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SUPPLEMENTAL UNEMPLOYMENT BENEFIT TRUSTS

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Mr. BYRD of Virginia, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 8229]

The Committee on Finance, to whom was referred the bill (H.R. 8229) to amend the Internal Revenue Code of 1954 to provide an exemption from income tax for supplemental unemployment benefit trusts, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

SUMMARY OF BILL

This bill provides a new exempt category for income tax purposes in the case of trusts providing for the payment of supplemental unemployment compensation benefits. These may be the only benefit payments made by the trusts, or may be payments made together with subordinate sick or accident benefits (but not retirement or death benefits). This exempt category differs from the category, already under existing law, under which some of these trusts obtain exemption, in that the new provision does not require the SUB trusts to obtain at least 85 percent of their income from employers or employees (and not from investment income).

The so-called nondiscriminatory provisions of present law applying to qualified pension, profit-sharing, and stock-bonus plans are in general made applicable to the trusts qualifying under the new exemption category. In addition, the "prohibited transaction" provisions, and "unrelated business income" provisions (including the business lease provisions) of present law are made applicable to the new exemption category.

In general this new exemption is to apply to taxable years beginning after December 31, 1959.

GENERAL STATEMENT

Supplementary unemployment benefit plans arose out of attempts of various labor unions to negotiate guaranteed annual wage plans. The concern was primarily directed, however, toward the significant difference between the average weekly earnings received when employed and the unemployment benefits received when unemployed. As a result, supplementary unemployment benefit plans were developed, rather than guaranteed annual wages.

The first of the main SUB plans were those negotiated with the automobile industry in 1955. The bulk of the plans developed since that time have followed the same general pattern. Under the automobile industry plans a worker is eligible for a SUB payment if he is laid off by the company, either in a reduction in force or in a temporary layoff. Usually these payments also depend upon the concurrent receipt (at least during part of the period) of State unemployment benefits. More recently, these benefits frequently are supplemented with lump-sum separation payments paid to an employee who is laid off for a period of at least 12 months; or is retired on or after reaching age 60 but is not eligible for a company retirement pension, or becomes permanently disabled but does not qualify for a company disability pension. Under these plans the employee has no vested interest in amounts the employer pays into the fund and if the employee leaves the company voluntarily or if he is discharged for misconduct he is not eligible for a benefit.

However, in the glass industry there has developed a second type of plan sometimes referred to as the "income security" type of SUB under which a worker may collect benefits not only because of a layoff but also because of illness. As a result of his vested interest in the fund, if he quits his job he may draw down any balance in his account. Similarly, if he dies, any balance in his account is paid to his estate or heirs.

Most of the plans are set up as separate trusts and are funded by payments by the employer to the trusts of something like 3 to 5 cents per hour per employee. Various rulings of the Internal Revenue Service have held that the contributions to these funds are deductible to the employers and distributions from these funds are taxable to the recipients as income (although not generally subject to withholding).

The income which the trusts earn on the contributions by employers and which is not necessary to meet current benefit payments, generally has qualified for income tax exemption under section 501(a) by the application of section 501(c)(9). This latter paragraph provides exemption for—

> Voluntary employee's beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents, if—
>
> (A) no part of their net earnings inures (other than through such payments) to the benefit of any private shareholder or individual, and
>
> (B) 85 percent or more of the income consists of amounts collected from members and amounts contributed to the association by the employer of the members for the sole purpose of making such payments and meeting expenses.

Recently, however, these SUB trusts have had difficulty in qualifying for exemption under the above provision because their investment income has in some cases represented more than 15 percent of their income. As a result, these trusts do not receive the required 85 percent of their funds from employees or employers.

Your committee believes it is appropriate to exempt from tax trusts providing unemployment compensation benefits, even though investment and other income exceeds the 15-percent limit allowed by section 501(c)(9) since the funds are nonprofit in character and provide worthwhile benefits, but at the same time are not in competition with profitmaking enterprises. A new paragraph (17), therefore, is added to section 501(c) which has the effect of providing such an exemption. In the case of trusts providing sickness and accident benefits, however, because of possible competition with private enterprise, it was thought that such benefits should be a subordinate part of the plan. Retirement and death benefits are not covered, however, since other provisions in the Internal Revenue Code are designed to specify the conditions which must be met to obtain income tax exemption in the case of trusts providing such benefits.

