



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

OFFICE OF
CHIEF COUNSEL
CC:TEGE:EB:HW
JLaufer FREV-102516-00

JAN 12 2001

MEMORANDUM FOR Director, Exempt Organizations T:EO

FROM: Assistant Chief Counsel (Employee Benefits) CC:TEGE:EB

SUBJECT: [REDACTED]

This responds to your October 16, 2000 memorandum, requesting assistance in connection with the above-referenced application for recognition of exemption. Specifically, you ask us to address whether "severance benefits" provided to an owner of a small business are permissible VEBA benefits or whether they are deferred compensation.

[REDACTED] is the 100% shareholder of the sponsoring employer, [REDACTED] which has five employees: [REDACTED]. Neither [REDACTED] nor [REDACTED] is related to the [REDACTED]. The [REDACTED] (the Trust) provides severance benefits to all employees of [REDACTED]. [REDACTED] annual salary is \$ [REDACTED] and he earns more than [REDACTED] % of the total salaries paid by [REDACTED]. [REDACTED] is an [REDACTED], and [REDACTED] business is related to [REDACTED] work. From the information provided in [REDACTED] counsel's letter of August 22, 2000, in response to your proposed adverse determination letter, work performed by [REDACTED] other employees is related to [REDACTED].

Under the severance plan, participants are entitled to a severance benefit when they terminate employment with [REDACTED] after having completed [REDACTED] years of participation in the plan, regardless of the reason(s) for their departure, except "For Cause", which entails either criminal conduct or "acts in aid of a competitor." The August 22, 2000, letter proposes adding additional requirements to the severance plan, including limiting payment of a severance benefit for any [REDACTED] family members to a time when [REDACTED] or any loan out corporation with which he is affiliated, has been without a contract from [REDACTED] for a period of [REDACTED] consecutive months. The letter further states:

[REDACTED]

[REDACTED]

[REDACTED]

Section 501(c)(9) of the Code lists as exempt organizations VEBAs providing for payment of life, sick, accident, or other benefits to members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual. Regulation § 1.501(c)(9)-3(d) defines "other benefits" to include only benefits that are similar to life, sick, or accident benefits. That regulation states that 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 interrupts or impairs a member's earning power.

Section 1.501(c)(9)-3(e) sets forth examples of "other benefits," and states that "severance benefits (under a severance pay plan within the meaning of 29 CFR § 2510.3-2(b)...are considered 'other benefits' because they protect against a contingency that interrupts earning power."

Section § 501(c)(9)-3(f) provides that benefits that are not described in paragraphs (d) or (e) of § 1.501(c)(9)-3 are not "other benefits." It also provides that the term "other benefits" does not include any benefit that is similar to a pension or annuity payable at the time of mandatory or voluntary retirement, or a benefit that is similar to the benefit provided under a stock bonus or profit-sharing plan. The regulation further states that, for this purpose, 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.

Since the [REDACTED] family members employed by Taxpayer are not spouses or dependents of each other, it is arguable that [REDACTED] ownership interest in [REDACTED] should not be attributed to the other family members.¹ However, it is not

¹For some purposes at least, [REDACTED] ownership interest would be attributed to [REDACTED]. For example, constructive ownership rules under section 318(a) of the Code would attribute [REDACTED] ownership interest to [REDACTED] for purposes of determining whether [REDACTED] is a 5-percent owner under section 416(i)(1)(B). That determination is relevant to the determination of whether [REDACTED] is a highly compensated individual under section 505(b)(5) in favor of whom

necessary to reach that issue, because [REDACTED] has effective control over the payment of his severance benefit, even after adoption of the proposed amendment. [REDACTED] can simply decline to enter into additional [REDACTED] contracts. Accordingly, the purported severance benefit does not protect against a contingency that interrupts earning power, but rather is conditioned upon circumstances that can be reasonably expected to be in [REDACTED] control. Thus, even assuming (as [REDACTED] counsel states in its August 22, 2000, letter) that the benefits provided through the Trust are provided under a severance pay plan within the meaning of 29 CFR § 2510.3-2(b),² the benefits provided by the Trust are not "severance benefits" within the meaning of §1.501(c)(9)-3(e) (which provides examples of "other benefits") because they do not in fact protect against a contingency that interrupts earning power. Accordingly, the severance benefits also fail to satisfy the definition of "other benefits" under §1.501(c)(9)-3(d) of the regulations.

Furthermore, the severance benefits are payable by reason of the passage of time, rather than as the result of an unanticipated event. Indeed, the August 22, 2000, letter states that the intention of the severance plan is to provide [REDACTED] a benefit upon his retirement from the [REDACTED] industry. Thus, our conclusion is supported by the holding in Lima Surgical Associates, Inc. v. United States, 944 F.2d 885 (Fed. Cir. 1991), in which the court stated:

In this case, the taxpayer acknowledges that retirement is one of the several types of terminations that will trigger benefits under the Plan. The trial judge found that one of the important purposes of the Plan is to pay benefits to eligible members upon retirement...We agree with the trial judge that "the plan in issue here, by paying retirement benefits as part and parcel of its alleged severance pay plan, is both organized and operated to provide nonqualifying benefits."

discrimination is generally prohibited under the nondiscrimination requirements applicable to VEBAs contained in section 505(b). (In this case, however, he appears to be a highly compensated individual without regard to that determination, in view of the dollar amount of his compensation.)

² We note that in a case in which only owners of a business (no common-law employees) are covered by a severance plan, there may be an additional argument that the plan is not a severance plan within the meaning of 29 CFR 2510.3-2(b) (a regulation adopted and interpreted by the Department of Labor). In that event, the severance benefit would not be an example of "other benefits" described in § 1.501(c)(9)-3(e) of the Treasury regulations. Under the facts of this case, that possible argument is not relevant. However, we wanted to bring it to your attention due to the broader question raised by your assistance request regarding severance benefits paid to owners.

Lima Surgical, 944 F.2d 855, 880, citing 20 Cl. Ct. 674 at 685. See also, Wellons v. Comm'r, 31 F. 3d 569 (7th Cir. 1994), holding that a deduction to fund a severance pay benefit was governed by section 404 on the ground that the severance pay benefit was actually deferred compensation, because it was payable upon termination for any reason except dishonesty or fraud or if the employee took a leave of absence or converted to part time employment.

In summary, the severance benefit provided to [REDACTED] under the Trust is not an "other benefit" described in regulation § 1.501(c)(9)-3(d), because it does not protect against a contingency that interrupts earning power but rather is conditioned upon circumstances under which [REDACTED] would generally have control. Furthermore, because [REDACTED] ceasing to enter into [REDACTED] contracts (or retiring from his work as an [REDACTED] is an event that can be anticipated, the benefits are payable by reason of the passage of time rather than as the result of an unanticipated event. Accordingly, the severance benefits are in the nature of deferred compensation.

We are not prepared to say more generally that a "severance benefit" provided to an owner of a small business can never be a permissible VEBA benefit. However, it is hard to imagine circumstances under which a severance benefit to an owner or principal employee of a business would be payable only upon conditions under which that owner would not have control.

Please note that you have not asked us to address, and we are not herein addressing, the issue of prohibited inurement.

If you have any questions regarding this memorandum, please contact Janet Laufer at (202) 622

ALAN TAWSHUNSKY

By:



MARK SCHWIMMER
Senior Technician Reviewer
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)