An introduction to VEBAs

Many employers are looking for creative options to continue to provide employees with cost-prohibitive benefits that they've traditionally provided. A Veba (Voluntary Employees' Beneficiary Association) is one way to preserve existing benefits and shift some benefit costs to employees. Read on for more information on what a Veba is, its benefits, and how it's administered.

A Veba is a tax-exempt entity created pursuant to Internal Revenue Code (Code) § 501(c)(9), and may include health benefit plans, life insurance, disability insurance, accident insurance, vacation, or other employee benefits. A Veba can be a trust, corporation, or association to which employer and/or employee contributions are made. If the plan meets the requirements of Code Sections 501(c)(9) and 505, then it will be tax exempt. IRC § 505 subsection (b) imposes nondiscrimination requirements while subsection (c) requires that VEBAs apply for and receive a favorable ruling from the IRS. A trust that is not tax-exempt is taxed under the rules of Sub-chapter J at the IRC § 1(e) rates applicable to trusts, which for taxable income of over $11,950 is 39.6% in 2013.

Deductibility

Normally, amounts employers pay or accrue for unfunded welfare benefit plans are deductible under Code § 162 if they are ordinary and necessary expenses of the trade or business. In addition, payments by the employer to a “welfare benefit fund” (VEBAs) must also be deductible under both Code §§ 419 and 419A. This limits employer contributions to a welfare benefit fund; they are not paid out in direct benefits or for expenses in the year of the contribution, or to an amount that is determined to be actuarially reasonable (in some cases a statutory safe harbor). These sections impose strict limits on the amount of tax-deductible prefunding for contributions to a Veba. Section 419A limits the account to administrative costs and to the amount that is necessary to fund the account for claims incurred but not paid. In addition, the limit includes a reserve for postretirement medical and life insurance benefits.

Section 419 limits the deductible amount to the fund’s qualified cost for the year, which equals the sum of qualified direct cost subject to limits in 419A(b), and any additions to a qualified asset account for the tax year. The qualified direct cost is the aggregate amount, including administrative expenses that would have been allowable if the benefits had been provided directly by the employer using the cash method. A qualified asset account consists of the assets set aside for the payment of benefits.

Income generated

A funded welfare benefit plan will normally generate income, which, to the extent it exceeds deductible expenses, will be taxable unless otherwise excluded from income. If the fund is simply an earmarked account of the employer, any income will be taxable to the employer. If it is a trust, the income still might be taxable to the employer unless the trust is established as a separate entity. If the trust is established as part of a Veba, it would be tax-exempt under 501(c)(9), although it would still be subject to federal income tax on its unrelated business taxable income.

Funding

Health benefits may be paid out of the employer’s general assets, by means of insurance, or from a trust created by the employer, or by some combination of these funding mechanisms. The trust will be tax-exempt if it meets the requirements of Code § 501(c)(9). Trusts may also be set up on behalf of Veba members to collect contributions and pay benefits when they are due. A Veba that is funded with reserves for future benefit costs for active or retired employees will need an actuarial certification.

IRS filing

In the case of a § 501(c)(9) organization, notification is required to be filed with the IRS to obtain a tax-exempt status. This must be done with Form 1024, Application for Recognition for Exemption under Code § 501(a). Also, Schedule F must be filed along with a conformed copy of the Veba’s organizational documents. (Note: VEBAs must be amended to reflect OBRA ‘93’s compensation limit, which is $255,000 for 2013).
VEBA questions and answers

What does “employees’ association” mean?
A VEBA must be a bona fide association with governing documents — an entity independent of both employer and employees. A bank account established by an employer as a means of funding employee benefits would not qualify as a VEBA.

Since a VEBA is an association, current IRS ruling policy is not to approve VEBAs covering only one person. The IRS is reluctant to approve VEBAs covering only a few employees, some of whom are owners.

Regulations mandate that a VEBA be an “association of employees.” A plan that qualifies under ERISA § 3(1) as an “employee welfare benefit plan” — which includes most VEBAs — will be deemed to satisfy this requirement.

Who can be members?
VEBA membership is made up of employees (in the legal and bona fide sense of the word). Individuals are entitled to membership in the VEBA if they are or ever have been an employee. The VEBA may cover employees on leave of absence, temporarily working elsewhere, retired, disabled, or laid off.

Not all employees of one employer or group of employers must be members. VEBA membership eligibility, according to the regulations, is based on “objective standards that constitute an employment-related common bond ...” (Reg§ 1.501 (c)(9)-2(a)).

Consequently, membership in a VEBA could be open to all employees under a collective bargaining agreement, or to all employees belonging to a certain union or local, as well as to employees of a particular employer or group of employers. An employment-related common bond might even be established by geographical location or job classification.

IRC § 505 imposes coverage and benefit nondiscrimination rules. Generally, a nondiscriminatory class of employees must be covered, but the VEBA may disregard:
- Employees with less than three years of service
- Employees under age 21
- Seasonal or less than half-time employees
- Union employees
- Non-resident aliens with no U.S. income

Trust or organization
VEBAs typically use a bank or financial institution to serve as an independent trustee. However, a VEBA does not have to use a trust as its funding vehicle. It may be organized as a corporation or association that is recognized under local law. The use of one of these alternatives would require state law filing requirements be met, including articles of incorporation or association and any requisite state tax implications.

