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CC:PA:LPD:PR (REG-143874-10)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20224

Re: Comment Concerning Proposed Regulation REG-143874-10 Regarding the Calculation of UBTI

To Whom It May Concern:

Set forth below is my comment with regard to Proposed Treasury Regulation § 1.512(a)-5 concerning the determination of unrelated business taxable income ("UBTI") as applied to IRC § 501(c)(9) entities ("VEBAs"). As directed, enclosed are eight (8) copies of this comment.

REQUEST FOR PUBLIC HEARING. I respectfully request that if a public hearing is to be held with regard to the proposed regulation, I be permitted to testify. However, if there is no other commenter requesting a public hearing, then I am not requesting a hearing solely to consider my comment.

MY INTEREST IN THIS REGULATION.

While with the Office of Chief Counsel to the IRS (Employee Plans and Exempt Organizations Division), I was credited with being the principal author of the 1980 proposed VEBA regulations[1] which were finalized later that year. Since leaving the Treasury Department I have been in private legal practice, engaged in large part in assisting taxpayers and service providers in providing welfare benefits to employees, frequently through VEBAs. I have helped implement or advise with regard to over several hundred VEBAs. I am concerned that unless the proposed regulation is revised to address the concern expressed below, many of these VEBAs will be adversely impacted in an unfair manner. There is no client, VEBA nor otherwise, who has retained me to express the concern set forth below.

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[1] 45 Fed. Reg. 47871 (July 17, 1980).

BACKGROUND.

The statute which is the subject of the regulation, IRC § 512(a)(3)(E), was enacted in 1984 and became effective in 1986. I was actively involved on the Hill during the Congressional effort which culminated in the statute, including having testified to the House Ways and Means Committee on the proposal[2] and meeting with the staff members. As regards the specific position taken in the proposed regulation, I do not believe that Congress addressed the particular question nor do I think that there is any reliable contemporaneous authority on the matter.

It is my opinion that there was no reliable authority addressing the question, let alone resolving it, prior to the decisions of the U.S. Tax Court in 2000 and the Sixth Circuit Court of Appeals in 2003. Sherwin-Williams Co. Employee Health Plan Trust v. Comm'r, 330 F.3d 449 (6th Cir. 2003), 2003-1 USTC ¶50,484, rev'g. 115 T.C. 440 (2000). Up until that time there was great confusion in the legal and tax community as to what the proper method or methods were for computing UBTI under IRC § 512(a)(3)(E), especially under circumstances such as those addressed by the Tax Court and the Sixth Circuit Court of Appeals.

I had studied and written extensively on the subject, evaluating the various methods for determining UBTI generally under such circumstances.[3] I disagreed with two of the methods widely-espoused by tax practitioners (taxing all income attributable to a retiree medical reserve; taxing all income set aside to provide retiree medical benefits), and instead stated my agreement with the position espoused by the IRS.[4] However that position, as I understand it to have been stated, was that income was subject to tax to the extent it was set aside and the yearend asset value of the fund exceeded the adjusted account limit under IRC § 419A(c). To my knowledge, prior to Sherwin-Williams, the IRS had never taken a position regarding what, if anything, could or could not be done regarding paying out investment income instead of setting it aside as of yearend. If the IRS had previously taken a position with regard to that subject, I do not believe the position to have ever been released to the public, whether in a ruling, technical advice memorandum, Continuing Professional Education Technical Instruction Program, Internal Revenue Manual, Audit Handbook, or otherwise.

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[2] Hearings Before The Committee on Ways and Means, House of Representatives on Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms, 98th. Cong., Second Session (Feb. 28, 1984), considering Proposals Relating to Tax Shelters and Other Tax-Motivated Transactions, Joint Committee on Taxation (Feb. 17, 1983).

[3] See, for example, Greenblatt and Harris, "Applying the New UBIT Rules to VEBAs," Vol. 4, No. 1 Benefits Law Journal 61 (Spring 1991).

[4] Id., at endnote 18, p. 73.

