NONDISCRIMINATION REQUIREMENTS

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1. USE OF VEBA RULES

Why does the Trust use the VEBA rules? Because of tax breaks. The Wisconsin Bankers Association Insurance Trust Fund is a "Voluntary Employees' Beneficiary Association" or "VEBA." Complying with the VEBA rules gives the Trust tax-exempt status, but also means that special nondiscrimination rules apply.

What are the special nondiscrimination rules that apply to VEBAs? Among the VEBA rules are special nondiscrimination requirements that apply to Bank plans. Internal Revenue Code of 1986 ("Code") Section 505 rules are generally discussed below. The VEBA is subject to other rules that prevent prohibited inurement and also generally limit discriminatory designs. One aspect of the prohibited inurement rule, for example, generally restricts plans from paying disproportionate benefits to officers, shareholders, or highly compensated employees. This manual does not provide a complete discussion of these rules. Please consult with your legal counsel or other competent advisor for assistance with compliance.

2. IMPACT ON BANKS

How do the VEBA nondiscrimination rules affect Banks? *Banks must take steps to ensure that their plans comply with the VEBA nondiscrimination rules.* If a Bank's plan does not satisfy the nondiscrimination requirements for VEBAs, the Trust could lose its status as a VEBA, as explained in Section 6. The nondiscrimination rules are very complex and this manual merely highlights some of the requirements. Please consult with your legal counsel or other competent advisor for assistance with compliance.

3. GENERAL NONDISCRIMINATION TESTS UNDER CODE SECTION 505

What VEBA nondiscrimination tests under Code Section 505 generally apply to benefits offered by Banks?[1] Benefits offered under a VEBA generally are subject to the following tests under Code Section 505:

- **VEBA Classification Test:** Each class of benefits must be provided to a classification of employees that is set forth in the plan and which is found by the IRS not to be discriminatory in favor of highly compensated employees; and

- **VEBA Benefit Test:** The benefit provided may not discriminate in favor of highly compensated employees.

Code Section 505 provides that life insurance and disability benefits will not fail the VEBA Benefit Test merely because the benefits available bear a uniform relationship to total compensation, or the basic or regular rate of compensation, of the covered employees.

Also, benefits that are subject to their own Internal Revenue Code nondiscrimination tests, such as group term life insurance subject to Code Section 79, do not need to meet the two VEBA tests listed above, but rather must meet the special nondiscrimination standards specific to those benefits.

[1]All of the benefits funded under the Trust are insured. Compare Code Section 505(b)(3). If the medical, dental, or vision benefits were self-insured, different rules would apply.

What employees may be excluded from the VEBA Classification Test? For purposes of the VEBA Classification Test, the following employees may be excluded:

- Employees who have not completed 3 years of service;
- Employees who have not attained age 21;
- Seasonal employees or less than half-time employees;
- Employees who are included in a unit of employees covered under a collective bargaining agreement if the benefit involved was the subject of good faith bargaining between employee representatives and employers; and
- Employees who are nonresident aliens and who receive no earned income from the employer that constitutes income from sources within the United States.

What compensation is taken into account for the VEBA Classification and Benefits Tests? The annual compensation of each employee that may be taken into account for purposes of providing benefits under these benefit plans may not exceed a dollar limit.[2]

What is the definition of a "highly compensated employee?" A "highly compensated employee" generally is an employee who, in the preceding ("look-back") year earned more than a dollar limit[3] or who in the current or preceding year, was a more than 5% owner. The group earning more than the dollar limit may be limited further if the employer adopts the top-paid 20% group election.

An "employee" for purposes of determining highly compensated employees includes former employees who were highly compensated in their year of separation from employment or during any year ending on or after their 55th birthdays.

What are the safe harbor guidelines for meeting the VEBA Classification and Benefits Test? The 1999 IRS Internal Revenue Manual,[4] provided safe harbor guidelines for employers. As a general matter, health benefits (non-income replacement benefits) satisfy the safe harbor only if they are offered to participants in equal amounts under equal terms, eligibility requirements, and conditions, without regard to salary level, position, or ownership interest in the employer. Income replacement benefits are discussed in the next question and answer. The Internal Revenue Manual contains other details and requirements for satisfying the safe harbor.

How are income replacement benefits, like life and disability benefits, affected by the safe harbor VEBA Benefits Test? The law provides that income replacement benefits, like life and disability

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[2]This limit is subject to adjustment by the IRS for inflation using the same adjustment as the Code Section 401(a)(17) limit. The dollar limit for 2006 generally was $220,000.

