O. AN EXPLANATION OF THE DEFICIT REDUCTION ACT OF 1984: ITS EFFECT ON TAX EXEMPT WELFARE BENEFIT ORGANIZATIONS

1. Introduction

The CPE programs for 1981-84 contained articles that discussed the clarifying regulations under IRC 501(c)(9). This article focuses on the recent provisions of the Deficit Reduction Act of 1984, P. L. 98-369 (DEFRA), as they apply to tax-exempt welfare benefit organizations. The specific organizations affected by the legislation are voluntary employees' beneficiary associations (VEBAs) described in IRC 501(c)(9), supplemental unemployment benefit trusts (SUBs) described in IRC 501(c)(17), and group legal services organizations (GLSOs) exempt under IRC 501(c)(20).

New Code sections 419, 419A, 505, 4976, and the amendments to section 512(a)(3) were enacted to deal with a number of concerns that arose with respect to the tax treatment of exempt and non-exempt employee welfare plans. A principal concern was that existing Internal Revenue Code provisions did not adequately determine the timing and amount of deduction allowable to an employer for contributions to a funded welfare plan (or organization). Also, the application of antidiscrimination rules under IRC 501(c)(9) was unclear. An additional concern was that the Code did not provide a clear distinction between certain welfare benefits, such as post retirement life insurance or medical coverage, and deferred compensation.

The recent legislation seeks to address these concerns by placing objective limits on the funding of welfare benefit plans. In addition, new discrimination guidelines, a notification requirement applicable to a welfare plan's exemption qualification, and changes to the unrelated business income tax provisions were enacted to remedy concerns in the employee welfare benefit area. This article will survey the effects of these new provisions on welfare benefit organizations that seek exemption qualification under IRC 501(c)(9), (17), or (20).

2. IRC 505(a) and (b): Nondiscrimination Requirements Applicable to Organizations Described in IRC 501(c)(9) or (20)

The nondiscrimination standard set forth in IRC 505(b) is effective for tax years beginning after December 31, 1984, and, as the legislative history suggests, is intended to override current regulatory nondiscrimination rules. These regulatory nondiscrimination rules were published in final regulations on January 7, 1981.

The new nondiscrimination standard applies to IRC 501(c)(9) and (20) organizations. SUB trusts described in IRC 501(c)(17) are not subject to the nondiscrimination standard of IRC 505(b) but are subject to the notification requirements of IRC 505(c) (discussed later) along with VEBA and GLSO applicants. The nondiscrimination standard described in IRC 501(c)(17) will continue to apply to SUB trusts. However, when a VEBA provides supplemental unemployment benefits as part of its activities, those benefits will be subject to the IRC 505 standard. In addition, collectively bargained welfare benefit trusts have been excluded from application of the new nondiscrimination standard. These trusts will continue to be subject to the nondiscrimination standards set forth in the regulations under IRC 501(c)(9).

The plain language of the nondiscrimination standard indicates that its drafters intend that the Secretary of Treasury will refine the standard by clarifying regulations. In addition, the Code provision appears to endorse a benefit by benefit analysis when testing a welfare benefit organization for discrimination. Under a benefit by benefit analysis, each benefit is scrutinized separately for discrimination. If any benefit is found to be discriminatory, the organization can not qualify for exemption. Authority for this analysis seems clear from the language of IRC 505(b)(1)(B) where it is said that the nondiscrimination requirement will be met, in part, if "in the case of <u>each class of benefits</u>, such benefits do not discriminate in favor of employees who are highly compensated employees". (Emphasis added) Moreover, the inurement proscription under IRC 501(c)(9), as interpreted by the regulations published in 1981, is unchanged. In this regard, the Service's current thinking is that an organization is not entitled to exemption under IRC 501(c)(9) where employees who effectively control the organization by virtue of their ownership of the sponsoring employer are entitled to a dominant share of benefits available through it. The rationale for this view is that the inurement standard is violated where owner-employees are entitled to a dominant share of available benefits since the purported employees' association is essentially a personal investment fund for owner-employees. See pages 95-97 of the 1984 EO CPE for further explanation.

The actual nondiscrimination standard enacted by recent legislation is found in IRC 505(b)(1), which says that a plan is nondiscriminatory if -

(A) each class of benefits under the plan is provided under a classification of employees which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are highly compensated individuals, and

(B) in the case of each class of benefits, such benefits do not discriminate in favor of employees who are highly compensated employees.

