VEBAS, WELFARE PLANS, AND SEC. 419A(f)(6): IS THE IRS TRYING TO REGULATE OR SPREAD PROPAGANDA?

by

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I. INTRODUCTION

There is great social utility in taking care of employees, surviving spouses, children, elderly, and the sick. The measure of social utility of, or increase in well-being that results from, public laws and programs are often driven by “market preferences” and efficiency of systems, in addition to a rational decision to provide a program, service or to address a moral responsibility. A program generally is deemed to be socially useful when a “policy increases the sum total of welfare in society.” Furthermore, if we deem the value of a social program to be high enough to outweigh lost tax money, then there is still an increase in social welfare that would justify maintenance of the program. Under our democratic system, legislators must evaluate programs and policies with the goal of maximizing social utility for all citizens. In our American society, there are numerous indicators of the social utility of providing for employees, surviving spouses, and the elderly and sick. Quite simply, poverty imposes a high cost on

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3 See Robert Goodin, Vulnerabilities and Responsibilities: An Ethical Defense of the Welfare State, in WELFARE LAW 111 (Peter Robson ed., 1992) (“We all acknowledge strong special responsibilities towards families, friends, clients and compatriots. The moral basis of these responsibilities is traditionally analyzed in terms of self-assumed obligations.”); Curt Anderson, House Ok’s Boost in Benefits for Widows, Divorced Women, THE COMMERCIAL APPEAL (MEMPHIS, TN), May 15, 2002, at 8A. When IRC § 501(c)(9) was enacted, the Ways and Means Committee Report states that the exemption was granted because "voluntary employees' beneficiary associations providing for the payment of life, sick, accident or other benefits to members and their dependents are common to-day and it appears desirable to provide specifically for their exemption from the ordinary corporation tax . . . .“ H.R. Rep. No. 2, 70th Cong., 1st Sess. at 17, 1939-1 C.B. (Part 2) 384, 395. See also S. Rep. No. 960, 70th Cong., 1st Sess. at 25, 1939-1 C.B. (Part 2) 409, 426 (same as Ways and Means Committee Report except for clerical changes).

4 Herbert Hovenkamp, Legislation, Well-Being, and Public Choice, 57 U. CHI. L. REV. 63, 63 (1990)(“Particularly, economists have settled on revealed market preferences as the most robust measure of the social utility that public laws and programs produce. These means have in time overtaken the economists' original ends, so that for many of those engaged in economic analysis of law, social welfare comprises no more than can be assessed by economic criteria, particularly the Kaldor-Hicks measure of allocative efficiency.”); Lee Ann Fennell, Interdependence and Choice in Distributive Justice: The Welfare Conundrum, 1994 WIS. L. REV. 235 (1994)(“the non-poor react rationally by providing assistance to the poor, but that they are dissatisfied with this outcome insofar as it imposes costs on them. Indeed, the author contends that some of the most troubling of these costs result from decisions made by the poor in reaction to the non-poor's decision to provide assistance”).

5 Hovenkamp, supra note 4, at 65.

6 Hovenkamp, supra note 4, at 66 (“Under the Kaldor-Hicks test, interpersonal comparisons of utility are believed to be unnecessary. If the value of A's job training program is great enough that A could compensate B for her lost tax money and still be better off, then the forced wealth transfer increases social welfare. Since after the compensation is made there are only gainers and no losers, one need not be concerned with whether A's pleasure in the job training program exceeds B's pain in having to pay for it.”).

7 Hovenkamp, supra note 4, at 75.

8 Posner, ECONOMIC ANALYSIS OF LAW 463 (4th ed. 1992)(“[T]here are economic arguments for governmental efforts to reduce the gross inequality (in a wealthy society) that we call poverty.”).

9 For a discussion on the measure and meaning of poverty, see generally Peter Townsend, Measuring Poverty, in WELFARE LAW 3 (Peter Robson ed.,1992); Miller et. al., Poverty, Inequality, and Conflict, in WELFARE LAW 19; Mollie Orshansky, Perspectives on Poverty 2: How Poverty is Measured, in WELFARE LAW 57.
society at large.\textsuperscript{10} The very risk that an individual might become impoverished in the future is an economic risk to those individuals that, at present, are not impoverished.\textsuperscript{11}

Most of us can easily envision the financial difficulties that we, or our families, might encounter upon retirement.\textsuperscript{12} As just one example, in the United States, women often outlive men,\textsuperscript{13} earn less money, and even those working outside the home often take time away from work for childcare.\textsuperscript{14} However, about forty percent of women depend on Social Security, one of the social programs designed to help prevent individuals from falling into poverty,\textsuperscript{15} for their retirement\textsuperscript{16} and poverty amongst widows is typically higher than that of other elderly persons.\textsuperscript{17} The societal problem becomes especially sensitive in light of the long-term deficits of about $\ldots$

\textsuperscript{10} Posner, ECONOMIC ANALYSIS OF LAW, supra note 1, at 463; Fennell, supra note 1, at 240, 267 (“The welfare dilemma grows out of the fact that poverty is extremely costly to all of society, including the non-poor. Because of the costs that poverty imposes on all of society, the non-poor would be willing to pay to have it alleviated.”).

\textsuperscript{11} Posner, ECONOMIC ANALYSIS OF LAW, supra note 2, at 465 (“An affluent person who is risk adverse will want to insure against the possibility of becoming poor in the future, because of business reverses, poor health, changes in the labor market, or other misfortunes.”); Fennell, supra note 2, at 241 (“The existence of poverty may also represent a costly economic risk to people who are not presently poor, but who fear that they might become poor at some point in the future.”).

\textsuperscript{12} Fennell, supra note 3, at 272.

\textsuperscript{13} See National Economic Council Interagency Working Group on Social Security, Women and Retirement Security at 8 (1998) [hereinafter Women and Retirement Security] (stating that at 65, a woman can expect to live to 85 while a man only to 81). This gap in life expectancy between men and women is expected to continue in the future. See id.

\textsuperscript{14} Curt Anderson, House Ok’s Boost in Benefits for Widows, Divorced Women, THE COMMERCIAL APPEAL (MEMPHIS, TN), May 15, 2002, at 8A. For a discussion about women’s role in caring for family, see generally Hillary Land, Who Cares for the Family, in WELFARE LAW, supra note 3, 487, 490 (“Women acquire a set of domestic duties which include caring for their children, their elderly or sick relatives and of course their husbands. . . . The majority of married women [also] have paid employment for most of their married lives.”).

\textsuperscript{15} See Social Security Administration, A Brief History of Social Security 4 (1995) (quoting President Roosevelt at the August 14, 1935 signing of the Social Security Act as stating "we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age"); Fennell, supra note 4, at 272. See also Laura E. Stiglin, A Classic Case of Overreaction: Women and Social Security, NEW ENG. ECON. REV., Jan./Feb. 1981, at 32 (commenting that working women often "do not get their "money's worth from Social Security" because even though these women have paid into Social Security from their wages "they often get no or only slightly higher benefits as workers than ... as spouses").


\textsuperscript{17} Curt Anderson, House Ok’s Boost in Benefits for Widows, Divorced Women, THE COMMERCIAL APPEAL (MEMPHIS, TN), May 15, 2002, at 8A. For a discussion of the plight of elderly women generally, see National Economic Council Interagency Working Group on Social Security, Women and Retirement Security 12 (1998) (noting that the poverty rate for elderly widowed women is 18% compared to a rate of only 4.6% for elderly married couples in 1997); M.L. Reig, The Unspoken Poor: Single Elderly Women Surviving in Rural America, 9 ELDER L.J. 257 (2001); Nina Mojiri-Azad, Social Security Benefits to Widows: The Ongoing Favoritism of Single-Earner Families and the Impact on Elderly Women, 17 LAW & INEQ. J. 537 (1999). President Clinton had recognized this issue in his 1999 State of the Union address when he said, "we should reduce poverty among elderly women, who are nearly twice as likely to be poor as our other seniors." Address Before a Joint Session of the Congress on the State of the Union, 35 Weekly Comp. Pres. Doc. 78, 79 (Jan. 19, 1999). See also, Senator Carol Moseley-Braun, Women’s Retirement Security, 4 ELDER L. J. 493, 495 (1996), (stating that 80% of the elderly widows who are living below the poverty standard were not poor when their spouses were alive).
$22.2 trillion facing the Social Security program in the next 70 years. Furthermore, solving the long term problem of Social Security is massive and will likely require: higher payroll taxes; higher rate of return for trust fund assets, additional revenues for Social Security and/or reduction of benefits. The most likely scenario involves a significant reduction of benefits in the future to retirees.

Because lifting individuals out of poverty is also costly to society, the most efficient route is to allow individuals to aid in self-help such that individuals can lift themselves from poverty or avoid it altogether, rather than “free-ride” on the efforts of the rest of the community. Historically, most of the American workforce has engaged in this very type of self-help by obtaining medical, dental, disability, life insurance and similar employee welfare benefits from their employer. That is, most of the American workforce engages in a form of self-insurance against poverty because they appreciate the risk that without the benefits they

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21 Fennell, supra note 5, at 240 (“Yet because the alleviation of poverty is very costly (although less so than poverty itself), the non-poor would prefer that the dependent poor engage in self-help to lift themselves out of poverty rather than "free-ride" on the non-poor’s transfers. To the extent the poor can be convinced to do this, however, the non-poor can free-ride off the poverty-reduction efforts of the poor, enjoying the benefits of reduced poverty at no cost to themselves”). See also, e.g., Richard A. Posner, ECONOMIC ANALYSIS OF LAW 463, 465 (4th ed. 1992).

22 Welfare benefits are generally benefits other than pension or retirement benefits primarily for the benefit of employees and their beneficiaries. See generally, EMPLOYEE FRINGE AND WELFARE BENEFIT PLANS §9.2 (2002); 7 MERTENS LAW OF FEDERAL INCOME TAX’N §25E:36.105 (2002); Fed. Tax Coordinator ¶H-4106 (2002); Gary Thornhill, Welfare Benefit Plans: Current Trends and Legislative Proposals, SF59 ALI-ABA 255, 258 (2001). For a discussion of public choice theory and welfare generally, see Herbert Hovenkamp, Legislation, Well-Being, and Public Choice, 57 U. CHI. L. REV. 63, 63 (1990) (“Laypeople think of welfare mainly in subjective terms: Whether A has more welfare than B depends on whether A has certain feelings that B lacks, or feelings of a certain magnitude, that we wish to characterize as welfare.”); Fennell, supra note 6, at 237 (“Welfare is a longstanding feature of our social and political landscape, yet it remains a uniquely puzzling piece of social policy. Society grudgingly spends money to transfer holdings from the more well-off to the less well-off, yet it is not clear why, at a philosophical level, these transfers are made.”). Under ERISA, a welfare benefit plan is a plan “established or maintained by an employer . . . for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise . . . medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, or disability.” ERISA section 3(1), 29 U.S.C. section 1002(1) (1988).

23 IRS Training Manual, Veba Awareness. See also Cynthia Shupe, Current Veba and Welfare Plan Funding Issues, SF72 ALI-ABA 583, 595-95 (2001); The Uninsured: Employers Create ‘Barriers’ to Coverage, AMERICAN HEALTH LINE, August 20, 2001; Health Care ‘Consumerism?’ Not in the Workplace; Study Shows Employees Don't Understand Their Health Plan Benefits and Options, PR NEWSWIRE, June 12, 2001. Posner notes that some types of poverty can be insured against, while others cannot. Posner, ECONOMIC ANALYSIS OF LAW, supra note 3, at 466.
could end up in poverty themselves without those protections.\textsuperscript{24} Due to significant increases in the cost of these welfare benefits, though, many employees can no longer count on the provision of these once-relied-upon benefits and protections against poverty, even if the employee is able to share in the cost of the benefits.\textsuperscript{25} Some Americans have had to decline medical insurance and benefits altogether due to the high cost and have had to elect to pay out of pocket when they or their family members become sick, which results in a societal reality that many individuals lack this form of insurance against poverty and misfortune.\textsuperscript{26} As a result of these realities, many Americans have insufficient amounts of life insurance, medical coverage, disability coverage and long term care coverage to adequately guard against the risk that themselves, or their families, will fall into poverty in the future.\textsuperscript{27}

Welfare itself has long been a component of our American political and social system.\textsuperscript{28} Welfare benefit plans directly help employers and employees to fill in the gaps in their coverage in order to protect them and their families.\textsuperscript{29} One mechanism among many available for providing welfare benefits to employees,\textsuperscript{30} the voluntary employees' beneficiary association (“VEBA”), has been around since 1928 and is a trust or separate tax entity that provides certain types of welfare benefits, some in the nature of insurance like life, disability, and medical benefits, while others are unique to a VEBA, like severance and children's educational benefits.\textsuperscript{31}

\footnotesize{\textsuperscript{24} Posner, supra note 4, at 465 ("An affluent person who is risk averse will want to insure against the possibility of becoming poor sometime in the future, because of business reverses, poor health, changes in the labor market, or other misfortunes."); Fennell, supra note 7, at 271-72.  
\textsuperscript{25} IRS Training Manual, VEBA Awareness; see also, Shupe, supra note 1, at 594-95; The Uninsured: Employers Create 'Barriers' to Coverage, AMERICAN HEALTH LINE, August 20, 2001; The Rising Cost of Healthcare, NATIONAL CONFERENCE OF STATE LEGISLATURES, January 1, 2002.  
\textsuperscript{26} The Uninsured: Employers Create 'Barriers' to Coverage, AMERICAN HEALTH LINE, August 20, 2001.  
\textsuperscript{27} Thornhill, supra note 1, at 264. See generally Posner, supra note 5, at 465.  
\textsuperscript{28} Fennell, supra note 8, at 237.  
\textsuperscript{29} Thornhill, supra note 2, at 265; See generally David E. Weiss, The Multiple Employer Welfare Benefit Trust, Journal of the American Society CLU & ChFC, May 1990.  
\textsuperscript{30} Although there are many differing ways for employers to provide welfare benefits to employees, this Article’s focus is on VEBA. For a discussion of other types of plans and related employee benefit issues, see, e.g., generally, Procedure and Administration in Employee Benefit Plans, 6 MERTENS LAW OF FED. INCOME TAx’N § 25B-1.01(2002)(establishment and operation of qualified employee benefit plans governed by federal income tax law); Harold S. Bloomenthal and Samuel Wolff, Form 5-8- Employee Benefit Plans, 3B SEC. & FED. CORP. LAW § 9:50 (2002)(simplified registration for employee benefit plans and the employer's securities); Jody L. Mikasen, J.D., Leonard I. Reiser, J.D., and Todd R. Smyth, J.D., "What is an Employee Benefit Plan?: ERISA Preemption of ‘Any Willing Provider’ Laws After Pegram", 101 CLMLR 1107 (2001)(arguing that state laws that regulate the relationship between managed care organizations and health care providers, such as "any willing provider" laws, should not be preempted by ERISA).  
\textsuperscript{31} IRC § 501(c)(9) was first enacted as § 103(16) of the Revenue Act of 1928, ch. 852, 45 Stat. 791. The Ways and Means Committee Report stated that the exemption was granted because 'voluntary employees' beneficiary associations providing for the payment of life, sick, accident or other benefits to members and their dependents are common to-day and it appears desirable to provide specifically for their exemption from the ordinary corporation tax . . . " H.R. Rep. No. 2, 70th Cong., 1st Sess. at 17, 1939-1 C.B. (Part 2) 384, 395. See also S. Rep. No. 960, 70th Cong., 1st Sess. at 25, 1939-1 C.B. (Part 2) 409, 426 (same). See also generally Cynthia Shupe, Current VEBA and Welfare Plan Funding Issues, SF72 ALI-ABA 583, 585 (2001); Thornhill, supra note 3, at 265; Separate tax entity can provide employee welfare benefits: IRS may deny funds if beneficiary plan expands beyond its intended...}
If designed to provide meaningful employee benefits, and not as a tax gimmick for small business owners, contributions to a VEOA may be tax deductible, and VEOAs themselves are tax-exempt entities.  

VEOAs are primarily used by small businesses to provide welfare benefits to the small business owners and their employees. Small businesses are crucial to our economy and represent 99% of employers and employ 50% of the private workforce in America. It is this particular cross-section of persons whose welfare is benefited by federal legislation allowing tax deduction and deferral, such as that available to VEOAs. Less than half of small business owners provide typical employee welfare benefits to their employees. Small business owners and professionals, such as merchants, physicians, attorneys, and other professionals are often anxious about their ability to obtain these benefits for their employees, themselves and their families and the tax planning mechanisms involved in such welfare benefit plans. As stated by
Senator Orin Hatch (R-Ut): “[i]f an employer is forced to reduce or eliminate benefits for some workers to avoid litigation exposure or to avoid going afoul of the law, we have to ask the question: Is it worth it?”

Although there are socially useful reasons for having VEBAs and protecting the ability of small businesses using VEBAs to provide the much needed welfare benefits to both business owners and their employees, there is the potential for misuse and schemes by those seeking only to evade taxes. Prior to 1985, a businessman could maintain an individual Veba similar to the way an individual keeps a pension or profit sharing plan. VEBAs operated as tax-deductible accumulation vehicles without much regard to funding employees’ benefits. Most VEBAs were used for life insurance, because the premiums justified large contributions. Contributions were effectively unlimited. However, challenges to the deductibility of Veba contributions by the Internal Revenue Service (“IRS”) in response to large and/or unusual Veba contributions for dubious “benefits” such as planes, boats, condominiums and other items for which the taxpayer took deductions to pay for the items, along with the lack of deduction limits, caused the Congress to amend the Internal Revenue Code, applicable to years after 1984. These new provisions effectively froze existing VEBAs and substantially curtailed the use of individual VEBAs as a tax shelter device.

