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Internal Revenue Service

Uniform Issue List

505.01-01
512.01-00
501.09-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:

OP:E:EO:T:4

Date:

FEB 25 1999

Employer Identification Number:
Key District:

Legend:

M =
N =
O =

Dear Applicant:

This is in further response to your ruling request dated April 3, 1997, as modified by subsequent correspondence, concerning the tax treatment of contributions to M, a newly formed welfare benefit fund. Earlier, in a ruling letter dated May 11, 1998, Actuarial Branch 1 of our Employee Plans Division responded to Issues 1 and 2 of your letter, as discussed below. As indicated in the ruling letter, the administrative file was then forwarded to the Exempt Organizations Division to respond to Issues 3 and 4.

The sponsoring company, N, provides health insurance and post-retirement medical benefits for its employees represented by the union, O. The health insurance coverage for these employees is provided pursuant to the terms of collective bargaining agreements with O. The most recent agreement was negotiated in 1997.

N has established M, which will fund post-retirement accident and health benefits for O retirees. Prior to the establishment of M, N funded a portion of the health benefit obligation through an account under section 401(h) of the Internal Revenue Code (the "section 401(h) account"), previously established under a pension plan N sponsors. N paid the balance of the post-retirement health benefits from its general assets.

The sole purpose of M is to fund the post-retirement medical benefits set forth in the collective bargaining agreement. The pension plan will be amended to provide that the post-retirement medical benefits will be provided first by the assets in the section 401(h) account and then from M. M is exempt from federal income tax as a voluntary employees' beneficiary association ("VEBA") described in section 501(c)(9) of the Code.

N intends to contribute to M an amount equal to the present value of post-retirement health obligations for those persons whose benefits are funded under the section 401(h) account less the value of the assets held in the section 401(h) account.

N has represented that no additional amounts will be contributed to the 401(h) account if the sum of (i) the value of the assets held in the 401(h) account and (ii) the value of the assets held in M for post-retirement health benefit obligations, exceeds the present value of post-retirement health obligations for those persons whose benefits are funded under the 401(h) account and/or M.

Our Employee Plans Division ruled favorably on the first two issues posed in your ruling request, as follows:

Issue 1 - Whether N's contributions to M will constitute contributions to a welfare benefit fund maintained pursuant to a collective bargaining agreement within the meaning of section 419A(f)(5) of the Code and would therefore not be limited by any account limit under section 419 A.

Issue 2 - Whether N's contributions to M to fund post-retirement medical benefits for retirees will be treated as not exceeding M's "qualified cost" under section 419(c) for N's taxable year in which such contributions are made, and the amount of any such deductions with respect to such contributions shall not be limited by reference to the cost allocation principles described in Rev. Rul. 69-382, 1969-2 C.B. 28, Rev. Rul. 69-478, 1969-2 C.B. 29, and Rev. Rul. 73-559, 1973-2 C.B. 40.

The following two issues, to be addressed below, fall within our jurisdiction:

Issue 3 - Whether the gross income of M that is set aside to fund post-retirement medical benefits will constitute exempt function income under section 512(a)(3) of the Code.

Issue 4 - Whether M is subject to the nondiscrimination rules of section 505(b) of the Code.

Section 511 of the Internal Revenue Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

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

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). Further, it is "substantially related", for purposes of section 513 of the Code, only if the causal relationship is a substantial one. For this relationship to exist, the production or the performance of the service from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes. Whether the activities productive of gross income contribute importantly to such purposes depends, in each case, upon the facts and circumstances involved.

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

Section 512(a)(3)(B) of the Code provides that for purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes for which the

organization is tax exempt. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to section 512(a)(1)), which is set aside, in the case of a section 501(c)(9) organization, to provide for the payment of life, sick, accident, or other benefits. If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that just described, such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

Section 512(a)(3)(E)(i) of the Code provides that in the case of an organization described in section 501(c)(9), a set aside 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).

Our Employee Plans Division has ruled that M is maintained pursuant to a collective bargaining agreement within the meaning of section 419A of the Code. Accordingly, the account limit set forth in section 512(a)(3)(E)(i) does not apply. Therefore, we now rule that the gross income of M which is set aside for the payment of post retirement medical benefits will constitute exempt function income within the meaning of section 512(a)(3)(B). Accordingly, this income is not subject to tax as unrelated business income.

Section 501(c)(9) of the Code describes a voluntary employees' beneficiary association ("VEBA") providing for the payment of life, sick, accident or other benefits to its members or their dependents or designated beneficiaries, and in which no part of its net earnings inures (other than through such payments) to the benefit of any private shareholder or individual.

Section 505 of the Code sets forth additional requirements for an organization desiring to qualify for exemption under section 501(c)(9). It is effective for all plan years beginning after December 31, 1984. Section 505(a)(1) states that an organization described in section 501(c)(9) which is part of a plan shall not be exempt under section 501(a) unless such plan meets the requirements of section 505(b). Section 505(b)(1) sets forth the following nondiscrimination requirements:

(A) each class of benefits under the plan is provided under a classification of employees which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are highly compensated individuals, and

(B) in the case of each class of benefits, such benefits do not discriminate in favor of employees who are highly compensated individuals.

Section 505(a)(2) of the Code provides that section 505(a)(1) shall not apply to any organization which is part of a plan maintained pursuant to an agreement between employee representatives and one or more employers if the Secretary finds that such agreement is a collective bargaining agreement and that such plan was the subject of good faith bargaining between such employee representatives and such employer or employers.

In the present instance, M is maintained pursuant to a collective bargaining agreement which was the subject of good faith bargaining between N and O. Therefore, we rule that the nondiscrimination requirements of section 505(b) of the Code will not apply to M.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any changes that may have a bearing upon your tax status should be reported to your key District Director.

We are sending a copy of this ruling to your Key District for exempt organizations matters in [redacted]. Because this letter could help resolve any questions about your tax status, you should keep it with your permanent records.

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

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

Thank you for your cooperation.

Sincerely,

Gerald V. Sack

Gerald V. Sack
Chief, Exempt Organizations
Technical Branch 4