Uniform Issue List
4976.00-00
512.09-03
419.03-00

200011063

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: DEC 20 1999

Contact Person:

ID Number:

Telephone Number:

Employer Identification Number:
EO Area Office:

Legend:

M =
N =
O =
P =
Q =
R =
s =

Dear Applicant:

This is in response to your letter dated June 24, 1999, wherein you requested a ruling as to the tax consequences of the proposed transactions described below.

M was established effective as of January 1, 1994, under a Trust Agreement between N and 0 as trustee bank. M is a voluntary employees beneficiary association (VEBA) and is exempt from federal income tax under section 501(c)(9) of the Internal Revenue Code, per a determination issued by the Service on June 1, 1995.

Up until now. M has been used exclusively as a funding vehicle for the payment of welfare benefits for certain retired employees of N and its affiliated companies. Inasmuch as M was originally intended to benefit retirees only. the exemption application on Form 1024 stated that its purpose was to fund medical, dental. and life insurance benefits for eligible retirees and their dependents; no mention was made of active employees. However, the Trust Agreement, included with the application, specifically states that the trust may be used as a funding mechanism for both active and retired employees.

N sponsors and maintains a group health plan (Health Plan) for the benefit of its active and retired employees and the active and retired employees of its affiliated companies. Prior to January 1. 1995, the Health Plan was fully insured under a policy issued by an insurance company. P. The P policy was originally issued effective on or around July 1, 1977. and was most recently reissued

effective February 1, 1991. Benefits under the P policy included comprehensive medical and dental, prescription drug and death benefits. Policy premiums were paid through a combination of contributions from N and covered individuals.

As part of the group policy, N and P executed a rider to the policy dated July 28, 1986, and effective June 1, 1986, which required that a premium stabilization reserve (the P Reserve) be established. The P policy is a welfare benefit fund as defined in section 419(e) of the Code. The purpose of the P Reserve was to help avoid fluctuations in the annual premiums charged for coverage. As of the end of each policy Year, the P Reserve was credited or charged with any net surplus or deficit based on that Yeats claims experience, service expense, and interest credited on the reserve balance. To the extent the P Reserve fell below the established reserve level for any policy Year, N was required to contribute an additional premium to P.

All amounts paid by N to P, including amounts credited to the P Reserve, were fully deducted by N under sections 162 or 419 of the Code for the Years in which the amounts were paid in compliance with Rev. Rul. 69-382, 1969-2 C.B. 28. Both the Health Plan and N have taxable years ending December 31.

Effective January 1, 1995 (or June 1, 1995, with respect to employees employed in the Q division of N), N terminated the P policy and began self-insuring benefits under the Health Plan. At that time, N was informed that P would not complete the final accounting under the policy until sometime around June 1, 1997, and that any surplus credited to the P Reserve would not be payable until that accounting was finished. As a result of an apparent administrative oversight on the part of P, N was not notified until April 29, 1999, that P continued to hold a surplus in the P Reserve and that such surplus was currently payable.

As of April, 1999, the total value of the P Reserve was approximately $2,402,058. Of that amount, an estimated $416,593 was attributable to the period beginning January 1. 1995, and ending June 1, 1995, during which the P policy only covered employees of N's Q division and their beneficiaries.

In a FAX submission on November 12. 1999, Your attorney informed us that the P Reserve was wired by P directly to M during June, 1999. N intends to apply that amount as an offset to the employer contribution otherwise due to M for calendar Year 1999. You have indicated previously that, pursuant to the terms of the Trust Agreement, the transferred P Reserve will be used exclusively to provide life, medical, dental, long term disability and other permissible welfare benefits to active and retired employees and their beneficiaries.

N also sponsors and maintains a fully insured long term disability plan (the "LTD" Plan) for the benefit of its active employees and the active employees of its affiliated companies. Eligible employees who become disabled while actively at work may receive a specified percentage of their monthly pre-disability earnings (up to a maximum dollar amount per month) for the duration of their disability (not to exceed the maximum benefit period). The percentage of pre-disability earnings payable under the LTD Plan varies depending upon the employee's employment classification and the maximum benefit period varies depending the age of the individual at the time of disability. Eligible employees are not required to contribute to the Plan; however, individuals employed in

certain employment classifications may choose to contribute additional premiums in order to increase their level of disability benefits.

