA to correct the problem of excessive funding, i.e., an attempt to put too much money into a deferred compensation arrangement.

The other pressures which led to the enactment of ERISA, that is, the quest for a pension benefit which was vested and ascertainable and one that was portable, are not, strictly speaking, present in the VEBA area. The VEBA is meant to supply benefits by virtue of association in an employment relationship. VEBA benefits are thus supposed to be tied to employment and normally terminate when that employment ends. Thus, there is normally no need to ascertain nor vest the benefit.

Correction of funding problems in the VEBA area presents many more potential problems than the pension area because of the multiplicity of benefits provided and the lack of actuarial standards.

A. Underfunding

At this stage of our experience with VEBAs this is merely a theoretical problem, but there is a question of whether a self-insured medical or life insurance plan is in fact "providing" an IRC 501(c)(9) benefit when it is unfunded or substantially underfunded. The VEBA is promising a benefit that it may or may not be able to deliver for various reasons. However, there is no clear requirement that the employer properly fund the VEBA even if the "proper" level of funding could be ascertained. And, the provisions of ERISA that require proper funding and vesting with respect to pension plans, do not apply to VEBAs. Second, without actuarial standards, the fund could be exhausted by prior claims with no obligation on the employer or other members to meet the liability for future claims.

B. Overfunding

The VEBA is becoming an attractive receptacle for funds that can no longer be put into a qualified deferred compensation plan because of certain limitations. This is especially true in the context of VEBAs with a small membership that include several members of the highly-compensated prohibited group. While TEFRA imposed specific limitations on contributions to a tax-deferred compensation plan, there is no such specific limitation under IRC 501(c)(9). If the intention is to merely defer income tax, a plan can be set up as a self-insured life insurance or disability plan or a severance pay plan and attempt to be recognized as exempt under IRC 501(c)(9).

While there is nothing in the IRC 501(c)(9) regulations that provides specific authority for objecting to the level of funding, this does not mean that any level of funding is permissible. In most cases "excess" funding would occur in a trust that is controlled by a small group of employees who receive a dominant share of the benefits. In such case the trust would not qualify under IRC 501(c)(9). See the later discussion under "Limited-Membership VEBA". In other cases the limitation on the deductibility of contributions to VEBAs under IRC 162 (based on the "ordinary and necessary" business expense rules) will probably limit the "excess" funding problem.

3. Deductibility Issue

A. Introduction

Questions frequently arise about the deductibility of employer contributions to a VEBA. Under what Code section or sections are employer contributions or payments deductible? Does deductibility depend on an association or trust being exempt under IRC 501(c)(9)? If the association or trust is exempt as a VEBA does this mean that all employer contributions to it are automatically deductible?

In general, the Code provision that governs the deductibility of contributions to a VEBA is IRC 162. Reg. 1.162-10 provides as follows:

> (a) In general.--Amounts paid or accrued by a taxpayer on account of injuries received by employees, and lump-sum amounts paid or accrued as compensation for injuries, are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business. However, except as provided in paragraph (b) of this section, such amounts shall not be deductible under section 162(a) if, under any circumstances, they may be used to provide benefits under a stock bonus, pension, annuity, profit-sharing, or other deferred compensation plan of the type

referred to in section 404(a). In such an event, the extent to which these amounts are deductible from gross income shall be governed by the provisions of section 404 and the regulations issued thereunder.

The chart below illustrates the types of payments deductible under IRC 162 and those deductible under IRC 404(a).

EMPLOYEE WELFARE BENEFITS		PLANS OF DEFERRED COMPENSATION
Presently deductible under IRC 162	v.	Deductible later under IRC 404
dismissal wages		stock bonus
unemployment benefits		pension
guaranteed annual wages		annuity
vacations		profit sharing
sickness plan		other deferred compensation plan of the type referred to in IRC 404(a)
accident plan		
hospitalization plan		
medical expense plan		
recreational plan		
welfare, or similar benefit plan		

The difference in treatment is the timing of the deduction. If the deduction qualifies under IRC 162 the amounts are deductible currently. If the amount is deductible under IRC 404(a)(5) it is deductible in the year that the payment of benefit is actually made to the beneficiary. *

* We are not concerned here with contributions to a qualified pension, stock bonus, annuity, or profit sharing plan. Although these contributions are currently deductible under IRC 404(a)(1) through (4), they are clearly not of the type of benefit contemplated under IRC 501(c)(9).

It is clear from the above that deductibility of an employer contribution to an employee welfare benefit plan is not dependent upon recognition of exemption under IRC 501(c)(9). Similarly, the fact that a payment is made to an IRC 501(c)(9) organization does not necessarily mean that it is deductible under IRC 162. However, a reading of Reg. 1.162-10 indicates that contributions with respect to most, if not all, benefits permissible under IRC 501(c)(9) are deductible under IRC 162.

Greensboro Pathology Associates, P.A. v. United States, 83-1 USTC Paragraph 9112 (Ct. App. Fed. 1982), (a case on appeals from the U. S. Claims Court) considered the question of whether an educational benefit plan for children of employees was deductible under IRC 162 or under IRC 404.

This case involved a professional corporation of physicians. It claimed that, in order to attract and retain high quality employees, it instituted a company wide educational benefit plan. Under this plan every employee was eligible for benefits amounting to $4,000 per year for up to four years for each child between the ages of 18 and 20 pursuing a course of undergraduate or graduate study at an accredited college or university. At the plan's inception participation was available to all employees without restriction and out of eleven (11) children eligible, nine (9) were children of shareholders. At the time of the plan's adoption, the children of one employee-shareholder had already completed their education. The benefits were available without regard to academic achievement or financial need. The educational benefit was continued except in the case of dismissal for cause. The educational benefit could be terminated at the discretion of the association board of directors but the monies in the plan would not revert to the employer.

