VEBAs: Possibilities for Employee Benefit Funding

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Voluntary employee beneficiary associations (VEBAs) are arrangements that include a trust established to fund certain benefit plans of the employer; usually the trust is referred to as a Veba. Employers segregate assets used to fund employee benefits for a number of reasons—to set aside or earmark funds from the employer’s general assets, to satisfy obligations to a union, to generate tax benefits from prefunding, or to create an offsetting asset for an employer’s liability. In addition to the perceived advantages of segregation of funds in a trust, when a VEBA is used for this purpose, the income earned by these trusts can grow tax-free if the VEBA meets certain requirements of the Internal Revenue Code (Code). However, as discussed below, this tax-free growth is not permitted in all circumstances (VEBAs funding retiree medical benefits do not enjoy this advantage), and the Code’s conditions for entitlement to tax-free growth may not be consistent with the employer’s benefit needs. Nevertheless, VEBAs remain popular with employers, and benefits professionals need to be aware of their possibilities and pitfalls. After a brief discussion of the rules governing VEBAs, this article looks at some of the current issues involving their use.

Basic Veba Rules

Generally, employers establish VEBAs as a convenient way to fund their own health, life insurance, or disability plans. VEBAs are often used to receive employee co-payments to medical, disability, and life

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insurance plans because Labor Department regulations encourage the placement of these monies in trusts separate from the employer's assets. VEBAs have been authorized under the Code for over 60 years. Prior to 1984, however, many employers used VEBAs as a means to accelerate employee benefit deductions by prefunding for the costs of employee benefits (some of which were never actually paid to employees) or to hold benefits that, while technically available to employees, were essentially discriminatory. Congress passed a broad series of tax measures in 1984 designed to stop these perceived abuses.

Section 501(c)(9) of the Code sets for the basic requirements of a Veba. A Veba must be a beneficiaries' association, controlled by its members, that provides life, sick, accident, health, or other benefits to its members or their dependents or beneficiaries. It must meet certain nondiscrimination rules. No part of any net earnings of the Veba can “inure to the benefit” of any individual, except for payment of Veba-permitted benefits, and assets of a Veba cannot revert to the employer. A Veba must file an application with the Internal Revenue Service (IRS) to confirm its tax-exempt status. The taxability of the benefits received under a Veba depends on the taxability of the underlying benefit; for example, payments for medical expenses would be tax-free; severance payments would not. A number of these requirements are discussed in more detail below.

**Benefits That May Be Offered by a Veba**

The benefits offered by VEBAs are restricted to certain types of welfare benefits—generally, life, health, disability, and certain severance benefits. “Other benefits” that are intended to improve the health of a member or dependents, or to safeguard against a contingency that impairs a member's earning power, may also be provided. For example, a supplemental unemployment compensation benefit (SUB) trust might be an “other benefit.” The restrictions on the type of permissible Veba benefits were in large part a reaction to reported practices of certain employers in the 1970s and 1980s, who would establish VEBAs to hold vacation homes, airplanes, and other exotic assets as benefits for the company's top executives.

One significant limitation is that VEBAs cannot fund “deferred compensation.” Thus, any severance benefits funded by a Veba must not be conditional on retirement. A benefit that is payable upon voluntary termination that includes retirement would be deemed to be a pension benefit and not eligible for funding by a Veba.
Coverage and Nondiscrimination Rules

VEBAs can provide benefits only to member-employees and their “dependents” as defined in Section 152 of the Code. *De minimis* number of individuals who are not employees or dependents may be covered by a Veba—e.g., a self-employed owner may be covered under a Veba even if he or she is not technically an employee. The IRS has informally permitted use of this *de minimis* rule to allow VEBAs to cover domestic partners of employees who are not dependents as defined in Section 152, as long as the numbers of such covered individuals are *de minimis*.6

The nondiscrimination rules for VEBAs were also part of the Veba reform legislation enacted in 1984. Now, Section 505(b) of the Code prohibits discrimination in favor of the highly paid. If the benefits funded by the Veba are subject to their own separate nondiscrimination rules, satisfaction of those separate rules satisfies the nondiscrimination rules for VEBAs. But if the benefits funded by the Veba are not subject to other nondiscrimination rules, they must meet the Veba’s nondiscrimination rules. Essentially, Veba benefits cannot be provided to a classification of employees that favors the highly paid. Certain employees can be excluded when testing the Veba for nondiscrimination—employees with fewer than three years of service, those under age 21, and certain part-time, seasonal, and collectively bargained employees. Also, Section 505(b)(7) of the Code provides that benefits that are based on compensation and offered under a Veba cannot be based on compensation in excess of a statutory dollar cap (currently, $200,000).

