

[JOINT COMMITTEE PRINT]

**TAX TREATMENT OF
WORKERS' COMPENSATION FUNDS
(POOLED SELF-INSURANCE FUNDS)**

SCHEDULED FOR A HEARING
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE
MEASURES
OF THE
COMMITTEE ON WAYS AND MEANS
ON APRIL 7, 1987

PREPARED BY THE STAFF
OF THE
JOINT COMMITTEE ON TAXATION



APRIL 7, 1987

U.S. GOVERNMENT PRINTING OFFICE

71-424

WASHINGTON : 1987

JCS-8-87

CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	2
II. OPERATION OF WORKERS' COMPENSATION FUNDS	4
III. FEDERAL TAX ISSUES	6
A. Tax Treatment of Entity	6
B. Deductibility of Employer Payments	10
IV. MORATORIUM IN TAX REFORM ACT OF 1986	14
V. LEGISLATIVE PROPOSALS	15

INTRODUCTION

The Subcommittee on Select Revenue Measures of the Ways and Means Committee has scheduled a public hearing on April 7, 1987, on the tax treatment of workers' compensation funds (pooled self-insurance funds).

This pamphlet,¹ prepared by the staff of the Joint Committee on Taxation, provides background and a discussion of the tax treatment of such funds. Part I is a summary. Part II is background on the operation of workers' compensation funds. Part III is a discussion of Federal tax issues. Part IV describes the moratorium enacted in the Tax Reform Act of 1986, and Part V describes current legislative proposals (H.R. 1489, introduced by Mr. Vander Jagt, and an identical bill, H.R. 1709, introduced by Mr. Vander Jagt and others).

¹ This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Treatment of Workers' Compensation Funds (Pooled Self-Insurance Funds)* (JCS-8-87), April 7, 1987.

I. SUMMARY

State workers' compensation requirements

State workers' compensation laws typically subject employers in certain lines of business to liability for workers' compensation claims arising from work-related injuries. Under present law, workers' compensation insurance is required for approximately 90 percent of all employees in the United States. The only States that do not require compulsory workers' compensation insurance are New Jersey, South Carolina, and Texas.

State law may permit employers to self-insure the liability if they can demonstrate to the State agency administering the workers' compensation rules that they meet applicable net worth or other financial standards.

In some States, employers are permitted to pool their liabilities to qualify as self-insurers of this workers' compensation obligation. Such pooling arrangements, or workers' compensation self-insurance funds, may for State law purposes take the form of nonprofit corporations or trusts, and are generally subject to State regulation (either by State workers' compensation boards or State insurance commissioners) in connection with applicable requirements of the workers' compensation rules.

Status of entities for Federal tax purposes

The Internal Revenue Service has ruled that the State law characterization of pooled workers' compensation funds does not control their character for Federal tax purposes, and has ruled privately that certain such funds are subject to Federal income tax as mutual property and casualty insurance companies.

In recent Internal Revenue Service audits of workers' compensation funds, an issue has arisen as to the timing of deductions for policyholder dividends. Some States require approval by the State workers' compensation board or other regulatory authority of amounts declared as dividends before such amounts may be distributed to policyholders, and the amount declared as a dividend may not be the same as the amount that the State authority approves for distribution.

The IRS has taken the position that policyholder dividends that are required to be approved by the State regulatory authority are not deductible in the year in which the dividends are declared if the State approval process does not occur prior to the end of the taxable year. Instead, the dividends would be deductible no earlier than the taxable year in which the State approves the policyholder dividends.

Deductibility of employer payments to an entity

Payments made by an employer to a pooled workers' compensation fund that is classified as a mutual property and casualty insurance company for Federal tax purposes generally are deductible as premiums paid to an insurance company. If the employer subsequently receives a policyholder dividend or rebate because the fund's experience was better than anticipated, then the amount of the dividend or rebate is includible in the employer's income when it is received.

Often, policyholder dividends are paid in a taxable year of the employer after the taxable year in which the premium payments to which the dividend relates are deductible. Thus, the employer frequently obtains a deferral of tax liability by deducting a premium payment in one year that is partially returned in a subsequent taxable year.

