VEBAs Fund Welfare Benefits For Active Employees and Retirees

A voluntary employees' beneficiary association (VEBA) is a trust that is tax-exempt under section 501(c)(9) of the Internal Revenue Code (the "Code"), through which an employer provides welfare benefits such as life, sick, accident, or other benefits to active or retired employees or their beneficiaries. Clients often ask us to explain the advantages of establishing or maintaining a VEBA trust. In addition, VEBAs have received some press attention recently because several established industrial companies have transferred the present value of retiree health care liabilities to a VEBA that is maintained by an independent board of trustees.

This article highlights some of the primary reasons that an employer may use a VEBA trust to fund welfare benefits for active employees and/or retirees rather than paying for such benefits out of the employer's general assets. The attachment describes the wide variety of services that Groom Law Group provides in the VEBA area based on decades of experience.

I. When is a VEBA Required?

The circumstances under which an employer is required to use a trust to provide welfare benefits to comply with ERISA are fairly limited. In general, section 403 of ERISA requires that a trust be maintained to hold "plan assets." Generally, welfare plans will have plan assets where there are participant contributions and/or the employer voluntarily chooses to set aside funds to meet ERISA plan obligations. However, participant contributions withheld in connection with a cafeteria plan (ERISA Tech. Rel. 92-01) are exempt from the trust requirement. Moreover, insurance policies need not be held in trust. Nevertheless, to the extent these exceptions do not apply for a particular employer, a VEBA clearly satisfies ERISA's trust requirement.

A company may also be required to establish a stand-alone VEBA to fund large retiree health liabilities because of collective bargaining, class action litigation, or bankruptcy reorganization. For example, several established industrial companies with large retiree health liabilities on their balance sheets have recently been required to transfer an amount equal to the present value of the company's health care obligations (for a specified collectively bargained group) to a new VEBA trust that funds a new ERISA-covered retiree health plan, the named fiduciary of which is an independent board of trustees. A majority of the trustees are appointed by the court and are thereafter self-perpetuating. The remaining trustees are appointed by the union and do not involve any company-appointed trustees. A specified level of benefits may be guaranteed for a period and then left to the discretion of the trustees. The key challenge for the trustees is to invest the VEBA's assets in a manner that will enable them to offer a retiree health plan that will provide benefits for life to retirees and eligible beneficiaries.

Depending on the particular arrangement, once the independent VEBA is initially funded, the company may no longer have (or may have only limited) additional future funding obligations, and retiree health may no longer be a subject of collective bargaining. In that model, the arrangement shifts all (or most) of the risk of retiree medical funding from the company to the new VEBA. The benefits for the employer may include increasing the company's cash flow and improving its debt rating, which may lower its cost of borrowing. The arrangement helps
ensure the ongoing feasibility of the company continuing in business and providing jobs. In addition, for the retirees, the arrangement converts what was an unsecured promise to pay retiree health benefits to a funded arrangement that will remain largely unaffected if the company goes into bankruptcy.

II. **Why Use a VEBA if Not Required?**

Even if not required, a VEBA can be a convenient way for an employer to administer self-insured and insured benefit programs for employees because a VEBA provides a useful mechanism to hold plan assets where unusual circumstances arise (such as where the plan is correcting mistakes, receiving overpayments back from vendors, receiving demutualization proceeds or receiving insurance policy dividends). Another consideration is that insured and self-insured ERISA benefit plans – whether or not funded with a VEBA – partially or fully benefit from state law preemption. However, certain other benefits (e.g., vacation pay) may be easier to qualify as an ERISA plan if funded by a VEBA and therefore obtain the benefit of state law preemption.