The question in this case was whether the payments were deductible under IRC 162 as welfare benefits (currently deductible) or IRC 404(a)(5) as deferred compensation (deductible when and to the extent included in employees' gross income). The court held there was no single differentiating factor but rather a set of factors. These include the following:

1. Is this a welfare plan; i.e., one concerned with the well-being of the employees?

2. Are the benefits provided employees based upon the employer's earnings?

3. Do the benefits increase for those who have been employed longer by the employer?

4. Are benefits provided to all employees?

5. Are the plan benefits a substitute for salary?

6. Does the plan serve its stated purpose or is it a sham?

7. Does the employer lose control of the funds it gives the plan? Is there any sort of reversion of funds to the employer? Is the plan independently administered?

The court reasoned that where the provision of a plan's benefits are dependent upon an employee's length of service or position, the plan's characteristics are then analogous to those of deferred compensation since the type of compensation also depends upon these factors. Where a plan's benefits depend on an employer's earnings, that is also a form of deferred compensation because it is similar to a profit-sharing plan. In addition, a plan has the appearance of a plan of deferred compensation when someone not eligible for its benefits receives a salary increase instead. On the other hand, the medical and vacation plans specified by regulation are considered welfare benefit plans and their cost is deductible under IRC 162. These plans are in general instituted to insure well-being of employees and are provided to all employees. Thus, the court held such characteristics were essential to a finding that a plan is a welfare benefit plan.

Of course, in any instance where a company maintains total control of and retains all rights to the plan's funds, no deduction is allowed because the company has not in reality spent this money. Similarly, all plans must be closely examined to see that they are in substance what they claim to be.

In deciding that the amounts contributed were presently deductible under IRC 162 the court decided that the monies had been irrevocably turned over to an independent trust not controlled by the employer, that benefits were available to all employees not just children or owners or key employees, that the plan was not a sham to provide for the education of the shareholders' children, and that benefits were not linked to salary. The court reached this latter conclusion, in part, because the children of one shareholder-employee had already completed their education. Two cases out of the Tax Court: Grant-Jacoby, Inc. v. Commissioner, 73 T.C. 700 (1980) and Citrus Orthopedic Medical Group v. Commissioner, 72 T.C. 461 (1979) were cited with approval by the court for their analysis and rationale on the issue. This analysis turned on the question of whether the plan benefited employees generally (deductible presently under IRC 162) or whether the plan was for the benefit of owners or restricted to owners, a reason for requiring that the deduction be deferred under IRC 404 until distributions were made from the plan.

Although Greensboro did not involve an exemption issue and is limited to the IRC 162 question it remains an interesting case in the IRC 501(c)(9) area. What if Greensboro had involved a VEBA and the exemption issue? We believe the court would have held that the trust was not entitled to exemption because it paid the type of educational benefits that are impermissible under Regs. 1.501(c)(9)-3(e) and (f). Educational benefits to dependents are only permissible if provided by a collectively bargained trust in a manner permitted in paragraphs (5) et. seq. of section 302(c) of the Labor Management Relations Act of 1947, 61 Stat. 136, as amended, 29 U.S.C. 141 (1979). Educational benefits are discussed later in the text. Thus, we believe, that in addition to the holding that contributions were deductible under IRC 162 as proper "welfare" benefits the court would have also held that the trust would fail to qualify under IRC 501(c)(9) because it was not paying permissible IRC 501(c)(9) benefits. This points out that "welfare" benefits under IRC 162 do not necessarily mean the same thing as they do under IRC 501(c)(9).

B. Position on Deductibility/Taxability Questions for VEBAs

Reg. 1.501(c)(9)-6 makes clear that exemption does not confer any special status with respect to taxability of benefits paid by a VEBA nor with respect to the exclusion from gross income of contributions paid to a VEBA. Despite this fact, many persons are under the impression that tax exemption does provide some special status for these items. (See pages 220 through 222 of the 1982 E.O. CPE).

In order to place VEBAs on notice concerning potential tax and deduction issues, two caveat paragraphs are now required in most IRC 501(c)(9) ruling letters pursuant to IRM 7668.(12), effective August 16, 1983. The paragraphs read as follows:

> Cash and noncash benefits realized by a person on account of your activities must be included in gross income to the extent provided in the Code. No opinion is expressed or implied as to whether there is any provision available under the Code to exclude from gross income contributions to you or payments made by you.

Further, no opinion is expressed or implied as to whether you are liable for taxes under the Federal Insurance Contributions Act (social security taxes) or the Federal Unemployment Tax Act on the payment of benefits. If you have any questions about these matters, please contact your key district office.

No opinion is expressed or implied as to whether employer contributions to you are deductible under the Code.

4. Discrimination

A. In General

Probably the single most important consideration in qualifying for exemption under IRC 501(c)(9) is determining whether the plan discriminates in favor of officers, shareholders, or highly compensated employees (the highly-compensated group, for short). The term is somewhat analogous to the terms "key employees" or "prohibited group" used elsewhere in the Code.

The rule is simple to state - a VEBA cannot discriminate in favor of the highly-compensated group, benefits cannot be disproportionate in favor of that group. But, on the basis of the existing regulations, the rule is very difficult to apply. Discrimination might occur if certain employees are excluded from membership, or once made members, provided with different benefits. However, the regulations clearly permit certain arrangements that generally favor the highly-compensated group. For example, membership can be denied on the basis of a reasonable job classification, a minimum length of service, part-time employment, or union coverage. Even within the membership, the regulations permit certain variations in benefits that could favor the highly compensated group. For example, life insurance or severance benefits may be paid based on a uniform multiple of compensation. See the 1983 CPE text, pages 61-65, and the following discussion on variations in benefits.

