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

TAX EXEMPT AND
VERNMENT ENTITIES
DIVISION

Release Number: 200836041
Release Date: 9/5/08
Date: April 17, 2008

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend:

(M) = VEBA
(N) = Applicant Corp
(O) = Person #1
(P) = Person #2
(Q) = Person #3
(R) = Family (O, P & Q)
(S) = Person #4
(T) = Person #5
(U) = Person #6
(V) = Trust Company

UIL #'s:

501.09-00
501.09-01
501.09-02
501.09-03
501.09-04

Dear

We have considered your application for recognition of exemption from Federal income tax under Internal Revenue Code section 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under Code subsection 501(c)(9) or under any other subsection of 501(a). The basis for our conclusion is set forth below.

Issue:

Do you, (M), meet the requirements to obtain exemption under 501(c)(9) of the Code?

Facts:

You were formed by a financial services company, (N), to provide death benefits, pre-retirement disability benefits and post-retirement health care benefits to the employees of the founder. The founder will finance the trust. On January 17, 2007 you filed an application for exemption under Section 501(c)(9) of the Code.

(O), (P) and (Q) are all related. (Q) is the mother and (O) & (P) are her daughters. Together, (O), (P) and (Q) make up the controlling family, (R).

A board resolution, dated December 30, , indicates, in part, that your trustees will be all three members of the controlling family. Any two trustees, may, on behalf of the Plan, (1) give orders in the said account or accounts for the purchase, sale or other disposition of stocks, bonds, and other securities, (2) deliver to and receive from any Insurance Company on behalf of the Plan any monies, stocks, bonds, and other securities, (3) sign acknowledgements of the correctness of all statements of accounts and (4) make, execute and deliver under the seal any and all written endorsements and documents necessary or proper to effectuate the authority hereby conferred. The resolution was signed solely by one member of the controlling family, the CEO and President of the sponsor, (O).

Your Trust Agreement, adopted December 30, , indicates, in part, the plan administrators duties and authorizations and the powers of the trustees. Article 6.2 indicates that the founder, (N), may remove the Trustee at any time upon 30 days written notice. Article 7.2 indicates that the Trust agreement may be modified at any time by the founder. Your trust agreement was signed three times but all signatures were by one person; (O) as President of (N), Trustee of the Trust and attesting as secretary.

Your Plan Adoption Agreement was signed solely by (O) as President of the founder. Your Plan, effective January 1, , indicates, in part, when an employee of the founder is entitled to benefits under the Plan. For example, the employee must be 21 years of age, complete 1,000 or more hours of service within a fiscal year, and have a minimum of 24 months of service. Death benefits are provided to all participants at 20 times their annual salary. Disability benefits are provided up to $120,000 per year in benefit payable for up to five years.

The Plan actuarial valuation submitted by you indicates death benefits to all employees at 16 times their annual salary, disability benefits of 60% of salary for up to five years, post-retirement medicate benefits of "all expenses not covered by Medicare or Health Insurance after Normal Retirement Age" (normal retirement age is defined as age 55), and upon 6 years of service an employee, upon termination, is entitled to 100% of his/her accrued benefit.

The Plan actuarial valuation also includes the following tables:

Estimated Benefits
For Plan Year Ending December 31,

Participant Name	Date of Birth	Salary	Death Benefit	Disability Benefit	Medical Benefit
(O)		$	$	$	All
(Q)		$	$	$	All

Estimated Costs

For Plan Year Ending December 31,

Participant Name	Contribution for Death Benefit	Contribution for Disability Benefit	Contribution for Medical Benefits	Total
(O)	$	$	$	$
(Q)	$	$	$	$

The controlling family, (R), represents the majority of the employees of the founder, (N), who controls you, (M), through the governing employee plan. The founder can amend the trust at any time and can appoint an investment manager to manage the fund assets in any way it deems desirable.

The current participants of the plan are as follows:

(O) – CEO and President of (N) and member of the controlling family.

(P) – Escrow Officer of (N) and member of the controlling family.

(Q) – Auditor of (N) and member of the controlling family.

(S) – Receptionist of (N)

(T) – Processor of (N)

As noted earlier, (O), (P) and (Q) are all related. (Q) is the mother and (O) & (P) are her daughters. Together, (O), (P) and (Q) make up the controlling family, (R).

The Plan adoption agreement further indicates that a member of the controlling family, (O), is the governing employee board and (U) is the Plan Administrator. An amendment to the Adoption Agreement dated 8/1/ indicates that (U) was added as a second member of the governing employee board. (U) is the insurance agent who sold policies to the VEBA.

The Voluntary Employee Welfare Benefit Plan document was adopted on the day and date set forth in the Plan Adoption Agreement, January 1, , and indicates, in part, the following:

1) Section 5.1(a): The governing employee board shall be the governing board of the Plan, as appointed from the Participants in the Plan. The Governing Employee Board shall consist of at least two (2) Participants, only one (1) of whom may own stock in the Company, and shall be appointed by the Board to serve terms of two years which terms may be automatically renewed if the Board agrees. In the event the number of Participants falls below the minimum number necessary to constitute the Governing Employee Board, then seats shall be filled by the appointment of any other individuals (who may include Participants who own stock in the Company or Employees who are not Participants).

2) Section 5.2(a), indicates, in part, that the plan administrator is designated and can be removed by the governing employee board.

3) Section 5.9 indicates, in part, that the founder, (N), may appoint a qualified investment manager to manage the assets of the fund.

Therefore, the controlling family has total control of the VEBA because they choose and can remove the governing board, plan administrator or any investment manager.