If the workers' compensation fund is not treated as an insurance company, but rather as a form of self insurance arrangement (such as a captive insurance arrangement), then employer payments to the fund generally are not currently deductible under the economic performance rules (sec. 461(h)). Payments to a voluntary employee beneficiary association (VEBA), however, may be deductible (no earlier than the time they are paid over), provided that certain statutory requirements are satisfied.

Moratorium in the Tax Reform Act of 1986

Under a provision of the Tax Reform Act of 1986 (the 1986 Act), a moratorium was imposed on audits of workers' compensation funds involving the issue of whether such fund is a mutual insurance company. For the period October 22, 1986, to August 16, 1987, pending audits and collection activities are suspended and audits are not to be initiated. The statute of limitations for filing a petition in Tax Court with respect to any notice of deficiency where the time to file had not expired by August 16, 1986, is extended to August 16, 1987, and penalties and interest with respect to underpayments by workers' compensation funds involving such issue are waived for the period August 16, 1986 to August 16, 1987.

Legislative proposals

Identical bills introduced by Mr. Vander Jagt (H.R. 1489) and by Mr. Vander Jagt and others (H.R. 1709) would grant tax-exempt status to workers' compensation funds.

II. OPERATION OF WORKERS' COMPENSATION FUNDS

In general

State workers' compensation laws typically subject employers in certain lines of business to liability for workers' compensation claims arising from work-related injuries. Under present law, workers' compensation insurance is required for approximately 90 percent of all employees in the United States. The only States that do not require compulsory workers' compensation insurance are New Jersey, South Carolina, and Texas.² Often, State law requires employers to insure this liability. Some States permit employers to self-insure the liability upon a showing of financial capability to pay the compensation required under the State workers' compensation law.

State regulation of commercial insurers

Commercial insurers who engage in the business of insuring employers' liability under State workers' compensation law, like those which insure other types of risks, are generally regulated by State insurance commissions. The State insurance commissioners, through their national organization, the National Association of Insurance Commissioners (NAIC), have achieved a degree of uniformity in insurance laws and regulations.

States regulate premium rates of commercial insurers and often determine how they are set. The State insurance laws generally require that premium rates be adequate, reasonable, and not unfairly discriminatory. All States, however, do not follow the same practice with respect to rate setting.

Several States also regulate the type of investments that an insurance company may make in order to provide for company solvency and liquidity. In such States, a property and casualty insurance company chartered by the State may be required to invest an amount equal to minimum capital requirements in Federal, State, or local government bonds, or bonds or notes secured by mortgages or deeds of trust on improved, unencumbered real estate.

Self-insurance of workers' compensation liability

Some States may permit employers to self-insure their workers' compensation liability or may permit employers who are members of a bona fide trade association, or employers with similar risk characteristics, to pool their liabilities to qualify as self-insurers in order to satisfy obligations imposed under State law for workers' compensation. Such pooling arrangements, like single employer self-insurance arrangements, typically are subject to regulation by

² Insurance Information Institute, *Insurance Facts: 1986-87 Property/Casualty Fact Book* 30.

a State workers' compensation board or agency that administers the State workers' compensation rules.

Workers' compensation funds may be established under State nonprofit corporation law, where applicable. Under some State laws, the fund may be organized as a trust under the management of a board of trustees that is responsible for the operation of the fund.

The premiums that are assessed against all members of the self-insurance pool are based upon the actual payrolls and experience of each member. Premium rate guidelines by specific occupational job classification, which have been established by the National Council on Workers' Compensation Insurance, are used by the managers or trustees of self-insured groups in establishing premium charges to members.

Managers or trustees are responsible for assessing and collecting all premiums from group members. In addition, trustees are responsible for all disbursements, including payment of claims, payments of reinsurance and bond premiums, payments of fees under agreements with servicing organizations and fiscal agents, payment of all other reasonable and necessary expenses, and payment of dividends to members. Dividends are payments to group members from surplus funds from the operations and earnings of the fund. Dividend distributions are made to members relative to their individual contributions and claims experience.

