J. THE DEPTHS OF IRC 419 AND 419A

by
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1. Introduction

Nirvana for many investors is to invest pre-tax dollars on a tax-free basis. It is an investor's karma, however, to be thwarted by the Internal Revenue Code. Thus, investors and their financial advisers find themselves journeying in a never-ending samsara of searching for shelters and loopholes, using them briefly, only to watch in chagrin as a sometimes vigilant Congress closes yet another avenue to true beatitude.

So it was with VEBA's. The popularity that IRC 501(c)(9) voluntary employee's beneficiary associations enjoyed in the early 1980's can be ascribed, in part, to many small corporations or unincorporated businesses that attempted to shelter assets in employee benefit trusts. However, even where the purpose of providing employee benefits was genuine, as was doubtless true among larger employers and many smaller ones, prefunding the benefits presented the prospect of current deductions by employers for future expenses, with a consequent cost to the U.S. Treasury. An IRC 162 deduction would be taken for amounts placed in trust, and the trust would seek IRC 501(c)(9) exempt status to shelter future earnings. While qualified pension plans were capable of being used to attain the same sheltering effect, Congress had recently acted to lower funding levels, and now much tighter restrictions applied. Consequently, as the prospects for successful pension plan manipulation faded, applications for IRC 501(c)(9) status began to rise.

IRC 501(c)(9) provides for tax exemption for associations of employees that provide life, sick, and other benefits to members or their dependents or designated beneficiaries, if no part of the net earnings inures (other than through the payment of such benefits) to the benefit of any private individual. The statute is innocent enough, as befits the product of a more innocent era. The regulations that underlie IRC 501(c)(9) are much more recent, but even they apparently did not foresee the patterns of abuse that were to follow. While it was clear that many employers were legitimately using VEBA's only to provide their employees with benefits as contemplated by the statute, a trend of applications from employers with only a very few employees, often just one or two, began to emerge. At the same time, large sums were being used to pre-fund the benefits offered. Severance benefits were offered to the employees of a one-person employer; a vacation home for the use of a two-person employer (doctor and wife); in many more cases the life, severance, and disability

benefits were concentrated in the hands of the few highly-compensated employees who controlled the employer and the VEBA, offered in amounts proportionate to their copious salaries, while the secretaries and other employees would receive benefits in proportion to their meager salaries. Generally, dissolution provisions allowed for the distribution of assets to employees in proportion to salary, and the timing of such dissolution was effectively in the hands of the highly compensated employees. While these benefits were not on the surface in clear violation of the IRC 501(c)(9) regulations, neither did they seem consistent with sound tax policy.

The Service took several steps to deal with the trend. One-person VEBA's were barred from exemption, a position ultimately published in Rev. Rul. 85-199, 1985-2 C.B. 163. G.C.M. 39300 set forth grounds to deny exemption to certain small self-insured VEBA's on the basis that earnings inured to the benefit of a single private individual, where the benefits and power to terminate the VEBA were concentrated in the same individual.

It was Congress, however, that played the decisive role in reducing the attractiveness of VEBA's as an investment vehicle through provisions of the Deficit Reduction Act of 1984. In IRC 419, effective for contributions paid or accrued after December 31, 1985, in taxable years ending after that date, it curtailed current deductions for payment of future benefits. With certain exceptions, this ended the ability to use pre-tax dollars for anything except currently paid benefits. A second restriction, IRC 512(a)(3)(E), in conjunction with IRC 419A, subjected VEBA income to unrelated business income tax to the extent that setasides exceeded certain account limits for health, disability, life, supplemental unemployment, and severance benefits. This provision ended the ability to shelter future earnings from taxation, to the extent that these accounts were overfunded. Another provision sought to ensure that highly compensated employees were not favored in the provision of benefits (IRC 505(b)).

The result was to better ensure that employee welfare benefit plans are actually used for employee welfare benefits, and not as a tax shelter.

This article deals with IRC 419 and 419A, as well as IRC 512(a)(3)(E), the provisions that most directly limited the investment potential of employee welfare benefit plans.

2. IRC 419. The Limitation on Employer Deductions

A. IRC 419 vs. IRC 162 and IRC 212

Although it uses rather obtuse language to say it, IRC 419(a) provides that contributions paid or accrued by an employer to an employee welfare benefit fund are deductible only by virtue of IRC 419, and only if the expense would be deductible under some other provision of the Code relating to income taxes. The standards used for determining deductibility are found under provisions that would otherwise govern deductions for income tax purposes, which normally are IRC 162 or IRC 212. Thus, if an employer contribution otherwise would have been deductible under section 162 as an ordinary and necessary trade or business expense, it can be deducted only under IRC 419 and not IRC 162.

The purpose behind prohibiting IRC 162 or IRC 212 from being used as the direct basis for a deduction for a contribution to an employee welfare benefit fund is to ensure that the specific provisions of IRC 419 control and limit the amount of any employer deduction. In general, Congressional intent was to allow deductions only for the costs of current benefits plus an actuarially determined allowance for certain reserves and benefit accounts. What Congress sought to prohibit was a current deduction for future benefits, except in certain clearly defined situations for post-retirement purposes.

B. The Welfare Benefit Fund

Definition of "fund". IRC 419(e)(1) defines welfare benefit fund as any fund that is part of a plan of an employer and through which the employer provides welfare benefits (other than deferred compensation benefits, such as pension benefits, to which other IRC provisions apply) to employees or their beneficiaries. For these purposes, the term "fund" is extremely comprehensive. It covers:

1. any organization described in IRC 501(c)(7), 501(c)(9), 501(c)(17), or 501(c)(20);

2. any taxable organization; and

3. any account held for an employer by any person, to the extent provided in regulations. (See Reg. 1.419-1T, Q&A 3, discussed below);

which is part of a plan, or a method or arrangement, of an employer used for providing welfare benefits.

Insurance contracts as funds. In general, if an employer purchases an insurance contract to provide current benefits under a welfare benefit plan, the insurance

contract does not create a "fund" under IRC 419(e). However, an account maintained by an insurance company to provide benefits exclusively for the employees of one employer or a reserve established by an insurance company under the provisions of a group insurance contract may be a fund under IRC 419(e). For example, (1) if the insurance company provides services to a welfare benefit plan under an "administrative services only" contract; or (2) if the insurance company establishes a reserve for post-retirement life insurance or medical benefits as part of an insurance contract; or (3) if the insurance company maintains a premium stabilization reserve under a group insurance policy and the reserve is charged and credited based only on the experience of the employer, then the account through which the plan benefits are paid or the reserve is a fund under IRC 419(e).

The Treasury originally sought to treat a variety of insurance arrangements as "funds" under IRC 419(e)(3)(C). See Reg. 1.419-1T, Q&A 3 (promulgated on January 26, 1986). However, in the Tax Reform Act of 1986, Congress enacted IRC 419(e)(4), which provides that amounts held pursuant to certain insurance contracts, including a newly defined class of "qualified nonguaranteed contracts", will not be treated as funds, notwithstanding IRC 419(e)(3)(C).[1]

Independent contractors. IRC 419 is fully intended to cover benefits provided to independent contractors. If a fund would be a welfare benefit fund except for the fact that benefits are provided to persons who are independent contractors rather than employees of an employer, IRC 419 applies to the fund as if an employer-employee relationship exists.