A letter dated August 8, 2007 from you indicated that the Trust Company (V) would replace both (O) & (Q) as trustees of your trust. No trust amendment to this effect has been received.

Incomplete financial information was submitted by you. A summary of information submitted is as follows:

Participant Name	Compensation Levels	Contributions to the plan for Death Benefits	Insurance Amount
(O)	$	$	$
(P)		$	$
(Q)	$	$	$
		$	$
(S)		?	$
(T)	$	?	$

Pre-retirement disability benefits = 100% of salary up to $120,000 per year for up to 5 years.

Participant Name	Compensation Levels	Contribution to the plan for Disability Benefits
(O)	$	$
(P)		
(Q)	$	$
(S)		
(T)	$	

Post-retirement health benefits = all expenses not covered by Medicare or Health Insurance after Normal Retirement Age.

Participant Name	Age	Contributions to plan for post-retirement health benefits
(O)		$
(P)		
(Q)		$
(S)		
(T)		

The total contributions to the plan in , and were $ per year. The information for was taken from copies of insurance policies submitted with the application. No complete financial information was submitted.

The controlling family, (R), members accounted for 100% of the contributions in , and ($ per year). Taking what we know and making reasonable assumptions regarding the missing information (such as younger employees will require less contributions, etc...) it appears that in the controlling family members accounted for 80% of the contributions.

A review of the insurance policies submitted with your application indicates that the members of the controlling family, (O), (P) and (Q), all had whole life insurance policies in the amount of $, $ and $ respectively. Each policy specification indicated that loans could be obtained.

On the other hand, the other two insurance policies for the unrelated clerical employees, (S) and (T), were both 20 year level terms policies with no loan privileges.

Your letter dated July 20, 2007 indicated that the plan does not allow participants to obtain loans.

Law:

The Voluntary Employees' Beneficiary Association (VEBA) is a mutual association of employees providing certain specified benefits to its members or their designated beneficiaries. It may be funded by the employees or their employer. The VEBA has existed in the tax law since the Revenue Act of 1928 when it was given exempt status under section 101(16) of the Act. Exemption for this entity was re-enacted by the Revenue Acts of 1932, 1934, 1936 and 1938. The VEBA was incorporated into the 1939 Code as IRC 101(16) and subsequently into the 1954 Code, as amended to date, as IRC 501(c)(9).

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

Section 1.501(c)(9)-1 of the Income Tax Regulations provides that for an organization to be described in section 501(c)(9) an organization must meet all the following requirements:

(a) The organization must be an association of employees;
(b) Membership in the association must be voluntary;
(c) The organization's purpose is to provide for the payment of life, sick, accident, or other benefits to its members or their dependents or designated beneficiaries, and substantially all of its operations are in furtherance of providing such benefits, and
(d) No part of the net earnings of the organization inures, other than by payment of the benefits referred to in (c), to the benefit of any private shareholder or individual.

Treas. Reg. section 1.501(c)(9)-2(a)(2)(i) provides rules relating to permissible restrictions a VEBA may impose on eligibility for benefits:

"Eligibility for benefits may be restricted by objective conditions relating to the type or amount of benefits offered. Any objective criteria used to restrict eligibility . . . for benefits may not, however, be selected or administered in a manner that limits . . . benefits to officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association. Similarly, eligibility for benefits may not be subject to conditions or limitations that have the effect of entitling officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association to benefits that are disproportionate in relation to benefits which other members of the association are entitled. See § 1.501(c)(9)-4(b). Whether the selection or administration of objective conditions has the effect of providing disproportionate benefits to officers, shareholders, or highly compensated employees generally is to be determined on the basis of all the facts and circumstances."

Section 1.501(c)(9)-2(c)(3) of the regulations states that in order to be described in section 501(c)(9) an organization must be controlled by independent trustee(s) (such as a bank).

Section 1.501(c)(9)-3(a) states that severance benefits under a severance payment plan within the meaning of Labor Reg. section 2510.3-2(b) are qualifying "other benefits." Labor Reg. section 2510.3-2(b) identifies the criteria by which a plan will be considered to be a severance payment plan rather than a pension plan for purposes of Title I of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1002(3) (Supp. V 1975). The Employee Retirement Income Security Act of 1974, more commonly known as ERISA was enacted by Congress primarily because of concerns about abuses in the private pension system.

Section 1.501(c)(9)-3(d) of the regulations defines "other benefits". The section states that "the term "other benefits" includes only benefits that are similar to life, sick, or accident benefits. A benefit is similar to a life, sick, or accident benefit if; (1) It is intended to safeguard or improve the health of a member or a member's dependents, or (2) It protects against a contingency that interrupts or impairs a member's earning power".

Section 1.501(c)(9)-3(f) of the regulations provides examples of non-qualifying VEBA benefits. The section states, in part, that "for purposes of section 501(c)(9) and these regulations, a benefit will be considered similar to that provided under a pension, annuity, stock bonus or profit-sharing plan if it provides for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event. Thus, for example, supplemental unemployment benefits, which generally become payable by reason of unanticipated layoff, are not, for purposes of these regulations, considered similar to the benefit provided under a pension, annuity, stock bonus or profit-sharing plan".

Section 1.501(c)(9)-4(a) of the regulations provides that no part of the net earnings of a VEBA may inure to the benefit of any shareholder or individual other than through the payment of permitted types of life, sick, accident, or other benefit. Prohibited inurement will be determined with regard to all of the facts and circumstances. Whether prohibited inurement has occurred is a question to be determined with regard to all of the facts and circumstances, taking into

account the guidelines set forth in this section. The guidelines and examples contained in this section are not an exhaustive list of the activities that may constitute prohibited inurement, or the persons to whom the association's earnings could impermissibly inure.

