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The Current Status of VEBA Planning and Controversies

By Russell E. Greenblatt

§ 16.01 INTRODUCTION

The enactment in 1984 of DEFRA[1] radically changed the rules regarding the deductible funding of Voluntary Employees' Beneficiary Associations ("VEBAs").[2] Effective January 1, 1986, contributions to all "welfare benefit funds,"[3] including VEBAs, must comply with the requirements and limitations of Internal Revenue Code Sections 419 and 419A.[4] Shortly after the effective date of these Sections, the Treasury Department promulgated Temporary Regulations which provide guidance with respect to some elements of these provisions.[5] Unfortunately, in the intervening 11 years there has been no further formal guidance provided by either the Treasury Department or IRS. The purpose of this article is to discuss several of the most important issues arising under Sections 419 and 419A that are not addressed in the Regulations and instead are being developed through the Tax Court.

§ 16.02 DEDUCTIONS FOR CONTRIBUTIONS WITH RESPECT TO RESERVES FOR INCURRED BUT UNPAID MEDICAL CLAIMS

Perhaps the most commonly maintained reserve within a welfare benefit fund is one determined with respect to claims incurred but unpaid at year end. This includes both claims which have been reported to the claims administrator by the end of the year as well as those which have not yet been reported, all of which are generally referred to, collectively, as the "IBNR." Generally the type of fund within which such a reserve is maintained is one which has been determined by the IRS to constitute a VEBA.[6]

Because this type of reserve is likely the most common type of reserve maintained within welfare benefit funds, and a lot of confusion still exists with respect to how this type of reserve is to be determined, it is not surprising that it is commonly called into question upon audit of contributing employers.

[1] Account Limit

In order to be deductible under Section 419, an employer's contribution to a welfare benefit fund has to satisfy numerous requirements, one of which is that it cannot exceed the fund's "qualified cost."[7] For this purpose, a taxpayer is permitted to take into account "any addition to a qualified asset account" to the extent that such addition does not cause the assets in the account at year end to exceed the fund's "account limit."[8] Section 419A(c) contains five paragraphs which address the components of the "account limit" of a qualified asset account. Together, they operate to delineate the maximum amount that may be taken into account.[9]

Partner, Katten Muchin Zavis Rosenman, Chicago, IL. Previously, he served as Attorney-Advisor in the Office of Chief Counsel, IRS (Employee Plans and Exempt Organizations Division) where he was the principal author of Proposed Treasury Regulations regarding VEBAs. Also, he has authored many articles on the subject of VEBAs.

Section 419A(c)(1) provides the general rule that the account limit of a qualified asset account is "the amount reasonably and actuarially necessary to fund claims incurred but unpaid (as of the close of such taxable year)..."

[2] Safe Harbor

Typically, an actuarial certification of the IBNR is not secured. The statute provides that unless there is an actuarial certification of the account limit under Section 419A(c), the account limit shall not exceed the sum of the "safe harbor limits."[10]

The "safe harbor limit" with respect to IBNR is set forth in Section 419A(c)(5)(B)(ii) which provides: "Medical benefits. In the case of medical benefits the safe harbor limit for any taxable year is 35 percent of the qualified direct costs (other than insurance premiums) for the immediately preceding taxable year with respect to medical benefits."

The safe harbor limit is computed based on the *preceding* year's "qualified direct costs."[11] The reason for this is that in order to be deductible, a contribution to a welfare benefit fund must actually be paid to the fund by the end of the taxable year.[12] Practically speaking, it would be impossible for an employer to wait until it can determine what the qualified direct costs were for the *current* year before applying a percentage to this amount and then actually making the contribution into the trust by the end of the year. Therefore, in light of the fact that the amount of the current year's IBNR safe harbor will be determined based upon the preceding year's qualified direct costs, the Internal Revenue Code presumably provides the contributing employer with an opportunity to plan in advance for the current year's reserve. As discussed below however, an employer who relies upon the preceding year's results for purposes of planning the current year's reserve, as was commonly the case prior to recent Tax Court litigation, will be disappointed because the safe harbor provides little safety.

The use of 35% in the safe harbor calculation is somewhat generous in light of the fact that the actual IBNR is commonly in the range of 22-28%. However, 35% of the preceding year's qualified direct costs may not be significantly greater than 28% of the current year's qualified direct costs if the company experiences even modest growth in its work force and typical inflation in the cost of healthcare.

[3] **General Signal Corporation and Subsidiaries v. Commissioner,** ***103 T.C. 216 (1994)***

As was common in 1986-87 (the years in question in this case), the taxpayer determined the amount of its IBNR by reference to the preceding year's qualified direct costs. In the intervening ten years between the date of enactment of Sections 419 and 419A (1984) and the rendering of the Tax Court's opinion in this case, there was no guidance in the form of regulations, revenue rulings, or other formal authoritative guidance with respect to the application of the safe harbor limits and it was quite common for employers to calculate their IBNR in this manner.

However, in *General Signal* the Tax Court explained the purpose of the safe harbor as follows: "While titled 'Safe Harbor Limits', section 419A(c)(5)(B) does not allow a taxpayer to automatically claim 35 percent of its prior year's qualified direct costs as the amount of incurred but unpaid medical claims. Rather, the statute merely allows a taxpayer to claim amounts at or below this threshold without obtaining an actuarial certification." 103 T.C. at 232.

In *General Signal,* the taxpayer and IRS stipulated that if the safe harbor limit was not available, the appropriate amount of IBNR was 26% (for 1986) and 27% (for 1987) as applied to the *current* year's qualified direct costs.

[4] Other Litigation

[a] Square D Company and Subsidiaries v. Commissioner, *109 T.C. No. 9 (1997)*

In this case, similar to *General Signal*, the taxpayer claimed an IBNR reserve computed by reference to the preceding year's qualified direct costs. Similar to its holding in *General Signal*, the Tax Court determined that the safe harbor was not available and that the amount claimed as deductible under the IBNR was not "reasonably and actuarially necessary."

The Tax Court rejected the taxpayer's argument that the phrase in Section 419A(c)(1): "[e]xcept as otherwise provided in this subsection" means that any other provision, i.e., Section 419A(c)(5) concerning the safe harbor, is outside of, and not subject to, the general requirement of "reasonably and actuarially necessary" contained in Section 419A(c)(1).

Unlike *General Signal*, the difference between the safe harbor amount and the actual IBNR which was stipulated to by the parties was dramatic. With regard to the second (1987) of the two years in question, the safe harbor limit (for medical, dental and short-term disability benefits) was $11,925,881, whereas the stipulated amount was $5,551,961.

[b] Hy-Vee Employee Benefit, Plan and Trust v. Commissioner, *Tax Court Docket No. 2834-93 and* Hy-Vee Food Stores, Inc. and Subsidiaries v. Commissioner, *Tax Court Docket No. 1202-95.*

In the case of *Hy-Vee Employee Benefit Plan and Trust v. Commissioner*, the IRS had assessed unrelated business income tax against the VEBA with respect to the VEBA years ended September 30, 1989 and September 30, 1990. The basis for this assessment was that the trust was overfunded for IBNR regarding medical, dental and short-term disability benefits and that therefore the investment income of the VEBA during the years ($253,709 and $407,823) was subject to unrelated business income tax. The IRS also assessed penalties under Section 6651(a) against the VEBA for failure to file an unrelated business income tax return (Form 990T).

In the second case, *Hy-Vee Food Stores, Inc. and Subsidiaries v. Commissioner*, the IRS had gone against the company (rather than the VEBA) with respect to the company year ended September 29, 1991, again on the basis that the IBNR was overfunded. The IRS alleged that out of the total company contributions to the VEBA of $11,656,489 during the year, the IBNR was overstated by $387,216.

Although a reported decision was not rendered in either of these cases, it is understood that a settlement was reached as a result of the Tax Court's opinion in *General Signal* and that the settlement was for an IBNR of approximately 27% of qualified direct costs.

[c] General Signal Appeal

The Appeal in *General Signal* has been docketed with the Second Circuit Court of Appeals (Docket No. 97-4018) and has been briefed. However, the IBNR/safe harbor issue has not been appealed in this case.

[5] What Constitutes A "Reasonably And Actuarially Necessary" IBNR?

Presuming that a taxpayer does not secure an actuarial certification of the account limit, and presuming that the Tax Court is correct that taxpayers cannot calculate their IBNR by merely applying a percentage to the preceding year's qualified direct costs, how should a taxpayer determine the amount which, in accordance with Section 419A(c)(1), is "reasonably and actuarially necessary" for its IBNR liability?

[a] Recommended Assistance from the Claims Administrator

It is strongly recommended that taxpayers secure an estimate of the projected IBNR from the claims administrator prior to year end and then secure a "lag study" or "claims runoff report" from the claims administrator after the end of the year in order to substantiate that estimate. Further, it is strongly suggested that such estimates, studies and reports be secured *as of* the end of the fund year rather than the date the report is prepared. In *General Signal*, the Tax Court was unpersuaded by estimates provided by claims administrators with respect to the IBNR as of a date prior to or subsequent to the end of the year, despite the fact that there was evidence that there were no substantial changes in the number of employees covered, substantive benefits provided, etc. from the date of the estimate to the end of the year.

[b] Technical Advice Memorandum 9446002

In TAM 9446002 the reserve established for IBNR exceeded the safe harbor limit and the employer utilized an actuarial method known as the "completion factor" method. Although the precise methodology was not made available, the Pension Actuarial Branch of the Employee Plans Technical and Actuarial Division of the IRS analyzed the reasonableness of the reserve by comparing the overall levels of claim reserves reported for a representative period of years (four) and the actual claims incurred in those years and paid in subsequent years (i.e., the runoff). Because the computations reflected that the reserves established under this method were not consistently overstated based on the period of years for which data was available, the Pension Actuarial Branch determined that the reserve was reasonable and actuarially necessary.

[6] IRS Training Material

In various internal IRS training materials, the Service has addressed the subject of the safe harbor but has not provided guidance with respect to the type or amount of support necessary to justify any particular amount of IBNR or method for determining it. Rather, the guidance has been limited to merely stating that the safe harbor is not truly "safe" and that the amount of claimed IBNR must be "reasonably and actuarially necessary" to fund the benefits.[13]

§ 16.03 DEDUCTIONS FOR CONTRIBUTIONS WITH RESPECT TO RESERVES FOR POST-RETIREMENT BENEFITS

Another issue which is the subject of great debate regarding the deductibility of contributions to welfare benefit funds concerns the requirements under Section 419A(c)(2) pertaining to reserves for post-retirement medical and life insurance benefits.

[1] Section 419A(c)(2)

Section 419A(c)(2), which provides the basis for the deduction with respect to such reserves, provides as follows:

Additional reserve for postretirement medical and life insurance benefits. The account limit for any taxable year may include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis (using assumptions that are reasonable in the aggregate) as necessary for — (A) post-retirement medical benefits to be provided to covered employees (determined on the basis of current medical costs), or (B) post-retirement life insurance benefits to be provided to covered employees.

There have been no regulations promulgated nor revenue rulings issued with regard to this provision.

