TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Date: October 19, 2004

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Dear :

This is in response to a ruling request from X's (the "Corporation") authorized representative, who has requested certain rulings relating to the federal tax consequences of a proposed transaction.

The information submitted shows that Corporation is a non-profit corporation exempt from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(6) of the Code. On November 1, , X established a Voluntary Employees' Beneficiary Association (VEBA) for the benefit of member employers in order to provide benefits set forth under section 501(c)(9) of the Code to employees of employer members, and their spouses, and/or dependents.

In , Corporation entered into an agreement with Blue Cross and Blue Shield of Y ("BC/BS") whereby BC/BS insured benefits provided under the VEBA. The benefits offered included health insurance, life insurance, and a prescription drug benefit. Member employees

paid premiums to the VEBA trust for employer-provided insurance benefits and insurance coverages elected by employees under section 125 Cafeteria Plans operated by some of the member employers. In that year, when the VEBA switched to an insured arrangement, member employers made contributions to the VEBA trust. Currently, there are only member employers.

In December , BC/BS informed Corporation that it was dissolving its association sponsorship of BC/BS for Corporation member firms due to declining enrollment and administrative expenses. At the time, the VEBA's member employers had roughly BC/BS contracts in force covering members' employees, their spouses, and dependents. Currently, the VEBA trust has approximately $ in assets, which consist exclusively of rebates from BC/BS for favorable claims experience of the VEBA members from to present.

Since March , Corporation has spent approximately $ of rebates and contributions in excess of reserves to pay for premium holidays and to subsidize the expansion of benefit options.

Corporation proposes terminating the VEBA trust and distributing assets (minus a reasonable reserve for administrative expenses) to member employers who are still in existence and locatable. Distributions would be made on a pro rata basis, based upon the number of insurance contracts attributable to the employer and the number of plan years the employer was a VEBA member on and after the date in which the VEBA benefits were insured by BC/BS. Thus, an employer's rebate amount for each year that it was a member will be a fraction of the total VEBA trust assets, the numerator of which is the employer's number of contracts in effect for the years as a member and the denominator of which is the total number of contracts with BC/BS for all employers since .

In order to receive a pro rata share of the trust assets, the member employer must, by written agreement, agree to the following: (1) the employer may distribute to employees any amounts attributable to such employee's premium payments, to the extent the employer still has records reasonably accounting for such employee contributions and such a distribution is practicable; (2) the employer must agree that any remaining share of trust assets will be used to provide current employees either directly, or through the purchase of insurance, with life, disability, sickness or accident benefits described in section 1.501(c)(9)-3 of the regulations in a manner that does not provide disproportionate benefits as between officers, owners and highly compensated employees and non-owner, non-highly compensated employees; and (3) in order to insure that requirement (2) above is met, any health insurance benefits must be provided on an equal basis as between highly compensated employees, officer, and owners and rank-and-file employees, and any life insurance or wage replacement benefits, if not provided equally to all employees, must be based uniformly upon employee participant compensation.

If a member does not respond to the notice, is not locatable, or does not agree to the terms and conditions for receiving the distribution, then that employer's amount will revert back to the corpus of the trust assets and be allocated among remaining employers. Upon the

distribution of all remaining assets and the payment of all administrative expenses, the VEBA trust will terminate.

The following rulings have been requested:

1. The proposed transactions will not adversely affect the tax-exempt status of the VEBA trust under section 501(c)(9) of the Code.

2. The proposed transaction will not result in the imposition of tax on the employer members under section 4976 of the Code.

3. The distributions from member employers to employees will constitute "rebates" as contemplated in section 1.501(c)(9)-4(c) of the regulations.

4. The distributions to employees by member employers will not result in the VEBA trust incurring unrelated business taxable income under section 511 of the Code.

Ruling Request 1:

Section 501(c)(9) of the Code provides for the exemption from federal income tax of voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

Section 1.501(c)(9)-1 of the Income Tax Regulations provides that for an organization to be described in section 501(c)(9), it must be an employees' association; membership in the association must be voluntary; the organization must provide for the payment of life, sick, accident, or other benefits to its members; and there can be no inurement (other than by payment of permitted benefits) to the benefit of any private shareholder or individual.

