F. VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS

by
Cheryl Chasin and Robert Fontenrose

1. Introduction

The purpose of this article is to identify and discuss issues currently arising in cases involving VEBAs.

2. Identifying Deferred Compensation Plans and Savings Plans

A. Overview

This section discusses two types of impermissible benefits. At first glance, they may seem similar, but the nature of the arrangements in question and the motivation for their establishment are generally quite different.

As discussed more extensively below, plans making use of individual accounts are increasingly being used by employers who want to encourage employees to fund all or some of their post-retirement medical coverage through contributions made during their working lives. If employee contributions are involved, ERISA requires that those contributions be kept in a separate trust. Naturally enough, employers and employees prefer that such a trust's earnings be tax-exempt. In some circumstances, the plan's particular features may cause it to be a savings plan, and not a permissible VEBA benefit.

Deferred compensation issues with respect to VEBAs arise most often in the context of plans established by small professional corporations, in which the shareholders are also highly compensated employees. The shareholder-employees want to maximize the corporation's current deductions while preserving most of the benefits provided for themselves.

B. Savings Plans

Reg. 1.501(c)(9)-3(f) describes types of benefits that a VEBA may not provide. These impermissible benefits include "the provision of savings facilities for members." These impermissible benefits also include

> *any benefit that is similar to a pension or annuity payable at the time of mandatory or voluntary retirement, or a benefit that is similar to the benefit provided under a stock bonus or profit-sharing plan.*

A benefit is considered similar to that provided under a pension, annuity, stock bonus or profit-sharing plan if it provides for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event. Deferred compensation is discussed in greater detail in the next section of this article.

The regulations under IRC 501(c)(9) do not further define "savings facilities." However, two examples are provided in Reg, 1.501(c)(9)-3(g) to assist in identifying plans that provide savings facilities for their members. Both plans provide vacation benefits, a permissible VEBA benefit, and both plans were created pursuant to a collective bargaining agreement.

In the first (good) example, the employer contributes to the trust a specified sum per hour worked by each employee. Each covered employee receives a check in payment of his or her vacation benefit during the year following the year in which the employer made contributions to the trust. The amount of the payment is equal to the amount of the contributions made by the employer for that employee. An additional amount may be paid to employees if the trust's earnings exceed the expenses of administering the plan.

In the second (bad) example, the facts are the same, except that each covered employee is entitled to contribute up to an additional $1,000 each year to the trust. The trust agrees to pay a stated rate of interest on these additional amounts. In addition, each employee may elect to leave all or a portion of his/her distributable benefit on deposit past the normal time of distribution, in which case interest will continue to accrue.

There are four factors that the two examples have in common, and which are therefore not factors that definitively indicate the presence of a savings plan. First, the trust must account separately for the contributions made on behalf of each employee. Thus, the existence of individual accounts will not, standing alone, result in the conclusion that a plan is a savings facility. Second, in both cases participants receive a share of the trust's investment earnings. Third, employees are paid in cash. Fourth, both plans are collectively bargained.

What are the factors that distinguish these two examples? The ability of employees to contribute additional amounts to the trust, the promise to pay a stated amount of interest, and the ability to leave amounts on deposit indefinitely cause the plan in the second example to fail to qualify for exemption. We would not rule favorably on a plan which provided a "Christmas club" type savings plan where employees could make contributions throughout the year, earn interest on them, and receive their deposits plus earnings at a specified date. Likewise, even if the interest rate were not explicitly stated, but depended upon investment performance, the result would be no different.

We are seeing an increasing number of cases raising this issue, as employers look for ways to fund post-retirement medical benefits by encouraging employees to pick up part of the cost. Many such plans qualify for exemption, but if amounts are vested in employees as described below, so that there is little or no possibility of an employee forfeiting the amounts attributable to that employee, the plan will not qualify.

For example, some plans require participants to contribute amounts during their working lives. Individual accounts are maintained and are credited with a proportionate share of the plan's earnings. Upon retirement, funds in the employee's account must be used for certain specified purposes, usually medical insurance premiums and medical expenses not covered by insurance. If the employee dies before his or her account is depleted, remaining funds are paid to a designated beneficiary.

Although viewed in isolation the benefits provided by such a trust may appear to be permissible VEBA benefits (a permissible medical benefit plus a death benefit), the combination of the availability of trust funds to pay current health insurance premiums and the residual payment upon death suggest that the trust is in effect operating as a permanent wealth-building vehicle. Individuals would be able to use the individual accounts in the trust as a savings vehicle and mechanism for deferring tax on earnings. Any amounts not used to pay health insurance premiums during the lifetimes of the participant and the participant's spouse would eventually be paid to beneficiaries designated by the participant. Tax practitioners could promote trusts of this type as a tax-advantaged vehicle for saving money to pass on to beneficiaries. Furthermore, such a payment upon death is not a permissible VEBA benefit. There is no current protection (as required by Reg. 1.501(c)(9)-3(b)), no insurance-type protection, and no set death benefit.

C. Deferred Compensation

As noted above, Reg. 1.501(c)(9)-3(f) provides that a VEBA may not provide any benefit that is similar to a pension or annuity payable at the time of mandatory or voluntary retirement, or a benefit that is similar to the benefit provided under a stock bonus or profit-sharing plan. A benefit is similar to that provided under a pension, annuity, stock bonus or profit-sharing plan if it provides for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event.

What is deferred compensation? The Code does not explicitly define the term, but the tension between IRC 162 and IRC 404 provides us with an answer. IRC 162 permits the deduction of ordinary and necessary business expenses. As a general rule (and assuming an accrual-basis taxpayer), expenses are properly deducted when they are incurred. Reg. 1.162-10(a) enumerates various employee benefits, payment for which may be currently deductible, but provides that contributions to a plan are not deductible under IRC 162 "if, under any circumstances, they may be used to provide benefits under a . . . deferred compensation plan of the type referred to in IRC 404(a)."

Correspondingly, IRC 404(a) provides that

> *If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 . . . or section 212 . . ., but if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year.*

The limitations referred to are those that apply to qualified plans described in IRC 404(a)(1) through 404(a)(3). The deductibility rules for non-qualified plans appear in IRC 404(a)(5). Contributions to the latter type of plan may be deducted by the employer only when the amount becomes includible in the gross income of the employees.

A series of Tax Court cases has established identifying features of plans subject to IRC 404. In New York Seven-Up Bottling Co., Inc. v. Commissioner, 50 T.C. 391 (1968), the Tax Court considered the deductibility of amounts paid to a severance pay plan established pursuant to a collective bargaining agreement. In that case, the taxpayer argued that IRC 404(a) did not apply to all forms of deferred compensation, but only to plans providing retirement benefits. The Tax Court readily dismissed this argument, noting that "we have not found any requirement that a plan, in order to come within IRC 404(a), must withhold all benefits until the employee's final retirement." The plan was similar to a pension plan in that the right to receive benefits vested after a certain term of employment, the extent of benefits was related to years of service, and the receipt of benefits by the employee would not begin until after termination of his employment.