Section 1.501(c)(9)-4(b) of the regulations states, "For purposes of subsection (a), the payment to any member of disproportionate benefits, where such payment is not pursuant to objective and nondiscriminatory standards, will not be considered a benefit within the meaning of § 1.501(c)(9)-3 even though the benefit otherwise is one of the type permitted by that section. For example, the payment to highly compensated personnel of benefits that are disproportionate in relation to benefits received by other members of the association will constitute prohibited inurement."

Treas. Reg. § 1.501(c)(9)-4(d) provides that "It will not constitute prohibited inurement if, on termination of a plan established by an employer and funded through an association described in section 501(c)(9), any assets remaining in the association, after satisfaction of all liabilities to existing beneficiaries of the plan, are applied to provide, either directly or through the purchase of insurance, life, sick, accident or other benefits within the meaning of § 1.501(c)(9)-3 pursuant to criteria that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees of the employer. See § 1.501(c)(9)-2(a)(2). Similarly, a distribution to members upon the dissolution of the association will not constitute prohibited inurement if the amount[s] distributed to members are determined pursuant to the terms of a collective bargaining agreement or on the basis of objective and reasonable standards which do not result in either unequal payments to similarly situated members or in disproportionate payments to officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association".

Section 1.501(a)-1(c) of the Regulations provides that the words "private shareholder" or "individual" in section 501 refers to persons having a private interest in the activities of an organization.

Revenue Ruling 81-94, 1981-1 C.B. 330 holds that the inurement prohibition precludes the tax exemption of an organization operated to promote the private interests of an individual or individuals standing in relation to the organization as an investor for private gain.

Revenue Ruling 85-199, 1985-2 C.B. 163 holds that a VEBA with just one member cannot qualify for exemption.

Knollwood Memorial Gardens v. Commissioner, 46 T.C. 764 (1969) provides a broad interpretation of "net earnings" subjecting all the assets of an organization to the inurement prohibition.

In Lima Surgical Associates, Inc. Voluntary Employees Beneficiary Plan Trust v. U.S., No. 72-86T (June 15, 1990), the Court of Claims found in favor of the governments position that the VEBA in question did not qualify for exemption under section 501(c)(9) of the Code. In this case, the trust provided severance benefits to seven employees of a medical practice, three of whom were the doctors who were the sole shareholders of the employer corporation. Benefits were payable upon termination of employment for any reason other than death or termination

for cause. The trust was created subsequent to the termination of the employer's pension plan. Benefits were based on a combination of compensation and years of service, with the three doctors entitled to 95% of the benefits. Benefits were actually paid to one (non-physician) employee upon her retirement. A bank was named as trustee of the Trust, but the employer (and therefore the highly compensated physician-shareholders) retained ultimate control over all operations of the Trust. The Service, in denying exemption to the Trust, relied on three grounds, all of which were sustained by the Court.

(1) The "control test" of Regulations 1.501(c)(9)-2(c)(3) was not satisfied because the employer, not the bank trustee, actually controlled the Trust. Furthermore, the Trust could not be deemed to be controlled by the employees as an employee welfare benefit plan under ERISA section 3(1).
(2) Because the benefits could be payable upon retirement, the Court concluded the ERISA definition of a "severance pay benefit" at 29 CFR 2510.3-2(b) was not met. The Court stated that "any payment that is necessitated by the employee's retirement, be it voluntary or mandatory, does not qualify for treatment as a severance benefit..."
(3) Inurement to the three highly compensated shareholder-employees. A dominant share of the benefits (95%) would be paid to the three highly compensated shareholders-employees who controlled the employer. Furthermore, the benefits were clearly not based on a uniform percentage of compensation because length of service was also a factor in the benefit calculation. The Court therefore concluded that the plan provided for disproportionate benefits to highly compensated employees, resulting in inurement to the shareholder employees.

In Wade L. Moser v. Commissioner, 56 TCM 1604, T.C. Memo, 1989-142 (1989) aff'd as to other issues, 914F.2d 1040, 90-2USTC ¶50,498 (8th Cir. 1990) the IRS disallowed a $200,000 deduction by the taxpayer to a VEBA Plan. The Tax Court allowed the deduction in full as a section 162 business expense. The tax-exempt status for the VEBA plan was not an issue decided by the Court. The VEBA was subsequently revoked by the IRS.

In Joel A. Schneider, M.D., 63 TCM 1787, T.C. Memo 1992-24 (1992) a doctor was allowed to deduct VEBA contributions in excess of $1.1 million over three years where 95% of the benefit was for the doctor and his children. The trust applied for tax-exempt status under section 501(c)(9) but was denied, and this was not an issue in the case.

Sunrise Construction Company, Inc., Petitioner v. Commissioner of Internal Revenue, Respondent, Docket No. 39499-85, United States Tax Court, T.C. Memo 1987-21 (1987), held that the plan in question was not an exempt VEBA where (1) the amounts contributed far exceeded the amounts reasonable for the stated purposes of the contributions; (2) excess funds were invested at the direction of the shareholder in a non-fiduciary manner; and (3) terms of the organizing agreement were not honored upon termination of the plan. Contributions to the plan were therefore not deductible under sec. 162(a). In an interesting summary, the court concluded that:

In summary, the simple rule applicable to this case is the one frequently cited from Gregory v. Helvering, 293 U.S. 465 (1935), in which the Supreme Court concluded that what was done there, although in accord with the literal language of the statute, was mere artifice. Adapting the language to substitute the circumstances in this case for those involved in Gregory v. Helvering, supra, the rule is as follows:

> *No doubt, a new and valid [entity] was created. But that [entity] was nothing more than a contrivance to the end [of transferring property to the corporate shareholder]. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.*

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of [the applicable statute], was in fact an elaborate and devious form of conveyance masquerading as a [VEBA], and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. [Gregory v. Helvering, 293 U.S. at 469-470.]