Although VEBAs fell into disfavor as a tax-planning device initially as a result of the new legislation, Congress left an exception in the law for so-called multiple-employer VEBAs. If 10 or more employers (“TOME”) join a plan, and the plan satisfies other important statutory requirements under Internal Revenue Code of 1986, as amended (the “IRC”) and the Regulations issued thereunder (the “Regulations”), then the new restrictions imposed by the amended IRC

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38 See infra discussion at Part III.A.1-2.
39 Shupe supra note 2, at 587-88. Furthermore, sections 201 and 301 of ERISA expressly exempt welfare plans, including VEBAs, from ERISA’s requirements for eligibility, participation, vesting and funding rules.
40 Shupe, supra note 3, at 587-88.
41 Shupe, supra note 4, at 587-88.
42 See, e.g., Joel A. Schneider, M.D., S.C. v. Commissioner, 63 T.C.M. (CCH) 1787 (1992). This famous Veba cases involved a physician in the Midwest named Joel Schneider. Schneider operated his medical practice with only one other employee. Over a three-year period, Dr. Schneider contributed over $1.1 million to his Veba to fund over $4.5 million in life insurance, disability insurance, and a tax-deductible education fund for his three teenage children. Over 98% of the deduction was attributable to benefits covering himself. The IRS audited him and they went to Tax Court, where Dr. Schneider prevailed. Similarly, the IRS lost in a case called Moser v. Commissioner, 56 T.C.M. (CCH)1604 (1989). In Moser, the Tax Court upheld a deduction of $200,000 taken by the Mosers, although this represented full funding of their severance benefit in one year. The Court commented that prudent business practices often compel an employer to fund a Veba with large contributions during years of good earnings, because money may not be available in bad years. Moser v. Commissioner, 56 T.C.M. (CCH) 1604 (1989)
44 Shupe, supra note 5, at 587-88; Thornhill, supra note 4, at 257.
45 VEBAs; voluntary employees’ beneficiary associations, THE NATIONAL PUBLIC ACCOUNTANT, May 1, 2001.
46 All references to “Section” or “Sections” [abbreviated § and §§, respectively] are to sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated. Citations to Regulations refer to Treasury Regulations issued under the Code, unless otherwise indicated.
on deductions to certain welfare benefit plans, such as VEBAs, do not apply.\(^{47}\) As a result, businesses can still enjoy the huge benefits of welfare benefit plans, such as VEBAs, that have historically been upheld by the Tax Courts.\(^{48}\)

The IRC clearly provides for the creation and use of VEBAs to provide employee welfare benefits.\(^{49}\) However, not all terminology and requirements were clearly delineated in the IRC, such as “experience rating arrangements”, the meaning of “single plan” and the line between deferred compensation and welfare benefit plans.\(^{50}\) The Tax Court has clarified some requirements for VEBAs and has also consistently reiterated that employers may use VEBAs and take deductions for the contributions, but only if the Veba is a properly structured Veba in accordance with the IRC.\(^{51}\) Of course, the IRS is always on the lookout for investment schemes that are disguised as employee welfare benefit plans and has used the courts to challenge suspect plans.\(^{52}\) The IRS, though, has consistently taken positions that appear inconsistent with either the IRC or the tax court rulings. This leads to uncertainty for small business owners desiring to provide these important employee benefits to their staff.\(^{53}\)

Although the Congress has made it clear through legislation that small businesses may take advantage of tax deductions and deferral when they provide welfare benefits to their employees, on July 11, 2002, the IRS issued a Notice of proposed rulemaking and notice of public hearing with respect to 10 or More Employer Plans (the “Proposed Regulations”).\(^{54}\) The Proposed Regulations, if finalized, would have significant impact upon qualification of a Veba as a TOME under IRC §419A(f)(6), which provides for special tax relief for qualifying taxpayers. Additionally, there are bills pending in both the Senate and the House to revise §419A(f)(6) that would address many of the issues needing clarity with respect to TOMEs, but would allow small businesses to continue to take advantage of the tax incentives and provide welfare benefits to the employees. Senator Rick Santorum (R-Pa) introduced the Employee Welfare Benefit Equity Act of 2001 (“EWBEA”) as Senate Bill 1386 in August, 2001.\(^{55}\) Representative Weller (R-IL) introduced the Small Business Welfare Benefits Protection Act” (“SBWBPA”) as House Bill 2370 in June, 2001.\(^{56}\)


\(^{49}\) I.R.C. § 501(c)(9).

\(^{50}\) See infra Parts III, V, and VI.


\(^{52}\) VEBAs; voluntary employees' beneficiary associations, THE NATIONAL PUBLIC ACCOUNTANT, May 1, 2001; Simmons, A Guide to Evaluating a Proposed Section 419A(F)(6) Plan, supra note 1.

\(^{53}\) Simmons, A Guide to Evaluating a Proposed Section 419A(F)(6) Plan, supra note 2.


\(^{55}\) 2001 Bill Tracking S. 1386.

\(^{56}\) 107 H.R. 2370.
The IRS has itself defined propaganda as the "mere presentation of unsupported opinion." In describing its position on propaganda with respect to determining the tax-exempt status of organizations, the IRS has compared for tax purposes organizations that encourage citizen participation in governmental and political issues that are tax exempt, with those that are promoting propaganda by engaging in a political campaign in an attempt to influence or sway public opinion. The latter are not tax exempt organizations. In fact, the IRS has identified the following factors are being indicators of an organization that is engaging in propaganda: (i) unsupported viewpoints are a significant portion of its communications; (ii) one that distorts facts to support its view; (iii) one that employs excessive inflammatory and disparaging terms and bases its conclusions on strong emotional feelings; and (iv) one that does not evaluate the background of the audience.

The IRS has been somewhat adverse to VEBAs for decades, and some portions of the Proposed Regulations appear to be more of the nature of propaganda, as defined even by the IRS, than a genuine attempt by the IRS to appropriately regulate limitations on the taxpayer’s use of TOBE plans. For instance, with respect to experience rating, the IRS has focused so entirely on its own viewpoint to disallow termination of a plan for what the IRS sees as tax avoidance purposes, and completely disregarded, without any objective evaluation for doing so, the definitions for experience rating: (i) described by the Supreme Court in American Bar Endowment v. U.S.; (ii) described by Judge Laro in Booth v. Commissioner; and (iii) advanced by the industry in Supreme Court cases and as articulated by the insurance industry. The Treasury Department has also disregarded the definition of experience rating advanced by its lawyers and the testimony of its expert witness in Booth. Defining experience rating in this way is contrary to the Congressional intent of the 1984 Deficit Reduction Act, for

57 Reg § 1.501(c)(3)-1(d)(3)(i).
59 Rev Proc 86-43, 1986-2 CB 729. (though determined on the facts of each case, viewpoints are generally propaganda and not educational if “1 The presentation of viewpoints or positions unsupported by facts is a significant portion of the organization's communications. 2 The facts that purport to support the viewpoints or positions are distorted. 3 The organization's presentations make substantial use of inflammatory and disparaging terms and express conclusions more on the basis of strong emotional feelings than of objective evaluations. 4 The approach used in the organization's presentations is not aimed at developing an understanding on the part of the intended audience or readership because it does not consider their background or training in the subject matter.”); See also, 9 MERTENS LAW OF FED. INCOME TAX’N § 34:58 (2002)(describing the IRS position on the activities of organizations that put out propaganda).
62 Booth, 108 T.C. at 574, citing United States v. American Bar Endowment, 477 U.S. 105, 107 (1986). ("experience rated * * * means that the cost of insurance to the group is based on that group's claims experience, rather than general actuarial tables"). That is, experience rating goes to pricing, and the ability to receive a refund of the purchase price. It has nothing to do with dividends earned in a policy. Dividends have never been "experience rating." Cash refunds to a payer indicate experience rating under Judge Laro’s reasoning in Booth. The Proposed Regulations try to circumvent this requirement by saying that employees are "proxies" for the employer. However, even if an employer has paid too much in one year, its cost of the benefit has not changed. The employer cannot get the money back.
63 See infra Part III.B.3.
which the Proposed Regulations are apparently written. As another example, the Proposed Regulations also advance that a termination distribution to employees under a TOME plan should be equated with the concept of "automatic rebate to the employer." Here too, the IRS arguably is distorting the law regarding TOME plans far beyond any limits that Congress might have imagined, in a way that seems to disregard judicial authority in favor of the IRS own desire to limit the use of plans that are approved by Congress.

This article describes the attributes of welfare benefit plans generally and those specific attributes of a properly designed §419A(f)(6) multiple-employer VEBA and argues for reform in the IRC that would clarify issues of qualification, deductibility and contribution limits that have been troublesome for courts and small business taxpayers. Part II explores the nature of potential tax vehicles for welfare benefit plans, including the VEBA, discussing common arrangements and benefits of the various structures. Part III discusses the impact of leading Tax Court cases, such as *Booth v. Commissioner*, and *Neonatology Associates, P.A. v. Commissioner*, as well as key regulations, notices and rulings issued by the IRS, including the Proposed Regulations. Part IV examines the areas that need clarification relating to §419A(f)(6) plans. Part IV also discusses how the IRS appears to be engaging in propaganda rather than regulation by comparing the IRS’ position with established authority. Part IV also includes a discussion of how congressional proposals have addressed current unresolved issues facing small businesses desiring to take advantage of the tax programs. Part VI recommends the adoption by Congress of legislation that provides further guidance to the IRS and the tax courts on several of the issues that have caused uncertainty to small business owners.

This article concludes that VEBAs and other nondiscriminatory welfare benefit plans under IRC 419A(f)(6) are valuable employee benefit plans that should not be discouraged by congressional legislation or the apparent propaganda of the Proposed Regulations for the primary reason that it is socially useful to provide programs that help keep individuals from falling into poverty, particularly those that are likely to benefit small businesses that are essential to our economy and the owners, employees and their families in general. Ideally, the IRS would on its own accord reconsider the recently issued Proposed Regulations regarding “experience rating arrangements” and other positions it has taken that are adverse to these important employee benefits, while still “policing” potential schemes that are inconsistent with the IRC. Of course, the Tax Court has been able to intervene and rule on some specific issues are necessitated, but many issues remain unresolved. Ultimately, though, in light of the IRS apparent determination

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67 Booth v. Commissioner, 108 T.C. at 563-64.


to disregard existing authority and reluctance to issue regulations that would enforce the law and allow small businesses to receive the tax benefits that Congress intended, the most comprehensive resolution of the pending issues would be for Congress to pass legislation that clarifies once and for all the parameters of deductibility of contributions to welfare benefit plans under IRC 419A(f)(6), such as VEBAs.

II. GENERAL BACKGROUND ON WELFARE BENEFIT PLANS

A. Multiple-Employer Plans Generally

Although a VEBA allows an employer to join with other employers to fund certain employee welfare benefits in a tax free environment, it is certainly not the sole vehicle for such funding of a multiple-employer welfare benefit plan used now or in the past. Welfare benefits can also be funded through taxable entities called “welfare benefit funds” that are sponsored by individual employers to provide the employees or their beneficiaries welfare benefits. Some employers that are unwilling to assume the costs or requirements of structuring a VEBA may decide to use a taxable trust (rather than a tax-exempt VEBA) to fund the welfare benefits. Furthermore, employers can also join multiple employer trusts (“METs”), often organized by type of business or professional organization, through which the MET provides welfare benefits to the employees of two or more employers in a situation that resembles a VEBA, though without the qualification as one. The MET will allow the employers participating to keep insurance premiums at lower levels than otherwise available by pooling the risks of several small employers together. Like the special tax rules applicable to VEBAS, contributions by employers to welfare benefit funds are also subject to special tax rules regarding deductibility. Contributions by employees are normally not deductible.

71 Shupe, supra note 6, at 587.
72 Shupe, supra note 7. at 587.
73 See infra Part II.B.
74 While the VEBA design may be preferable because of the assurances of welfare plan and nondiscrimination compliance that a determination letter gives, see infra Part II.C.D., non-VEBA plans are permitted and Regs. § 1.162-10(a) does not impose a VEBA requirement. Also a non-VEBA plan (that is, one that has not applied for exemption) can voluntarily comply with § 505(b) standards and thus avoid excise tax exposure. The plans operate virtually identically if a non-VEBA funds with non-taxable assets (such as life insurance policies).
75 Shupe, supra note 8, at 587.
76 AMJUR EMPLOYMENT § 116 EMPLOYER SPONSORSHIP OR OTHER INVOLVEMENT; MULTIPLE-EMPLOYER TRUSTS (2d ed. 2002)(“METs are usually cast in terms of a master trust that requires an adoption or subscription agreement on the part of any subscribing employer.”); Canan and Mitchell, Employee Fringe & Welfare Benefit Plans § 8.1-8.3 (2002 ed.).
77 AMJUR EMPLOYMENT § 116; Canan and Mitchell, Employee Fringe & Welfare Benefit Plans § 8.1-8.3 (2002 ed.).
78 Canan and Mitchell, EMPLOYEE FRINGE & WELFARE BENEFIT PLANS § 9.2 (2002 ed.). If a multiple employer trust does not meet the requirements of IRC § 419A(f)(6), but is nevertheless a welfare benefit plan, deductions for income tax purposes are determined pursuant to IRC §§ 419 and 419A.
B. Benefits of forming a VEBA

A properly designed multiple-employer VEBA trust under IRC §501(c)(9) provides unlimited potential for small businesses to provide welfare benefits to employees and their dependents which are different from the pension benefits that the small business employer may provide, for instance:

1. Different from a retirement plan, a VEBA does not have a specific deduction limit.\(^{81}\)

2. Funds contributed to a VEBA grow tax-deferred.\(^{82}\)

3. There are no penalties for distributions from a VEBA prior to retirement age.\(^{83}\)

4. There are no excise taxes for excess accumulations or insufficient distributions.\(^{84}\)

5. Unlike a pension plan, at death, a VEBA death benefit is completely exempt from income taxes.\(^{85}\)

6. The death benefits from a VEBA may be structured to avoid all estate taxes because participants do not normally have incidents of ownership in insurance policies owned by the VEBA.\(^{86}\)

7. There are usually no gift taxes payable on contributions to a VEBA trust because such amounts are compensatory, not gratuitous, and the annual economic value of any death benefit coverage is normally within the gift tax annual exclusion.\(^{87}\)

8. Because a VEBA is often structured with cash value life insurance, assuring current and long-term protection, cash value insurance serves the secondary purpose of providing a source for future benefits that are funded with today's deductible dollars, which is typically more than most people would purchase for themselves if using after-tax dollars.\(^{88}\)

\(^{80}\) See infra Part II.C.


\(^{82}\) John J. Koresko, The VEBA: Understanding Multi-employer Voluntary Employees’ Beneficiary Associations, ADVANCED TAX STRATEGY SERIES, at 7 (1994).

\(^{83}\) John J. Koresko, supra note 1, at 13.

\(^{84}\) John J. Koresko, supra note 2, at 11-13.

\(^{85}\) John J. Koresko, supra note 3, at 14-15.

\(^{86}\) John J. Koresko, supra note 4, at 15-16.

\(^{87}\) John J. Koresko, supra note 5, at 16.

\(^{88}\) John J. Koresko, supra note 6, at 12-13. See Generally David Dunkle, VEBA’s and Other Self-Insured Arrangements, 395 2nd T.M. (2002); Chris Penttila, VIVA VEBAs; Voluntary Employees’ Beneficiary Association, 29 No. 8 ENTREPRENEUR 44 (Aug 2001).
9. Unlike a retirement plan, there is no mandatory vesting, so if an employees terminate they are not usually eligible to receive benefits from the VEBA.\textsuperscript{89}

10. The assets of a VEBA are also not reachable by creditors of the employees and their dependents, so long as benefits remain unvested and the plan contains spendthrift trust language.\textsuperscript{90}

Additionally, sections 201 and 301 of ERISA expressly exempt welfare plans, including VEBAs, from ERISA’s requirements for eligibility, participation, vesting and funding rules.

After many years, an employer may find that a VEBA is no longer necessary or the small business might not be able to fund the VEBA. The employer would withdraw from the multiple-employer plan.\textsuperscript{91} The plan then terminates for that employer, and current participants receive a distribution [usually, the cash values of insurance policies] based upon cumulative salary during all years of participation.\textsuperscript{92} The following example illustrates what could happen when a small business terminates a VEBA. Assume that a small business person participated for 10 years in a VEBA at an average salary of $195,000, resulting in cumulative compensation of $1,950,000. Meanwhile, due to turnover, her only employee worked 5 years at an average compensation of $25,000 per year. Since the employee was not eligible to participate until after 3 years of service, the employee had cumulative compensation of $50,000 (2 years @ $25,000) for purposes of calculating the termination distribution. Upon termination, the assets in the VEBA would be distributed in the following proportion based upon relative cumulative compensation: small business owner, 97.5%; employee, 2.5%. This result complies with §505(b) and is not discriminatory, since the basis for distribution is an objective standard. Certain types of retirement plans permit similar disparity, so the advantage for owners should not be seen as unique to VEBAs. It should be noted, however, that more plan assets will be distributed to non-owner-employees as the percentage of compensation attributable to non-owners increases.

Thousands of small businesses and professionals have already joined these IRC §501(c)(9) qualifying VEBAs and other welfare plans, with contributions limited by the standard of "reasonableness".\textsuperscript{93} The key is to find a plan possessing the intricate design characteristics that enable it to fit the limited exception in the law.\textsuperscript{94} Unfortunately, there are many defective programs out there.\textsuperscript{95} Small businesses should beware of the so-called "419 Plans" and "Taxable Welfare Benefit Trusts" that promise VEBA benefits without complying with the VEBA rules.\textsuperscript{96} Participating employers should also demand a legal opinion on how the multiple-employer plan

\textsuperscript{89} John J. Koresko, supra note 7, at 16-19. The Seventh Circuit case of Wellons v. Commissioner illustrates the potential problems of providing a severance benefit upon voluntary termination. It could be re-characterized as nondeductible deferred compensation. Furthermore, sections 201 and 301 of ERISA expressly exempt welfare plans, including VEBAs, from ERISA’s requirements for eligibility, participation, vesting and funding rules.

\textsuperscript{90} John J. Koresko, supra note 8, at 23.

\textsuperscript{91} John J. Koresko, supra note 9, at 23-30.

\textsuperscript{92} John J. Koresko, supra note 10, at 23-30.

\textsuperscript{93} John J. Koresko, supra note 11.

\textsuperscript{94} John J. Koresko, supra note 12.

\textsuperscript{95} Chris Pentilla, VIVA VEBAs; Voluntary Employees’ Beneficiary Association, 29 No. 8 ENTREPRENEUR 44 (Aug 2001). See generally Steven A. Horowtiz, Regarding Multiple Employer Welfare Benefit Plans (VEBA and Non-VEBA): It’s Time to Stop All the Insanity, 77 No. 2 Taxes Magazine 19 (1999).

\textsuperscript{96} See generally Carol Gould, Time Will Tell, BLOOMBERG WEALTH MANAGER, Oct 2000 at 51; Steven A. Horowitz, Regarding Multiple Employer Welfare Benefit Plans (VEBA and Non-VEBA): It’s Time to Stop All the Insanity, 77 No. 2 Taxes 19 (1999).
avoids experience rating and why it qualifies as a single plan and should ask for a letter of
determination from the IRS, which only VEBAs can get. Finally, a small business employer
should find a plan sponsor who puts things in writing and squarely addresses the complex legal
issues. There are many charlatans running around who induce the unwary into these programs,
and hide behind some "phantom" counsel.

C. Voluntary Employees’ Beneficiary Associations under IRC 501(c)(9)

Qualification as a section 501(c)(9) organization under the IRC generally exempts a VEBA
from federal income taxation, and defers the taxation of VEBA benefits until the benefits are
received by the beneficiaries of the VEBA. In order to qualify as a VEBA, an organization must
meet the following requirements:

1. there must be a voluntary association of employees separate from the participating
employer;
2. there must be a complete description of the benefits offered;
3. the VEBA must have a membership composed of individuals who have an
employment-related common bond;
4. the VEBA must provide qualifying benefits;
5. each class of VEBA benefits must be provided under a classification of employees
set forth in the plan which does not discriminate in favor of highly compensated
employees; and
6. no part of the net earnings of the organization can inure to the benefit of any private
shareholder or individual, other than by payment of benefits to participants.

