New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

TSB-A-02(9)C
Corporation Tax
June 25, 2002

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. C011107A

On November 7, 2001, a Petition for Advisory Opinion was received from Metropolitan Life Insurance Company, One Madison Avenue, New York, New York 10010.

The issues raised by Petitioner, Metropolitan Life Insurance Company, are:

1. Whether a voluntary employees' beneficiary association ("VEBA") is carrying on an unrelated trade or business in New York and, thus, is subject to the tax imposed under Article 13 of the Tax Law on its unrelated business taxable income, because it received demutualization proceeds.

2. Whether the VEBA is carrying on an unrelated trade or business in New York and, thus, is subject to the tax imposed under Article 13 of the Tax Law on its unrelated business income, because it invested the demutualization proceeds and received income generated by such investment activity.

3. Assuming it is concluded that the VEBA is carrying on an unrelated trade or business in New York under either Issue 1 or 2, whether sufficient facts exist for the Commissioner to make a discretionary adjustment to the statutory apportionment formula to properly reflect the VEBA's income in New York.

Petitioner submits the following facts as the basis for this Advisory Opinion.

Petitioner is a life insurance corporation doing business in New York. Petitioner established Metropolitan Life Insurance Company and Participating Affiliates Voluntary Employees' Beneficiary Association Trust, (the VEBA), for the purpose of providing medical benefits to current and future retired employees of Petitioner. The benefits are partially funded through a life insurance policy issued by Petitioner to the VEBA. The VEBA is described in section 501(c)(9) of the Internal Revenue Code ("IRC"), and is exempt from federal income tax pursuant to section 501(a) of the IRC, except with respect to its unrelated business income.

Recently, Petitioner ceased being a mutual corporation and now operates as a stock corporation. As a result of the demutualization, the VEBA, as a policyholder, was entitled to receive demutualization proceeds in cash or a stock interest. An independent fiduciary appointed by Petitioner to make decisions on behalf of the employee medical plan opted to receive cash. The assets of the VEBA, prior to the demutualization, were in excess of the account limit under section 419A of the IRC. As a result, the VEBA is subject to the tax on unrelated business income imposed

under section 512(a)(3)(B) of the IRC to the extent it receives taxable investment income from those assets.

Petitioner states that the VEBA's taxability under section 512(a)(3)(B) of the IRC is not as a result of its regularly carrying on an unrelated trade or business.

Discussion

Section 290(a) of Article 13 of the Tax Law provides that for every taxable year or part thereof, every organization described in section 511(a)(2) of the IRC and every trust described in section 511(b)(2) of the IRC carrying on an unrelated trade or business in New York shall pay a tax at the rate of nine percent on its unrelated business taxable income for such year, or portion thereof allocated to New York State, or two hundred fifty dollars, whichever is greater.

Section 511(a)(1) of the IRC imposes a tax on the unrelated business taxable income of charitable, etc., organizations described in section 511(a)(2) of the IRC. Section 511(a)(2) of the IRC provides that the tax imposed under section 511(a)(1) of the IRC "shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)(1)) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a)."

Section 511(b)(1) of the IRC imposes a tax on the unrelated business taxable income of charitable, etc., trusts described in section 511(b)(2) of the IRC. Section 511(b)(2) of the IRC provides that the tax imposed under section 511(b)(1) of the IRC "shall apply in the case of any trust which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a) and which, if it were not for such exemption, would be subject to subchapter J (sec.641 and following, relating to estates, trusts, beneficiaries, and decedents)."

Article 13 of the Tax Law does not define an "unrelated trade or business", but section 291(a) of the Tax Law provides that any term used in Article 13 shall have the same meaning as when used in a comparable context in the IRC, unless a different meaning is clearly required.

Section 513(a) of the IRC provides the following general rule with respect to an unrelated trade or business:

> [t]he term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in

the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)), except that such term does not include any trade or business –

(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) which is carried on, in the case of an organization described in section 501(c)(3) or in the case of a college or university described in section 511(a)(2)(B), by the organization primarily for the convenience of its members, students, patients, officers, or employees, or, in the case of a local association of employees described in section 501(c)(4) organized before May 27, 1969, which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or

(3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

Section 512(a)(1) of the IRC provides that:

[e]xcept as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

However, section 512(a)(3) of the IRC provides special rules that are applicable, in part, to organizations described in section 501(c)(9) of the IRC. Pursuant to section 512(a)(3)(A) of the IRC, the "unrelated business taxable income" of a VEBA means the "gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6),(10), (11), and (12) of subsection (b)."

Section 512(a)(3)(B) of the IRC provides that:

[f]or purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis of the exemption 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 regularly carried on by such organization computed as if the organization were subject to paragraph (1) [of section 512(a)]), which is set aside —
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> (i) for a purpose specified in section 170(c)(4), or
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> (ii) in the case of an organization described in paragraph (9) ... of section 501(c), to provide for the payment of life, sick, accident, or other benefits,
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> including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii). If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

Section 512(a)(3)(E)(i) of the IRC provides that:

> [i]n the case of any organization described in paragraph (9) ... of section 501(c), a set-aside for any purpose specified in clause (ii) of subparagraph (B) may be taken into account under subparagraph (B) only to the extent that such set-aside does not result in an amount of assets set aside for such purpose in excess of the account limit determined under section 419A (without regard to subsection (f)(6) thereof) for the taxable year (not taking into account any reserve described in section 419A(c)(2)(A) for post-retirement medical benefits).

In this case, for federal income tax purposes, the VEBA is an organization that is described in sections 501(c)(9) and 511(a)(2) of the IRC. The VEBA is exempt from federal income tax pursuant to section 501(a) of the IRC, except with respect to any unrelated business taxable income determined pursuant to section 512(a)(3)(B) and (E) of the IRC. Petitioner states that the VEBA is not carrying on an unrelated trade or business as described in section 513(a) of the IRC. However, the assets of the VEBA prior to the demutualization were in excess of the account limit under section 419A of the IRC. Therefore, pursuant to section 512(a)(3)(B) and (E) of the IRC, the VEBA has unrelated business taxable income, and the VEBA is subject to the tax imposed under section 511 of the IRC to the extent that it receives taxable investment income from those assets.

Even though the VEBA has unrelated business taxable income under section 512 of the IRC, the VEBA is not regularly carrying on an unrelated trade or business as described in section 513 of the IRC. Accordingly, the VEBA is not carrying on an unrelated trade or business for purposes of section 290 of Article 13 of the Tax Law.

With respect to Issue 1, Article 13 of the Tax Law imposes, pursuant to section 290(a) of the Tax Law, a tax for every taxable year that an organization described in section 511(a)(2) of the IRC or a trust described in section 511(b)(2) of the IRC is carrying on an unrelated trade or business in New York. The receipt of demutualization proceeds by the VEBA does not constitute the carrying on of an unrelated trade or business in New York pursuant to section 290 of the Tax Law. Therefore, such receipt does not create a taxable status for the VEBA for purposes of Article 13 of the Tax Law.

Likewise, with respect to Issue 2, the investment of the demutualization proceeds and the income generated by such investment does not constitute the carrying on of an unrelated trade or business in New York pursuant to section 290 of the Tax Law, and , therefore, the investment of the proceeds and the income that is generated does not create a taxable status for the VEBA for purposes of Article 13 of the Tax Law.

Based on the conclusions of Issues 1 and 2, Issue 3 is moot.

DATED: June 25, 2002

/s/
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NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.