Membership Control

Regulations issued under Section 501(c)(9) interpreted the statutory requirement that members “control” the Veba to mandate that the Veba trustees either be elected or controlled in part by employees. This caused great consternation among employers who viewed VEBAs as their own voluntary funding vehicles and who were reluctant to share investment control or administration with employees. The employers were successful in changing the regulations to state that “membership control” is deemed satisfied if the plan of which the Veba is a part is subject to ERISA,7 or its trustees are appointed pursuant to a collective bargaining agreement.

In addition to requiring that members control the Veba, the regulations also require that membership in a Veba be “voluntary.” Recognizing that in reality many employer plans cover all employees of an employer as a matter of course, the regulations provide that “an
association will be considered voluntary although membership is required of all employees, provided that the employees do not incur a detriment (for example, in the form of deductions from pay) as the result of membership in the association."

Prohibited Inurement and Reversions

The earnings of a VEBA cannot inure to the benefit of any private individual, other than through payment of VEBA benefits. As discussed in more detail below, this requirement has been applied in conjunction with a statutory 100 percent excise tax on reversion of VEBA assets to an employer. The major consequence of these rules is that any employer that makes contributions to a VEBA should be confident that the benefits to be paid from the VEBA exceed the amount of contributions and earnings, because the employer cannot recover excess funds without a confiscatory tax. Moreover, as discussed below, once the assets become plan assets subject to ERISA, they can only be returned to the employer under very limited circumstances (e.g., mistake of fact within one year of contribution). Since there are no minimum funding requirements for VEBAs, it is generally easy to be conservative on this issue, but this is sometimes at the expense of maximizing deductions or protecting the employees' benefits adequately by providing separate funding.

Limitations on VEBA Funding

Prior to the 1984 reform legislation, many employers accelerated tax deductions by “prefunding” VEBAs for future costs of employee benefits. They argued that if the money was irrevocably contributed to the VEBA, the expense was thus accrued and deductible. This worked well for employers who used accrual basis accounting, but was draining the government of revenue.

Congress responded by limiting the amount that could be deducted for contributions to a “welfare benefit fund.” Welfare benefit funds include VEBAs as well as certain taxable trusts and certain insurance policies that require lives reserves or premium stabilization reserves (essentially reserves that give the employer the right to apply the reserve against future benefit obligations of the employer). The account limit depends in part on the type of benefit being funded. Generally, deductible contributions are limited to the employer’s “qualified cost,” which is the sum of (1) the employer’s “qualified direct cost” plus (2) allowable additions to the fund’s “qualified asset account,” and minus any income earned by the VEBA. The qualified direct cost is the amount the employer could deduct if it were a cash

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basis taxpayer (very generally, the amount the VEBA actually disburses for benefits for the year). The qualified asset account is the feature of the VEBA that allows some prefunding. The qualified asset account equals the incurred but unpaid claims at year-end, plus necessary administrative costs. Presumably the “incurred but unpaid claims” is a concept similar to the more commonly used term of claims “incurred but not reported”; one IRS technical advice memorandum, TAM 9446002 (July 12, 1994), treated these concepts as the same.

The account limit for supplemental unemployment and severance benefit plans is 75 percent of the average annual direct costs of such benefits for any two of the immediately preceding seven years (as selected by the fund). In addition, the amount of severance benefits that can be taken into account [for purposes of the safe harbor or the account limit] is 150 percent of the maximum contribution limit for deferred contribution pension plans. That limit is now $40,000, so the VEBA limit would be $60,000. Finally, as discussed below, special reserves are also permitted to fund estimated future costs of retiree medical plans.