The bill limits exemption under the new paragraph to SUB plans which meet certain conditions as to nondiscrimination. For the most part these are the types of restrictions which presently must be met by qualified pension, profit-sharing, and stock bonus plans. In general these requirements are:

(1) It must not be possible to divert any of the corpus or income to any purpose other than the payment of supplemental unemployment compensation benefits or sick or accident benefits.

(2) The plan must provide for the payment of benefits under a classification which is not discriminatory in favor of officers or stockholders of the company or supervisory or highly paid employees.

(3) The benefits under the plan also must not discriminate in favor of employees who are officers, shareholders, or supervisory or highly paid employees (benefits based on a uniform relationship to total compensation are not considered discriminatory for this purpose).

Also, in determining whether a plan is nondiscriminatory, benefits provided under State or Federal plans may be taken into account in certain cases.

As in the case of the pension, profit-sharing, and stock bonus trusts the so-called prohibited transactions provisions are made applicable to the trusts exempt under the new paragraph, which in general means that these trusts cannot enter into transactions which tend to result in the diversion of the corpus or income of the trust to creators of the trust, those who have made substantial contributions to it, or members of their families, or to corporations controlled by such persons.

Similarly, the "unrelated business income" provisions of present law, including the "business lease" provisions in the case of indebtedness, are made applicable to this new exempt supplemental unemployment compensation benefit category.

The new exempt category and other related provisions generally are made applicable to taxable years beginning after December 31, 1959. The prohibited transaction provisions and business lease indebtedness provisions are also to be effective on and after Decem-

ber 31, 1959. Also the references to loans in the "prohibited transaction" provisions are to apply to those made, nenewed, or continued after December 31, 1959.

COMMITTEE AMENDMENT

Your committee has amended the House-passed bill to make it plain that the new paragraph (17) which is added to section 501(c) is not to be the exclusive rule for determining exemption from income tax of organizations which provide supplemental unemployment benefits. Such organizations may continue to qualify for income tax exemption under paragraph (9) if they meet the requirements of that paragraph. Although the House bill itself was silent on the point, the committee report accompanying that bill indicates that the purpose of new paragraph (17) is to prescribe an alternative rule for exempting organizations which provide supplemental unemployment benefits. The committee amendment clarifies this intent.

Your committee also has amended the definition of "supplemental unemployment compensation benefits," which is contained in the new paragraph (17). The purpose of this amendment is to clarify the provisions of the House bill to make certain that the term "supplemental unemployment compensation benefits" includes payments made under a plan although an employee accepts temporary employment during the period he is not on the employer's payroll. Thus, a laid-off employee could continue to receive supplemental unemployment benefits even though he obtains other part-time or temporary work during the layoff period.

As passed the House, the bill applied to taxable years after December 31, 1958. Because of the passage of time, your committee has amended the effective date of the bill and changed the dates on which the rules relating to prohibited transactions, the unrelated business income tax and business leases are made applicable. As amended, the bill applies to taxable years beginning after December 31, 1960, and the special rules apply with respect to transactions after that date.

TECHNICAL EXPLANATION

The first section of the bill would amend section 501(c) of the Internal Revenue Code of 1954 by adding a new paragraph (17) thereto. The new paragraph (17) sets forth rules under which certain trusts may qualify for exemption under section 501(a).

The new paragraph (17) would apply to any trust or trusts which form a part of a plan providing for the payment of supplemental unemployment compensation benefits, if the plan meets the requirements set forth in the new paragraph (17). A plan under the new paragraph (17) may provide only for the payment of supplemental unemployment compensation benefits, and subparagraph (D) of the new paragraph (17) defines supplemental unemployment compensation benefits. Such definition, as amended by the committee, provides that the tern "supplemental unemployment compensation benefits" means (1) benefits which are paid to an employee because of his involuntary separation from the employment of the employer (whether or not such separation was temporary) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, and (2) sick and accident benefits subordinate to

