E. RECENT DEVELOPMENTS IN THE INTERPRETATION OF FINAL REGULATIONS UNDER IRC 501(c)(9) VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATION

1. Introduction

With the finalization of regulations under IRC 501(c)(9), there has been increased activity in the area of the Voluntary Employees' Beneficiary Association (VEBA). This article addresses a number of problems in the interpretation of those regulations.

2. Regulation Section 1.501(c)(9)-2(a)(1)

a. Definition of "Geographic Locale":

The regulations under IRC 501(c)(9) require a special degree of affiliation (or "employment-related bond") among employees in order to enable an "employees' association" to qualify as a VEBA. Such affiliation can be established by proof of a common employer or affiliated employers, coverage under one or more collective bargaining agreements, or membership in a national or international labor union. In addition, in the case of employees covered by multiple employers, the regulations restrict membership in a VEBA to employees of employers engaged "in the same line of business in the same geographic locale." (Reg. 1.501(c)(9)-2(a)(1).)

The policies behind adoption of this membership requirement can be traced first to the legislative history of IRC 501(c)(9). In enacting a tax exemption for VEBAs, Congress explained that such associations were "common" in 1928, and, in recognition of the functions of these associations, Congress thought it "desirable to provide specifically for their exemption from ordinary corporation tax." [H.R. Rept. No. 2, 70th Cong., 1st Sess. 17 (1923); S. Rept. No. 960, 70th Cong., 1 Sess. 25 (1928).]

Ascertaining the nature of employee beneficiary associations existing at the time the predecessor of IRC 501(c)(9) [IRC 103(16)] was enacted discloses the type of "common" organizations Congress intended to benefit through tax exemption. It appears that the organizations prevalent at the time were those formed to insure the employees of a single employer; i.e., nonmultiple-employer associations. This information tends to support the view that Congress intended

that IRC 103(16) benefit employee beneficiary associations which were composed of employees sharing a common employer. Multiple-employer associations insuring employees of unrelated employers spread over a wide geographic area were not within the purview of legislative intent. This view is consistent with the longstanding principle of statutory construction known as the "Cambridge doctrine" which provides that, in using a combination of definitional and popular-name descriptions to designate the various exempt organizations, Congress is presumed to have employed those terms according to their legal significance at the time of the enactment of the particular provisions in which they are used. United States v. Cambridge Loan and Building Company, 278 U.S. 55 (1928). Accordingly, by using the term "voluntary employees' beneficiary associations," Congress is presumed to have been referring to organizations as they actually existed and were commonly known at the time of the enactment of IRC 501(c)(9). Although this analysis of legislative intent is by no means decisive in giving meaning to "geographic locale," it is a factor favoring a limitation on the scope of the term.

The purpose and policy behind limiting employers to the same geographic locale are manifested in the history of the regulations under IRC 501(c)(9). Regulations for IRC 501(c)(9) were first proposed on January 23, 1969. In describing the nature of a qualifying association of employees, Prop. Reg. 1.501(c)(9)-1(b)(1)(i), 34 Fed. Reg. 1038 (1969), stated that:

> An organization described in section 501(c)(9) must be composed of individuals who are entitled to participate in the association by reason of their status as employees who are members of a common working unit. The members of a common working unit include, for example, employees of a single employer, employees of one industry, or the members of one labor union....Whether a group of employees constitutes an acceptable class is a question to be determined with regard to all the facts and circumstances, taking into account the guidelines set forth in this subdivision. [Emphasis added.]

On July 17, 1980, the then-pending proposed regulations were revoked and another set of proposals was promulgated. Prop. Reg. 1.501(c)(9)-2(a)(1), 45 Fed. Reg. 47871 (1980), provided:

> The membership of an organization described in section 501(c)(9) must consist of individuals who become entitled to participate by reason of their being employees and whose eligibility

> for membership is defined by reference to objective standards that constitute an employment-related common bond among such individuals. Typically, those eligible for membership in an organization described in section 501(c)(9) are defined by reference to a common employer (or affiliated employers), to common coverage under one or more collective bargaining agreements (with respect to benefits provided pursuant to such agreement), to membership in a labor union or to membership in one or more locals of a national or international labor union.... In addition, employees of one or more employers engaged in the same geographic area will be considered to share an employment-related bond for purposes of an organization through which their employers provide benefits. Whether a group of individuals is defined by reference to a permissible standard or standards is a question to be determined with regard to all the facts and circumstances, taking into account guidelines set forth in this paragraph. [Emphasis added].

The Final Regulations as adopted recite the above language except that the term "geographic area" has been changed to "geographic locale."

