Bond Case Briefs

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IRS LTR: VEBA's Settlement Amount Is Exempt Function Income.

The IRS ruled that an amount paid to a limited liability company the sole member of which is a tax-exempt voluntary employees' beneficiary association established as a result of a settlement agreement following a bankruptcy is exempt function income under section 512(a)(3)(B) and will not be treated as unrelated business taxable income.

Contact Person: * * *
Identification Number: * * *
Telephone Number: * * *

UIL: 501.09-00, 512.00-00, 512.09-03, 7701.00-00
Release Date: 8/22/2014
Date: May 30, 2014

Employer Identification Number: * * *

LEGEND:

Debtors = * * *
LLC = * * *
State = * * *
x = * * *

Dear * * *:

This responds to your ruling request dated December 9, 2013 as to the federal tax consequences of the proposed transactions under the Internal Revenue Code (I.R.C.) and the Federal Tax Regulations.

FACTS

You are a trust, a voluntary employees' beneficiary association (VEBA), recognized as tax-exempt as an organization described under § 501(c)(9).
You were established as a result of a Settlement Agreement approved by the United States Bankruptcy Court after Debtors filed voluntary petitions for relief under chapter 11 of title 11 of the Bankruptcy Code. Debtors had historically provided a number of benefits to their retired employees and the retirees' surviving spouses and eligible dependents through various welfare benefit programs ("Retiree Welfare Plans").

The Bankruptcy Court issued an order directing the Office of the United States Trustee to appoint a Retiree Committee to represent the interests of the Retiree Welfare Plans' retirees and beneficiaries. Following negotiations between Debtors and the Retiree Committee, the Bankruptcy Court issued an order approving a Settlement Agreement in which the parties mutually agreed to the termination

and termination date of the Retiree Welfare Plans. As part of the Settlement Agreement, a Settlement Amount of $x would be paid to a limited liability company ("LLC") whose single member is to be you. LLC was required to hold the Settlement Amount in its account for a minimum of five business days before distributions were to be made to you in your capacity as the single member of LLC.

The Settlement Agreement further provided that the Retiree Committee intended that you provide medical benefits to eligible retiree claim holders, based on an Apportionment Methodology.

In accordance with the terms of the Settlement Agreement, the Retiree Committee established you. Shortly thereafter, LLC was formed under the laws of State with you as the single member. No election has been made on a Form 8832, Entity Classification Election, to treat LLC as an association taxable as a corporation.

The LLC Agreement provides that the sole purpose of LLC is to function as a conduit by which the consideration payable by Debtors under the Settlement Agreement is to be contributed to you. The LLC Agreement further provides that as soon as reasonably possible following LLC's receipt of the Settlement Amount from Debtors, and after paying or making reasonable provision for any expenses, liabilities, reserves or other contingencies, LLC shall distribute all available funds to you. Moreover, upon dissolution of LLC, and after paying or making reasonable provision for creditors, all remaining funds of LLC will be distributed to you. The LLC Agreement further provides that the management of LLC shall be vested solely in you but that you have the right to delegate its management rights and powers.

Debtors paid an initial installment of the Settlement Amount to LLC shortly after LLC was formed. The following month, Debtors paid the balance of the Settlement Amount to LLC. These amounts were deposited into an interest-bearing account maintained by LLC. The next month, LLC distributed the full Settlement Amount to you, and the Retiree Welfare Plans were terminated.

Pursuant to your trust documents and the Settlement Agreement, you will use the Settlement Amount to provide healthcare reimbursement benefits to retiree participants, their spouses and their dependents, as permitted under § 501(c)(9), and based on the Apportionment Methodology as set forth in the Settlement Agreement.

RULING REQUESTED

You have requested the following ruling:

That the Settlement Amount be treated as "exempt function income" under § 512(a)(3)(B), with the further result that no portion of the Settlement Amount will be treated as "unrelated business taxable income" to you.

LAW

Section 501(a) provides that an organization described in § 501(c) (including a VEBA described in § 501(c)(9)) shall be exempt from taxation unless the exemption is denied under §§ 502 or 503.

Section 511 imposes tax on the unrelated business taxable income (as described in § 512) of organizations described in § 501(c).

Section 512(a)(3)(A) provides that, in the case of an organization described in § 501(c)(9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the allowable deductions that are directly connected with the production of gross income (excluding exempt function income), both computed with specified modifications.