Each of these requirements is discussed herein.

1. Voluntary association of employees.

97 John J. Koresko, supra note 13. See Floyd Culhanne, Risks Involved in the Sale of Life Insurance to Multiple
Employer Welfare Benefit Plans, J. of the AM. SOC. of CLU & ChFC, Jan. 1992, at 66; David E. Weiss, The
Multiple Employer Welfare Benefit Trust, J. of the AM. SOC. CLU & ChFC, May 1990. The determination letter
provides comfort as to form of a trust and ammunition against the IRS in audits. For example, the VEBA
regulations prohibit a VEBA from containing a deferred compensation benefit. Once a VEBA receives a favorable
determination letter, and is operated accordingly, the benefits described therein [including severance] should be
immune from attack as deferred compensation. The IRS letter does not, however, provide any guidance on the
amount of a deduction.

98 John J. Koresko, supra note 14.
99 EMPLOYEE FRINGE AND WELFARE BENEFIT PLANS §9.2 (2002); Cynthia Shupe, Current VEBA and Welfare Plan
Funding Issues, SF72 ALI-ABA 583, 585 (2001).
101 See infra Part II.C.1.
102 See infra Part II.C.2.
103 See infra Part II.C.3.
104 See infra Part II.C.4.
105 See infra Part II.C.5.
106 See infra Part II.C.6.
The first 501(c)(9) trait can be characterized as three elements: (i) an association; (ii) voluntary membership; and (iii) members who are employees. First, a VEBA can be organized as a trust, corporation, or an unincorporated organization treated as a corporation. Second, the Regulations provide that an association is voluntary if an affirmative act is required on the part of an employee to become a member. An association is still considered voluntary although membership is required of all employees, provided employees do not incur a detriment as the result of membership in the association. The third subpart of the organizational tests is satisfied if the VEBA is controlled (i) by its membership, (ii) by independent trustee(s) (such as a bank), or (iii) by trustees or fiduciaries at least some of whom are designated by, or on behalf of, the membership. An organization is deemed controlled by independent trustees if it is an "employee welfare benefit plan," as defined in section 3(1) of the Employee Retirement Income Security Act of 1974 ("ERISA"), and, as such, is subject to the requirements of Parts 1 and 4 of Subtitle B, Title I of ERISA. To qualify as a VEBA, an organization must have more than one member employee.

2. Complete description of benefits offered.

VEBAs are subject to the documentation requirements of ERISA, which requires a written plan document that is sufficiently complete so that for each benefit offered, a reader can determine which persons are eligible recipients, what conditions trigger the payment or distribution of the benefit, whether and to what extent employees are offered the benefit upon different conditions and

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108 Regs. § 1.501(c)(9)-2(c)(1).
109 Regs. § 1.501(c)(9)-2(c)(2).
110 *Id.*
111 Regs. § 1.501(c)(9)-2(c)(3).
112 Under ERISA section 3(1), the term "employee welfare benefit plan" means any plan established or maintained by an employer or by an employee organization, for the purpose of providing for its participants or their beneficiaries, the following types of benefits through the purchase of insurance or otherwise: medical, surgical, sickness, disability, death, or unemployment.
113 *Id.* The Internal Revenue Service ("IRS") attacked a VEBA with a "friendly" trustee in Lima Surgical Associates, Inc. Voluntary Employees' Beneficiary Plan Trust v. U.S., 20 Cl. Ct. 674 (1990), aff'd, 944 F.2d 885 (Fed. Cir. 1991). Although the trustee was a national bank, the IRS alleged that the cooperative relationship between the employer and the trustee negated the requirement of independence. *Id.* The Lima Court rejected the IRS' argument because of the employer's lack of actual control of the bank, and the association's literal compliance with the statutory language of §501(c)(9) and the IRS' own guidelines. *Id.* See *Exempt Organizations Handbook*, § 950 (CCH reprint 1982) ("A financial intermediary . . ., acting in a fiduciary capacity, will generally be considered an independent trustee").
114 Rev. Rul. 85-199, 1985-2 C.B. 163. A VEBA must by necessity meet this requirement in order to qualify as a multiple-employer VEBA pursuant to section 419A(f)(6) (not more than 10% of the regular contributions to the trust can be attributable to a single employer). This can be contrasted with the plan described in Rev. Rul 85-199. In the Revenue Ruling, the association had one member because it was formed only for that employer's employee so that no one else participated. In GCM 39284, Chief Counsel of IRS opined that a multiple employer VEBA should be governed by rules similar to those applicable to more-than-one-employer pension plans, as described in Code §413(c). That statute, at §413(c)(1) and (2), provides that for purposes of determining participation and whether the plan meets the "exclusive benefit" test, all employees of all other participating employers are deemed employees of a given employer. Thus, the VEBA in which any employee participates cannot be deemed to benefit only a key employee. The VEBA benefit structure adopted by an employer cannot, by operation of the statute and the interpretation recommended by the Internal Revenue Service, be equated with the structure assailed in Rev. Rul. 85-199.
how the amount of the benefit is calculated or determined. Moreover, as a condition for exempt status, IRS Regulations require the sponsor of a VEBA to submit Form 1024, which includes a full description of the benefits available under the VEBA document. Eligibility and benefits must be set forth, and the benefits must be sufficiently described so that each benefit is definitely ascertainable. A benefit is said to be definitely ascertainable if the amount of the benefit, its duration, and the persons eligible to receive it can be determined by reference to the plan document itself.

3. Composition of membership.

A VEBA must have a membership of individuals who have an employment-related common bond. The employment-related common bond requirement may be satisfied by defining membership by reference to a common employer, affiliated employers, a labor union, one or more collective bargaining agreements, or employers in the same line of business in the same geographic locale. The Deficit Reduction Act of 1984 added section 419A(f)(6) to the Code, which specifically recognizes the existence of multiple-employer VEBAs. Moreover, Reg. section 1.501(c)(9)-2(a)(1) states that "employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to share an employment-related common bond."

The IRS at one time mandated that employers also be in the same geographic locale. The IRS considered employers to be in the same geographic locale if they were located in the same state, metropolitan statistical area or consolidated metropolitan statistical area. This geographic limitation was sternly rejected by the United States Seventh Circuit Court of Appeals in Water Quality Ass'n Employee's Benefit Corp. v. U.S.

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115 ERISA §§ 101(a) and 503. See also, IRS Pub., 501(c)(4), 501(c)(9), and 501(c)(17) -- Employees' Associations.
116 IRS FORM 1024; IRS Pub., 501(c)(4), 501(c)(9), and 501(c)(17) -- Employees' Associations.
117 Id.
118 I.R.C. § 1.501(c)(9)-2(a)(1); IRS Pub., 501(c)(4), 501(c)(9), and 501(c)(17) -- Employees' Associations.
119 IRS Pub., 501(c)(4), 501(c)(9), and 501(c)(17) -- Employees' Associations.
121 I.R.C. § 1.501(c)(9)-2(a)(1).
122 Exempt Organization Handbook, § 932 (CCH reprint 1982); see also General Counsel Memorandum ("GCM") 39817, 1990 IRS GCM LEXIS 10. IRS Chief Counsel has also opined that a geographic region can include parts of contiguous states if a standard metropolitan statistical area ("SMSA") extends so far. GCM 39817, p. 29. The IRS asserted that geographic limitations on membership prevent VEBAs from circumventing unrelated business income tax otherwise applicable to commercial insurance carriers. 46 Fed. Reg. 1719, 1720, 1981-1 CB 338, 339. After emphasizing the IRS' strict interpretation of the geographic locale restriction, the Chief Counsel conceded that even where a trust operates in a region extending beyond state borders, like the Mississippi Delta (cotton industry), the Pacific Northwest (fishing industry), and the Midwest (grain industry), there is some "theoretical merit" to considering such regions as geographic locales for purposes of the VEBA rules. However, there must clearly be a strong employment-related common bond among the members to negate the insurance company attributes. GCM 39817, 1990 IRS GCM LEXIS 10, p. 31.
123 795 F.2d 1303, 86-2 USTC ¶ 9527 (7th Cir. 1986).
124 795 F.2d 1303, 86-2 USTC ¶ 9527 (7th Cir. 1986). The trust was used to fund an insurance program, which allowed employees of members to purchase group life, health and disability insurance at a decreased cost. Id. The trust at no time underwrote the insurance coverage, but appointed a commercial insurer to do the underwriting. The
for the benefit of members of the Water Quality Association ("WQA") and their dependents. After an exhaustive analysis of the legislative history surrounding section 501(c)(9) and other provisions enacted contemporaneously, the Seventh Circuit found the geographic locale restriction advanced by the IRS to be an unreasonable interpretation of section 501(c)(9). Although the Water Quality decision is binding in the area of the Seventh Circuit - Illinois, Indiana and Wisconsin - the case is persuasive elsewhere. Disturbingly, in its official literature, the IRS has not abandoned its position on this issue and has announced its intention to litigate to enforce the geographic locale restriction in other jurisdictions.

4. Qualifying benefits.

That the quintessential element of a § 501(c)(9) tax-exempt VEBA is the commonality of interests among its members is not disputed. An association of unrelated individuals scattered throughout the country plainly would not fall within the scope of § 501(c)(9) though its membership is comprised entirely of employees because there is no "employment related common bond" among such individuals . . . . But by the same token the relatedness among a group of employees is neither established nor dissipated depending upon the geographic locale of the group's members.

Unlike the commonality associated with labor union membership, a common employer or employment in the same line of business, geography alone has no reasonable or logical relation to establishment of an "employment-related" bond; rather, the Secretary's "same geographic locale" requirement for certain VEBAs may be likened to an organization whose membership is based on the national origin or religious affiliation of its members; in both cases, the employment status of the individual members is irrelevant. We therefore join in the district court's skepticism of and reject the government's assertion that employees who work for employers located in the same geographic area are likely to have "something employment related in common"; "[i]t is not clear why living in a similar locality renders two employees of different employers somehow more related in their employment than they would be if employed in different localities."

* * *

We therefore conclude that the Secretary's distinction among VEBAs based on geography is unreasonable and that it impermissibly excludes VEBAs that the statute otherwise exempts.

Water Quality Ass'n Employees Benefit Corp. v. U.S., 86-2 USTC ¶ 9527 at 85,132-3. Since the Seventh Circuit struck down the geographic locale restriction, there have been no other reported decisions on the issue. However, attacks on alleged VEBAs based on geographic locale have been conspicuously absent in other cases. See, e.g., American Association of Christian Schools Voluntary Employees Beneficiary Association Welfare Trust v. U.S., 663 F.Supp 275 (M.D. Ala. 1987), aff'd 850 F.2d 1510 (11th Cir. 1988). (association covered 1,000 members in all 50 states; IRS attacked VEBA on the basis of control, not geographic locale).
VEBAs can provide life, sick, accident and other benefits to members, their dependents and designated beneficiaries.\(^{128}\) Typically, life benefits, severance benefits, and sickness, accident, and disability benefits are provided by a Veba.\(^{129}\)

Life benefits are benefits payable on the lives of a member or a member's dependents.\(^{130}\) In addition to the express provisions in the regulations permitting certain types of permanent insurance benefits, the IRS Chief Counsel announced "a refinement of the prohibition on employer-funded permanent life benefits" in GCM 39440, 1985 IRS GCM LEXIS 116.\(^{131}\) The Chief Counsel noted, however, that the prior prohibitions on permanent benefits (and thus, the revised guidelines) only applied to whole-life policies purchased from life insurance companies and that "[t]he prohibition has not been effective with respect to the pre-funding of life insurance on a self-insured basis nor with respect to the pre-funding of other Veba benefits."\(^{132}\) When one considers the foregoing with

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\(^{128}\) Regs. § 1.501(c)(9)-3(a). Dependents include a member's spouse, his or her minor children, children who are students, any other minor children living with the member, and any other individual who an association, relying in good faith on information furnished by a member, believes is a member. Id. Substantially all of a Veba's operations must be in furtherance of providing qualifying benefits, but non-qualifying benefits can be provided in de minimus amounts. Id. See generally Cynthia Shupe, Current Veba and Welfare Plan Funding Issues, SF72 ALI-ABA 583, 585 (2001); IRS Pub., 501(c)(4), 501(c)(9), and 501(c)(17) -- Employees' Associations.


\(^{130}\) Regs. § 1.501(c)(9)-3(b). The regulations permit the payment of benefits that are either furnished pursuant to a contract of insurance with a life insurance company or paid directly by the Veba. Id. According to the regulations, "life benefits" generally must consist of current protection only. Id. There are three exceptions to this rule in the regulations. First, continuation coverage is permitted after termination of membership in the association. Id. Second, a Veba can provide permanent insurance in accordance with the regulations under section 79 of the Code. Id. Finally, an employee-funded organization can offer life benefits that involve permanent benefits. Id. Where permanent benefits are allowed, cash surrender and policy loan benefits are permitted as these are commonly provided in permanent life insurance contracts. Exempt Organizations Handbook, § 962 (CCH reprint 1982). A pension, annuity contract or similar benefit is not a "life benefit," although a Veba can pay a death benefit in the form of an annuity, rather than a lump sum. I.R.C. § 1.501(c)(9)-3(b). See generally Cynthia Shupe, Current Veba and Welfare Plan Funding Issues, SF72 ALI-ABA 583, 585 (2001).

\(^{131}\) The GCM considered a request from the Exempt Organizations Technical Division for guidance on the propriety of including employer-funded, non-section 79 permanent life benefits in a Veba. GCM 39440, 1985 IRS GCM LEXIS 116. Approximately 70 VEBAs including such benefits were awaiting determinations upon their exempt status at the time of the GCM. Id. at 8. In view of changes in the law and the increasing appearance of term policies with features economically similar to whole-life policies, Chief Counsel recommended approval of non-section 79 whole life benefits meeting the following guidelines: (1) the policies must be owned by the Veba; (2) the policies must be purchased through level premiums (i.e., level employer contributions) over the expected lives or working lives of the individual members; and (3) the cash values or investment portions of the policies must accrue to the Veba. Id. at 10-11.

\(^{132}\) Id at 9. Such a conclusion of law invites an inquiry as to whether there are any limitations on deductions for the self-insured portion of the life benefit in the context of multiple-employer VEBAs. The answer may lie in the following statement by Chief Counsel:

"[T]he basis for precluding employer-funded permanent life benefits in a Veba was to compensate, through the Veba qualification rules, for the absence of meaningful deduction limits on employer contributions (i.e., the deduction-inclusion mismatch). However, the Tax Reform Act of 1984 (Pub.L.No.98-369) enacted § 419A, which provides rules for reserves for life insurance benefits . . . . These rules also contain meaningful deduction limits. Thus, for years beginning after December 31, 1985, the raison d'être for prohibiting employer-funded permanent life benefits will no longer exist."

GCM 39440, at 8-9.
the specific exclusion from the deduction limits of section 419A given by Congress to multiple-employer VEBAs, section 419A(f)(6), there certainly appear to be no deduction limitations on the self-insured portion of a life benefit offered by a multiple-employer VEBA.133

Certain severance benefits are among the "other benefits" which the Regulations permit a VEBA to offer.134 However, a severance benefit cannot be a pension benefit, or a form of deferred compensation that becomes payable by reason of the page of time, rather than as a result of an unanticipated event.135 Permissible severance benefits are defined by reference to 29 CFR section 2510.3-2(b), a labor law provision that distinguishes a severance pay plan from a pension plan for purposes of Title I of ERISA.136 The labor regulations provide that a severance pay arrangement

In §419A(f)(6), the available deduction under the Code is unaffected by whether a plan is funded with insurance or self-funded, except to the extent self-funding would indicate the presence of experience-rating. Use of insurance policies, however, eliminates any potential unrelated business income that might be taxable under §512. The more problematic issue is ERISA §514, which applies to multiple-employer welfare arrangements ("MEWAs"). A MEWA that self-funds its benefits may be regulated as a de facto insurance company under state law. If the MEWA is fully-insured, the degree of state regulation is quite limited. Ergo, designers of §419A(f)(6) arrangements have almost uniformly opted for the fully-insured model.

Moreover, Congress apparently decided not to limit the exclusion of § 419A(f)(6) to self-insured plans only; the exclusion from the deduction limits applies to all qualifying multiple-employer plans. One can reasonably conclude, therefore, that the level premium requirement of GCM 39440 should not apply to multiple-employer VEBAs, which choose to fund with commercial insurance policies. Since Congress enacted an exemption from the deduction limits, and the IRS' prohibition on permanent insurance was intended "to compensate, through the VEBA qualification rules, for the absence of meaningful deduction limits," GCM 39440 at 8, it would appear that Congress has vitiated IRS' authority to indirectly limit the Congressional exemption for multiple -employer VEBAs through any restrictions on permanent insurance, including the limitation in GCM 39440 which purports to limit non-section 79 permanent life benefits to those purchased through level premiums. In light of the enactment of § 419A(f)(6) in 1984, the prohibition on permanent life insurance in found in I.R.C. § 1.501(c)(9)-3(b) (promulgated in 1981) may now be invalid in the context of multiple-employer plans. The regulation is no longer "a substantially contemporaneous construction of § 501(c)(9)." National Muffler Dealers Association, Inc. v. United States, 440 U.S. 472, 477 (1979). As the Seventh Circuit observed in Water Quality, supra note 1:

the Secretary has no power to change the language of the revenue statutes because he thinks Congress may have overlooked something. United States. v. Calamaro, 354 U.S. 351, 359 ("We cannot but regard this Treasury Regulation as no more than an attempted addition to the statute of something which is not there."); Bates v. United States, 581 F.2d 575, 579 (6th Cir. 1978) ("[R]egulations may not be used to supply supposed omissions in a revenue act or to enlarge the scope of a statute . . . . Nor may a regulation be used to alter or amend a statute by prescribing requirements which are inconsistent with its language.")
shall not constitute a pension plan solely by reason of payment on account of the termination of an employee's services, provided that:

(i) Such payments are not contingent, directly or indirectly, upon the employee's retiring;

(ii) The total amount of such payments does not exceed the equivalent of twice the employee's annual compensation during the year immediately preceding the termination of his service; and

(iii) All such payments are completed within 24 months after termination of the employee's service.\(^{137}\)

Sickness, accident, and disability benefits are also typically provided by a qualifying VEBA with benefits computed by reference to a uniform percentage of compensation.\(^{138}\) These benefits are specifically permitted in the regulations.\(^{139}\)


A VEBA must meet the nondiscrimination requirement of section 505(b) with respect to: (i) form of the plan; (ii) operation; and (iii) termination.\(^{140}\) If it does not, it will not qualify for tax exemption under section 501(a).