B. The Limited-Membership VEBA

We have encountered a problem with limited-membership VEBAs when the owners of the creating employer corporation control the corporation and the VEBA, and receive a dominant share of the benefits from the VEBA. An example will show the scope of the problem.

<u>EXAMPLE</u>

Dr. X is the sole shareholder of a professional corporation which provides medical services and he earns $500,000 annually. Y and Z are his wife and daughter and are employees who earn $2,400 and $1,200 annually. Additional employees are two nurses and a receptionist paid $24,000, $24,000, and $15,000 respectively. Dr. X establishes a trust with himself, Y, and Z as trustees. The trust provides a life benefit and an accidental death and disability (AD&D) benefit equal to three times annual compensation. The trust is terminable at will by the employer, the professional corporation. Upon termination, assets will be distributed on the same basis as the distribution of benefits, as a uniform percentage of compensation. Benefits are completely self-funded (that is, not provided through policies of insurance).

Does the trust qualify for exemption under IRC 501(c)(9)?

In analyzing this situation we look at the benefits as related to each individual. In this case benefits are provided on the following schedule:

	ANNUAL SALARY	Life Benefit	AD&D Benefit
Dr. X	$ 500,000	$ 1,500,000	$ 1,500,000
Y	2,400	7,200	7,200
Z	1,200	3,600	3,600
Nurse 1	24,000	72,000	72,000
Nurse 2	24,000	72,000	72,000
Receptionist	15,000	45,000	45,000

Upon termination, each employee would receive a proportionate share of the assets based on the above schedule, that is, based upon a percentage of compensation.

The trust provides a dominant share of the aggregate benefits to the highly-compensated owner/employee. In addition, the owner/employee has the power to terminate the trust by reason of having direct control over the employer corporation. In the event of trust termination, the owner/employee would receive trust assets in proportion to his dominant share of the benefits.

The allocation of a dominant share of benefits to the owner/employee who exercises direct control over the employer corporation, and therefore, effective control over the trust, indicates that the trust is operated primarily for the benefit of the owner/employee rather than primarily for the benefit of an employee group. This is shown by the accumulation of funds by the trust predominantly for the current benefit of the owner/employee. Furthermore, the trust is subject to termination at the discretion of the owner/employee. By controlling the timing of the trust termination, the owner/employee is able to direct the distribution of his allocable share of trust assets. Thus, the current thinking in the National Office is that the trust functions substantially as an tax-deferred investment fund for the direct and private benefit of the owner/employee. Under these circumstances, even though the benefits are provided in amounts that conform with Reg. 1.501(c)(9)-2(a)(2)(ii)(F) and (G) and would not ordinarily violate the disproportionality rule, the terms and structure of the trust are incompatible with the inurement proscription of Reg. 1.501(c)(9)-4(a).

The example indicates that a trust established by the owner of a professional association failed to qualify for exemption. The problem is not limited to the professional corporation and a trust controlled by a single person. The problem occurs anytime a small group of owner-employees in control, directly or indirectly, receive a dominant share of the benefits.

This tentative National Office position in effect establishes an anti-discrimination guideline even though the rationale is based on the inurement proscription. Cases involving the Limited-Membership VEBA where the membership includes the employer-owners are still required to be referred to the National Office pursuant to IRM 7664.31(12)(b).

C. Variations in Benefits

In last year's E.O. CPE, on pages 65 and 66, we discussed in terms of disproportionate benefits, variations in benefits based upon the company department in which a worker was employed or the payment of different benefits based on geographic location. This problem is often found in the context of the large conglomerate employer who, because of very large size has many different plant locations geographically distant from one another. Typically in this situation, life, AD&D, medical, dental, and vacation pay benefits will be provided to various employees at various locations based upon whether they are classified as hourly or salaried employees, members of a collective bargaining unit or not, and which subsidiary or plant they are located at. However, these differences are not limited to the conglomerate. A company with one plant may also base benefits on hourly salary or other worker classification. An employer in this context may employ many workers and offer several different benefit packages or variations thereof.

How do we apply the regulations requiring reasonable and objective bases for eligibility for membership and benefits, and prevent the payment of disproportionate benefits to highly compensated group members in such situations? Are variations in these manifold benefit packages per se discriminatory or disproportionate? Do these variations favor a highly compensated group with disproportionate benefits?

The benefits packages available at a particular plant or within a particular subsidiary may be the result of a number of factors including the history of a plant and its labor force, the result of unionization and collective bargaining, prevailing wages and benefits practices within the particular industry group and, finally, in the case of a conglomerate the date the subsidiary was acquired, merged, or re-organized into the conglomerate corporation. Thus, variations in benefit packages may be the result of historical accident and circumstances or the customs and usages of a particular industry.

Under the regulations, discrimination can be a function of restrictions on either eligibility for membership or eligibility for benefits. However, the discrimination provisions are susceptible to several interpretations. The first two sentences of Reg. 1.501(c)(9)-2(a)(2)(i), if read in isolation, suggest a clear dichotomy between the standards governing membership and those governing benefits. Thus, it is stated that eligibility for membership may be restricted by objective conditions reasonably related to employment (e.g., geographic location, classification of workers, reasonable minimum period of service). In contrast, it is stated that eligibility for benefits may be restricted by objective conditions relating to the type or amount of benefits offered. However, when that subparagraph is read in its entirety, such a narrow reading is not warranted. For example, under Reg. 1.501(c)(9)-2(a)(2)(ii), which lists "safe harbor" restrictions on membership and benefits, it is permissible to vary benefits within membership on the bases of coverage under a collectively bargaining agreement, contributions to the cost of the benefit, meeting a reasonable health standard, and on the compensation level of the participants. Moreover, under Reg. 1.501(c)(9)-4(b), benefits may vary in both kind and amount as to employees who are similarly situated if the differences can be justified on the basis of objective and reasonable standards. Although the regulations permit variations in the level of benefits in each of these situations, none of the variations is dependent upon or related to the "type or amount of benefits" offered. It is thus clear that the regulations neither mandate uniform benefit levels for all members of a VEBA nor inexorably tie those benefits to any particular "objective criteria."