Applicable State law may require that all amounts in excess of the amounts needed to pay claims and expenses be returned to policyholders as dividends. The amounts declared as dividends may be subject to approval by the State agency administering the workers' compensation rules. The State agency's determination may occur after the end of the year in which the dividend is declared. Often, the amounts declared as dividends are not approved by the State agency, on the basis of its assessment of the likelihood of future claims or of the sufficiency of surplus or reserves established by the fund to meet claims.

III. FEDERAL INCOME TAX ISSUES

The tax treatment of workers' compensation funds raises two principal issues. One issue is whether the arrangement constitutes insurance under present law, or is more properly treated as self insurance. Amounts set aside for self insurance (including amounts paid to a separate captive entity) are not deductible. Special rules provide, however, that an employer may deduct certain amounts contributed to a voluntary employee beneficiary association (VEBA), provided that certain requirements are met. The issue of the deductibility of employer payments is discussed in B, below.

If the arrangement is treated as insurance, so that employer payments to the fund are treated as deductible, then the relevant issues center on the appropriate regime for taxing the fund. In this connection, IRS audits of certain workers' compensation funds have raised the issue of the timing of the funds' deduction for policyholder dividends, discussed further in A, below.

A. Tax Treatment of Entity

Present law

For Federal tax purposes, State law requirements applicable to workers' compensation funds are not necessarily controlling.³ For example, a fund may be established as a trust and governed by a board of trustees, in accordance with applicable State law, while it is subject to Federal income tax as a mutual insurance company and subject to tax at the corporate tax rates.⁴

The Internal Revenue Service has ruled privately on several occasions that entities treated as workers' compensation funds under applicable State law are subject to tax as mutual property and casualty insurance companies.⁵ In reaching this conclusion in the ruling letters, the IRS reasoned that sufficient shifting and distribution of insurance risk was present so that the arrangement did not constitute self insurance.⁶ In addition, the Service found that the workers' compensation funds satisfied the characteristics that evidence status as a mutual company: (1) policyholders have the right to be members to the exclusion of others and have the right to choose management; (2) the sole business purpose is to supply

³ See, e.g., Rev. Rul. 83-172, 1983-2 C.B. 107.

⁴ See, e.g., Private Letter Ruling 8314109 (December 23, 1982).

⁵ See IRS Private Letter Rulings 8117035 (January 27, 1981); 8314019 (December 23, 1982); 8316033 (January 13, 1983); 8325042 (March 18, 1983); 8404031 (October 21, 1983); 8405034 (October 31, 1983).

⁶ Under applicable Federal tax law, because the employers are not economically related to each other, the economic risk of loss with respect to their workers' compensation liability can be shifted and distributed among them, and the arrangement therefore can constitute insurance (rather than self-insurance, as it is characterized for State workers' compensation law purposes). See *Helvering v. LeGierse*, 312 U.S. 531 (1941). The Internal Revenue Service has ruled that risk shifting and risk distribution are necessary to a valid insurance transaction. See Rev. Rul. 77-316, 1977-2 C.B. 53, and Rev. Rul. 78-338, 1978-2 C.B. 107.

insurance substantially at cost; (3) members have the right to the return of premiums in excess of those amounts needed to cover losses and expenses; and (4) members have common equitable ownership of the assets.⁷

Tax consequences of classification as property and casualty insurance company

In general

Under present law, the taxable income of a property and casualty insurance company (whether stock or mutual) includes its underwriting income or loss and its investment income or loss. Underwriting income for this purpose means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred (Code sec. 832(b)(3)). Premiums earned are calculated by subtracting 80 percent of the amount of unearned premiums (Code sec. 832(b)(4)). Both the deduction for losses incurred and the deduction for unearned premiums incurred reflect the accounting conventions generally imposed under State law. These accounting conventions require the establishment of reserves for losses incurred and for unearned premiums.

The rules of present law relating to the taxation of property and casualty insurance companies apply to workers' compensation funds that are classified as property and casualty insurance companies.