This provision goes on to indicate that a life insurance, disability, severance pay, or supplemental unemployment compensation benefit shall not be considered to fail to meet the nondiscrimination standard merely because the benefits available bear a uniform relationship to total compensation or the basic or regular rate of compensation, of employees covered by the plan.

Also, of particular note, is the special rule that the IRC 505(b) standard does not apply with respect to a particular type of benefit when another Code section establishes a nondiscrimination standard with regard to such benefit. Thus, group term life insurance described in IRC 79, medical benefits described in IRC 105, benefits under qualified group legal services plans described in IRC 120, and dependent care assistance benefits described in IRC 129 are not subject to the nondiscrimination standards of IRC 505. These benefits, however, will be subject to the nondiscrimination standard of the Code provision that provides for their exclusion from gross income of covered individuals.

Under IRC 505(b)(2), a plan is not discriminatory if it excludes from coverage certain classes of employees. These employees are employees who have not completed three years of service, employees who have not attained age 21, seasonal employees or less than half time employees, employees not included in the plan who are included in a unit of employees covered by an agreement between employee representatives and one or more employers which is found to be a collective bargaining agreement if the class of benefits involved was the subject of good faith bargaining, and employees who are nonresident aliens who receive no earned income from the employer which constitutes income from sources within the United States.

IRC 505(b)(5) defines "highly compensated individuals" for purposes of applying the nondiscrimination standard. "Highly compensated individual" has the same meaning as the term does under IRC 105(h)(5) except that 10 percent is substituted for 25 percent. Thus, a "highly compensated individual" is one who is one of the five highest paid officers, is a shareholder who owns (after applying IRC 318) more than 10 percent in value of the stock of the employer, or is among the highest paid 10 percent of all employees (other than employees described in IRC 105(h)(3)(B) who are not participants).

For purposes of the nondiscrimination requirement, IRC 505(b)(4) allows an employer to aggregate plans when testing discrimination. Although this will be clarified by regulations, we understand that plans that provide benefits through non-VEBAs and non-GLSOs may not be aggregated under this rule. In addition, in testing a VEBA for discrimination, aggregation rules similar to those set forth in IRC 414(b), (c), (m) and (n) are to apply. These Code provisions were enacted to prevent employers from forming multiple corporations, partnerships, proprietorships, trusts, estates or other business arrangements such as employee leasing that would circumvent the coverage and nondiscrimination requirements applicable to pension and other employee benefit plans under IRC 401. In essence, they treat certain groups of employers as a single employer for purposes of testing for discrimination. Thus, the employees of a controlled group of corporations, a commonly controlled trade or business, or an affiliated service group are treated as employed by a single employer. Also, certain leased employees may be treated as employed by a single employer. Under new Code section 505(b)(4)(B), these affiliation rules for single employer treatment are to apply to welfare benefit plans provided through VEBAs and GLSOs when testing for discrimination.

Although not specifically mentioned in the statute, the Conference Report explains the extent to which a disability plan may be integrated with disability benefits provided under the Social Security Act without resulting in discrimination. First, only that part of the social security benefit that is considered to have been provided by the employer is taken into account. Of that amount only the Disability Income (DI) part of the social security benefit is considered. Thus, only the employer-provided DI is taken into account by the plan providing benefits through an IRC 501(c)(9) organization. The extent of integration is also limited where the employer has also integrated its pension plan. This approach is intended to avoid situations of double integration when testing a welfare plan for discrimination. Integration of long term disability with worker's compensation benefits is also permitted.

The Conference Report explains integration in more detail:

> The conferees wish to clarify the rules of the House bill relating to integration of benefits under a VEBA with social security. In testing whether a

disability plan funded with an exempt trust violates the rules forbidding discrimination in favor of employees who are officers, shareholders, or highly compensated, a part of each employee's Social Security benefit (the part considered to be paid for by the employer) can be taken into account as if it were provided under the employer's plan. Similar integration rules are provided for qualified pension plans.