In Grant-Jacoby, Inc., et al. v. Commissioner, 73 T.C. 700 (1980), the Tax Court considered the deductibility of amounts used to fund an educational benefit plan which paid certain college expenses of the children of key employees. First, the court considered the issue of whether the payments were "compensation." Concluding that they were, the court stated that "it is more significant to look to whether the plan benefits employees generally or whether the plan is for the benefit of the owners; when the benefits are restricted to the owners, there is reason for requiring that the deduction be deferred until the distributions are made from the plan." The court concluded that the plan in Grant-Jacoby was similar to a profit-sharing plan. The provision of benefits only for key employees is not necessary to a finding of deferred compensation, but it is a strong indicator that deferred compensation is involved.

It is important to note, as the Tax Court did in Grant-Jacoby, that all of the employee benefits enumerated in Reg. 1.162-10 are, in a more general sense, also a form of deferred compensation. The services that earn an employee the right to receive, for example, severance pay, may be performed in one year, but he may not receive the severance pay until many years later. Similarly, unemployment benefits and health benefits may be paid years after the performance of the services to which they are attributable. The name given to a particular benefit or the form which it takes are not determinative.

In Greensboro Pathology Associates, P.A. v. U. S., 698 F.2d 1196 (Fed. Cir. 1982), the Court of Appeals for the Federal Circuit, reversing a decision of the Claims Court, determined that an educational benefit plan was not a plan of deferred compensation. The court identified a set of factors to be used in distinguishing between IRC 162 plans and IRC 404 plans. The court stated:

> *Where the provision of a plan's benefits are dependent upon an employee's length of service or position, the plan's characteristics are then analogous to those of compensation since amount and type of compensation also depend upon these factors. Where a plan's benefits depend on an employer's earnings, that is also a form of deferred compensation because it is similar to a profit-sharing plan. In addition, a plan has the appearance of a plan of deferred compensation when someone not eligible for its benefits receives a salary increase instead. On the other hand, the medical and vacation plans specified by regulation are considered welfare benefit plans and their cost is deductible under section 162. These plans are in general instituted to insure the well-being of employees and are provided to all employees. Thus, we hold such characteristics are essential to a finding that a plan is a welfare benefit plan. Of course, in any instance where a company maintains total control of and retains all rights to the plan's funds, no deduction is allowed because the company has not in reality spent this money. Similarly, all plans must be closely examined to see that they are in substance what they are claimed to be.*

However, there are other cases that have held educational benefits to be a form of deferred compensation where those benefits were mandated under the terms of a collective bargaining agreement. These cases include Ohio Teamsters Educational and

Safety Training Trust Fund v. Commissioner, 77 T.C. 189 (1981), affd. 692 F.2d 432 (6th Cir. 1982), Local Union 712, I.B.E.W. Scholarship Trust Fund v. Commissioner, T.C.M. 1983-76, and The Newspaper Guild Of New York, Times Unit-The New York Times College Scholarship Fund v. Commissioner, T.C.M. 1989-314.

To summarize, deferred compensation must first of all be compensation paid by an employer. Factors indicating deferred compensation include benefits dependent upon length of service, position, or the employer's earnings and provision of a salary increase in lieu of plan benefits. Factors indicating a welfare benefit plan include providing benefits intended to further the well-being of employees and providing benefits to all employees.

A VEBA cannot provide deferred compensation, so there have been attempts to disguise it. One such attempt has involved the use of severance benefits payable upon termination of employment for any reason. Such benefits would, naturally, be payable upon retirement. In Lima Surgical Associates, Inc. Voluntary Employees Beneficiary Association Plan Trust v. U.S., 944 F.2d 885 (Fed. Cir. 1991), the Court of Appeals for the Federal Circuit affirmed the judgment of the Claims Court in holding that a plan that provided "severance benefits" payable upon retirement did not qualify for exemption under IRC 501(c)(9). The Claims Court stated, and the Appeals Court agreed, that "the Plan in issue here, by paying retirement benefits as part and parcel of its alleged severance pay plan, is both organized and operated to provide nonqualifying benefits."

In the small employer context, *any* self-funded benefit might be a form of deferred compensation. The employer might in fact retain the power to amend or terminate participation in the plan at any time. The shareholder-employee wishing to receive a distribution from the plan need only terminate the plan, thus forcing a distribution of plan assets. This is also a problem where life insurance benefits are funded with any form of permanent life insurance. Although the trust formally owns the policies and any cash values, the termination of the plan, or the termination of an employer's participation in a multiple employer welfare arrangement, means that the policies may be cashed in by the trust and the resulting funds distributed to participants.

In Robert D. Booth and Janice Booth, et al. v. Commissioner, 108 T.C. 524 (1997), one of the arguments made by the Service was that this was a deferred compensation plan, not a welfare benefit plan within the meaning of IRC 419. The plan provided death benefits and dismissal wage benefits (severance pay). Benefits were not payable upon retirement. The court stated that this case was distinguishable from the cases discussed above, but did not explicitly cite any distinguishing factors. In fact, the only specific reason given by the court was the statement that "Mr. Weiss [drafter of the plan] testified credibly that he designed the Prime Plan intending entirely to provide employees with 'real' welfare benefits that would not be subject to abuse, and we read the record to support his testimony." The court explicitly rejected the argument that the employer's ability to terminate its participation at will made the plan one of deferred compensation, noting that Congress could have created such a requirement had it chosen to do so. Despite the decision on this issue in Booth, the issue of whether a plan is a deferred compensation plan may be very fact specific. It may be raised again in an appropriate case.

In a recent technical advice memorandum, the Employee Plans Division considered the qualification of a money purchase pension plan which received funds transferred from a VEBA. [Note: the TAM dealt *only* with the status of the pension plan. The effect of this arrangement on the VEBA was not considered.] The pension plan and the VEBA are maintained by a union pursuant to the terms of a collective bargaining agreement. The VEBA includes a fund for sick leave. Employees accrue sick leave pay for each month of employment. The collective bargaining agreement permits, and in some cases requires, the transfer of an employee's unused sick leave balance from the VEBA to the money purchase plan account of the employee. In addition to this TAM, the Employee Plans Division has been requested to rule on a similar arrangement involving transfers from a VEBA to a 401(k) plan.