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[1] In the Tax Reform Act of 1986, Congress also delayed the effective date of most provisions of the regulations under IRC 419(e)(3)(C) until six months after the date the regulations are published in final form. (Sec. 1851(a)(8)(B) of the Act, P.L. 99- 514). The statute contains an exception allowing those provisions of the regulations applicable to reserves for post-retirement life and medical benefits, and to arrangements between an insurance company and an employer under which the employer has a contractual right to a refund or dividend based solely on its own experience, to become effective before final regulations are published. The Service has not yet published final regulations under IRC 419(e)(3)(C). Accordingly, the existing temporary regulation, Reg. 1.419-1T, Q&A 3, has only limited applicability.

Definition of "welfare benefit". IRC 419(e)(2) defines welfare benefit by reference to what is not a welfare benefit. The term means any benefit other than a benefit to which:

1. IRC 83(h) applies.

2. IRC 404 applies. This refers to deferred compensation plans such as pension, profit-sharing, stock-bonus, or annuity plans.

3. IRC 404A applies. This refers to foreign deferred compensation plans.

It is apparent from this definition that for purposes of IRC 501(c)(9), (17), and (20) organizations, virtually all permissible benefits that may be provided by these organizations are included within the term "welfare benefit". Thus, employer deductions for contributions provided to these organizations are governed by IRC 419.

C. Limitation on Employer Deductions: The Mechanics

IRC 419(a)(2) requires that employer contributions to a welfare benefit fund must actually be paid (rather than accrued) during a taxable year before a deduction may be taken.

IRC 419(b) limits the amount of any employer deduction under IRC 419 to the "qualified cost" for any taxable year. The qualified cost has two components: the "qualified direct cost", and any addition to a qualified asset account described in IRC 419A to the extent that the account limit described in that section is not exceeded. It is the fund's qualified cost that is determinative of the IRC 419 limitation on an employer's deduction. In computing the fund's qualified cost, the qualified cost is reduced by the "after-tax income" of the fund. Thus, for a contribution to a welfare benefit fund, the qualified cost determination is made under this formula:

QUALIFIED COST = Qualified direct cost
Plus
Addition to qualified asset account
(up to account limit)
Less
After-tax income of fund

Once the qualified cost determination is made, the limit of the employer's available IRC 419 deduction is known. If the amount of employer contributions that were paid during the employer's taxable year exceeds the amount of the allowable IRC 419 deduction, the employer is allowed a carryover of the employer's excess contributions into the employer's succeeding year, and the carryover will be treated as a contribution made on the first day of the succeeding year. Conversely, if the amount the employer contributes during its taxable year is less than the fund's qualified cost, the employer's deduction is limited to the amount the employer actually paid (or is considered to have paid, in the event the employer has carried over excess contributions from a prior taxable year).

Employer year v. fund year. When the employer and the fund have different taxable years, the taxable year of the welfare benefit fund that ends within the employer's taxable year is considered to be the year that is related to the employer's taxable year, under Reg. 1.419-1T, Q&A 4.[2]

> ***Example***: Widget Co. has a taxable year ending December 31. Widget Co. is the sole contributor to Widget VEBA, whose taxable year ends June 30. For Widget VEBA's taxable year ending June 30, 1991, the VEBA had a qualified cost of $10,000. For Widget Co.'s taxable year ending December 31, 1991, Widget Co.'s IRC 419 deduction is limited to $10,000, or the amount contributed to the VEBA during the taxable year ending December 31, whichever is less.

D. Computing Qualified Direct Cost and After-Tax Income

The qualified direct cost component of the formula represents the expenses of the welfare benefit fund attributable to the cost of the provision of current benefits. The qualified direct cost is the aggregate amount (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided during the fund's taxable year if:

1. the benefits were provided directly by the employer, and
2. the employer used the cash receipts and disbursements method of accounting.

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[2] Special rules may apply to employer deductions in the taxable year that a fund is created, as well as in the employer's immediately succeeding taxable year. See Reg. 1.419A-1T, Q&A 7.

In order to ensure that current deductions are not taken for the provision of future benefits, IRC 419(c)(3)(B) provides that a benefit is considered to be provided at the time that it is includible in the gross income of the employee if provided directly by the employer (or would be included in income but for the fact that a provision of the Code excludes it).

> ***Example***: VEBA Trust's taxable year ends on December 31, 1990. In July 1990, the trust paid an insurance company the premium for a full year of disability insurance coverage for the 12-month period ending June 30, 1991. Only the portion of the premium payment applicable for 1990 coverage is considered a qualified direct cost for the taxable year ending December 31, 1990. The balance of the premium payment is considered a qualified direct cost of the trust for 1991.

Contributions of tangible assets. Reg. 1.419-1T, Q&A 6(b) provides a special rule for assets with a useful life extending substantially beyond the end of the taxable year, such as buildings, vehicles, licenses, etc. If the asset is used in the provision of welfare benefits to employees, the qualified direct cost of the fund is the amount that would have been allowable to the employer as a deduction, such as under IRC 168 or IRC 179, with respect to the portion of the asset used in the provision of the welfare benefits for the year. The calculation of the amount that would have been deductible by the employer is made as if the employer had acquired and placed the asset in service at the same time as the fund acquired and placed the asset in service, and as if the employer had the same taxable year as the fund. This rule applies whether the asset was donated by the employer or acquired or constructed by the fund.

> ***Example 1***: In May 1990, Widget Co., as an ordinary and necessary business expense, contributes an apprenticeship training facility to Widget VEBA for the use of Widget Co.'s employees. It is placed in service immediately. Widget Co.'s taxable year ends December 31, while the VEBA's taxable year ends June 30. Assume that the facility is IRC 168(c) recovery property. This transaction has several tax consequences.
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> a. First, Widget Co. will be treated as having sold the property for its 1990 calendar year return, and must recognize gain on its return to the extent that the fair market value of the property exceeds Widget Co.'s adjusted basis. See IRC 1239(d).
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> b. Second, Widget Co. is treated as having made a contribution to the fund in the amount of the fair market value of the property, and this amount can be deducted under IRC 419, subject to the limitation of this amount plus other contributions not exceeding Widget VEBA's qualified cost.

c. Third, in computing Widget VEBA's qualified cost, the amount that Widget Co. could have deducted for depreciation under IRC 168 is Widget VEBA's qualified direct cost with respect to the facility. For this third computation, the amount that Widget Co. may deduct under IRC 168 is computed as if Widget Co. had placed the asset in service in May 1990, and as if Widget Co.'s taxable year ended on June 30, 1990. Since the May 1990-June 1990 period is relatively short, the qualified direct cost for Widget VEBA's June 30, 1990 taxable year, and thus the applicable deduction on Widget Co.'s 1990 calendar year return, is relatively small. The balance of Widget Co.'s deduction is carried forward to subsequent years.

Example 2: Widget VEBA uses cash on hand to construct the training facility in Example 1, which it places in service in May 1990. For purposes of determining Widget VEBA's qualified direct cost, the third computation in Example 1 is used. Thus, the qualified direct cost is the same whether or not the employer directly contributes the facility, and the limit on the employer's deduction is the same. In this case, however, the employer is not entitled to treat the fair market value of the facility as a contribution. Any Widget Co. deduction for 1990 must be established through other Widget Co. contributions in Widget VEBA's taxable year ending June 30, 1990, or through Widget Co. contributions carried over to 1990 from prior years.