With respect to the form of the plan, section 505(b)(1) provides that a VEBA will be exempt only if each class of benefits under the VEBA is provided under a classification of employees that is set forth in the plan and does not discriminate in favor of highly compensated employees, and as to each class of benefits, such benefits do not discriminate in favor of highly

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\(^{137}\) 29 C.F.R § 2510.3-2(b).


\(^{139}\) Regs. § 1.501(c)(9)-3(c); IRS Pub., 501(c)(4), 501(c)(9), and 501(c)(17) -- Employees' Associations; Committee Report on Pub. L. No. 98-369, reprinted in CCH Standard Federal Tax Reports ¶ 3098.02 (1989).

\(^{140}\) IRS Pub., 501(c)(4), 501(c)(9), and 501(c)(17) -- Employees' Associations.
compensated individuals. Furthermore, certain employees can be excluded from consideration when testing for nondiscrimination, including employees who: (i) do not have 3 years of service with the employer; (ii) are not over the age of 21; (iii) are seasonal or less than half-time employees; (iv) are part of certain collective bargaining agreements; or (v) are certain nonresident aliens.

With respect to operation of the plan, under section 505, a plan is discriminatory in operation if operating the plan has the effect of discriminating in favor of highly compensated employees with respect to a class of benefits, regardless of nondiscriminatory language in the plan documents. In testing for discrimination in operation, the IRS relies almost exclusively on facts and circumstances.

Similar to “operation”, a plan is discriminatory upon “termination” if it violates section 505(b) or Reg. section 1.501(c)(9)-2(a)(2). It is clear that these sections would not be violated if the trust distributed plan assets to participants in proportion to compensation, or in accordance with eligibility for severance benefits, or pro-rata based on entitlement to overall benefits. The Regulations permit distributions upon plan termination provided that they are made on the basis of objective and reasonable standards which do not have the effect of giving a disproportionate amount of the assets to highly compensated employees.

IRS Pub., 501(c)(4), 501(c)(9), and 501(c)(17) -- Employees' Associations. A life insurance, disability, or severance pay plan is not discriminatory merely because the benefits bear a uniform relationship to total compensation of employees covered by the plan. However, the amount of compensation used to determine benefits cannot exceed $150,000 adjusted for cost of living increases in accordance with section 415(d).

§ 505(b)(7).

§505(b)(2); IRS Pub., 501(c)(4), 501(c)(9), and 501(c)(17) -- Employees' Associations.

§505; IRS Pub., 501(c)(4), 501(c)(9), and 501(c)(17) -- Employees' Associations.

Regs. § 1.501(c)(9)-2(a)(2); IRS Pub., 501(c)(4), 501(c)(9), and 501(c)(17) -- Employees' Associations. Prior to the enactment of § 505(b) in 1984, VEBA's were subject to general nondiscrimination rules contained in regulations § 1.501(c)(9)-2(a)(2). While a VEBA can restrict eligibility for membership or benefits based upon objective criteria, the criteria cannot be selected or administered in a manner that limits membership or benefits to officers, shareholders, or highly compensated employees. Eligibility for benefits cannot have the effect of providing officers, shareholders or highly compensated employees with disproportionate benefits. The criteria cannot be selected or administered in a manner that limits membership or benefits to officers, shareholders, or highly compensated employees generally is to be determined on the basis of all the facts and circumstances.

§505(b); Regs. § 1.501(c)(9)-2(a)(2).

cf. GCM 39818; Joel A. Schneider, M.D., S.C., 63 T.C.M. (CCH) 1787 (1992).

Regs. § 1.501(c)(9)-4(c). The VEBAs termination distribution mechanism is not substantially different from that approved in Private Letter Ruling 8925091 (3/30/89). Although not usable as precedent, that PLR is enlightening. It held that a distribution of VEBAS assets at termination of the plan did not constitute private inurement although it was allocated among employees based upon cumulative salary credits for each year of participation in the plan, leading to the conclusion that highly compensated employees with long service would benefit most from the distribution. Notwithstanding, the Service found this method to be an objective and nondiscriminatory formula that did not provide disproportionate benefits to officers, shareholders, or highly compensated employees. Because the Service has equated the private inurement argument with the deferred compensation argument, the PLR should also indicate that no deferred compensation was present. Consequently, it would seem that similar treatment should attach to a VEBA.
6. Earnings must be for payment of benefits to participants.

No part of the net earnings of a VEBA (other than the payment of benefits provided by the plan) may inure to the benefit of any private shareholder or individual. The payment of a benefit enumerated in the plan may constitute private inurement if done disproportionately. The payment of benefits, which differ in kind or amount to similarly situated employees will not constitute inurement if the benefits are paid pursuant to objective and reasonable standards. Whether prohibited inurement has occurred is a question to be determined with regard to all of the facts and circumstances. According to Chief Counsel, prohibited inurement arises when a VEBA serves the use or benefit of an individual other than through the proper performance of functions characteristic of organizations described in section 501(c)(9). While an organization may provide benefits to promote the common welfare of employees consistent with section 501(c)(9), tax-exempt status will be denied if an organization is predominantly organized and operated to promote the interest of an individual standing in relationship to the organization as an investor for private gain.

D. Deduction of Contributions to Welfare Benefit Plans under IRC §419

1. Introduction

The IRS raised the issue of plan termination in Booth v. Commissioner, 108 T.C. 524, 564 (1997). The Service argued that the dismissal wage benefits in that case were deferred compensation because an employer could voluntarily terminate its participation in the multiple employer plan. The Tax Court was unable to find any statutory or regulatory provisions that limit welfare benefit treatment to those cases in which an employer cannot voluntarily terminate participation in a plan. Although the IRS was concerned that the ability of an employer to voluntarily terminate its participation allows the employer to control the timing of income to its employees, the Court regarded that concern as “misplaced.”

Regs. § 1.501(c)(9)-4(a).

Regs. § 1.501(c)(9)-3(e).

Id.

Id.

Id.

GCM 39818, at 18. In GCM 39818, the Chief Counsel considered seven VEBAs operated by professional corporations. All of the VEBAs based their life, disability and severance benefits on a uniform percentage of compensation. Moreover, on termination the assets of the VEBAs were distributed based on a uniform percentage of compensation. Not surprisingly, Chief Counsel opined (1) that the benefits, although based on a uniform percentage of compensation, constituted private inurement; (2) that the distribution of assets on termination based on a uniform percentage of compensation did not constitute deferred compensation unless the VEBA were characterized as a private investment fund under a theory of private inurement; and (3) the use of a uniform percentage of a participant's compensation constitutes a permissible restriction on eligibility for benefits. But see, Joel A. Schneider, M.D., S.C., 63 T.C.M. (CCH) 1787 (1992). (the mere retention by the employer of a right to terminate the plans did not make VEBAs illusory, and thus tantamount to private investment vehicles, so the critical inquiry becomes “whether the funds in the plan may ever revert to or inure to the benefit of the company), citing Greensboro Pathology Associates, P.A. v. United States, 698 F.2d 1196 (Fed. Cir. 1982); Moser v. Commissioner, T.C. M. (CCH) 1989-142, aff’d. as to other issues 914 F.2d 1040 (8th Cir. 1990); Wade L. Moser, 56 T.C.M. (CCH) 1604 (1989). (Tax Court rejected the IRS' argument that the employer retained control over the amounts contributed under the plan through its ability to effect amendments or termination of the plan because "several provisions in the plan documents clearly prohibit[ed] the reversion of any funds to the employer" and the Veba was operated in accordance with those plan provisions).

Id.
Congress enacted IRC sections 419 and 419A in 1984 to curtail current deductions for amounts contributed to welfare benefit plans that could be used to pay future, rather than current, benefits. In addition, Congress also enacted Section 512(a)(3)(E) to subject VEBA income to the unrelated business income tax ("UBIT") to the extent that funds allocated to the VEBA exceeded established limits for disability, life, health, SUB, and severance benefits. Congress did not forget about non-VEBA arrangements in enacting the new statutory scheme. UBIT was also extended to non-VEBA welfare benefit funds in a very interesting way. Employers (not the trust) are now taxed on deemed UBIT, at the employer's rate. Taxes paid by the employers are deductible as a contribution to the welfare benefit fund only to the extent otherwise permitted by section 419. Without a doubt, the interaction of these provisions established a barrier to funding welfare benefit plans of any type.

2. General Section 419 Limits on Contributions

Contributions paid or accrued by an employer to an employee welfare benefit fund are deductible only if "they would otherwise be deductible" under some provision of the Code. Reg. Sec. 1.162-10(a) clearly states that a deduction is permitted for a contribution to a welfare benefit plan, provided the amount is ordinary and necessary. The contribution is generally deductible in the taxable year in which it is paid. According to the statute, the limitation on the amount of the deduction is the "qualified cost" for the fund's taxable year that relates to the employer's taxable year. The qualified cost consists of two components: the "qualified direct cost" ("QDC") plus an addition to the "qualified asset account" ("QAA") allowed under §419A(b).

The QDC is the aggregate amount that would have been allowed as a deduction to the employer with respect to benefits provided during the taxable year if (1) the employer had provided the benefits directly, and (2) the employer had used the cash method of accounting. QDC includes insurance coverage for such year. It also includes administrative expenses incurred by the fund to deliver the benefits for such year. According to the DERFA legislative history, QDC also includes insurance premiums. The Treasury Department conveniently forgot this instruction when it

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155 Shupe, supra note 11, at 588.

156 Shupe, supra note 11, at 588.

157 §419A(g)(1), (2).

158 Shupe, supra note 12, at 588.

159 EMPLOYEE FRINGE AND WELFARE BENEFIT PLANS §9.2 (2002); Shupe, supra note 13, at 590-91.

156 Either I.R.C. §162 (trade of business expense) or § 212 (production of income) provide authority for the deduction. EMPLOYEE FRINGE AND WELFARE BENEFIT PLANS §9.2 (2002); 7 MERTENS LAW OF FEDERAL INCOME TAX'N §25E:36.105 (2002).

155 See also 7 MERTENS LAW OF FEDERAL INCOME TAX'N §25E:36.105 (2002); Shupe, supra note 14, at 588.

156 See also 7 MERTENS LAW OF FEDERAL INCOME TAX'N §25E:36.105 (2002); Shupe, supra note 15, at 588.

155 See also 7 MERTENS LAW OF FEDERAL INCOME TAX'N §25E:36.105 (2002); Shupe, supra note 16, at 588.


156 Regs. § 1.419-1T(A-6)(a). The regulation contains a confusing citation to §264. See also 7 MERTENS LAW OF FEDERAL INCOME TAX'N §25E:36.105 (2002).

drafted its first set of temporary regulations. A benefit is deemed provided when the benefit would have been includable in the income of the employee (but for provisions in Chapter 1, subtitle A of the Code which exclude the benefit from gross income).\footnote{\textsection 419(a)(3)(B). See also Shupe, supra note 17, at 588-89.}

The QAA for a welfare benefit consists of the assets set aside for the payment of disability, medical, supplemental unemployment benefits ("SUB"), severance, or life insurance benefits.\footnote{\textsection 419A(a). Section 419A(f)(3) defines "life insurance benefit" to include "any other death benefit." See also Shupe, supra note 18, at 589.} The deductible amount of an addition to the QAA is limited to amount estimated to be necessary (under reasonable actuarial assumptions) to fund the liabilities of the plan for the amount of claims incurred but unpaid (as of the close of the tax year) for the types of benefits provided by the plan, plus administrative costs.\footnote{\textsection 419A(c)(1).}

3. Deduction of Contributions to VEBAs

Pursuant to IRC section 162(a), businesses may deduct “ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.”\footnote{IRC \textsection 162(a); see also John Simmons, A Guide to Evaluating a Proposed Section 419A(F)(6) Plan, 14 No. 4 PRAC. TAX L. 17 (2000).} However, under established case law, the taxpayer business must prove that the business expense: (1) was paid or incurred during the taxable year; (2) was for carrying on his, her, or its trade or business; (3) was an expense; (4) was a necessary expense; and (5) was an ordinary expense.\footnote{See Commissioner v. Lincoln Savs. & Loan Association, 403 U.S. 345, 352, 29 L. Ed. 2d 519, 91 S. Ct. 1893 (1971); Commissioner v. Heininger, 320 U.S. 467, 475, 88 L. Ed. 171, 64 S. Ct. 249 (1943); Welch v. Helvering, 290 U.S. 111, 115, 54 S. Ct. 8, 78 L. Ed. 212 (1933). Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances. S. B. Heininger, 320 U.S. 467 (1944).} Certain contributions made by businesses to fund welfare benefit plans can be deductible business expenses under \textsection 162 of the IRC.\footnote{See Commissioner v. Heininger, 320 U.S. 467 (1944).}

Welfare benefit plans, which are often structured as either nondiscriminatory VEBAs\footnote{There is little authority governing the deductibility of an employer's contribution to an employee benefit plan, such as a Veba. The primary authority is found in Regs. \textsection 1.162-10(a):} or taxable trusts, often offer life insurance and/or severance benefits to participants. The plans are generally intended for use by many unrelated employers, and are thus referred to as multiple employer plans. The plans are often designed to fit within one of the exceptions to severe deduction limitations otherwise contained in sections 419 and 419A of the Internal Revenue Code, discussed \textit{supra} in the previous subsection. These limitations and the exceptions were

\footnote{\textsection 501(c)(9) and 505 as exempt organizations.}
both enacted by Congress in the Deficit Reduction Act of 1984. If the exception applies, employers can apparently take large deductions, sometimes hundreds of thousands of dollars annually, in the manner available to taxpayers in years prior to the Deficit Reduction Act of 1984.175 Aside from pre-funding benefit costs and the inherent opportunities for tax minimization in a given year, the plans offer employers the ability to deduct the cost of permanent life insurance for employees with nominal current tax consequence to those employees. If properly structured, these plans offer the ultimate in tax advantages: current deductions and a source of family wealth that is income tax free (sec. 101(a)) and potentially estate tax free.

The IRC sections 419A(f)(5) and 419A(f)(6) contain three statutory exceptions to the deduction limitations to provide favorable tax treatment to the following specified plans: (i) union plans; (ii) fifty or more employee-pay-all plans; and (iii) ten or more employer-plans. A properly structured VEBA can qualify as a ten or more employer plan ("TOME") that is entitled to the favorable tax treatment set forth in section 419A(f)(6). 176 Section 419A(f)(6) contains three requirements: (i) no single employer that regularly pays greater than ten percent (10%) of the annual contributions to the plan;177 (ii) the welfare benefit fund cannot maintain experience-rating arrangements with individual employees;178 and (iii) the plan must be a single plan and not a collection of individual plans.179

The legislative history in connection with section 419A(f)(6) gives little guidance with respect to Congress' intent with respect to satisfying the above requirements. The Conference Committee Report states the following:

10 or more employer plans. -- For a plan year in which no employer (or employers related to an employer) are [is] required to contribute more than 10 percent of the total contributions, the conference agreement provides that the deduction limits to do not apply. The exclusion is provided because under such a

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176 The term "10-or-more employer plan" is defined by § 419A(f)(6), which provides as follows: (6) Exception for 10-or-More Employer Plans. -- (A) In general. -- This subpart [i.e., the rules of subpt. D that generally limit an employer's deduction for its contributions to a welfare benefit fund to the amount that would have been deductible had it provided the benefits directly to its employees] 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 that 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.

177 I.R.C. § 419A(f)(6).
plan, the relationship of a participating employer to the plan is often similar to the relationship of an insured to an insurer...

The agreement provides however, that notwithstanding 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 that an insured to an insurer.\(^{180}\)

Again, the principal benefit of classification as a 10-or-more employer plan is that an employer that contributes to the plan is not subject to the deduction limitations of sections 419 and 419A.\(^{181}\) Consequently, pre-1985 law as applied to individual VEBAs would define the amount of a contribution, which is deductible by a contributing employer in a given year. In many cases, the allowable deductions under pre-1985 law vastly exceeded the amount that would be allowed if sections 419 and 419A applied to a particular plan.

4. Taxation of VEBA Benefits.

Most VEBA benefits are taxable to the beneficiary when they become non-forfeitable.\(^{182}\) If benefits are forfeitable, that is, contingent on some event not within the employee's control, such as involuntary unemployment, income will not be realized until payments are made by the section 501(c)(9) trust.\(^ {183} \) Additionally, VEBA benefits are excludable from income when paid to the recipient (or when they become non-forfeitable), to the extent exclusions exist in the Code for certain payments.\(^ {184} \) Severance benefits are generally taxable when received, especially when the trust instrument provides for denial of benefits under certain conditions.\(^ {185} \)

In general, the IRS would argue that non-vested life insurance benefits provided by an employer are currently taxable to an employee only to the extent of the current reasonable economic benefit of the life insurance protection.\(^ {186} \) The IRS has specifically declined, though,\(^ {186} \)...

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\(^{181}\) I.R.C. § § 419, 419A (which comprise the "subpart" of the Code referred to in § 419A(f)(6)). See generally Fed. Tax Coordinator ¶H-4154 (2002); Thornhill, supra note 9, at 257-58.

\(^{182}\) I.R.C. § 83(a).

\(^{183}\) See Exempt Organizations Handbook, § 984 (CCH reprint 1982).

\(^{184}\) See, e.g., I.R.C. § 105 and regulations thereunder relating to exclusions for medical and disability benefits; I.R.C. § 127 educational expense reimbursements.

\(^{185}\) In GCM 39818, Chief Counsel determined that severance benefits which were not assured to members, but were contingent upon a bona fide termination of employment for reasons other than cause or retirement, were not deferred compensation; it is implicit in such finding that the benefits were substantially non-vested and thus not currently taxable. See I.R.C. § 1.83-3(b); See also Schneider, 63 T.C.M. (CCH) 1787 (1992). (severance benefits not taxable until benefits are provided).

\(^{186}\)Regs. § 1.81-1(a)(2); GCM 39818; GCM 39440. A similar result ensues if the life insurance arrangement is intended as a section 79 plan. The taxation of life insurance provided by a VEBA is unclear. Analogy may be made to the tax consequences of life insurance provided by a qualified pension or profit sharing plan exempt pursuant to § § 401(a) and 501(a). An employee realizes income each year for the cost of the current insurance protection generated by the plan. However if the employer would have provided this coverage in the form of a whole life policy in any event, the income is not the entire premium paid by the plan, but only the term or P.S. 58 cost which can be used to offset the amount of
to give guidance on this point. IRS has also continued to give general guidance as to whether distributions of death benefits from a self-funded plan are excluded from gross income under section 101(a) of the Code, although the case law and Chief Counsel agree that section 101(a) should apply. In Technical Advice Memorandum 200002030, IRS advised that a death benefit from a self-funded VEBA would be eligible for §101(a) treatment so long as the plan benefit satisfied the definition of insurance under §7702. There is no reason why a death benefit from a fully-insured VEBA should be denied §101(a) treatment.