Loss reserves

Present law limits the deduction for unpaid losses (reported losses that have not been paid, estimates of losses incurred but not reported and resisted claims, and unpaid loss adjustment expenses) to the amount of discounted unpaid losses (sec. 846). The loss reserve discounting rules apply to the undiscounted loss reserves (as reported on the annual statement for the accident year with respect to the line of business to which the discounting applies). The relevant annual statement is the statement filed by the taxpayer for State regulatory purposes for the fiscal year ending with or within the taxable year of the taxpayer.

The provisions relating to the discounting of unpaid loss reserve deductions for property and casualty companies were added by the Tax Reform Act of 1986 and apply to taxable years beginning after December 31, 1986.

Proration

Property and casualty insurance companies are subject to special rules (proration rules) with respect to tax-exempt income in taxable years beginning after 1986. As a result, the amount of the addition to loss reserves that is deductible is reduced by a portion of tax-exempt interest or wholly or partially deductible dividends received.

Under the proration rules, the deduction for losses incurred is reduced by 15 percent of (1) the insurer's tax-exempt interest and (2) the deductible portion of dividends received (with special rules for

⁷ Rev. Rul. 74-196, 1974-1 C.B. 140.

dividends from affiliates). For this purpose, tax-exempt interest includes interest income excludable under section 103 (or deductible under sec. 832(c)(7)), the portion of interest income excludable under section 133, and other similar items. If the amount of this reduction exceeds the amount otherwise deductible as losses incurred, the excess is includible in income.

Unearned premium reserves

Effective for taxable years beginning after December 31, 1986, a property and casualty insurance company generally is required to reduce its deduction for increases in unearned premiums by 20 percent. This amount represents the allocable portion of expenses incurred in generating the unearned premiums. Thus, for taxable years beginning after 1986, only 80 percent of the increase in unearned premiums in each year is deductible. To the extent there is a decrease in the unearned premium reserve for a taxable year beginning after 1986, the resulting inclusion in income of the decrease is reduced; only 80 percent of the amount is includible in income.

Small property and casualty companies

A workers' compensation fund that is treated as a mutual property and casualty insurance company may be eligible for tax-exempt status, or eligible to elect taxation only of investment income. Both mutual and stock property and casualty companies are eligible for exemption from tax if their net written premiums or direct written premiums (whichever is greater) do not exceed \$350,000 (sec. 501(c)(15)). Stock and mutual companies with net written premiums or direct written premiums (whichever is greater) in excess of \$350,000 but less than \$1,200,000 are permitted to elect to be taxed only on taxable investment income (sec. 831(b)). To determine the amount of direct or net written premiums of a member of a controlled group of corporations, the direct or net written premiums of all members of the controlled group are aggregated. In determining whether a taxpayer is a member of a controlled group of corporations for purposes of eligibility for the provision, a 50 percent ownership test applies.

Differences in tax treatment of mutual and stock insurance companies

The tax treatment described above applies generally to all property and casualty insurance companies under subchapter L of the Code, whether they are stock or mutual companies. Differences in tax treatment, however, stem from differences in the way mutual and stock companies are structured.

Like other C corporations, stock property and casualty companies may not deduct dividends paid to shareholders in their capacity as such. Mutual companies, however, have no shareholders and are generally considered to be owned by the policyholders, who have the right to choose management.⁸ Property and casualty insurance

⁸ See Rev. Rul. 74-196, supra note 7.

companies are generally permitted to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such (as discussed in more detail below). Thus, distributions to owners of mutual companies are generally deductible by the payor, whereas distributions to owners of stock companies are not.⁹

Policyholder dividends and shareholder dividends are treated differently for tax purposes at the distributee level as well as the company level. Policyholder dividends are generally considered price rebates and are not taxable distributions (unless the insurance premiums were deducted by the policyholder). Dividends paid to shareholders in their capacity as shareholders, on the other hand, constitute ordinary income to the recipient shareholders to the extent of the distributing corporation's earnings and profits.

