set aside (including commissions earned as agent for an insurance company) may be so set aside. Moreover unless such income is used for providing insurance benefits, for those purposes specified in section 170(c)(4), or for reasonable costs of administration, such income must be set aside within the period described in paragraph (b)(3) of this section in order to avoid being included as an item of unrelated business taxable income under section 512(a)(4).

(3) *Time within which income must be set aside.* Income from amounts in the insurance set aside generally must be set aside in the taxable year in which it would be includible in gross income but for this section. However, income set aside on or before the date prescribed for filing the organization's return of unrelated business taxable income (whether or not it had such income) for the taxable year (including any extension of time) may, at the election of the organization, be treated as having been set aside in such taxable year.

(4) *Computation of income from set aside.* Income from amounts in the insurance set aside shall consist solely of items of investment income from, and other gains derived from dealings in, property in the set aside. The deductions allowed against such items of income or other gains are those amounts which are related to the production of such income or other gains. Only the amounts of income or other gain which are in excess of such deductions may be set aside in the insurance set aside.

(5) *Requirements for set aside.* An amount is not properly set aside if the organization commingles it with any amount which is not to be set aside. However, adequate records describing the amount set aside and indicating that it is to be used for the designated purpose are sufficient. Amounts that are set aside need not be permanently committed to such use either under state law or by contract. Thus, for example, it is not necessary that the organization place these funds in an irrevocable trust. Although set aside income may be accumulated, any accumulation which is unreasonable in amount or duration is evidence that the income was not accumulated for the purposes set forth. For purposes of the preceding sentence, accumulations which are reasonably necessary for the purpose of providing life, sick, health, or accident insurance benefits on the basis of recognized mortality or morbidity tables and assumed rates of interest under an actuarially acceptable method would not be unreasonable even though such accumulations are quite large and the time between the receipt by the organization of such amounts and the date of payment of the benefits is quite long. For example, an accumulation of income for 20 years or longer which is determined to be reasonable necessary to pay life insurance benefits to members, their dependents or designated beneficiaries, generally would not be an unreasonable accumulation. Income which has been set aside may be invested, pending the action contemplated by the set aside, without being regarded as having been used for other purposes.

[T.D. 7438, 41 FR 44393, Oct. 8, 1976]

§ 1.512(a)–5T Questions and answers relating to the unrelated business taxable income of organizations described in paragraphs (9), (17) or (20) of Section 501(c) (temporary).

Q–1: What does section 512(a)(3), as amended by the Tax Reform Act of 1984 (Act), provide with respect to organizations described in paragraphs (9), (17) or (20) of section 501(c)?

A–1: In general, section 512(a)(3), as amended by section 511 of the Act, extends the rules for determining the unrelated business income tax of voluntary employees' beneficiary associations (VEBAs) to supplemental unemployment compensation benefit trusts (SUBs) and group legal service organizations (GLSOs). The section also restricts the amount of income that may be set aside by such organizations for exempt purposes.

Q–2: What is the effective date of the amendments to section 512(a)(3)?

A–2: The amendments to section 512(a)(3) will apply to income earned by VEBAs, SUBs or GLSOs after December 31, 1985, in the taxable years of such organizations ending after such date. For purposes of applying section 512(a)(3) to the first taxable year of such an organization ending after December 31, 1985, the income of the VEBA, SUB or GLSO earned after December 31, 1985, will be determined by allocating the total income earned for such taxable year on the basis of the calendar year 1985 and 1986 months in such taxable year. However, if a VEBA, SUB or GLSO is part of a plan that is maintained pursuant to one or more collective bargaining agreements (a) between employee representatives and one or more employers, and (b) which are in effect on July 1, 1985 (or ratified on or before that date), the amendments do not apply to income earned in a taxable year of a VEBA, SUB or GLSO beginning before the termination of the last of the collective bargaining agreements pursuant to which the plan is maintained (determined without regard to any extension of the contract agreed to after July 1, 1985). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added under section 511 of the Tax Reform Act 1984 (i.e., requirements under section 419, 419A, 512(a)(3)(E), and 4976) shall not be treated as a termination of such collective bargaining agreements.