III. LEADING CASES AND IRS RULINGS

A. Tax Court rulings

1. Booth v. Commissioner: Contributions to TOME Plans

For several years, practitioners interested in the future of multiple-employer VEBAs and other welfare benefit plans waited somewhat anxiously for the Tax Court's decision in Booth v. Commissioner ("Booth"). Booth was the lead case in a series of test cases brought by IRS against employers who adopted the Prime Financial Benefits Trust Multiple Employer Welfare Benefit Plan and Trust ("Prime Plan"). The Prime Plan was designed to be a multiple employer welfare plan which would fit the definition of a TOME pursuant to Internal Revenue Code §419A(f)(6). Prime offered two types of welfare benefits: Dismissal Wage Benefits

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proceeds includable at death. The result is the same if the employee owns the policy, or the trust owns the policy, but the trustee must turn over all the proceeds to the employee's beneficiary. Upon death, such a policy is taxed to the estate of the decedent to the extent of cash value as a plan distribution; the excess of the death benefit over cash value is tax-free.

There are two important exceptions to these rules. If the policy is a key person policy with the proceeds to be retained by the trustee, there are no current income tax consequences to the insured employee. Similarly, the employee is not taxed on the cost of any insurance protection where the proceeds are payable to the trustee, if the trust has a right under any circumstances to retain any part of the proceeds. Regs. § 1.72-16(b)(6); see Rev. Rul 66-138, 1966-1 C.B. 25. If the qualified plan provides for an uninsured death benefit, there also is no P.S. 58 cost income to the employee. The cost of no current taxation is taxation of all proceeds of the policy as a distribution from the qualified plan. Regs. § 1.72-16(c)(4).

187 T.D. 7750, reprinted in Exempt Organizations Handbook, Exhibit 900-1 (CCH reprint 1982); see also Rev. Proc. 89-3, 1989-1 C.B. 761, § 5; Rev. Proc. 89-36, 1989-1 C.B. 309. Presumably, the issue is still open for interpretation. In Ross v. Odom, 66-2 USTC ¶9587 (5th Cir. 1968), the court held that a death benefit payable for the State of Georgia's welfare plan was in the nature of insurance excludable under §101(a). Similarly, in GCM 36969 (12/27/76), the IRS Chief Counsel opined that proceeds paid from a self-funded VEBA qualified under §501(c)(9) would be treated as life insurance exempt under §101(a). Private Letter Ruling 9014068 provides similar guidance.

188 Booth v. Commissioner, 108 T.C. 524 (1997); See generally Koresko, '419' Welfare Benefit Plans Require Careful Drafting to Survive IRS Attack, 3 J. TAX OF EMPLOY. BEN. 147 (Nov./Dec. 1995); Notice 95-34 Represents a Line in the Sand For '419' Plans, 3 J. TAX OF EMPLOY. BEN 223 (Jan./Feb. 1996); VEBAs Can Reduce Taxes and Preserve Wealth, 57 TAXATION FOR ACCOUNTANTS 333 (Dec. 1996); Current Developments in §419 Plans: Don't Call the Coroner Yet, (distributed by the American Society of CLU and ChFC Estate Planning Section during 1995); Life Insurance Answer Book for Qualified Plans and Estate Planning, Chapters 39, 40 (Panel Publishers 1997) (documenting view that Booth would probably be decided adversely to the taxpayers).


190 108 T.C. at 528-29, 561-62. See infra Part II.D.
("DWB") and death benefits. The DWB were payable upon certain terminations of employment, both voluntary and involuntary. The death benefits were payable on death. The benefits were funded with various types of life insurance policies and with tax-free securities.

The Prime Plan exhibited certain notable structural characteristics. First, each employer contributed to the Prime Plan an amount determined by the plan administrator to be necessary to fund benefits. These contributions to the Prime Plan were accounted for separately for each employer. The trust documents for the Prime Plan provided that none of the employer's contributions could be used to pay for benefits of employees of other employers. The trust documents for the Prime Plan also provided that in the event an employer's account did not have sufficient assets to pay the claim of an employee, then the plan trustee had the power to reduce the benefit payable consistent with the amount of assets available in the employer's account. The Prime Plan did, however, maintain a “suspense account.” The suspense account was comprised of experience gains and losses of the Prime Plan as a whole. The suspense account was theoretically available to pay certain claims to the extent an employer's account was short. However, if the suspense account and the employer's individual account were insufficient, neither the Prime Plan nor any other person or entity had any obligation to pay the shortfall in a claim.

The IRS attacked the Prime Plan primarily on the following grounds: (1) the Prime Plan was one of deferred compensation, not welfare benefit; (2) the Prime Plan was not a single plan; and (3) the Prime Plan was experience rated. As a result of the alleged violations of

191 108 T.C. at 528-29.
192 108 T.C. at 534.
193 108 T.C. at 535-36.
194 108 T.C. at 535-36.
195 For additional description of the Prime Plan, see Siske et al., What's New In Employee Benefits: A Summary of Current Case and Other Developments, SC62 ALI-ABA 1, 210 (1998).
196 108 T.C. at 538.
197 108 T.C. at 534 n.9, 538, 572.
198 108 T.C. at 572.
199 108 T.C. at 538, 572.
201 108 T.C. at 538.
202 Id.
203 Id.
204 108 T.C. at 562. It is not surprising that IRS argued that the Prime plan contained elements of deferred compensation. This was the argument raised in Harry A. Wellons, Jr. M.D., S.C. v. Commissioner, 31 F.3d 569 (7th Cir. 1994). The Tax Court held, however, that the Service's reliance on Wellons was misplaced. Wellons involved a severance pay plan that was self-funded. It did not contain a death benefit. The Wellons plan did not exclude retirement from the definition of severance and permitted highly compensated employees to effectuate severance for themselves at their discretion. Relying on the previous Federal Circuit Court decision of Lima Surgical, the Seventh Circuit agreed with the IRS that the Wellons plan displayed sufficient elements of deferred compensation to cause the deductions to be governed by § 404. Harry A. Wellons, Jr. M.D., S.C. v. Commissioner, 31 F.3d 569 (7th Cir. 1994).
205 108 T.C. at 562, 565.
206 108 T.C. at 565. Neither the Code nor Treasury regulations define the term "experience rating." The Supreme Court's decision in American Bar Endowment v. United States, 477 U.S. 105 (1986) (experience rating means that the cost of insurance to the group is based on that group's claims experience rather than general actuarial tables), and the definition of experience rating supplied by Congress in the legislative history to §419 provide some direction. Under the American Bar Endowment test, a plan is not experience-rated if contributions are not
the experience rating and single plan requirements, the IRS denied the deductions claimed by the participating employers because the plan was not qualified under section 419A(f)(6). The Tax Court first confirmed that the Prime Plan intended to provide real welfare benefits, not deferred compensation as argued by the IRS. Judge Laro observed that "all welfare plans have some indicia of deferred compensation." Quite simply, taxpayers may seek to obtain the tax benefits provided by welfare benefit plans. Judge Laro added that the presence of certain features (like severance-type benefits, vesting schedules, benefits measured by length of service and compensation) "were swallowed up by the Prime Plan's valid welfare purpose so as to make the deferred compensation features incidental and meaningless." With respect to the IRS’ claim that deferred compensation existed because the employer retained the right to terminate the plan, Judge Laro concluded:

We are unable to find any requirement in the applicable statutory and regulatory provisions that would limit welfare benefits to cases in which the 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. Although [the IRS] is concerned that the ability of a participating employer to terminate voluntarily its participation in the Prime Plan allows the employer to control the timing of income to its employees, we regard that concern as misplaced . . ., it does not necessarily follow that such a plan provides for receipt of deferred compensation merely because the

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207 108 T.C at 567-77.
208 108 T.C. at 562-63. See also Siske et al., What's New In Employee Benefits: A Summary of Current Case and Other Developments, SC62 ALI-ABA 1, 212 (1998). Essentially, if the Prime Plan were a deferred compensation plan, the employers would have been prohibited by the IRC from claiming a deduction for the contribution until the year in which the contribution was includable as gross income to the employee. Siske supra note 1, at 212. If the Prime Plan was a welfare benefit plan, the employers could deduct an amount equal to that which the employer provided benefits directly to the employees. Id. at 212. Finally, if the employers could take advantage of IRC 419(f)(6), the limitations on deductions would not apply and the employers could deduct the full amount of the contributions even though the employees may not have to include the corresponding amounts in their taxable income. Id. at 212.
209 108 T.C. at 564.
210 108 T.C. at 564. It should be clear that the elements in the Wellons plan are not present in a death benefit plan, or a plan that limits severance to non-key employees and excludes retirement from the definition of severance. Although Wellons was decided correctly, the case is of questionable authority beyond its facts. See generally 108 T.C. at 564.
211 108 T.C 563. The Booth case hopefully put to bed a recurring theme in IRS arguments: that the power to terminate a plan is tantamount to deferred compensation. See Siske et al., What’s New In Employee Benefits: A Summary of Current Case and Other Developments, SC62 ALI-ABA at 213. The Court effectively reiterated its previous holdings in Schneider, 63 TCM 1787 (1992) and Moser, 56 TCM 1604 (1989) that an employer must retain the ability to terminate a plan in order to respond to the changing needs of the employer or its employees. 108 T.C. at 564. Judge Laro reasoned that since the ability of an employer to terminate a pension plan at will does not result in adverse consequences, the same should apply to welfare plans. Id. at 564.
owner/shareholder has the ability to terminate the [plan] at will.\footnote{108 T.C. at 564.}

Without articulating a clear test, Judge Laro appears to be indicating that a “valid welfare benefit purpose” is sufficient to defeat a claim of deferred compensation, even where there are some elements of deferred compensation and even when the employer retains the ability to terminate the plan.\footnote{108 T.C. at 563-64.}

After disposing of the deferred compensation argument, the Tax Court went on the question of whether the Prime Plan was a single TOME plan for purposes of §419A(f)(6).\footnote{108 T.C. at 565.} The Court noted that the TOME must be, in fact, a single plan, and not a collection of individual plans using a common document.\footnote{108 T.C. at 571.} Judge Laro conducted an analysis that substantially resembled an examination under Reg. §1.414(l)-1(b)(1).\footnote{108 T.C at 571-73. The Court in \textit{Booth} made no reference to GCM 39284 or the pension provisions of the Code.} The Judge concluded as a matter of fact and law that the Prime Plan did not make all assets of the trust available for all claims.\footnote{108 T.C. at 570-71.} The judge reiterated that a portion of the plan was not available for the payment of certain claims.\footnote{108 T.C. at 572-73.} The impregnable segregation of the employers' accounts created an amalgamation of separate plans under a single trustee, but did not give rise to a single plan where ten or more employers were contributing to a single pool.\footnote{108 T.C. at 571.} Because the Prime Plan was not a single plan, it was not a TOME.\footnote{108 T.C. at 571.} And since the plan was not a TOME, the deduction limits of §419 and 419A applied.\footnote{108 T.C. at 570-73.} The Court noted:

The fact that [the promoters] structured the Prime Plan to have one administrator, one Trust, and a Suspense Account with some commonality among employers does not change the fact that each of the employers separately had unbridled authority to select many of the relevant terms under which its employees would collect benefits from the Prime Plan, that no Employee Group had a right to any contributions, or earnings thereon, which had been made by any other Employee Group, and that 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.\footnote{Id. at 570-71.}
After concluding that the Prime Plan was not a single plan, the Court tackled the issue of whether Prime engaged in experience rating. Judge Laro apparently rejected the definitions of experience rating suggested by the Supreme Court and Congress, but did look to legislative history. The Judge noted that applying these definitions might cause the Court to reach a result that he felt was inconsistent with the intent of the statute. The Judge opined that the statute referred to "experience-rated arrangements" not just "experience rating." He decided that the concept of "experience-rated arrangement" went far beyond the definitions or "experience-rating" contained in the available authorities. The judge observed that "the essence of experience rating is the charging of employer accounts." Essentially, the Prime Plan was experience rated in that it more mirrored self-funding, rather than an insurance arrangement. An individual employee’s claim could only be satisfied out of the employer’s account and the employee had no recourse against the employer, the Prime plan, or any other person for any shortfall in benefits.


108. T.C. at 573-74, 576-77.

108 T.C. at 574.

U.S. v. American Bar Endowment, 477 U.S. 105, 107-08 (1986). (“ This means that the cost of insurance to the group is based on that group's claims experience, rather than general actuarial tables. Because ABA members have favorable mortality and morbidity rates, experience rating results in a substantially lower insurance cost.”).

108 T.C. at 574-75 (“The legislative history states that § 419A(f)(6) was enacted because the relationship of a participating employer to a 10 or more employer plan typically resembles that of an insured to an insurer.”) Judge Laro failed to note the 1986 Legislative History. According to Congress, a premature deduction does not occur when risk is shifted onto an insurance company. Experience-rating cannot occur in the presence of risk-shifting.

108 T.C. at 574-75.

108 T.C. at 574. It is very possible that another court may not agree with the reasoning of *Booth* on the issue of experience-rating. It is a serious stretch to conclude that the terms "experience-rating" and "experience-rated arrangements" mean different things. After all, the Congressional Committee Report states clearly:

The agreement provides however, that notwithstanding 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.

Conference Committee Report on Pub.L. No. 98-369 (Tax Reform Act of 1984), reprinted at CCH Standard Federal Tax Reports, Vol. 4, pg. 33708 (hereinafter referred to as the "1984 Committee Report"). *See generally* Thornhill, supra note 11, at 258 (“Although the Code does not define this term, it is generally understood to mean that the plan cannot maintain experience rating arrangements with respect to individual employers relative to other employers in the group.”)

108 T.C. at 574-75. This hypothesis is quite questionable. Congress did not indicate this anywhere, and in fact, clarified its common understanding of experience-rating in the legislative history to the Tax Reform Act of 1986 relating to amendments of §419A(f)(6). The *Booth* court ignored the rule of statutory construction *ejusdem generis*. Experience-rating arrangement means nothing more than a vehicle (“arrangement”) through which pricing (“rating”) of benefits is determined by reference to claims experience of a particular group. It is not a separate concept or term of art, but this observation in dicta has apparently empowered Treasury in Proposed Regulations to expand the term experience-rating beyond any traditional, legal, or rational definition ever attached to the term.

108 T.C. at 575.

108 T.C. at 575.

108 T.C. at 576.
The last issue before the Court was whether the taxpayers in Booth were liable for accuracy related penalties because they took a position that the Prime Plan qualified under §419A(f)(6). This issue was resolved in favor of the taxpayers. The Tax Court held that the issues of §419A(f)(6) were novel issues of law and that the taxpayers’ position was based upon substantial legal authority. Although the taxpayers had failed in their efforts to get an opinion from the IRS, the promoters of the Prime Plan had engaged tax counsel who prepared an opinion that was provided to the taxpayers considering the Prime Plan. Therefore, the taxpayer’s position was based on “substantial authority” and penalties were properly expunged.

2. Neonatology Associates, P.A. v. Commissioner: An insurance scheme “too good to be true”, not a case about VEBAs

In Neonatology Associates, P.A. v. Commissioner the Tax Court examined payments related to certain life insurance policies contributed to plans called “VEBAs” by professional medical corporations. The IRS challenged the deductibility of contributions to the plans in excess of the purchase price for insurance policies on the covered employees. The payments on the policies exceeded the cost of the term life insurance because they funded not only the purchase price of the insurance, but also “credits” that would apply to enable the participants to

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231 108 T.C. at 577-78.  
232 108 T.C. at 578.  
233 108 T.C. at 578.  
234 108 T.C. at 578. See also Siske et al., What’s New In Employee Benefits: A Summary of Current Case and Other Developments, SC62 ALI-ABA 1, 210 (1998).  
235 108 T.C. at 578.  
237 Neonatology is not actually a case about VEBAs. 115 T.C. at 44-45 n.2, n.4. See also Thornhill, supra note 13, at 262 (“Court held that neither of these plans qualified as a Veba or a Code § 419A(f)(6) plan; note that the plans were not intended to be Code § 419A(f)(6) plans.”). No less than three times the Judge said that he was not rendering any opinion on whether the plans were welfare funds described in § 419(e) or VEBAs under § 501(c)(9). Id. In fact, he said that the plans were not "welfare benefit funds" in the Booth sense, because they did not benefit employees generally and were not operated to provide "real" welfare benefits. 115 T.C. at 84; See also Booth v. Commissioner, 108 T.C. No. 25 (1997); Koreshko, J., Reflections on Booth, J. PENSION BENEFITS (Summer 2000). It does not appear that the Neonatology plans could qualify as "single plans" under the test of Booth v. Commissioner, because each employer's assets only covered its group of employees. That is, there was no cross invasion potential among the employers, which was precisely one of the failings of the Prime Plan in Booth. See generally Booth v. Commissioner, 108 T.C. at 571-73; infra Part III.B.1. Post Booth, it is axiomatic that you cannot assert the existence of a single plan when you treat the arrangement as a collection of individual plans.  
238 115 T.C. at 45. Although the IRS made other arguments in its briefings to the Court, the IRS’ argument that the plans were shams designed solely for the bail-out of corporate earnings to shareholders without any compensatory element, so no deduction was available under § 162, was the argument that Tax Court Judge David Laro seized upon, and expressly rendered no opinion with respect to any other IRS argument. See generally John Koreshko, Neonatology: A Case About Greed, Not VEBAs, J. OF PENSION BENEFITS (Winter 2001).
convert the policies into universal life insurance policies with cash value.\textsuperscript{239} The IRS argued that the disallowed contributions would properly be includable in the gross income of the employer and, thus, be taxable.\textsuperscript{240} The Tax Court agreed with the IRS, holding that the excess contributions to the plans in excess of the cost of the life insurance policies were properly disallowed\textsuperscript{241} and were, rather, taxable as distributions to the employees.\textsuperscript{242} A deduction was allowed, however, for the cost of the term life insurance policies themselves.\textsuperscript{243}

Judge Laro observed that:

The VEBAs' framework was crafted by the insurance salesmen mentioned herein and marketed to professional, small business owners as a viable tax planning device. The VEBAs' scheme was subscribed to by varied small businesses whose employee/owners sought primarily the advertised tax benefits and tax-free asset accumulation. The subject VEBA's were not designed, marketed, purchased, or sold as a means for an employer to provide welfare benefits to its employees.\textsuperscript{244}

\textsuperscript{239} 115 T.C. at 51-81. The insurance salesmen formed two groups called the Southern California Medical Profession Association and the New Jersey Medical Profession Association, though neither was a “professional association.” The insurance salesmen paid the Medical Society of New Jersey approximately $25,000 to endorse their Veba by representing to the Medical Society of New Jersey that the participants would be able to obtain large life insurance policies with the payments being tax-deductible and that the participants would be able to convert some or all of those tax free payments made to the Veba into annuities or cash value life insurance which would allow the physician participants to withdraw cash value life insurance policies tax free at a later date. \textit{Id.}

\textsuperscript{240} 115 T.C. at 45.