Effective on or around February 1, 1989, R, an insurance company, was selected as the insurance carrier for the LTD Plan and a policy was issued to N. The LTD policy was most recently reissued effective January 1, 1997. R continued to serve as the LTD insurance carrier until January 1, 1999, at which time, S became the new carrier. The R LTD policy is a welfare benefit fund as defined in section 419(e) of the Code.

As part of the R LTD policy, N and R entered into a claims fluctuation reserve agreement (the R Reserve) made effective January 1, 1997, for the purpose of stabilizing the amount of monthly premiums payable under the policy. As of each policy renewal date, the R Reserve was credited or charged with any net surplus or deficit based on that yeal s claims experience, service expense, and interested credited on the reserve balance. Pursuant to the terms of the R Reserve agreement, any surplus reserve is paid directly to N approximately one year after the date the policy is terminated. The value of the R Reserve is estimated to be approximately $100,000 and is expected to be paid on or around April, 2000.

All amounts paid by N to R, including amounts credited to the R Reserve, were deducted by N under sections 162 or 419 of the Code in compliance with Rev. Rul. 69-382. The LTD Plan also has a taxable year ending December 31.

N proposes to enter into an agreement with R whereby R will transfer the surplus R Reserve directly to M's trustee. The agreement will prohibit the transfer of any portion of the R Reserve to N or of any of its affiliated companies. In accordance with the terms of the Trust Agreement, the transferred R Reserve will be used for the exclusive purpose of providing life. medical, dental, long term disability and other permissible welfare benefits to active and retired employees and their beneficiaries.

In a letter dated March 23, 1999, N was formally notified by R that it was in the process of a demutualization pursuant to which R would cease to be a mutual corporation and would instead become a stock corporation. As part of that demutualization, N, as a former policyholder, will be entitled to approximately 17,750 shares of common stock of R (the 'Demutualization Proceeds"). The Demutualization Proceeds will be payable following the completion of R's initial public offering.

N has elected to receive the value of its shares of common stock in cash. Further, N has directed R to deposit the cash amounts in an interest bearing account pending the receipt of a letter ruling from the Service with respect to the matters raised herein.

N proposes that the Demutualization Proceeds be transferred directly to the M's trustee. In accordance with the Trust Agreement, the transferred amounts will be used for the exclusive purpose of providing life, dental, long term disability and other permissible welfare benefits to active and retired employees and their beneficiaries.

In the FAX submission of November 12, 1999, your attorney also informed us that, in connection with the demutualization of R, N has received a cash dividend check in the amount of

approximately $1,000. N proposes to endorse that check over to the trustee , to be used for the purpose of providing life, medical, long term disability and other welfare benefits to active and retired employees and their beneficiaries.

You have requested the following rulings:

(1) The transfer of the P Reserve, the R Reserve, and the Demutualization Proceeds to M will not result in the imposition upon N of the excise tax under section 4976.

(2) M will not incur any unrelated business taxable income under section 512 of the Code from the receipt of the P Reserve, the R Reserve, and the Demutualization Proceeds.

(3) M may be used as a funding mechanism for both active and retired employees even though the Form 1024 application stated that M would be used exclusively for eligible retirees and their dependents.

Section 4976(a) of the Code imposes a tax on an employer for any disqualified benefit provided under a welfare benefit fund maintained by such employer. The term" disqualified benefit includes, in pertinent part, any portion of a welfare fund reverting to the benefit of the employer. See Code section 4976(b). The term "welfare benefit fund" has the same meaning set forth in section 419(e).

Both the P health insurance policy and the R long term disability policy constitute "welfare benefit funds" within the meaning of Code section 419(e).

Section 4976 was added to the Code by the Deficit Reduction Act of 1984 ("DEFRA"). The House and Senate Committee Reports on DEFRA provide no guidance as to the meaning of "reverting to the benefit of the employer." However, the Joint Committee on Taxation "BlueBook" on DEFRA included the following interpretation of section 4976:

> [I]f an amount is paid by a fund to another fund for the purpose of providing welfare benefits to employees of the employer, then the payment is not to be considered a reversion. Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 794 (1985).

Technical corrections to Code section 4976(b)(1)(C) were made by section 1851(a)(1) of the Tax Reform Act of 1986. However, the House Report explaining these changes described existing law as providing that a portion of a welfare benefit fund is not considered to revert to the benefit of an employer merely because it is applied, in accordance with the plan, to provide welfare benefits to employees or their beneficiaries. H.R. Rep. No. 426, 99th Cong., 1st Sess (1985), 1986-3 C.B. (Vol. 2) at 985. The Senate Report includes a similar statement. S. Rep. No. 313. 99th Cong., 2nd Sess. (1986), 1986~3 C.B. (Vol. 3) at 1009.