[2] Legislative History

Unfortunately the legislative history of Section 419A(c)(2) does not shed much light upon the question of what must be done in order to be able to include within the account limit a reserve for post-retirement medical and life insurance benefits. The report of the House Ways and Means Committee states as follows:

The committee recognizes, however, that it is appropriate to permit a reasonable level of reserves to accumulate in a welfare benefit plan for certain self-funded insurance-type benefits, such as life, accident, sickness, disability, severance pay, supplemental unemployment compensation, and group legal service benefits. Accordingly, although deductions for advance funding already are allowed for disability and post-retirement medical benefits that are part of a qualified pension plan, the committee has provided that an employer also should be permitted to deduct contributions for funding a limited reserve in a welfare benefit plan for these particular benefits.[14]

Similarly, the Conference Report regarding the prefunding of life insurance, death benefits, or medical benefits for retirees states:

Prefunding of life insurance, death benefits, or medical benefits for retirees. — The qualified asset account limits allow amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that the medical benefit or life insurance (including death benefit) payable to a retired employee during retirement is fully funded upon retirement. These amounts may be accumulated no more rapidly than on a level basis over the working life of the employee, with the employer of each employee... . The conferees intend that the Treasury Department prescribe rules requiring that the funding of retiree benefits be based on reasonable and consistently applied actuarial cost methods, which take into account experience gains and losses, changes in assumptions, and other similar items, and be no more rapid than on a level basis over the remaining working lifetimes of the current participants (reduced on the basis of reasonable turnover and mortality assumptions)."[15]

[3] Typical Fact Pattern

The typical fact pattern, true of many employers from 1986 until the Tax Court rendered its opinion in *General Signal*, is one in which the VEBA was "prefunded" (frequently in 1986, although not necessarily the case) in an amount determined in several component parts. These components of the account limit typically included IBNR plus a reserve under Section 419A(c)(2) for postretirement medical (and perhaps life insurance) benefits and which may have also included other components such as incurred but unpaid long-term disability benefits. The assets within the trust were typically considered fungible and were used to provide benefits as claims were presented in the succeeding year(s). The additional contributions made to the trust in succeeding years typically consisted of (1) employee contributions withheld during the year, (2) employer contributions necessary to pay ongoing claims after the prefunded reserve (which may or may not have been replenished) was exhausted, and (3) an amount at year end sufficient to bring the year end assets of the fund up to the level computed to be the account limit in succeeding years. This process may then have been repeated for one or more subsequent years, although frequently the process of prefunding the VEBA was eventually terminated and the VEBA maintained thereafter on a pay-as-you-go basis.

[a] General Signal

General Signal established its VEBA in 1985 and made an initial contribution in the amount of $30,000,000 at the end of 1985. The IRS audited *General Signal*'s 1985 tax return and proposed no adjustment with respect to this contribution. The company made substantial year end contributions in 1986 ($35.3 million) and 1987 ($40.2 million), computed in large part by reference to its postretirement medical and life insurance benefit liabilities determined under Section 419A(c)(2). A substantial year end contribution ($5,000,000) was also made in 1988. In 1989 and thereafter, funding of the VEBA was changed to pay-as-you-go.

[b] Square D

Square D's VEBA was established in 1982. Similar to *General Signal*, at year end 1985 the company made a substantial ($36.6 million) contribution to the VEBA. Also similar to *General Signal*, no contributions were made during the early portion of 1986 and a substantial contribution ($27,000,000) was made to the VEBA at year end 1986, which was determined with regard to postretirement benefits under Section 419A(c)(2). A similar, substantial year end contribution was made in 1987, although the amount ($12.4 million) was less because during 1987 the company established a separate trust with respect to its collectively bargained employees to which it also made a 1987 year end contribution. The assets of the VEBA were depleted during 1988, after which the funding of the VEBA was changed to pay-as-you-go.

[c] Parker-Hannifin

Unlike *General Signal* and Square D, Parker-Hannifin did not establish its VEBA prior to the year in which it made a contribution computed, in part, by reference to its post-retirement benefit liabilities under Section 419A(c)(2). Instead, when it established its VEBA at year end 1987 and contributed a substantial amount ($42,000,000) to the VEBA, the majority of that initial contribution ($26.9 million) was computed with regard to a post-retirement medical benefit reserve. In succeeding years, Parker-Hannifin deposited into the VEBA amounts withheld from its employees for their share of the cost of covered benefits. No additional employer contributions were made to the VEBA until the assets of the trust were depleted, which was two months into the 1989 fiscal year. Unlike *General Signal* and Square D, the reserve was never replenished. As soon as the initial reserve contribution was dissipated, the trust was maintained on a pay-as-you-go basis.

[d] Other Cases

Many other companies have made contributions to welfare benefit funds on the basis, at least in part, of Section 419A(c)(2). As stated previously, it was not uncommon, at least prior to the Tax Court's opinion in *General Signal*, for companies to fund their VEBAs in a manner similar to that described above. On the other hand, there are companies which have funded and continue to fund post-retirement benefit reserves in a manner different than that summarized above, principally by retaining or accumulating assets within the trust on a long-term basis.

[4] Tax Court's Position

In all three cases (*General Signal*; *Parker-Hannifin*;[16] and *Square D*), the Tax Court concluded that the taxpayer was not entitled to deduct that portion of its contribution which the taxpayer computed with reference to Section 419A(c)(2). In all three cases the Tax Court's reasoning was that the taxpayer had failed to establish a reserve as required under Section 419A(c)(2).

[a] General Signal

The Tax Court concluded that in order to be entitled to a deduction for a post-retirement benefit reserve under Section 419A(c)(2), the taxpayer must have intended to *accumulate* funds for that specific purpose. In other words, Section 419A(c)(2) does not merely set forth the method of calculating one component (among several) of the account limit under Section 419A(c). Rather, it mandates certain action which must be taken in order for a taxpayer to be able to take into account that element of the account limit. According to the Tax Court: "On its face, the language 'reserve funded' suggests that Congress intended this provision to allow the *accumulation* of funds by a welfare benefit fund for the purpose of providing postretirement benefits." (Emphasis in original).[17]

[b] Parker-Hannifin

Again, the Tax Court concluded that because the contribution was not intended to be set aside (and was not in fact set aside) to be used to provide benefits only to retirees, the taxpayer had failed to comply with what the Tax Court understood to be required by Section 419A(c)(2). The Tax Court was unpersuaded by the taxpayer's argument that any such requirement could not reasonably be gleaned from the face of the statute and that in the intervening 12 years no regulation or other guidance was provided by the Treasury or the IRS setting forth such a requirement. In response to the taxpayer's argument that the account limit under Section 419A(c) is only a mathematical computation that limits the deduction rather than a requirement that a segregated reserve be included in the welfare benefit fund, the Tax Court responded: "[h]owever, the VEBA Trust did not retain even general assets that were sufficient to fund the reserves claimed by petitioner. Thus, petitioner's position has the same shortcomings as the position that the Court considered and rejected in *General Signal Corp. & Subs. v. Commissioner*."[18]

[c] Square D

The Tax Court applied that same analysis in *Square D* as it had in the prior two cases, and concluded that no reserve for postretirement benefits had been established. However, in this case even more so than in the previous two, the Tax Court appeared to place significant emphasis upon the fact that the taxpayer did not adequately "disclose" the existence of a claimed reserve for postretirement benefits. Square D had not given notice to its shareholders, employees or retirees of the existence of a reserve within the VEBA for the accumulation of assets for the provision of postretirement medical benefits. Nor did it disclose such a reserve in the financial statements of the VEBA. Similarly, the company did not take into account such a reserve for purposes of disclosure on the company's financial statements under Financial Accounting Standards Board Statement No. 81 entitled "Disclosure of Post Retirement Health Care and Life Insurance Benefits." According to the Court, although these various disclosures may not have been required under any law, particularly not under Section 419A(c)(2), they nonetheless are additional facts which suggest that a reserve was not established.

[d] Validity of Temporary Treasury Regulation Section 1.419-1T Q&A-5(b)(1)

In *Square D*, the Court also addressed the question of whether Temporary Regulation Section 1.419-1T Q&A-5(b)(1) is valid. As stated by the Court, the validity of the regulation was called into question with regard to the provision that requires contributions which are made after the close of the fund's year but during the company's taxable year to be included within the fund's year end balance for purposes of determining whether the fund's year end balance exceeds the account limit.

This question was relevant because the VEBA was on a November 30 year end whereas the company was on a December 31 year end, and the year end contribution was made during the month of December. The taxpayer had argued that since the contribution was not made during the fund's year, it should not have been taken into account.

According to the Court, the year end of Square D's VEBA was changed in 1985 in order to accelerate deductions from 1986 into 1985 and avoid the account limit rules, something which arguably Square D was entitled to accomplish under the statute but which the regulation outlawed. In response, the Court held that the regulation is consistent with the intent of Sections 419 and 419A which was to prevent employers from accelerating deductions prior to their being incurred, and that the regulation permissibly filled a gap created between Sections 419 and 419A.

Interestingly, it was the taxpayer that argued that the regulation was a "legislative" regulation, pointing out the regulation's reference to Section 419A(i).[19] The taxpayer's argument was that the regulation was invalid because it contradicted the statute by depriving the taxpayer of a deduction that was otherwise granted by the statute. The IRS, on the other hand, argued that the regulation was instead an "interpretative" regulation, claiming that it was merely interpreting the introductory provisions of Section 419 (such as those that require contributions to be otherwise deductible under the Code). Generally, it is the IRS which argues that a regulation is legislative because the regulation would thereby generally be afforded more deference.[20] The Court stated that based upon its conclusion that the regulation effectuated Congress' intent, it was unnecessary to decide whether the regulation is interpretative or legislative.

[e] PepsiCo, Inc.

One other case is known to also have reached the Tax Court with regard to the question of entitlement to a reserve for post-retirement benefits. In the case of *PepsiCo, Inc. and Affiliates v. Commissioner* Tax Court Docket No. 4654-94, the issue was described in the notice of deficiency as follows: "It is determined, pursuant to Sections 419 and 419A and the regulations thereunder, that you are not entitled to certain deductions claimed for your contributions to your welfare benefit fund since you failed to properly establish and fund for it. Alternatively, you did not properly establish and fund an additional reserve for post-retirement medical and life insurance benefits pursuant to the requirements of Sections 419 and 419A. Accordingly, your taxable income for the taxable year 1986 is increased in the amount of $39,904,516." This issue appears to have been settled between the parties in Tax Court without a reported decision of the Court.

[5] Basis for Appeals

At the time of this writing, *General Signal* is on appeal to the Second Circuit, *Parker-Hannifin* is on appeal to the Sixth Circuit, and *Square D* will be appealable to the Seventh Circuit. Set forth below is a brief summary of the principal legal arguments for appeal with regard to the Tax Court's interpretation of Section 419A(c)(2). They focus upon not only the construction of that statutory provision (and related provisions), but also the practical problems which would appear to follow from the Court's interpretation.