\textsuperscript{241} 115 T.C. at 46-47. Essentially, the excess amounts paid into a springing cash value reserve account were not insurance at all, and therefore, not deductible. The Court observed:

The substance of the purported premium payment outweighs its form, and, after closely scrutinizing the facts and circumstances of this case, including especially the interrelationship between the two policies underlying the C-group product and the expectations and understandings of the parties to the contracts underlying that product, we are left without any doubt that the amount credited to the conversion account balance was neither charged nor paid as the cost of current life insurance protection. The parties to those contracts have always expected and understood that the conversion credit balance would be returned to the insured in the future by way of no-cost policy loans.

\textit{Id.} at 90. The Court went on to observe that "forfeiture" provision whereby the credits could be lost if not used prior to death did not alter the court’s conclusion that the conversion credit was simply a deposit that could grow or dissipate and was “insufficiently related to the current life insurance protection to label it as such.” \textit{Id.} at 91.

\textsuperscript{242} 115 T.C. at 92. There was no evidence of compensatory intent demonstrated by the taxpayers, so the amounts could not be considered components of compensation to qualify for any deduction. \textit{Id.} Since only shareholder-employees in \textit{Neonatology} got the "coverage," the excess amounts were classified as constructive dividends. \textit{Id.} at 95-96.

\textsuperscript{243} 115 T.C. at 88-89. A deduction was allowed for the term insurance cost, but remainder of the so-called term insurance premium was a side-fund in the hands of an insurance company, which the doctor/participants always had a right to get through the conversion feature. 115 T.C. at 88-89, citing with approval the seminal Veba case, Joel A. Schneider, M.D.S.C. v. Commissioner, T.C.M. (CCH) 1992-24. See generally John Koresko, \textit{Neonatology: A Case About Greed, Not VEBAs}, J. OF PENSION BENEFITS (Winter 2001).

\textsuperscript{244} 115 T.C. at 81-82, citing Booth v. Commissioner, 108 T.C. 524, 561-63 (1997). The Judge did not make any determination as to whether in fact the plan at issue was a Veba at all, but rather quotes IRC 419A(f)(6) and refers to \textit{Booth} for a discussion of the requirements and tax consequences of that kind of plan. 115 T.C. at 83 n.24.
As a result, the Tax Court concluded that the contributions to the plans in excess of the cost of term life insurance policy for the individual tax year were “disguised (constructive) distributions to the petitioning employee/owners” of the medical offices, whether characterized by the businesses are distributions or not, and thus, the contributions were non-deductible under IRC section 162. The Tax Court noted that such contributions were not “ordinary and necessary business expense[s]”. Furthermore, the Tax Court upheld the penalties for negligence and disregard of the IRC and its regulations because the businesses had relied on the advice of the life insurance salesman who was not a tax professional of any sort, and the represented tax benefits “were simply too good to be true”. Additionally, the preparation of the tax returns after the investment was made was insufficient and did not constitute an opinion on the items reported in the tax return. The Court did not impose, however, the $25,000 penalty for frivolous and groundless litigation as the business owners had reasonably relied on the advice of their trial counsel that the position had merit.

Affirming the decision of the Tax Court, the Third Circuit Court of Appeals considered three issues on appeal: (1) whether the amounts contributed to the plans in excess of the annual cost of the term life insurance were not ordinary and necessary business expenses and, as such, not deductible; if so, (2) whether those amounts were actually dividends to the shareholders properly includible as taxable individual income; and, (3) whether the taxpayers were negligent such that penalties could be assessed. The Court of Appeals noted that the contributions made were so far in excess of the cost of the life insurance that it was not possible for the contributions to qualify as “ordinary and necessary business expenses in accordance with I.R.C. § 162.” The physicians were attempting to circumvent the IRC as a means of distributing earnings to the shareholders free of tax and, as such, the amounts were disguised dividends and not deductible expenses. Finally, the taxpayers could not claim that they relied on professional advice, such that the imposition of penalties for accuracy related negligence were appropriate.

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245 115 T.C. at 91-92. As a matter of fact and law, the Judge found no record that any employer made the contributions as components of compensation of any of the participants. Id. Apparently, the taxpayers forgot that corporate resolutions and minutes are a necessary part of operating a service corporation if they truly intended to document this as a component of compensation!

246 115 T.C. at 91.

247 115 T.C. at 91.


249 115 T.C. at 100.

250 115 T.C. at 103.


253 Id. at 34. The court commented: “We recognize that it is axiomatic that taxpayers lawfully may arrange their affairs to keep taxes as low as possible. Nevertheless, at the same time the law imposes certain threshold duties, which a taxpayer may not shirk simply by manipulating figures or maneuvering assets to conceal their real character. See Court Holding Co., 324 U.S. at 334, 65 S. Ct. at 708 ("to permit the true nature of a transaction to be disguised by mere formalisms . . . would seriously impair the effective administration of the tax policies of Congress."); see also Saviano v. Comm'r, 765 F.2d 643, 654 (7th Cir. 1985) ("The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service will play along.").”(footnotes omitted).

254 Id. at 3.
B. IRS Regulations, Notices and Rulings

1. PLR 200127047

PLR 200127047, 2001 WL 757790 (“2001 PLR”), issued July 6, 2001,255 written by James Holland, a manager in the employee actuarial group at the IRS, evaluates a severance plan which was submitted for ruling regarding compliance under §419A(f)(6).256 The 2001 PLR held that the trust at issue did not comply with §419A(f)(6) for the following reasons: (i) the trust was a plan of deferred compensation; (ii) the trust was not a single plan; and (iii) the trust was experience rated with respect to individual employers.257 The 2001 PLR is still relevant as the Proposed Regulations, discussed infra, appear to carry forward the same rationales.258

a) Description of the Plan at Issue

The trust at issue was the "Third Amended and Restated" version of the original (dated September 15, 1997) (the “Trust”).259 Like the plan at issue in Booth,260 the Trust by its terms provided death and severance benefits to employees who were specified in the adoption agreement signed by those employers who chose to participate in the Trust.261 All participants in the Trust received death benefits, but severance benefits were only provided to participants whose employers elected to provide those benefits.262 The Trust provided that each employer was a "plan administrator" with "all discretionary and other authority to control and manage the operation and administration of the Trust."263 However, the Trust required each employer to delegate the following duties and responsibilities to a "contract administrator" specified in the Trust: (i) directing the Trust's trustee as to the crediting and distribution of funds, (ii) making claims decisions, and (iii) maintaining accounting records.264

b) Particulars of the Death Benefit

Consistent with a common design for welfare plans, the death benefits provided by the Trust were calculated based on a specified percentage of compensation, chosen by the employer

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255 PLR 200127047, 2001 WL 757790 (IRS PLR) (2001). This ruling was requested in 1997, just months after the Booth decision. Therefore, Jim Holland and the IRS were holding onto this request for 3 1/2 years. There is no concrete explanation for the delay in this ruling.
258 See infra Part III.B.3.
259 PLR 200127047, 2001 WL 757790 (IRS PLR) (2001). The actual identity of the plan at issue was not provided in the 2001 PLR. However, the Tax Court issued the opinion in Booth on June 30, 1997, so the amendment and restatement of the plan at issue in September 1997 was most likely no coincidence and very may well have been revised in response to Booth.
260 108 T.C. 524, 532-33.
at the time the Trust was adopted, not to be less than an amount set forth in the Trust.\textsuperscript{265} Death benefits could be forfeited by participants upon a "termination of employment" or a "discharge for cause".\textsuperscript{266} However, if the employer also provided severance benefits under the Trust, owners of a significant amount of the total voting power or value of stock in the employer forfeited their right to receive death benefits upon the later of (i) age 70 1/2 or (ii) ten years of participation in the plan.\textsuperscript{267} Upon forfeiture, however, the participants would have the option of purchasing the death benefit insurance policy.\textsuperscript{268}

c) Particulars of the Severance Benefit

Pursuant to the Trust, employees would receive severance benefits in the event of a "termination of employment": when the participant became totally disabled, resigned or was discharged "without cause."\textsuperscript{269} Severance benefits, however, were forfeited upon death, retirement, discharge "for cause" or voluntary employment termination "without good cause."\textsuperscript{270} Similar to the death benefits, severance benefits were also forfeited with respect to participants who owned at least 5% of the employer, upon the later of (i) age 70 1/2 or (ii) ten years of participation.\textsuperscript{271}

d) Analysis in the 2001 PLR

First, the 2001 PLR noted that the IRS was not asked to determine whether the Trust provided constructive dividends to employees relative to insurance premiums in excess of current insurance protection under the reasoning of Neonatology v. Commissioner.\textsuperscript{272} The 2001 PLR then turned to the issue of deferred compensation where it concluded that the Trust provided deferred compensation, and therefore could not qualify for treatment under 419A(f)(6), because of the "virtual certainty" that the participants would receive the death benefits and severance benefits.\textsuperscript{273} With respect to death benefit plans, the 2001 PLR seems to be taking the position that the ability to terminate a death benefit plan is deferred compensation because the excess contributions would be provided to the participants upon termination at the will of the owner/employees.\textsuperscript{274} With respect to severance benefits, the 2001 PLR found that, based on the

\begin{itemize}
\item \textsuperscript{265} PLR 200127047, 2001 WL 757790 (IRS PLR) (2001).
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\item \textsuperscript{267} PLR 200127047, 2001 WL 757790 (IRS PLR) (2001).
\item \textsuperscript{268} PLR 200127047, 2001 WL 757790 (IRS PLR) (2001).
\item \textsuperscript{269} PLR 200127047, 2001 WL 757790 (IRS PLR) (2001).
\item \textsuperscript{270} PLR 200127047, 2001 WL 757790 (IRS PLR) (2001).
\item \textsuperscript{271} PLR 200127047, 2001 WL 757790 (IRS PLR) (2001).
\item \textsuperscript{272} PLR 200127047, 2001 WL 757790 (IRS PLR) (2001), citing Neonatology, 115 T.C. 43. \textit{See} discussion infra Part IIIA.2.
\item \textsuperscript{273} The 2001 PLR cannot apply to nondiscriminatory plans, if there is no virtual certainty of termination. Employers who provide benefits through a properly structured VEBA face no adverse consequences by not terminating the benefits can always be structured to convert into other benefits if needed, such as medical, disability or long-term care. Termination forces ordinary income taxation, unless the alternative is the 100% excise tax of § 4976. Fortunately, § 4976 does not apply to a properly structured VEBA, which complies with the nondiscrimination rules of § 505(b) and prohibits any reversion to a contributing employer.\textsuperscript{274} PLR 200127047, 2001 WL 757790 (IRS PLR) (2001). But previous court holdings have consistently rejected the argument of the IRS in the past that termination itself equates with deferred compensation. \textit{See} Booth v. Commissioner, 108 T.C. No. 25 (1997), 108 T.C. 524 (1997); Joel A. Schneider, M.D., S.C. v. Commissioner, 63 T.C.M. 1787 (1992); Moser v. Commissioner, 56 T.C.M. 1604 (1989); Greensboro Pathology Associates, P.A. v.
marketing materials related to the Trust, forfeiture would not occur because the event was controlled by the employee/owner by timing the receipt of benefits, sale of the business or employer termination of the plan.\textsuperscript{275}

Next, the 2001 PLR turned to the issue of whether the plan was a single plan within the requirements of §419A(f)(6).\textsuperscript{276} The 2001 PLR concluded that the Trust assets and liabilities were not pooled amongst the employers, so the plan was an aggregation of single plans, because the plan limited the “risk of cross-invasion” to a number of dedicated accounts within the plan, which does not seem much different than the “suspense account” structure challenged in \textit{Booth}.\textsuperscript{277} That is, just like in \textit{Booth},\textsuperscript{278} the plan did not make all assets available for the payment of all claims.\textsuperscript{279}

The 2001 PLR next concluded that the Trust was experience rated with respect to the employers, such that it could not qualify under §419A(f)(6).\textsuperscript{280} First, the 2001 PLR concludes that the unilateral ability of the Trustee of the Trust to adjust benefits to reflect amounts credited in the individual employer’s account is experience rating.\textsuperscript{281} The 2001 PLR goes on, however to also conclude that the provision of termination distributions is experience rating with respect to individual employers because the funds used to make the distributions represent the excess of contributions made by the employer over the cost of the insurance premiums, resulting in “experience refunds”.\textsuperscript{282} Consequently, it appears that the Mr. Holland in the 2001 PLR concludes that plan termination itself is a form of \textit{de facto} deferred compensation.\textsuperscript{283}

United States, 698 F.2d 1196 (Fed. Cir. 1982). Mr. Holland never describes his conclusion that the plan had a "virtual certainty" of returning money to the contributors, but as a matter of practice both the severance benefits and death benefits would end at age 70 ½ to prevent imposition of § 4976 (the 100% excise tax on postretirement benefits). Therefore, the plan had a fixed date of distribution, measured by a term of years, rather than event, which equates to deferred compensation.

\textsuperscript{278} \textit{See infra} Part III.A.1.
\textsuperscript{279} PLR 200127047, 2001 WL 757790 (IRS PLR) (2001). \textit{Booth}, 108 T.C. at 571. The Treasury Regulations, §1.414(l)-1(b)(1), governing multiple employer pension plans, state clearly that a plan will not be considered a single plan unless \textit{ALL ASSETS ARE AVAILABLE FOR ALL CLAIMS}. Those regulations also state that separate accounting does not impair single plan treatment, so long as the method of accounting does not operate to impact the legal duties of the plan to pay participants’ benefits in the amounts promised by the plan. In General Counsel Memorandum 39284, the IRS said that this Regulation should be applied to multiple-employer welfare plans.
\textsuperscript{281} PLR 200127047, 2001 WL 757790 (IRS PLR) (2001), citing \textit{Booth}, 108 T.C. 524. The Plan in the 2001 PLR tried to segregate liabilities. They didn't learn the first time around in \textit{Booth} that the trustee cannot have the unilateral ability to reduce benefits. In contrast, the trustee of should have no authority to unilaterally adjust benefits because of the contributions to the plan. The only thing the Trustee should be able to do is declare an involuntary termination, similar to the way an insurance company cancels a policy, if a required contribution is not made.
Finally, in the 2001 PLR, Mr. Holland noted that plan contributions were about $20 million in one year.\footnote{PLR 200127047, 2001 WL 757790 (IRS PLR) (2001).} He pointed out, however, that one employer had contributed about $3 million during that year. IRC §419A(f)(6) requires that no employer “normally” contribute more than 10% of the total annual contributions to the Plan made by all employers.\footnote{I.R.C. § 419A(f)(6). (“to which no employer normally contributes more than 10 percent of the total contributions contributed under the plan by all employers”).} Therefore, according to Mr. Holland, the plan violated the Ten Percent Rule because it failed the test in a single year.\footnote{PLR 200127047, 2001 WL 757790 (IRS PLR) (2001). Such an interpretation appears to disregard the plain language of the statute. The Code requires that the 10% limit be measured by reference to the “normal” contributions of the taxpayer and the plan. Query, what if the plan had an average of $30 million over three successive years? It would appear that $3 million would not normally exceed 10% of $30 million. Alternatively, what if the employer made contributions of $1.5 million in the next two years. That would total $6 million in 3 years, or an average of $2 million. The average would not exceed 10%, and contributions 2 of the 3 years would not exceed 10%.}

2. Modification to Tax Shelter Rules III

On June 18, 2002, the IRS published the Modification to Tax Shelter Rules III as final and temporary regulations requiring specified taxpayers to file a statement with the IRS along with their Federal income tax return if the taxpayer participates in “certain reportable transactions” ("Listed Transactions Regulations").\footnote{67 F.R. 41324 (June 18, 2002).} Essentially, the Listed Transactions Regulations are intended to compel disclosure. The Listed Transactions Regulations are designed to provide the IRS with information “needed to evaluate potentially abusive transactions.”\footnote{Id. at 41325.}

Pursuant to the Listed Transactions Regulations, a reportable transaction is one that is a “listed transaction” (including substantially similar transactions) or one that satisfies the “projected tax effect test” and is also a transaction with two of five specific characteristics.\footnote{Id. at 41326.} The first prong of the “projected tax effect test” is met if the tax liability would be reduced in any year by $1 million or by a total of $2 million for any combination of taxable years.\footnote{Id.} It appears that TOMEs would now be Listed Transactions in that they would potentially be “substantially similar transactions” to the 6011 listed transactions if they were “substantially similar to the plan described in Notice 95-34.”\footnote{Id.}

3. Proposed Regulations Affecting TOME Plans

As discussed \textit{infra}, IRC Sections 419 and 419A were enacted in 1984 as a specific limitation on income tax deductions for contributions to welfare benefit plans. However, IRC Section 419A(f)(6) provides that the deduction limitations do not apply in the case of TOME plans that are not based on any "experience-rating arrangement" respecting any individual
employer(s). The IRS has been somewhat adverse to these plans for a decade, and the Proposed Regulations appear to be an attempt by the IRS to limit the small business taxpayer’s use of TOME plans, arguably far beyond any limits that Congress might have imagined.

On July 11, 2002, the IRS issued a Notice of Proposed Rulemaking and Notice of Public Hearing with Respect to 10 or More Employer Plans (the “Proposed Regulations”). The IRS has stated that it is providing guidance to taxpayers regarding amendments to the IRC made by the Deficit Reduction Act of 1984. Although such proposed regulations are often withdrawn and not finalized, the Proposed Regulations, if finalized, would have significant impact upon qualification of a VEBA as a TOME.

The first section of the Proposed Regulations sets out the legislative and regulatory history of §419A(f)(6) and reiterates that the exception to TOME plans was enacted because "the relationship of a participating employer to [such a] plan often is similar to the relationship of an insured to an insurer," such that no limitation on deductions is needed “where a payment by an employer in excess of the minimum necessary to currently provide for the benefits under the plan is effectively lost to that employer, because the economics of the plan will discourage excessive contributions.” The exception, however, does not apply to plans that maintain “experience-rating arrangements” 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.”

The Proposed Regulations themselves and as described in the “explanation of the provisions” section address two matters: 1) the definition and identification of “experience-rating arrangements” that violate IRC Section 419A(f)(6) and thus make a welfare benefit plan subject

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292 IRS Notice 95-34; Booth v. Commissioner, 108 T.C. 524 (1997); Neonatology Associates, P.A. v. Commissioner, 115 T.C. 43 (2000); 2001 PLR. The reader should not that Notice 95-34 described the plan at issue in Booth. Using this standard as the threshold for disclosure eliminates many plans from the requirements of Reg. §1.6011-4T. After all, that plan had a severance benefit, was not a VEBA, did not put all assets available for all claims, and allowed the trustee discretion to unilaterally reduce benefits based on plan balances. Such a structure is inherently defective. The Treasury Department failed to articulate a firm standard for disclosure, apparently as part of the overall propaganda initiative discussed in this article, and intending to inject fear and doubt into taxpayers who desire the benefits offered by §419A(f)(6).