[3]This limit (under Code Section 414(q)) is subject to adjustment by the IRS for inflation. The limit for the 2005 look-back year generally was $95,000 and $100,000 for 2006.

[4]*Internal Revenue Manual* Sec. 7.25.9.3.3.1 (Nondiscrimination Safe Harbor) and 7.25.9.3.4.4 (General Nondiscrimination Safe Harbor Requirements for Non-Income Replacement Benefits) (2-09-1999).

benefits, do not fail the VEBA Benefits Test merely because the benefits available bear a "uniform relationship" to compensation of those covered. The IRS Internal Revenue Manual safe harbor requirements specify that the benefit offered to each highly compensated individual cannot bear a larger ratio to that individual's compensation than the average benefit offered to lower paid employees bears to their average compensation. The Internal Revenue Manual contains other details and requirements for satisfying the safe harbor.[5]

4. SPECIAL NONDISCRIMINATION TESTS FOR LIFE INSURANCE UNDER CODE SECTION 79

What are the nondiscrimination tests for group term life insurance plans? Group term life insurance provided under the Trust that is subject to its own nondiscrimination provisions under Code Section 79(d) does not need to comply with the general VEBA tests, but must meet the Code Section 79 special standards for that benefit. The statute provides that a plan may not discriminate in favor of "key employees" with respect to eligibility or benefits.

A plan will not meet the eligibility nondiscrimination requirements for life insurance benefits unless one of the following tests is met:

- The plan must benefit 70% or more of all employees of the employer;

- At least 85% of all participants in the plan are non-key employees;

- The plan benefits such employees as qualify under a classification set up by the employer and found by the Secretary of the Treasury not to be discriminatory in favor of key employees; or

- The plan is part of a cafeteria plan and the requirements for cafeteria plans are met.

A plan will not meet the benefits nondiscrimination requirements for life insurance benefits unless all benefits available to participants who are key employees are available to all other participants. Life insurance benefits will not be considered discriminatory merely because the benefits available bear a uniform relationship to the compensation of the employees covered. The dollar limit cap on compensation used to determine whether VEBA benefits are discriminatory does not apply to group life insurance plans. For purposes of this test, the term "employee" includes former employees.

What employees can be excluded from the Code Section 79 life insurance tests? For purposes of the eligibility life insurance test, the following employees may be excluded:

- Employees who have not completed 3 years of service;

- Part-time or seasonal employees;

- Employees who are included in a collective bargaining unit where the plan has been the subject of good faith bargaining between employee representatives and the employer; and

- Employees who are nonresident aliens and who receive no earned income that constitutes income from sources within the United States.

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[5]*Internal Revenue Manual* Sec. 7.25.9.3.4 (Income Replacement Benefits) (2-09-1999).

Who is a "key employee?" A "key employee" for purposes of the Code Section 79 life insurance nondiscrimination rules generally is an employee who is:

- An officer with an annual compensation greater than a dollar limit.[6] The number of officer/key employees is limited to the greater of 3 or 10% of employees. In no event shall the number of officer/key employees be more than 50;

- An owner, directly or indirectly, of more than 5% of the employer; or

- An owner, directly or indirectly, of more than 5% of the employer and has an annual compensation from the employer of more than $150,000.

A key employee also includes any former employee if such employee when he or she retired or separated from service was a key employee.

What happens to a life insurance plan that does not meet the Code Section 79 nondiscrimination testing requirements? If the life insurance does not satisfy the nondiscrimination requirements, the $50,000 worth of life insurance that otherwise would be provided on a tax-free basis instead will be includible in the income of the key employees benefiting under the life insurance plan.

5. EFFECT OF BEING PART OF LARGER CONTROLLED GROUP

What if a Bank is part of a larger group by virtue of common ownership? Banks that are part of a "controlled group" of banks (that is, are under common ownership as defined in Code Section 414(b), (c), or (m)) generally must treat the employees of all the members of the controlled group as employed by a single employer for purposes of determining whether the nondiscrimination requirements are met.[7]

6. VIOLATION OF NONDISCRIMINATION RULES

What happens to the VEBA if the nondiscrimination rules are violated? If a Bank provides discriminatory benefits to its employees under the Trust, the Trust could lose its status as a VEBA and its tax exemption. This could means that all of the Trust's income would be taxable and thus that the amount of benefits available under the Trust would be reduced. In order to ensure that this does not occur, it is essential that Banks comply with the nondiscrimination rules.

[6] This limit (under Code Section 416(i)) is subject to adjustment by the IRS for inflation. The limit in 2006 was $140,000.

[7] Code Section 414(t).