In our opinion the regulations require only that, whatever criteria are used to determine eligibility for membership and benefits in the association, such criteria may not be selected, established or administered in a manner that has the overall effect of limiting membership or benefits to officers, shareholders or highly compensated employees or that has the effect of entitling members of the highly compensated group to disproportionate benefits. Criteria which do not violate this proscription may generally be considered "objective and reasonable." In the case of one corporation acquiring another, the fact that the benefits available merely reflect the benefit packages in place at the time the subsidiary of the parent corporation was acquired, would lend some credence to the argument that the criteria were neither selected nor established so as to result in discrimination. On the other hand, where the effect of a restriction is to favor the highly compensated group by excluding from membership or denying a benefit or providing a lesser benefit to a group of employees, including, in particular, lower compensated employees, the restriction is not permissible. Thus, where a VEBA is initially established and eligibility for benefits are based on "job classification" or "geographic location," discrimination may be the intended result. Such plans merit close scrutiny. However, the question of whether the effect of any particular restriction favors the highly compensated group is a determination which is based, in each case, on the particular facts and circumstances presented.

Accordingly, the fact that an association's benefit package varies on the basis geographic locale, job classification, or employment in different subsidiaries of the same employer (i.e., factors relating to employment), will not per se affect exemption. This will hold true so long as the benefits are not administered in a manner that impermissibly favors the highly compensated group. In effect, geographic location and job classification may constitute "objective and reasonable" standards for determining an employee's eligibility for a particular benefit as well as for determining an employee's eligibility for membership in the association and "similarly situated," for purposes of Reg. 1.501(c)(9)-4(b), may therefore be determined with reference to these factors.

5. Affiliated Employers

Eligibility for membership in a VEBA must be defined by reference to objective standards that constitute an employment-related common bond. One such bond under the regulations is employees of affiliated employers. The term "affiliated employers" is not defined under the regulations but is meant to include a corporation and its wholly-owned subsidiary.

We have recently been asked whether the term "affiliated services group" under IRC 414(m) would be included within the term "affiliated employers". In the 1983 EO CPE text, on pages 59 through 61, we discussed what the term "affiliated employers" might include. We determined that the arrangements described in IRC 414(b) and (c) and the temporary regulations thereunder would be included within the definition of "affiliated employers" for IRC 501(c)(9) purposes. In the context in which it was originally considered in last year's CPE, we were concerned primarily with permitting employers who were offering nondiscriminatory benefits for closely affiliated groups of employees to be treated as "affiliated employers" and thus qualify for exemption under IRC 501(c)(9). The underlying rationale of IRC 501(c)(9) and the juxtaposition of the term "affiliated employers" with the term "common employer" indicates that the employees of "affiliated employers" may be viewed as maintaining a common bond with one another where their relationship is similar to that of employees of a single employer.

IRC 414(b) and (c) relating to the pension area, were designed to prevent employers from forming multiple corporations or other entities in order to circumvent the coverage and anti-discrimination requirements of IRC 401. IRC 414(b) provided that all employees of corporations belonging to a controlled group (as defined in IRC 1563(a)) must be treated as employed by a single employer. IRC 414(c) provided that employees of two or more business entities which are under common control shall be treated as employed by a single employer. Thus, the legal differences between members of a group of employers were viewed as artificial and the employees of such member-employers were treated as if employed by the same employer if the standards set forth in IRC 414(b) or (c) were met.

This has the effect in the pension area of preventing discrimination in the provision of benefits, by preventing the separation of highly-compensated and lower-compensated employees into different groups.

In last year's CPE we explained that if employers met the tests of either IRC 414(b) or (c) they would be considered affiliated employers for IRC 501(c)(9) purposes provided the VEBA met the tests of the regulations including the nondiscrimination rules. Thus, under IRC 414(b) and (c) we put employers together. Under IRC 501(c)(9) if the employers meet the same tests we permit them to be treated as affiliated.

IRC 414(m) is similar to IRC 414(b) and (c) in that it was also designed to prevent employers from forming multiple corporations or other entities in order to circumvent the coverage and anti-discrimination requirements of IRC 401.

IRC 414(m)(1) provides that, for purposes of certain employee benefit requirements, all employees of the members of an affiliated service group shall be treated as employed by a single employer.

While the aggregation rules of IRC 414(m) are not based on controlled group principles of IRC 414(b) and (c) as such, we nevertheless believe that reliance may generally be placed on IRC 414(m) for defining "affiliated employers" under Reg. 1.501(c)(9)-2(a)(1). Therefore, IRC 414(m) provides an objective and permissible standard under IRC 501(c)(9) for finding an employment-related common bond among the employees of such employers.

Accordingly, a group of employers may be considered "affiliated" for purposes of Reg. 1.501(c)(9)-2(a)(1) if such employers would be subject to single-employer treatment under the aggregation rules of IRC 414(b), (c) or (m). This is not, of course, an exclusive listing of when affiliation will be deemed to exist under IRC 501(c)(9), for the regulations specifically provide that eligibility for membership "is a question to be determined with regard to all the facts and circumstances."