The 1969 Proposed Regulations required a "common working unit" that could be satisfied if all members of an association were "employees of one industry." The "employment-related common bond" test first appeared in the 1980 Proposed Regulations and was adopted in the Final Regulations. Under that test, membership eligibility was narrowed by the removal of "employees of one industry" as an example of an eligible group. The common bond test requires at least a showing of membership employment by employers engaged in the same line of business in the same geographic locale.

Despite requests for deletion of the geographic restriction in the multiple-employer context, the provision was retained in the Final Regulations. T.D. 7750 (Preamble), 46 Fed. Reg. 1719 (1981). The stated policies for doing so were (1) that an association conducted to market insurance products to unrelated individuals scattered throughout the country should not be allowed to use IRC 501(c)(9) as a means to circumvent provisions prescribing the income tax treatment of insurance companies, and (2) that a trade association should not be allowed to use IRC 501(c)(9) as a means to circumvent the unrelated trade or business income tax on proceeds arising from insurance programs offered to its members.

In some respects, an IRC 501(c)(9) trust may be similar to a plan whereby benefits are provided by an insurance company. The manifest policy is to tax organizations conducting activities amounting to a business of insurance as distinguished from organizations legitimately formed as VEBAs. Where an employee beneficiary association is formed to serve employees whose only common bond is working for employers engaged in the same line of business, the "geographic locale" requirement represents a further membership trait for purposes of distinguishing between an association entitled to exemption and one that is not entitled because of its similarity to an insurance business. To achieve the policy as stated, the scope of "geographic locale" must be drawn so as to exclude from exemption employee beneficiary associations with attributes not characteristic of a VEBA but normally associated with the conduct of an insurance business.

There are several attributes which distinguish an employee benefit program from an insurance program. First, an employee benefit plan generally identifies an employer-employee relationship while an insurance program identifies an insurance company-customer relationship. See, Bell v. Employee Sec. Ben. Ass'n., 437 F. Supp. 382, 391-92 (1977) (hereinafter cited as Bell).

When a single employer establishes an employee benefit plan for its employees, the employer-employee relationship remains intact. However, when employers pool their resources to form a multiple-employer plan, the employer-employee relationship is less dominant. Instead, a new relationship between the employee and multiple-employer trust or plan arises in which the employee-beneficiaries deal with an independent insurer-entity representing all participating employers.

When the employment-related common bond of an alleged VEBA consists of "employers engaged in the same line of business," the "geographic locale" requirement serves to sustain an employer-employee relationship. Without geographic restriction, the number of employers that may take part in a VEBA is limited only to the number of willing employers that actually exist in a given line of business. As the number of participating employers increase, the identification of a VEBA with any employer or group of employers is diminished to a point where a VEBA may be viewed as an entity independent of the employment relationships it serves. An insurance company-customer relationship thus evolves. This is especially so where employers, who do not wish to concern themselves with the tasks of the administration of a VEBA, turn to insurance carriers who are willing to provide such services (e.g., handling of claims, payment of claims,

printing of booklets and forms, legal work etc.) under an "administrative service only" (ASO) contract.

Second, unlike an insurance program, an employee benefit plan is noncommercial in nature and lacks a profit motive. See, Bell, supra, at 391. Although an IRC 501(c)(9) organization lacks profit motives, its operation may be deemed commercial if it provides profit-making opportunities for third-party marketing agencies and other administrative services providers. See, Bell, supra, at 392. As the size of a multiple-employer VEBA grows larger, third-party services tend to become more necessary because of the complexity of administration, and more feasible because costs for such services are allocated among many, with the resulting economies of scale. Without a geographic restriction, those whose primary interest is in profiting from the provision of administrative services may freely recruit employers and market insurance packages designed to establish and operate IRC 501(c)(9) organizations.

Third, an employee benefit plan does not involve public solicitation while insurance programs are predominantly marketed in this manner. See, Bell supra, at 391; SEC v. National Securities, Inc. 393 U.S. 453 (1969); Metropolitan Police Retirement Ass'n v. Tobriner, 306 F. 2d 775 (D.C. Cir. 1962). Because of resource pooling and economies of scale, IRC 501(c)(9) becomes a more cost effective alternative to funding an employee benefit program when the number of participants is large. As mentioned, the number of potential participants are practically unlimited when the only "employment-related common bond" required is employers who engage in the "same line of business." Because of their numbers, in many circumstances solicitation of these potential participants may be viewed as a solicitation to the public. While assuring that IRC 501(c)(9) remains an economically feasible employee plan alternative in most instances, a geographic restriction can be drawn to limit the number of eligible participants so that marketing of a VEBA does not amount to public solicitation.