such unemployment benefits. As a result of the requirement of subparagraph (A)(i) and the definition of subparagraph (D), a qualified plan cannot include any benefits which are not paid because of sickness, accident, or unemployment. Thus, for example, if a plan provides for the payment of a retirement benefit, the plan cannot qualify under the new paragraph (17). Under the definition of supplemental unemployment compensation benefits, a qualified plan may provide for the payment of benefits in installments or in a lump sum when an employee is involuntarily unemployed for a short period or permanently, or for the payment of such benefits on account of unemployment resulting directly from a reduction in force or the discontinuance of a plant or operation or from causes similar to a reduction in force or the discontinuance of a plant or operation. However, a qualified plan cannot provide for the payment of benefits when the unemployment results from a voluntary decision by the employee or results from any cause not described in the preceding sentence.

Under the definition of supplemental unemployment compensation benefits, a qualified plan may provide for the payment of sick and accident benefits in addition to unemployment benefits. However, such sick and accident benefits must be subordinate to the unemployment benefits. Thus, if it is obvious from all the facts and circumstances that the real purpose of a plan is to provide accident and sick benefits rather than unemployment benefits, such plan will not qualify under the new paragraph (17). Since the new paragraph (17) provides for payments only to employees, a qualified plan cannot provide for the payment of a death benefit resulting from sickness or accident.

The first of the requirements set forth in the new paragraph (17) is that under the plan, it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the plan, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of sick, accident, or supplemental unemployment compensation benefits. Thus, if the plan provides for the payment of any other benefits, the trust cannot qualify under the new paragraph (17). However, the payment of any necessary or appropriate expenses in connection with the administration of a plan providing sick, accident, or supplemental unemployment compensation benefits is to provide such benefits and does not affect the qualification of the trust. Moreover, if such a plan terminates and there are any remaining assets in the trust after the satisfaction of all liabilities under the plan, this requirement does not affect any arrangement which may be made for the distribution of such remaining assets.

The second requirement for qualification under the new paragraph (17) is that the benefits under the plan are payable to employees under a classification which is set forth in the plan and which is found by the Secretary or his delegate not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. Thus, the plan must set forth the conditions under which employees will be eligible to receive benefits under the plan, and such conditions for eligibility must not discriminate in favor of the proscribed groups.

The third requirement for qualification under the new paragraph (17) is that the benefits under the plan do not discriminate in favor of

employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. However, it is provided that a plan shall not be considered discriminatory within the meaning of such requirement merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan. Accordingly, the benefits provided for highly paid employees may be greater than the benefits provided for lower paid employees if the benefits are determined by reference to their compensation, but in such a case, the plan will not qualify if the benefits paid to the higher paid employees bear a larger ratio to their compensation than the benefits paid to the lower paid employees bear to their compensation.

Subparagraph (B) of the new paragraph (17) provides that in determining whether a plan meets the nondiscrimination requirements, any benefits provided under any other plan shall not be taken into consideration, except in certain specified situations. Under these exceptions, a plan will not be considered discriminatory (1) merely because the benefits under the plan which are first determined in a nondiscriminatory manner are then reduced by any sick, accident, or unemployment compensation benefits received under State or Federal law (or are reduced by a portion of such benefits if determined in a nondiscriminatory manner), (2) merely because the plan provides only for employees who are not eligible to receive sick, accident, or unemployment compensation benefits under State or Federal law the same benefits (or a portion of such benefits if determined in a nondiscriminatory manner) which such employees would receive under such laws if such employees were eligible for such benefits, or (3) merely because the plan provides only for employees who are not eligible under another plan (which meets the requirements of subpar. (A) of the new par. (17)) of sick, accident, or supplemental unemployment compensation benefits provided wholly by the employer the same benefits (or a portion of such benefits if determined in a nondiscriminatory manner) which such employees would receive under such other plan if such employees were eligible under such other plan. However, in the last case, the plan is considered nondiscriminatory only if the employees eligible under both plans would make a classification which would be nondiscriminatory.