294 Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat 858, 98th Cong. 2nd Sess. (July 18, 1984). One must wonder why it has taken the IRS apparently in excess of fifteen years to issue the Proposed Regulations.

295 67 F.R. 45933. These are proposed regulations – they are not final regulations, and the IRS has solicited comments and scheduled hearings on November 5th in Washington, D.C. Id. The regulations apply to contributions paid or incurred for tax years beginning on or after July 11, 2002, which for most taxpayers will mean the tax year beginning 1/1/2003. However, the regulations leave open the possibility that deductions for contributions made before July 11th may also be challenged, and state “…taxpayers should not infer that a contribution that would be nondeductible under the regulations would be deductible if made before that date.” If finalized, however, courts ordinarily give deference to agencies in construing statutes of the “[implements] the congressional mandate in some reasonable manner.” United States v. Correll, 389 U.S. 299, 307 (1967). However, this principal sets "the framework for judicial analysis; it does not displace it." United States v. Cartwright, 411 U.S. 546, 550 (1973). Bills favorable to welfare benefit plans, however, are pending in the House Ways & Means Committee (H.R. 2370) and Senate Finance Committee (S. 1398) that, if enacted, would render these Proposed Regulations meaningless.


297 67 F.R. at 45934.

to the deduction limitations of IRC Sections 419 and 419A; 2) the creation of record-keeping and compliance requirements for plan administrators.\textsuperscript{299}

The Proposed Regulations provide the following general description:

A plan maintains an experience-rating arrangement with respect to an employer if the employer’s cost of coverage for any period is based, in whole or in part, either on the benefits experience or on the overall experience (or any proxy for the benefits experience or overall experience) of that employer or one or more employees of that employer. The prohibition against experience-rating with respect to individual employers applies under all circumstances, including employer withdrawals and plan terminations.\textsuperscript{300}

Foremost, the Proposed Regulations set forth five characteristics that will disqualify a plan from qualification as a TOME:

1. if assets of the plan are allocated among employers “through a separate accounting of contributions and expenditures for individual employers or otherwise.”
2. if “amounts charged under the plan differ among the employers in a manner that is not reflective of differences in risk or rating factors that are commonly taken into account in manual rates used by insurers (such as age, gender, dependents covered, geographic locale, or the benefit package).”
3. if “the plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed price.”
4. if “the plan charges the participating employers an unreasonably high amount for the covered risk;” or
5. if “the plan provides for payment of benefits upon triggering events other than the illness, personal injury, or death of an employee or family member, or the employee’s involuntary termination of employment.”\textsuperscript{301}

The five characteristics are explained in more detail in the preamble to the regulations, and the characteristics are illustrated in 13 examples contained in the Proposed Regulations presenting various factual scenarios.\textsuperscript{302} As a result of the breadth of the characteristics, however, the Proposed Regulations seem to take the position that virtually any plan that provides for separate accounting of participating employer contributions, benefit payments or withdrawals will be considered experience-rated, and thus disqualified from treatment as a Code § 419A(f)(6)

\textsuperscript{299} 67 F.R. at 45935-44.
\textsuperscript{300} 67 F.R. 133, p. 45933 (July 11, 2002) (emphasis added).
\textsuperscript{301} 67 F.R. at 45935. The Proposed Regulations state that the IRS will, when evaluating compliance of a plan, consider, not only plan documents, but marketing and promotional materials and other employer and employee communications.
\textsuperscript{302} 67 F.R. at 45940-44. None of these characteristics denotes the presence of experience-rating under any traditional definition of the term.
The IRS’ position in this regard is reinforced by the IRS’ inclusion of its Notice 95-34 in the Appendix to the Proposed Regulations.

Finally, the Proposed Regulations add a new compliance requirement for the exemption under 419A(f)(6), stating that the plan administrator must maintain records sufficient for the IRS or any participating employer to readily verify that the plan satisfies the requirements of section 419A(f)(6) and the regulations, and must allow the IRS or any participating employer to inspect and copy such records upon written request.

IV. UNCERTAINTY AND THE NEED FOR REFORM

A. Problem areas

Due to the inconsistencies in the judicial opinions and the positions taken by the IRS, small business taxpayers are certainly at a quandary as to whether any tax or other investment adviser has prepared a TOME plan that will uphold a challenge brought by the IRS to deductibility of contributions to a VEBA under IRC 419A(f)(6), even if the small business taxpayer has obtained a well reasoned opinion from the tax professional. A number of issues seem to be present in need of some type of reform:

67 F.R. at 45940. See infra Part II.D. IRS Notice 95-34 also states that plans with separate accounting features are experience rated because the employers are insulated from the gain or loss experience of other participating employers. This conclusion is grossly inaccurate if all assets are available for all claims, consistent with the requirements of Treas. Reg. 1.414(l)-1(b)(1). The accounting of plan contributions and expenditures has nothing to do with overall liability of the plan to pay a claim.

67 F.R. at 45940. See infra Part III.

67 F.R. at 45940. See also Thornhill, supra note 14, at 262 (“The IRS has cited [Neonatology] to try and establish that Code § 419A(f)(6) plans should be disqualified as deferred compensation arrangements. . . . However, the egregious facts of this case make it clear that it has no impact on a validly implemented multiple employer welfare benefit plan; the IRS application of this case will not withstand tax court scrutiny.”).

On June 7, 1985, the Committee on Ethics and Professional Responsibility of the American Bar Association issued Formal Opinion 85-352 (the “ABA Opinion”). The ABA Opinion sets forth model ethical standards governing a lawyer’s duty in advising his clients on positions that can be taken in a client’s tax return. The ABA Opinion provides that a lawyer, in advising the client in the course of preparation of the client’s tax return, may advise the client to take a position most favorable to the client if the lawyer believes in good faith that the position is warranted in existing law or can be supported by a good faith argument for the extension, modification or reversal of existing law and there is some reasonable possibility of success if the position is challenged in litigation.

The ABA Opinion provides that a lawyer can have a good faith belief as to the propriety of a client’s tax position, even if the lawyer believes the client’s position probably will not prevail if challenged, as long as the position has a “realistic possibility of success” if litigated. The lawyer may not, in reaching the conclusion as to the propriety of his advice in this regard, rely on the likelihood of audit or detection in determining the possibility of success of the return position. Rather, he must form the belief of “realistic possibility of success” solely upon the
1. How can the line between welfare benefit plans and deferred compensation be best delineated? 

2. What is necessary to meet the “single plan” requirement that was at issue in Booth? Although Booth addressed the particulars of the Prime Plan, general parameters were not set forth by the Court for use in other cases. Furthermore, despite Booth, the IRS appears to be committed to their contention that all TOME plans are separate plans and are not single plans.

3. What is needed for a VEBA to satisfy the prohibition against “experience rating arrangements”?

4. Should the IRC require a determination letter process involving the IRS in order to track VEBA plans?

5. Can a VEBA pass §419A(f)(6) scrutiny if it provides severance benefits in addition to death benefits?

Several of the leading proposals to address these issues will be discussed in turn.

B. Legislative and Other Proposals

1. IRS Proposals

During the Clinton Administration, the IRS introduced a legislative proposal to address some issues with VEBAs that ultimately was not passed. The IRS would propose that life insurance not be an allowable funding vehicle and would completely eliminate the ability of employers to withdraw from plans. President Clinton ultimately vetoed the IRS’ legislative proposal in one piece of legislation and Congress ultimately eliminated it from others.
Currently, the IRS seems to be advancing by virtue of the Proposed Regulations a seemingly propagandized position that substantial previous authority should be abandoned altogether, except IRS’ own opinions as set forth in 2001 PLR and Notice 95-34, and a more restrictive approach to TOMEs be adopted by means of rulemaking alone, rather than legislation by Congress. First, the Proposed Regulations appear to reject the prior definitions for experience rating: (i) described by the Supreme Court in American Bar Endowment v. U.S.; (ii) described by Judge Laro in Booth v. Commissioner; and (iii) advanced by the industry. The Proposed Regulations focus on experience rating to disallow termination of a plan for what the IRS sees as tax avoidance purposes. Using experience rating in this way is contrary to the Congressional intent of the 1984 Deficit Reduction Act, for which the Proposed Regulations are apparently written leading one to wonder whether the IRS is regulating properly or engaging in propaganda by issuing regulations that seem to only its own viewpoint as a significant portion of the regulations to the exclusion of previous authority.

Second, the Proposed Regulations effectively disqualify a TOME plan from the use of cash value insurance, which could cause 419A(f)(6) plans to run afoul of ERISA sec. 514, which requires a multiple employer plan to be fully-insured. Congress never sought to interrupt the ability of a welfare plan to provide post-retirement benefits, yet the Proposed Regulations do just that by effectively preventing a plan from accumulating cash value for those benefits.

Third, the Proposed Regulations also advance that a termination distribution to employees should be equated with the concept of "automatic rebate to the employer." Stated another way, a possible distribution to employees is tantamount to a "rebate" back to the small business employer. The IRS seems to ignore the distinction between a contribution by an employer and a distribution to an employee that would violate the distinction as a matter of law between the entity that is the small business and the individual persons that are the employees.

318 Reg § 1.501(c)(3)-1(d)(3)(i). The IRS has itself defined propaganda as the "mere presentation of unsupported opinion." Id.
319 See infra Part III.B.3.
320 H.R. Conf. Rep., Pub. L. No. 98-369, U.S. Cong. & Admin. News 1843 (July 18, 1984). The purpose of the Deficit Reduction Act of 1984 was to prevent employers from taking deductions in a tax year for welfare benefit expenses not incurred until future tax years by interposing a trust or other intermediate entity. H.R. Conf. Rep., Pub. L. No. 98-369, U.S. Cong. & Admin. News 1843 (July 18, 1984). Furthermore, the House Conference Report states that a plan maintains an "experience-rating arrangement" where “the liability” of an employer for contributions to the plan in a particular year is determined based upon the experience rating of that employer’s plan account. H.R. Conf. Rep., Pub. L. No. 98-369, p. 1159. Rev Proc 86-43, 1986-2 CB 729. (though determined on the facts of each case, viewpoints are generally propaganda and not educational if “1 The presentation of viewpoints or positions unsupported by facts is a significant portion of the organization's communications. 2 The facts that purport to support the viewpoints or positions are distorted. 3 The organization's presentations make substantial use of inflammatory and disparaging terms and express conclusions more on the basis of strong emotional feelings than of objective evaluations. 4 The approach used in the organization's presentations is not aimed at developing an understanding on the part of the intended audience or readership because it does not consider their background or training in the subject matter.")); See also, 9 MERTENS LAW OF FED. INCOME TAX'N § 34:58 (2002)(describing the IRS position on the activities of organizations that put out propaganda).
321 ERISA sec. 514.
322 67 F.R. 45940.
2. Senate Bill 1386

Senator Rick Santorum (R-Pa) introduced the Employee Welfare Benefit Equity Act of 2001 ("EWBEA") as Senate Bill 1386 in August, 2001. The EWBEA is designed to eliminate many abusive welfare benefit arrangements and enable the IRS to appropriately enforce the law. The EWBEA also clarifies several areas that have been troublesome for courts and taxpayers.

The EWBEA would require that all TOME plans must: (1) meet specific nondiscrimination standards with respect to all plan benefits; (2) receive a favorable determination letter from the IRS that the plan is a VEBA meeting specified criteria; and (3) not provide severance pay benefits. The EWBEA also directly defines the term “experience-rated plan” as “a plan, which determines contributions by individual employers on the basis of actual gain or loss experience.” The EWBEA excludes from experience-relating arrangements “guaranteed benefit” plans that are funded with insurance contracts or otherwise determinable and payable to a participant without reference to, or limitation by, the amount of contributions to the plan attributable to any contributing employer.

With respect to “single plan requirements” the EWBEA sets forth a definition: (i) requiring all assets of the plan(s) to be “available to pay benefits of all participants without regard to the participant's contributing employer;” and (ii) the plans may not use a method of accounting to “limit or reduce the benefits payable to a participant at any time before the withdrawal of the participant's employer from the plan or the termination of any benefit arrangement under the plan.”

The EWBEA states that a welfare benefit fund meeting all applicable requirements shall not be treated as a tax shelter or corporate tax shelter.

The EWBEA also would require taxpayers to apply for and receive a determination letter from the IRS, where applicable, that any collective bargaining agreement is "bona fide" and the welfare benefits provided under it "were the subject of good faith bargaining" before a qualified asset account may be unlimited under an employee pay-all plan.

Finally, the EWBEA would impose an excise tax with respect to "funded welfare benefit plans." The excise tax would be equal to 100 percent of all contributions to a funded welfare benefit plan: (i) that is terminated “prematurely;” or (ii) with respect to certain “disqualified benefits” provided or funded by a plan. Premature termination is termination within six years.

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324 2001 Bill Tracking S. 1386.
325 107 S. 1386.
326 107 S. 1386 § 101(a).
327 107 S. 1386 § 101(b).
328 107 S. 1386 § 101(b). (“The term 'guaranteed benefit plan' means a plan the benefits of which are funded with insurance contracts or are otherwise determinable and payable to a participant without reference to, or limitation by, the amount of contributions to the plan attributable to any contributing employer. A plan shall not fail to be treated as a guaranteed benefit plan solely because benefits may be limited or denied in the event a contributing employer fails to pay premiums or assessments required by the plan as a condition of continued participation.”)
329 107 S. 1386 § 101(c).
330 107 S. 1386 § 104.
331 107 S. 1386 § 102.
332 107 S. 1386 § 201.
333 107 S. 1386 § 201.
after the first contribution to the fund that benefits any “highly compensated employee”, except in the case of insolvency.  

3. House Bill 2370

Representative Jerry Weller (R-IL) introduced the Small Business Welfare Benefits Protection Act” (“SBWBPA”) as House Bill 2370 in June, 2001. The SBWBPA, like the EWBEA, is designed to eliminate many abusive welfare benefit arrangements and enable the IRS to appropriately enforce the law. House Bill 2370 also attempts to clarify areas that have been troublesome for courts and taxpayers. The SBWBPA would permit TOME plans to fall outside the definition of “experience-rating arrangements” if “all plan assets are available as a single, undivided pool to provide benefits to the covered employees of all individual employers participating in the plan.”

The SBWBPA also provides specific rules with respect to nondiscrimination: (i) benefits must be available to all employees under the same formula; (ii) plan benefits are available to employees who are 21 years of age, working more than 1000 hours per year and have completed one year of service with the employer; (iii) benefit formulas must be a uniform multiple of compensation for all employees, but highly compensated employees can have a lower benefit; (iv) upon termination of the plan, “all eligible employees are entitled to a pro rata share of the plan's assets,” with benefit payable to all former eligible employees terminated within 24 months of the employer termination of the plan; (v) requirements on non-owner employee participation in the TOME plan by employer; and (vi) requirements for non-owner employee participation in the TOME plan for the TOME as a whole.

The SBWBPA also addresses issues related to distribution of benefits and termination. In order to receive favorable tax status as a TOME plan: (i) the assets may not revert back to the employer during plan administration; (ii) no loans are allowed to employees under the plan; and (iii) specific requirements for termination must be followed by the employer. Specifically, if the plan does not have severance benefits, then termination is permitted if all employees receive a pro rata share of benefits. If the plan has severance benefits, then termination of the plan is permitted for severance benefits not exceeding 200 percent of annual compensation and payable not over a period greater than 24 months. If the plan has post-retirement medical benefits, termination of the plan is permitted for those benefits if they are distributed for post-retirement medical benefits. Rollovers are also permitted.
The SBWBPA also sets forth benefit limitations. First, death benefit minimums are determined under a plan formula or the insurance provider. Second, severance benefits cannot exceed 200 percent of annual compensation. Post retirement medical benefits cannot be paid until normal retirement age and benefits revert to the plan at death.

The SBWBPA would propose deduction limitations be imposed. For insured death benefits, the limitation would be the annual premium for term insurance, the level annual premium to normal retirement age for whole life insurance, or for universal life the guideline level annual premium. With respect to severance benefits, the deduction is limited to reasonability using actuarial principles, with no pre-funding of the benefit. With respect to medical, health and disability the deduction is limited to the amount required to pay the insurance company premium or anticipated liability if self-funded.

Finally, the SBWBPA requires that “all assets in the forfeiture pool [be available for use] in a nondiscriminatory manner for the benefit of participating employees.”

V. ANALYSIS AND RECOMMENDATIONS

A. Deferred Compensation or Welfare Benefit Plan?

After the 1984 Deficit Reduction Act, IRC § 404 commands that all deferred benefit plans are deferred compensation unless they are welfare benefit plans. A plan can be a welfare benefit plan for purposes of ERISA §3(1), yet have sufficient attributes of deferred compensation to be considered as deferred compensation for tax purposes. Treas. Reg. 1.401(a)-1 provides the following rule: welfare benefits plus deferred compensation attributes equals deferred compensation for tax purposes. Judge Laro explained, "all welfare plans have some indicia of deferred compensation." It is when the welfare benefit purpose is subsumed by deferred compensation intention that the plan falls outside of the welfare plan deduction rules and into the deferred compensation rules.

This falls far short of providing clear standards for small business taxpayers. In general, courts have also failed to add clarity to this issue. For example, in Greensboro Pathology, the Federal Circuit court enumerated several factors that indicate the existence of a welfare plan:

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345 107 H.R. 2370 § 2(a).
346 107 H.R. 2370 § 2(a).
347 107 H.R. 2370 § 2(a).
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352 107 H.R. 2370 § 2(a).
353 107 H.R. 2370 § 2(a).
354 Wellons v. Commissioner, 31 F.3d 569 (7th Cir. 1994). Therefore, the ERISA definition is only the beginning. For example, a plan that provides severance benefits may be a welfare plan under ERISA, but Lima Surgical and Wellons demonstrate that a severance plan may be deferred compensation for tax purposes.
355 108 T.C. at 564. Similarly, in Greensboro Pathology Assoc. v. United States, 698 F.2d 1196, 1200 (Fed. Cir. 1982) the court stated: “All types of fringe benefit plans have elements of compensation.”
356 Regs. § 1.162-10(a).
358 Greensboro Pathology Assoc. v. United States, 698 F.2d 1196 (Fed. Cir. 1982).
1. Is this a welfare plan; *i.e.*, one concerned with the well-being of the employees?
2. Are the benefits provided employees based upon the employer's earnings?
3. Do the benefits increase for those who have been employed longer by the employer?
4. Are benefits provided to all the employees?
5. Are the plan benefits a substitute for salary?
6. Does the plan serve its stated purpose or is it a sham?
7. Does the employer lose control of the funds it gives the plan? Is there any sort of reversion of funds to the employer? Is the plan independently administered?\(^{359}\)

As discussed herein, in *Booth*, Judge Laro appears to have done little more ultimately than to rely on the testimony of the plan's draftsman, David Weiss, that he intended to create a plan with "real" welfare features.\(^{360}\)

In the context of the Proposed Regulations, the IRS can, and should, clarify the positions enunciated by the courts and clearly define the term "welfare plan" and integrate the common law tests. The common law definition of welfare plan for purposes of section 162, 404 and 419 does not seem to have been changed by the enactment of section 419. Just because section 419 enumerated severance, medical, disability and life insurance as welfare benefits subject to the deduction standards of that section, and called plans with such benefits "welfare benefit funds," does not mean that section 419 eviscerated the distinction between deferred compensation and welfare plans which must determined under the section 404 regulations.\(^{361}\) Most importantly, the IRS has authority under case law and tradition to recognize that welfare benefits are available for employees other than simply a highly compensated group.