For example, a pension plan may provide a retirement benefit that is reduced by up to 83 1/3 of the primary insurance amount for the employee under Social Security. This 83 1/3 percent offset represents the part of the employee's Social Security benefit that the employer is considered to have provided. It includes the value of the employer's Disability Income (DI) contribution, as well as his Old-Age and Survivor's Insurance (OASI) contribution. The Disability Income benefit is considered to make up 10 percent of the value of employer-provided Social Security benefits.

Thus, if the employer provides a disability benefit under the pension plan and the disability benefit is reduced by 100 percent of the Social Security benefit, then the employer may "take credit" for only 90 percent of employer-provided Social Security benefits when paying a retirement benefit. Accordingly, only 75 percent (90 percent of 83 1/3) of Social Security benefits could be subtracted from the retirement benefit. Thus, under the agreement, if an employer's pension plan is not more than 90 percent integrated--that is, it does not reduce benefits by more than 90 percent of the amount by which they could be reduced (e.g., by more than 75 percent of social security benefits)--then double integration does not occur. In this case, the agreement requires no change in either the pension plan or the disability plan.

On the other hand, if an employer's pension plan is more than 90 percent integrated, the full value of the Disability Income benefit under Social Security could not be used to reduce long-term disability benefits under the employer's plan. For example, if the pension plan is 93 percent integrated (so that 30 percent of the employer's Social Security Disability Income benefit has been used by the pension plan), then no more than 70 percent of the Disability Income benefit could be applied to reduce long-term disability benefits under the employer's plan. Of course, if the pension plan were 100 percent integrated, the long-term disability benefit under the employer's plan could not be integrated with Social Security. The rules relating to integration of long-term disability benefits apply to benefits funded by employer contributions as well as benefits funded by employee contributions.

Of course, the agreement also permits the integration of long-term disability benefits with workers' compensation benefits.

In addition, the agreement does not affect the integration of long-term disability benefits for employees who are disabled before the effective date.

The nondiscrimination requirements added by IRC 505 are effective for years beginning after December 31, 1984. At the election of an employer, disability and severance payments payable to individuals who are in pay status as of January 1, 1984 are not subject to the new nondiscrimination standard. This does not apply to payments increased by plan amendments adopted after June 22, 1984. See section 513(c) of DEFRA.

While some of the provisions of IRC 505 are quite clear as to application of the nondiscrimination standard, the basic standard waits to be clarified by Treasury regulations. Currently, the National Office is actively pursuing development of these regulations.

3. IRC 505(c): Notification Requirement for Recognition of Exemption

A notification requirement is now applicable to organizations claiming exempt status under IRC 501(c)(9), (17) or (20). Thus, these organizations will not be treated as exempt from tax under these Code sections unless they give appropriate notice that they are applying for recognition of exemption. Treasury regulations, which should be released soon, will outline the manner in which notification is to be given by these organizations. We expect that notification will be accomplished by submission of a substantially completed exemption application on Form 1024. Generally, organizations in existence on July 18, 1984, will have at least until one year after that date to submit an application for exemption. Since administrative rules have already been promulgated with regard to notification requirements applicable to qualified group legal services under IRC 120, those requirements will probably continue to apply to a GLSO. See Regs. 1.120-3. In addition, an organization that has received a ruling or determination letter recognizing exemption will probably not have to renotify the Service. As in the case of the nondiscrimination standard, IRC 505(c) is effective for tax years beginning after December 31, 1984.

4. IRC 419: Deductibility of Employer Contributions to Welfare Funds

As indicated earlier, this new Code section places objective limits on the amount an employer can deduct for contributions to a welfare plan for employees. These limits were necessary because the rules under IRC 162 were unclear and it appeared that employers were seeking to take advance deductions for contributions to welfare plans that provided benefits in the nature of deferred compensation.

The application of the new deduction limitations is quite broad and goes beyond VEBAs. It is achieved through an inclusive definition of "welfare benefit fund" provided in IRC 419(e). Generally, the limitations apply to contributions to welfare benefit funds which are organizations, reserves, or accounts held by organizations, through which an employer provides welfare benefits. A welfare benefit means any benefit other than a benefit to which IRC 83(h), 404, (determined without regard to IRC 404(b)(2)), 404A, or an election under IRC 463 apply.