Q–3: What amount of income may a VEBA, SUB or GLSO set aside for exempt purposes?

A–3: (a) Pursuant to section 512(a)(3)(E)(i), the amounts set aside in a VEBA, SUB, or GLSO (including a VEBA, SUB, or GLSO that is part of a 10 or more employer plan, as defined in section 419A(f)(6)(B)) as of the close of a taxable year of such VEBA, SUB, or GLSO to provide for the payment of life, sick, accident, or other benefits may not be taken into account for purposes of determining *exempt function income* to the extent that such amounts exceed the qualified asset account limit, determined under sections 419A(c) and 419A(f)(7), for such taxable year of the VEBA, SUB, or GLSO. In calculating the qualified asset account limit for this purpose, a reserve for post-retirement medical benefits under section 419A(c)(2)(A) is not to be taken into account.

(b) The exempt function income of a VEBA, SUB, or GLSO for a taxable year of such an organization, under section 512(a)(3)(B), includes: (1) Certain amounts paid by members of the VEBA, SUB, or GLSO within the meaning of the first sentence of section 512(a)(3)(B) (*member contributions*); and (2) other income of the VEBA, SUB, or GLSO (including earnings on member contributions) that is set aside for the payment of life, sick, accident, or other benefits to the extent that the total amount set aside in the VEBA, SUB or GLSO as of the close of the taxable year for any purpose (including member contributions and other income set aside in the VEBA, SUB, or GLSO as of the close of the year) does not exceed the qualified asset account limit for such taxable year of the organization. For purposes of section 512(c)(3)(B), member contributions include both employee contributions and employer contributions to the VEBA, SUB, or GLSO. In calculating the total amount set aside in a VEBA, SUB, or GLSO as of the close of a taxable year, certain assets with useful lives extending substantially beyond the end of the taxable year (e.g., buildings, and licenses) are not to be taken into account to the extent they are used in the provision of life, sick, accident, or other benefits. For example, cash and securities (and similar investments) held by a VEBA, SUB or GLSO are not disregarded in calculating the total amount set aside for this purpose because they are used to pay welfare benefits, rather than merely used in the provision of such benefits. Accordingly, the unrelated business taxable income of a VEBA, SUB, or GLSO for a taxable year of such an organization generally will equal the lesser of two amounts: the income of the VEBA, SUB, or GLSO for the taxable year (excluding member contributions); or, the excess of the total amount set aside as of the close of the taxable year (including member contributions, and excluding certain assets with a useful life extending substantially beyond the end of the taxable year to the extent they are used in the provision of welfare benefits) over the qualified asset account limit (calculated without regard to the otherwise permitted reserve for post-retirement medical benefits) for the taxable year. See §1.419A–2T for special rules relating to collectively bargained welfare benefit funds.

(c) The income of a VEBA, SUB, or GLSO for any taxable year includes gain realized by the organization on the sale or disposition of any asset during such year. The gain realized by a VEBA, SUB, or GLSO on the sale or disposition of an asset is equal to the amount realized by the organization over the basis of such asset (in the hands of the organization), reduced by any qualified direct costs attributable to such asset (under paragraphs (b), (c), and (d) of Q&A–6 of §1.419–1T).

Q–4: What transition rules apply to *existing reserves for post-retirement medical or life insurance benefits*?

A–4: (a) Section 512(a)(3)(E)(iii)(I) provides that income that is either directly or indirectly attributable to *existing reserves for post-retirement medical or life insurance benefits* will not be treated as unrelated business taxable income. An *existing reserve for post-retirement medical or life insurance benefits* (as defined in section 512(a)(3)(E)(iii)(II)) is the total amount of assets actually set aside in a VEBA, SUB, or GLSO on July 18, 1984 (calculated in the manner set forth in Q&A–3 of the regulation, and adjusted under paragraph (c) of Q&A–11 of §1.419–1T), reduced by employer contributions to the fund on or before such date to the extent such contributions are not deductible for the taxable year of the employer containing July 18, 1984, and for any prior taxable year of the employer, for purposes of providing such post-retirement benefits. For purposes of the preceding sentence only, an amount that was not actually set aside on July 18, 1984, will be treated as having been actually set aside on such date if (1) such amount was incurred by the employer (without regard to section 461(h)) as of the close of the last taxable year of the VEBA, SUB, or GLSO ending before July 18, 1984, and (2) such amount was actually contributed to the VEBA, SUB, or GLSO within 8½ months following the close of such taxable year.