Deductibility of policyholder dividends

Under present law, a deduction is permitted for dividends and similar distributions paid or declared to policyholders in their capacity as such (sec. 832 (c)(11)) in determining the taxable income of a property and casualty insurance company. For purposes of this deduction, the statute provides that the term "paid or declared" is construed according to the method of accounting regularly employed in keeping the books of the insurance company. Treasury regulations provide that deductible dividends to policyholders include amounts returned to policyholders if the amount is not fixed in the insurance contract but depends on the experience of the company or the discretion of the management (Treas. Reg. sec. 1.822-12).

Since 1957,¹⁰ the Internal Revenue Service has taken the position that property and casualty insurance companies utilizing the accrual method of accounting may deduct dividends to policyholders in the year of declaration, even though such dividends are declared in unspecified amounts representing all or a specified portion of net profits for such year and are not paid until the following year. In the 1957 ruling, the IRS noted that, at the end of the taxable year in which the dividend was declared pursuant to a resolution of the board of directors, the liability for payment of the dividend could not be affected by anything transpiring later than the end of the year. In reaching this conclusion that such policyholder dividends were deductible in the year declared, the IRS stated that the deduction for policyholder dividends is subject to the all events test, i.e., the deduction is permitted in the year when all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy (see Treas. Reg. sec. 1.461-1(a)(2)).

⁹ Life insurance companies are treated differently from property and casualty companies in this regard. Mutual life insurance companies reduce the amount of deductible policyholder dividends by an amount intended to reflect the portion of the distribution allocable to the life insurance companies' earnings on equity (as distinguished from the proportion which is a policyholder rebate (sec. 809)). In light of the treatment of policyholder dividends of life insurance companies, the 1986 Act requires the Treasury Department to conduct a study covering, *inter alia*, the regular tax and corporate minimum tax treatment of policyholder dividends of mutual property and casualty companies.

¹⁰ See Rev. Rul. 57-134, 1957-1 C.B. 210.

More recently, the IRS has continued to rely on the reasoning set forth in the 1957 ruling,¹¹ and has ruled privately with respect to certain workers' compensation funds that a fund treated as a mutual property and casualty company may deduct dividends in the year declared, provided the dividend declaration by its terms creates a binding and enforceable unconditional obligation to pay the members.¹²

Questions have been raised recently whether the all events test is met in cases in which the declared dividend is contingent upon subsequent approval of its amount by State regulatory authorities (e.g., the State workers' compensation board). In this situation, the fund cannot pay a dividend in the amount declared, or indeed, in any specific amount, until it knows the State regulatory authority's determination as to the amount approved for distribution. Thus, it could be argued, if the amount of the declared dividend is subject to subsequent approval by the State regulatory authority, the dividend is not covered by the IRS' earlier ruling permitting dividends to be deducted in the year declared under the all events test.

On the other hand, it could be argued that, because applicable State workers' compensation law or regulations require the fund to return to policyholders amounts in excess of amounts needed to pay claims and expenses, the entire amount declared as a dividend in any one year will very likely be returned to policyholders eventually (absent a sudden or unforeseen increase in claims or some other event such as insolvency).

Taking such an argument to its logical extreme, however, could imply that any amount should be deductible if a taxpayer sets it aside with the expectation that it will, at some unspecified future time, be used to pay a deductible expenditure.

To the extent that there is clearly an obligation to return dividends to the policyholders, the central question is in what year the fact and amount of the liability to pay is sufficiently fixed. The all events test, including the requirement that economic performance must have occurred before the deduction is allowed (sec. 461(h)), would not permit the deduction in the year the dividend is declared of a subsequent contingency (such as the determination of State regulatory authorities) could change the permitted amount of the dividend.

B. Deductibility of Employer Payments

If workers' compensation funds were treated as self-insurance arrangements rather than mutual property and casualty insurance companies, then the employers' payments to the funds would generally not be deductible. Special rules permit an employer to deduct certain payments to voluntary employee beneficiary associations (VEBAs), provided certain statutory requirements are met. A qualifying VEBA is exempt from tax, as discussed below.

¹¹ See also *Commercial Fisherman's Inter-Insurance Exchange v. Commissioner*, 38 T.C. 915 (1962), Acq. in result, 1966-2 C.B. 4.