[a] Language and Structure of Sections 419 and 419A

[i] Rules of Statutory Construction

Under general rules of statutory construction, a statute cannot be construed by simply applying a dictionary definition of a term within a statute without considering the statutory context. The terms in a statute whose meaning appear plain outside the statute can take on a different meaning when read in their proper context.[21] As a result, it is inappropriate to focus solely upon the word "funded" or the phrase "reserved funded" without putting those two words into the proper context. In this case, context means the need to relate Section 419A(c)(2) with Section 419A(a) and related provisions.[22]

Furthermore, each part or section of a statutory scheme passed as a whole must be construed in connection with every other part or section so as to produce a harmonious whole.[23] Because the words "reserve funded" and "for" which are found in Section 419A(c)(2) appear to have no relevance other than to modify the lead-in language which is that: "[t]he *account limit* for any taxable year may include..." (emphasis added), it is particularly important to consider Section 419A(a).

[ii] Section 419A(a)

The Tax Court's conclusion that Congress' use of the phrase "reserve funded" in Section 419A(c)(2) evidences an intention to require the *accumulation* of assets for the specific purpose of providing post-retirement benefits appears to be inconsistent with the language and purpose of Section 419A.

Instead, Section 419A(a) is the only provision within Sections 419 and 419A requiring that assets be "set aside." Section 419A(a) uses that specific phrase in the following manner:

the term "qualified asset account" means any account consisting of *assets set aside* to provide for the payment of (1) disability benefits, (2) medical benefits, (3) SUB [supplemental unemployment benefits] or severance pay benefits, or (4) life insurance benefits.

(Emphasis added). Had Congress intended to link contributions with one particular component of a welfare benefit fund's account limit, it would not have so clearly implied fungibility of a welfare benefit fund's assets under Section 419A(a), and would have instead employed the "set aside" language in Section 419A(c)(2).

In contrast to Section 419A(a), when referring to a reserve under Section 419A(c)(2) Congress merely provided that such a reserve level may be "taken into account" in computing the Section 419A(c) account limit. Because Section 419A(c) does not address assets, there does not appear to be an asset "set aside" requirement within that subsection (nor any of its individual component paragraphs, including paragraph 2).

[iii] Specialized Meaning of "Reserve"?

It is particularly important to define or interpret words within their statutory context where provisions have been drafted by Congress in the context of a specialized industry or practice area. In that setting, lay definitions are irrelevant or misleading.[24] As a provision calling for an actuarially-determined computation of a reserve level for post-retirement medical and life insurance benefits, Section 419A(c)(2) requires the input of actuaries to be fully comprehended.

In the *General Signal* trial, all four actuarial experts agreed that "reserve" is an actuarial term of art meaning "liability." In direct contrast to the *Black's Law Dictionary* definition (i.e. "funds set aside to cover future expenses, losses, claims or liabilities"), each of the experts testified that a reserve does not necessarily suggest or involve assets, a trust or a fund.[25]

[iv] The Alternative Meaning of "Reserve Funded"

Subsection 419A(c) contains five paragraphs which address the components of the "account limit" of a qualified asset account. Section 419A(c) does not set forth the account *limits* (plural) applicable to each of the individual types of benefits enumerated in Section 419A(a). Rather, Sections 419A(a) and 419A(c) each refer to a *singular* "account limit." Therefore, Section 419A(c) defines *the* limit of *the* account.

Because Section 419A(c)(2) merely computes one component of the account limit used only in determining the maximum addition to the account limit that a taxpayer may "take into account" in computing its qualified costs, the most logical interpretation of "funded" may be that it, together with the words following it, modifies "reserve" to mean, in essence, recognition of the liabilities over the applicable statutory period. In other words, the phrase "funded over the working lives of the covered employees" may merely designate the period over which the reserve (liability) is to be determined or recognized. In effect, that phrase provides guidance and limitation to the fund's actuary in the calculation of the component of the account limit concerning retiree medical and life insurance liabilities and thereby precludes immediate recognition of the present value of the liability attributable to active employees.

[b] Congress Knew How to Require an "Accumulation" When It Wanted to Do So

In order to understand what Congress intended in Section 419A(c)(2), it is important to contrast that provision with the other statutory provisions in which Congress has authorized deductions for the funding of post-retirement medical benefits. In two instances Congress has required special treatment with respect to trust fund contributions intended to provide post-retirement medical benefits so that amounts contributed could not be used other than for the provision of post-retirement medical benefits. In each instance, Congress has clearly required that the amounts contributed must be dedicated for the enumerated purpose or accounted for in a special manner, and has specified the penalty imposed for violating the mandate.

[i] Section 419A(d)

The most relevant example is Section 419A(d), which was added to the Code contemporaneously with the enactment of Section 419A(c)(2). It provides that as of "the first taxable year for which a *reserve is taken into account*" under Section 419A(c)(2), and if that reserve includes post-retirement benefits to key employees:[26]

(A) a *separate account shall be established* for any medical benefits or life insurance benefits provided with respect to such employee after retirement, and

(B) medical benefits and life insurance benefits provided with respect to such employee after retirement may only be *paid from such separate account*.[27]

(Emphasis added). The penalty for providing a post-retirement medical or life insurance benefit to a retired key employee other than through his or her separate account in this situation is the imposition of a 100% excise tax pursuant to Section 4976, also enacted as part of the 1984 Tax Act.[28]

The Conference Committee Report explains the special accounting rules with respect to key employees as follows:

Further, contributions for any employee who is a key employee are required to be accounted for separately by a welfare benefit fund. The separate account is to include amounts contributed to the plan with respect to any service after the employee becomes a key employee as well as a reasonable allocation (determined under Treasury Regulations) of amounts contributed to the fund on account of the employee before key employee status was attained. Medical and life insurance benefits with respect to such an employee may be paid only from such account.[29]

Under well-settled rules of statutory construction, if Congress had intended to mandate treatment such as the "establishment" of a "separate account" to monitor or regulate the handling of retiree reserves under Section 419A(c)(2), it would not have limited the separate accounting requirements under Section 419A(d) to apply only with respect to the retiree reserves attributable to key employees. Instead, it would have imposed special accounting requirements in all cases where a reserve under Section 419A(c)(2) is taken into account. Moreover, ii would also have specified penalties for violations of the requirement, such as by imposing the Section 4976(b)(1)(A) penalty in any case where the assets of a Section 419A(c)(2) reserve are used to provide nonretiree benefits.[30]

[ii] Section 401(h)

Section 401(h) is another example of clear Congressional intent to mandate dedication of amounts contributed to a trust for postretirement medical benefits. Enacted by Congress in 1962, Section 401(h) authorizes the provision of post-retirement medical benefits from a qualified pension plan. In accordance with Section 401(h), a pension plan may provide such benefits if certain requirements are met, including the requirement that "a separate account is established and maintained for such benefits"[31] and that "it is impossible, at any time prior to the satisfaction of all liabilities under the plan to provide such benefits, for any part of the corpus or income of such separate account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits."[32]

Section 401(h)(6) also contains a requirement similar to Section 419A(d), to "establish" and "maintain" a separate account for each key employee who is to receive post-retirement medical benefits. The penalty for violating Section 401(h) is loss of tax-qualified status for the pension plan under Section 401(a) and its underlying trust under Section 501(a).[33]

[iii] Specific Language Utilized by Congress

The Tax Court, in its interpretation of Section 419A(c)(2), has in effect required that in order to "take into account" a reserve for post-retirement benefits under Section 419A(c)(2), a reserve must be "established" and "maintained." While Congress expressly used the terms "established" and "maintained" in connection with the separate account requirements of Sections 419A(d) and 401(h), no such language is used with respect to a retiree reserve under Section 419A(c)(2).

In sharp contrast, in referring to a retiree reserve under Section 419A(c)(2), Congress merely provided that the reserve may be "taken into account."[34] This further supports the construction of Section 419A(c)(2) as a provision intended to measure liabilities rather than a provision mandating that a separate account be established or maintained or, as it mandated in Section 419A(a), that assets be set aside for any specific use.[35]

[c] Practical Problems with the Tax Court's Reasoning

The Tax Court itself noted, in *General Signal*, that its interpretation of Section 419A(c)(2) leaves open certain unanswered questions. More accurately stated, it is the Tax Court's opinion which for the first time raises these particular questions in the minds of many. Indeed, they are questions which are likely to be quite disturbing even for companies who "accumulate" reserves for postretirement benefits. As stated by the Tax Court:

We recognize that the interpretation of section 419A(c)(2) which we are adopting may leave open related issues such as the rate of required funding and the consequences of diversion of a reserve. However, such uncertainties cannot justify ignoring the plain meaning and legislative history of section 419A(c)(2)... . To the extent our interpretation of section 419A(c)(2) leaves open related issues the resolution of which are not required by this case, we can only hope that Congress or the Treasury will provide additional guidance.[36]

[i] Is There a Minimum or Level Funding Requirement?

The logical implication from the Tax Court's interpretation of Section 419A(c)(2) is that it is the payment of contributions, rather than liability accrual for purposes of calculating the account limit, which must be done on a level basis. However, neither the level accumulation of reserves nor any minimum amount of contributions was required under pre-DEFRA law.[37] There is also nothing in the legislative history to DEFRA which suggests adoption of such a requirement.

The imposition of a minimum funding requirement would also appear to be inconsistent with ERISA. If the establishment of a post-retirement benefit reserve under Section 419A(c)(2) requires the "accumulation" of assets to provide post-retirement benefits, then a certain rate of contributions appears to be required to accumulate or maintain that level. Such a result would likely not have been intended by Congress because ERISA expressly provides that employee welfare benefit plans are not subject to such requirements.[38] Several commentators have identified this issue as being one of the more fundamental problems with the Tax Court's reasoning.[39]

Furthermore, because the statute contains the word "level" and appears to require level funding, and if the Tax Court is correct that in this context "funding" is an accumulation of assets rather than an actuarially-determined measurement of liability with regard to an account limit, what are the ramifications if contributions or asset accumulations are not level from year to year? For example, what if in the year the reserve is first taken into account, only 50% of the maximum reserve contribution is made, then nothing is contributed in the second year and 20% is contributed in the third year. The "accumulation" in such a scenario could hardly be considered "level," yet employers would be rudely awakened if it was later determined that these contributions were at least in part not deductible because they were not "level" or did not meet a required minimum amount in subsequent years. The Court pointed out that although in its brief the IRS denied that minimum annual funding would be required under the Commissioner's interpretation of Section 419A(c)(2), the Commissioner "fails to explain the basis for her position."[40] Nonetheless, irrespective of whether the Tax Court's interpretation of Section 419A(c)(2) necessarily implies a minimum (and level) funding requirement, the Court sidestepped this problem by finding that "because petitioner has failed the minimum requirement of establishing a funded reserve, this case does not require us to decide issues related to the required rate of funding."[41]

However, the minimum (and level) funding implication should be relevant to the question of statutory interpretation because the interpretation to require the creation of a funded reserve necessarily implies a minimum and level funding requirement that is inconsistent with ERISA and contrary to the manner in which the benefits community (and the IRS) has previously presumed this provision to operate.