Thus, to give effect to the policy against circumvention of income tax provisions by an insurance business, the "geographic locale" restriction limits the recognition of exempt status to organizations generally lacking the attributes of insurance as discussed. It is our view that organizations formed by employers within the geographic area of a standard metropolitan statistical area (SMSA) a county, a city, a municipality, or a town would generally lack the pertinent insurance attributes and be entitled to exemption under IRC 501(c)(9). We note this interpretation both supports stated policy and ultimately describes and promotes the affinity among employees that is necessary to meet the over-all

requirement of an "employment-related common bond." Although political lines are significant, it is necessary to examine the facts of each case to fix realistically the limits of a pertinent "geographic locale." For example, a community at the fringe of an SMSA may be considered part of the same "geographic locale" of that SMSA where facts and circumstances establish a close affinity between the two based on economic, political, or other relevant factors in a manner that assures that the operation of a VEBA within such a geographic area would lack any significant degree of proscribed insurance attributes.

Employers located within a single state often organize in various combinations and establish VEBAs that operate over geographic areas not confined within the borders of political subdivisions. In some cases, any objectionable degree of insurance attributes associated with multiple-employer VEBAs operating within any given state may be mitigated where there is a unity between participants arising out of a strong commonality of interest in the operation of a single line of business within a single state. In this regard, we note that a labor community engaged in the same line of business in the same state may sometimes maintain a close bond established through a strong common concern in the manner of the state's regulation over the community's affairs and, more generally, in the economic, social, and political conditions peculiar to the state and particularly relevant to the community. By contrast, in other cases a labor community located within a state may be connected by nothing more than a thread of common interest in acquiring convenient low-cost insurance through a VEBA. In these latter cases, it would be difficult to find a bond among participants that is sufficient to eliminate the insurance attributes. Ordinarily, where employers are spread over geographic areas falling within a state but extending beyond those qualifying "locales" designated above (e.g., SMSA, county, city, etc.), a determination of whether such areas qualify as "geographic locales" would require a case-by-case examination. A case-by-case examination, however, creates the heavy administrative burden of setting and applying fine standards to an endless array of geographic areas of various shapes and sizes. Giving due consideration to this burden and to the close bond exhibited between participants of many multiple-employer organizations which operate within a state, the Service has concluded that a geographic area falling within any given state should be included as a qualifying "geographic locale." While posing some risk of being overly inclusive, an area encompassing a state provides the Service a practical administrative standard.

Members of a labor community extending beyond the boundary of a state, unless falling within the qualifying SMSA described above, do not ordinarily share

mutual concerns which are as definite as those experienced by many intrastate communities. Generally, multiple-employer organizations open to employers scattered over several states, or the nation represent a weak bond between employees, and such organizations are inclined to possess the attributes of an insurance business. Thus, absent special circumstances indicating otherwise, these areas do not define a "geographic locale," and exemption under IRC 501(c)(9) is generally unwarranted in such cases.

b. Definition of "Affiliated Employers":

As previously mentioned, eligibility for membership in a VEBA must be defined by reference to objective standards that constitute an employment-related common bond. One such bond under the regulations is employees of affiliated employers. The term "affiliated employers" is not defined under the regulations but is meant to include a corporation and its wholly-owned subsidiary. However, questions have arisen concerning "brother-sister" corporations, chains of corporations controlled by a common parent, and organizations that are not subject to ownership interests.

Although we cannot provide a precise definition of "affiliated employers", we believe there are guidelines under other Code sections that might be utilized. The tests of Temp. Reg. 11.414(c)-2 would seem to be appropriate for determining "affiliated employers" with respect to corporations and other proprietorships. Using the principles of section 1563(a) (providing the definition of "controlled group of corporations" under the rules relating to the filing of consolidated returns) this Regulation defines "two or more trades or businesses under common control." Falling within this description is any group of trades or businesses which is either a "parent-subsidiary group of trades or businesses under common control," a "brother-sister group of trades or businesses under common control," or a "combined group of trades or businesses under common control." These controlled employer groups are determined with reference to control by a common parent, common group of persons, or both.

Generally, Temp. Reg. 11.414(c)-2(b) defines a "parent-subsidiary group of trades or businesses under common control" as one or more chains of "organizations conducting trades or businesses" connected through 80 percent ownership with a common parent organization. Temp. Reg.11.414(c)-2(c) defines a "brother-sister group of trades or businesses under common control" as two or more "organizations conducting trades or businesses" that are owned by common groups of five or fewer persons (who are individuals, estates, or trusts) in certain

prescribed percentages. Temp. Reg. 11.414(c)-2(d) defines a "combined group of trades or businesses under common control" as three or more organizations that are comprised of a combination of parent-subsidiary and brother-sister groups. Under these definitions, "organizations conducting trade or businesses" may include corporations, partnerships, proprietorships, trusts, and estates.