¹² See Private Letter Rulings 8314109 (December 23, 1982); 8404031 (October 21, 1983); and 8405034 (October 31, 1983); cf 8526012 (March 26, 1985).

Treatment of captive insurance arrangements

Generally, under present law, taxpayers are not allowed deductions for anticipated expenses or losses unless the liability is fixed and the amount reasonably ascertained, and unless economic performance has occurred (sec. 461).

Amounts set aside by a taxpayer as a reserve for self insurance, though they may be equivalent in amount (though not in character) to commercial insurance premiums, are not deductible on a current basis for Federal income tax purposes. Administration of a self-insurance fund by an independent agent does not make the payments currently deductible. Thus, although most types of insurance premiums payments are deductible if they are paid or incurred in connection with the taxpayer's trade or business, amounts that are added to a self-insurance fund are not deductible.

Captive insurance arrangements have been viewed as a form of self insurance. The Internal Revenue Service has ruled that the amounts described as premiums paid by a domestic corporation and its domestic subsidiaries to the parent's wholly owned foreign subsidiary are not deductible premiums if the subsidiary does not also insure risks of insureds outside its own corporate family.¹³ Recent case law has developed the identifying characteristics of a captive, which distinguish it from a true insurance arrangement. In *Humana, Inc. and Subsidiaries v. Commissioner*, T.C.M. 1985-426 (August 14, 1985) and *Mobil Oil Corp. v. U.S.*, 8 Cl. Ct. 555 (August 1, 1985), the courts indicated that the primary criterion in distinguishing a captive from a true insurance arrangement is the absence of risk shifting. So long as a wholly owned subsidiary of the taxpayer bears the taxpayer's risk of loss, there has not been sufficient risk shifting to constitute true insurance, for which premium payments could be deductible.¹⁴

The Service has ruled privately that sufficient risk shifting to constitute true insurance is present in the case of certain workers' compensation funds, because the employers who pool their workers' compensation obligations are not commonly owned or interrelated.¹⁵

The arrangement might be analyzed differently, if it were shown that premiums and policyholder dividends are experience rated separately with respect to the experience of each employer that is a member of the fund. If premium rates are set, and rebates and policyholder dividends are distributed to members of the fund based on each member's separate claims experience, the arrangement appears to be a pooling for administrative efficiency, rather than an arrangement to spread or share the risk of workers' com-

¹³ Rev. Rul. 77-316, supra note 6. The Service concluded that because the insureds and the "insurance" subsidiary (though separate corporate entities) represented one economic family, those who bear the ultimate economic burden of the loss are the same persons who suffer the loss. Thus the required risk shifting and risk distribution of a valid insurance transaction were missing. This position of the Service was favorably cited by the Ninth Circuit in *Carnation Co. v. U.S.*, 640 F.2d 1010, (9th Cir. 1981), cert. denied, 454 U.S. 965.

¹⁴ Cf. *Crawford Fitting Co. v. U.S.*, 606 F. Supp. 136 (N.D. Ohio 1985), in which sufficient risk shifting was found where a risk was shifted to an insurance company which was only partially commonly controlled (i.e., the insurer was 80 percent owned by four separate corporations, in each of which the individual 100 percent owner of the insured corporate taxpayer had an interest).

¹⁵ See note 6, supra.

pensation liability of each member among all members of the group.

Similarly, if the fund never has a deficit that must be spread among the participating employers, it could be said that there is no risk shifting among members of the fund, and that instead of resembling a true insurance arrangement, the fund more closely resembles a self-insurance arrangement for each employer that is centrally administered by the fund. In that case, contributions to the fund would not constitute deductible insurance premiums, but rather would merely be amounts set aside for the purpose of self-insurance.

If employer payments to a workers' compensation fund were treated as not currently deductible, on the theory that the fund is essentially a captive self insurance arrangement, then the economic performance rules (sec. 461(h)) would determine the timing of the employer's deduction. In the case of liability for workers' compensation claims, economic performance does not occur until the workers' compensation benefits are paid to an injured worker (sec. 461(h)(2)(C)).