[ii] What Happens If a Reserve Is "Diverted"?

The Tax Court implies that there may be a penalty for the "diversion" of assets from a reserve which has been accumulated under Section 419A(c)(2). If the statute does indeed comprehend the accumulation of a reserve, under what circumstances would a "diversion" be considered to have occurred and what is the resulting penalty? Again, though the Tax Court sidestepped these questions,[42] they nonetheless need to be considered by an employer taking into account a reserve under Section 419A(c)(2). For example, the Tax Court's decision appears to create a dilemma for VEBA trustees and other ERISA fiduciaries with responsibility for the distribution of assets from VEBA trusts. Although Section 501(c)(9) appears to comprehend assets in a VEBA trust being commingled and used to provide any permissible benefits as claims are presented for payment, and ERISA appears to do likewise with regard to assets within the same plan, the Tax Court's interpretation appears to force fiduciaries with insufficient trust assets to choose between (1) segregating those assets into accounts for different types of benefits, or (2) paying all types of benefits permitted under the trust agreement as the claims are presented and thereby jeopardizing (on a retroactive basis) the deductibility of the contributions.

The Tax Court endorsed the IRS's unexplained suggestion that 419A(c)(2) might be "read to require the creation of a reserve funded with general assets rather than segregated assets."[43] Under this view, according to the Tax Court, the statute "requires only that the overall balance maintained in the VEBA be sufficient to support the postretirement reserve" and not "that a separate account be established with respect to the reserve."[44]

However, such an explanation is rather superficial because it does not address the inconsistency between the principle that assets in a VEBA are fungible and the conclusion that a deduction is only available if funds are accumulated and maintained in a reserve for retiree benefits. If funds have to be accumulated and maintained to provide retiree benefits, those accumulated funds would appear to cease being fungible irrespective of whether the VEBA treats them as "general assets" or "segregated assets." If the Tax Court's interpretation is correct, the IRS and taxpayers have a long list of questions to ask with regard to the administration of VEBAs which take into account post-retirement medical and life insurance reserves.[45]

[6] **Parker-Hannifin** ***Extended the "Reserve" Requirement to LTD Benefits***

In *General Signal*, the Tax Court determined that the specific language of Section 419A(c)(2), read in conjunction with the legislative history of DEFRA, requires that in order to be deductible a reserve must be "accumulated" for the specific purpose of providing post-retirement benefits. However, neither the Tax Court's conclusion nor its underlying analysis suggests that such a requirement exists with respect to the other types of liabilities funded into a VEBA under Section 419. Nonetheless, in *Parker Hannifin* the Tax Court extended this notion to long-term disability ("LTD") benefits.

In *Parker-Hannifin*, the Tax Court referred to *General Signal*'s consideration of the post-retirement benefit reserve under Section 419A(c)(2) as being an "analogous context" and concluded that "[t]he same analysis and conclusion apply here."[46] The Court acknowledged that the term "reserve" does not appear in Section 419A(c)(1) regarding the component of the account limit attributable to incurred but unpaid claims, and which was the basis for Parker-Hannifin's deduction with respect to LTD benefits. The Court determined that nonetheless in order for a taxpayer to be entitled to a deduction under Section 419A(c)(1), "the assets must be *set aside*." (Emphasis in original.) The Court concluded that Parker-Hannifin had "ignored" this "requirement" and that in effect the assets contributed with respect to this liability were treated within the trust to be as fungible as were the contributions made with respect to post-retirement medical benefits. In addition, similar to the post-retirement medical benefit contributions, Parker-Hannifin did not disclose in its financial reporting or to its employees or to the IRS (on Form 1024 when the VEBA applied for qualification) that it had established any reserves for LTD benefits.

The Court concluded that "while disclosure is not required by the applicable Code and regulations, the lack of disclosure, along with petitioner's other actions regarding the VEBA Trust, shows that petitioner did not accumulate assets in the VEBA Trust for the purpose of setting aside assets for the payment of future long-term disability benefits that were incurred but unpaid."[47]

The Tax Court's conclusion in *Parker-Hannifin* regarding the taxpayer's entitlement to a deduction for its LTD liability appears to have been based, at least in part, upon a legislative analysis which may have been flawed. The Court was of the belief that an interpretation that the provisions of Section 419A "are purely computational" would ignore the legislative history of Section 419A. In this regard, it quoted the portion of legislative history which stated that "the principal purpose of this provision of the bill is to prevent employers from taking premature deductions, for expenses which have not yet been incurred, by interposing an intermediary organization which holds assets which are used to provide benefits to the employees of the employer."[48] However, in light of the fact that it was undisputed that Parker-Hannifin had LTD claims which were incurred but unpaid at year end, the facts of the case were dramatically different than the type of perceived abuse considered by Congress at the time DEFRA was enacted. Unlike some taxpayers who prior to DEFRA "prefunded" into their VEBA the premiums for a fully-insured LTD (or medical insurance) plan and could thereby be characterized as "taking premature deductions for expenses which have not yet been incurred," Parker-Hannifin had actually incurred the LTD claims liabilities in question. The Court however never considered the question of the reasonableness of the amount of contributions because it concluded that the contributions were never properly "set aside"[49] for this specific purpose.

Interestingly, in none of the cases did the IRS allege that the company had failed to establish, fund or properly "set aside" the IBNR reserve under Section 419A(c)(1), despite the fact that the VEBA's Section 419A(c)(1) and 419A(c)(2) reserves were treated identically (i.e., in a fungible manner). Their contributions were based in part upon the account limit component attributable to its IBNR, but were neither separately accounted for nor dedicated to such purpose. In the next case, the IRS may argue and the Court may conclude that the taxpayer is not even entitled to a deduction for its IBNR due to the company's failure to properly "set aside" the assets.

The problem with the Tax Court's position, as extended to LTD benefits and perhaps IBNR, can be demonstrated by the following example. Assume that a taxpayer contributes $15 to its VEBA at year end, such amount having been calculated to be equal to its IBNR ($5) and a reserve for post-retirement medical benefits ($10). Further assume that an employee (not a retiree) incurs a medical claim of $1 *after* the VEBA's year end. Under the Tax Court's interpretation of Section 419A(c), it would be inappropriate to pay the claim out of assets contributed based on either the IBNR reserve or the reserve for post-retirement medical benefits. (The $5 contributed based on IBNR claims could only be used to pay medical claims incurred *prior to* year end; the $10 could only be used for retirees.) Therefore, even though the VEBA has $15 of plan assets attributable to the medical plan, the taxpayer would be required to contribute an additional $1 to pay the claim or the claim would remain unpaid.

[7] How Are Retiree Reserves To Be Computed?

There are some employers who make contributions to VEBAs that are determined partially or totally by reference to postretirement medical or life insurance benefits. Although many may have previously funded their trusts in a manner similar to that employed by the companies discussed above, there are many other companies who have "accumulated" assets within their trust in a manner which more closely comports with the Tax Court's interpretation of Section 419A(c)(2). The question which these contributing employers must address is that of how to compute the account limit with respect to such reserves.

As required by Section 419A(c)(5), an "actuarial certification" of the account limit must be secured. Interestingly, the certification requirement does not refer to a certification of the post-retirement benefit reserve. Rather, it refers to a certification of "the account limit." Presumably this means that the certification must be of the singular account limit governed by Section 419A(c) of the entire qualified asset account under Section 419A(a) and would appear to necessarily have to embrace all of the component parts of the account limit. However, requiring such a singular certification is an unnecessary burden and would not appear to serve any purpose. Instead, perhaps it would be sufficient if, for example, one actuary rendered a certification with respect to post-retirement medical and life insurance benefit reserves while a different actuary rendered its certification with respect to LTD liabilities. Maybe even a third component of the account limit, such as IBNR, could be funded without being addressed by any actuarial certification but merely through reasonable support for an amount less than the safe harbor. In *General Signal*, Parker-Hannifin and *Square D* the IRS did not argue that a singular certification of the entire account limit was necessary, and therefore did not challenge the deduction in those cases on that particular ground. This does not necessarily mean that the IRS will not raise this argument in a future case. Instead, it may merely mean that either the IRS failed to realize that this appears to be required by the statute, or that no one in the benefits community, including the IRS, believes that such a requirement should apply.

Section 419A(c)(2) provides the statutory authority with respect to the manner in which the reserve is to be computed. It provides that the account limit "may include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis (using assumptions that are reasonable in the aggregate) as necessary for — (A) post-retirement medical benefits to be provided to covered employees (determined on the basis of current medical costs), or (B) post-retirement life insurance benefits to be provided to covered employees."

The only other relevant authority is the Conference Committee Report, which states:

Prefunding of life insurance, death benefits, or medical benefits for retirees. — The qualified asset account limits allow amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that the medical benefit or life insurance (including death benefit) payable to a retired employee during retirement is fully funded upon retirement. These amounts may be accumulated no more rapidly than on a level basis over the working life of the employee, with the employer of each employee . . . . The conferees intend that the Treasury Department prescribe rules requiring that the funding of retiree benefits be based on reasonable and consistently applied actuarial cost methods, which take into account experience gains and losses, changes in assumptions, and other similar items, and be no more rapid than on a level basis over the remaining working lifetimes of the current participants . . . .[50]

[a] IRS Position Regarding Retirees

During taxpayer audits, the IRS has frequently raised the argument that the taxpayer's actuarial computation should not take into account individuals who have already retired, because they no longer have any working lives over which to fund the reserve. This argument has surfaced in numerous audits, and is stated in the 1992 CPE at page 205 as follows:

> [S]eparate reserves may be established for post-retirement medical and post-retirement life insurance benefits. These are not intended to be reserves established for current retirees. Instead, they are accounts that are funded during the working years of employees to be used for the provision of medical benefits or life insurance benefits after retirement.

However, if challenged on this point the IRS readily concedes that its position is untenable. In fact, the IRS has acknowledged on numerous occasions that the liability with respect to retirees may be taken into account in the calculation.[51]

[b] How Rapidly Can a Reserve for Retirees be Recognized?

Presuming that it is permissible to take into account the liability with respect to individuals who have already retired, must that liability be amortized and if so over what period of time? The IRS has indicated that the issue of how rapidly a reserve for current retirees can be recognized is under review, and that "[i]mmediate and full funding of benefits for current retirees at the time such a reserve is established does not appear to be in accord with the intent of Congress."[52] According to the IRS, the total present value of the liability with respect to retirees must be amortized on a level basis over the remaining working lifetime of the current active employees. Furthermore, the IRS has indicated that when determining what the remaining working lifetime is with respect to employees, this determination cannot be reduced by factoring in a zero remaining working lifetime for each current retiree.[53] Such a position would appear to be questionable under the statute because of the fact that it would appear to be inconsistent to consider retirees to be employees for purposes of recognizing their liability under Section 419A(c)(2) yet at the same time ignoring the fact that these "employees" have a zero remaining working lifetime.