Notwithstanding these rules, the qualified direct cost of the VEBA does not include any expenditure by the VEBA for which the employer would not have been allowed a deduction if the expenditure had been made directly by the employer. See Reg. 1.419-IT, Q&A 6(c). For example, a fund's purchase of land in a year for an employee recreational facility will not be treated as a qualified direct cost because, if made directly by the employer, the purchase would not have been deductible under IRC 263. (However, improvements on the land for a recreational facility would be treated under the rules applicable to tangible assets, discussed above. See Example 2.).

Special Rule for Child Care Facilities. For child care facilities, the Code allows more favorable treatment than otherwise would have been available under the rules for treatment of tangible assets with a useful life of more than one taxable year. IRC 419(c)(3)(C) provides that in lieu of depreciation such facilities are to be amortized over a 60-month period on a straight-line basis beginning with the month in which the facility is placed in service. This is much faster than would have been allowable under IRC 168, and the fund's qualified direct cost with respect to such a facility will correspondingly be much higher. This, in turn, allows a much increased limit on employer deductions.

To qualify as a child care facility for these purposes, the facility must be tangible property used as a child care center primarily for children of employees of the employer. Further, the property must be located in the United States and be of a character subject to depreciation.

Reduction for After-Tax Income of the Fund. The qualified cost of a welfare benefit fund is reduced by the fund's after-tax income. After-tax income is defined as the gross income of the fund reduced by the sum of:

1. the allowable deductions directly connected with the production of such income; and

2. the income tax imposed on the fund for the taxable year.

For this purpose, gross income includes contributions, dues, fees, and other amounts received from employees, as well as the fund's investment income, but does not include employer contributions.

The effect of the after-tax income reduction is to provide an additional deterrent to the overfunding of welfare benefit funds. The more investment income and employee contributions that are received by the fund, the lower the ceiling on employer deductions. The rule ensures that a fund's qualified cost for a taxable year is first to be considered paid from the investment income of, and employee contributions to, the fund, and only after such income is accounted for will an employer be eligible to deduct for amounts contributed to the fund in the employer's related taxable year.

3. Additions to a Qualified Asset Account

A. Types of Benefits

The qualified cost of a fund not only includes the qualified direct cost, but also additions to a qualified asset account described in IRC 419A. A qualified asset account may be established only for the specific purposes described in IRC 419A,

and no addition is allowed if an account is overfunded. The account limit set forth in IRC 419A(c) determines when a qualified asset account is overfunded.[3]

The specific benefits listed in IRC 419A for which a qualified asset account is available are:

disability benefits
medical benefits
supplemental unemployment benefits (SUB)
severance benefits
life insurance benefits

Additional reserves are allowed for reserves for post-retirement medical and life insurance benefits funded over the working lives of covered employees.

For benefits not specifically listed in IRC 419A, there cannot be a qualified asset account, and thus no addition to a qualified asset account is taken into account. Therefore, only the qualified direct cost with respect to such other benefits may be used in determining the qualified cost of the fund.

Dual significance of qualified asset accounts. Limitations on qualified asset accounts are significant not only for determining the ceiling on deductibility of employer contributions, but, as will be discussed later, amounts that are in excess of these limits could also subject a fund to unrelated business income tax on investment income to the extent the account limits are exceeded.

B. Limitations on Additions to a Qualified Asset Account - Reasonable Actuarial Estimates

The account limit of IRC 419A(c) is the amount estimated to be necessary to fund plan liabilities for the amount of claims incurred but unpaid as of the close of the taxable year of the fund for disability, medical, supplemental unemployment benefits,

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[3] See Reg. 1.419-1T, Q&A 5(b) for a discussion of the "eat-up rule". In essence, this is a transition rule that limits deductions where welfare benefit funds carry over excess funding from periods before the effective date of IRC 419. No deduction is allowed for employer contributions until the excess amounts are used up through benefit payments. An example of the application of the "eat-up rule" is contained in Reg. 1.419-1T, Q&A 5(b)(3).

severance pay, and life insurance benefits. It also includes estimated administrative costs with respect to such claims. The estimates for all of these benefits are to be made under actuarial assumptions that are reasonable in the aggregate.

The Conference Committee Report on P.L. 98-369 (Deficit Reduction Act of 1984) states that claims are incurred, for these purposes, only when an event entitling the employee to benefits, such as a medical expense, a separation from employment, a disability, or a death actually occurs. The allowable reserve includes only amounts or claims estimated to have been incurred but which have not yet been reported, as well as those that have been reported but have not yet been paid. An example of an incurred but unpaid claim is the death of an employee during the year under a plan that provides for periodic payments to a survivor. In this case, the qualified asset account may include the estimated present value of the future stream of benefits payable to the survivor, using reasonable assumptions as to future earnings of the fund and as to mortality experience. Likewise, an amount necessary to fund a stream of future payments to a currently disabled employee can be set aside currently if the amount is actuarially reasonable.

Only with respect to the additional reserves for post-retirement life and post-retirement medical benefits is the pre-funding of benefits permissible where the event that entitles a person to benefits has not yet occurred. However, the Code provides strict rules to ensure that these reserves are not overfunded. IRC 419A(c)(2) provides that such a reserve is to be funded over the working lives of covered employees and actuarially determined so that they are funded no more rapidly than on a level basis. In addition, with respect to post-retirement medical benefits, the actuarial determination is to be based on current medical costs rather than on projections of future cost increases. The general idea of these additional reserves is to allow for a fully funded benefit for employees upon retirement.

Insurance premiums. The account limit does not include any amounts set aside for the payment of insurance premiums. Insurance premiums for current coverage are considered to be qualified direct costs only when the fund pays the premium to the insurance company. No addition to a qualified asset account for claims incurred but unpaid is permitted with respect to benefits that are provided through insurance. The payment of insurance premiums shifts the risk of claims from the fund to the insurance carrier, and hence there are no claims incurred but unpaid for which a reserve is allowable. If a fund pays an insurance premium that covers a period extending beyond the end of the taxable year of the employer, the employer must allocate the qualified direct costs associated with that payment to the taxable years covered by the premium. Only the portion of the payment that is attributable to the

cost of coverage during the taxable year in which the fund pays the premium is includible in the qualified direct cost of the fund and deductible in that year.[4]

Actuarial Certification and Safe Harbor Limits. The Code sets forth specific standards for amounts to be taken into account for the reserve for each benefit in determining the account limit. These standards are based upon the principle that the amount allowable is the amount "reasonably and actuarially necessary" to provide the benefits for which the account has been established. If the employer obtains an acceptable actuarial certification of the amount necessary to provide the benefits under its plan, then the amount determined by the actuary is the account limit.[5] If, however, the employer does not obtain an actuarial certification, the account limit is still the amount reasonably and actuarially necessary to provide the benefits, but the addition claimed for each benefit provided under the plan cannot exceed the so-called "safe-harbor limit" set forth in IRC 419A(c)(5) for that benefit. Note that the limits set forth in IRC 419A(c)(5) are not true "safe harbors" as that term is generally used in tax law. The statute does not authorize a taxpayer to add the limit amount to its qualified asset account whether or not that amount is "reasonably and actuarially necessary" to fund the benefit provided under the plan. Rather, the taxpayer must substantiate its deduction by showing that the amount added to the qualified asset account meets the reasonably and actuarially necessary test of IRC 419A(c)(1) and,

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[4] A reserve for post-retirement medical or life insurance benefits, however, may include amounts intended to provide for the payment of insurance premiums covering retirees even though the insurance premiums related to these benefits will not be due until after the covered employees retire. The basic statutory principle allowing for the creation of a reserve for the payment of post-retirement medical or life insurance benefits is that the employer may contribute and deduct the amount reasonably and actuarially necessary to fund these benefits on a level basis over the working lives of covered employees. It does not matter whether the fund through which the benefits are provided self-insures the cost of the retiree benefits or provides those benefits through insurance. In either case, the employer may contribute and deduct the current portion of the cost of retiree medical and life insurance benefits each year, based upon reasonable actuarial assumptions and methods, and determined (in the case of medical benefits) on the basis of current medical costs.