Employer organizations that are not subject to ownership interests and therefore do not lend themselves to an analysis as provided under IRC 414(b) and (c) may be viewed as "affiliated" under Reg. 1.501(c)(9)-2(a)(1) if they are subservient to a common organization through a substantial degree of control and close supervision as determined from all the facts and circumstances. For example, where the board of trustees or directors of two such employer organizations consist of individuals representing a common entity, the organization should be considered "affiliated" for IRC 501(c)(9) purposes.

In summary, although no precise definition of "affiliated employers" can be provided, it is clear that an employer business and the businesses under its control would qualify. If an ownership interest is involved, a group of employers would qualify as affiliated if they met the tests of Temp. Reg. 11.414(c)-2. However, there is no requirement that a group qualify under this regulation in order to be "affiliated." They might be able to show that they are "affiliated" based on some other control test. If a group of employers are not subject to ownership interests, they could be "affiliated employers" by a showing of substantial control and close supervision from all the facts and circumstances. Temp. Reg. 11.414(c) can be found at 1975-2 C.B. 180-188, as T.D. 7388.

3. Regulation section 1.501(c)(9)-2(a)(2)

a. Membership Restrictions, Section 1.501(c)(9)-2(a)(2)(ii)(A)(B)(C):

Eligibility for membership may be restricted by objective criteria, provided the manner in which the criteria are selected and administered do not result in favoring officers, shareholders, or the highly compensated. For example, many benefit plans involving small corporations seek to use a restriction on eligibility for membership based on 3 years of service and attainment of 25 years of age. This restriction is derived from pension plan experience, in particular, the minimum participation standards required for pension plans under IRC 401(a)(3) and set forth in IRC 410(a)(1)(A) and (B). The "three years of service and 25 years of age" membership requirement which these plans seek to impose is not permissible for a VEBA where the effect is to exclude the majority of potential employee-members,

including, in particular, all the lower-compensated employees. The "three-year and 25 years of age" rule for pension plans does not constitute a safe harbor for membership eligibility requirements for a VEBA. In fact, there are no safe harbors with regard to length-of-service restrictions under IRC 501(c)(9). The question of whether the effect of any particular membership restriction favors the "highly-compensateds" with disproportionate benefits is a determination to be based, in each case, on the particular facts and circumstances. Indeed, there may be cases where no restriction on eligibility for membership is acceptable, depending upon the particular facts and circumstances. Length-of-service provisions are thought to be most acceptable where the benefits are provided by way of insurance and immediate coverage of starting employees can be shown to be either impracticable (because of the nature of the business) or prohibitively expensive. Age restrictions (that is, excluding those below a certain minimum age) are generally unacceptable, since experience has shown that for a VEBA the result is usually, if not invariably, the favoring of the "highly-compensateds" and disproportionate benefits. Age restrictions over a certain attained age (that is, exclusion from coverage) based upon actuarial considerations, may be acceptable. Again, what is acceptable in any particular case must depend upon the particular facts and circumstances.

Three other membership eligibility problems need to be briefly addressed. The first is the "one-person VEBA." This is also a spill-over from the pension plan area. One-person pension plans are permissible under the regulations to IRC 401. The National Office position is that the "one-person VEBA" does not qualify for exemption under IRC 501(c)(9). However, because of questions over the "one-person VEBA", especially in light of the one-person pension plan rules under IRC 401, these cases should be sent to the National Office, as lacking published precedent.

The second issue is a spin-off from the "one-person VEBA" situation and occurs when a second person is added (usually after denial) or when the original application indicates a small, "limited-membership VEBA." This situation also occurs commonly with the small professional corporation. Most typically these corporations will have one to four stockholder/employees (a highly compensated class) and zero to three clerical/non-stockholder employees (a lower-compensated class.) The following example illustrates the problem:

A owns 100% of the stock of P, a professional corporation. A and S, A's secretary, are the only employees of P and their respective salaries are $90,000 and $15,000. A and S are both members of an employer-funded VEBA trust that

provides life insurance benefits equal in amount to salaries. A appoints the trustees of the VEBA.

Under these circumstances, the current thinking in the National Office is that an owner-member would maintain a posture incompatible with the inurement proscription because the owner-member possesses effective control over the contributing employer. A limited membership in combination with the allocation of a dominant share of benefits to an owner-member, indicates that a trust is organized and operated for the benefit of its owner-member and not for any employee group. Prior to termination, such a trust accumulates funds mainly for the current benefit of its owner-member. With effective control over the contributing employer, the owner-member would have the power to manage trust operations and direct the investment of trust assets. Further, with effective control, the trust would be subject to termination at the whim of the owner-member. By controlling the timing of trust termination, the owner-member would be able to direct the distribution of his allocable share of trust assets. Under these circumstances, a VEBA would function substantially as an investment fund for the direct personal and private benefit of its owner-member. The current thinking in the National Office is that an organization functioning in this manner is inconsistent with the exempt purpose of a VEBA in providing benefits to promote the common welfare of an association of employees as opposed to the welfare of a single employee. Cases involving this problem should be referred to the National Office.