6. Inurement Problem - The Inter-VEBA Transfer

This issue was discussed briefly in the 1983 E.O. CPE text, pages 72 and 73. The issue was presented in two contexts. First, there were two VEBAs that had the same membership but were paying two different benefits. The funds of one VEBA were exhausted necessitating a transfer from the other VEBA. Second, two VEBAs had different but "affiliated" memberships (for, example different locals of one parent union) and sought to transfer funds from a viable fund of one local to the depleted fund of the second. At that time there was a question whether transfer of assets between existing VEBAs was permissible, where the purpose of the transfer was either to replenish the funds of a depleted union-sponsored VEBA or transfer funds out of an "over funded" union-sponsored VEBA. This can be a problem in times of economic downturn. There was cause for concern because it appeared that Reg. 1.501(c)(9)-4(d) did not permit any disposition of assets other than upon dissolution of the association or continued payment of IRC 501(c)(9) benefits. It was thought that inter-VEBA transfers would constitute inurement because the

VEBA's earnings would be paid to persons other than those who were originally intended to be beneficiaries of the association or trust.

The persons to whom a VEBA's earnings could impermissibly inure include those individuals having a personal and private interest in the activities of the organization. See Reg. 1.501(c)(9)-4(a) and 1.501(a)-1(c). The word "private" is the antonym of "public" -- used merely to distinguish a private individual from the general public -- and is intended to limit the scope of those persons who personally profit to the intended beneficiaries of the allowable activities.

Whether a VEBA satisfies the requirement that no part of its net income can inure to the benefit of any individual is a question to be determined with regard to all the facts and circumstances. Reg. 1.501(c)(9)-4 indicates that prohibited inurement may arise in a variety of circumstances. For example, the disposition of property to a person for less than the greater of fair market value or cost to a VEBA, other than as a permissible benefit, constitutes prohibited inurement. In addition, paragraphs (a) and (b) of Reg. 1.501(c)(9)-4, when read in conjunction, generally provide that the payment of disproportionate benefits, where such payment is not pursuant to objective and nondiscriminatory standards, will result in prohibited inurement. Prohibited inurement will also arise upon the termination or dissolution of a VEBA if all existing liabilities of the organization are not satisfied, to the extent of any remaining assets. See Reg. 1.501(c)(9)-4(d). These examples are not an exhaustive list of the circumstances giving rise to prohibited inurement.

The tentative thinking in the National Office is that prohibited inurement usually does not occur in the transfer of funds between VEBAs "sponsored" by union locals having the same parent or affiliated parents. The requirement that a VEBA receive consideration equal to the greater of fair market value or cost whenever there is a transfer of assets by the VEBA is not applicable when:

(1) The transferor and transferee trusts/associations are each exempt under IRC 501(c)(9),

(2) The transferred assets will be used to provide permissible benefits,

(3) The participants of each trust association share an employment-related bond,

(4) The transfer is not used to avoid the applicable requirements of IRC 501(c)(9) and the regulations thereunder that otherwise would apply to each VEBA,

(5) The transfer is approved by the memberships of both VEBAs (either directly or through their authorized representatives), and

(6) The transferor VEBA keeps sufficient funds for the satisfaction of all current anticipated liabilities (including an estimated reserve for incurred but unreported claims).

It should be noted that VEBAs must ordinarily meet the fiduciary and reporting requirements of ERISA. In this regard, while the inter-VEBA transfer may meet IRC 501(c)(9) standards proscribing inurement, the transfer may yet be violative of the ERISA "Exclusive Benefit" rule.

7. Administrative Services vs. The Provision of Benefits

In some instances we have seen organizations that are set up by IRC 501(c)(9) organizations or by IRC 501(c)(9) organizations and IRC 401 trusts to provide administrative services for these creating organizations. Some of these administrative service organizations, which are sometimes referred to as master trusts or pooled fund arrangements (see Rev. Rul. 81-100, 1981-1 C.B. 326), attempt to qualify for exemption under IRC 501(c)(9). We have conceptual difficulties with such organizations. In order to qualify for exemption under IRC 501(c)(9), an organization must consist of employees sharing an employment related common bond. A pooled fund arrangement is not made up of such individuals (employees) and there is usually no employment-related common bond.

There is a second variation of this fact pattern. In some cases existing IRC 501(c)(9) VEBAs may make an otherwise nonqualifying benefit indirectly available to its membership. For example, in one case a VEBA made its membership list available to an insurance company for the solicitation of individual retirement accounts (IRAs). The VEBA agreed to collect the IRA amounts from its members and pass these amounts along to the insurance company. The VEBA contracted with the insurance company on behalf of its members as to the terms of the arrangement. An IRA benefit is not a qualifying benefit for a VEBA because it is similar to a pension. However, the question is whether the VEBA is actually providing this benefit or merely acting as conduit, i.e., providing an administrative service. This is a significant problem since the nonqualifying benefits section of the regulations (Reg. 1.501(c)(9)-3(e)) would operate in conjunction with the "de minimis" rule of the regulations (Reg. 1.501(c)(9)-3(a)) to deny exempt status to a previously recognized VEBA on the basis that the VEBA is providing benefit that is a nonqualifying benefit of more than a de minimis amount. VEBAs seeking to offer such non-qualifying benefits seek to surmount this difficulty by claiming that they are only providing an administrative service with regard to the benefit and are not in fact a principal engaged in providing the benefit. The VEBA, assuming we accepted this argument, would act merely as a conduit through which monies would flow from the members to the benefit provider. No final decision has been reached with respect to this type of case. Cases described in this paragraph should be referred to the National Office.

