INTERNAL REVENUE SERVICE
DEC -2 2002 TECHNICAL ADVICE MEMORANDUM

EO Area Manager:

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's EIN:

Tax Years Involved:

Uniform Issue List: 419.13-00
419A.00-00
501.09-00
512.09-03

T:EO:B2

Legend:

M =
N =
P =
Q =
R =
S =
T =
U =
x =

Issue:

May an employer elect to aggregate two welfare benefit funds for purposes of computing unrelated business taxable income (UBTI) where one of the funds is exempt under section 501(c)(9) of the Internal Revenue Code and the other fund is not exempt?

Facts:

In 1986, M entered into an agreement with T to establish a qualified asset account consisting of assets set aside to provide for the payment of life or disability premiums or benefits. Under that agreement, the account limit of the qualified asset account could include a reserve funded over the working lives of covered employees and actuarially determined on a level basis (using assumptions that were reasonable in the aggregate) for life insurance benefits provided to retired employees, such reserve to be called P. P is a welfare benefit fund as defined in section 419(e) of the Code. Pursuant to the terms of the agreement, M established P and funded it from time to time subject to the limitations of section 419A.

In 1976, an affiliated company of N established VEBA I, a voluntary employees' beneficiary association within the meaning of section 501(c)(9) of the Code, to provide and facilitate the payment of benefits under certain employee welfare benefit plans. VEBA I is a "welfare benefit fund" as defined in section 419(e) of the Code. In 1991, N became a sponsor of VEBA I which, in 1996, was renamed Q.

On June 18, 1997, N became a wholly owned subsidiary of M. Subsequently, Q was renamed U.

N maintains a life insurance program for the benefit of eligible employees and retirees. The program is composed of two plans: R and S. R and S are among several plans currently funded through Q. The assets held under Q have been allocated to and maintained in separate qualified asset accounts (as defined in section 419A(a) of the Code). Effective as of December 31, 1997, 92.12% of the assets of Q were allocated to R and 4.33% of the assets were allocated to S.

M made a contribution of approximately $51.7x to P during 1997 and deducted the contribution on its 1997 tax return. The total amount set aside under P on December 31, 1997, was less than P's qualified asset account limit under section 419A(c) of the Code on that date. Thus, there was no deemed unrelated income under section 419A(g) relating to P during M's tax year ending December 31, 1997, and M did not pay any taxes on deemed unrelated income relating to P.

For the tax year ending December 31, 1997, the UBTI of Q under section 512(a)(3) of the Code was calculated separately and without aggregating Q's accounts with any other welfare benefit funds of M or any entity affiliated with M under section 414(b), (c), or (m) of the Code. For its tax year ending December 31, 1997, Q had UBTI of $150.5x, of which $142.7x was attributable to R and $7.8x was attributable to S. Q paid unrelated business income tax (UBIT) of $59.6x on its UBTI, of which $56.5x was attributable to R and $3.1x was attributable to S. N did not make any contributions to R in 1997.

For its tax year ending December 31, 1997, M subsequently elected to permissively aggregate P and Q under section 419A(h)(1)(B) of the Code and to recalculate the UBTI for the combined fund. M filed an amended Form 990-T on behalf of Q for its 1997 tax year. Because the assets set aside under P as of December 31, 1997, were $1,825.2x less than its qualified asset account limit as of that date, the retroactive permissive aggregation eliminated the 1997 UBTI of Q attributable to R.

Law:

Section 419(a) of the Code provides that contributions paid or accrued by an employer to a welfare benefit fund (e.g., a VEBA) shall not be deductible under chapter 1 of the Code but, if they would otherwise be deductible, shall be deductible under section 419 in the taxable year when paid, subject to the limitation of section 419(b).

Section 419(b) of the Code provides that the deduction allowable under section 419(a) shall not exceed the welfare benefit fund's qualified cost for the taxable year.

