DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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ACTION ON DECISION

SUBJECT: Sherwin-Williams Co. Employee Health Plan Trust v. Commissioner, 330 F.3rd 449 (6th Cir. 2003), rev'g 115 T.C. 440 (2000).

Issue:

Whether the taxpayer's investment income is excludible from its unrelated business taxable income under I.R.C. §512(a)(3) as exempt function income.

Discussion:

The Sherwin-Williams Employee Health Plan Trust (the "Trust") is a voluntary employees' beneficiary association under I.R.C. §501(c)(9). As such, it funds health care benefits for the employees of Sherwin-Williams Company.

In 1991 and 1992 the Trust derived income from employer and participant contributions and investments. The Trust determined that this income was set aside and used to provide for the payment of health care benefits and reasonable costs of administration directly connected with providing for the payment of such benefits.

The Trust filed Forms 990 and 990-T for the years at issue in which it reported investment income of $1,851,399 and $1,155,793 for 1991 and 1992, respectively. In its Forms 990-T for 1991 and 1992 the Trust also claimed various expenses as deductions directly connected with this investment income. These deductions included $1,580,455 and $1,853,529, respectively, claimed as reasonable costs of administration directly connected with providing for the payment of health care benefits.

The Commissioner determined that the expenses claimed as reasonable costs of administration were not deductible by the Trust as deductions against its unrelated business income since they were not directly related to the investment income. The Commissioner therefore concluded that the related amount of investment income was unrelated business taxable income (UBTI) under §512 and asserted deficiencies for the two years.

In the Tax Court the Trust did not argue that the expenses were deductible as expenses directly related to the investment income but argued instead that the income used to pay these expenses was exempt function income under §512(a)(3)(B) and therefore excluded from unrelated business taxable income. The Tax Court held that the income set aside to pay benefits and administrative costs was exempt function income but that it exceeded the limits of §512(a)(3)(E), and thus ruled in favor of the Commissioner. Petitioner paid the deficiencies with interest and appealed the case to the Sixth Circuit Court of Appeals. On May 23, 2003, the Sixth Circuit reversed the Tax Court decision and ruled that investment income set aside and then spent before the end of the taxable year on reasonable costs of administration is not subject to §512(a)(3)(E)'s limit on set-aside income.

Section 512(a)(3) provides that the UBTI of a VEBA (and certain other tax-exempt organizations) generally includes all gross income except Aexempt function income.

The term exempt function income is defined by section 512(a)(3)(B) to include income set aside –

(i) for a purpose specified in section 170(c)(4), or

(ii) in the case of an organization described in paragraph (9)...of section 501(c), to provide for the payment of life, sick, accident, or other benefits,

including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii).

The income set aside for these purposes (and thus excluded from UBTI) is limited by section 512(a)(3)(E), which provides that 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 ...for the taxable year (not taking into account any reserve described in section 419A(c)(2)(A) for post-retirement medical benefits).

This limit is explained in Temp. Reg. §1.512(a)-5T, Q&A 3(b), which states that the UBTI of a VEBA for a taxable year generally will equal the lesser of two amounts: (1) the income of the VEBA for the taxable year (other than member contributions), or (2) the excess of the total amount set aside as of the close of the taxable year over the qualified

asset account limit for the taxable year (not taking into account any reserve for post-retirement medical benefits).

In its opinion, the Tax Court concluded that investment income set aside by the Trust to provide for the payment of health care benefits, including reasonable costs of administration directly connected with the providing of such benefits, is subject to the limit imposed by §512(a)(3)(E). The court stated that Congress intended to limit "set-asides" and that income used to pay the costs of administration is a set-aside under the clear language of the statute.

The Sixth Circuit held that income, including investment income, used to pay the costs of administration is eligible for treatment as a set-aside under the statute. The court correctly construed the language of §512(a)(3)(E) as a limit only on the amount set aside and still in the trust as of the end of the taxable year, noting that Temp. Reg. §1.512(a)-5T, Q&A-3(a) imposes the limit on set-asides "as of the close of a taxable year." However, the court failed to apply this limit on set-asides correctly. Under Temp. Reg. §1.512(a)-5T, Q&A-3(b), as discussed above, the UBTI of the trust is the lesser of the investment income of the trust or the excess of the amount set aside in the trust at the end of the year over the account limit under section 419A (without taking into account the amount of any reserve for post-retirement medical benefits under section 419A(c)(2)). Using the figures given by the Tax Court for 1991 (115 T.C. No. 33, p. 5), the UBTI of the trust becomes the lesser of the investment income of the trust ($1,851,399) or the amount set aside in the trust at the end of the year ($41,975,366) minus the account limit under section 419A ($64,615,936) without taking into account the amount of any reserve for post-retirement medical benefits ($53,313,236). The second prong of the algorithm becomes $30,672,666, calculated as follows:

$41,975,366 - ($64,615,936 - $53,313,236) = $41,975,366 - $11,302,700
$41,975,366 - $11,302,700 = $30,672,666

Since the net amount set aside in the trust at the end of the taxable year in excess of the adjusted section 419A limit ($30,672,666) greatly exceeds the investment income of the trust ($1,851,399), the algorithm contained in Temp. Reg. §1.512(a)-5T, Q&A 3(b) makes the UBTI of the trust equal to its investment income. The figures for 1992 are similar. In each case, the amount set aside at the end of the year greatly exceeded the taxable investment income of the trust because the trust included a large reserve for post-retirement medical benefits.

Although the Tax Court opinion (115 T.C. No. 33, p. 5, n. 4) stated that the costs of administration of the trust for 1992 were paid first from the investment income for that year,

there is no provision in the regulation for allocating income from a particular source to the payment of a particular expense. Rather, the total amount set aside in the trust at the end of the taxable year in excess of the adjusted section 419A limit is compared with the investment income of the trust for the taxable year to determine if any or all of the investment income of the trust is UBTI.

We disagree with the Sixth Circuit's conclusion that investment income can be set aside and used separately before the end of a taxable year to pay the reasonable costs of administering health care benefits and thereby avoid the limits imposed by §512(a)(3)(E) on exempt function income. As discussed above, the statutory provisions are not dependent upon a determination as to whether particular sources of income were used to pay the costs of administration in any particular year. Rather, §512(a)(3)(E) provides that amounts set aside to pay reasonable costs of administration are treated as exempt function income only to the extent the amount set aside is equal to or less than "the account limit determined under section 419A… for the taxable year (not taking into account any reserve described in section 419A(c)(2)(A) for post-retirement medical benefits)."

Recommendation:

Nonacquiescence

Although we disagree with the decision of the court, we recognize the precedential effect of the decision to cases appealable to the Sixth Circuit, and therefore will follow it with respect to cases within that circuit, if the opinion cannot be meaningfully distinguished.

Reviewers:

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