Although the Code itself is not entirely clear on this point, an actuarial certification that the account limits are justified under the plan is required unless certain safe harbors are met. The IRS takes the position, however, that these safe harbors do not allow the employer to deduct more than the qualified cost under the general rule; they merely avoid the need for an actuarial certification of such costs. The safe harbors differ for each benefit as follows:

- for medical, 35 percent of the qualified direct costs (excluding insurance premiums) for the immediately preceding tax year;
- for short-term disability, 17.5 percent of qualified direct costs (excluding insurance premiums) for the immediately preceding tax year;
- for long-term disability, a safe harbor to be provided in regulations, which have yet to be issued;
- for SUB plans and severance plans, the same as the qualified cost.

**Treatment of VEBA Income**

As noted above, in general, assets in a VEBA grow tax-free as long as the income is “exempt function” income set aside to provide for benefits permitted under a VEBA.

A VEBA’s unrelated business income tax (UBIT) is computed by subtracting exempt function income from its gross income. Gross income is determined as such income is normally computed under the Code; thus, for example, tax-exempt bond income or capital appreciation on stocks is not included. Exempt function income generally includes employee and member contributions (e.g., employer contri-
butions and any co-pays or fees paid by employees as well as income “set aside for exempt purposes,” including reasonable costs of administration.) Income “set aside” at the end of the year for exempt purposes that exceed the qualified account limit will be taxed as UBIT. The amount of UBIT is generally the lower of (1) the income of the VEBA excluding member contributions, or (2) the total amount set aside at the end of the tax year (including member contributions) over the qualified account limit. Thus, a VEBA is taxed on its investment income to the extent it is overfunded because contributions exceed the account limits of Section 419 and 419A of the Code. In determining the amount set aside for purposes of calculating UBIT, certain assets with useful lives extending beyond a year (e.g., licenses, buildings) are not taken into account to the extent they are used to provide permissible VEBA benefits.

SPECIAL RULES FOR RETIREE MEDICAL AND LIFE BENEFITS

The use of VEBAs to fund retiree medical benefits assumed prominence in the late 1980s when the Financial Accounting Standards Board (FASB) required employers to quantify and state as a current liability the amortized estimated cost of future retiree medical liabilities on their financial statements. This significantly increased employers’ costs and lowered reported income and profits. As a result, employers searched for a way to offset these costs with an asset. VEBAs were the logical choice, but the limitations on retiree medical VEBAs—some prefunding permitted, but not as much as the employer’s actual costs—were an obstacle. Retiree life insurance benefits are subject to similar rules and are often provided in a VEBA, although the scope of such benefits is significantly less than retiree life benefits, particularly since retiree life insurance benefits are limited to $50,000 per retiree.

Retiree medical and life benefits have special account limits that allow for more prefunding than permitted for other VEBA benefits. The qualified asset account limit for such benefits must be (1) funded over the working lives of covered employees, (2) actuarially determined on a level basis using assumptions reasonable in the aggregate, and (3) based on covered costs. This last requirement means that when estimating future costs, inflation cannot be taken into account, a rather unrealistic assumption given the high rate of medical cost inflation.

Although some reserves are permitted for retiree medical and life plans, the advantage of this prefunding opportunity is offset to a large extent by the fact that under Section 512(a)(3)(E)(i) of the Code, income or retiree medical accounts is not tax-free because reserves for
retiree medical are not permitted to be taken into account as an allowable set aside for this purpose. In some cases, however, employers deal with this problem by investing in tax-free instruments such as bonds, stock, or life insurance, but if such instruments must be sold to pay benefits, income will be generated. Another rule that applies to VEBAs for retiree medical and life benefits is that separate accounts must be set up for key employees and contributions to such accounts applied against the maximum pension plan contribution limits. Most employers deal with this requirement by excluding key employees from receipt of Veba funds (although they participate in the retiree benefit plans).