[5] The determination of the actuary, however, is not binding on the Internal Revenue Service. Here, as in the case of pension plan valuations, the actuary's calculation of the allowable amount must be based on reasonable actuarial assumptions and methods in order to meet the statutory standard. If an examining agent believes that an actuarial certification of the account limit for a welfare benefit fund is not based on assumptions that are reasonable in the aggregate, the agent should refer the matter to the National Office for advice, where the question will be coordinated with the Pension Actuarial Branch in the Employee Plans Technical and Actuarial Division.

unless the taxpayer obtains an appropriate actuarial certification, the amount added to the qualified asset account may not exceed the sum of the "safe harbor limits" of IRC 419A(c)(5). SUB and severance pay benefits are subject to a special rule. The statutory account limit in IRC 419A(c)(3)(A) for SUB and severance pay benefits is 75 percent of the average annual qualified direct costs for those benefits in any two of the preceding seven taxable years (as chosen by the fund).[6] The calculation of this amount is not dependent upon any determination that the amount of the resulting reserve is reasonably and actuarially necessary to provide the benefits. The "safe harbor limit" of IRC 419A(c)(5)(B)(iii) is defined by cross-reference to the statutory limit in IRC 419A(c)(3). Accordingly, actuarial determinations may not be used to support a claim for an addition to a qualified asset account in excess of the statutory account limit applicable to SUB and severance pay benefits.

C. Account Limit - With Actuarial Certification

Where an actuarial certification of the account limit by a qualified actuary is obtained, the account limit of a qualified asset account of a welfare benefit fund is governed by the general rule of IRC 419A(c)(1), with specific standards and limits for particular benefits set forth in IRC 419A(c)(3) and (4). As discussed above, the general rule is that the account limit for a qualified asset account is the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of the fund's taxable year) for disability, medical, or life insurance benefits, and administrative costs with respect to such claims. A separate rule applies for SUB and severance pay benefits. The presence of an actuarial certification does not preclude the Service from questioning its basis or the accuracy of the certified account limit.

Current-year medical and death benefits. The full amount of actuarially certified reserves for medical and death benefit claims incurred but unpaid at the end of the year is taken into account in computing the qualified asset account limit. As long as the examining agent is satisfied that the actuarial assumptions and methods used by the certifying actuary are reasonable, no further inquiry is necessary.

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[6] IRC 419A(c)(3)(B) provides that the limit for new plans that do not provide SUB or severance pay benefits for any key employee shall be determined under regulations prescribed by the Secretary. No regulations have been issued under this provision.

Disability benefits. In addition to the requirement of IRC 419A(c)(1) that the reserve for disability benefits must be reasonably and actuarially necessary to fund claims incurred but unpaid, IRC 419A(c)(4)(A) provides that disability benefits may not be taken into account to the extent that the benefit for any individual is payable at an annual rate in excess of the lower of:

1. 75% of that individual's average compensation for his or her high 3 years; or

2. the amount in effect under IRC 415(b)(1)(A). This amount is indexed annually for inflation. For 1991, it is $108,963.

For disability benefits, there is a mandatory aggregation of all plans of an employer to ensure that this limitation is not exceeded with respect to any individual through the use of multiple plans.

SUB and severance pay benefits. Supplemental unemployment benefits (defined in IRC 501(c)(17)(D)) and severance pay benefits are treated differently from medical, life, and disability benefits. The general rule applicable to life, medical, and disability benefits is not applicable to SUB and severance pay benefits, in that for these latter benefits the actuarial certification requirement does not apply. Instead, IRC 419A(c)(3) provides that the account limit for any taxable year with respect to these benefits is 75% of the average annual qualified direct costs for any two of the immediately preceding seven taxable years, as selected by the fund. Since this is an objectively determined amount, there is no need for actuarial certification.

A further limitation also applies to these benefits. No amount can be taken into account with respect to SUB and severance pay benefits to the extent that the benefit is payable at an annual rate in excess of 150% of the limitation in effect under IRC 415(c)(1)(A). At the present time, the applicable amount in IRC 415(c)(1)(A) is $30,000, which places the SUB and severance pay limitation at $45,000. All plans of an employer must be aggregated to ensure that this limitation is not exceeded through the use of multiple plans.

For new plans without a history of qualified direct costs from which to determine an account limit, IRC 419A(c)(3)(B) provides that where SUB and severance benefits are not available to any key employee, an interim amount to be taken into account will be established by regulations. No regulations have yet been issued for this purpose. It would seem evident from the statute, however, that new

plans that provide SUB and severance benefits to key employees would not be eligible to have any amount taken into account for SUB and severance benefits until at least a two-year history of qualified direct costs is established.

Example:

In 1991, Slimco VEBA Trust offers a wide range of employee benefits. It has obtained an actuarial certification for its account limit. In that certification the actuary has determined that the amounts reasonably and actuarially necessary to fund the costs incurred but unpaid are as follows: medical benefits ($20,000), disability benefits ($10,000), and life insurance benefits ($15,000), all of which are self-funded. The trust also offers a self-funded severance benefit of 12 months compensation for which its qualified direct cost for prior years is as follows:

1984	$ 30,000
1985	$ 25,000
1986	$ 148,500
1987	$ 23,000
1988	$ 0
1989	$ 31,500
1990	$ 27,000

The 1986 figure of $148,500 represents a 12-month salary payment of $148,000 to one employee of Slimco, Inc. plus $500 in administrative costs. VEBA Trust selects 1986 and 1989 to calculate its average qualified direct cost for severance benefits, which it determines to be $90,000. ($148,500 + $31,500 = $180,000; $180,000/2 = $90,000).

VEBA Trust offers no post-retirement medical and life benefits. VEBA Trust treated its qualified asset account limit for 1991 as $112,500, based upon $67,500 for severance benefits (using the 75% limitation of IRC 419A(c)(3)(A)), $20,000 for medical benefits, $15,000 for life insurance benefits, and $10,000 for disability benefits.

An adjustment must be made to the severance benefit reserve in determining the account limit. The $148,000 salary in 1986 must be reduced to $45,000 under the rule set forth in IRC 419A(c)(4)(B). Thus, the trust's average qualified direct cost attributable to severance benefits is $38,500. [($45,500 + $31,500)/2]. Multiplied by the 75% limitation in IRC 419A(c)(3)(A), the result is $28,875. Therefore, the limit for VEBA Trust's qualified asset account should be adjusted downward to $73,875.