Any such arrangement is inconsistent with exempt status under IRC 501(c)(9). There is no difference between a VEBA providing impermissible pension benefits directly, or doing it indirectly by transferring funds to a pension plan. Reg. 1.501(c)(9)-3(a) requires that substantially all of a VEBA's operations must be in furtherance of providing permissible benefits. Transferring funds from a VEBA to a pension plan is not in furtherance of providing permissible benefits.

Can a plan be both a savings facility and a plan of deferred compensation? Yes, if there are both employer and employee contributions.

3. ERISA and VEBAs

The regulations under IRC 501(c)(9) refer to the Employee Retirement Income Security Act of 1974, more commonly known as ERISA. Furthermore, ERISA requirements impact the operation of VEBAs in other ways not specified in these regulations. The purpose of this section is to provide a general explanation of ERISA and its effect on VEBAs.

A. A Brief History of ERISA

Congress enacted ERISA in 1974 primarily because of concerns about abuses in the private pension system. However, ERISA also provides employees with some protection with respect to welfare benefits. Welfare benefits are "medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death, or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or any benefits described in section 302(c) of the Labor Management Relations Act of 1947 (other than pensions on retirement or death, and insurance to provide such pensions)." The definition of welfare benefits is similar to the definition of permissible benefits under IRC 501(c)(9), but the two are not identical. For example, ERISA explicitly excludes from its definition facilities (other than day care centers) located on the employer's premises for use by employees. Under IRC 501(c)(9), however, a fitness center for use by employees would undoubtedly be considered a permissible benefit.

ERISA has four major sections, Titles I through IV. Title I contains provisions intended to protect employee rights. These provisions relate to reporting and disclosure, vesting, participation, funding, and fiduciary standards. Title II contains amendments to the Internal Revenue Code relating to retirement plans. Title III describes the enforcement responsibilities of the Department of Labor (DOL) and the Department of the Treasury. Title IV covers plan termination insurance and the establishment of the Pension Benefit Guaranty Corporation.

DOL issues advisory opinions, which are similar to the private letter rulings that we issue. The procedures for requesting such an opinion are set forth in ERISA Proc. 76-1. In general, an "advisory opinion" is a written statement issued to an individual or organization that interprets and applies ERISA provisions to a specific factual situation. These advisory opinions are available to the public in their original form; identifying information is not redacted as in our IRC 6110 rulings. Furthermore, any individual or organization affected directly or indirectly by ERISA may request an advisory opinion. For example, a state insurance commissioner could request an advisory opinion regarding a particular plan operating in that state. This is quite different from our rulings process, in which only the exempt organization whose tax status is at issue can request a ruling. No conference is required in the event of an adverse decision, although DOL can hold a conference if it wishes. Finally, background files (including the request for an advisory opinion and related correspondence) are available to the public upon request.

B. Control Test -- Reg. 1.501(c)(9)-2(c)(3)(iii)

The most common interaction between ERISA and IRC 501(c)(9) appears in Reg. 1.501(c)(9)-2(c)(3)(iii). To be described in this section, an organization must be controlled by its membership, by an independent trustee (such as a bank), or by trustees or other fiduciaries at least some of whom are designated by, or on behalf of, the membership. This would appear to preclude exemption for most employer established and controlled VEBAs. However, the next sentence in the regulation provides a very large escape hatch. An organization will be considered to be controlled by independent trustees if it is an "employee welfare benefit plan", as defined in section 3(1) of the Employee Retirement Income Security Act of 1974 (ERISA), and, as such, is subject to the requirements of Parts 1 and 4 of Subtitle B, Title I of ERISA. The reason for this exception is that ERISA itself imposes strict requirements on fiduciaries with respect to employee welfare benefit plans. Those requirements are considered to protect the interests of the employees as much as having an independent trustee would.

Section 3(1) of ERISA defines an employee welfare benefit plan as any plan, fund, or program which is established or maintained by an employer or by an employee organization, or both, to provide for its participants or their beneficiaries the welfare benefits described above in section III A of this topic.

A plan subject to ERISA is generally **not** subject to state regulation. Federal regulation by the Department of Labor **preempts** state regulation. This "ERISA preemption" is quite limited with respect to multiple employer welfare arrangements (MEWAs) as discussed later in this section. Because of "ERISA preemption" the question of whether a particular arrangement is an "employee welfare benefit plan" has been the subject of numerous DOL opinions and much litigation. ERISA preemption does not, however, apply to Federal agencies such as the Service.

The most common area of dispute (as it relates to VEBAs) is the requirement that a plan be established or maintained by an employer or by an employee organization. Of course, many of the plans we see meet this basic requirement, since they are clearly established and maintained by a single employer. However, with some multiple employer welfare arrangements (MEWAs), this point is open to serious question. [Note: In the past we have occasionally used the term "multiemployer plan" or "multiple employer plan" to describe these arrangements. However, under ERISA and with respect to employee pension plans, the term "multiemployer plan" has a specific meaning relating to plans maintained under a collective bargaining agreement to which more than one employer contributes. To avoid confusion, it is probably best to avoid using these terms.]

ERISA itself states that the term "employer" means "any person acting directly as an employer, or indirectly in the interest of an employer in relation to an employee benefit plan; and includes a group or association of employers acting for the employer in such capacity." Soon after ERISA was enacted, entrepreneurs organized "associations" to market insurance products supposedly free from state regulation. Congress recognized the existence of this problem in 1977, but apparently felt that current law was sufficient to deal with the situation:

> *Certain entrepreneurs have undertaken to market insurance products to employers and employees at large claiming these products to be ERISA covered plans. For instance, persons whose primary interest is profiting from the provision of administrative services are establishing insurance companies and related enterprises. The entrepreneur will then argue*

> *that his enterprise is an ERISA benefit plan which is protected under ERISA's preemption provision from state regulation. We are concerned with this type of development, but on the basis of the facts provided us, we are of the opinion that these programs are not "employee benefit plans" as defined in Section 3(3). As described to us, these plans are established and maintained by entrepreneurs for the purpose of marketing insurance products or services to others. They are not established or maintained by the appropriate parties to confer ERISA jurisdiction, nor is the purpose for their establishment or maintenance appropriate to meet the jurisdictional prerequisites of the Act. They are no more ERISA plans than is any other insurance policy sold to an employee benefit plan.* (H.R. Rep. No. 1785, 94th Cong., 2d Sess 48)

In MDPhysicians & Associates, Inc. v. State Board of Insurance, 957 F.2d 178 (5th Cir. 1992), the Court of Appeals held that an independent physician practice association was not an employee welfare benefit plan under ERISA. MDPhysicians (MDP) marketed its health plan to employers located in the Texas panhandle. MDP argued that it established and maintained the MDP Plan as an employer. The court quoted the ERISA definition of an employer -- "any person acting directly as an employer or indirectly in the interests of an employer in relation to an employee benefit plan; . . . including a group or association of employers," noting that ERISA provides no definition of "group or association of employers." The court reasoned that MDP had to prove that it acted in one of two ways to fall within the scope of the term. Either MDP acted directly as an employer, or MDP acted indirectly in the interests of an employer. MDP did not act directly as an employer because no employment or economic relationship existed between the doctors who established the plan and the employees of the subscribing employers. Outside the provision of medical and health benefits under the plan, MDP had no relationship with the employees of subscribing employers. MDP did not act indirectly in the interests of an employer because the subscribing employers did not establish the plan, nor did they participate in the day-to-day operation or administration of the plan.