The rules of subparagraph (B) permit arrangements to combine Federal or State plans providing sick, accident, or unemployment compensation benefits with the benefits provided under a plan set up to qualify under the new paragraph (17), subject to certain restrictions. These restrictions allow reasonable flexibility in combining such plans. For example, a plan may qualify under the new paragraph (17) if it provides for the payment of an unemployment benefit determined as a percentage of the employee's compensation and reduced by any unemployment benefit which the employee receives under a State plan. Such a plan could provide for the reduction of the plan benefit by one-half of the State benefit. A plan may also qualify if it provides for the payment to an unemployed employee of an amount which when added to any State unemployment benefit equals a percentage of his compensation. Moreover, an employer may establish for employees who are not eligible to receive State unemployment benefits a qualified plan providing for such employees the same benefits which they would

receive under a State plan. Such a plan could also qualify although it does not provide all of the benefits provided under the State plan. However, in determining whether a plan is discriminatory, the benefits provided under other plans will not be taken into consideration except as specifically provided in subparagraph (B). Accordingly, if a plan provides for employees who are not eligible to receive benefits under a State plan benefits which are greater or of a different type than those of the State plan, the qualification of the plan must be determined without regard to the State-provided benefits. In such a case, if the plan covers only lower paid employees or any other group which is not discriminatory, the plan will, nevertheless, qualify, but if the plan covers only a discriminatory group (such as a group of highly paid employees), the plan will not qualify.

Subparagraph (C) of the new paragraph (17) provides that a plan shall be considered to meet the nondiscrimination requirements during the whole of any year of the plan if on 1 day in each quarter it satisfies such requirements.

Subparagraph (E) of the new paragraph (17) provides that exemption from income tax shall not be denied to any organization entitled to such exemption as an association described in paragraph (9) of this subsection merely because such organization provides for the payment of supplemental unemployment benefits as defined in subparagraph (D)(i). Organizations entitled to exemption under paragraph (9) could continue their exemption under that paragraph without regard to the new provision in paragraph (17).

Section 2 of the bill would amend section 503 of the Internal Revenue Code of 1954 to make the trusts described in the new section 501(c)(17) subject to the prohibited transaction rules of section 503. Section 503(b), which sets forth the organizations that are subject to section 503, is amended to include a trust described in section 501(c)(17), and section 503(a)(1) is revised to include as a prohibited transaction any prohibited transaction by such a trust occurring after December 31, 1959. Section 503(h) is also amended so that a trust described in section 501(c)(17) may purchase unsecured obligations of the employer or other person referred to in section 503(c), subject to the limitation of section 503(h).

Section 3 of the bill would amend section 511 of the Internal Revenue Code of 1954, relating to the tax on unrelated trade or business income of an exempt organization. A trust described in the new section 501(c)(17) is included among the organizations which are subject to such tax.

Section 4 of the bill would amend section 513 of the Internal Revenue Code of 1954, relating to the definition of unrelated trade or business, to make clear that any trade or business regularly carried on by a trust described in section 501(c)(17) is an unrelated trade or business.

Section 5 of the bill would amend section 514 of the Internal Revenue Code of 1954, relating to business leases of exempt organizations, by adding at the end of subsection (c) a new paragraph (8). This new paragraph provides that any indebtedness incurred by a trust described in section 501(c)(17) before January 1, 1960, in connection with real property which is leased before such date, shall not be considered a business lease indebtedness for purposes of section 514. A similar rule is applicable to indebtedness incurred by a corporation described in section 501(c)(2) all of the stock of which was acquired

before January 1, 1960, by a trust described in section 501(c)(17) and to any other indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease. The new paragraph also provides that if a trust described in section 501(c)(17) forming part of a sick, accident, or supplemental unemployment compensation benefit plan lends any money to another trust described in section 501(c)(17) forming part of the same plan, such loan shall not be treated as a business lease indebtedness of the borrowing trust, except to the extent that the loaning trust incurs any indebtedness in order to make such loan, incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan, or incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

The amendments made by sections 2, 3, 4, and 5 of the bill apply to trusts which qualify for exemption from income tax on the basis of the new section 501(c)(17) of the code. Thus, they will not apply in the case of a trust qualifying for such exemption on the basis of section 501(c)(9) of such code.

Section 6 of the bill would provide the effective date for the bill. The bill would be applicable to taxable years beginning after December 31, 1959, and the amendments made to section 503 would apply to loans made, renewed, or continued after December 31, 1959.

CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).