D. Sum of the Safe Harbors - Where Actuarial Certification is Lacking

Where no actuarial certification has been obtained by the fund, its determination of the amount reasonably and actuarially necessary to fund the benefits provided under the plan is limited by reference to objective standards. IRC 419A(c)(5) provides that unless there is an actuarial certification of the account limit for the taxable year, the account limit shall not exceed the sum of the safe harbor limits set forth below:

Short-term disability benefits. The safe harbor limit for any taxable year is 17.5% of the qualified direct costs (other than insurance premiums) for the immediately preceding taxable year with respect to short-term disability benefits. The committee reports indicate that benefits for disabilities that are expected to last more than five months may be funded under this provision. If after five months the disability is then expected to last more than one year, it is treated as a long-term disability. After twelve months, a disability is always treated as a long-term disability.

Medical benefits. The safe harbor limit for any taxable year is 35% of the qualified direct costs (other than insurance premiums) for the immediately preceding taxable year.

SUB and severance pay benefits. Because these benefits are not subject to actuarial certification requirements in any case, the safe harbor limit is no different from the regular account limit for SUB and severance pay benefits. This is discussed above under the section on account limits that are actuarially certified.

Long-term disability and life insurance benefits. IRC 419A(c)(5)(iv) provides that the safe harbor limit for these benefits will be prescribed by regulations. No regulations have been published. Without such regulations, it would not appear that any safe harbor limit with respect to these benefits can be relied upon in establishing the account limit for a fund. Consequently, plans that wish to make additions to a qualified asset account with respect to these benefits are probably best advised to secure an actuarial certification of the account limit for the fund.

E. Post-Retirement Medical and Life Insurance Benefits: Additional Reserves

As discussed earlier, in addition to the currently provided benefits, separate reserves may be established for post-retirement medical and post-retirement life insurance benefits. These are not intended to be reserves established for current

retirees.[7] Instead, they are accounts that are funded during the working years of employees to be used for the provision of medical benefits or life insurance benefits after retirement.

These reserves must be funded on a level basis over the working lives of employees, using assumptions as to interest rates and mortality that are reasonable in the aggregate. With respect to medical benefits, inflation cannot be assumed; consequently, projections for future costs of medical benefits must be made on a year-to-year basis using current costs as the standard. With respect to both post-retirement medical and post-retirement life insurance reserves, either an actuarial certification or an employer determination subject to the safe harbor limit applicable to the specific benefit is necessary.[8]

Restrictions on key employees. If a reserve for post-retirement medical or life insurance benefits is established, a separate account must be established for each employee who at any time during the fund's taxable year or any preceding taxable year is a key employee described in IRC 416(i).[9] Thus, once an employee becomes a key employee, he or she will remain a key employee for all periods thereafter. After retirement, medical and life benefits for the key employee may be paid only from this account.

If a post-retirement medical or life insurance benefit is provided to a key employee and it is not made from the separate account established for that employee, it is a disqualified benefit. Under IRC 4976, the employer will be subject to an excise tax equal to 100% of the amount of the disqualified benefit. The tax applies whether or not the plan is a collectively bargained plan.

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[7] Medical and life benefits for current retirees can be provided in accordance with the general rules of IRC 419 and 419A, subject to the account limit of IRC 419A(c)(1).

[8] Congressional committee reports in 1986 clarified that actuarial certifications and safe harbor limits were to apply to post-retirement benefits, but did not explain how a safe harbor was to apply. Such a safe harbor must await regulations.

[9] IRC 416(i) provides objective salary or ownership standards for determining those employees who are key employees. They generally either are highly compensated by or are significant owners of the employer, or are both.

Nondiscrimination requirements. Unless a plan is maintained pursuant to a collective bargaining agreement in which post-retirement medical and life insurance benefits were the subject of good faith bargaining, IRC 419A(e)(1) provides that a reserve for post-retirement medical or life insurance benefits may not be taken into account in computing the qualified asset account limit unless the plan meets the nondiscrimination requirements of IRC 505(b). IRC 505(b) provides that each class of benefits under the plan must be provided under a classification of employees that is set forth in the plan and that is not discriminatory in favor of employees who are highly compensated individuals, and the benefits themselves must not discriminate in favor of highly compensated individuals.[10]

With respect to post-retirement life benefits, benefits provided to employees who retired on or before December 31, 1986 are not considered discriminatory even if the requirements of IRC 505(b) are not satisfied.

If the plan is discriminatory in favor of highly compensated employees, and the benefits were not the subject of good faith negotiations in a collective bargaining agreement, any post-retirement medical or life insurance benefit paid to a highly compensated individual is a disqualified benefit. Under IRC 4976, the employer will be subject to an excise tax equal to 100% of the amount of the disqualified benefit.

Limits on post-retirement life insurance. IRC 419A(e)(2) provides that life insurance benefits shall not be taken into account to the extent that the aggregate amount of the benefit provided to employees exceeds $50,000. This applies to the

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[10] The provisions of IRC 505(b) are more often encountered in the initial determination of exempt status for organizations described in IRC 501(c)(9) and (20). While no regulations exist to provide guidance, a set of safe harbor guidelines has been developed in Chapter 900 of the Exempt Organizations Handbook (IRM 7751). In one respect, however, the safe harbor guidelines in Chapter 900 should not be used for purposes of determining whether a post- retirement benefit is nondiscriminatory for purposes of IRC 419A(e)(1). In the case of post-retirement life benefits, the general rules applicable to income replacement benefits found in section 935.21 of IRM 7751 are applicable to post-retirement life benefits. The special rules for group-term life benefits of section 935.222 are not used for purposes of determining whether a post-retirement life benefit is nondiscriminatory for purposes of IRC 419A(e)(1).

aggregate of all self-insured and insured life benefits under all funds maintained by the employer.[11]

Medical benefit drawbacks. In December 1990, the Financial Accounting Standards Board (FASB) issued Statement No. 106, to be effective in December 1992. Statement No. 106 provides accounting standards to be used for prefunding post-retirement medical benefits. Because it provides for assumptions concerning expanding future health care costs, use of Statement No. 106 by an organization does not guarantee that a post-retirement medical reserve will be within the limitations on such a reserve set forth in IRC 419A(c)(2). In fact, the contrary may be true. Unlike the FASB Statement, the Code allows level funding of the reserve based only upon current health care costs. Consequently, an employer using Statement No. 106 that funds a post-retirement medical benefit reserve through a VEBA or other welfare benefit fund is likely to find that a part of its contributions is not deductible under IRC 419. Further, as well be discussed later, a newly established post-retirement medical benefit reserve is not sheltered from unrelated business income taxation. Finally, the amount of an employer's contribution to such a reserve on behalf of any key employee is considered as a contribution to a defined contribution plan for that employee under IRC 415, and counts against that employee's limit set forth in IRC 415(c)(1)(A).

