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Integral Part Trusts: The Little-Known Tool that Tax-Exempt Organizations Can Use to Fund Employee Benefits in a Tax Efficient, Safe, and Flexible Way

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Organizations exempt from income tax under the Internal Revenue Code (Code), including tax-exempt hospitals and health organizations (Exempt Organizations), use a variety of methods to fund employee benefits, such as active and retiree medical, unemployment, severance, disability, and paid family and medical leave benefits. Some of the most common methods Exempt Organizations use to fund these benefits include voluntary employees' beneficiary associations (VEBAs), taxable employee benefits trusts, and direct funding from the Exempt Organization's general assets. One often overlooked funding vehicle uniquely available to Exempt Organizations is tax-exempt trusts that serve as an integral part of the Exempt Organization's activities ("Integral Part Trusts"). Integral Part Trusts offer a unique blend of tax benefits, flexibility, and creditor protections that are not typically available with other funding methods. Despite these benefits, many Exempt Organizations continue to rely on other funding methods, perhaps due to a general lack of awareness surrounding Integral Part Trusts or the compliance costs associated with creating and maintaining Integral Part Trusts.

This article seeks to raise awareness of Integral Part Trusts and includes a discussion of the legal rules governing Integral Part Trusts, the benefits of Integral Part Trusts, and key compliance and implementation considerations for Exempt Organizations.

Legal Background

Federal Tax Law

The Internal Revenue Service (IRS) generally requires an Exempt Organization to obtain recognition of its tax-exempt status on its own merits, even if a parent or affiliated entity is tax-exempt.[1] But, the IRS and federal courts have historically recognized an exception to this general rule under the "integral part doctrine." There is no specific definition in the Code or the Treasury regulations of the integral part doctrine. However, there is a reference to the doctrine in Treasury regulation Section 1.502-1(b), which states in pertinent part:

> If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities *are an integral part of the exempt activities of the parent organization*, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, a tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization . . .

(Emphasis added.)

Treasury regulation Section 1.502-1(b) does not expressly list any qualification requirements that a subsidiary must meet to obtain a tax exemption based on the integral part doctrine. But the regulation does indicate that a subsidiary can qualify as a tax-exempt entity in reliance on the parent's tax exemption, as long as the subsidiary's activities would be tax-exempt if carried on by the parent.

In Rev. Rul. 78-41, the IRS considered whether a trust created by a hospital that was exempt from tax under Code Section 501(c)(3), whose sole purpose was to accumulate and hold funds for the use of satisfying malpractice claims against the hospital, could be recognized as tax-exempt under Code Section 501(c)(3).[2] The trust's trustee paid out trust funds for malpractice claims at the direction of the hospital, and the trustee merely acted as the hospital's agent in disbursing funds. The IRS ruled that the trust was exempt from tax under Code Section 501(c)(3). In reaching its conclusion, the IRS stated:

> [by] serving as a repository for funds paid in by the hospital, and by making payments at the direction of the hospital to persons with malpractice claims against the hospital, the trust is operating as an integral part of the hospital. Of equal importance is the fact that the trust is performing a function that the hospital could do directly.[3]

Notably, the IRS also stated that, even though the trust could rely on the hospital's tax-exemption, the trust was required to file a Form 1023, Application for Recognition of Exemption, to be recognized as tax-exempt by the IRS.[4]

Relatedly, the IRS has recognized employee benefits trusts that tax-exempt organizations create and control as tax-exempt trusts based on the tax-exempt parent's exemption.[5] The IRS has implicitly relied on the integral part doctrine when it has treated these trusts as tax-exempt.