A related problem involves an arrangement where two (or more) related corporations are established, with the highly compensated employed by one and the lowly compensated employed by the other. Under this arrangement the corporation employing the highly compensated provides a benefit plan while the other does not. This would seem to be an attempt to avoid the rule against favoring the "highly-compensated" and it is possible that the rules under IRC 414 would be employed to treat these two corporations as one for purposes of the membership rules. The regulations under IRC 414 provides rules for treating the employees of two or more "trades or businesses" under common control as being employed by one employer. See the prior discussion of "Affiliated Employers".

The previous membership restriction questions involved arrangements where, at least in part, the highly compensated might be favored. The next question is what employees may be excluded from membership (assuming the highly compensated employees are not favored). Reg. 1.501(c)(9)-2(a)(2)(i) provides that eligibility for membership may be restricted by geographic proximity or by

objective conditions or limitations reasonable related to employment, such as limitation to a reasonable classification of workers, a limitation based on a reasonable minimum period of service, a limitation based on maximum compensation, or a requirement that a member be employed on a full-time basis. Employees covered under a collective bargaining agreement may also be excluded from membership. Reg. 1.501(c)(9)-2(a)(2)(ii)(B) and (C). Under the regulations it is clear that part-time employees may be excluded from membership. In addition, the exclusion of all employees at a distant branch is probably permissible. However, a plan that excludes hourly employees is questionable, as is one that includes hourly employees and excludes salaried employees.

b. Benefits Restrictions, Section 1.501(c)(9)-2(a)(2)(ii)(B) through (G):

I. General Requirements-Permissible Restrictions:

Eligibility for benefits is a problem related to eligibility for membership. Eligibility for benefits may also be restricted based on objective conditions relating to the type or amount of benefits offered. Like eligibility for membership, the criteria for eligibility for benefits cannot be selected or administered in a manner which favors officers, shareholders or highly compensated employees. This is also a facts and circumstances determination. What constitutes "objective conditions relating to the amount of benefits offered" is clear in at least a few instances. Where, for example, the benefits amounts are set by a collective bargaining agreement, the requirement of objectivity is met. Where a reasonable health standard (for example, for medical insurance - the absence of disease and reasonably good health plus passage of a medical examination) is required, there is usually no problem in finding it to be an "objective condition." Another question resolved is whether additional benefits are allowable to spouses and/or dependants of members, on condition that the member-employee contribute to the costs of such benefits. It has been determined that this is a permissible restriction. The requirement of such contributions has been found an "objective condition" relying on Reg. 1.501(c)(9)-2(a)(2)(ii)(D). Thus, an employer can require an employee-member to contribute to an otherwise wholly employer-funded VEBA in order for the employee to obtain additional benefits for spouse and/or dependents. The requirement of Reg. 1.501(c)(9)2(a)(2)(ii)(D) above, must be met, however. Additional benefits must be based solely on contributions and those making contributions must be entitled to comparable benefits. Also, such additional benefits must be available to all employees within the same class upon the same terms. Despite these requirements, experience has shown that there are usually no problems with additional benefits for spouses and dependents.

II. Disproportionate Benefits:

As the previous paragraph indicates, benefits may be restricted by objective conditions relating to type or amount of benefits offered. In addition, Reg. 1.501(c)(9)-4(b) provides that the payment to similarly situated employees of benefits that differ in kind or amount will constitute prohibited inurement unless the difference can be justified on the basis of objective and reasonable standards adopted by an association, or, on the basis of standards adopted pursuant to the terms of a collective bargaining agreement.

May an employer-funded plan provide benefits that differ in kind or amount on the "objective" condition of worker classification (salaried versus hourly, for example) or geographic location (assuming that the highly compensated are not favored and that none of the generally permissible restrictions of Reg. 1.501(c)(9)-2(a)(2)(ii)(A) to (G) apply)? For example, can an employer choose, for business reasons, to pay through a plan higher benefits to employees at one location than to those at another location? This question is considered in two contexts.

First, let us assume that in a particular case, the membership rules of the regulations require that all employees be included in the plan. For example, all employees of one employer are salaried and are located in one office building. Could the plan provide that the employees in one department be paid greater benefits than the employees in another department?