Section 419(c)(1) of the Code provides that the term "qualified cost" means, with respect to any taxable year, the sum of the qualified direct cost (as defined in section 419(c)(3)) for such taxable year and, subject to the limitation of section 419A(b), any addition to a qualified asset account for the taxable year.

Section 419(e)(1) of the Code provides that the term "welfare benefit fund" means any fund which is part of a plan of an employer, and through which the employer provides welfare benefits to employees or their beneficiaries.

Section 419(e)(2) of the Code provides that the term "welfare benefit" means any benefit other than a benefit with respect to which section 83(h), section 404, or section 404A applies.

Section 419(e)(3) of the Code provides that the term "fund" means, among other things, any organization described in section 501(c)(9).

Section 419A(a) of the Code provides that the term "qualified asset account" means any account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits.

Section 419A(b) of the Code provides that no addition to any qualified asset account may be taken into account under section 419(c)(1)(B) to the extent such addition results in the amount in such account exceeding the account limit.

Section 419A(c) of the Code provides that, in general, the account limit for any qualified asset account for any taxable year is the amount reasonably and actuarially necessary to fund claims incurred but unpaid as of the close of such taxable year for benefits referred to in section 419A(a) and administrative costs with respect to such claims. In addition, 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 as necessary for post-retirement medical or life insurance benefits to be provided to covered employees.

The provisions of section 419A(h) of the Code contain rules for mandatory and permissive aggregation relating to welfare benefit funds maintained by the same employer. Section 419A(h)(1)(A) requires that all welfare benefit funds of an employer be treated as one fund in applying certain limits imposed by section 419A. This aggregation requirement applies to the following statutory provisions: (1) all welfare benefit funds of an employer must be aggregated in calculating the limit imposed by section 419A(c)(4)(A) on the amount of disability benefits payable to an individual and in calculating the limit imposed by section 419A(c)(4)(B) on the amount of SUB or severance pay benefits; (2) all welfare benefit funds of an employer must be aggregated in applying section 419A(d)(2) to determine the amount to be treated as an annual addition to a defined contribution plan for a key employee arising out of an allocation to a separate account for post-retirement medical or life insurance benefits payable to that key employee; and (3) all welfare benefit funds of an employer must be aggregated in applying section 419A(e)(2), which imposes a limit of $50,000 on the aggregate amount of post-retirement life insurance provided to any employee that may be taken into account in calculating the amount of the reserve that the employer may fund over the working lives of the covered participants in accordance with section 419A(c)(2).

Section 419A(h)(1)(B) of the Code permits an employer, at its election, to treat two or more of its welfare benefit funds as one fund for any purpose (other than with respect to the provisions for which the mandatory aggregation rules apply) to the extent that this treatment is not inconsistent with the purposes of section 419, section 419A, or section 512.

Section 419A(g) of the Code provides that, in the case of any welfare benefit fund which is not an organization described in paragraph (7), (9), (17), or (20) of section

501(c), the employer shall include in gross income for any taxable year an amount equal to such fund's deemed unrelated income for the fund's taxable year ending within the employer's taxable year. Deemed unrelated income of any welfare benefit fund shall be the amount which would have been unrelated business taxable income under section 512(a)(3) if such fund were an organization described in paragraph (7), (9), (17), or (20) of section 501(c).

Section 511(b) of the Code imposes for each taxable year a tax on the unrelated business taxable income (as defined in section 512) of every trust which is exempt from tax under section 501(a) and which, were it not for such exemption, would be subject to taxation under subchapter J (relating to estates, trusts, beneficiaries, and decedents).

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 certain modifications provided in section 512(b) relating to net operating losses and charitable contributions.

Section 512(a)(3)(B) of the Code provides that the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization) which is set aside to provide for the payment of life, sick, accident, or other benefits.

Section 512(a)(3)(E) of the Code provides that, in the case of organizations described in section 501(c)(9), a set-aside to provide for the payment of life, sick, accident, or other benefits may be taken into account under section 512(a)(3)(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).

