Sherwin-Williams Co. Employee Health Plan Trust v. Commissioner, 115 T. C. 440 (2000)

Investment income set aside by a VEBA for administrative costs connected with providing benefits is subject to set-aside limits under IRC Section 512(a)(3)(E)(i).

Summary

The Sherwin-Williams Company Employee Health Plan Trust (Trust), a tax-exempt voluntary employees' beneficiary association (VEBA), challenged the IRS's determination that its investment income set aside for administrative costs was subject to unrelated business income tax (UBTI). The Trust argued that these costs were exempt function income and not subject to the set-aside limits under IRC Section 512(a)(3)(E)(i). The Tax Court ruled against the Trust, holding that the set-aside limits do apply to such income, and the amounts set aside must not exceed the account limit determined under IRC Section 419A without regard to the post-retirement medical benefits reserve.

Facts

The Trust was established by Sherwin-Williams to fund health care benefits for its employees. It was recognized as a VEBA under IRC Section 501(c)(9). The Trust's income came from member contributions and investments. For the tax years 1991 and 1992, the Trust set aside investment income to cover administrative costs related to health care benefits. The IRS determined that these amounts were subject to UBTI because they exceeded the set-aside limits prescribed by IRC Section 512(a)(3)(E)(i).

Procedural History

The IRS issued a notice of deficiency to the Trust for the tax years 1991 and 1992, asserting deficiencies due to the Trust's failure to include the set-aside investment income in its UBTI calculations. The Trust filed a petition with the U. S. Tax Court challenging the IRS's determinations. The Tax Court held in favor of the IRS, finding that the investment income at issue was subject to the set-aside limits under IRC Section 512(a)(3)(E)(i).

Issue(s)

1. Whether the amount of investment income set aside by the Trust to provide for the payment of reasonable costs of administration directly connected with providing for the payment of health care benefits is subject to the limitation prescribed by IRC Section 512(a)(3)(E)(i)?
2. Whether, in calculating the limitation prescribed by IRC Section 512(a)(3)(E)(i), the amount of assets set aside by the Trust to provide for the payment of health care benefits, including reasonable costs of administration, must be reduced by the reserve for post-retirement medical benefits described in IRC Section 419A(c)(2)(A)?

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Holding

1. Yes, because the plain language of IRC Section 512(a)(3)(B) treats income set aside for administrative costs as income set aside for the purpose described in that section, which is subject to the limitation prescribed by IRC Section 512(a)(3)(E)(i).
2. No, because the limitation prescribed by IRC Section 512(a)(3)(E)(i) requires only the account limit determined under IRC Section 419A to be reduced by the reserve for post-retirement medical benefits, not the amount of assets set aside.

Court's Reasoning

The Tax Court interpreted IRC Section 512(a)(3)(B) to mean that income set aside for administrative costs related to exempt purposes is still subject to the set-aside limits under IRC Section 512(a)(3)(E)(i). The court rejected the Trust's argument that administrative costs constitute an independent source of exempt function income, stating that such costs are part of the set-aside for benefits under IRC Section 512(a)(3)(B)(ii). The court also clarified that the parenthetical phrase in IRC Section 512(a)(3)(E)(i) regarding the exclusion of the post-retirement medical benefits reserve applies only to the calculation of the account limit under IRC Section 419A, not to the calculation of the total assets set aside. This interpretation was supported by the legislative history and temporary regulations. The court noted that the Trust's own agreement acknowledged the applicability of IRC Section 512(a)(3)(E)(i) to administrative costs.

Practical Implications

This decision clarifies that VEBAs must include investment income set aside for administrative costs in their UBTI calculations if such amounts exceed the limits set by IRC Section 512(a)(3)(E)(i). Practitioners should ensure that their clients' VEBAs adhere to these set-aside limits, carefully calculating the account limit under IRC Section 419A without including the post-retirement medical benefits reserve. This ruling impacts how VEBAs structure their reserves and may influence their financial planning and tax strategies. Subsequent cases, such as those involving other types of exempt organizations, may reference this decision to interpret similar set-aside provisions.

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