The IRS can also define welfare plans by reference to discrimination under another theory. IRC Section 4976 imposes a 100% excise tax on disqualified benefits. Among those are "post-retirement benefits payable to a highly compensated individual from a plan that does not comply with section 505." The statute and legislative history make clear that 4976 applies whether or not the plan operates by reference to IRC section 505. Stated another way, a VEBA must comply with IRC section 505 to be tax-exempt. Some other welfare plans simply fund with tax-exempt vehicles and accomplish most of the same effect. These latter plans do not seek VEBA status under IRC sections 501(c)(9) and 505. Notwithstanding, these latter plans are subject to section 4976 if they violate IRC section 505.

It is important to remember the three things the 1984 Deficit Reduction Act did with respect to welfare benefit plans. First, IRC sections 419 and 419A were enacted to impose

\(^{359}\) Id. at 1200. The court relied on the case of Grant-Jacoby, Inc. v. Commissioner, 73 T.C. 700 (1980).

\(^{360}\) 108 T.C. at 563. The court stated: "Mr. Weiss testified credibly that he designed the Prime Plan intending entirely to provide employees with "real" welfare benefits that would not be subject to abuse, and we read the record to support his testimony. 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. See *Harry A. Wellons, Jr., M.D., S.C. v. Commissioner*, 31 F.3d 569 (7th Cir.1994), affg. T.C. Memo.1992-704. 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."

\(^{361}\) *Booth*, 108 T.C. at 562-63.
deduction rules on certain plans not specifically exempted by the statute (e.g., sec. 419A(f)(6) arrangements). Secondly, section 505 created additional nondiscrimination rules (which basically supplanted the 1981 VEBA regulations). Third, section 4976 was meant to be the enforcement mechanism to prevent over-accumulation in the plans. It is clear that the term post-retirement benefit can be interpreted to mean an express or implied benefit meant to be paid beyond normal retirement age. Accordingly, section 4976 must apply to all amounts not reasonably necessary for pre-retirement benefits. This was IRS' weapon to combat the "excessive tax free accumulations" that the legislative history assailed. Excessive accumulations are potentially found in all welfare plans, not just those who have sought tax-exemption. In light of the foregoing, section 4976 cannot be defined without reference to section 505. Section 505 cannot be applied without reference to nondiscrimination. To bring certainty to the taxpayer, either the IRS or proposed legislation must address the distinction between deferred compensation and welfare benefit plans that provides a useful test for small business employers so that they will not have uncertainty in taking advantage of tax incentives provided by Congress.

B. Single Plan Requirements

As described above, the EWBEA provides requirement for TOMEs to be operated as a "single plan" in order to qualify for favorable tax treatment. The proposal requires all assets of the plan(s) to be “available to pay benefits of all participants without regard to the participant's contributing employer;” and that plans may not use a method of accounting to “limit or reduce the benefits payable to a participant at any time before the withdrawal of the participant's employer from the plan or the termination of any benefit arrangement under the plan.” This definition is consistent with the opinion of Judge Laro in Booth v. Commissioner, and, as such, should be included in any legislation or IRS regulations as it provides further guidance to taxpayers on this issue. Although the SBWB also appears to take a position on this issue, the lack of clarity in the SBWB’s language should be addressed prior to passage.

C. Defining Experience Rating

The Supreme Court has held that terms used by Congress in statutes that are not defined in the statute itself should be construed in accordance with their common meaning. However, if...
a term is not defined by Congress and has no “plain meaning” and is therefore ambiguous, a “reasonable meaning” advanced by the IRS, rather than the “best interpretation of the statute” will prevail. Furthermore, where an agency has itself changed its position, the Supreme Court has held that its position later articulated is entitled to less deference. Finally, a court should not give deference to the IRS's interpretation when it amounts to no more than a self-serving or litigating position.

Although the Proposed Regulations make no mention of the common meaning and understanding of the terms “experience rated” and “experience-rating arrangement”, such terms have a plain meaning in the insurance industry. The industry definition also appears to be more consistent with the meaning conveyed by the legislative history of the Deficit Reduction Act of 1984, than the construction relied upon by the IRS in its Proposed Regulations. In this


Atlantic Mutual Ins. Co. v. Commissioner, 523 U.S. 382, 389 (1998). (plain meaning can be determined by industry usage where available). See also, e.g., Connecticut Gen. Life Ins. Co. v. Commissioner, 177 F.3d 136 (3d Cir. 1999). (“When reviewing an agency's construction of a statute, if the intent of Congress is clear, then we must give effect to that intent. If the statute is silent or ambiguous with respect to a specific issue, then a deference standard applies, and the question for the court becomes whether the agency's answer is based on a reasonable construction of the statute. In determining whether an agency's regulation complies with its congressional mandate, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose. So long as the regulation bears a fair relationship to the language of the statute, reflects the views of those who sought its enactment, and matches the purpose they articulated, it will merit deference.”); E.I. du Pont de Nemours & Co. v. Commissioner, 41 F.3d 130, 135-36 (3d Cir. 1994). (“Furthermore, in the tax area, we are still required to treat regulations issued under a general grant of authority with broad deference, although to a somewhat lesser degree than when Congress has made a specific delegation of authority in a specific statute. As the Supreme Court has explained: "Because Congress has delegated to the Commissioner the power to promulgate 'all needful rules and regulations for the enforcement of [the Internal Revenue Code],': 26 U.S.C. § 7805(a), we must defer to his regulatory interpretations of the Code so long as they are reasonable."). However, when the agency interpretation is clearly inconsistent with the plain meaning of a phrase and the structure of the Act, there is simply no need and thus no justification for a discussion of whether the interpretation is entitled to deference. See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-843 (1984). INS v. CARDOZA-FONSECA, at 453.

"[C]ourts must give effect to a reasonable agency interpretation of a statute unless that interpretation is inconsistent with a clearly expressed congressional intent. (Citations omitted.)" Id. at 454. Justice Scalia's interpretation of Chevron continues to dominate contemporary Supreme Court jurisprudence. His rule is pretty clear: "Judges interpret laws rather than reconstruct legislators’ intentions. Where the language of those laws is clear, we are not free to replace it with an unenacted legislative intent." Id. at 453-4. The only exception is an interpretation that results in "patent absurdity." Id. at 453, (citations omitted). A court, however, should not give deference to the IRS's interpretation when it amounts to no more than a self-serving litigating position. See Bowen v. Georgetown University Hospital, 488 U.S. 204, 213 (1988).

However, it is arguable that the IRS has changed its position regarding its own view of "experience rating," in light of the trial transcript of the IRS’ own expert witness, Charles DeWeese, as well as the text of Page 9 from the IRS Memorandum of Issues filed in Booth v. Commissioner. These two sources appear to more closely resemble the prevailing industry definition of the term "experience rating." The Supreme Court does not countenance changed interpretations by an agency, especially those done in post-hoc fashion 19 years after a statute appears. The Court observed in INS v. CARDOZA-FONSECA, 480 U.S. 421 (1987) "An agency interpretation of a relevant provision which conflicts with the agency's earlier interpretation is "entitled to considerably less deference" than a consistently held agency view. Watt v. Alaska, 451 U.S. 259, 273 (1981); see also General Electric Co. v. Gilbert, 429 U.S. 125, 143 (1976)." Id., at 447-8, f.n. 30.

See Bowen v. Georgetown University Hospital, 488 U.S. 204, 213 (1988).

See infra Part III.B.3. The Proposed Regs focus only on the definition of "experience rating arrangement." The IRS seems to be arguing that "experience rating arrangement" means something more than simply "an arrangement that contains prohibited experience rating." From an industry standpoint, it is very important to emphasize that the
instance, insurance industry authorities have defined “experience rated” arrangements as those arrangements in which:

1. An employer’s contribution costs are increased as a result of unfavorable claims experience;
2. premium costs are calculated based upon interest credits, benefits payments or rate adjustments to an employer;
3. premium costs are affected by an employer’s number and size of claims made under the plan;
4. period premium costs are established based upon an employer’s claims experience for the prior period.

Courts have also construed the terms “experience rated” and “experience-rating arrangements” more in line with insurance industry authorities, leaving the speculation that the IRS’ Proposed Regulations are more of the nature of propaganda against a tax program that the IRS dislikes, rather than a genuine exercise of regulatory power. For instance, in United States v. American Bar Endowment, the Supreme Court described experience rated to “mean[] that the cost of insurance to the group is based on that group's claims experience, rather than general actuarial tables.” Citing American Bar Endowment, Judge Laro in Booth v. Commissioner quite clearly stated that “[t]he term "experience-rated" means generally that premiums (contributions) are adjusted to reflect experience.” In describing the Prime Plan in Booth, Judge Laro explained:

classic operation of an insurance contract, its dividends, cash surrender value, flexibility of premiums, and ability to cancel, have never been considered relevant in classifying an insurance contract as "experience rated." After all, if, as Judge Laro observed, that the TOME VEBA is supposed to be like an insurance arrangement, rather than an investment arrangement, then it naturally follows that the VEBA benefit structure should not be disqualified if it does not resemble an arrangement defined in insurance company terms as experience rated.


373 29 C.F.R. § 2550.401c-1 (definition of “plan assets”).

374 29 C.F.R. § 2520.104b-10 (summary plan description content requirements).


376 See, e.g., U.S. v. American Bar Endowment, 477 U.S. 105, 107 (1986) (Court describes “experience rating” in dicta); IRS Field Service Advisory, 1993 WL 1609057 (June 10, 1993); PLR 200116041; Internal Revenue Manual, Examination Process, Insurance Industry Handbook, ch. 4.4.2.5.6.1.1; PLR 200127047 (July 6, 2001) (plan maintains an experience arrangement when death benefits paid to employee/participants are tied to amounts contributed by their employer); H.R. 98-432 (Part 2), supra at 1280 n.18 (the term "purely experience-rated" means "the employer is entitled to an automatic rebate if the amount paid exceeds the benefit claims and is liable if the benefit claims exceed the amount paid"); § 1851(a) (8) (B) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2860, (an experience-rated insurance policy means "the employer has a contractual right to a refund or dividend based solely upon the experience of such employer"); 26 U.S.C. § 808(d)(3); IRS Notice 95-34, 1995-23 IRB 10; Booth v. CIR, 108 T.C. 524 (1997); IRS Litigation Bulletin No. 94-5 (May 1994).


378 Booth, 108 T.C. at 574, citing United States v. American Bar Endowment, 477 U.S. 105, 107 (1986). ("experience rated * * * means that the cost of insurance to the group is based on that group's claims experience, rather than general actuarial tables"). That is, experience rating goes to pricing, and the ability to receive a refund of the purchase price. It has nothing to do with dividends earned in a policy. Dividends have never been "experience rating." Cash refunds to a payer indicate experience rating under Judge Laro’s reasoning in Booth. The Proposed Regulations try to circumvent this requirement by saying that employees are "proxies" for the employer. However,
The essence of experience rating is the charging back of employee claims to the employer's account. The Prime Plan accomplished the same result by adjusting the employees' benefits to equal its employer's contributions. The Prime Plan charged back the employees' claims to their employers' accounts by carrying the accounts' year-end balances over to future years and limiting an employee's benefits to the amount in his or her employer's account. This was an experience-rating arrangement. Mr. DeWeese concluded that experience-rating may occur by adjusting benefits, rather than premiums, and Mr. Barnhart agreed. Mr. Barnhart also acknowledged that the term "experience-rating" means that, over time, the premiums less expenses equal the benefits. This credible expert testimony supports our view that the Prime Plan had experience-rating arrangements with respect to all participating employers.  

More aptly, in *Sears Roebuck & Co. v. Com'r*, the court said:

Large commercial risks with a sufficient number of exposure units can be individually rated in various degrees. Individual rating of large commercial risks takes several forms, including experience rating and retrospective rating. Experience rating differs from retrospective rating in that the former is prospective, i.e., the policyholder's premium for any given period is determined by its past loss experience, but not by its experience during the policy period.

The premium under a retrospectively rated policy is set using the loss data generated over the year in which the policy is in force. The retrospectively rated insured typically pays a deposit premium at the beginning of the year. At the end of the year, the insured receives a refund if loss experience has been favorable and may have to pay an additional premium if loss experience is unfavorable. There are usually limits on the amount of the additional premium that must be paid.

Retrospective rating is designed partially to adjust after the fact for errors made in the estimation of the pure premium, and partially to reflect the fact that large insureds need insurance protection primarily for large losses, rather than for small deviations of losses from their expected values. In a retrospective rating plan, risk loading compensates the insurance company for bearing losses greater than the upper limit or maximum of the plan.

As the *Sears* Court made clear, "rating" means pricing. "Experience rating" means pricing solely by reference to the experience of the insured, with an automatic entitlement to refund if experience is good, and an automatic rebate if experience is bad. This contrasts from a typical life insurance contract. Even though a payor employer may

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379 108 T.C. at 575.
choose to make a limited-payment premium contract, the cost is set by reference to the world of risks, not the employer’s particular risk. There is no additional premium that can be extracted if at least the minimum amount is paid by the employer. But if there is a death, the cash surrender value resulting from the agreed premium schedule will disappear into the death benefit. The amount paid is at risk, and there is no right to a refund on an insurance policy if the employer "paid too much."

Furthermore, language in the DEFRA committee report states that: "pure experience rating means automatic rebate in the event of good experience and automatic liability in the event of bad experience." Congress apparently intended experience rating to be an arrangement where an employer would be assessed additional money for the plan if too many benefits were paid, and the employer would receive a refund or pay a lesser amount to the plan if fewer benefits were paid.

Nothing in the legislative history of the Deficit Reduction Act of 1984 seems to suggest the construction advanced by the IRS in its Proposed Regulations that Congress intended to disqualify any plan for Code § 419A(f)(6) treatment merely: (i) because the plan maintained separate record accounts for various participating employers or (ii) because, upon withdrawal from a TOME plan, an employer’s participating employees could receive a taxable distribution that is based, in part, on the value of the assets held in the TOME plan as welfare benefits. In light of the expansiveness of the phrase “experience-rating arrangement” set forth in the Proposed Regulations, one could argue that the IRS intends to eliminate the availability of the TOME exception provided under IRC § 419A(f)(6) through regulation, rather than seeking legislation from Congress. This position should be rejected as propaganda of its own initiative.

There is clear congressional and judicial authority that demonstrate that the IRS may be attempting to propagandize or legislate through rulemaking, which is improper. Amendments to the IRC are proper for evaluation by Congress in its sole legislative capacity.

Both the current legislative proposals, the EBWEA and the SBWBPA provide definitions that are consistent with prior law. The current economic environment already has shaken small business employers and the welfare benefits that they can offer and left them facing serious and justified concerns about the viability of other important welfare benefits, such as retirement accounts and 401(k) accounts. To avoid
uncertainty, the Congress should intervene and put the issue of experience rating arrangements to rest, which will provide some certainty to small businesses in an uncertain economic period.

D. Determination Letters or Listing Transactions?

As stated by Senator Hatch, “We must be concerned about the impact on all employees of additional Federal requirements that unnecessarily complicate existing arrangements or that will shift a firm's resources from actual benefits into regulatory compliance or litigation.”\(^{386}\) Although the IRS has proposed that taxpayers provide certain information with respect to TOME plans, it seems that the more expedient and less complicated means by which to avoid these issues entirely is simply to require a determination letter from the IRS for all such plans so that the IRS can keep track of the plans and potential abuses in contravention of the law. The EWBEA provides for such determination letters and is a good model for legislative action on this issue. Providing for complicated or excessive reporting requirements should be avoided, especially in light of the burden this would pose on small businesses that don’t employ large staffs by their very nature.

E. Severance Benefits.

The Proposed Regulations do not appear to directly take a position with respect to whether employers should be able to provide severance benefits as part of a TOME plan. Although such welfare benefits can be excluded entirely as proposed by the EWBEA,\(^{387}\) if severance benefits are allowed to be provided by small business employers under this statutory provision, then severance should be linked to a non-controllable event in order to be covered, so that employer abuse is not present. Alternatively, if severance benefits are permitted, the SBWBPA provides one means by which these benefits can be limited.\(^{388}\)

VI. Conclusion

“It has been our policy to encourage employers to provide generous employee benefits. Clearly, this objective is frustrated, if not defeated, if Congress enacts legislation that so heavily encumbers American companies that they must reduce or eliminate such benefits.”\(^{389}\) A properly designed VEBA program offers small business employers opportunities for tax-advantaged financial planning that encourages small business owners to provide welfare benefits to themselves and their employees. TOME plans offer creditor protection and relief from onerous rules impacting substantial pension plans that suffer from probable confiscatory taxation. It may

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\(^{387}\) See infra Part IV.B.2.
\(^{388}\) See infra Part IV.B.3.
offer some small business employers an additional alternative to putting insurance in a retirement plan. Providing the employees of small businesses with welfare benefit plans, such as the VEBA, rewards company loyalty, encourages small business growth and protects families. Furthermore, use of VEBA plans in particular is backed by 74 years of statutory, judicial and regulatory precedent.  

The IRS is correct in its dedication to put an end to abuses of TOME plans, but Congress clearly intended for 419A(f)(6) plans to be used as an incentive for small business employers to help them provide for welfare benefits, such as long-term care, medical, disability and death benefits. From a public policy standpoint, if the private sector is able to provide for the small business owners, their employees and their families, the government is relieved of that burden. It is essential that in its efforts to curtail illegitimate tax practitioners, that the IRS regulate the laws as made by Congress and not engage in any type of propaganda campaign because it sees the possibility for misuse in a tax deferment plan that Congress legislated. Furthermore, it is imperative that Congress continue in its prior path of supporting initiatives that aid the small businesses that are crucial to our economy and not extinguish the market for 419A(f)(6) plans that ultimately incentivize small business employers to provide needed welfare benefits for themselves and their employees. Of all the proposals that have been advanced to date, the EWBEA appears to be the only one that addresses most of the issues with respect to TOME plans that are very much in need of resolution. Because of the IRS’ reluctance to engage in meaningful development of effective regulations that will effectuate the statutory provisions as articulated by Congress, some form of legislative action with the attributes of the EWBEA appear to be the only solution short of litigation to avoid the impact of the IRS’ proposed propaganda.

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390 See infra Parts I, II.
391 See infra Part I.
392 See infra Part IV.