The Third Circuit has succinctly summarized the integral part doctrine as follows:

> The integral part doctrine provides a means by which organizations may qualify for [tax] exemption vicariously through related organizations, as long as they are engaged in activities which would be exempt if the related organization engaged in them, and as long as those activities are furthering the exempt purposes of the related organizations. [6]

Read collectively, these authorities indicate that a trust's tax exemption as an Integral Part Trust is most defensible where several factors are present: (i) the affiliated Exempt Organization controls the trust; (ii) the trust's activities are an "integral part" of the Exempt Organization's operations; (iii) the trust's activities further the Exempt Organization's tax-exempt purpose; and (iv) the trust obtains recognition of its tax-exempt status from the IRS. However, there are many Integral Part Trusts that do not apply for tax-exempt status.

ERISA

If an Exempt Organization uses an Integral Part Trust to fund an employee welfare benefit plan subject to the Employee Retirement Income Security Act of 1974 (ERISA), ERISA may impose certain additional legal requirements on the Integral Part Trust. Most pertinent:

- If the Integral Part Trust's assets are ERISA plan assets, those assets must not inure to the benefit of the Exempt Organization and must be used exclusively to pay plan benefits and reasonable administrative expenses.[7] Further, the ERISA plan's fiduciary has a duty to act prudently and solely in the interest of plan participants and beneficiaries when dealing with plan assets.[8] Thus, ERISA may restrict how Integral Part Trust assets can be spent.
- ERISA's fiduciary duties and prohibited transaction rules apply to the Integral Part Trust's trustees and/or fiduciaries.
- The Integral Part Trust's assets may be subject to reporting and disclosure obligations, including on Form 5500.

However, certain qualifying governmental plans and church plans are exempt from Title I of ERISA (which could include welfare plans operated by religiously affiliated hospital systems and state and local governmental hospital systems), and thus these ERISA restrictions may not apply.[9] These ERISA exemptions are highly fact dependent, and Integral Part Trusts should not assume they qualify for them without consulting with experienced legal counsel.[10]

Unique Benefits of Integral Part Trusts

Integral Part Trusts are subject to complex rules, but, if those rules are properly navigated, these trusts can offer considerable benefits that are not offered by other common funding methods. Some of the key benefits of Integral Part Trusts are as follows:

- **Tax-exempt**—Any passive income generated by assets held in an Integral Part Trust is typically exempt from federal income tax.[11]
- **Flexibility**—The Code generally does not restrict what employee benefits an Integral Part Trust can fund. Thus, these trusts are highly flexible and can be used for a diverse set of benefits. For

example, these trusts can be used to fund diverse employee benefits, including active and retiree medical, unemployment, paid family and medical leave, and disaster relief benefits for employees, retirees, and their dependents.

- **Liability protection**—Integral Part Trusts are typically designed as irrevocable trusts that are distinct and separate entities from the Exempt Organization creating the trust. This may offer enhanced legal protection for the funds set aside in the trust from legal liability if the Exempt Organization is subject to a legal judgment or forced into bankruptcy.
- **Funding certainty**—Integral Part Trusts are generally not subject to any restrictions on pre-funding. Thus, these trusts allow Exempt Organizations to plan ahead to pre-fund future benefit obligations in a protected and tax-efficient manner.

These benefits are particularly noticeable when compared with other common funding methods such as VEBAs, taxable employee benefits trusts, and the use of an Exempt Organization's general assets. For example, one of the most common funding methods used by Exempt Organizations to fund health, welfare, and other employee benefits are VEBAs. VEBAs are tax-exempt trusts that both for-profit entities and Exempt Organizations can use to fund a legally restricted set of employee benefits. However, VEBAs may be less advantageous funding vehicles than Integral Part Trusts for Exempt Organizations for the following reasons:

- **Legal restrictions on the use of VEBA assets**—An employer can generally only use VEBA assets to fund life, sick, accident, and certain other similar benefits, such as unemployment, apprenticeship, vacation, and severance benefits.[12] Integral Part Trusts are not subject to any such restrictions and can typically fund any health, welfare, or other employee benefits that an Exempt Organization wishes to provide to employees.
- **Nondiscrimination testing**—VEBAs are subject to the Code Section 505(b) nondiscrimination requirements, which can impact benefit design if the benefits disproportionately benefit highly compensated individuals or if certain benefits (e.g., life insurance or disability) are based on income above certain thresholds. Integral Part Trusts are not subject to those nondiscrimination requirements, although other nondiscrimination requirements (such as those governing group term life insurance under Code Section 79 or self-insured medical plans under Code Section 105(h)) could still apply.
- **Code Section 4976 excise tax**—An employer is subject to a 100% excise tax under Code Section 4976 if a VEBA (or taxable trust) provides certain disqualified benefits. Specifically, a VEBA provides disqualified benefits if the VEBA pays retiree medical or life insurance benefits for highly compensated individuals that are discriminatory under Code Section 505(b) or pays retiree medical or life insurance benefits for key employees, and those benefits are not paid from a separate account (as required under Code Section 419A(d)). Integral Part Trusts are generally not subject to Code Section 4976.

In addition, Exempt Organizations occasionally use taxable employee benefits trusts to fund a variety of employee benefits including health and welfare benefits. Although the benefits these trusts can fund are generally not limited by the Code, these trusts typically must pay tax on investment income. Further, this risk of generating taxable income may implicitly disfavor the trust from investing in certain preferred investment vehicles (e.g., fixed income subject to federal income tax) and/or an Exempt Organization from pre-funding future liabilities. Thus, Integral Part Trusts offer superior tax benefits and investment flexibility and give Exempt Organizations greater ability to prefund liabilities.

Further, some Exempt Organizations fund employee benefits out of their general assets rather than with a separate trust. But Integral Part Trusts can offer unique liability protections under state trust law that would otherwise be unavailable to the general assets of an Exempt Organization. For example, an Exempt Organization can design an Integral Part Trust as an irrevocable trust under state law that offers protection from legal judgments against an Exempt Organization or the Exempt Organization's creditors in the event of bankruptcy (although irrevocable Integral Part Trusts can trigger unique and state-specific filing and compliance requirements). However, the level of protection that the Integral Part Trust provides is highly fact dependent, including on the specific terms of the Integral Part Trust and state trust law in the state where it is created.

Compliance and Implementation Considerations

If an Exempt Organization wants to create an Integral Part Trust to fund employee benefits, there are a number of practical compliance and implementation considerations the Exempt Organization should consider. These considerations are briefly summarized below.

Federal Income Tax Compliance Considerations

Some of the key federal income tax compliance and implementation considerations for Exempt Organizations in connection with an Integral Part Trust are as follows:

- **Confirm recognition of the tax exemption with the IRS**—An Integral Part Trust should typically apply for and obtain a determination letter from the IRS confirming that it is tax-exempt.[13] For example, if an Integral Part Trust's affiliated Exempt Organization is a Code Section 501(c)(3) organization, the Integral Part Trust should generally file a Form 1023 with the IRS. This determination letter provides certainty to the Exempt Organization, the trust, and its beneficiaries, and is often requested during audits or deal diligence.
- **Obtain a separate employer identification number (EIN)**—An Integral Part Trust is a separate taxpayer from the Exempt Organization it relies on for its tax exemption and thus must obtain its own EIN.
- **File a Form 990**—Depending on the Integral Part Trust's assets and specific tax exemption, it may be required to annually file a Form 990 with the IRS.
- **Ongoing monitoring**—Once an Integral Part Trust is recognized as tax-exempt, the Exempt Organization (or the Integral Part Trust's trustees, depending on the trust design) must monitor the Integral Part Trust's operations to ensure that it continues to operate in accordance with its tax-exempt purpose. Otherwise, the Integral Part Trust could generate unrelated business income tax (UBIT) (or in extreme instances, lose its tax-exemption). Exempt Organizations and trustees should also be attentive to the debt-financed income rules of Code Section 514, which can convert an Integral Part Trust's otherwise passive investment income into UBIT if any trust assets are acquired or operated with borrowed funds.