In the first instance above, however, there is precedent in the form of a tax court decision. Recently, in the case of Bricklayers Benefit Plans of Delaware Valley, Inc. v. Commissioner, 81 T.C. 44, (1983) our rationale for disallowing IRC 501(c)(9) status to the group master trust or the pooled fund arrangement was given judicial support. Bricklayers sought IRC 501(c)(9) status for a corporation which ran a collective incorporated investment fund for three VEBAs and three pension funds. The incorporated fund in Bricklayers was for the sole purpose of providing administrative services on behalf of the three pension funds and IRC 501(c)(9) funds, which were to be its members. In providing administrative services for the member funds Bricklayers collected employer contributions, distributed employer benefits, maintained all records, and provided information to all parties involved. Prior to the formation of Bricklayers, the incorporated fund, the IRC 501(c)(9)s and pension funds which were its members either hired their own administrators or contracted with a commercial third party to perform the administrative services in question. The government and the corporation agreed that pension benefits were being paid by the corporation. Arguably, the corporation was not paying any benefits but was merely providing administrative services. If this argument was made and accepted it would mean that the corporation seeking IRC 501(c)(9) status would not, in fact, qualify for exemption because it did not (or would not) provide any benefits.

The court found two grounds for denial of IRC 501(c)(9) status here. First, pension benefits are "non-qualifying benefits" as that term is set forth in Reg. 1.501(c)(9)-3(f). The court specifically upheld the validity of Reg. 1.501(c)(9)-3(f). Also upheld was the validity of Reg. 1.501(c)(9)-3(b) dealing with what is considered a non-qualifying life benefit.

A second ground for denial was also cited by the court that was in line with our thinking as to why these pooled fund arrangements do not qualify for exemption. The court found that these arrangements consisted of entities which could not be considered an "association of employees." The court stated:

> Clearly, petitioner is not an association of employees within the meaning of section 501(c)(9). Its members are tax-exempt welfare and pension funds, not individual employees. Although the member funds are associations of individual employees, we find no basis for concluding that petitioner is therefore an association of those employees. Petitioner is in essence a cooperative of tax-exempt organizations, not an association of employees within the meaning of section section 501(c)(9). Although petitioner's member funds have already been granted tax-exempt status by respondent, grouping them together to form petitioner does not therefore create a tax-exempt voluntary employees' beneficiary association under section 501(c)(9).

The <u>Bricklayers</u> case is significant since it is the first case to interpret the newly implemented regulations. It is also significant since the Tax Court found the "other benefits" definition in Reg. 1.501(c)(9)-3(d) to be both a reasonable and a consistent interpretation of the language of the statute. Also, Reg. 1.501(c)(9)-3(f) defining "nonqualifying benefits" was deemed to be consistent with the definition of "other benefits" in Reg. 1.501(c)(9)-3(d). Further, Regs. 1.501(c)(9)-3(b) and (f) which specifically exclude pension benefits as a qualifying benefit were upheld. These regulation sections indicate that pensions, annuities, or similar types of benefits which are payable by reason of the passage of time rather than as the result of an unanticipated event, are not appropriate VEBA benefits.

8. <u>VEBA Benefits: A Discussion by Types</u>

A. <u>Life Benefits - Permanent vs. Current Protection</u>

Under Reg. 1.501(c)(9)-3(b), a "life benefit" is defined as a benefit payable by reason of the death of a member or dependent. The benefit may be provided directly (self-insured) or through insurance.

Generally, the regulations require that life benefits consist of current protection only and do not permit various forms of "permanent" life insurance contracts. The regulations under IRC 79 define a "permanent benefit" as 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.

There are three exceptions to the rule that life benefits under IRC 501(c)(9) must consist of current protection only and not "permanent" benefits. First, any organization may provide a certificate of eligibility for individual coverage to a participant in a group life insurance contract without evidence of insurability on termination of the member's relationship with the association. Second, a VEBA may provide a permanent benefit as defined in, and subject to the conditions in, the regulations under IRC 79. This second exception covers employer-funded associations. Third, an organization that is funded with employee, rather than employer, contributions may offer life benefits that involve permanent life insurance contracts. This third exception includes employee funded organizations which sell whole-life insurance policies to members and which have long been recognized as exempt under IRC 501(c)(9).

Worthy of note here are several clarifying statements in the preamble to the regulations. These statements indicate that the regulations permit IRC 501(c)(9) organizations that receive employer funding to <u>use</u> insurance policies involving cash values <u>only</u> where the policies are a part of the plan of so-called "group-permanent" life insurance subject to IRC 79 and the regulations thereunder. Also, the regulations were not intended to address whether benefits paid by a self-funded plan are eligible for exclusion from the income of the beneficiary under IRC 101(a). (Note that there is a "no rulings" position on whether proceeds of self-insured life and survivor benefit plans established by a VEBA are excludable from the beneficiary's gross income as amounts paid by reason of death. Section 5.03, Rev. Proc. 83-22, 1983-1 C.B. 680.) Finally, the preamble indicates that the regulations were revised to permit settlement of a life insurance policy in the form of an annuity where the treatment of the annuity is the same as if the annuity had been taken in a lump sum, that is, where the interest element in the periodic payment is includable in the recipient's gross income.

The questions in the life benefits section of the IRC 501(c)(9) regulations that create concern for us include what is an employer-funded permanent benefit that would have to satisfy IRC 79 (as distinguished from current protection), beneficiary designation problems, retired lives reserves, (a form of life insurance protection for retired employees), and a number of other life insurance issues left unresolved by the regulations.