F. Valuation of Accounts

The value of assets in a qualified asset account is a matter that should be carefully scrutinized. While a fund that confines its holdings to cash will never be a problem with respect to valuation, holdings of stocks and bonds will fluctuate in value. A fund has an incentive to undervalue account assets in order to minimize the potential liability for unrelated business income taxation under IRC 512(a)(3)(E), as well as to permit enlarged additions to qualified asset accounts for purposes of enhancing employer deductions. IRC 419A(f)(4) provides that regulations will determine how accounts will be valued, but no regulations have been issued.

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[11] However, for plans in existence on January 1, 1984, and only with respect to individuals who attained age 55 on or before that date, and who had either retired by that date or worked for that employer in 1983, amounts in excess of $50,000 can be taken into account.

The valuation of assets, including long-term bonds, at fair market value is consistent with accepted financial accounting standards for employee benefit plans. (See AICPA, Audits of Employee Benefit Plans, section 4.9 (1983), and FASB Statement No. 35).[12] Thus, in the absence of regulations that give further guidance, we should accept as a safe harbor only accounting methods that appropriately reflect fair market value or are otherwise consistent with accepted financial accounting standards for employee plans.

G. Aggregation of Funds and Related Employers.

Mandatory aggregation. All welfare benefit funds of an employer are required to be treated as one fund for specific purposes. Such an aggregation is required with respect to the specific limitations on disability, SUB, and severance benefits found in IRC 419A(c)(4). For example, if an employer uses one fund to pay a disability benefit of 60% of compensation to employees, and another fund to pay a disability benefit of 30% of compensation to the same employees, the funds must be considered together to reduce the amount of the disability benefit to be taken into consideration to 75% of compensation (or less, for those employees whose benefit would still exceed the applicable amount in IRC 415(b)(1)(A)).

Likewise, all funds of an employer must be aggregated for purposes of the limitation on life insurance in reserves for post-retirement life benefits. The aggregate amount of post-retirement life benefits for any employee cannot be taken into account to the extent it exceeds $50,000. Where several funds provide post-retirement life benefits for the same employee(s), these funds must be aggregated.

Finally, all funds of an employer must be aggregated where post-retirement medical benefits are provided to the same key employee(s). As noted earlier, designated separate accounts must be set up for post-retirement benefits to key employees. Such amounts added during the fund's taxable year and attributable to medical benefits are treated as an annual addition to a defined contribution plan for purposes of IRC 415(c), and are subject to the limitation of IRC 415(c)(1)(A).

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[12] FASB Statement No. 35 is specifically concerned with pension benefits, but valuation standards should be similar for nonpension benefits. The Financial Accounting Standards Board (FASB) on December 21, 1990 set forth financial accounting standards for nonpension employee benefits, to be effective in December 1992. (FASB Statement No. 106). The principal focus is on the expected cost of future health care benefits.

Permissive aggregation. Where aggregation is not mandatory, an employer with more than one welfare benefit fund is permitted to aggregate two or more funds so that they may be considered one fund. However, the Code adds a cautionary note that such an aggregation is not permitted if it is inconsistent with the purposes of IRC 419, 419A, or 512. For example, if two plans are aggregated for purposes of a deduction under IRC 419, they also must be aggregated for determining whether a post-retirement life or medical reserve is discriminatory under IRC 505(b).

Related employers. For purposes of these rules, all related employers are treated as one employer. Employers are related when:

1. they are a members of a controlled group of corporations (see IRC 414(b) and IRC 1563(a));

2. there is common control of employers as determined under IRC 414(c); or

3. there is an affiliated service group as defined in IRC 414(m).

For these purposes, the employer of a leased employee is determined under the rules of IRC 414(n).

H. Transition Rules

In order to ease the burden on welfare benefit funds in existence at the time that IRC 419 and 419A were enacted, and which would be overfunded as a result of their enactment, IRC 419A(f)(7) allows a five-year transition period to meet the new account limits of IRC 419A, effective for taxable years ending after December 31, 1985. This period permitted a gradual reduction in the reserves of funds that were in existence on July 18, 1984 and had reserves set aside for disability, medical, SUB, severance pay, or life insurance benefits as of that date.

The amount of assets set aside to provide benefits is determined as of the close of the first taxable year ending after July 18, 1984. The amount of excess reserves for each year to which IRC 419(f)(7) applies is then computed by subtracting the amount of the IRC 419A account limit for that year (determined without regard to this transition rule) from the amount of assets set aside to provide benefits, as described in the previous sentence. The decrease in the qualified asset account limit for each year can then be determined by multiplying the excess reserves for that year by the applicable percentage, as stated in IRC 419A(f)(7)(B). The applicable percentage

starts at 80% of the excess reserves in the first year to which IRC 419A(f)(7) applies and then decreases by 20% each year, until it reaches zero in the fifth taxable year to which the section applies. This transition rule is illustrated for a calendar year fund as follows:

Year		**Applicable percentage of excess reserves**
1984	Computation year	100%
1986	First year that 419A applies	80%
1987	Second year that 419A applies	60%
1988	Third year that 419A applies	40%
1989	Fourth year that 419A applies	20%
1990	End of transition	0%

By 1990, a calendar year taxpayer was no longer permitted any excess reserves under the transition rule.[13]

Example. A calendar year VEBA provides self-funded medical benefits. Its reserve as of 12-31-84 was $150,000. Its qualified direct cost was $50,000 in 1985, $60,000 in 1986, $70,000 in 1987, and $80,000 in 1988. For each year, assume that 35% of the qualified direct cost (the applicable "safe harbor limit") is in fact an actuarially reasonable estimate of claims incurred but unpaid. The account limit for each year is calculated as follows:

1986	(35% of $ 50,000)		$ 17,500
	12-31-84 reserve	$ 150,000	
	1986 account limit	$ 17,500	
	Excess reserve	$ 132,500	
	Applicable percentage	80%	106,500
	1986 adjusted account limit		$ 124,000
1987	(35% of $ 60,000)		$ 21,000
	12-31-84 reserve	$ 150,000	
	1987 account limit	$ 21,000	
	Excess reserve	$ 129,000	
	Applicable percentage	60%	77,400
	1987 adjusted account limit		$ 98,400

[13] Examples of calculations involved in applying this transition rule are extensively set forth in the 1989 CPE on pp. 223- 226. The example in the text is Example 9 from the 1989 CPE.

1988	(35% of $ 70,000)		$ 24,500
	12-31-84 reserve	$ 150,000	
	1988 account limit	$ 24,500	
	Excess reserve	$ 125,500	
	Applicable percentage	40%	50,200
	1988 adjusted account limit		$ 74,700
1989	(35% of $ 80,000)		$ 28,000
	12-31-84 reserve	$ 150,000	
	1989 account limit	$ 28,000	
	Excess reserve	$ 122,000	
	Applicable percentage	20%	24,400
	1989 adjusted account limit		$ 52,400

For purposes of determining unrelated business income only, a separate transition rule applies to pre-existing reserves for post-retirement life and post-retirement medical benefits. This will be discussed later.

4. Unrelated Business Income - IRC 512(a)(3)(B) and (E)

A welfare benefit fund that is exempt from tax under IRC 501(c)(9), (17), or (20), is liable for unrelated business income tax on its income to the extent of the excess of the amount in the fund over the assets set aside for the provision of welfare benefits. The tax is triggered when the account limit of IRC 419A is exceeded as of the close of the taxable year. In the case of the provision of welfare benefits by an organization not described in IRC 501(c)(9), (17), or (20), the employer is taxed on the fund's deemed unrelated income.