The new provision limits the deductions for contributions to a welfare benefit fund to the fund's "qualified cost" for the taxable year, which is the sum of (1) "qualified direct costs", and (2) additions, within limits provided by IRC 419A, to a "qualified asset account". IRC 419(c)(3) defines "qualified direct costs" as the aggregate amount which would have been allowable as a deduction to an employer for benefits provided if (1) the benefits were provided directly by the employer and (2) the employer used the cash receipts and disbursements method of accounting. In addition, the "qualified cost" is reduced by after-tax income as defined in IRC 419(c)(4). Thus, "qualified direct costs" are those amounts actually paid for benefits provided directly to employees during the year as if the employer used the cash method of accounting. This may include properly allocable administrative costs and insurance premiums as well as direct benefit costs. For example, in the case of a self-insured medical reimbursement plan, the qualified direct cost equals the actual benefit payments made to employees for the taxable year, plus a properly allocable share of the administrative costs of providing such benefits.

Under IRC 419(c)(3)(B), for the purpose of determining the qualified direct cost, a benefit is to be treated as provided when the benefit would be includible in the gross income of the employee (or would be includible in the employee's gross income but for a provision of the Code). For example, if an employer contributes to a fund to pay premiums for insurance under a plan, then the qualified direct cost of the year would be the cost of the insurance for the period for which the coverage is provided, without regard to whether any part of that cost is excludable from the gross income of an employee. On the other hand, to the extent the liability is self-insured, the time at which benefits would be included in the employee's gross income would be based on the time at which benefits are paid, rather than the time of current insurance coverage, because this is the time when benefits would be included if the self-insured benefits were provided directly by the employer on an unfunded basis. It is important to note that in determining "qualified direct costs" with regard to a child care facility, the adjusted basis of the facility is treated as deductible ratably over a 60 month period in lieu of a depreciation deduction.

As previously stated, in calculating the amount of "qualified cost" for which a deduction is allowed, additions to a "qualified asset account" are permitted. Essentially the "qualified asset account" is a reserve set aside only for the payment of:

(1) disability benefits,
(2) medical benefits,
(3) supplemental unemployment benefits or severance pay benefits, and
(4) life insurance or death benefits.

Contributions to a "qualified asset account" are deductible only within certain prescribed limits applicable to the benefits listed above and detailed in IRC 419A. In general, though, the account limit for any benefit reserve is the amount estimated to be necessary under actuarial assumptions that are reasonable in the aggregate, to fund the liabilities of the plan for the amount of claims incurred but unpaid, for benefits described above and administrative costs of such benefits, as of the close of the taxable year. Claims are incurred only when an event entitling the employee to benefits, such as a medical expense, a separation, a disability, or a death, actually occurs. The allowable reserve includes amounts for claims estimated to have been incurred but which have not yet been reported, as well as those claims which have been reported but have not yet been paid. An example of an incurred but unpaid claim is the occurrence of the death of an employee during the year under a plan that provides for payments to a survivor of the employee for the survivor's remaining life. The qualified asset account may include the estimated present value of the future stream of benefits payable to this survivor, using reasonable assumptions as to earnings of the fund and mortality experience.

The account limits set forth in IRC 419A, in general, require actuarial certification in order to obtain a deduction for a contribution to a qualified asset account. However, certification is not necessary if the account limits do not exceed the applicable "safe harbor" of IRC 419A. These "safe harbors" are set forth in IRC 419A(c)(5), but are not safe harbors in the strict sense because there must be a determination, but not a "certification", that the safe harbor additions are reasonable and necessary.

The legislation also provides a transition period for determining the account limits for each of the first four years to which the new rules apply. The account limit for any of the first four taxable years under the new rules is increased by the applicable percentage in IRC 419A(f)(7)(B) of any existing reserves (as defined in IRC 419A(f)(7)(C)). The applicable percentage is 80 percent for the first taxable year and is reduced 20 percent a year for each of the three subsequent years.

The deduction limits (IRC 419 and 419A) do not apply to any welfare benefit fund which is part of a 10-or-more employer plan. Such plan is one to which more than one employer contributes, and to which no employer normally contributes more than 10 percent of the total contribution to the plan by all employers. IRC 419A(f)(6).