Section 1.501(c)(9)-4(a) of the regulations provides, in part, that whether prohibited inurement has occurred is a question to be determined with regard to all of the facts and circumstances, taking into account the guidelines set forth in this section.

Section 1.501(c)(9)-4(b) of the regulations provides that whether benefits are paid pursuant to standards that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees is determined under section 1.501(c)(9)-2(a)(2) and (3).

Section 1.501(c)(9)-4(d) of the regulations provides that it will not constitute prohibited inurement if, on termination of a plan funded through a VEBA, any assets remaining after satisfying all liabilities to existing plan beneficiaries are applied to provide life, sick, accident or other appropriate welfare benefits pursuant to criteria that do not provide for disproportionate benefits to officers, shareholders or highly compensated employees.

The regulations provide that it does not constitute prohibited inurement, if on termination of a plan, any assets remaining, after satisfaction of all liabilities to existing beneficiaries, are applied to provide benefits described in section 501(c)(9) of the Code pursuant to criteria that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees of the employer. Here, in order for member employers to receive the trust assets upon termination of the VEBA, they are contractually obligated to dedicate such distribution proceeds to the provision of benefits allowable under section 501(c)(9).

If a member employer does not agree to the terms and a condition for receiving the distribution, respond to the notice, or is not locatable, then that employer's amount will revert back to the corpus of the trust assets and be allocated among remaining employers. Upon the distribution of all remaining assets and the payment of all administrative expenses, the VEBA trust will terminate.

Therefore, the termination and transfer of assets will not adversely affect the VEBA's tax-exempt status under section 501(c)(9).

Ruling Request 2:

Section 4976(a) of the Code imposes a 100% excise tax if an employer maintains a welfare benefit fund, and there is a disqualified benefit provided during any taxable year.

Section 4976(b)(1)(C) of the Code provides that for purposes of subsection (a), the term "disqualified benefit" means any portion of a welfare benefit fund reverting to the benefit of the employer.

Section 4976(b)(3) of the Code provides that paragraph (1)(C) shall not apply to any amount attributable to a contribution to the fund which is not allowable as a deduction under section 419 for the taxable year or any prior year taxable year.

In this case, member employers are contractually obligated to dedicate such distributive assets to the provision of benefits allowable under section 501(c)(9), precluding member employers' from benefiting from the assets. If a member employer does not agree to the terms and conditions for receiving the distribution, then that employer's amount will revert back to the corpus of the trust assets and be allocated among remaining employers.

Therefore, the proposed transactions will not result in the provision of any "disqualified benefit" within the meaning of section 4976 of the Code and, consequently, will not cause employer members to be liable for the tax imposed by section 4976.

Ruling Request 3:

Section 1.501(c)(9)-4(c) of the regulations provides that the rebate of excess insurance premiums, based on the mortality or morbidity experience of the insurer to which the premiums

were paid, to the person or persons whose contributions were applied to such premiums, does not constitute prohibited inurement.

The overpayment of the employer's premiums to the VEBA trust can be classified as "rebates" under applicable regulations and therefore do not constitute prohibited inurement. The rebate proceeds were primarily for claims experience associated with health insurance.

Ruling Request 4:

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(9).

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

Section 512(a)(3)(B)(ii) provides that "exempt function income" includes all income other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to section 512(a)(1) which, in the case of an organization described in paragraph (9), (17) or (20) of section 501(c), is used to provide for the payment of life, sick, accident, or other benefits.

Assets distributed to member employers and dedicated to the provision of section 501(c)(9) benefits for employees would be deemed to come from exempt function income as contemplated by section 512(a)(3)(B). Furthermore, the distribution to member employers under the auspices of the regulations of section 501(c)(9), does not constitute the disbursement of accrued income from an unrelated trade or business and is in fact related to the VEBA's primary purpose of providing section 501(c)(9) benefits.

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

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

Sincerely,

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3