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New IRS Guidance for Tax-Exempt Entities Funding Employee Benefits

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The IRS recently released a final regulation clarifying how voluntary employees' beneficiary associations (VEBAs) and supplemental unemployment benefit trusts (SUBs) should calculate unrelated business taxable income. VEBAs and SUBs are tax-exempt entities that are used to fund employee benefit programs. Read below for background, details of the final regulation, and the applicability date.

Background

Although VEBAs and SUBs are tax-exempt entities, they are subject to tax on their unrelated business taxable income. However, under an exception to this general rule, collectively-bargained VEBAs and SUBs are ***not*** subject to tax on their unrelated business income. The analysis below applies to non-collectively bargained VEBAs and SUBs.

For VEBAs and SUBs, unrelated business taxable income is defined to include all gross income earned during the year, but excluding member contributions and excluding amounts set aside to pay benefits and related costs up to the IRC section 419A account limit for the year (which, generally speaking, is the amount necessary to pay incurred but unpaid benefit claims at year-end). Amounts set aside to pay benefits in excess of the IRC section 419A account limit are included in unrelated business taxable income and subject to tax.

Against this backdrop, some taxpayers had taken the position that VEBA or SUB investment income earned during the year but spent on benefits was not included in unrelated business taxable income for the year. The U.S. Court of Appeals for the Sixth Circuit endorsed this interpretation in *Sherwin-Williams Co. Employee Health Plan Trust v. Commissioner* (6th Cir. 2003), and concluded that a VEBA's investment income spent on administrative costs was not included in unrelated business taxable income for that year.

Final regulation and applicability date

The final regulation clarifies that, for VEBAs and SUBs, investment income earned during the year is subject to unrelated business income tax to the extent it exceeds the IRC section 419A account limit for the year. This rule applies regardless of whether the investment income is spent on benefits during the year. Recognizing that VEBAs and SUBs under the Sixth Circuit's jurisdiction may have been operating in good faith reliance on the Sixth Circuit's decision in *Sherwin-Williams*, the IRS provided a delayed applicability date for the final regulation. The final regulation will apply to taxable years ***beginning*** on or after the date of publication of the final regulation (December 10, 2019).

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Plan sponsors should carefully review the current treatment of non-collectively bargained VEBA and SUB investment income to confirm that their approach complies with the final regulation.

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