A. Taxation of Exempt Welfare Benefit Funds.

For VEBA's and other tax-exempt welfare benefit funds, the account limit of IRC 419A(c) is crucial not only for determining the extent to which an employer can deduct contributions to a welfare benefit fund for benefits described in IRC 419A(a), it is also the standard used to determine to what extent the fund will be taxed with respect to those benefits. While IRC 512(a)(3)(B) provides that an organization described in IRC 501(c)(9), (17), or (20), is not subject to unrelated business taxable income on amounts set aside for the provision of life, sick, accident, or other benefits ("exempt function income"), IRC 512(a)(3)(E) provides that a set-aside may not be taken into account to the extent that the account limit of IRC 419A (calculated without regard to any reserve for post-retirement medical benefits) is exceeded. Consequently, where amounts are set aside for exempt purposes, or for certain post-

retirement benefits, unrelated business income taxation can occur when a VEBA or IRC 501(c)(17) or (20) organization exceeds the account limit.

The "Bottom Line". The tax is based upon the lesser of the amount the account limit is exceeded or the income of the fund.

> ***Example***. VEBA Medical Trust receives $1,000,000 in employer contributions in its taxable year, and $500,000 in employee contributions. Investment income and capital gains total $250,000. The qualified asset account limit is $50,000. At the end of the taxable year, VEBA Medical Trust had a fund balance of $350,000 set aside for medical claims. To determine unrelated business income, separate computations must be made with respect to fund income and fund assets:
>
> Step 1: Assets: Trust assets at the end of the taxable year are $350,000, which exceed the qualified asset account limit ($50,000) by $300,000.
>
> Step 2: Income: Employer and employee contributions are disregarded in determining income for this purpose. Thus, the trust's income for purposes of IRC 512(a)(3) is $250,000.
>
> Step 3: Comparison: Because the $ 250,000 income determined in Step 2 is less than the excess reserves of $300,000 determined in Step 1, VEBA Medical Trust's unrelated business income is $250,000.

When an account limit is computed under IRC 419A(c) with respect to disability, medical, supplemental unemployment, severance pay, and life insurance benefits, any amounts set aside for any benefits in excess of the account limit as of the close of the fund's taxable year may be taxed, to the extent of fund income. This is true notwithstanding that the amounts set aside include amounts earmarked for childcare, apprenticeship training, or other acceptable section 501(c)(9) benefits that are not described in section 419A(a).

Certain assets not taken into account. Assets with a useful life extending substantially beyond the end of the taxable year (such as buildings and licenses) are disregarded in determining assets set aside if the assets are used in the provision of life, sick, accident, or other benefits. Reg. 1.512(a)-5T, Q&A 3(b). Moreover, in the legislative history of the Tax Reform Act of 1986 (P.L. 99-514), the Senate Finance Committee indicated that regulations are to provide that facilities used to provide permissible benefits are disregarded in determining whether fund assets exceed the account limit of a qualified asset account. The 1986 Act deleted a provision in the Deficit Reduction Act of 1984 (P.L. 98-369) that provided that a set aside was not to include any facility used to provide benefits. No additional regulations have been

issued to this effect, but it appears likely that Congress intended that such set asides were to include not only facilities themselves, but amounts set aside for the acquisition or construction of facilities.

Post-retirement medical reserve deducted from account limit. Although an additional reserve for post-retirement medical benefits is allowed for purposes of computing deductibility of employer contributions, such a reserve is not given such favorable treatment in computing unrelated business income. Consequently, the amount of the reserve to the extent described in IRC 419A(c)(2) is to be subtracted in computing the 419A account limit for UBI purposes. In contrast, no reduction is made for post-retirement life benefits.

Grandfathered post-retirement benefits: transition rules. Income from certain grandfathered post-retirement medical and life reserves that are in excess of the limitation on such reserves under IRC 419A(c)(2) and (e)(2) is not subject to tax as unrelated trade or business income. Consequently, income derived from such grandfathered reserves is subtracted from the fund's income in determining UBI. As a transitional rule, all payments from reserves for post-retirement medical or life benefits in taxable years of the fund ending after July 18, 1984 are first considered to be charged against the grandfathered amounts. Consequently, such grandfathered reserves should eventually be used up.

The amount of the reserves subject to these grandfather rules is the greater of:

a. the amount of assets actually set aside for post-retirement medical or life insurance benefits on July 18, 1984, less certain amounts as indicated in Regs. 1.512(a)-5T, Q&A 4(a) and 1.419-1T, Q&A 11(c); or

b. the amount of assets actually set aside for post-retirement medical or life insurance benefits at the close of the last taxable year of the fund ending before July 18, 1984, less certain amounts determined in accordance with rules set forth in Regs. 1.512(a)-5T, Q&A 4(a) and 1.419-1T, Q&A 11(c).

Further, under Reg. 1.512(a)-5T, Q&A 4(b), such reserves must not exceed amounts determined in accordance with Rev. Ruls. 69-382, 1969-2 C.B. 28; 69-478, 1969-2 C.B. 29; and 73-599, 1973-2 C.B. 40. Otherwise, the favorable treatment for income from such reserves will not apply to the extent the principles set forth in these revenue rulings are not followed. In general, these revenue rulings provide that contributions into post-retirement reserves to be deductible are to be funded on an actuarially determined level basis over the working lives of employees.

Unrelated business income is computed by determining the lesser of the amount by which assets set aside (as of the close of the taxable year) exceed the IRC 419A(c) account limit with respect to the fund, and the amount of income of the fund, excluding employer and employee contributions. The following formula is used:

UBI = The lesser of:

(x-y) - (z-w) "excess assets"

or

(p-q) - r "income"

where

x = the assets of the fund (including employer and employee contributions)

y = assets not taken into account (facilities; assets with a useful life substantially in excess of one year)

z = account limit

w = post-retirement medical reserve to the extent described in IRC 419A(c)(2); excluded for this purpose are any grandfathered amounts described in IRC 512(a)(3)(E)(ii) that exceed the IRC 419A(c)(2) limit on such a reserve and any other amounts in excess of the limit on the post-retirement medical reserve

p = income of fund

q = employer and employee contributions

r = income from grandfathered postretirement reserves.

Example: VEBA Trust is on a calendar year basis. On December 31, 1990, it had cash in its medical reserve of $16,600, a child-care facility worth $80,000, and a post-retirement medical benefit reserve of $1,100. Its actuarially certified account limit for benefits is $17,000, which includes a post-retirement medical reserve of $1000. $100 of its post-retirement medical benefit reserve still qualifies as a grandfathered reserve under the transitional rule. VEBA Trust's membership contributions from the employer were $16,800. Investment income was $1,008, of which $8 was attributable to grandfathered post-retirement reserves.

Step 1. (x-y). VEBA Trust's total assets are $ 97,700 ($80,000 + $16,600 + $1,100). From $97,700, the value of the facility ($80,000) is subtracted, leaving $17,700.

Step 2. (z-w). From the account limit of $ 17,000 is subtracted the portion of the post-retirement medical reserve described in IRC 419A(c)(2) ($1,000), leaving $16,000.