Let us consider a second fact pattern. Assume in this case that the membership rules of the regulations permit certain employees to be excluded from membership but the plan, in fact, includes such employees. In this case, some employee-members who are located at a distant plant (who probably could be excluded from membership under Reg. 1.501(c)(9)-2(a)(2)) are paid lower benefits than the other employee-members. Would the payment of different benefits in this case violate the disproportionate benefit rules of the regulations? We ask this question since the regulation's membership restrictions seem to be different (a more liberal standard) than the benefits restriction standards of the regulations. If they are different, this would permit certain employees to be excluded from membership but, if included, require that they receive the same benefits.

At present, the National Office has not reached any definite conclusions on either of these fact patterns, but both of these cases are under study. Timely

resolution of these questions is anticipated. Cases involving these questions should be referred to the National Office as lacking published precedent.

III. Benefits Provided by Job Classification:

The provision of life and disability benefits based upon a uniform percentage of compensation is clearly permissible under Regs. 1.501(c)(9)-2(a)(ii)(F) and 1.501(c)(9)-2(a)(2)(ii)(G). A problem exists, however, where the provision of benefits is based upon a rough uniform percentage of compensation basis tied to employee job category or classification.

The provision of benefits based upon the class into which the employee is placed may, or may not, be a form of disproportionate benefit, depending upon how far it deviates from the generally permissible restriction on benefits under the regulations.

The following example illustrates the nature of the problem.

Example:

Company A provides a life benefit and an accidental death and dismemberment (AD&D) benefit to employees. A supplied the following information relative to the benefits:

Number of Employees	Category of Employees	Salary Ranges	Average Salary	Life Benefit	AD & D Benefit
100	Officers	$ 100-$ 250,000	$ 150,000	$ 400,000	$ 500,000
1,000	Supervisors	$ 20-$ 50,000	$ 35,000	$ 100,000	$ 125,000
10,000	Others	$ 15-$ 25,000	$ 20,000	$ 60,000	$ 100,000

A also indicated that the benefits are wholly paid for by it and that it has contracted with an insurance company to provide the benefits amounts by way of a master group life and AD&D insurance policy.

Our experience would indicate that this situation is typical. The issue here is whether the benefits provided may be based upon the rough uniform percentage of compensation standard, based upon average compensation levels for each job category. The thinking on these "job classification" cases runs along two lines.

First, where the benefits in question are roughly proportional to compensation (when the class is considered as a whole) the restrictions on eligibility for benefits are permissible, even though the actual benefits, as compared to each individual employee's salary, are not exactly the same percentage of compensation. Second, where the benefits in question are weighted in favor of the "lower-compensateds" this fact affirmatively negates the presumption that the benefits classifications are selected or administered in a manner which favors the "highly-compensateds." The problem with making either of these determinations is that they imposed an onerous administrative burden upon the Service and require extensive factual analysis to determine whether the benefits are close enough to the generally permissible restriction of benefits based upon a uniform percentage of compensation.

At present, the issue of "job classification" restrictions on benefits and the previously discussed rationales are under study in the National Office. Cases involving the provision of fixed-amount benefits based on job category of classification and <u>not strictly based upon a uniform percentage of compensation requirement</u> should be referred to the National Office as not clear under the regulations.

IV. <u>Integration of Benefits</u>:

Another question that has arisen is the question of "integration of benefits." Reg. 1.501(c)(9)-2(a)(2)(ii)(G) provides that benefits in the nature of wage replacement in the event of disability may be offset by Social Security or similar benefits (worker's compensation), provided, however, the benefits provided by the VEBA are a uniform percentage of compensation of the covered individuals (either before or after taking into account any disability benefits provided through Social Security or any similar plan providing wage replacement in the event of disability).

Benefits under Social Security include old age, survivors and disability benefits. Disability benefits provided through Social Security are similar to a wage replacement plan because a prerequisite for the receipt of benefits under both is that the employee is no longer physically capable of performing his or her job. Old-age insurance benefits provided through Social Security are generally available only to retired workers who have attained age 62 (see 42 U.S.C. Section 402(a)). These benefits are payable because of an employee's accumulated time spent in the work force, that is, by reason of the passage of time rather than as a result of an unanticipated event, and therefore should be considered a benefit similar to that provided under a pension, annuity, stock bonus or profit-sharing

plan. See Reg. 1.501(c)(9)-3(f). Survivors benefits provided through Social Security are generally available to surviving spouses who have attained age 60 (see 42 U.S.C. Section 402(e) and (f)). These benefits are payable to the deceased's family by reason of the employee's death rather than by the passage of time. Thus, survivors benefits provided through Social Security are similar, in part, to a permissible type of section 501(c)(9) benefit. However, a problem exists with the integration of this type of benefit because, the payment of survivors benefits also depends, in part, on the surrounding circumstances of the beneficiary.