The Supreme Court's opinion in Gregory v. Helvering, supra, has been relied on for a variety of purposes in a variety of transactions. See Moore v. Commissioner, 85 T.C. 72, 103 (1985). The case before us, however, is one of those in which its application is directly analogous to its original context. The requirement of section 501(c)(9) that no part of the net earnings of a VEBA inure to the benefit of any private shareholder or individual is patently intended to prevent use of a VEBA as a private investment account for a person in Battershell's position. Superficial compliance with the formalities cannot overcome the undisputed substantive facts. See also Knollwood Memorial Gardens v. Commissioner, 46 T.C. 764, 791 (1966).

IRC 505(b) contains certain requirements for organizations described in IRC 501(c)(9) and IRC 501(c)(20) unless they are subject to the exception of IRC 505(a)(2) for collective bargaining agreements. Under 505(b)(1), a plan will meet the requirements of IRC 505(b)(1) only if, (1) each class of benefits under the plan is provided under a classification of employees which is set forth in the plan and that does not discriminate in favor of employees who are highly compensated individuals, and (2) In the case of each class of benefits, such benefits do not discriminate in favor of employees who are highly compensated individuals. A life insurance, disability, severance pay, or supplemental unemployment compensation benefit shall not be considered to fail to meet the requirements of subparagraph (B) merely because the benefits available bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of employees covered by the plan.

Under section 105(a), amounts received by an employee through a self-insured medical reimbursement plan which are attributable to contributions of the employer, or are paid by the employer, are included in the employee's gross income unless such amounts are excludable under section 105(b). For amounts reimbursed to a highly compensated individual to be fully excludable from such individual's gross income under section 105(b), the plan must satisfy the requirements of section 105(h). Section 105(h) is not satisfied if the plan discriminates in favor

of highly compensated individuals as to eligibility to participate or benefits. All or a portion of the reimbursements or payments on behalf of such individuals under a discriminatory plan are not excludable from gross income under section 105(b). A self-insured medical reimbursement plan is a separate written plan for the benefit of employees which provides for reimbursement of employee medical expenses under section 105(b). A plan or arrangement is self-insured unless reimbursement is provided under an individual or group policy of accident or health issued by a licensed insurance company or under an arrangement in the nature of a prepaid health care plan that is regulated under federal or state law in a manner similar to the regulation of insurance companies.

Section 105(h)(2) of the Code provides that a plan satisfies the requirements of section 105(h) only if it does not discriminate in either eligibility or benefits in favor of highly-compensated individuals. Section 105(h)(5) of the Code provides, in part, that a highly-compensated individual is an individual who owns more than 10% in value of the stock of the employer and is among the highest paid 25% of all employees (other than those employees described in section 105(h)(3)(B) who are not participants.

A plan meets the requirements of IRC 105(h)(3)(A)(i) if it benefits at least 70% of all employees or 80% or more of all the employees who are eligible to benefit under the plan if 70% or more of all employees are eligible to benefit under the plan. In addition to the percentage test, IRC 105(h)(3)(A)(ii) indicates a plan must meet a classification test to ensure that its benefits do not favor a classification of employees who are highly compensated individuals.

In order to qualify for tax exemption under section 501(c)(9), an organization must provide benefits which meet the requirements of section 105(h). Section 105(h) is not satisfied if the plan discriminates in favor of highly compensated individuals as to eligibility to participate or benefits. Code section 105(h)(2).

In Notice 2007-83, the IRS notes that it is aware of certain trust arrangements utilizing cash value life insurance policies and purporting to provide welfare benefits to active employees. These arrangements are being promoted to small businesses and other closely held businesses as a way to provide cash and other property to the owners of the business on a tax-favored basis and to improperly claim federal income and employment tax benefits.

The arrangements are sometimes referred to by persons advocating their use as "single-employer plans" and sometimes as "419(e) plans." According to the IRS, advocates claim that the employers' contributions to the trust are deductible under IRC Secs. 419 and 419A as a qualified cost, but that there is not a corresponding inclusion in the owner's income.

Notice 2007-83 informs taxpayers that the tax benefits claimed for these arrangements are not allowable for federal tax purposes. These transactions are tax avoidance transactions, and the IRS identifies certain transactions using trust arrangements involving cash value life insurance policies, and substantially similar transactions, as "listed transactions." If a transaction is designated as a listed transaction, affected persons have disclosure obligations and might be subject to applicable penalties. Taxpayers who otherwise would be required to file a disclosure

statement prior to Jan. 15, 2008, as a result of Notice 2007-83 have until Jan. 15, 2008, to make the required disclosure.

In Rev. Rul. 2007-65, the IRS concludes in two specific situations that for purposes of allowable deductions under Sec. 419, a welfare benefit fund's qualified direct cost does not include premium amounts for cash value life insurance policies paid by the fund, whenever the fund is directly or indirectly a beneficiary under the policy.