[c] Actuarial Cost Methodology

Absent an express statutory, regulatory or actuarial standard to the contrary, an actuary presumably has discretion to determine the actuarial cost method to be employed in a particular case based upon his or her professional judgment under the circumstances and in accordance with the statute. Similarly, Congress has expressed an intent to defer to the professional judgment of actuaries with respect to employee benefit plan actuarial determinations.[54]

In some contexts, there are limitations placed upon an actuary's discretion. For example, although not determinative of which methods are appropriate for purposes of welfare benefit fund determinations under Section 419A(c)(2), in ERISA Congress specifically enumerated six permissible actuarial cost methods and two impermissible methods with respect to pension plans.[55]

In contrast to pension plan and financial accounting rules, Section 419(c)(2) neither specifically authorizes nor prohibits the use of any particular actuarial cost methods. The only two parameters that can be gleaned from the statute are that the reserve is to be determined on a level basis and that the reserve is to be determined over the working lives of the employees. The Conference Committee Report adds that the reserve may be accumulated "no more rapidly" than on a level basis over the working life of the employee, and so that the benefit payable to a retiree is "fully funded upon retirement."[56]

[d] Projected Unit Credit Method

The projected unit credit method ("PUC") is identified in ERISA as one of the enumerated permissible actuarial cost methods to be used for pension plans. In addition, PUC is so commonly used as the actuarial cost method in pension plan certifications that the Financial Accounting Standards Board requires its use under both Statement of Financial Accounting Standards No. 87 ("Employers' Accounting for Pensions") and No. 106 ("Employers' Accounting for Postretirement Benefits Other Than Pensions").

However, PUC is not a "level" method. This is because the allocation of annual normal costs under PUC increases over time. Therefore, they are smaller in early years but greater in later years rather than being level from year to year. However, the reserve level begins and ends at the same point under both PUC and a level method, and is never in any year greater under PUC than under a level method. As a result, until the year in which the employee retires, at which time the reserve would be equal under both methods, PUC always generates a smaller reserve than does a level method.

Despite the fact that PUC is not a level method, its use appears to be consistent with both Section 419A(c)(2) and the Conference Committee Report. This is because although the statute provides a maximum limit, it does not appear to contain any minimum amount. In this respect, the statutory structure of Sections 419 and 419A differs radically from the structure of Sections 404 and 412 which require minimum contributions to a pension plan. If Section 419A were also to provide a minimum funding requirement and mandate that the contribution be the amount derived from a level method, an actuary would appear to be required to use one of the level methods rather than PUC. Since it does not so provide, it is relatively common for actuaries to utilize PUC when performing certifications under Section 419A(c)(2).

[e] The Treatment of Retirees Under PUC

Under PUC, a reserve component is calculated with respect to each participant and then all of the components are aggregated to determine the amount of reserve for the entire group. As a result, the projected liability with respect to each individual is recognized over that individual's remaining working lifetime. Consequently, in effect the reserve determination recognizes the liability for retirees in its totality at the time the reserve is established.

The legislative history to Section 419A(c)(2) supports the interpretation that for purposes of account limit calculations, the reserve can be computed on an individual-by-individual basis, recognizing the liability for each retiree upon that person's retirement, rather than requiring it to be aggregated with the liability of the active employees.[57]

[f] How Will the Issue of Actuarial Methodology be Resolved?

How and when will guidance be provided with regard to the question of what actuarial cost methodology is permissible under Section 419A(c)(2)? If one of the three Tax Court cases is overturned on appeal, the result will likely be remand to the Tax Court for a determination of the appropriate amount of reserve, including specifically whether PUC is an acceptable actuarial cost method.[58]

Although the Treasury Department has not provided any formal guidance and the IRS has not issued any revenue rulings with regard to this question, there have been several private letter rulings issued with regard to a particular cost method "approved" by the IRS under the facts of those particular cases. As expected, the method "blessed" by the IRS in the rulings requires recognition of the liability for individuals already retired to be spread over the remaining working years of the active employees.[59]

On the other hand, the matter may be resolved legislatively. Various legislative proposals were considered in 1993-94 which would have amended Section 419 to (1) require the maintenance of a separate account for any post-retirement reserve (similar to that already required under Section 419A(d) for key employees or a reserve established under Section 401(h)), (2) provide that funding with respect to retirees can be no more rapidly than over ten years, and (3) impose a 100% excise tax upon withdrawals from the retiree reserve which are used for purposes other than providing post-retirement benefits.[60]

§ 16.04 SMALL EMPLOYER ISSUES: SECTION 419A(f)(6)

[1] Introduction

In DEFRA, Congress presumed that it was closing the loophole that existed at that time with respect to the prefunding of benefits. The perceived abuses which Congress focused most clearly upon in the legislative history to DEFRA were those engaged in by small, closely-held corporations who frequently were establishing thinly-veiled deferred compensation arrangements or other tax-deferred or tax-sheltered arrangements which principally benefitted the officers, shareholders and highly compensated employees of closely-held corporations.[61]

Despite the fact that Congress was under the impression that it was closing the perceived "loophole" available to closely-held corporations, creative entrepreneurs and tax planners have developed programs in the intervening decade to attempt to take advantage of a new opportunity created by DEFRA. The statutory authority for this opportunity is Section 419A(f)(6), which provides that Sections 419 and 419A do not apply to "multiple employer" plans described in Section 419A(f)(6). The exception for these plans, commonly referred to as "TOM Plans" (an acronym for "10-or-More" employer plans) provides as follows:

> (6) Exception for 10-or-more employer plans.
>
> (A) In general. This subpart shall not apply in the case of any welfare benefit fund which is part of a 10 or more employer plan. The preceding sentence shall not apply to any plan which maintains experience-rating arrangements with respect to individual employers.
>
> (B) 10 or more employer plan. For purposes of subparagraph (A), the term "10 or more employer plan" means a plan --
>
> (i) to which more than 1 employer contributes, and
>
> (ii) to which no employer normally contributes more than 10 percent of the total contributions contributed under the plan by all employers.

The reason for this exception is that Congress presumed that in the case of a TOM Plan, "the relationship of a participating employer to the plan often is similar to the relationship of an insured to an insurer."[62] The House-Senate Conferees focused however upon the importance that the Plan not maintain prohibited experience-rating arrangements, by explaining:

> [N]otwithstanding compliance with the 10-percent rule, and consistent with the discussion above on definition of a fund, a plan is not exempt from the deduction limits if the liability of any employer who maintains the plan is determined on the basis of experience rating because the employer's interest with respect to such a plan is more similar to the relationship of an employer to a fund than an insured to an insurer.[63]

Unfortunately, the Treasury Department has provided no guidance in the form of regulations or otherwise with regard to Section 419A(f)(6). In addition, it took the IRS over ten years before it provided any guidance with respect to this question. Although several of the IRS's internal training materials referred to TOM Plans, the materials contained virtually no analysis or guidance with respect to any of the potential issues arising under Section 419A(f)(6).[64] The guidance which was finally provided came in the form of Notice 95-34,[65] which in effect was a summary of the legal arguments which the IRS was asserting in the TOM Plan test cases involving the Prime Financial Benefits Trust (discussed in detail in § 16.04[2]).

[2] Prime Financial Benefits Trust

The IRS's first major effort with respect to Section 419A(f)(6) was a series of cases brought with respect to the operation of the Prime Financial Benefits Trust Multiple Employer Welfare Benefit Plan and Trust (hereinafter referred to as the "Prime Plan"). For purposes of trial, the Tax Court considered four groups of test cases. Each of these four groups consisted of a closely held corporation and one or more of its owner/employees. The IRS had determined that the corporations could not deduct the contributions to the Prime Plan, and that the individual owner/employees should have reported taxable income to the extent that the contributions allegedly benefitted them personally. The opinion of the Tax Court was reported in *Robert D. Booth and Janice Booth, et al. v. Commissioner,* 108 T.C. No. 25 (1997).

[a] Overview

The Prime Plan was and still is a large program. As of December 31, 1994, approximately 800 employers had participated, of which approximately 625 continued to participate. During the period 1988-92, over $92 million had been contributed to the trust.

Under the Prime Plan, each participating employer made a one-time, nonrevertible contribution to a single trust, equal to the amount estimated to be necessary to fund the dismissal wage and death benefits of its qualifying employees. The trust segregated each contribution into a separate account for payment of benefits to only the contributing employer's qualifying employees. If an employer's account did not have enough assets to pay a promised benefit, the trustee could supplement the account's asset with assets from a "suspense account" that was funded primarily by actuarial gains and amounts forfeited from the employers' accounts in certain enumerated situations. Each employer selected options under the Prime Plan, including participation and vesting requirements. Except through the suspense account, an employee had no right to receive benefits from other than his or her employer's account.

In *Booth*, the Tax Court reached three important conclusions: (1) the Prime Plan is a "welfare benefit plan" under Section 419 and does not constitute a plan of deferred compensation; (2) the Prime Plan as currently constituted is not described in Section 419A(f)(6) because it is an aggregation of separate plans each having an experienced-rating arrangement with the related employer; and (3) none of the contributing employers is liable for the accuracy-related penalties.

[b] The Plan is a "Welfare Benefit Plan"

The Court pointed out the importance of determining whether the Prime Plan is a deferred compensation plan, because in such a case Section 404(a)(5) prohibits a participating employer from deducting a contribution until the year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan. If, on the other hand, the Prime Plan is a welfare benefit plan, contributions to it would be deductible under Section 419, which generally limits the employer's deduction for its contributions to that amount which would have been deductible had the employer provided the benefits directly to its employees. The related importance of qualification under Section 419A(f)(6) is that if the Prime Plan constitutes a TOM Plan, the Section 419 limitations are inapplicable and generally an employer can fully deduct its contributions in the year made despite the fact that its employees may not have to report these contributions as income until a later year (if at all).

The Tax Court ruled against the IRS with regard to the question of whether the Prime Plan provides a deferred compensation benefit. The IRS's principal argument in this regard was that the "dismissal wage benefits" (referred to by the Court as "DWB's") had features of deferred compensation. In this regard, the Court held as follows:

> The DWB's under the Trust Agreement also are not payable upon the happening of a certainty, but more closely resemble insurance payable only in the case of an uncertainty [citations omitted]. Although the Prime Plan had features of deferred compensation (e.g., the payment of DWB's upon an employee's termination from employment based on his or her compensation and length of service, the presence of vesting schedules), these features were swallowed up by the Prime Plan's valid welfare benefit purpose so as to make the deferred compensation features incidental and meaningless for purposes of our analysis . . . .
>
> Nor do we agree with respondent's reading of the Seventh Circuit's opinion in *Harry A. Wellons, Jr., M.D., S.C. v. Commissioner,* 31 F.3d 569 (7th Cir. 1994), to provide that the DWB's were deferred compensation because the Prime Plan had some indicia of a deferred compensation plan. All welfare benefit plans bear some element of deferred compensation . . ..[66]

This determination is important because it acknowledges that the Prime Plan or similar programs can permissibly provide severance benefits through a welfare benefit fund and have the deductibility of employer contributions governed by Section 419 rather than 404.