The first and second questions generally arise where a VEBA purchases cash value policies in order to fund the promised benefits. Typically, in some exemption applications we have received, the VEBA will provide employee participants with a term life benefit during active employment and retirement in an amount that is a uniform multiple of compensation. These VEBAs are employer-funded and the trustee uses the funds to purchase whole life policies with cash surrender values as a means to provide the term life benefits. In other words, the VEBA is using the whole life policies as an investment vehicle. Usually, the policies are written on the lives of named participants of the VEBA and the trustee is named as the owner and beneficiary of these cash value policies. Also, the covered members of the VEBA do not have the right to designate beneficiaries. Rather, this power is delegated to a VEBA committee which may designate a beneficiary from a predetermined class of potential beneficiaries.

Under this arrangement, our concern is whether the intent of the regulations at Reg. 1.501(c)(9)-3(b) would be thwarted were we to recognize exemption of a VEBA funded in this manner. The applicants have argued that a VEBA, under these circumstances, is providing current protection only since the covered members have no right or interest in any cash values associated with the life policies owned by the trustee of the VEBA. Moreover, this arrangement probably cannot be considered a group-permanent plan subject to IRC 79.

We have become uncomfortable with this type of arrangement in light of the preamble to the final regulations under IRC 501(c)(9). The preamble states that employer-funded IRC 501(c)(9) associations may use insurance policies involving cash values only where the policies are part of a plan of so-called "group-permanent" life insurance subject to IRC 79. Under the arrangement described above, a group-permanent plan subject to IRC 79 is not present and the VEBA life benefit may not be considered appropriate since policies with cash values are used. The preamble suggests that any use of cash values by an employer-funded association must be in the form of a group-permanent life insurance plan that satisfies IRC 79.

We similarly have problems where a VEBA committee rather than the member designates the beneficiary. IRC 501(c)(9) states that benefits must flow to the members, their dependents or their designated beneficiaries. We interpret "their designated beneficiaries" as beneficiaries designated by the members. Thus, it would seem that benefits may only flow to those three groups and that to the extent a committee had powers to designate to other than dependents would seem inconsistent with the statute. Cases where a committee designates beneficiaries should be referred to the National Office.

While it is permissible to provide life insurance to members after they retire, it is not clear how it may be funded. In the so-called "retired lives reserves" (RLR) insurance, a fund is built up by the VEBA during a member's employment years to be used for life benefits during retirement. In the "pure" RLR a fund is built up during the employees active years and used exclusively for providing insurance in retirement. The tentative National Office position is that such an employer-funded RLR benefit is not permissible under IRC 501(c)(9) because it is not current protection and does not come under any of the exceptions provided under Reg. 1.501(c)(9)-3(b).

However, under the more typical situation the VEBA builds a fund or buys a whole life policy under which the VEBA is named as beneficiary, to provide set life benefits for both active and retired employees. Our problem here is whether the fund, or the purchase of a whole life policy, is permissible under IRC 501(c)(9). See the discussion above concerning IRC 79 and funding benefits through purchase of whole life policies. In addition, there is a "no rulings" position on whether RLRs satisfy IRC 79. See Section 5.02 of Rev. Proc. 83-22, 1983-1 C.B. 680. Cases involving RLRs should be forwarded to the National Office.

B. Educational Benefits

Reg. 1.501(c)(9)-3(e) includes as an example of "other benefits", education or training benefits or courses (such as apprentice training programs for members), because they protect against a contingency that interrupts earning power. Also included as "other benefits" are those provided in the manner permitted by paragraphs (5) et. seq. of section 302 (c) of the Labor Management Relations Act (LMRA) of 1947. Thus, collectively bargained trusts may provide scholarships to dependents by reason of section 302(c)(5) et seq. of the LMRA. See the preamble to the regulations under IRC 501(c)(9). One question that has arisen in regard to educational benefits is whether VEBAs, other than those that are collectively bargained and meet the organizational requirements of section 302(c)(5) et. seq. of the LMRA, may provide scholarship benefits to dependents. Our view is that trusts, which are not collectively bargained, may not provide scholarships to dependents. This view is based on the regulations and the preamble to those regulations which states that collectively bargained trusts may provide scholarship benefits to dependents. In this regard, the wording of the regulations has the effect of permitting section 302(c)(5) benefits only when paid to a collectively bargained trust, not simply of permitting the categories of benefits enumerated in section 302(c)(5) to be offered by any otherwise eligible IRC 501(c)(9) organization. In addition, section 302(c)(5) speaks in terms of a trust fund established by the representative of employees. Therefore, a trust established solely by employers would not be able to utilize the additional benefits permitted by the section 501(c)(9) regulation's reference to section 302(c)(5) of the LMRA. See also the discussion of Greensboro Pathology Associates, P.A., supra.

One way in which some non-collectively bargained trusts have sought to circumvent the regulations in this area is to broaden employment in a small corporation to include certain family members as part-time employees. In at least one case we have seen, membership in the VEBA was available to full-time and part-time employees. Essentially, all participants were family members with one of their members a college-age son, the only part-time employee. As indicated above, education, or training benefits, or courses (such as apprentice training programs) for employee-members are permissible benefits under IRC 501(c)(9). Furthermore, education benefits may be provided without restriction, that is, it does not appear that the benefits provided have to improve or enhance an employee's job skills. The only restriction is that education benefits be provided to employee-members only. This excludes dependents of employees.

The obvious way to get around this membership restriction is to add dependents as part-time employees who would then be eligible for educational benefits such as college tuition. In the case described above, we denied exemption because in our opinion the inurement standard of IRC 501(c)(9) was violated. Our reasoning was that a dominant share of the benefits were flowing to those employee-shareholders who controlled the employer corporation and the VEBA. See the discussion above on the Limited Membership VEBA.