Section 512(a)(3)(B) provides that the term "exempt function income" means, for a § 501(c)(9) organization, the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing the members or their dependents or guests goods, facilities, or services in furtherance of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business carried on by the organization) which is set aside to provide for the payment of life, sick, accident, or other benefits, including reasonable costs of administration directly connected with the provision of such benefits.

Section 512(a)(3)(E) provides that the amounts set aside as of the close of a taxable year for the payment of life, sick, accident, or other benefits may not be taken into account for purposes of determining "exempt function income" to the extent that such amounts exceed the qualified asset limit, determined under §§ 419A(c) and 419A(f)(7), for such taxable year. In calculating the qualified asset account limit for this purpose, a reserve for post-retirement medical benefits under § 419A(c)(2)(A) is not to be taken into account. See, also Temp. Treas. Reg. § 1.512(a)-5T, Q&A-3(a), and Prop. Treas. Reg. § 1.512(a)-5.

Treas. Reg. § 1.512(a)-5T, Q&A-3(b), provides that the exempt function income of a VEBA includes certain amounts paid by members of the VEBA ("member contributions"). Member contributions include both employee contributions and employer contributions to a VEBA.

Treas. Reg. § 301.7701-1(a)(1) provides that the Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Treas. Reg. § 301.7701-2(a) provides, in part, that a business entity is any entity recognized for federal tax purposes (including a disregarded entity) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity is domestic if it is created or organized in the United States, or under the law of the United States or of any State. See § 301.7701-5(a).

Treas. Reg. § 301.7701-3(a) provides, in part, that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes. An eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Treas. Reg. § 301.7701-3(b)(1)(ii) provides, in part, that unless the entity elects otherwise, a domestic eligible entity is disregarded as an entity separate from its owner if it has a single owner.

Treas. Reg. § 301.7701-2(a) provides, in part, that if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. However, for employment and certain excise tax purposes, a disregarded entity is treated as a corporation. See § 301.7701-2(c)(2)(iv) and (v).

Announcement 99-102, 1999-43 I.R.B. 545, provides that when the owner of an eligible entity that is treated as a disregarded entity is exempt from taxation under section 501(a) of the Code, it must include, as its own, information pertaining to the finances and operation of the disregarded entity in its annual information return. Announcement 99-102 further states that "when an entity is disregarded as separate from its owner, its operations are treated as a branch or division of the owner."

ANALYSIS

Debtors contributed the Settlement Amount to LLC. Under the Settlement Agreement, LLC was required after paying or making reasonable provision for any expenses, liabilities, reserves or other contingencies, to distribute the remaining Settlement Amount to you which you will use to provide medical benefits to participants (their spouses and eligible dependents) of the Reimbursement Plan. Pursuant to your trust documents and the Settlement Agreement, you will use the Settlement Amount specifically to provide healthcare reimbursement benefits permitted under § 501(c)(9).

Based on the information provided, you are the single member of LLC and LLC has not made an election to be treated as an association taxable as a corporation. Accordingly, LLC is disregarded as an entity separate from its owner and its activities are treated as yours. As a result, the Settlement Amount paid to LLC by Debtors is treated as if paid to you by Debtors.

Further, the retirees eligible to receive medical benefits from you had been employed by Debtors and had been eligible to receive welfare benefits under Debtors' Retiree Benefit Plans. Based on these facts, we conclude that the Settlement Amount is treated as employer contributions to you.

Pursuant to Treas. Reg. § 1.512(a)-5T, Q&A-3(b), employer contributions to a VEBA are treated as exempt function income and, therefore, excluded from the definition of "unrelated business taxable income."

Accordingly, we conclude that the Settlement Amount is exempt function income under the first sentence of § 512(a)(3)(B), with the further result that no portion of the Settlement Amount will be treated as unrelated business taxable income to you.

RULING

Based on the information submitted, representations made, and the authorities cited above, we rule that:

The Settlement Amount is treated as "exempt function income" under § 512(a)(3)(B), with the further result that no portion of the Settlement Amount will be treated as "unrelated business taxable income" to you.

This ruling will be made available for public inspection under § 6110 after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.
This ruling is directed only to the organization that requested it. Section 6110(k)(3) provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

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

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are

sending a copy of this letter to your authorized representative.

Sincerely,

Michael Seto
Manager, EO Technical
Enclosure
Notice 437

Citations: LTR 201434025

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