The IRS also argued that the Prime Plan constituted deferred compensation because of the control which an individual participating employer could exercise through termination of its participation in the Prime Plan. The IRS had argued that an employer could voluntarily terminate its participation in the Prime Plan, triggering distributions to its covered employees, and thereby controlling the timing of income to its employees. In this regard, the Court held:

> Nor do we agree with respondent's claim that the DWB's were deferred compensation because an employer could voluntarily terminate its participation in the Prime Plan. We are unable to find any requirement in the applicable statutory and regulatory provisions that would limit welfare benefits to cases in which an employer could not voluntarily terminate its participation in a plan . . .. In the absence of a legislative pronouncement that limits severance benefits to cases where an employer could not voluntarily terminate its participation in a plan, we refuse to adopt such a pronouncement here.[67]

[c] Experience-rating

The Court considered the many factors present in the Prime Plan which were indicative of a singular plan,[68] as well as the many factors which were more indicative of an aggregation of individual employer plans.[69] The Court concluded that the Prime Plan maintained experience-rating with respect to individual employers and that as a result the Plan did not qualify as a TOM Plan. The Court also appeared to be of the belief that the Prime Plan did not meet the standard set forth in legislative history that the employer's relationship to the plan has to be more similar to the relationship of an insured to an insurer than an employer to a fund.[70] The Court summarized its analysis as follows:

> The Prime Plan is nothing more than an aggregation of individual, unique plans formed by separate employers who have: (1) Delegated to a common administrator their (the employers') duties and responsibilities with respect to the respective plans that each employee/owner has tailored personally for his or her business and (2) contributed funds to a trust overseen by a common trustee that was required to disburse each employer's contributions, and earnings thereon, primarily for the benefit of the contributing employer's employees . . .. [E]ach of the employers separately had the unbridled authority to select many of the relevant terms under which its employees would collect benefits from the Prime Plan . . . [N]o Employee Group had a right to any contributions, or earnings thereon, which had been made by the employer of another Employee Group, and . . . a severed employee could end up receiving less than

his or her promised benefit, even though the Prime Plan, as a whole, had enough assets to compensate the employee for this shortage.[71]

[d] No Penalties

The IRS had imposed Section 6662(b)(2) substantial understatement penalties on the corporations, asserting that there was not "substantial authority" for deducting the contribution. The Court concluded however that they were not liable for the penalties in dispute. The basis for this conclusion was that the Court agreed with the taxpayers that the Prime Plan is not a plan of deferred compensation and that furthermore the question of whether the Prime Plan is within the scope of Section 419A(f)(6) was a novel question. Although the Court concluded that the Prime Plan was not a TOM Plan, the Court nonetheless believed that the taxpayers' position was supported by a well-reasoned construction of the relevant statutory provisions and therefore the corporations had "substantial authority" for claiming the deductions.

[e] Miscellaneous

The Tax Court did not need to consider the question of whether the individual owner/employees covered by the Prime Plan were required to include in taxable income any portion of the corporate contributions paid to the trust. The reason is that the IRS had conceded that amounts attributable to contributions to the Prime Plan are not includible in the gross income of the individual taxpayers under Section 83 if the Prime Plan is determined to be a welfare benefit plan. Although the IRS did not necessarily have to take this position, it appears that such a concession is appropriate where the Court determines that the substantive benefit being provided under the plan constitutes a welfare benefit rather than deferred compensation benefit.

Despite the fact that (1) the contributing employers were not liable for substantial understatement penalties, and (2) the covered employees were not required to report in taxable income the contributions made with respect to the dismissal wage benefits or reserves, the employers contributing to the Prime Plan nonetheless find themselves in the unenviable position of not being able to deduct the contributions at the time made. This is because the employers would likely be unable to demonstrate that the contributions constituted qualified costs[72] except to the extent the Prime Plan paid insurance premiums which provided current life insurance protection during that year. A whole host of questions remain to be resolved, such as (1) to what extent a contributing employer will be entitled to a deduction at the time a DWB is paid to one of its employees if arguably a portion of such payment is made out of earnings of the trust or an allocation from the suspense account (derived from forfeitures or actuarial gains attributable to all of the employers' accounts); (2) to what extent an employer will be entitled to a deduction for its contribution if an employee dies while employed and therefore a life insurance benefit is paid from the insurer rather than any payment being made from the reserve accumulated to provide him with a DWB; and (3) whether any deduction arising as a result of the events described in (1) or (2) would be delayed an additional year after the year in which the benefit payment is made if the fund year end is subsequent to the employer's year end.[73]

[3] Other Alleged Section 419A(f)(6) Plans in Litigation

The Prime Plan is far from the only program which has been marketed as qualifying under Section 419A(f)(6). Although it is understood that the IRS has never issued a letter ruling that any particular fund qualifies under Section 419A(f)(6),[74] this does not mean that no such fund exists. Funds claiming to be described in Section 419A(f)(6) are not required to apply for a qualification letter from the IRS, and to the author's knowledge the IRS has never issued a private letter ruling or technical advice memorandum that any particular fund does *not* qualify under Section 419A(f)(6). Furthermore, it is presumed that to the extent a program wants to consider itself to qualify (or continue to qualify) as a TOM Plan, it will modify its method of operations (and governing documents to the extent necessary) in accordance with the Tax Court's opinion in *Booth*.

There are at least two programs represented to be TOM Plans which are the subject of Tax Court cases which have not yet been resolved. They are the Southern California Medical Profession Association Voluntary Employees' Benefits Association Trust and the Commonwealth Benefit Plan and Trust, each of which is discussed below.

[a] Southern California Medical Profession Association Voluntary Employees' Benefits Association Trust

The Southern California Medical Profession Association Voluntary Employees' Benefits Association Trust ("SCMPA VEBA") appears to be the subject of another coordinated assault by the IRS, similar to the Prime Plan. Numerous corporate and personal taxpayers filed petitions in Tax Court in 1996-97 with regard to contributions made to (or participation in) SCMPA VEBA.[75] Interestingly, each of the taxpayers in the cited Tax Court cases was either a *New Jersey* professional corporation or an officer-employee of such a corporation.

According to the notices of deficiency and Tax Court petitions,, the IRS alleges that the SCMPA VEBA provides a plan of deferred compensation rather than a welfare benefit plan, in addition to death benefits. In these cases, the IRS has disallowed the deductions made by the corporations for the years 1991-93, although the amount of disallowance was (at least in one case) reduced by both the amount of fees paid to the VEBA administrator and the amount of taxable income (computed at the PS-58 rate) included in taxable income of the covered employees.

In several of the cases, the IRS also asserted that the company's contribution to the SCMPA VEBA constituted a constructive dividend to the officers-employees. In every case the IRS also asserted substantial understatement penalties under Section 6662(a).

[b] Commonwealth Benefit Plan and Trust

The Commonwealth Benefit Plan and Trust ("Commonwealth Plan") is another program represented to qualify under Section 419A(f)(6) which is the subject of substantial, unresolved litigation. However, only one case is known to have been docketed in Tax Court.[76] In that case, the taxpayer challenged the IRS's disallowance of a $500,000 contribution made to the Commonwealth Plan. The IRS also asserted a Section 6662(a) substantial understatement penalty. Although the Plan Administrator is attempting to have this case resolved in a manner which does not jeopardize what is alleged to be the plan's qualified status under Section 419A(f)(6), companies contributing to the Commonwealth Plan have other serious concerns.

The Commonwealth Plan has been the subject of numerous non-tax cases which are currently consolidated and pending in U.S. District Court in California.[77] The litigation principally involves the confusion regarding what rights individual participating employers have with regard to the Commonwealth Plan, how the plan is administered and whether the employers in fact have the "flexibility" which they claim was promised to them at the time they commenced participation in the plan. As a result of alleged improprieties, conflicts of interest and other questionable practices regarding the handling, investment and use of plan assets, the Court removed the Plan Administrator and appointed a new Plan Administrator who is in the process of accounting for plan assets and restructuring the program in a manner which best accomplishes the objectives of the participating employers and the provisions of the governing documents and applicable law.

Similar to the Prime Plan and the SCMPA VEBA, the Commonwealth Plan provides death benefits and severance benefits. Its total assets are somewhere in the range of $50.6 million (according to the June 30, 1996 Form 5500) to $42 million (at June 30, 1997 according to the Interim Report of the new Plan Administrator), whereas total benefits paid through June 30, 1997 were only $1.7 million. According to the court-appointed Plan Administrator, there are well over ten versions of plan documentation, none free from defects and all with inconsistencies, and there even exists an issue as to who has the power to amend the plan. Furthermore, there are many inconsistencies between the terms of the individual employer adoption agreements, the plan specifications set forth in the actuarial reports, and the provisions that participants and employers believe exist. As a result, the Commonwealth Plan serves as a reminder of the many questions which could arise in the administration of a multiple-employer program over which the contributing employer may have little control.

§ 16.05 UNRELATED BUSINESS INCOME TAX ("UBIT")

DEFRA also imposed a cap upon the amount of investment income that a VEBA could earn tax-free. Section 512(a)(3)(E), effective in 1986, limits the amount of investment income which can be considered "set aside" for permissible VEBA purposes (and thereby exempt from tax). The specific language used in the Code is particularly important in light of the fact that there are no regulations or revenue rulings which explain the limitation. Section 512(a)(3)(E) provides in relevant part:

> *(E) Limitation on Amount of Setaside in the Case of Organizations Described in Paragraph (9), (17), or (20) of Section 501(c).—*
>
> (i) In General.— In the case of any organization described in paragraph (9), (17), or (20) of section 501(c), a set-aside for any purpose specified in clause (ii) of subparagraph (B) may be taken into account under subparagraph (B) only to the extent that such set-aside does not result in an amount of assets set aside for such purpose in excess of the account limit determined under section 419A (without regard to subsection (f)(6) thereof) for the taxable year (not taking into account any reserve described in section 419A(c)(2)(A) for post-retirement medical benefits).

Thirteen years after the enactment of Section 512(a)(3)(E), there still appears to be substantial confusion regarding how the limitation is to be applied. Many commentators[78] appear to believe that Section 512(a)(3)(E) imposes UBIT upon investment income *attributable to* reserves maintained within a welfare benefit fund for post-retirement medical benefits (hereinafter referred to as the "Source Test"). On the other hand, some commentators[79] appear to believe that the provision instead imposes UBIT upon investment income which is *used* to provide post-retirement medical benefits (hereinafter referred to as the "Use Test"). However, the statutory language does not appear to mandate either interpretation. In fact, it may not even provide substantial authority or reasonable basis for either interpretation. This is because the statute does not appear to require or even recognize the allocation or attribution of investment income on the basis of either how the income was derived or used.