Several interpretational difficulties have arisen under Reg. 1.501(c)(9)-2(a)(2)(ii)(G) as associations applying for exemption under IRC 501(c)(9) attempt to offset not only disability benefits, but also old-age and survivors benefits, against benefits provided by the VEBA. This is another spill-over from the pension plan area where integration of benefits under certain circumstances is permissible.

The potential for abuse can be seen from the following example:

Example

A welfare plan provides life benefits for all its employees at one-half of their salaries offset by survivors' benefits provided by Social Security. However, after the offset only the highly compensated employees receive any VEBA benefits. This results from the fact that the survivors benefit under Social Security tends to be the same for all employees under the VEBA.

Category of Employees	Average Salary	Initial VEBA Benefit	Social Security Offset	Final VEBA Benefit
Executives	$ 80 X	$ 40 X	$ 12 X	$ 28 X
Others	$ 20 X	$ 10 X	$ 12 X	- 0 -

In addition to the fact that Social Security survivors benefits are not the same in all respects to life benefits, this type of arrangement, if allowed, would permit employers to set up life benefit plans that provide benefits only to the highly compensated.

As of this writing, no case involving the integration of Social Security benefits has been approved and the area remains under study in the National Office. Cases involving the "integration of benefits" under Social Security must be referred to the National Office as being without published precedent.

4. Regulation Section 1.501(c)(9)-3

a. Permissible "Life" Benefits

The issue of what constitutes permissible benefits under the regulations is still with us. Our experience has indicated that non-qualifying benefits is an issue which occurs in at least half of all of our application cases. The problem also exists in pre-regulation VEBAs, which are beginning to come in under Announcement 81-95, 1981 I.R.B. 37, for confirmatory rulings of exempt status.

The first area of concern is with regard to life benefits under Reg. 1.501(c)(9)-3(b).

Reg. 1.501(c)(9)-3(b) states that the term "life benefits" means a benefit payable by reason of the death of a member or dependent. This section also provides that a "life benefit" may be provided directly or through insurance. It specifies that it generally must consist of current protection, but also may include a right to convert to individual coverage on termination of eligibility for coverage through the association, or a permanent benefit as defined in, and subject to the conditions in, the regulations under IRC 79. (Emphasis supplied.) This section of the regulations also states that the term "life benefit" does not include a pension, annuity or similar benefit, except that a benefit payable by reason of the death of an insured may be settled in the form of an annuity to the beneficiary in lieu of a lump-sum death benefit (whether or not the contract provides for settlement in a lump-sum).

With the publication of the regulations, the tax advantages of VEBAs as an employer-funded fringe benefit, either alone or as part of a package, have become evident to employers. As a result, we are seeing more applications with combinations of life benefits including the "retired lives reserve."

The "retired lives reserve" (RLR) consists of a term life insurance benefit with an effective date coinciding with the employee's retirement. Thus, under a "pure" RLR benefit, the employee is entitled to nothing until retirement. At time of retirement he/she gets term life insurance protection. RLR may also be included in

a premium for a policy that includes current protection. Whatever the case, the RLR is not a current benefit and based on Reg. 1.501(c)(9)-3(b), it must qualify under IRC 79. However there is a serious question whether the RLR benefit qualifies under that section. Because of lack of published precedent, cases involving "retired lives reserves" should be referred to the National Office.

b. Permissible "Other" Benefits

Two issues have been raised in the "other benefit" area which should be discussed here.

The first issue is the question of whether worker's compensation benefits may be paid by a collectively-bargained-for trust and be an appropriate "other benefit" within the meaning of Reg. 1.501(c)(9)-3(e). Rev. Rul. 74-18, 1974-1 C.B. 139, provides that a fund established by an employer to provide worker's compensation benefits required by state law was not exempt under IRC 501(c)(9). The reason was that employees were already entitled to worker's compensation benefits under state law. Thus, the unilateral establishment of the fund by the employer for the discharge of the employer's legal obligation in effect provided an employer benefit as opposed to an additional employee benefit. Under this fact situation, such a fund could not be exempt under IRC 501(C)(9) as a VEBA.

With a collectively-bargained-for trust, however, the situation is different. Under the new regulations, in particular Reg. section 1.501(c)(9)-2(a)(2)(ii)(C), wider latitude has been given these trusts because of the belief that they significantly benefit employees and have adequate safeguards for protection of employee rights through the collective bargaining mechanism. The basis for this treatment is the proposition that the Service should not, as a rule, impose its judgment on the types of benefits to be provided or the mechanics of their provision which emerge from a legitimate collective bargaining situation. In other words, the employees must believe that, under the circumstances, providing worker's compensation benefits, through the VEBA, is a benefit to them. Thus, Rev. Rul. 74-18, supra, and Rev. Rul. 66-354, 1966-2 C.B. 207, upon which Rev. Rul. 74-18 relies, are distinguishable. In a collectively-bargained-for trust, worker's compensation benefits are appropriate "other benefits" and the trust qualifies for exemption as a VEBA under IRC 501(c)(9).