In the first situation, an employer-financed group term life insurance plan is provided through a taxable trust. The trustee has obtained a cash value life insurance policy on the life of each employee, where the amount of the death benefit equals the amount payable under the plan to the employee's beneficiary and the death benefit proceeds under each policy are payable to the beneficiary designated by the employee. The trust has retained all other policy rights. During the year, the employer contributes to the trust an amount equal to the aggregate premiums due on the life insurance policies payable by the trustee.

In the second situation, the facts are the same, except that the plan provides disability benefits to the employees. The trust is the owner and the named beneficiary of the life insurance policies held by the trust, which are intended to accumulate value to pay the disability benefits.

In the first situation, the revenue ruling notes that "if the benefit provided through the fund is life insurance coverage, premiums paid on cash value life insurance policies by the fund are not included in the fund's qualified direct cost whenever the fund is directly or indirectly a beneficiary under the policy."

In the second situation, if the benefit provided through the fund is other than life insurance coverage, "premiums paid on cash value life insurance policies by the fund are not included in the fund's qualified direct cost whenever the fund is directly or indirectly a beneficiary under the policy. However, the fund's qualified direct cost includes amounts paid as welfare benefits by the fund during the taxable year for claims incurred during the year."

<u>Application of the Law:</u>

Section 501(c)(9), in conjunction with section 501(a), exempts from Federal income tax a voluntary employees' beneficiary association (VEBA) providing for the payment of life, sick, accident, or other benefit to its members or their dependents, or designated beneficiaries, if no part of the "net earnings" of the association inures (other than through such payments) to the benefit of any private shareholder or individual.

The phrase "net earnings" is given a broad interpretation, subjecting all of the assets of an organization to the inurement prohibition. See, <u>Knollwood Memorial Gardens v. Commissioner</u>, 46 T.C. 764 (1969), appeal dismissed nolle pros.

Probably the single most important consideration in qualifying for exemption under IRC 501(c)(9) is determining whether the plan discriminates in favor of officers, shareholders, or

highly compensated employees (the highly compensated group). The term is somewhat analogous to the terms "key employees" or "prohibited group" used elsewhere in the Code.

A VEBA cannot discriminate in favor of a highly compensated group and benefits cannot be disproportionate in favor of the group. However, the regulations clearly permit certain arrangements that generally favor the highly compensated group. For example, membership can be denied on the basis of a reasonable job classification, a minimum length of service, part-time employment, or union coverage. Even within the membership, the regulations permit certain variations in benefits that could favor the highly compensated group. For example, life insurance or severance benefits may be paid based on a uniform multiple of compensation.

Significant inurement problems can arise when the membership of the VEBA is limited to a few individuals. Typically, in these cases the owners of the creating employer corporation control the corporation and the VEBA, and receive a dominant share of the benefits from the VEBA.

Revenue Ruling 85-199, 1985-2 C.B. 163 holds that a VEBA with just one member cannot qualify for exemption. A VEBA with only a few members (usually less than 15-20) is at great risk of being used to provide impermissible deferred compensation benefits or other forms of prohibited inurement. This is particularly true when a small business or a key employee effectively controls the VEBA.

Whether a VEBA meets the definitional requirement that no part of its net income can inure to the benefit of any individual is a question to be determined with regard to all the facts and circumstances. Treas. Reg. § 1.501(c)(9)-4(a). 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).

A VEBA functions primarily as a cooperative device for pooling funds and distributing risks over and benefits to a defined group of employees sharing an employment-related common bond. While an organization may provide benefits to promote the common welfare of an association of employees in a manner consistent with section 501(c)(9), the inurement proscription bars the tax-exempt treatment of an organization predominantly organized and operated to promote the interests of an individual standing in relationship to the organization as an investor for private gain.

Treas. Reg. § 1.501(a)-1(c) provides that the "words 'private shareholder or individual' in section 501 refer to persons having a personal and private interest in the activities of the organization." The word "private" is the antonym of "public" -- used merely to distinguish a private individual from the general public -- and is intended to limit the scope of those persons who personally profit from the organization to the intended beneficiaries of the allowable activities. Clearly, an individual related to a VEBA as trust administrator, beneficiary, and owner of the contributing employer has a personal interest in the VEBA's activities and is subject to the section 501(c)(9) inurement proscription.

You do not qualify for exemption under Section 501(c)(9) of the Code as a voluntary employees' beneficiary association (VEBA) for the following reasons.

Inurement:

(O), a member of the controlling family, is related to the VEBA as one of the two primary beneficiaries and is the majority shareholder of the contributing employer and has a personal interest in the VEBA's activities and is subject to the section 501(c)(9) inurement prohibition. The other primary beneficiary is the mother of (O), (Q).

Thus, the holding of Rev. Rul. 81-94 (supra) applies to your Plan in that the Plan promotes the private interests of the controlling family and specifically (O) and (Q) and thus fails to qualify for tax-exempt status. Because of the close relationship of (O) to your Plan, the Plan is not controlled by an independent person as required in Section 1.501(c)(9)-2(c)(3)(ii) of the Regulations.

Your Plan is similar to the Plan discussed in Lima Surgical Associates, Inc. VEBA (supra) in that in its present form, it covers a small number of employees and provides a dominant share of the aggregate benefits to the controlling family, specifically (O) and (Q). You were set up by the controlling family to primarily benefit (O) and (Q).