Inasmuch as the funds credited to the P Reserve have been transferred directly to M and the funds in the R Reserve will be so transferred by the respective insurance companies, and because all amounts credited to M will be used for the exclusive benefit of eligible persons thereunder, the transfer of such reserve funds should not subject N or any of its affiliates to the 100 percent excise tax under section 4976 of the Code.

N proposes that the Demutualization Proceeds be transferred directly to M and that such proceeds be used exclusively for the purpose of providing welfare benefits to eligible persons under the terms of the M Trust Agreement. N will not have any control over such proceeds. Accordingly, the transfer of the Demutualization Proceeds to M should not subject N or any of its affiliates to the 100 percent tax under section 4976 of the Code for the same reasons that the transfer of the premium stabilization reserves does not result in the imposition of the excise tax.

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 5121 of organizations exempt from tax under section 501 (c).

Section 512(a)(1) of the Code defines the term unrelated business taxable income to mean the gross income derived by any organization from any unrelated trade or business (defined in section 5131 regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 513(a) of the Code provides that the term unrelated trade or business means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

Section 1.513-t (d)(2) of the Income Tax Regulations provides that a trade or business is " relate8 to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). Further, it is 'substantially related", for purposes of section 513 of the Code, only if the causal relationship is a substantial one. For this relationship to exist, the production or the performance of the service from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes. Whether the activities productive of gross income contribute importantly to such purposes depends, in each case, upon the facts and circumstances involved.

Section 512(a)(3)(A) of the Code provides that in the case of an organization described in section 501(c)(9), the term "unrelated business taxable income" means the gross income (excluding any exempt income), less the deductions allowed by Chapter 1 which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications set forth in certain paragraphs of section 512(b).

Section 512(a)(3)(B) of the Code provides that for purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes for which the organization is tax exempt. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to section 512(a)(1)), which is set aside, in the case of a section 501(c)(9) organization, to provide for the payment of life, sick, accident, or other benefits. If, during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that just described, such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

Pursuant to section 61 of the Code, N is required to include the P Reserve, the R Reserve, and the Demutualization Proceeds in gross income. See also Rev. Rul. 73-599, 1973-2 C.B. 40, which holds that a policyholder must include in gross income amounts payable from a retired lives reserve account and premium stabilization reserve where the insurance contract does not expressly prohibit the return of such funds to the policyholder. This rule applies even though the 100 percent excise tax under Code section 4976 will not apply if such amounts are transferred directly to M. Inasmuch as such amounts are includable in N's gross income, the transfer of such funds to M should be considered an 'employer contribution" as described in section 1.512(a)-5T Q&A-3(b) of the Temporary Regulations and "exempt function income" within the meaning of Code section 512(a)(3)(B).

The exemption application of M on Form 1024 stated that the VEBA was to be used as a funding vehicle for certain retirees of N and its affiliates and their eligible dependents. However. under the terms of the Trust Agreement for M, which was included as part of the exemption application, M is not limited to fund benefits for retirees only. Accordingly, N proposes to use M, without further modification, to fund benefits for both active employees and retires and their eligible dependents.

Based on the foregoing, we are able to rule as follows:

1. The transfer by N of the P Reserve, the R Reserve, and the Demutualization Proceeds (including the cash dividend check referred to in your recent FAX submission) will not result in the imposition upon N of the excise tax under section 4976 of the Code.

2. Except to the extent that section 513(a)(3)(e) of the Code may be applicable, M will not incur any unrelated business taxable income under section 5 12 from the receipt of the P Reserve, the R Reserve, and the Demutualization Proceeds.

3. M may be used as a funding vehicle for both active and retired employees of N and its affiliates even though the exemption application on Form 1024 stated that M would be used exclusively to fund benefits for eligible retirees and their dependents.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any changes that may have a bearing upon your tax status should be reported to your EO Area Office, which deals with exempt organizations matters.

We are sending a copy of this ruling to your EO Area Office. Because this letter could resolve any questions about your tax status, you should keep it with your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

This ruling is directed only to the organization that requested. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Thank you for your cooperation.

Sincerely.

Gerald V. Sack

Gerald V. Sack
Manager, Exempt Organizations
Technical Branch 4