The second issue which has been raised is the question of what kind of "vacation facilities" are considered appropriate "other benefits" under Reg. 1.501(c)(9)-3(e). The issue has arisen in the context of the "limited-membership

VEBA," supra, where there is a high percentage of "highly-compensateds" to "lower-compensateds." The cases seen so far involve condominiums at resort locations geographically-distant (250 miles to 1500 miles) from the place of employment. Even where a reasonable and non-discriminatory (equal use/random use) schedule has been devised by the association, there remains the question of whether the location of the vacation facility, in effect, results in a de facto benefit restriction which favors the highly-compensated group. A secondary question is whether this is the type of vacation facility contemplated by the regulations under Reg. 1.501(c)(9)-3(e) as an appropriate "other benefit." Both of these issues are under study in the National Office. Where a "limited-membership VEBA" provides as an "other benefit" the use of a geographically-distant "vacation facility", the case should be referred to the National Office as without precedent and not clear under the regulations.

5. Regulation Section 1.501(c)(9)-4

a. Transfer of Assets between VEBAs

The issue of inter-VEBA transfers of assets is being considered in the National Office. Under the present regulations, there is no basis for the transfer of assets from one VEBA to a second VEBA. The only uses of such assets (aside from the payment of benefits to members) permitted by the regulations are the rebate of excess premium amounts on insurance policies to the contributor(s), incidental administrative adjustments and the distribution of assets upon dissolution. Regs. 1.501(c)(9)-4(c)(d). This has arisen as an issue in two types of cases. First, we have seen the case where two VEBAs set up to pay different types of permissible IRC 501(c)(9) benefits with identical memberships seek approval for an inter-VEBA transfer of assets because of one VEBA's funds having been depleted or exhausted. In a second type of case, we have seen two VEBAs with different memberships request approval of a transfer because of accumulated excess funds and a declining membership in one and need for funds in the second. In this second case, the VEBAs were established as a result of one union's collective bargaining with two employers in a particular industry. Here the membership is not the same, the members of the two VEBAs are all members of the same union, but different locals. Where the membership of VEBAs differs, an argument can be made that such a transfer constitutes inurement. A collateral problem may also be present in the inter-VEBA transfer situation under IRC 512 (a)(3)(B)(ii) as to what the transfer does to funds "set aside" and whether they remain "set aside."

Proposed inter-VEBA transfer of assets cases should be treated as proposed transaction requests and forwarded to the National Office. When such transfers are discovered upon examination, technical advice should be sought since the result is not clear under the regulations.

6. Obsoleted Rulings

There are a number of revenue rulings and a procedure dealing with IRC 501(c)(9) that have been obsoleted. These are Rev. Rul. 57-61, 1957-1 C.B. 197, Rev. Rul. 57-494, 1957-2 C.B. 315, Rev. Rul. 58-442, 1958-2 C.B. 194, Rev. Rul. 59-28, 1959-1 C.B. 120, Rev. Rul. 64-258, 1964-2 C.B. 134, Rev. Rul. 65-81, 1965-1 C.B. 225, and Rev. Proc. 66-30, 1966-2 C.B. 1212. These should not be relied on in disposing of cases. See Rev. Rul. 82-148, 1982-32 I.R.B. 11 and Rev. Proc. 82-46, 1982-32 I.R.B. 12, dated August 9, 1982.

Three other revenue rulings, Rev. Rul. 66-212, 1966-2 C.B. 230, Rev. Rul. 66-354, 1966-2 C.B. 207, and Rev. Rul. 74-18, 1974-1 C.B. 139, remain in force, but may be affected by subsequent interpretations of pertinent regulations provisions.

7. Conclusion

The finalization of regulations under IRC 501(c)(9) has resulted in severe definitional and interpretational problems as employers seek to use the VEBA as an employee fringe benefit for the highly compensated employee and as a tax deferral device. Problems have arisen with the definition of eligible classes of beneficiaries and the permissible bases for exclusion, the types and amounts of benefits provided and the integration, offset, coordination or reduction of those benefits, the manner of funding of benefits, and the disposition of "excess" assets.

The regulations as finalized attempt to provide only general guidelines for the equitable treatment of employee-members, as intended by the statutory enactment. The "anti-discrimination" provisions, in particular, must be carefully and thoughtfully applied to prevent VEBAs from becoming a tax-abuse area. Additional experience and precedent is necessary before problems highlighted in this article will be satisfactorily or fully resolved.