In Lima, the primary issue was whether a Trust qualified for tax-exempt status under section 501(c)(9). The Court held that the plan did not qualify for exemption as it did not meet three of the four mandatory requirements listed in Regulations 1.501(c)(9)-1. The Court held the Trust was not a voluntary association of employees because it was not controlled by an independent trustee; it did not provide for the payment of life, sick, accident, or other benefits; and the Trust violated the proscriptions against private inurement because it provides disproportionate benefits to its officers, shareholders, and highly compensated employees in a way prohibited under Regulations 1.501(c)(9)-4(b). Your Plan can be compared to Lima in that you do not have an independent trustee and you are providing disproportionate benefits to the two members of the controlling family, (O) and (Q).

As it is structured, you serve the private interests of the controlling family, (R). You effectively provide deferred compensation to the controlling family. The entire organization is a tax-sheltered saving device for the controlling family.

Under the circumstances, the controlling family would maintain a posture incompatible with the inurement proscription. The limited number of participants in combination with the allocation of a dominant share (100% of past benefits and a projected 80% of future benefits) of aggregate benefits to two members of the controlling family indicates that you are organized and operated for their benefit and not for any employee group.

Additionally, we think that a separate and independent basis for determining prohibited inurement, which does not turn directly on the portion of aggregate benefits provided to the controlling family, (R), is the degree of economic benefit conferred on them through your establishment. The private beneficence of utilizing you primarily as an investment fund to finance the insurance needs of the controlling family would not be incidental to the purpose of

pooling the risks of an employee group generally. A finding of inurement would therefore be also supported if, at the time you were established and based on actuarial assumptions that are reasonable in the aggregate, a dominant share of all costs or contributions necessary to fund all benefits provided under you were determined to be attributable to the funding of benefits provided to the controlling family. In that case, the line of demarcation between the interests of you and the financial interests of the controlling family blur and, by preconceived design, your manifest purpose would be to serve primarily as a tax-exempt device to confer economic benefit on the controlling family.

Control:

You are subject to the total control of the controlling family, (R).

As beneficiary, the controlling family receives the allocation of a substantially all of the aggregate benefits.

(O) is the CEO and President of the founder, (N), which selects and removes members of the VEBA governing employee board. Along with her mother (Q) and sister (P), (O) comprises the controlling family, which is the majority of the participants in the VEBA.

The board resolution, dated December 30, , indicated that your trustees will be all three members of the controlling family and was signed solely by one member of the controlling family, the CEO and President of (N), (O). Your Trust Agreement was adopted December 30, and was signed three separate times by the same one person; (O) as President of (N), Trustee of the Trust and attesting as secretary. Your Plan Adoption Agreement was signed solely by (O) as President of (N). All of the preceding shows the actual control over your activities by (O), a member of the controlling family.

The for-profit founder, (N), has ultimate control over you in that it determines the level of contributions and benefits, reserves the right to terminate the plan at any time and for any reason, and governs the composition of the Governing Employee Board by directing the composition of those in the Company's employ. Also, the founder's Board of Directors may act jointly with the Governing Employee Board to amend you at any time.

(O) is related to the VEBA as a member of the governing board, Trustee, beneficiary and owner of the contributing employer; this clearly establishes (O) as a "private shareholder" subject to the section 501(c)(9) inurement proscription.

Under the circumstances, we believe that the controlling family, (R) would maintain a posture incompatible with the inurement proscription since they possessed effective control over the contributing employer. A limited membership in combination with the allocation of a dominant share of benefits to the controlling family indicates that you are organized and operated for the particular benefit of the controlling family and not for any employee group as a whole.

Prior to termination, you accumulate funds substantially all of which is for the benefit of the controlling family. With effective control over the contributing employer, the controlling family would have the power to determine the extent of contributions and benefits, manage your operations, and direct the investment of your assets. Further, with effective control, you would be subject to termination at the whim of the controlling family. By controlling the timing of your termination, the controlling family would be able to direct the distribution of their allocable share of the Plan. Under these circumstances, you would function substantially as an investment fund for the direct personal and private benefit of the controlling family. An organization functioning in this manner is inconsistent with the exempt purpose of a VEBA in providing benefits to promote the common welfare of an association of employees as opposed to the welfare of a single employee or family.

Additionally, in serving as an investment fund for the controlling family owner-members who have discretion over contributions and over withdrawal upon termination, you would be providing a non-qualifying benefit under Treas. Reg. section 1.501(c)(9)-3(f). Clearly, a vehicle for the accumulation of investment funds for the personal benefit of the controlling family does not fall within the ambit of permissible "other benefits" as described in Treas. Reg. section 1.501(c)(9)-3(d) and (e). Accordingly, your net earnings would improperly inure to the benefit of the controlling family.

Two aforementioned cases are often cited as supporting the exemption of a limited membership VEBA controlled by individuals who receive substantially all of the benefits; Wade L. Moser v. Commissioner and Joel A. Schneider, M.D.

In Moser the Court began their opinion by stating the question of whether the VEBA plan qualified for exemption under section 501(c)(9) was not an issue in their ruling. However, the Plan was subsequently revoked by the IRS. The Court was asked to rule on whether the funding corporation to the Plan was entitled to a $200,000 business deduction under section 162 as an ordinary and necessary business expense. The IRS disallowed the deduction, in part, because 90 percent of the deduction was attributable to one individual. Of note is the fact that the Trustee of the VEBA Plan was an independent trust company. The Court determined the contribution was a section 162 business deduction and that there wasn't a statutory or regulatory provision prohibiting a deduction to an employee benefit plan because a large portion of the benefits were attributable to one employee. The Court made its ruling, in part, because an independent Trustee exerted day-to-day control over the assets.