Step 3. (x-y) - (z-w). $ 16,000 (the Step 2 amount) is subtracted from $17,700 (the Step 1 amount), leaving $1,700. The amount by which VEBA Trust's assets exceed the account limit for UBI purposes is $1,700.

Step 4. (p-q). VEBA Trust's total income is $ 17,808 ($16,800 + $1,008). Employer contributions ($16,800) are subtracted, leaving $1,008.

Step 5. (p-q) - r. Income from the grandfathered reserve ($8) is subtracted from the Step 4 amount, leaving $1,000.

Step 6. Comparison. Since VEBA Trust's income from Step 5 ($1,000) is less than VEBA Trust's excess assets over the account limit from Step 3 ($1,700), VEBA Trust's unrelated business income is $1,000.

B. Taxation Where the Fund is Not Exempt.

Where the welfare benefit fund is not a VEBA, or an organization described in IRC 501(c)(7), (17), or (20), the employer, rather than the fund, is taxed on the fund's deemed unrelated income for the fund's taxable year that ends within the employer's taxable year.[14] Under IRC 419A(g)(2), the deemed unrelated income of a fund is the amount that would have been the fund's unrelated business income under IRC 512(a)(3) if the fund were described in IRC 501(c)(7), (9), (17), or (20).

Where an employer pays tax under this provision, the employer is treated as having made a contribution of the amount of the tax to the fund as of the last day of the employer's taxable year. The tax paid will be treated as paid by the fund for purposes of computing the fund's after-tax income.

5. Exceptions to IRC 419 and IRC 512(a)(3)(E)

Some plans are not subject to the limitations of IRC 419 that regulate the amount of employer deductions. A more privileged few are subject neither to IRC

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[14] Tax-exempt employers may be excepted from taxation. See below.

419 nor to the unrelated business income provisions of IRC 512(a)(3)(E). Those that are subject to neither, are collectively bargained plans.[15] 10-or-more employer plans are subject to the unrelated business income tax provisions of IRC 512(a)(3)(E), but not to the limits on employer deductions of IRC 419. Certain employee-pay-all plans and funds with tax-exempt employers are not subject to the unrelated business income taxation provisions of IRC 512(a)(3)(E), and employer deductibility is irrelevant with respect to such funds.

A. Collectively Bargained Plans.

The Tax Reform Act of 1986 definitively released funds established under collectively bargained agreements from the burden of the limitations of IRC 419A and IRC 512(a)(3)(E). Prior to 1986, IRC 419A(f)(5) provided that higher account limits would apply to collectively bargained plans, as established by regulations.

Nevertheless, the question of the definition of a collectively bargained plan continues to arise, particularly in private letter ruling requests, and Q&A 2 of Reg. 1.419A-2T still applies. Under this regulation, a collectively bargained welfare benefit fund is one that is maintained pursuant to an agreement that the Secretary of Labor determines to be a collective bargaining agreement, and only if the benefits provided through the fund were the subject of arms-length negotiations between employee representatives and the employer(s). Further, the agreement must satisfy the requirements of IRC 7701(a)(46), which provides that the term "employee representatives" shall not include any organization more than one-half of the members of which are employees who are owners, officers, or executives of the employer, and which provides that the agreement must be a bona fide agreement between bona fide employee representatives and the employer.

Even where an agreement has been determined to be a collective bargaining agreement, the fund may provide benefits to employees who are not covered by the agreement. In such a case, Reg. 1.419A-2T, Q&A 2(3) provides that only the portion of the fund attributable to those employees who are covered by the agreement is

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[15] Temporary regulations are the source of the broad exception for collectively bargained plans. See Reg. 1.419A-2T, Q&A 1. The statutory exception of IRC 419A(f)(5) is somewhat narrower in that the statute provides merely that no account limits will apply in the case of a qualified asset account of a collectively bargained plan. This leaves open the question of how benefits not described in IRC 419A(a) will be treated when final regulations are issued.

considered to be maintained pursuant to a collective bargaining agreement. The regulation states that allocation rules are to be provided to make this determination, but no such allocation rules have been issued. Until such time, a reasonable allocation method should be used. For example, in the case of a fund that provides medical benefits to employees, 5% of whom are not covered by a collective bargaining agreement, any excess over the account limit that would have been applicable if there were no collective bargaining agreement might be taxed under IRC 512(a)(3)(E) to the extent of 5% of the excess amount, or 5% of the fund's income, whichever is less.

The regulation also states that for purposes of a welfare benefit fund in existence on July 1, 1985, at least 50% of the employees eligible to receive benefits must be covered by the agreement in order for the agreement to be considered a collective bargaining agreement. In the case of a welfare benefit fund formed at a later time, at least 90% of the eligible employees must be covered. Finally, any increase in the number of noncovered eligible employees due to a merger, amendment, or other action of the employer or the fund will prevent a fund from being treated as a collectively bargained welfare fund.

It should be noted that these temporary regulations were drafted prior to the changes of the Tax Reform Act of 1986, so they will not be finalized in their current form. However, they are still to be used in determining which welfare benefit funds are to be considered to be maintained pursuant to a collective bargaining agreement.

B. Employee-pay-all Plans.

For welfare benefit funds under plans to which all contributions are made by employees rather than by employers, account limits also do not apply. Consequently, qualified asset accounts under IRC 419A may be funded to an unlimited extent without regard to IRC 512(a)(3)(E).[16] Employer deductions, of course, are not an issue with respect to these plans.

A plan is considered an employee-pay-all plan only if the plan has at least 50 employees prior to any aggregation of funds by the Service or by the employer under IRC 419(A)(h)(1). Further, experience-based refunds must be made on the basis of the experience of the group rather than of any employee.

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[16] Whether post-retirement medical benefits can be funded to an unlimited extent in these plans is still an open question.

C. Exception for Funds with Tax-exempt Employers.

A special provision relieves VEBA's or other welfare benefit funds sponsored by tax-exempt employers from the provisions of IRC 512(a)(3)(E). To qualify for this treatment, the fund must have received substantially all of its contributions from employers who were exempt from tax throughout the 5-taxable year period ending with the taxable year in which contributions were made. No provision relieves these funds from the limitations of IRC 419 and IRC 419A for purposes of deductibility of contributions, but deductibility should not be an issue for tax-exempt employers. In technical advice, the National Office has taken the position that a city may be considered a tax-exempt employer for these purposes.

D. 10-or-more Employer Plans

Account limits do not apply to funds that are part of 10-or-more employer plans for purposes of deductibility of employer contributions. They do apply for purposes of determining unrelated business income tax under IRC 512(a)(3)(E). Accounts that exceed the IRC 419A(c) account limit are taxable.

To be a 10-or-more employer plan, a plan must be a plan to which more than one employer contributes and to which no employer normally contributes more than 10% of the total contributions contributed by all employers, and experience-rating arrangements must not be maintained with respect to individual employers. Where experience ratings are maintained with respect to individual employers, the plan effectively is composed of separate funds with respect to each employer, and must not be treated more favorably than a single-employer plan.

In recent sessions of Congress, legislation has been introduced to relieve 10-or-more employer plans from the burdens of IRC 512(a)(3)(E), as well as to broaden the definition of such plans. To date, such attempts have been unsuccessful, although we expect that proponents will continue to press for such changes.