Significant Developments Affecting VEBAs – Final IRS Rules Clarify Unrelated Business Taxable Income ("UBTI") Issues But Renew Uncertainty on Reallocating VEBA Assets

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In December, the IRS/Treasury ("IRS") published final rules addressing how employers that fund health and welfare benefits through a VEBA (i.e., a voluntary employees' beneficiary association described in Section 501(c)(9) of the Internal Revenue Code of 1986 ("Code")) must calculate the VEBA's UBTI. 84 Fed. Reg. 67370 (Dec, 10, 2019). The final rules largely mirror proposed UBTI rules the IRS issued in 2014, with minimal changes.

A few weeks later, the IRS published Rev. Proc. 2020-3, its annual listing of areas where the IRS will not consider private letter rulings ("PLRs"). Unfortunately, the IRS added to that list a ban on PLRs involving whether the 100% excise tax on reversions applies to transfers of assets between VEBAs and/or "repurposing" assets within a single VEBA.

We summarize both of these significant developments below.

I. UBTI Calculation for VEBA Accumulations

In 1984, Congress enacted complex rules limiting deductions for employer contributions to VEBAs, including imposing a new unrelated business tax scheme on asset accumulations that exceed certain limits. IRS issued limited temporary/proposed rules on the calculation of UBTI for VEBAs in 1986, but provided minimal published guidance thereafter. Although the UBTI rules apply to all health and welfare benefits funded through a VEBA, they have the greatest impact on retiree medical benefits where large amounts may be accumulated to pay future benefits.

In 2014, as the result of litigation, the IRS revoked the temporary/proposed rules and replaced them with new proposed rules. 79 Fed. Reg. 7110 (Feb. 6, 2014). The recent final rules make minimal changes to the 2014 proposed rules.

Calculating UBTI on Retiree Medical Reserve Accounts

The intent of the 1984 legislation was to tax the investment income on VEBA reserves set aside to pay post-retirement medical benefits (except for collectively bargained arrangements) as UBTI. Under the 1984 guidance, the UBTI of a VEBA generally was 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. § 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 has a reserve for post-retirement medical benefits taxable at the trust level. (This result also applies to retiree medical reserves funded through certain insurance company reserve accounts.)

In 2003, despite the temporary UBTI rules, the Sixth Circuit held that investment income that a VEBA had earmarked and claimed it had spent before year-end to pay retiree medical benefits and the reasonable costs of administration was not UBTI because it was not held in the reserve at the end of the year. *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. *See 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 F. App'x 886 (Fed. Cir. 2012).

The 2014 proposed rules—now finalized—incorporate the IRS's position in the *CNG* and *Northrop* cases—*i.e.*, 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 final rules include several examples from the 2014 proposed rules that make the IRS position even more clear. The final rules, however, apply the IRS position only on a prospective basis, *i.e.*, the final rules are effective December 10, 2019, and apply to taxable years beginning on or after that date.

Three Clarifications

The final rules incorporate three clarifications from the 2014 proposed rules that one could glean from the statute, but that the 1984 temporary/proposed rules did not expressly address. They are as follows:

- ***Regular UBTI Applies to VEBAs, Too*** – The final 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 section 514),even if the VEBA has no "excess reserves."
- ***No UBTI For Tax-Exempt Employers*** – The final rules include the statutory UBTI exception for VEBAs maintained by one or more tax-exempt employers. Under that exception, if substantially all of the contributions to the VEBA are made by employers who were exempt from tax for the preceding five-year period, the VEBA is not subject to the special VEBA UBTI rules (but is subject to the regular UBTI rules) 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 on tax deductions if it meets the requirements of Code section 419A(f)(6). The final 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 is subject to UBTI if there are excess reserves.

II. Renewed Uncertainty on Reallocation of VEBA Assets

There still is no official IRS guidance on when assets held by a VEBA to pay one type of benefit may be reallocated to fund other types of benefits under that plan for the same or other employees. For example, this situation may arise when retiree health liabilities are reduced – or long-term disability benefits are paid down – and there may be "surplus" assets in the VEBA.

Over the years, the IRS has issued a number of non-precedential PLRs confirming that the 100% excise tax of Code section 4976 on "employer reversions" does not apply to a transfer of benefit amounts between VEBAs. (*See, e.g.*, PLR 200111046 and GCM 39774 (Jan. 24, 1989)). However, these and other letter rulings also indicate that:

- the use of amounts contributed to a VEBA to fund benefit A that are later used to pay benefit B may trigger the "tax benefit rule" if the new use is "fundamentally inconsistent" with the original use – according to the IRS, such a "fundamental inconsistency" is deemed to be triggered where different Code section 419A deduction rules apply to benefits A and B;
- the reallocation of assets might be deemed a "reversion" subjecting the employer to a 100% excise tax on the amount used for benefit B.

Consultants and attorneys advising employers in this area were very pleased to see the IRS issue favorable PLRs starting in 2015 to the effect that the 100% excise tax will <u>not</u> apply to reallocations of VEBA assets – usually to use retiree medical surplus to pay medical benefits for active employees. Subsequently, the IRS issued a succession of rulings (the most recent one is PLR 201927001) to the same effect.

Unfortunately, the IRS announced in January – in its annual revenue procedure on "no-rule" areas – that it would not rule on the excise tax issues. Specifically, the revenue procedure states that the IRS will not rule on:

> Whether a transfer of assets between welfare benefit funds (including voluntary employees' beneficiary associations (VEBAs)), or a new or different use of assets of a welfare benefit fund (including a VEBA), results in a reversion to the employer.

The legal basis for the new IRS "no-rule" policy is far from clear. One would hope it would be short-lived and that the IRS will resume ruling again in the near future. Unfortunately, there is no way to know – and IRS "no-rule" policies have been known to remain on the books for many years. As a result, it again falls on employers to evaluate the potential pros and cons of proceeding with VEBA asset reallocations and transfers, taking into account the potential tax risks (and, of course, following applicable ERISA principles, too).

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These new IRS developments enhance the importance of careful review of UBTI calculations as well as careful planning where VEBAs are overfunded. Groom attorneys have extensive experience advising clients on UBTI matters – and in structuring VEBA transfers and reallocations on a legally compliant basis to achieve sound benefit and business objectives.