Instead, Section 512(a)(3)(E) appears to require a determination of the total asset value of the fund at year end and a comparison of that asset value with the account limit of the fund at year end. For this purpose, the account limit is not to include a post-retirement medical benefit reserve under Section 419A(c)(2)(A). It appears that the statute requires that if the total asset value exceeds the adjusted account limit, all of the investment income of the fund (to the extent of the excess) is subject to UBIT irrespective of where the investment income came from or how it is to be spent. Although there are several commentators (including the IRS) which appear to agree with this interpretation, it appears to be the minority view.[80]

In the case where a fund includes (either in part or in whole) a reserve for post-retirement medical benefits under Section 419A(c)(2)(A), consideration should be given to the ramifications of the various interpretations of Section 512(a)(3)(E). For example, if a reserve for post-retirement medial benefits is included in a trust which also provides a reserve for incurred but unpaid claims (medical, disability or otherwise), then to do so may "taint" the investment income which is otherwise considered to derive from or be allocated to the IBNR reserve. On the other hand, investment income which the administrator may otherwise have presumed to be subject to UBIT because it is either attributable to or to be used to provide post-retirement medical benefits, may escape UBIT if the total asset value of the trust at fund year end does not exceed the IBNR. Such would be the case, for example, if the retiree medical benefits had been fully paid by the end of the year or if the trust was terminated by the end of the year.

This is an area of the tax law which would appear to be fertile for tax planning, but which has been relatively overlooked by the government and tax advisers up until now. Similar to the other issues arising under or as a result of Section 419A(c)(2), it appears to be about time that the Treasury Department promulgate regulations to provide guidance.

NOTES

1. Deficit Reduction and Fiscal Responsibility Act of 1984, P.L. 98-369.
2. A VEBA is a tax-exempt organization, generally an interdependent plan and trust, which meets the requirements of Internal Revenue Code Section 501(c)(9).
3. "Welfare benefit funds" is defined in Internal Revenue Code § 419(e)(1) as meaning, in general "any fund– (A) which is part of a plan of an employer, and (B) through which the employer provides welfare benefits to employees or their beneficiaries."
4. All references to "Section" are to the Internal Revenue Code of 1986 or the Treasury Regulations thereunder.
5. Treasury Decision 8073, 51 Fed. Reg. 4312 (Feb. 4, 1986).
6. See Section 419(e)(3)(A), which defines "fund" as including a VEBA.
7. Section 419(b).
8. Section 419(c); Temporary Treasury Regulation Section 1.419-1T Q&A-5.
9. For a more detailed discussion of these limitations and the deduction rules in general pertaining to contributions to welfare benefit funds, see Church and Johnson "Funded Welfare Benefit Plans After DEFRA: Limitations on Employer Contributions and Tax-Free Accumulations" Chapter 32, 43rd Annual N.Y.U. Tax Institute (1985); Greenblatt "Planning for VEBAs Under The Tax Reform Act of 1984" *Taxes* 605 (Sept. 1984); Greenblatt and Harris "Planning Opportunities for VEBAs" Vol. 1 No. 2 *Benefits Law Journal* 35 (Summer 1988).
10. Section 419A(c)(5)(A). However, there is no guidance provided under the Code, Regulations or otherwise with respect to what constitutes an "actuarial certification" for this purpose.
11. "Qualified direct cost" is defined in Section 419(c)(3) to mean,, in general: "the aggregate amount (including administrative expenses) which would have been allowable as a deduction to the employer with respect to the benefits provided during the taxable year, if -- (i) such benefits were provided directly by the employer, and (ii) the employer used the cash receipts and disbursements method of accounting."
12. Section 419(a)(2).
13. *See, e.g.,* 1989 Exempt Organizations Continuing Professional Education Technical Instruction Program (hereinafter referred to as "CPE"), pages 221-23; 1992 CPE, pages 200-01; and *VEBA Focus Training* (June, 1992), pages 16-18.
14. H.R. Rep. No. 98-432 (Part 2), 98th Cong., 2d Sess. at 1276.
15. H. Conf. Rep. No. 98-861, 98th Cong., 2d Sess. at 1157, *reprinted in* 1984-3 C.B. (Vol. 2) 1, 411.
16. *Parker-Hannifin Corporation v. Commissioner,* 72 T.C.M. 191 (1996).
17. 103 T.C. at 239.
18. 72 T.C.M. at 197
19. Section 419A(i) provides in relevant part: "[t]he Secretary shall prescribe such regulations as may be appropriate to carry cut the purposes of this subpart . . .:"
20. *See, United States v. Vogel Fertilizer Co.,* 455 U.S. 16, 24 (1982); *Fife v. Commissioner,* 82 T.C. 1 (1984); Costle "Judicial Deference to Interpretative Regulations in the Face of Inconclusive Legislative History: The Example of *Nalle v. Commissioner,*" Vol. 47 No. 1 *Tax Lawyer* 259, 262. *But see, Goodson-Todman Enterprises v. Commissioner,* 784 F.2d 66, 74 (2nd Cir. 1986) and *Iglesias v. United States,* 848 F.2d 362, 366 (2nd Cir. 1988).

NOTES (Cont.)

21. 2A N. Singer, Sutherland Statutory Construction, § 46.05 (5th Ed. 1992), quoting *Leach v. Federal Deposit Ins. Corp,* 860 F.2d 1266 (5th Cir. 1988), *cert. denied,* 491 U.S. 905 (1989) ("[e]ven apparently plain words, divorced from the context in which they arise and which their creators intended them to function, may not accurately convey the meaning the creators intended to impart. It is only within context that a word, any word, can communicate an idea."); Commissioner v. National Carbide Corp., 167 F.2d 304, 306 (2d Cir. 1948), *affd*, 336 U.S. 422 (1949) (Learned Hand, J.) (words can be "chameleons, which reflect the color of their environment").

22. If, alternatively, Sections 419A and 419A(c) did not exist and had Congress instead enacted a provision in lieu of the existing Section 419A(c)(2) that read "the qualified asset account may include a reserve funded . . . ." the Tax Court's analysis would appear to be a more reasonable interpretation of the provision.

23. *NuPulse, Inc. v. Schlueter Co.,* 853 F.2d 545, 549 (7th Cir. 1988) (when construing a statute, a court "must not be guided by a single sentence or member of a sentence, but [must] look to the provision of the whole law." (citations omitted)). *See also King v. St. Vincent's Hospital,* 502 U.S. 215, 221 (1991;) (the Court "follow[ed] the cardinal rule that a statute is to be read as a whole.").

24. The Tax Court determined that in interpreting the provisions of Subpart L of the Internal Revenue Code (relating to insurance reserve strengthening provisions), the language should be interpreted in accordance with the meaning generally attributed thereto by experts in the insurance industry and not considering the lay definition. *Western National Mutual Ins. Co. v. Commissioner,* 102 T.C. 338, 360 (1994), *aff'd,* 65 F.3d 90 (8th Cir. 1995).

25. It is well accepted that in the medical and life insurance company context, as in the actuarial context, the term "reserve" refers to "liabilities" and not to assets. For example, in *Mutual Benefit life Ins. Co. v. Commissioner,* 488 F.2d 1101, 1103 (3d Cir. 1973), *cert. denied,* 419 U.S. 882 (1974). the Third Circuit stated:

    Thus, at the very outset it is appropriate to note that *contrary to generally held belief, "reserves" are not trust funds or assets in escrow* but factually are merely statements of liability, involving no representation that specific assets are held to meet any particular claim or class of claims. (Emphasis added).

26. For this purpose, "key employee" is defined in Section 419A(d)(3).

27. Section 419A(d)(1).

28. Section 4976(b)(1)(A); Temporary Treasury Regulation Section 54.4976-1T Q&A-2.

29. Conference Committee Report, at p. 1157.

30. *See, e.g., United States v. Espinoza-Leon,* 873 F.2d 743, 746 (4th Cir. 1989), *cert. denied,* 492 U.S. 924, (1989) ("Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acted intentionally and purposely in excluding the particular language."). *See also* the proposed legislation cited at note 60 and accompanying text.

31. Section 401(h)(2).

32. Section 401(h)(4).

33. Regulation Sections 1.401-1(b)(1)(i) and 1.401-14.

34. *See* Sections 419A(d)(1) and 419A(e)(1).

35. *See also* Section 419A(f)(4) which provides for valuation of the assets in a qualified asset account (under Section 419A(a)) but which is silent with regard to a reserve taken into account under Section 419A(c)(2).

36. 103 T.C. at 246-47.

37. *See, Greensboro Pathology Assoc., P.A. v. United States,* 698 F.2d 1196 (Fed. Cir. 1982); *Moser v. Commissioner,* 56 T.C.M. (CCH) 1604 (1989); *Schneider v. Commissioner,* 63 T.C.M. (CCH) 1787 (1992).

38. 29 U.S.C. § 1081(a)(1).

39. *See,* Howard W. Hans, "Tax Court Restricts VEBA Deduction Techniques," 47 *The Tax Executive* 284, 287 (1995) (under the Tax Court's ruling, "taxpayers who have successfully established retiree benefits reserves under their welfare benefit funds must now be concerned that they are subject to an annual minimum funding requirement that may be similar to the one for qualified defined benefit pension plans"); and William Sollee, "Terminal Funding of Retiree Medical Benefits: Is *General Signal* Correct?," *Tax Notes* 888, 891 (Nov. 14, 1994) ("[H]ow can one rationalize the Tax Court's position in *General Signal* when there are not even any minimum funding rules for welfare benefit funds as there are with pension funds?"). *See also* Thomas Zesk and Louise Tudor, "*General Signal* Disallows VEBA Deductions, but Leaves Many Issues Unresolved," Vo1.2 No. 5 *Journal of Taxation of Employee Benefits* (Jan./Feb. 1995) 213.

40. *General Signal*, 103 T.C. at 246.

41. *Id.*

42. *Id.*

43. *Id.* at 244.

44. *Id.* at 246.

45. As posited by the Association of Private Pension and Welfare Plans. as *amicits curiae* to the Court of Appeals for the Second Circuit in *General Signal Corporation*: "For example, how long must a retiree benefit reserve be maintained so as not to jeopardize deductions taken for previous contributions? What portion of the retiree benefit reserve must be paid out for retiree benefits in order for contributions which take the reserve into account to be deductible? May a surplus in the reserve -- which may result, for example, from a retiree population dwindling faster or remaining healthier than projected -- be diverted to the payment of other benefits (which is the only other possible use of the surplus, since contributions to a VEBA are irrevocable)? If so, at what point? May the employer divert the retiree benefit reserve to the payment of other benefits if changed business or benefit circumstances make this necessary or desirable? What level of assets must remain in a VEBA at year-end in order to satisfy the requirement that a retiree benefit reserve is being accumulated? What public disclosures must be made with regard to a retiree benefit reserve -- such as disclosures in plan documents, to governmental agencies, or in accounting disclosures -- to protect the deduction? What alternative documentation may an employer provide that it has created a post-retirement benefit reserve? And any suggestion that a "sufficient general assets" test provides benefit plan sponsors with adequate guidance (see slip op., at 43) is frankly absurd. because it would still be unclear how those assets could be used." Brief at 21-22.

46. 72 T.C.M. at 199. As a result of this "extension" of the Tax Court's interpretation of Section 419A(c)(2) to 419A(c)(1), query whether the Opinion in *Parker-Hannifin* should have been a "regular" rather than "memorandum" decision.

47. *Id.* at 200.