SPENDING INVESTMENT INCOME RATHER THAN SETTING IT ASIDE AS OF YEAREND.

The "technique" of spending investment income rather than setting it aside as of yearend is not something that was contrived by people looking to avoid UBIT under IRC § 512(a)(3)(E). Rather, the question of what is to be done with investment income is something which has been around for a long time. The matter of accounting for investment income is common in the world of trusts, such as when the trust corpus is to benefit one beneficiary and the investment income is to benefit a different beneficiary. In such cases it is important to identify and track investment income and account for it separately from corpus. Therefore, trust instruments frequently contain a provision directing how, when and for what purpose the trust's investment income is to be spent.

Another example, one with which members of the exempt organizations bar should be familiar, is the importance of how investment income of tax-exempt entities is to be applied. A common technique, at least one that I am familiar with, is to incorporate into the trust instrument a provision which mandates that permissible VEBA benefits are to be paid first out of investment income, and any unspent income is to be set aside as of yearend for the payment of permissible benefits in the succeeding year. As a result, if during the year an impermissible benefit is paid from the VEBA, there is basis for taking the position that the prohibited payment was NOT made from investment income, and thus UBIT would not be owed.[5]

It was with this in mind that I have advised clients for the past 25+ years to spend investment income currently to provide permissible benefits rather than setting it aside as of yearend.

LITIGATION ON THE QUESTION.

This "technique" was considered by the Sixth Circuit Court of Appeals in Sherwin-Williams, and was found to result in the avoidance of UBIT under IRC § 512(a)(3)(E).

Because there was no authority against operating in such a manner, and in fact the only authority available (Sherwin-Williams) expressly approved of such handling for UBIT purposes, to my knowledge, many VEBAs continued to take that position and some (such as those in the Sixth Circuit) still do so to this day.

The IRS has opposed this method of tax reporting, nonacquiesced in Sherwin-Williams,[6] and was successful six years later in the Federal Circuit. CNG Transmission Mgmt VEBA v. U.S., 588 F.3d 1376 (Fed. Cir. 2009), 2010-1 USTC ¶50,147, aff'g. 84 Fed. Cl. 327 (2008); accord Northrop Corp.

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[5] See, for example, Prop. Treas. Reg. § 1.512(a)-3(c)(3)(vi) (withdrawn) and letter ruling 8035066 (ruling no. 9) (June 5, 1980).

[6] AOD 200502 (Aug. 29, 2005).

Employee Insurance Benefit Plans Master Trust v. U.S., 99 Fed. Cl. 1 (2011), 2011-2 USTC ¶50,478, aff'd. 467 Fed. Appx. 886 (Fed. Cir. April 10, 2012), cert. denied, (Dec. 3, 2012).

Presumably the IRS and Treasury Department acknowledge that there is some debate still existing on the question, including a split among the Circuits; therefore, the Treasury Department has chosen to promulgate a regulation on the subject.

MY CONCERN AND REQUESTED MODIFICATION OF THE PROPOSED REGULATION.

It is my opinion that VEBAs which operate in the manner which I have described above, and which account for investment income in the manner approved of by the Sixth Circuit Court of Appeals, have been operating in good faith and in accordance with a reasonable interpretation of the relevant Code provisions. However, if the regulation is finalized in the manner in which proposed, the investment income of those VEBAs will be RETROACTIVELY taxed.

I do not object to the position that has been taken in the proposed regulation, that VEBAs that operate in the manner described would generally be subject to UBIT under IRC § 512(a)(3)(E). I believe that it is a fair interpretation of the statute.

However, unless Q & A-5 is revised, VEBAs which have been operating in a permissible manner will find that their investment income which was earned during the current year in which the regulation is promulgated, and perhaps even prior to the date that the regulation is enacted, will be subject to tax. I respectfully request that Q & A-5 be revised to provide that the effective date of the regulation be the first taxable year STARTING (not ENDING) on or after the date of publication of the final regulation.

If you care to discuss my concern and request, please let me know.

Respectfully Submitted,

Russell E. Greenblatt