(b) In addition, section 512(a)(3)(E)(iii)(I) applies to existing reserves for such post-retirement benefits only to the extent that such *existing reserves* do not exceed the amount that could be accumulated under the principles set forth in Revenue Rulings 69–382, 1969–2, C.B. 28; 69–478, 1969–2 C.B. 29; and 73–599, 1973–2 C.B. 40. Thus, amounts attributable to such excess *existing reserves* are not within this transition rule eventhough they were actually set aside on July 18, 1984.

(c) All post-retirement medical or life insurance benefits (or other benefits to the extent paid with amounts set aside to provide post-retirement medical or life insurance benefits) provided after July 18, 1984 (whether or not the employer has maintained a reserve or fund for such benefits) are to be charged, first, against the *existing reserves* within this transition rule (including amounts attributable to *existing reserves* within this transition rule) for post-retirement medical benefits or for post-retirement life insurance benefits (as the case may be) and, second, against all other amounts. For this purpose, the qualified direct cost of an asset with a useful life extending substantially beyond the end of the taxable year (as determined under Q&A–6 of § 1.419–1T) will be treated as a benefit provided and thus charged against the *existing reserve* based on the extent to which such asset is used in the provision of post-retirement medical benefits or post-retirement life insurance benefits (as the case may be). All plans of an employer providing post-retirement medical benefits are to be treated as one plan for purposes of section 512(a)(3)(E)(iii)(III), and all plans of an employer providing post-retirement life insurance benefits are to be treated as one plan for purposes of section 512(a)(3)(E)(iii)(III).

(d) In calculating the unrelated business taxable income of a VEBA, SUB, or GLSO for a taxable year of such organization, the total income of the VEBA, SUB, or GLSO for the taxable year is reduced by the income attributable to *existing reserves* within the transition rule before such income is compared to the excess of the total amount set aside as of the close of the taxable year over the qualified asset account limit for the taxable year. Thus, for example, assume that the total income of a VEBA for a taxable year is $1,000, and that the excess of the total amount of the VEBA set aside as of the close of the taxable year over the applicable qualified asset account limit is $600. Assume also that of the $1,000 of total income, $500 is attributable to *existing reserves* within the transition rule of section 512(a)(3)(E)(iii)(I). The unrelated business income of this VEBA for the taxable year is equal to the lesser of the following two amounts: (1) the total income of the VEBA for the taxable year ($1,000), reduced to the extent that such income is attributable to *existing reserves* within the transition rule ($500); or (2) the excess of the total amount set aside as of the close of the taxable year over the applicable qualified asset account limit ($600). Thus, the unrelated business income of this VEBA for the taxable year is $500.

[T.D. 8073, 51 FR 4332, Feb. 4, 1986; 51 FR 7262, Mar. 3, 1986; 51 FR 11303, April 2, 1986]

§ 1.512(b)–1 Modifications.

Whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case. For example, if a payment termed *rent* by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or joint venturer, such payment is not within the modification for rents. The modifications provided in section 512(b) are as follows:

(a) *Certain Investment Income*—(1) *In general.* Dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), annuities, income from notional principal contracts (as defined in Treasury Regulations 26 CFR 1.863–7 or regulations issued under section 446), other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner, and all deductions directly connected with any of the foregoing items of income shall be excluded in computing unrelated business taxable income.

(2) *Limitations.* The exclusions under paragraph (a)(1) of this section do not apply to income derived from and deductions in connection with debt-financed property (as defined in section 514(b)). Moreover, the exclusions under paragraph (a)(1) of this section do not apply to gains or losses from the sale, exchange, or other disposition of any property, or to gains or losses from the lapse or termination of options to buy or sell securities. For rules regarding