48. H. Conf. Rept. 98-861, at 1155, 1984-3 C.B. (Vol.2) at 409.

49. See the discussion at § 16.03[5][a][ii] regarding the fact that the only requirement to "set aside" is found in Section 419A(a) which defines "qualified asset account" as being a single account consisting of assets set aside to provide numerous types of benefits. The "setting aside" appears to address the need to have them in an account of a welfare benefit fund separate from the assets of the employer.

50. Conference Committee Report, at p. 1157.

NOTES (Cont.)

51. *See* PLRs 9522054; 9710033; and VEBA Focus Training (June, 1992) p. 45 ("The National Office has informally indicated that it is not improper to include the present value of post-retirement benefits payable to current retirees in the total present value calculations used in determining the proper funding requirement for post-retirement reserves.").

52. VEBA Focus Training (June, 1992) at 22.

53. *Id.* at 45-6.

54. *Vinson & Elkins v. Commissioner*, 99 T.C. 9, 15-17, 56 (1992), *aff'd*, 7 F.3d 1235, 93-2 U.S.T.C. ¶ 50,632 (5th Cir. 1993); *Rhoades, McKee & Boer v. United States*, 822 F. Supp. 445, 450, 93-2 U.S.T.C., ¶ 50,425 at 89,298 (W.D. Mich. 1993).

55. 29 U.S.C. § 1002(31).

56. The DEFRA Blue Book commentary generally reflects the Conference Committee Report but adds: "Under the Act, funding will be considered level if it is determined under an acceptable funding method so that future post-retirement benefit and administrative costs will be systematically allocated ratably to future pre-retirement years." General Explanation of H..R. 4170, Staff of Joint Committee on Taxation, 98th Cong.. 2d Sess. (Dec. 31, 1984) 784.

57. Congress explained the phrase "over the working lives of covered employees" in a manner which would be inconsistent with a requirement that the liability for retirees could not be recognized immediately but must instead be spread over the lives of the employees:

    The qualified asset account limits allow amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that the medical benefit or life insurance (including death benefit) payable to *a* retired employee during retirement is *fully funded upon retirement*. These amounts may be accumulated no more rapidly than on a level basis over the working life of *the* employee, with the employer of each employee.

    Conference Committee Report, at p. 1157 (emphasis added).

58. Upon remand, the Tax Court may also be called upon to determine what constitutes an appropriate "certification" under Section 419A(c)(5). This question may be squarely addressed in the case of *Parker-Hannifin*, where it appears that the actuarial work may have been "abbreviated" and performed in part by the taxpayer.

59. PLRs 9522054 and 9710033. The guidance provided by PLR 9710033 may prove to be of little relevance in most circumstances in light of the fact that the plan only covers individuals who had been retired for over ten years. Furthermore, it is difficult to envision the "approved" methodology generating a reserve sufficient in size to pay even the ongoing benefit costs of the retiree plan let alone "accumulating" a reserve as envisioned by the Tax Court. In other words, it appears that pay-as-you go funding would generate a larger deductible contribution on the basis of qualified direct costs than would the approved "reserve."

60. Sections 7401-7402 of H.R. 3600, S. 1757 and S. 1755 (proposed "Health Security Act") and Section 781 of S. 2351.

61. H. Rept. 98-432 (Part 2), at 1275-76 (1984).

62. H. Conf. Rept. 98-861, at 1159, 1984-3 C.B. (Vol. 2) at 413.

63. *Id.*

64. 1992 CPE at p. 219; VEBA Focus Training (June, 1992) at p. 78.

65. 1995-1 C.B. 309.

66. *Booth* at 3863 (Highlights and Documents [Tax Analysts]). The Tax Court was of the opinion that the plan more closely resembles a welfare benefit plan in accordance with the authority of *Wheeler v. United States*, 768 F.2d 1333, 1336 (Fed. Cir. 1985), and *Greensboro Pathology Associates, P.A. v. United States*, 698 F.2d 1196, 1200 (Fed. Cir. 1982), than a deferred compensation plan under *Grant-Jacoby, Inc. v. Commissioner*, 73 T.C. 700 (1980), New York *Seven-Up Bottling Co. v. Commissioner*, 50 T.C. 391, 398 (1968), and *New York Post Corp. v. Commissioner*, 40 T.C. 882, 888 (1963).

67. *Booth* at 3863.

68. Among the factors argued by the petitioners as being determinative were: (1) common administrator and single trustee, neither of whom was controlled by any employer, (2) employers irrevocably delegated administrative functions to Prime, (3) Prime exercised unreviewable authority over the calculation of contributions, benefit distributions and forfeitures to the suspense account, (4) Prime determined disbursements from the suspense account in accordance with an objective formula, and (5) the suspense account served a limited common interest of all employers.

69. Among the factors argued by the IRS as being determinative were: (1) Prime maintained separate accounts for each employee group, (2) an employee's right to benefits was limited to the assets of his employee group, (3) annual valuations were performed for each employee group but never for the trust as a whole, (4) a separate summary plan description was prepared for each employee group, (5) documentation and adoption agreement were similar to documents used by separate employers establishing separate plans, (6) each employer selected its employees' level benefits, vesting schedule and minimum participation requirements, (7) each employer's contribution benefited primarily its employees, (8) employees' benefits would be reduced in the event of a shortfall, without subsidy from the trust as a whole, and (9) Prime did not pool all claim risks within the trust.

70. *Booth* at 3865. *See also* the text accompanying Notes 62 and 63.

71. *Booth* at 3866.

72. *See* Section 419(c) and Temporary Regulation Section 1.419-1T Q&A-5.

73 *See* Temporary Regulation Section 1.419-1T Q&A-4.

74 Notice 95-34 1995-1 C.B. 309, 310.

75 *Marvin A. Cetel, M.D., P.A. v. Commissioner* Tax Court Docket No. 26683-96; *Marvin and Karen Cetel v. Commissioner* Tax Court Docket No. 26684-96; *Pearlman Radiological Associates P.A. v. Commissioner* Tax Court Docket No. 26800-96; *Morton and Barbara Schneider v. Commissioner* Tax Court Docket No. 1027-97; *Neonatology Associates, P.A. v. Commissioner* Tax Court Docket No. 1201-97; *Boris Pearlman, et ux. v. Commissioner* Tax Court Docket No. 1728-97; *David W. Jenkins, et v. Commissioner* Tax Court Docket No. 17265-97. *See also Denville Radiology P.A. v. Commissioner* Tax Court Docket No. 17275-97; and *David W. Jenkins M.D., P.C. v. Commissioner* Tax Court Docket No. 17280-97.

76 *O'Brien Oil Pollution Services, Inc. v. Commissioner*, Tax Court Docket No. 4104-96.

77 Case No. CV 95-8360 DT (RMCx) (Consolidated with Case Nos. CV 96-1805 DT (RMCx) and CV 96-1925 DT (RMCx)) USDC Central District of California.

78 *See, e.g.*, Quintiere, Oliphant, Grace, Kerby and Strella, "Significant Employee Benefit Changes in the Tax Reform Act of 1984" Vol. 10 No. 5 *Journal of Pension Planning & Compliance* 325, 333 (Oct. 1984); Lieber, "Certain Welfare Benefit Plans: Unrelated Business Income" *ALI-ABA Course of Study: Pension, Profit-Sharing and Other Deferred Compensation Plans* 185, ¶ 1.2.1 (Oct. 1984); Trucker, "Taxation of Funded Welfare Benefit Plans Under the Tax Reform Act of 1984" *Pension & Profit Sharing Report* 1133, 1137 (Nov. 2, 1984); Gilman and Walshe, "The Effect of the Tax Reform Act of 1984 on VEBAs" *Employee Benefits Journal* 23, 25 (Dec. 1984); Amoroso, "Tax-Advantaged Financing Options for Post-Retirement Healthcare

Benefits" *Journal of Taxation* 242, 245 (Oct. 1986); Gartrell and Mailander "New Treasury Regulations Affecting Employee Benefit Plans" Vol. II No. 3 *Benefits Quarterly* 34, 41 (1986); Gideon (Statement of Assistant Treasury Secretary of Tax Policy Before House Ways and Means Select Revenue Measures Subcommittee Hearing on Feb. 21, 1990) 36 Daily Tax Reporter L-2, L-8 (Feb. 22, 1990); Hutchison "Prefunding Retiree Health Benefits: An Overview of Current Alternatives and Their Pros and Cons" Vol. 18 No. 51 *Pension & Benefits Reporter* 2291, § A(4) (Dec. 23, 1991); Morgan *Funding Post-Retirement Welfare Benefit Plans* 136 (1991).

79 *See, e.g.,* Birge "The Pending Crisis in Employer-Provided Health Benefits for Retirees: Are Tax Breaks for Employers the Answer?" 19 N.Y.U. Rev. L. & Soc. Change 797 (at text accompanying footnotes 84-5) (1992-93); Joint Committee on Taxation Staff Description and Analysis (JCS-20-93) of Title VII of Health Security Act (Dec. 29, 1993) at 74 (*reprinted in* Rep't. No. 243 Special Supplement, *BNA Pension Reporter* S-40 (Dec. 21, 1993)). *See also* Greenman "Funding Retiree Medical Plans" *PLI Tar Law and Estate Planning Course Handbook Series* (1991) which appears to embrace both the Use Test (at II(F)(2)) and the Source Test (at II(E)(2)).

80 *See* Greenblatt and Harris, "Applying the New UBIT Rules to VEBAs," Vol. 4 No. 1 *Benefits Law Journal* 61 (Spring 1991); Church and Johnson "Funded Welfare Benefit Plans After DEFRA: Limitations on Employer Contributions and Tax-Free Accumulations" *43rd Annual N.Y.U. Tax Institute* § 32.11 (1985); Sollee "Analyzing the new Temporary Regulations for welfare benefit plans: Part II" *Journal of Taxation* 322, 325 (June 1986); Examination Guidelines Handbook, Chapter 900 *Internal Revenue Manual – Administration* § 925(2) (July 13, 1987); 1989 CPE at p. 218; 1992 CPE at p. 212; VEBA Focus Training (June 1992) at 73-6.

KMZ Rosenman
KATTEN MUCHIN ZAVIS ROSENMAN

www.kmzr.com

525 West Monroe Street
Suite 1600
Chicago, IL 60661-3693
Tel 312.902.5200
Fax 312.902.1061

575 Madison Avenue
New York, NY 10022-2585
Tel 212.940.8800
Fax 212.940.8776

2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
Tel 310.788.4400
Fax 310.788.4471

1025 Thomas Jefferson St., N.W.
East Lobby, Suite 700
Washington, DC 20007-5201
Tel 202.625.3500
Fax 202.298.7570

401 South Tryon Street
Suite 2600
Charlotte, NC 28202-1935
Tel 704.444.2000
Fax 704.444.2050

260 Sheridan Avenue
Suite 450
Palo Alto, CA 94306-2047
Tel 650.330.3652
Fax 650.321.4746

One Gateway Center
Suite 2600
Newark, NJ 07102-5397
Tel 973.645.0572
Fax 973.645.0573