There are also tax advantages to using a VEBA to fund employee benefits. As described in Section III below, these tax benefits differ based upon whether the VEBA is used to fund benefits for active employees, retirees, or collectively bargained employees. Finally, there are some accounting advantages associated with use of a VEBA to fund retiree benefits. Specifically, funding retiree benefits effectively reduces the employer's balance sheet liabilities under Financial Accounting Standard ("FAS") 106.\(^1\)

III. **What Tax Advantages Does a VEBA Provide?**

A. **Benefits for Active Employees**

There are modest tax advantages of using a VEBA to fund benefits for active employees. Specifically, an employer is entitled to current deductions for contributions to the VEBA, up to the complex funding limits. (The excess is carried over and can be deducted in subsequent years.) These IRS funding limits, described in Code §§ 419 and 419A, generally require that, with respect to benefits provided to active employees, the VEBA be funded no more than necessary to satisfy the current year's claims plus administrative costs. For example, use of a VEBA provides a current tax deduction for contributions for medical/dental claims incurred but unpaid as well as for current year benefits. In addition, the full present value of long-term disability benefits generally may be funded in advance on a tax-deductible basis. Further, the investment income of a VEBA is not taxable, up to the IRS funding limits that apply to deductions, and this tax-free income may be used to help fund benefits. Finally, there also appears to be a slight timing advantage that permits VEBA contributions made early in the year to reduce a company's estimated taxes.

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B. Benefits for Retirees

With respect to benefits for retirees, a reserve to fund post-retirement health benefits (determined on the basis of current medical costs) or post-retirement life insurance benefits may be established as part of the VEBA. The reserves must be funded over the working lives of the covered employees and actuarially determined using assumptions that are reasonable in the aggregate, and are subject to additional requirements, including nondiscrimination requirements, described in Code § 419A. Moreover, the Tax Court has interpreted the "funded over the working lives" requirement to mean that contributions necessary to satisfy the employer's liability for already retired employees can be fully deducted in the year made. Wells Fargo & Co. v. Comm'r, 120 T.C. No. 5 (2003). On the downside, all of the gross income of the VEBA, less directly connected deductions, generally is subject to current taxation at relatively high marginal rates. Thus, tax-free buildup of retiree medical reserves generally is not possible unless the VEBA invests in life insurance, tax-exempt bonds, or other tax-exempt investments.

C. Additional Benefits for Collectively-Bargained Employees and Retirees

A collectively bargained welfare benefit fund is not subject to the section 419A deduction limits. For this and other reasons, a collectively bargained fund may be a particularly attractive vehicle for employers with significant numbers of union-represented employees. In general, the IRS allows a current deduction for the full amount needed to provide post-retirement benefits to all current and future retirees (i.e., the present value of all future benefits). In addition, IRS private letter rulings make it clear that the investment income of a collectively bargained fund for retiree medical benefits accumulates tax-free, under principles similar to those that apply to qualified plans generally.

IV. Conclusions

There are a few disadvantages to using a VEBA, including nondiscrimination rules, IRS reporting and DOL audit requirements, and certain limitations that apply to disability benefits. Further, once money is contributed to a VEBA, a 100% excise tax generally is imposed for funds reverting back to the employer. Nevertheless, many employers decide that the advantages of a VEBA outweigh the disadvantages. Groom Law Group has considerable experience with all types and uses of VEBAs, as indicated in the attachment. Please let us know if we can be of assistance.

Attachment: VEBA Experience

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Pursuant to IRS Circular 230, please note that the information contained in this article is not intended to, and cannot be used by anyone, to avoid IRS penalties. This is not intended as tax advice. Interested persons should seek specific advice based on their own circumstances.
VEBA Experience

Attorneys at Groom Law Group have designed VEBAs for dozens of Fortune 500 companies, labor organizations, trade associations and other tax-exempt organizations. Our extensive experience in this area includes advice on –

- Who can set up a VEBA
- What types of benefits may be provided
- Who can benefit from VEBAs (e.g., self-employed, domestic partners, etc.)
- The complex deduction limits for various types of welfare benefits
- Coordination of VEBAs and 401(h) accounts/420 pension transfers
- The unrelated business tax rules
- 10-or-more-employer plan VEBAs
- Collectively bargained VEBAs
- Medicare Part D and VEBAs
- Excise tax on welfare benefit funds
- Health reimbursement accounts and VEBAs
- Mergers and asset transfers between VEBAs
- Termination of VEBAs
- IRS applications for VEBA tax exemption (required for tax-exempt status)
- IRS private letter rulings on novel VEBA issues
- VEBAs invested in life insurance
- VEBA ownership of demutualization proceeds
- The use of VEBAs in bankruptcy proceedings
- The uses of VEBA assets for different groups of employees
- Form 5500 reporting issues
- Drafting trust and contractual agreements