Generally, these provisions apply to employer contributions paid or accrued after December 31, 1985, in taxable years ending after such date. Special effective dates are applicable in the case of collectively bargained plans and with regard to contributions of facilities to welfare plans. In the case of a collectively bargained plan (under agreements in effect on July 1, 1985), the new provisions will not apply to years beginning before the date on which the last of the bargaining agreements terminates. With regard to facilities, the law applies in the case of any contribution, after June 22, 1984, of a facility to a welfare benefit fund, and any other contribution, after June 22, 1984, to be used to purchase a facility. This rule does not apply to any facility which is acquired pursuant to a funding contract in effect on June 22, 1984, and at all times thereafter, or any facility the construction of which began before June 22, 1984.

5. Amendments to the Unrelated Business Income Tax Provisions

Prior to the amendment to IRC 512(a)(3) that section provided a special definition of "unrelated business taxable income" in the case of VEBAs and social clubs (IRC 501(c)(7)). It provided, and still provides, that the term "unrelated business taxable income" means the organization's gross income, less directly connected expenses, less "exempt function income", computed in accordance with certain modifications under IRC 512(b). "Exempt function income" means the amount of dues, fees, charges, or similar amounts of gross income from members, and, in the case of a VEBA, amounts set aside to pay permissible benefits. DEFRA amended IRC 512(a)(3) in two ways. First, it extended IRC 512(a)(3) to cover SUB trusts and GLSOs. Next, it placed limits on the amounts that could be set-aside for exempt purposes. (Prior to DEFRA there was, in effect, no limitation on the amount that could be set aside in the case of a VEBA except for a vague standard that set asides must be reasonable in amount and duration. See 1981 EO CPE text, pages 160 through 163, for a discussion of this issue.)

The new law (IRC 512(a)(3)(E)), in the case of IRC 501(c)(9), (17), or (20) organizations, limits the amount that can be set aside for a taxable year to the account limit determined under the deduction rules of IRC 419A(c). Thus, if a VEBA, SUB trust, or GLSO, sets aside an amount sufficient to eliminate its gross income from the definition of unrelated business income, the extent to which any set asides exceed the IRC 419A(c) limits will generally result in tax. In addition to the IRC 419A(c) limits, IRC 512(a)(3)(E)(ii) provides that no set aside is allowed for facilities used to provide life, sick, accident, or other permissible benefits. Further, no set-aside is allowed for amounts to provide medical benefits to retired employees, so called post-retirement benefits.

However, under IRC 512(a)(3)(E)(iii), a transitional rule is provided for existing reserves to provide medical benefits and life insurance benefits to retired employees. In this regard, the income attributable to an existing reserve is not subject to the new rules for calculating unrelated business taxable income. An existing reserve is the amount of assets set aside as of the close of the last plan year ending before July 18, 1984. The transition relief applies to a reserve to provide such benefits only to the extent the reserve does not exceed the amount that could be accumulated under the principles of Rev. Rul. 69-382, 1969-2 C.B. 28, and Rev. Rul. 73-599, 1973-2 C.B. 40. All future payments of medical or life insurance benefits to retirees under plans of the employer are to be charged against the reserve to which the transition rule applies.

The limit on set asides applies to more-than-10-employer VEBAs, GLSOs, and SUB trusts even though these large plans are excepted from the IRC 419A deduction limitations. Note further that the limit on amounts that may be set aside does not apply to any organization if substantially all of the contributions to the organization are made by employers who were exempt from income tax throughout the five-taxable year period in which contributions are made.

An interesting aspect of this new legislation is that nonexempt welfare funds may have what is referred to as "deemed unrelated income". Under this rule, income of a nonexempt welfare benefit fund that would be unrelated business income if it were exempt, is included in the employer's gross income for the taxable year. See IRC 419A(g).

These provisions relating to unrelated business income and deemed unrelated business income generally apply to contributions paid or accrued after December 31, 1985, in taxable years ending after such date.

6. IRC 4976: Taxes With Respect to Funded Welfare Benefit Plans

Where a "disqualified benefit" is provided through an employer-maintained welfare benefit fund, a 100 percent tax is imposed on the employer in the amount of the "disqualified benefit." Under this provision, a disqualified benefit is (1) any medical benefit or life insurance benefit with respect to a key employee not provided through a separate account in accordance with the new deduction rules under IRC 419A(d), (2) any medical benefit or life insurance benefit for retired employees that does not meet the nondiscrimination standards of IRC 505(b)(1), and (3) any reversion of such a fund to an employer.

This provision is also effective generally to contributions paid or accrued after December 31, 1985, in taxable years ending after such date.