The first factor generally considered by the courts in such cases is the existence of a common economic or representation interest. This means asking whether the entity that maintains the plan and the individuals that benefit from the plan are united by a common economic or representation interest, **unrelated to the provision of benefits** (emphasis added). Examples of a common representation interest are the relationship between employee and employer (MDPhysicians, supra) and between union member and union (Wisconsin Education. Association Insurance Trust et al. v. Iowa State Board of Public Instruction, 804 F. 2d 1059 (8th Cir. 1986). An appropriate common economic or representation interest also exists between employees and an association of employers in the same industry (National Business Association Trust v. Morgan, 770 F. Supp. 1169 (W.D. Ky. 1991)). However, this requirement is not satisfied by an association of employers who have nothing in common except their existence as businesses and their desire to participate in a particular plan.

The second factor usually considered by the courts is control over the plan by employer members. If participating employers have no authority over the plan, and no voice in its day-to-day operations, the plan cannot be considered to be established or maintained by an employer and will not be treated as an employee welfare benefit plan.

DOL has published in its advisory opinions six factors that it considers in determining whether a plan is established or maintained by a bona fide employer group. These are:

1. How members are solicited. If members are solicited by insurance agents, for example, that indicates a lack of a bona fide employer group.

2. Who is entitled to participate and who actually participates. If the sponsoring association does not limit its membership to persons who are actually "employers," it will generally not be considered a bona fide employer group. This is true even if participation in the benefit program itself is limited to employers.

3. The process by which the association was formed

4. The purposes for which it was formed and what, if any, were the preexisting relationships of its members

5. The powers, rights, and privileges of employer-members

6. Who actually controls and directs the activities and operations of the benefit program

DOL apparently views the last factor as the most important: participating employers must, either directly or indirectly, exercise control over the program, both in form and substance, in order to act as a bona fide employer group with respect to the benefit program.

What does all this have to do with VEBAs? If a plan is not an employee welfare benefit plan subject to ERISA, it must meet the control test in Reg. 1.501(c)(9)-

2(c)(3)(iii) by one of the other specified methods. That is, it must be controlled by its membership, i.e. the employees, by an independent trustee (such as a bank), or by trustees or other fiduciaries at least some of whom are designated by, or on behalf of, the membership. Many VEBAs will attempt to show that they are controlled by an independent trustee such as a bank. However, the mere designation of an unrelated person or firm as a trustee is not sufficient to satisfy this requirement. Many trust agreements provide for a nominally independent trustee, yet give other parties a great deal of authority to direct the trustee's actions. In such a case, the trustee is not truly independent, and the control test is not satisfied.

In Lima Surgical Associates, Inc. Voluntary Employees Beneficiary Association Plan Trust v. U.S., 20 Cl. Ct. 674 (1990), aff'd. 944 F.2d 885 (Fed. Cir. 1991), the Claims Court held that an organization did not meet the control test of the regulations, even though a bank was named as trustee. The court first held that the plan provided pension benefits and therefore was not an employee welfare benefit plan under ERISA. Second, the court stated that the employer, not the bank trustee, controlled the trust. While one portion of the trust agreement purported to give the bank trustee various and sundry powers, another portion stated that the employer had the power to direct the trustee in the exercise of any of the powers granted to it. The court reasoned that the employer had "paramount authority and control" and that the trust was not controlled by an independent trustee as required by Reg. 1.501(c)(9)-2(c)(3)(iii). [Note: The Court of Appeals, in upholding the Claims Court's refusal to grant exemption to this organization, did not reach this argument, but relied instead on the payment of severance benefits upon retirement as a disqualifying benefit.]

There are other types of plans, which although they are established or maintained by an employer, are explicitly excluded from coverage under ERISA and will thus have to satisfy the control test requirement in some other way. These non-ERISA plans include governmental plans, church plans, and plans maintained solely to comply with workers' compensation, unemployment compensation, or disability insurance laws.

C. Reg. 1.501(c)(9)-7

Reg. 1.501(c)(9)-7 provides that the term "voluntary employees' beneficiary association" in IRC 501(c)(9) of the Internal Revenue Code is not necessarily coextensive with the term "employees' beneficiary association" as used in section 3(4) of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1002(4), and the requirements which an organization must meet to be an "employees' beneficiary association" within the meaning of section 3(4) of ERISA are not necessarily identical to the requirements that an organization must meet in order to be a "voluntary employees' beneficiary association" within the meaning of IRC 501(c)(9). Under ERISA, an employees' beneficiary association is one type of employee organization which can establish or maintain an ERISA plan. The other type of employee organization is a labor union or similar entity.

A series of DOL Advisory Opinions has been issued setting forth the criteria used to define an employees' beneficiary association. Membership in such an association must be conditioned on employment status (such as membership limited to employees of a certain employer), the association must have a formal organization with officers, bylaws, or other indications of formality, the organization generally does not deal with employers (as a labor union does), and the association is organized for the purpose, in whole, or in part, of establishing a welfare or pension plan.

A DOL Opinion (#90-11A) issued in 1990 discussed whether the Missouri Pacific Employees' Health Association is an employee welfare benefit plan under ERISA. Membership is limited to employees of the Union Pacific Railroad, its transportation subsidiaries, and two other companies in the railroad industry in the St. Louis area. The governing board of the Association consists of representatives of participating labor unions, representatives of other employees, and employer representatives.

Such an organization could, if it met the other requirements, readily qualify for exemption under IRC 501(c)(9) since its members share an employment related common bond in that their employers are in the same line of business in the same geographic locale. However, DOL held it not to be an employee welfare benefit plan because it was not established or maintained by an employer (only two board members were designated by an employer), nor was it established or maintained by an employee organization. With respect to the latter issue, because a number of unions were involved, and employees were covered who had no board representation, DOL concluded that the plan was not established or maintained by one labor union. Furthermore, the organization was not an employees' beneficiary association because membership was not conditioned on employment status since more than one employer was involved. Also, because there was some employer representation on the board, it could not be said that the plan did not deal with employers.

Although the plan described in Opinion #90-11A is not employee welfare benefit plan under ERISA, it would have no problem meeting our control test due to the make-up of its governing board. Consequently, plans that qualify for exemption under IRC 501(c)(9) may not necessarily be employee welfare benefit plans as that term is defined in ERISA.

4. Multiple Employer Welfare Arrangements (MEWAs)

A. Overview

There are many legitimate multiple employer welfare arrangements (MEWAs) in existence. However, the benefits accruing to classification as a "10 or more employer" welfare fund under IRC 419A(f)(6) have encouraged the creation of less benign plans attempting to come within that definition. While the issues pertaining strictly to IRC 419A(f)(6) are discussed in section VI-A of this article, other issues frequently presented by MEWAs are discussed here.

B. Reg. 1.501(c)(9)-2(a)

(1) Employment Related Common Bond

Establishing the necessary employment related common bond is always a matter of concern for MEWAs. The two most common ways of doing this when more than one employer is involved are 1) coverage of employees under a collective bargaining agreement (discussed below) and 2) by virtue of being employees of employers in the same line of business in the same geographic locale.

a. Same Line of Business in the Same Geographic Locale

This requirement has been the subject of some controversy, and the geographic locale component was in fact held to be invalid in Water Quality Association Employees' Benefit Corp. v. United States, 795 F.2d 1303 (7th Cir. 1986). The preamble to the final regulations published as T.D. 7750, 1981-1 C.B. 338 (46 FR 1719 (January 7, 1981)), explains the reason for the geographic locale restriction. In relevant part, the preamble states:

> *[S]ection 501(c)(9) provides for the exemption of associations of employees who enjoy some employment related bond. Allowing section 501(c)(9) to be used as a tax-exempt vehicle for offering insurance products to unrelated individuals scattered throughout the country would undermine those provisions of the Internal Revenue Code that prescribe the income tax treatment of insurance companies.*

The Service has accepted the boundaries of any one state or standard metropolitan statistical area as a single geographic locale. However, largely in response to the Water Quality decision, the Service published Proposed Regulation 1.501(c)(9)-2(d). The proposed regulation establishes as a safe harbor a three contiguous state area as a single geographic locale, and authorizes the Commissioner to recognize larger areas as a single geographic locale on a case-by-case basis upon application by an organization seeking recognition as a VEBA. Thus, it is proposed that the Commissioner may recognize an organization as a VEBA under IRC 501(c)(9), even though its members are employed by unrelated employers engaged in the same line of business located more than three states. To obtain recognition as a VEBA under this discretionary authority, the applicant must show (1) that it would not be economically feasible to cover employees of employers engaged in that line of business in the relevant states under more than one VEBA, and (2) either that the states to be included are all contiguous or that there are legitimate reasons supporting the inclusion of those particular states. Although the proposed regulation has not been finalized, the Service has issued favorable determinations to MEWAs in the same line of business where the safe harbor was satisfied.

GCM 39299 considered the issue of what constitutes a "line of business" for purposes of this requirement. The GCM concluded that employers whose major economic activity consists of the production or distribution of products or the provision of services having markedly similar characteristics, who employ similar production and marketing facilities, and who compete in the same markets may be considered to be in the "same line of business" for purposes of the regulations. Thus, a VEBA covering employees of clothing manufacturers within a particular state would meet this requirement, while a VEBA covering employees of all manufacturers would not.

b. Coverage Under One or More Collective Bargaining Agreements

In view of the many exceptions within IRC 501(c)(9) and IRC 419 that apply to collectively bargained plans, it's not surprising to discover creative practitioners attempting to use these rules to their clients' advantage. Similar advantages exist under ERISA, since plans established pursuant to a collective bargaining agreement are excepted from the definition of a MEWA and thus not subject to state insurance regulation. Such creativity usually falls into one of two categories: creation of a sham union, or use of a pre-existing union.

Sham unions are nothing new. For example, in the late 1970's an organization existed whose membership was composed of business executives. Only "corporate employees having the designation of officer employees with executive duties" were eligible to participate. This organization purported to negotiate with the employers of members with respect to salaries and fringe benefits. Similar entrepreneurial ventures have appeared which are somewhat more subtle in that they appear to have as members the rank and file employees of small businesses. However, further investigation may show that the union "members" are unaware of the union's existence, or of their membership in it.

More recently, ventures wishing to market insurance products in the guise of a VEBA have joined with pre-existing labor unions to create entities based on purported "collective bargaining agreements." In these cases, the union may have bona fide collective bargaining agreements with some employers, yet also be engaged in sham transactions as described below. The motivations of these unions are not entirely clear, but are probably financial.

In one case, a union entered into purported "collective bargaining agreements" with a number of small employers in different lines of business throughout the country. Although this agreement was supposedly between a group of employers and the union, each employer individually controlled many of the terms, such as hours and pay scales. Furthermore, in most cases, the pay scale specified was "not less than the Federal minimum wage." The benefits to be provided were also individually specified by each participating employer. These so-called collective bargaining agreements were very brief, and included none of the typical detailed work rules and grievance procedures of legitimate collective bargaining agreements. Each employer could unilaterally terminate the collective bargaining agreement if its insurance premium was raised. Thirty percent of the individuals covered by the plan were business owners; more than fifty percent were business owners or members of their families.

IRC 7701(a)(46) provides that in determining whether there is a collective bargaining agreement between employee representatives and one or more employers, 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. An agreement shall not be treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and one or more employers.

Reg. 301.7701-17T elaborates further on this definition. Even if the 50% test in the statute is met, or the Secretary of Labor has found a plan to be maintained pursuant to a collective bargaining agreement, the Internal Revenue Service has the authority to determine whether there is a bona fide collective bargaining agreement for purposes of the Internal Revenue Code.

Because of increased activity in this area, the Department of Labor had published proposed regulations (60 Fed. Reg. 147 (1995)) to distinguish legitimate collective bargaining agreements from shams. In a section providing background information, DOL stated:

> *While the Multiple Employer Welfare Arrangement Act of 1983 significantly enhanced the states' ability to regulate MEWAs, problems in this area continue to exist as the result of the exception for collectively bargained plans contained in the 1983 amendments. This exception is now being exploited by some MEWA operators who, through the use of sham*

> *unions and collective bargaining agreements, market fraudulent insurance schemes under the guise of collectively bargained welfare plans exempt from state insurance regulation. Another problem in this area involves the use of collectively bargained arrangements as vehicles for marketing health care coverage nationwide to employees and employers with no relationship to the bargaining process or the underlying agreement.*

The proposed regulations first establish criteria that an agreement must meet in order to be a collective bargaining agreement. Among other things, the agreement must be one which cannot be unilaterally amended or terminated. It may not provide for termination of the agreement solely as a result of the failure to make contributions to the plan. Furthermore, an agreement will not be considered a collective bargaining agreement if, in addition to the provision of benefits, the agreement encompasses only the minimum requirements mandated by law with respect to the terms and conditions of employment. For example, an agreement which provided for a wage scale "no less than the Federal minimum wage" would not meet this requirement. No plan will be considered as established or maintained under one or more collective bargaining agreements unless no less than 85% of the individuals covered by the plan are employees and their beneficiaries, excluding supervisors and managers. The labor organization bargaining with the employer must operate for a substantial purpose other than that of providing benefits. The labor organization must be free of employer interference or domination.

While these proposed regulations have not been formally withdrawn, on April 15, 1998 DOL published a notice of intent to form a negotiated rulemaking advisory committee. This advisory committee will consist of representatives of the affected interests and of DOL for the purpose of reaching consensus on the proposed rule. Final regulations, if issued, may differ markedly from the proposed regulations.

Even if adopted in their present form, the proposed DOL regulations are not tax regulations. Instead, we should look to Reg. 301.7701-17T and IRC 7701(a)(46). Nevertheless, to the extent the proposed DOL regulations reflect common sense indicators of a bona fide collective bargaining agreement, it may be useful to review them when the issue of whether a particular arrangement is a bona fide agreement arises.

(2) <u>90% Test</u>

Some MEWAs include many small employers that are sole proprietorships or partnerships. Since neither partners nor proprietors are considered employees, a MEWA of this type may fail to meet the requirement that 90% of its total membership consist of persons who are employees.

(3) Discrimination

MEWAs frequently present discrimination and other issues that we do not often see in plans established by a single employer. Some MEWAs give participating employers a great deal of latitude in setting eligibility requirements and employee contributions, even though the benefits provided are the same for all. Since discrimination is tested with respect to each individual employer, a MEWA must provide the information necessary to make this determination. If a MEWA claims not to have information about employer-imposed elections or requirements, denial or revocation of exemption is appropriate, since the organization cannot demonstrate that it qualifies for exemption.

C. Reg. 1.501(c)(9)-2(c)

(1) Voluntary

It is also appropriate to verify that participation is in fact voluntary, since small employers may require 100% participation to meet insurers' requirements. This is not an issue if all benefits are funded by the employer.

(2) Control Test

MEWAs may have difficulty meeting the control test of Reg. 1.501(c)(9)-2(c)(3)(iii). As discussed above in section 3B, such a plan may not be an employee welfare benefit plan under ERISA if participating employers are not considered to have established or maintained the plan. MEWAs established by entrepreneurs to market insurance products to unrelated employers will have particular difficulty meeting this test. It should always be considered a potential issue with any MEWA, particularly if the MEWA was not established by a pre-existing association of employers.

D. Reg. 1.501(c)(9)-4

The "entrepreneurial" MEWAs referred to in the preceding paragraph may also present an inurement issue if insiders unduly benefit from the arrangement. Reg. 1.501(c)(9)-4(a) states that the "payment of unreasonable compensation to the trustees or employees of the association, or the purchase of insurance or services for amounts in excess of their fair market value from a company in which one or more of the association's trustees, officers or fiduciaries has an interest, will constitute prohibited inurement."

5. IRC 419 & 419A

In the early 1980's, the publication of final regulations under IRC 501(c)(9), the reduction in the amounts that could be contributed to pension plans, and the lack of explicit limitations on employer contributions caused both a dramatic increase in applications for exemption under that Code section and massive pre-funding of the benefits to be provided. To deal with the latter problem, Congress enacted sections 419 and 419A of the Code as part of the Deficit Reduction Act of 1984 to curtail current deductions for future benefits. For a detailed discussion of IRC 419 and 419A, see the article on that topic in the 1992 CPE text. This article discusses certain current issues with respect to section 419A.

A. IRC 419A(f)(6) – 10 or More Employer Plans

IRC 419A(f)(6) provides an exemption from the limits of IRC 419 and 419A for certain welfare benefit funds. To qualify for this exemption, no participating employer can contribute more than 10% of the total contributions, and the plan must not be experience rated with respect to individual employers. In Notice 95-34, 1995-1 C.B. 309, the Service warned the public about plans offered by promoters that purported to satisfy these requirements but in fact constituted separate plans maintained for each participating employer.

These issues have been the subject of recent litigation in Robert D. Booth and Janice Booth, et al. v. Commissioner, 108 T.C. 524 (1997), discussed above in connection with deferred compensation. This case involved several participants in the Prime Financial Benefits Multiple Employer Welfare Benefit Plan and Trust (hereinafter "Prime Financial"), which was set up to provide death benefits and severance pay benefits to small employers. Prime Financial did not apply for exemption under IRC 501(c)(9), but intended to avoid taxation of trust funds by investing them in municipal bonds and life insurance. Separate accounts were maintained for each participating employer. The trust agreement limited an employee's right to benefits to the assets of his or her employer's account.

The Tax Court concluded that Prime Financial was not a single plan, and that it had experience rating arrangements with respect to individual employers. The court stated:

> *We interpret the word "plan" to mean that there must be single pool of funds for use by the group as a whole (e.g. to pay the claims of all participants), and we interpret the phrase "10 or more employer plan" to mean that 10 or more employers must contribute to this single pool. We do not interpret the statutory language to include a program like the instant one where multiple employers have contributed funds to an independent party to hold in separate accounts until disbursed primarily for the benefit of the contributing employer's employees in accordance with unique terms established by that employer.*

The court relied on several factors in reaching this conclusion:

1. separate accounts and a separate accounting for each employee group;

2. trust agreement limited an employee's right to benefits to the assets of his or her employee group;

3. an annual valuation was performed for each employee group's account, but not for the trust as a whole

4. summary plan description was prepared separately for each employee group;

5. arrangement and adoption agreement signed by each employer were very similar to those used by separate employers establishing a separate plan under the terms of a master plan;

6. each employer selected its employees' level of benefits, vesting schedule, and minimum participation requirements;

7. each employer's contribution benefited primarily its own employees, and not the employees of other employers;

8. an employee's benefits would be reduced in the event of a shortfall, and without subsidy from the trust as a whole; and

9. the plan did not pool all claim risks within the trust.

The court went on to discuss Prime Financial's use of experience rating arrangements with respect to individual employers. The court stated that "experience-rated" means generally that premiums (contributions) are adjusted to reflect experience, but that Congress in using the term "experience-rating arrangements" in 419A(f)(6) had something broader in mind. The court said:

> *The essence of experience rating is the charging back of employee claims to the employer's account. The Prime Plan accomplished the same result by adjusting the employees' benefits to equal its employer's contributions. . . . We also conclude that the Prime Plan had experience-rating arrangements because each employer's relationship to the*

Trust was more akin to the relationship of an employer to a fund, than of an insurer to an insured.

Of equal importance is the method the court accepted in calculating the allowable deduction for participating employers. Under IRC 419, each employer's deduction is limited to the plan's qualified cost for the year, less the plan's after-tax income. The Service calculated, and the court accepted, that the qualified cost included only the cost of pure insurance protection, as reduced by the earnings on the life insurance policies, and not the premiums actually charged, which included investment features.

Many similar plans are being promoted today. Some attempt to qualify for exemption under IRC 501(c)(9). Many, like Prime Financial, do not. Many applying for tax exemption have certain features in common:

1. Only death benefits are provided

2. The death benefits are fully insured

3. Shareholder-employees (and family members, if participating) receive some form of whole life coverage. Rank and file employees receive term coverage.

We are also seeing plans established by individual employers that present these features.

Practitioners promoting these arrangements generally cite GCM 39440 to support their view that such an arrangement is permissible. In GCM 39440, the issue under consideration was whether the use of whole-life policies to fund VEBA benefits was consistent with the requirements of Reg. 1.501(c)(9)-3(b) that limited the use of permanent life insurance. The GCM reasoned that the concern addressed by the regulation was the problem of matching deductions by the employer with the income tax treatment for employees, and concluded that, after the adoption of IRC 419 and IRC 419A, the rationale for prohibiting employer-funded permanent life benefits no longer exists. The GCM concluded that if (1) whole-life policies are owned by the VEBA; (2) policies are purchased through level premiums over the expected lives or working lives of the employees; and (3) accumulated cash reserves accrue to the VEBA, the use of whole-life policies is acceptable.

GCM 39440 did not contemplate or discuss a situation in which whole-life policies are provided for some employees and term coverage is provided for others. GCM 39440 does not discuss any discrimination or inurement issues at all. We know that many of these plans are being promoted as tax shelters and estate planning tools. We know that their intent is to provide benefits to shareholder-employees while minimizing benefits to rank and file employees. Applications for exemption presenting this issue should be referred to the National Office.

The requirement that the employer's allowable deduction be limited to the cost of pure insurance protection, as in the Booth case, may operate to eliminate many of these arrangements.

B. Other 419A Issues

Issues under IRC 419A continue to be litigated with some regularity. IRC 419A(f)(6) was discussed in the preceding section; this section discusses litigation with respect to other parts of 419A.

(1) IRC 419A(a) -- Definition of "assets set aside"

In National Presto Industries, Inc. v. Comm., 104 T.C. 559 (1995), the Tax Court considered a case in which an employer claimed deductions for contributions to a VEBA which were not actually paid, but were reflected on the VEBA's books as an account receivable at the end of 1984. The issue decided was whether this receivable constituted "assets set aside." The court noted that the statute did not define "assets" or "assets set aside," and went on to consider the legislative history and Congress' expressed concern, with respect to IRC 404(b)(2), that an employer might claim a deduction before any benefit is provided to an employee. The court stated:

> *In light of the legislative history, we agree with the staff of the joint committee on Taxation that an unfunded obligation of an employer or employee is not to be considered an asset set aside to provide a benefit. Accordingly, the existing excess reserve does not include any value attributable to such an obligation.*

The court also examined the language of the trust document and concluded that the amount of the receivable greatly exceeded the employer's required contribution, and that the trust document itself defined a contribution as money paid to the fund.

Further refinement of this definition was provided by the Sixth Circuit Court of Appeals in Parker-Hannifin Corporation v. Commissioner, No. 96-2580 (March 23, 1998), which reversed (on this issue only) the Tax Court's decision in Parker-Hannifin Corporation v. Commissioner, T.C.M. 1996-337. In this case, the taxpayer had deducted \$2.5 million it contributed to its VEBA to fund incurred but unpaid claims for long-term disability benefits. These funds were expended in less than two years, and benefits were subsequently funded by the employer on a month-by-month basis. The Tax Court held that "assets set aside" required the creation of a funded reserve. The Court of Appeals held, however, that an employer has "set aside" assets for purposes of this section when it makes an irrevocable contribution to a welfare benefit fund. In other words, "set aside" has a different, less restrictive, meaning than "reserve."

(2) IRC 419A(c)(2) - Definition of "reserve"

In General Signal Corporation v. Commissioner, 103 T.C. 316 (1994), the Tax Court held that IRC 419A(c)(2) in requiring a "reserve funded over the working lives of the covered employees" actually required a separate accumulation of assets. In that case, the court extensively considered the legislative history of IRC 419A and concluded that both the plain language of the statute and the legislative history demonstrate that the accumulation of assets in a funded reserve is required. The court did not consider the consequences which would result from the establishment of a reserve for postretirement benefits followed by the later diversion of such reserve to provide current benefits. This issue was not presented by this case because the court held that no reserve had ever been established.

This decision was recently affirmed by the Court of Appeals for the Second Circuit in General Signal Corporation v. Commissioner, No. 97-4018 (April 24, 1998). On appeal, the taxpayer argued that requiring the establishment of an actual reserve fund would require it to make consistent contributions annually into the indefinite future, in effect requiring that a minimum balance be maintained. The Appeals Court disagreed, stating that the relevant factor is the taxpayer's intent at the time the reserve is established. Later depletions of a fund may serve as evidence of what a taxpayer's intent may have been, but depletions will not themselves render invalid deductions made for contributions to a fund established to accumulate assets for retirement benefits. The Appeals Court stated:

> *While our reading of the statute does imply a commitment to establish funding through the working lives of covered employees, if subsequent events rendered maintenance of the reserve impossible, evidence of the reason for discontinuing or spending down the reserve could be presented in response to any accusation that a taxpayer never intended a reserve to be established in the first place.*

Taxpayers continue to litigate the funding issue, insisting that IRC 419A(c)(2) merely describes a method of measuring a liability and does not require a separate accumulation of assets.

In Parker-Hannifin Corporation v. Commissioner, supra., the taxpayer claimed that the account limit under IRC 419A(c) is only a mathematical computation that limits the deduction, not a requirement that a segregated reserve be included in the welfare benefit fund. However, the VEBA Trust in this case did not retain even general assets that were sufficient to fund the claimed reserves. In other words, the "reserves" were disbursed for the current payment of benefits. The Tax Court considered the legislative history and concluded that an accumulation of assets, not just a calculation, is required. However, the Service argued, and the court agreed, that the overall balance maintained in the VEBA must be sufficient to support the claimed reserve. A separate account within the VEBA is not required for this purpose. The Sixth Circuit supported this interpretation and reviewed all the relevant facts and circumstances to determine whether Parker-Hannifin had established a reserve. The Court of Appeals specifically mentioned the following factors as demonstrating that no reserve was created:

1. Parker-Hannifin's treasurer stated, in a letter to the VEBA's trustee, that the full amount of the 1987 contribution was expected to be depleted within 12 to 18 months.

2. In a "Tax Matters" document for 1987, Parker-Hannifin stated that its entire contribution would be depleted within 14 to 18 months "primarily through the payment of health care benefits for active employees."

3. Parker-Hannifin did not disclose the existence of the VEBA Trust to employees, labor unions, retirees, or shareholders.

4. The VEBA's Form 1024 did not disclose the existence of a reserve.

5. Parker-Hannifin's financial statements included language that indicated that post-retirement benefits were expensed as paid.

In Square D Company and Subsidiaries v. Commissioner, 109 T.C. 9 (1997), the Tax Court, citing its own decisions in General Signal and Parker-Hannifin, reached the same conclusions. Square D also argued that the phrase "reserve funded over the working lives of the covered employees" in IRC 419A(c)(2) described a method of measuring a liability to provide post retirement medical benefits and does not require a separate accumulation of assets. Citing both General Signal and Parker-Hannifin (discussed below), the court held that the plain language of the statute and the legislative history required an accumulation of funds to create a reserve. The court considered the following facts and circumstances as showing that the Trust had not accumulated assets to fund a reserve:

1. Most of the amounts contributed were used to pay benefits to active employees.

2. Financial reports did not disclose the existence of a reserve.

3. No disclosure was made to employees or their unions.

4. Form 1024, containing projected yearend balances for 1986 through 1988, did not show reserves established for any purpose.

(3) IRC 419A(c)(5) -- "Safe Harbors"

It has long been the position of the Service that the use of the term "safe harbors" in this subsection is somewhat misleading. Our position that IRC 419A(c)(1) requires a showing of reasonableness has been supported again by the Tax Court. In Square D Company, supra., the taxpayer argued that it was automatically entitled to use the safe harbor limits, with no showing of reasonableness. The Tax Court, citing its earlier decision in General Signal Corporation said that the reasonableness standard expressed in IRC 419A(c)(1) applies to the safe harbor limits of IRC 419A(c)(5).

(4) IRC 419A(f)(5)(A)

This section provides that no account limits shall apply in the case of any qualified asset account under a separate welfare benefit fund under a collective bargaining agreement. In Parker-Hannifin Corporation, supra., the 6th Circuit Court of Appeals, affirming the decision of the Tax Court, held that Parker was not entitled to a deduction for a $3.2 million contribution to its VEBA Trust to cover medical benefits for union members. The court stated that:

> *The plain language of the statute requires the maintenance of a separate welfare benefit fund for collectively bargained employees, one which is distinct and apart from any funds provided for non-collectively bargained employees.*

Since amounts contributed to the VEBA Trust for union medical benefits were commingled with other contributions, the 419A(f)(5)(A) exception did not apply.

In a recent technical advice memorandum, the National Office considered the applicability of the account limits of 419A to that portion of a welfare benefit plan, established pursuant to a collective bargaining agreement, that provides benefits to employees not covered by the collective bargaining agreement. Citing Reg. 1.419A-2T, Q&A-2(3), the TAM concludes that only the portion of the fund attributable to the employees covered by the collective bargaining agreement is considered maintained pursuant to a collective bargaining agreement and thereby excepted from the account limit by IRC 419A(f)(5)(A). In addition, the TAM notes that since no guidance as to allocation methods has been provided by regulation, a reasonable allocation method should be used. In this particular case, the agent made an allocation based on the percentage of non-collectively bargained employees (less than 10%), and this was viewed as a reasonable method.

How then do we reconcile Reg. 1.419A-2T, Q&A-2(3) with the decision in Parker-Hannifin? That is, if the "plain language of the statute requires the maintenance of a separate welfare benefit fund for collectively bargained employees, one which is distinct and apart from any funds provided for non-collectively bargained employees," how can there ever be a need for an allocation? In fact, the taxpayer made a similar argument in Parker-Hannifin, stating that the allocation rule in the regulation means that a separate fund is not required. However, the regulation states that a welfare benefit fund is not maintained pursuant to a collective bargaining agreement unless at least 90% of the employees eligible to receive benefits under the fund are covered by the collective bargaining agreement. Thus, the allocation rule applies only in those cases, like the one in the TAM, where fewer than 10% of the employees are covered by the collective bargaining agreement.

6. IRC 6700

IRC 6700 imposes a penalty on promoters of abusive tax shelters. This issue is discussed in greater detail in Chapter M of this text, which lists five elements which must be present in order to invoke this penalty:

1. a promoter;
2. an investment, arrangement, or plan to be promoted;
3. a false statement;
4. knowledge by the promoter that the statement is false; and
5. the false statement is material.

A quick search of publications devoted to investing, tax planning, and similar topics reveals a number of promoters touting the advantages of a VEBA as a tax shelter. Some of the claims made are extremely dubious, and could conceivably result in IRC 6700 penalties.

For example, several promoters touting the advantages of a VEBA refer to a 1992 Tax Court decision in which a doctor was allowed to deduct VEBA contributions in excess of $1.1 million over three years, where 95% of the benefit was for the doctor and the doctor's children. The case referred to here is Joel A. Schneider, M.D. S.C. v. Commissioner (63 TCM 1787). According to the opinion itself, the trust in question applied for exemption under IRC 501(c)(9), but the application was denied. The exemption issue was not litigated. Therefore, the trust in the Schneider case was not a VEBA. Second, the years at issued in this case were all prior to the effective date of IRC 419 and 419A. In fact, the petitioner apparently argued, and the Court agreed, that the enactment of those sections demonstrated Congress' belief that no such limitation existed prior to their enactment. The Schneider case thus has no relevance to qualification for exemption under IRC 501(c)(9) and little relevance to current issues of deductibility. One promoter even refers to this case to support the proposition that a multiple employer VEBA permits contributions which greatly exceed permitted contributions to qualified retirement plans. The Schneider case involved only a single employer plan, and as previously stated, involved years in which the concept of a "multiple employer VEBA" had no relevance to deductibility.

Some promoters state, or strongly imply, that deductibility of employer contributions depends upon qualification as a VEBA. Of course, we know that deductibility of employer contributions depends upon IRC 419 and IRC 419A (among others) and is entirely unaffected by the exempt status of any welfare benefit fund involved. Others claim that all money contributed by an employer to a VEBA is immediately tax deductible. In fact, the claims of some promoters have become so outrageous that practitioners are writing articles warning of the falsity of the claims being made and suggesting extreme caution with respect to these plans.

If it can be show that the promoters making such claims knew, or had reason to know, that such statements are false or fraudulent, IRC 6700 penalties may be appropriate. Given the level of expertise these promoters claim to have, such a showing should not be impossible. Therefore, the examination of a VEBA should always include a review of any and all documents provided to the employer by the promoter.