State Law Compliance Considerations

Integral Part Trusts, like all trusts, are creatures of state law. Thus, the Exempt Organization must determine what state in which to create the trust. Important considerations for an Exempt Organization include the state of the grantor (i.e., the Exempt Organization creating the trust), state specific trust law protections, and state tax law. Notably, each state has its unique considerations, and certain trust designs (such as irrevocable trusts) may implicate other state law requirements, including additional filing requirements.

Other Practical Implementation Considerations

In addition to federal tax compliance and state law compliance, some additional practical steps an Exempt Organization will generally need to take to create an Integral Part Trust in conjunction with experienced legal counsel include:

- Preparing the trust document in accordance with requirements under the Code and state trust law.
- Selecting the benefits or other expenses that the Integral Part Trust will fund and preparing or amending the underlying welfare plan documents and any required participant communications under ERISA, if applicable.
- Selecting a trustee or trustees.
- Establishing trust governance and oversight procedures.
- Selecting the trust's appropriate funding levels and investments.
- Coordinating with the Exempt Organization's actuary on funding levels and with its auditors on the desired financial-statement treatment.
- Obtaining audited financials to disclose on the ERISA plan's Form 5500, if applicable.

Conclusion

Integral Part Trusts can offer a tax-efficient and flexible way for Exempt Organizations to leverage their tax exemptions to fund employee benefits and obtain legal protections for assets in a cost-effective manner. Hospitals and other medical organizations with highly complex affiliated structures and high levels of legal liability could particularly benefit from the use of Integral Part Trusts. However, Integral Part Trusts are highly complex and implicate a variety of legal requirements, including federal and state tax law and state trust law. Exempt Organizations that wish to consider using an Integral Part Trust would be wise to consult with experienced legal counsel to help create and operate any such trust.

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[1] *See Geisinger Health Plan v. Commissioner*, 30 F.3d 494, 498 (3d Cir. 1994).

[2] Rev. Rul. 78-41, 1978-1 C.B. 148.

[3] *Id.*

[4] The language in Treasury regulation Section 1.502-1(b) and the IRS' reasoning in Rev. Rul. 78-41 does not appear to limit the integral part doctrine to Code Section 501(c)(3) organizations. But the published IRS guidance on the integral part doctrine has overwhelmingly addressed Code Section 501(c)(3) organizations. Thus, while the application of the integral part doctrine to trusts created by other types of tax-exempt organizations may be supportable, Exempt Organizations should seek experienced legal counsel for guidance.

[5] *See Georgetown University Retiree Welfare Benefit Trust Determination Letter*, 1997 WL 433716 (July 29, 1997); *Yale University Retiree Health Benefits Coverage Trust,* IRS Form 990 (2024).

[6] *Geisinger Health Plan v. Commissioner*, 985 F.2d 1210, 1220 (3d Cir. 1993).

[7] ERISA § 403(c)(1).

[8] ERISA § 404(a)(1).

[9] ERISA § 4(b)(1), (2).

[10] Separately, trusts established by state or local government entities to fund employee benefits may be able to rely on the tax exclusion under Code Section 115 for income received by states or political subdivisions of a state performing an essential government function, rather than the tax exemption for Integral Part Trusts discussed in this article. Exempt Organizations that believe they may qualify for the Code Section 115 tax exclusion should discuss this tax exclusion with experienced legal counsel.

[11] Integral Part Trusts are still subject to the same UBIT rules as other tax-exempt organizations. Thus, debt-financed property and the active operation of an unrelated trade or business can generate UBIT. *See generally* Code §§ 511, 514.

[12] Treas. Reg. § 1.501(c)(9)-3(a).

[13] It may be reasonable for certain Integral Part Trusts, such as religiously affiliated Integral Part Trusts, to not apply for an IRS determination letter. However, this determination is highly fact dependent and should be discussed with experienced counsel.

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