Employers continued to seek ways to prefund retiree medical benefits. In *General Signal v. Commissioner*, 103 T.C. 216 (1994), aff’d, 142 F.3d 546 (2d Cir. 1998), an employer established a Veba to fund active and retiree medical claims. The employer prefunded the reserve up to the “safe harbor” level for a retiree medical qualified asset account, but immediately spent the reserve for active employee benefits. The taxpayer enjoyed a large deduction but as a practical matter never actually prefunded the Veba for retiree medical costs. The taxpayer was relying on the general rule that Veba assets can generally be aggregated for purposes of applying the account limits.

This method was employed by many taxpayers, but vigorously contested by the IRS as an end-run around the account limits. The Tax Court agreed with the IRS, holding that safe harbors of Code Section 419A(c)(5) did not serve to allow funding in excess of the amounts reasonably permitted under the qualified asset account limits. The court, in this case, ignored the commonly understood meaning of a reserve as a bookkeeping device and held that no “reserve” for retiree medical benefits actually existed, since assets were immediately used to pay active employee benefits. It did recognize that later events could change the need for certain assets and implied that the intent in establishing a reserve would affect the deduction.

If retiree medical benefit assets are segregated in a separate trust or subtrust (as would seem to be a good practice given the *General Signal* case), concerns were expressed that a plan solely for retirees would, in effect, be a deferred compensation arrangement that cannot be funded by a Veba. The IRS has taken the informal position, however, that retiree medical plans that are a continuation of an active employee plan (even if both are not funded) would be permitted to be funded by a Veba.

Some employers use VEBAs to fund retiree medical benefits, but given the lack of tax advantages for these trusts, are more likely to do so for collectively bargained obligations, which are exempt from the account limits.
VEBAS EXEMPT FROM ACCOUNT LIMITS

VEBAs exempt from the account limits that apply to other VEBA benefits include collectively bargained VEBAs, employee-pay-all VEBAs, and VEBAs established for ten or more employers. Such VEBAs are often used by employers with benefit plans that can be funded by them, since they do offer significant tax advantages.

Most common are VEBAs used to fund benefits paid to collectively bargained employees. These VEBAs must fund benefits that are the subject of good-faith bargaining and established pursuant to an agreement that satisfies Section 7701(a)(46) of the Code. At least 90 percent of the employees eligible to benefit must be covered by the collective bargaining agreement. Initially, most employers established a separate trust for these VEBAs; more recently the IRS has approved the use of a separate “sub trust” for union employees. Note that the IRS has interpreted the requirement that benefits be maintained pursuant to a collective bargaining agreement to require evidence of good-faith bargaining over the welfare benefits to be provided. Thus, it appears that the fund or VEBA itself can be established unilaterally by the employer, as long as the benefits are bargained.

Similarly, many large employers use VEBAs to fund “employee pay all” plans. Section 419A(f)(5)(B) of the Code requires that such plans have at least 50 employees, and no employee may receive a refund of amounts paid unless the refund is based on the experience of all members in the fund. Obviously, no deduction is involved here and there is little incentive to prefund since the contributions are employee contributions (which is probably why no limits are imposed), but the VEBA allows the employee contributions to grow tax-free.

A ten-or-more-employers Veba, which is also exempt from the account limits pursuant to Section 419A(f)(6) of the Code, is one that is not used often by large employers, but is used by smaller employers. Some of the more aggressive variations of the Veba have recently been clouded by case law and IRS scrutiny. The exemption was established for funding arrangements that resembled insurance policies, on the theory that employers participating in such arrangements would have little incentive to overfund, since they were not the sole beneficiary of such overfunding. However, more aggressive variations of ten-or-more-employers plans provided an experience-rating mechanism that eliminated in large part any shifting of insurance risk. For that reason, the Tax Court in Booth v. Commissioner, 108 T.C. 524 (1997), ruled that one such plan there-
fore did not qualify for the ten-or-more-employers exception. Although the Tax Court did not impose penalties on the taxpayer in that case, the IRS has classified such plans as a “listed transaction,” in essence, a potential tax shelter that would be subject to increased reporting requirements and IRS scrutiny.26

TREATMENT OF VEBAS WHEN CIRCUMSTANCES CHANGE

This discussion of abuses of the VEBA rules has focused on attempts to prefund VEBAs in an artificial manner. But there are situations in which VEBAs can become inappropriately funded, not by manipulation, but by a change in the employer’s workforce. For example, a divestiture of a division that had numerous employees entitled to retiree medical benefits might reduce the employer’s ongoing retiree medical obligation. Union contract renewal negotiations might result in a requirement for an employee benefit not currently funded by VEBAs. An employer could go out of business or lay off a significant number of employees. Employers with VEBAs need to be aware of the rules for changing VEBAs when their circumstances change.