In Schneider the issue was also the deductibility of contributions to a VEBA plan by a corporation as a section 162 business expense. The Service had already denied the application for tax-exempt status for the VEBA Plan that received the contributions that were being challenged. In Schneider, an independent bank served as trustee which gave the Court the assurance that the employer did not retain too much control over the Plan. Also, Schneider was decided prior to the section 419 and 419A of the Code which, in effect, allowed deductions only for the costs of current benefit plus and actuarially determined allowance for certain reserves

and benefits accounts. The Schneider case has no relevance to qualification for exemption under section 501(c)(9) and little relevance to current issues of deductibility.

Deferred Compensation:

Upon termination, you will distribute your assets in favor of controlling family members generally in proportion to compensation. You are sponsored by a professional for-profit corporation, controlled by the controlling family, whose ongoing operation is centered upon providing the professional services of highly compensated members-employees. Under these circumstances, there is a strong inference that you may terminate prematurely and distribute large amounts of assets to benefit its highly compensated members-employees. Distributions in this context would, in effect, constitute the provision of non-qualifying deferred compensation benefits.

This highly probable outcome is further evidenced by the fact that a review of the insurance policies submitted with your application indicates that the members of the controlling family, (O), (P) and (Q), all had whole life insurance policies in the amount of $, $ and $ respectively. On the other hand, the other two insurance policies for the unrelated clerical employees, (S) and (T), were both 20 year level terms policies. This would be consistent with an intent to terminate prematurely and distribute substantially all of your assets to the controlling family.

A distribution of assets for the benefit of members, after the satisfaction of liabilities to existing beneficiaries, is permissible upon the termination of a VEBA. See, Treas. Reg. 1.501(c)(9)-4(d). However, distributed assets may constitute deferred compensation if attributed to employer contributions which are in excess of that necessary to fund qualifying benefits or which are accumulated for later distribution to members upon a termination of a VEBA that is not unanticipated but based on the mere passage of time.

With reference to the inurement analysis as presented above, where a trust is characterized as a private investment fund subject to the control of, and providing a dominant share of aggregate benefits to, an owner-member, asset distributions to the owner-member upon trust termination would constitute non-qualifying deferred compensation benefits under Treas. Reg. section 1.501(c)(9)-3(f). Based on the owner-member's control over trust termination, such distributions would be payable by reason of the passage of time and not as a result of an unanticipated event. Further, the fact that termination distributions originate from a trust organized and operated primarily for the benefit of the owner-member indicates that such distributions are similar to those provided under a plan or arrangement of deferred compensation. Therefore, the termination distributions to the owner-members would constitute non-qualifying deferred compensation benefits under Treas. Reg. section 1.501(c)(9)-3(f) and the VEBA would not qualify for tax-exempt status under section 501(c)(9).

Clearly, a vehicle for the accumulation of investment funds for the personal benefit of the controlling family does not fall within the ambit of permissible "other benefits" as described in Treas. Reg. § 1.509(c)(9)-3(d) and (e). Accordingly, your net earnings improperly inure to the benefit of the controlling family and specifically to two members of that family, the President and CEO of the founder, (O), and her mother (Q).

Discrimination

In order to qualify for tax exemption under section 501(c)(9), an organization must provide benefits which meet the requirements of section 105(h). Section 105(h) is not satisfied if the plan discriminates in favor of highly compensated individuals as to eligibility to participate or benefits.

The proposed VEBA provides maximum annual benefits for two members of the controlling family, (O) and (Q). The low end of this range is reserved for the two clerical employees and the higher end of the range is reserved for the controlling family members. Although the plan's benefits are not derived from a uniform percentage of employee compensation, the maximum benefits are still in proportion to the amount of compensation in contravention of Treasury Regulation 1.105-11(3)(i). Therefore, the higher the compensation of the employee, the greater the amount of benefits they receive. Thus, the Plan favors a classification of employees who are highly compensated and does not meet the "classification test" under section 1.105-11(c)(2) of the Regulations. In addition, the benefits disparity between the controlling family (100% of past benefits and a projected 80% of future benefits) and the other non-family participants (0% of past benefits and a projected 20% of future benefits) represents an "excess reimbursement" to the controlling family.

Under Treasury Regulation 1.105-11(e)(1), a reimbursement paid to a highly compensated individual, such as controlling family members (O) and (Q), is an excess reimbursement if it is paid pursuant to a plan that fails to satisfy the requirements of paragraph (c)(2) or (c)(3) for the plan year. The plan has not satisfied the requirements of Treasury Regulation 1.105-11(c)(3) because all benefits provided for the highly compensated employees are not provided for the clerical help. The test is applied to the benefits subject to reimbursement under the plan rather than the actual benefit payments under the plan. Under your proposed VEBA, the maximum benefits for the controlling family members (O) and (Q) are not available to the clerical employees or "uniform for all participants". Example One of Treasury Regulation 1.105-11(e)(4) describes a plan arrangement that is on point. This example clearly illustrates that if a plan provides a maximum reimbursable benefit that is greater for highly compensated employees than for non-highly compensated employees, the plan benefits are discriminatory.

Applicant's Position:

Applicant asserts that it qualifies as a VEBA under section 501(c)(9); it is not a deferred compensation plan and does not discriminate in favor of highly compensated individuals.

The following modifications are proposed with respect to satisfying the issues raised:

- Two controlling family members, (O) and (Q), have been replaced on the Governing Board by (U), an insurance agent who sold the policies to the VEBA. The insurance agent is also the Plan Administrator and is unrelated to any of the VEBA parties by either blood or marriage.

- Your letter dated August 8, 2007 indicated that a trust company, (V), would be appointed as Trustee in place of (O) and (Q). As of this date, no trust amendment to this affect has been received.