Voluntary employees' beneficiary associations (VEBAs)

Employers may deduct certain payments to a VEBA no earlier than the year they are paid (sec. 419), provided that the VEBA satisfies the requirement of a fund (as defined in sec. 419). In the case of a fund providing workers' compensation payments, the rules for funded welfare benefit plans apply only with respect to benefits that do not arise under any workers' compensation act. The rules relating to economic performance (sec. 461(h)) apply to deductions with respect to payments that arise under a workers' compensation act.

Under present law, a VEBA is an organization providing for the payment of life, sick, accident, or other benefits to the members of the association or their dependents or designated beneficiaries, if no part of the net earnings of the association inures (other than through the payment of permissible benefits) to the benefit of any private shareholder or individual. An organization meeting these requirements is exempt from income taxation (sec. 501(c)(9)), other than the tax on unrelated business income (sec. 511 *et seq.*) to the extent it applies.

Generally, a VEBA is established and funded by an employer or by a group of employers to provide benefits to employees. A VEBA may also be established pursuant to a collective bargaining agreement. VEBAs may be funded solely by employer contributions, by employee contributions, or by a combination of employer and employee contributions. Special rules apply under present law to a VEBA maintained by ten or more employers.

The Internal Revenue Service has ruled that State-mandated benefits like workers' compensation coverage cannot be funded through a VEBA because such an arrangement merely ensures the discharge of an obligation already imposed by statute upon the employer.¹⁶ Nevertheless, if the trust (workers' compensation fund) is

¹⁶ Rev. Rul. 74-18, 1974-1 C.B. 139.

established pursuant to a collective bargaining agreement, and indeed may provide benefits in addition to benefits required under State law, the IRS has taken the position that the trust may be eligible for tax-exempt status as a VEBA.¹⁷

Under present law, certain amounts held by a VEBA may be subject to tax as unrelated business taxable income (sec. 512). In the case of State-mandated workers' compensation benefits funded through a VEBA, generally the income of the VEBA attributable to such amounts would be treated as unrelated business taxable income and subject to tax.

¹⁷ GCM 38922 (August 20, 1982).

IV. MORATORIUM IN TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 (sec. 1879(q), P.L. 99-514) imposed a moratorium with respect to audits and litigation relating to self-insured workers' compensation funds, to provide an opportunity to review the concerns of the Internal Revenue Service and the impact on the employers who have established self-insured workers' compensation funds. The provision directs the Secretary of the Treasury to suspend any pending audit of any self-insured workers' compensation fund if the audit involves the issue of whether such fund is a mutual insurance company, not to initiate an audit of any such fund involving such issue, and to take no steps to collect from such fund any underpayment, interest, or penalty involving such issue. This provision applies for the period commencing on October 22, 1986, and ending on August 16, 1987.

In addition, no interest is to be payable under chapter 67 of the Code on any underpayment by a self-insured workers' compensation fund involving such issue during the period from August 16, 1986, to August 16, 1987. Furthermore, the right of any self-insured workers' compensation fund to file with the Tax Court that had not expired before August 16, 1986, shall not expire before August 16, 1987.

The IRS has expressed concern ¹⁸ that the statute of limitations to assess deficiencies may expire during the moratorium. If the statute of limitations expires, the IRS would lose the opportunity to protect the Federal Government in cases where a deficiency may be warranted.

¹⁸ Letter from IRS Commissioner Lawrence B. Gibbs to Rep. John D. Dingell, January 29, 1987.

V. LEGISLATIVE PROPOSALS

H.R. 1489 (Mr. Vander Jagt) and H.R. 1709 (Messrs. Vander Jagt, Broomfield, Carr, Crockett, Davis of Michigan, Dingell, Ford of Michigan, Henry, Kildee, Levin of Michigan, Pursell, Schuette, Traxler, Upton, Wolpe, and Bonior of Michigan)

These identical bills would amend Code section 501(c) by adding a new subsection (26), which would grant tax-exempt status to any corporation, fund or trust whose principal purpose is to function as a self-insured workers' compensation or workers' disability fund. These bills would apply to all taxable years beginning before, on or after December 31, 1987.

○