C. Severance Pay Plans

1. Introduction and criteria for qualification

Severance pay plans were, traditionally, intended to provide a financial cushion for workers facing the loss of their jobs to carry them over the period of unemployment and to compensate them for the loss of seniority or other benefits that may have accrued by reason of their length of employment. Severance pay, or dismissal allowance, is normally made available to the employee if they quit, are fired, laidoff (if the layoff implies a permanent layoff), their job is abolished, if they become disabled, and, in some plans, upon death.

Severance pay plans are recognized as a permissible "other benefit" in Reg. 1.501(c)(9)-3(e): "... severance benefits (under a severance pay plan within the meaning of 29 CFR 2510.3-2(b))..."

Other than the reference to Department of Labor (D.O.L.) regulations, 29 CFR 2510.3, there is no guidance as to what provisions may, or may not, be included in a severance pay plan. The three basic requirements of 29 CFR 2510.3 are that:

(1) Payments cannot be contingent upon the employee's retiring,

(2) Payments cannot exceed twice the employee's annual compensation for the year immediately preceding termination, and

(3) Payments must be made within two years.

Using an IRC 501(c)(9) organization to provide severance pay has not been very common until very recently. The current popularity is due in part to the lowered benefit and contribution limitations imposed by TEFRA (discussed earlier). A severance pay plan appears to be an attractive vehicle to defer the income that would have gone into a qualified deferred compensation plan or pension plan.

2. <u>Administrative Problems</u>

Application of the existing rules with respect to severance pay plans is fairly simple because of the few restrictions or requirements, and those that do exist are relatively clear. Definitionally, there are only two problems at this time that have been recognized, but not yet resolved.

(1) Whether severance pay plan benefits paid by reason of disability or death should be treated as disability payments or life insurance benefits rather than severance pay benefits.

(2) Whether a benefit that is paid to the employee when she/he quits is severance pay or deferred compensation.

No conclusions have been reached on either issue. Cases involving these issues should be referred to the National Office as without precedent.

D. Vacation Benefits

1. General Problems

Under Reg. 1.501(c)(9)-3(e), paying vacation benefits, providing vacation facilities, reimbursing vacation expenses, and subsidizing recreational activities such as athletic leagues are considered "other benefits". Examples (1) and (2) of Reg. 1.501(c)(9)-3(g) illustrate factors that distinguish a qualifying vacation benefit from one that would be considered a savings plan and therefore nonqualifying. The essential nonqualifying features relate to whether participants have discretion to contribute additional amounts over and above employer contributions to the vacation plan, and whether they have the discretion to leave all or a portion of their distributable amount of benefit in the sponsored vacation plan, in which case interest may continue to accrue on such amounts.

In addition to the "employee contribution" and "unlimited accrual" problems mentioned above is that of payee designation. In a case recently submitted we were asked to recognize exemption of an organization which allowed the membership to make a third-party the payee of the vacation benefit (a cash benefit here) at a time when it was otherwise payable to the employee.

While it is true that once the member receives the benefit there is no restriction on its disposition, it does not necessarily follow that benefits may be designated or assigned in a similarly unrestricted manner. The benefits payable from an IRC 501(c)(9) organization must be qualifying benefits as provided under Reg. 1.501(c)(9)-3(a) through (c). An unrestricted assignment effectively changes the character of the vacation benefit paid by the IRC 501(c)(9) organization and could allow the trust or the membership to circumvent the restrictions on the nature of the benefits an IRC 501(c)(9) organization can provide. Once the vacation benefit is assigned to a third party, it may no longer be used by the member for vacations, and therefore ceases to retain its character as a vacation benefit. Moreover, an unrestricted designation power could permit the member to designate third parties who have no relation to the benefit provided, and would therefore neither safeguard or improve the health of the member, nor protect against a contingency that interrupts or impairs earning power. In such a case, the IRC 501(c)(9) organization would no longer be performing the function that provides the basis for its exempt status, but rather would be providing a benefit in the nature of savings facility or financial budgeting assistance to the employee. Such a benefit would be nonqualifying under Reg. 1.501(c)(9)-3(f).

2. Relationship of the Benefit provided to other Code Sections

Vacation benefitsare subject to the question of the extent of the allowable deduction under IRC 162. This problem arises because the operation of IRC 274(a) that limits the amount of entertainment, amusement, or recreation expenses which can be deducted. IRC 274(e)(5), however, provides an exception to this limitation. IRC 274(e)(5) provides that IRC 274(a) does not apply to expenses for recreational, social, or similar activities (including facilities) primarily for the benefit of employees (other than employees who are officers, shareholders or other owners, or highly compensated employees). Employees with less than a 10 percent interest in the employer business are not considered shareholders. The standards of IRC 274(e)(5) are not the same as those set forth in Regs. 1.501(c)(9)-2(a)(2) and 1.501(c)(9)-4(b) dealing with restrictions on eligibility for benefits or membership, and that dealing with disproportionate benefits.

As we previously pointed out in our discussion, recognition of exemption under IRC 501(c)(9) does not mean that contributions are fully or presently deductible under IRC 162. Likewise, exemption under IRC 501(c)(9) for a particular VEBA which offers a vacation benefit does not mean that the exception of IRC 274(e)(5) automatically applies. E. O. Specialists should be aware of these considerations. Problems in this area can be expected to arise where the employee membership group is small and includes the owner(s) of the employer business.

9. Summary and Conclusion

It is clear from our discussion that many problems have yet to be resolved in the IRC 501(c)(9) area. Further experience in the area, interpretative study of the regulations, extensive publication, and perhaps clarifying legislation will be necessary before all the problems discussed here are resolved.