Service's Response to Applicant's Position:

The proposed modifications do not alter our conclusion that you do not qualify for exemption under Section 501(c)(9) of the Code as a voluntary employees' beneficiary association.

Section 5.1(a) of your VEBA Plan indicates that *"The governing employee board shall be the governing board of the Plan, as appointed from the Participants in the Plan. The Governing Employee Board shall consist of at least two (2) Participants, only one (1) of whom may own stock in the Company, and shall be appointed by the Board to serve terms of two years which terms may be automatically renewed if the Board agrees. In the event the number of Participants falls below the minimum number necessary to constitute the Governing Employee Board, then seats shall be filled by the appointment of any other individuals (who may include Participants who own stock in the Company or Employees who are not Participants)."*

Your adoption agreement indicated that the sole member of the original governing board was (O), the CEO and President of the sponsor and a member of the controlling family. A board resolution, dated December 30, , indicated, in part, that your trustees would be all three members of the controlling family (O, P and Q).

Your letter dated July 20, 2007 indicated that (O) and her mother, (Q), had been replaced by the insurance agent, (U), on the governing board. Therefore, the governing board would now consist of one controlling family member, (P), and the insurance agent (U).

Since the Governing Employee Board is intended to be comprised of 2 employees it is unclear how a Governing Employee Board consisting of one controlling member and one non-employee insurance agent who is also the Plan Administrator is a positive change or even allowed under your current Plan. In fact, as the clear language of the Section 5.01(a) indicates, the Governing Employee Board should always be two employees unless "*the number of Participants falls below the minimum number necessary to constitute the Governing Employee Board*". This is clearly not the case. Furthermore, by definition, an "employee board" should consist of employees, not individuals from a for-profit entity profiting from providing services to you.

Your second change, the intention of appointing a new trustee to replace members of the controlling family, shows no evidence of having occurred. But, even if this new "independent" trustee was hired, they would still be controlled by the controlling family and could be replaced at the controlling family's discretion.

Neither the actual questionable change nor the proposed change addresses our issues with your proposed VEBA. Neither prevents our finding of prohibited inurement. The controlling family would continue to maintain control over you by virtue of their control of the sponsor who selects and removes members of the Governing Employee Board. The controlling family would also continue to receive substantially all of the benefits during your operational life and upon your termination. Your proposed VEBA is formed as a vehicle for the accumulation of investment funds for the personal benefit of the controlling family and the plan benefits are discriminatory.

Conclusion:

You fail to satisfy the requirement of no prohibited inurement and do not qualify for tax-exempt status under section 501(c)(9).

The controlling family would maintain a posture incompatible with the inurement proscription. The limited number of participants in combination with the allocation of a substantially all of the benefits to the controlling family indicates that you are organized and operated for their benefit and not for any employee group.

The controlling family would also maintain a posture incompatible with the inurement proscription since they possessed effective control over the contributing employer. Prior to termination, you accumulate funds mainly for the current benefit of the controlling family, and specifically for two members of that family, (O) and (Q). With effective control over the contributing employer, the controlling family would have the power to determine the extent of contributions and benefits, manage your operations, and direct the investment of your assets. Further, with effective control, you would be subject to termination at the whim of the controlling family. By controlling the timing of trust termination, the controlling family would be able to direct the distribution of their allocable share of your assets.

The trust is essentially a private investment fund subject to the control of, and providing a dominant share of aggregate benefits to the controlling family. The controlling family has received all of the past benefits and will receive substantially all of the future benefits (100% of past benefits and a projected 80% of future benefits) and the other non-family participants received none of the past benefits and will receive an insubstantial amount of future benefits (0% of past benefits and a projected 20% of future benefits)

Asset distributions to the controlling family upon your termination would constitute non-qualifying deferred compensation benefits under Treas. Reg. section 1.501(c)(9)-3(f).

The proposed VEBA has not satisfied the non-discriminatory requirements imposed under sections 105(a) and 505(b).

The exempt status of your Plan, specifically in regard to whether prohibited inurement occurred, must be determined on the basis of the substance of the Plan and not its form. We conclude that, in substance, your Plan was not adopted or operated as an employee benefit plan but was merely a separate fund controlled by the controlling family for the primary benefit of two members of the controlling family, (O) and (Q). The incidental coverage of other employees of the corporation appears to be merely a cost of attempting to secure tax-exempt status.

Therefore, you do not qualify for exemption under Code subsection 501(c)(9) as a voluntary employees' beneficiary association (VEBA). Furthermore, you do not qualify under any other subsection of 501(a).

Your Appeal Rights:

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter.

We will consider your statement and decide if that information affects our determination. If your statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in Publication 892, Exempt Organization Appeal Procedures for Unagreed Issues.

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. To be represented during the appeal process, you must file a proper power of attorney, Form 2848, Power of Attorney and Declaration of Representative, if you have not already done so. For more information about representation, see Publication 947, Practice Before the IRS and Power of Attorney. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter to you. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to the applicable address:

Mail to:

Internal Revenue Service
EO Determinations Quality Assurance
Room 7-008
P.O. Box 2508
Cincinnati, OH 45201

Deliver to:

Internal Revenue Service
EO Determinations Quality Assurance
550 Main Street, Room 7-008
Cincinnati, OH 45202

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

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

Sincerely,

Rob Choi
Director, Exempt Organizations
Rulings & Agreements

Enclosure, Publication 892

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: June 13, 2008

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

Dear

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(9). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, you should follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Rob Choi
Director, Exempt Organizations
Rulings & Agreements

Enclosures:
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter