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If you have questions, please contact your regular Groom attorney or any of the attorneys listed below:

**Kathryn Bjornstad Amin**
kamin@groom.com
(202) 861-2604

**Theodore R. Groom**
tgroom@groom.com
(202) 861-6607

**Christine L. Keller**
ckeller@groom.com
(202) 861-9371

**Louis T. Mazawey**
lmazawey@groom.com
(202) 861-6608

# Recent IRS Developments Affecting VEBAs and Group Term Life Insurance Plans

The IRS recently released two pieces of guidance that address issues you may have struggled with if your company funds retiree medical benefits through a VEBA (voluntary employees' beneficiary association described in Section 501(c)(9) of the Internal Revenue Code of 1986 ("Code")) or provides optional employee-pay-all group term life insurance. In both areas, the rules are quite arcane and non-intuitive – we make an effort to cut through the complexity below.

## I. <u>Proposed Rules on Unrelated Business Taxable Income ("UBTI") of VEBAs</u>

In 1984, Congress enacted complex rules limiting deductions for employer contributions to VEBAs and imposing a new unrelated business tax scheme on asset accumulations that exceed certain limits. IRS and Treasury issued limited temporary/proposed rules on the new scheme early in 1986, but have provided minimal published guidance ever since then. Almost 28 years later to the day, IRS has released some new proposed rules (which would revoke the old ones) affecting a handful of issues that have arisen. 79 Fed. Reg. 7110 (Feb. 6, 2014).

**<u>Calculating UBTI on Retiree Medical Reserve Accounts</u>** – The intent of the 1984 legislation was to tax income on VEBA reserves set aside to pay post-retirement medical benefits (except for collectively bargained arrangements) as UBTI. Under the previous guidance, the UBTI of a VEBA generally is the lesser of two amounts: (1) the investment income of the VEBA for the taxable year (excluding member contributions), or (2) the excess of the total amount set aside as of the close of taxable year (including member contributions and excluding certain long-term assets) over the Code section 419A qualified asset account limit (calculated without regard to the otherwise permitted reserve for post-retirement medical benefits) for the taxable year. Temp. Treas. Reg. Sec. 1.512(a)-5T. Since, for UBTI purposes, the qualified asset account limit for retiree medical pre-funding is zero, this generally makes all investment income of a VEBA that provides post-retirement medical benefits taxable at the trust level. (This result also applies to retiree medical reserves funded through insurance company accounts where the employer generally is subject to the tax.)

In 2003, the Sixth Circuit held that investment income that the taxpayer VEBA had earmarked and claimed it had spent before year-end to pay retiree medical benefits and the reasonable costs of administration was not subject to the above-described scheme. *Sherwin-Williams Co. Employee Health Plan Trust v. Comm'r*, 330 F.3d 449 (6th Cir. 2003), *rev'g*, 115 T.C. 440 (2000). The taxpayer victory was relatively short-lived, however (except in the Sixth Circuit), since the IRS later won two Federal Circuit rulings rejecting that position.

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*CNG Transmission Mgmt. VEBA v. U.S.*, 588 F.3d 1376 (Fed. Cir. 2009), *aff'g*, 84 Fed. Cl. 327 (2008); *accord Northrop Corp. Employee Insurance Benefit Plans Master Trust v. U.S.*, 99 Fed. Cl. 1 (2011), *aff'd*, 467 Fed. Appx. 886 (Fed. Cir. April 10, 2012), *cert. denied* (Dec. 3, 2012).

The new proposed rules, of course, incorporate the IRS position – they explicitly state that the UBTI calculation is the lesser of the two amounts described above (with slight modifications) "regardless of whether [the VEBA] spends . . . [its investment] income during the course of the year." The proposed rules include several new examples to make the IRS position even more clear.

We note that, while the proposed rules do not address the issue, income that is generally exempt from income tax (such as interest on state and local government bonds), would not be taxable investment income of a VEBA under this scheme. See IRS Letter Ruling 199932050 (gross income under Code section 61 principles applicable to UBTI).

**Three Clarifications** – The proposed rules clarify a few positions that one could glean from the statute, but which the prior temporary/proposed rules did not expressly address. They are as follows –

- ***Regular UBTI Applies to VEBAs, Too*** – The proposed rules make it clear that a VEBA may be subject to the traditional UBTI rules – as well as the special UBTI VEBA rules limiting asset accumulations. For example, if a VEBA borrows money to make an investment (or invests in a leveraged partnership), the investment income may be "debt-financed" UBTI (Code sec. 514) – even if the VEBA has no "excess reserves."

- ***No UBTI For Tax-Exempt Employers*** – The proposed rules include the statutory UBTI exception for VEBAs maintained by one or more tax-exempt employers. Technically, if substantially all of the contributions to the VEBA are made by employers who were exempt from tax for the preceding five-year period, an exemption from the special VEBA UBTI rules (but not from the regular UBTI rules) applies in the current year.

- ***UBTI Applies to 10-or-More Employer Plans*** – An employer's contributions to a 10-or-more employer welfare plan VEBA may be exempt from the Code section 419/419A account limits if it meets the requirements of Code section 419A(f)(6). The proposed rules clarify that for UBTI purposes, however, the account limit is determined as if the Code section 419A(f)(6) exception does not apply; thus, such a VEBA may be subject to UBTI if there are excess reserves. This reflects a 1986 technical correction that was enacted after the temporary/proposed rules were published.

**Comments/Effective Date** – Comments on the proposed rules may be filed through May 7. The proposed rules reflect current IRS positions that likely would be applied on audit. However, as a technical matter, the rules would be effective for taxable years ending on or after the date of publication of final rules.

## II. Using a VEBA to Avoid Imputed Income on Employee-Purchased Life Insurance Coverage

**Background** – Employers and employees unfamiliar with the nuances of the group term life insurance provisions of Code section 79 are often surprised to learn one may have imputed income – and even FICA tax – on group term insurance coverage the employees thought they were paying for themselves. This income typically arises where the rates actually charged to employees for their coverage "straddle" the IRS Table (at Treas. Reg. Sec. 1.79-3) for calculating imputed income on employer-purchased coverage over $50,000. "Straddle" occurs when some employees pay more than the Table rate and other employees pay less than the Table rate.

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Typically, employer-paid spouse and dependent coverage in excess of $2,000 is potentially subject to tax. (Based on Rev. Rul. 2013-17, coverage of a same-sex spouse should now qualify for the $2,000 exemption.) In addition, under Notice 89-110, the IRS position is that employees must include in income the difference between the amount paid by the employee on an after-tax basis for such coverage and the Table I cost unless the difference can be characterized as a "de minimis" fringe benefit. Thus, for example, employees who pay "significantly less" than the Table I rates will not be able to treat the coverage as a "de minimis" fringe.

**The Ruling** – A recent IRS letter ruling illustrates how a VEBA can be used to arrange and provide the optional employee coverage without worrying about whether the insurer's rates "straddle" the IRS Table – though it may take considerable work to set up the structure. In PLR 201350032, all of the employer-purchased supplemental insurance was provided under insurance policies issued by the same insurer as the employer's plan, but the employee's association, a VEBA, was the policyholder. Although not stated, a committee of employees presumably managed the VEBA's affairs. While the employer remitted employee premiums through payroll deduction, the VEBA –

- worked with the insurer to calculate premium rates which are financially self-supporting,
- arranged for the employer to add descriptive sections in benefit handbooks,
- enrolled employees and maintained records,
- paid accounting and audit fees, and
- reimbursed the employer for premium remission and other administrative services.

On the above facts, the IRS ruled that no income would be imputed to employees (or retirees) for both the supplemental employee coverage and the spouse and dependent coverages (which, in the latter case, was not deemed to be provided "in connection with the performance of services" under the IRS' fringe benefit rules). Because there was no taxable income, there also wouldn't be any FICA tax to hassle with.

Employers interested in an approach to avoid imputed income on supplemental life insurance should consider the structure in this ruling as one way to do so. Of course, only the employer who received the ruling is legally protected in relying on it.

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