The first rule is that the employer cannot economically recover VEBA assets even if circumstances change. Under Code Section 4976, an employer is taxed 100 percent on any reversion paid to it, and, in addition, all income of the VEBA is also immediately taxed. Most trusts are drafted to prohibit any reversion of assets upon termination; they authorize instead a division of assets among members or an alternative use of such assets in a manner consistent with the purposes of the VEBA rules.

If a VEBA’s assets cannot be used for the originally intended purpose because the VEBA-funded obligations have been reduced or eliminated, and if the employer still has employees with other benefit needs, an employer could amend the VEBA to add another benefit to be funded by the VEBA. Although some commentators have expressed concern as to whether it is proper to use VEBA assets to fund a current obligation, this practice has generally been approved by the IRS in private letter rulings. For example, in Private Letter Ruling 20004103 (October 17, 2002), a VEBA that provided disability benefits for a dwindling number of employees of a particular division was amended to provide dental benefits to employees of a parent company that acquired that division. In TAM 9647001 (November 22, 1996), the IRS approved payment of distributions to employees who had previously been covered by a discontinued sick leave plan.

Another common issue faced by employers is their ability to merge VEBA assets or to use VEBA assets originally set aside for one group...
of employees for another. Sometimes an employer will merge an underfunded trust with an overfunded one. The IRS again has ruled in a number of situations that such mergers are not indirect reversions to employers, and that employers can add or change members of a VEBA without creating an indirect reversion.27

Rebates and Demutualization Proceeds

Recent changes in circumstances faced by a number of employers include the receipt of premium rebates or special consideration received when mutual insurance companies, which are deemed owned by their policyholders, “demutualize” and become stock companies owned by shareholders.

The proper procedure for employers who receive rebates or demutualization proceeds (either directly or in a VEBA) is not entirely clear, and depends on the circumstances unique to each transaction, including the party who is deemed to own the rebate or proceeds, the terms of the plan or trust agreement, or the extent to which the rebate or proceeds are deemed to derive from employee contributions. Although each situation plan provides different results, a few generalizations are offered below.

Rebates

The IRS has taken the position in a number of private letter rulings that the receipt of rebates by an employer that has paid the premium will not result in prohibited inurement to the employer. Moreover, even if the recipient of the rebate is a VEBA, the IRS has ruled in private rulings such as PLR 9214030 (January 9, 1992) that the VEBA may distribute the rebate either to the employer—if the employer paid the full premium from which the rebate is derived—or to the employer and employee-members on a pro rata basis if the employer and employees both paid premiums. This is based in part on the provision in Treas. Reg. Section 1.501(c)(9)-4(c) that exempts rebates from the prohibited inurement prohibition of Section 501(c)(9).

The Labor Department, however, seems to be less flexible. In DOL Opinion to Michigan Petroleum Ass’n., 1994 ERISA Lexis 75 (November 30, 1994), the Department characterized rebates as a return of employer contributions, and stated that the exception to ERISA that allows returns of employer contributions from a trust within one year of the mistake of fact should be interpreted narrowly. It was not clear from the letter whether the Department would deem a rebate to be a “mistake of fact” but even if that were the case, assuming the Department’s position
remains as stated in 1994, it might be different for a trust to provide rebates to employers given that rebates do not often occur within a year. The result of the Department’s letter seems quite harsh in certain welfare benefit cases, where in many instances trusts are not required and set up as a matter of convenience. Department representatives have informally opined that their preferred method of dealing with rebates is a “premium holiday,” provided to participating employees or members, even though that sometimes benefits only current employees and employers, and not those who actually made the contribution that generated the rebate.