Section 1.512(a)-5T, Q&A-3(b), of the Income Tax Regulations provides that the unrelated business taxable income of a VEBA for a taxable year generally will equal the lesser of two amounts: the income of the VEBA for the taxable year (excluding member contributions) or the excess of the total amount set aside as of the close of the taxable year (including member contributions) over the qualified asset account limit (calculated without regard to the otherwise permitted reserve for post-retirement medical benefits) for the taxable year.

Rationale:

The calculation of UBTI or deemed unrelated income of a welfare benefit fund is not among the calculations expressly subject to mandatory aggregation under section 419A(h)(1)(A) of the Code. No regulations have been published prescribing specific methods of calculating UBTI or deemed unrelated income in a case in which the same employer contributes to two or more welfare benefit funds covering its employees.

The legislative history of the Deficit Reduction Act of 1984 (DEFRA), under which section 419 of the Code was enacted, suggests that an employer could elect permissive aggregation of two welfare benefit funds for purposes of computing UBTI under section 512(a)(3)(A). While the legislative history does not specifically address permissive aggregation of VEBAs or of a VEBA and a non-exempt welfare benefit fund in computing UBTI and deemed unrelated income, it does address permissive aggregation of non-exempt welfare benefit funds in computing deemed unrelated income of the fund under section 419A(g)(2) of the Code. Specifically, the conference report on DEFRA states "In determining deemed unrelated income, at the election of the employer, two or more non-exempt welfare benefit funds of the employer may be treated as a single fund." H.R. Conf. Rep. No. 98-861, at 1163 (1984). Since deemed unrelated income of a welfare benefit trust is defined in section 419A(g)(2) as the amount that would have been the fund's UBTI under section 512(a)(3) if the fund were a VEBA, and there is no indication that a different aggregation rule was intended for non-exempt welfare benefit funds than for VEBAs, we infer that Congress was assuming that an employer could elect to aggregate two or more VEBAs, or one or more VEBAs and one or more non-exempt funds under section 419A(h)(1)(B) for purposes of calculating UBTI under section 512(a)(3). Additionally, a position that VEBAs could not be involved in permissive aggregation under section 419A(h)(1)(B) would be difficult to reconcile with the requirement of section 419A(h)(1)(A) for mandatory aggregation in certain specified circumstances of all welfare benefit funds (which we interpret as including VEBAs through which the employer funds employee welfare benefits).

Because section 419A(h) of the Code states that aggregation of welfare benefit funds is permissible unless it is inconsistent with section 419, 419A, or 512, the presumption is that aggregation is permissible. To disallow permissive aggregation, there must be specific facts in a particular case that demonstrate an inconsistency with section 419, 419A, or 512. The underlying purpose of section 512 (as it relates to UBIT for VEBAs) and section 419A(g) (as it relates to "deemed unrelated income" for non-exempt welfare benefit funds) is to set reasonable limits on the extent to which a VEBA may accumulate income on a tax free basis. The underlying purpose of section 419 and 419A, generally, is to prevent deductions taken far in advance of when benefits are paid, resulting in excessive accumulation of funds. *See* H.R. Rep. No. 98-432, pt. 2, at 1275, 1291 (1984). Where permissive aggregation in any case conflicts with such purpose, it should not be permitted.

In this case, M elected to permissively aggregate P and Q under section 419(h)(1)(B) of the Code and to recalculate UBTI. Both P and Q fund retiree life benefits. M elected to aggregate similar types of reserves in two different welfare benefit plans offering the same type of benefits. This aggregation does not allow excess accumulation of income in either P or Q, but simply combines accounting figures for tax computation. Accordingly, such aggregation is not inconsistent with sections 419, 419A, or 512, and aggregation should be permitted.

Conclusion:

M may elect to aggregate P and Q under section 419A(h) for purposes of computing unrelated business taxable income under section 512(a)(3) on a timely filed amended return.