One interesting IRS private letter ruling, PLR 200223068 (March 13, 2002), permitted a VEBA trust that was in essence terminated (because the employer was using insurance to fund its benefits) to transfer a demutualization dividend payment (see discussion below) to a tax-exempt 501(c)(3) organization that provided charitable and other educational services to the employer’s employees.

In any instance in which an employer might want to enjoy the rebate (e.g., as a premium holiday) it is strongly recommended that the employer’s description of the benefit program and its funding method make it clear how such rebates will be applied.

Demutualization

When a company demutualizes, it must return to the policyholders some consideration reflecting the policyholders’ equity in the mutual company. This can be stock, cash, or an option to choose between the two. Many large companies that demutualized, such as Prudential Insurance Company and Metropolitan Life Insurance Company, sought rulings from the IRS and opinion letters from the Labor Department on the effect of the receipt of demutualization proceeds. None, to our knowledge, focused specifically on receipt of such proceeds by VEBAs. Again, although each instance of demutualization is different, a few general observations can be made.

First, the Labor Department takes the position that demutualization proceeds belong to the employee if employee contributions are involved. The Department also does not appear to rule out the possibility that such proceeds are plan assets even if the employer pays most of the premiums. If demutualization proceeds are plan assets, they need to be placed in trust. VEBAs can be used and have been established by employers for this purpose.

The tax treatment of demutualization proceeds may depend in part on who is the owner of the policy for which they are paid. If the employer is the owner, it will be taxed on receipt if the proceeds are paid in cash. If the proceeds are paid in stock, and the employer needs
to sell the stock or contribute it to a trust (on the theory that some or all of the proceeds are plan assets), then the sale arguably results in taxable gain. One could argue alternatively that if the employer is obligated to place the proceeds in a trust, it does not own the proceeds so enjoys no gain; it is not clear that this argument has been tested.

If the VEBA is the owner of the mutual insurance policy and receives the stock or cash, it will not be taxed unless the receipt of the proceeds generates UBIT. Unfortunately, this could easily happen if the proceeds are large enough to exceed the applicable account limits.

CONCLUSION

VEBAs can be useful for holding and managing assets of an employer’s benefit plans, although the account limits and other restrictions warrant careful scrutiny and may in some instances, when combined with the additional administrative costs, argue against establishing a VEBA. The operation of a VEBA may be not too difficult as long as the plans and members covered by the VEBA, as well as the underlying assets, are relatively stable. If circumstances change, however, the terms of the plan, the VEBA trust, and various rules governing use of plan assets will come into play.

NOTES

1. Plans with employee contributions (e.g., co-pays) must place such contributions in trust, since the Labor Department takes the position that such contributions are plan assets in 29 C.F.R. § 2510.3-102, and section 403(a) of ERISA requires that all plan assets be held in trust. Plans funded solely by employer contributions do not have to place plan assets in trust, as long as benefits are paid solely from the general assets of the employer or from insurance policies. ERISA § 302(b) and 29 C.F.R. § 2920-104-44(b)(1)(i).


8. Treas. Reg. § 1.501(c)(9)-2(c)(2).


11. Treas. Reg. § 1.419-1T, Q + A-3(c).

12. Id. at Q + A-5.

13. Code § 419A(c)(5).


15. The Service was supported in this view by the court in General Signal v. Commissioner, 103 T.C. 216 (1994); aff’d, 142 F.3d 546 (2d Cir. 1998).


17. Treas. Reg. § 1.512(a)-5T, Q + A, 3(b).

18. Id.


23. This number can be 50 percent if the fund was established before July 1, 1985. Treas. Reg. § 1.419-2T, Q + A-2(4).


28. Although the publicly available rulings do not mention the insurance company that obtained them, representative samples include Priv. Ltr. Ruls. 200011063 (Dec. 20, 1999) (use of demutualization proceeds to provide benefits not a reversion); 200301033 (Sept. 30, 2002) (same); 200223068 (March 13, 2002) (same plus stated no UBIT would apply in the circumstances described in the ruling).