VEBA membership eligibility, according to the regulations, is based on “objective standards that constitute an employment-related common bond ...” (Reg§ 1.501 (c)(9)-2(a)).

Control element
A VEBA is required to have a separate existence from the employer or its member employees. This means it needs to use a separate Employer Identification Number. The VEBA must be controlled by the membership or a trustee — whether independent, or designated by or on behalf of the membership. A separate trust meets the control requirement. However, use of an earmarked account that is the employer’s bank account does not meet the control requirement.

Multiple employer welfare benefit plan
Groups of ten or more employers who each contribute less than 10% of the total funding can use VEBAs. A welfare benefit plan may be established as either a tax-exempt VEBA trust or a taxable trust under 419A. The advantage of a welfare benefit plan is that the plan sponsor is allowed a deduction for contributions to the plan in the same year in which they are made, but the individual employees generally pay no income tax on amounts contributed on their behalf.

Generally there are no limits on annual contributions an employer may make to a plan that complies with Code §§ 419A(f)(6). This is distinct from the single-employer VEBAs that must comply with Code §§ 419 and 419A deduction limits. The benefits that are income replacement benefits, like life and disability benefits, must have a uniform relationship to compensation for all participants. The amount of benefits and the cost of the benefits must be considered — along with all other compensation received by an employee — and the total must be “reasonable.” Benefits must be uniform and proportionate among all employees of a sponsoring employer. Certain groups of employees may be excluded from participation.

Groups of ten or more employers who each contribute less than 10% of the total funding can use VEBAs.

401(h) accounts within a pension plan
401(h) accounts within a pension plan are another option for funding FAS 106 postretirement medical plans in addition to...
VEBAs. However, companies usually exhaust the 401(h) capacity and have some taxable income within their VEBA.

**Nondiscrimination**

Code § 501(c) requires that a VEBA must be nondiscriminatory in order to gain the tax-exempt status. The benefits under the plan must not discriminate in favor of highly compensated employees. A plan is not discriminatory 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. Code § 505(b) also contains general nondiscrimination requirements that apply to VEBAs. Multiple Employer Death Benefit Only Trusts described under Code § 419A(f)(6), unlike a VEBA, are not constrained by the nondiscrimination rules and can for the most part be very selective as to who is covered and how they are covered.

**ERISA and IRS reporting**

A VEBA is subject to the Fiduciary Responsibility, Disclosure and Reporting, and Administration and Enforcement sections of Title I, Part B of ERISA. It will have to file annual 5500 series forms (Return/Report of Employee Benefit Plan) if it provides a health and welfare benefit. It also must provide participants with a summary plan description. Form 990 (Return of Organization Exempt from Income Tax) must be filed if gross receipts exceed $50,000 in a year. In addition, Form 990 needs to be filed if the VEBA recognizes any unrelated trade or business income as defined in Section 513 of the Code.

**Termination**

Value in the VEBA is distributed upon termination on a pro rata basis among the current plan participants. The benefits are taxable as ordinary income in the year they are received. Assets of the VEBA cannot be returned to the employer.

**Benefits provided**

VEBAs can acquire life insurance on a tax-deductible basis. In addition, VEBAs can provide severance, education, sickness, accident, disability, and other benefits.

**FAS 106 postretirement medical and life liabilities**

VEBAs can be used to fund postretirement medical and life liabilities. In addition, an Insurance Continuance Fund (ICF) can be used. There is also a method of funding that removes the liability from the employer’s balance sheet through a single premium insurance settlement. This arrangement transfers the liability for a defined group of retirees to an insurance underwriter, who assumes full risk for mortality and interest. The settlement (known as a “buy-out”) retains the same tax treatment as VEBAs or ICF funding arrangements. The buy-out approach is irrevocable to the employer and represents a guarantee of future payments to retired plan participants and beneficiaries. This approach is often used to segregate liabilities in mergers, acquisitions, and divestitures.

**Candidates for VEBAs and welfare trusts**

The kinds of companies that should consider a VEBA or welfare benefit trust include:

- Any profitable company seeking a way to reduce tax liabilities through current deductions
- Companies whose qualified retirement plans are over-funded or no longer favor the business owner
- Business owners who would like to protect their assets designated for benefits from creditors
- Owner-employees who would like to reduce their estate tax exposure
- Owners who would like to buy tax-deductible insurance (key man, estate, buy/sell, etc.)

**Corporate-Owned or Trust-Owned Life Insurance (TOLI)**

One technique employed by plan professionals to avoid the problem of unrelated business income tax (UBIT) on VEBA assets is to use Corporate-Owned or Trust-Owned Life Insurance (TOLI). As death benefits are paid, the proceeds go toward retiree medical costs. In addition, offshore medical stop-loss insurance is used. How these techniques will be taxed in the future is questionable. In order to maintain the favorable tax treatment when using TOLI, the policy liabilities will need to approximate policy assets. This requires that all policies must be reviewed annually, and the benefit levels or the covered group of plan participants will be adjusted if necessary.

A VEBA established to provide postretirement medical benefits is subject to unrelated business taxable income (UBTI) for plan years ending after July 18, 1984, in an amount equal to: the lesser of (1) the income of the fund (excluding employee and employer contributions) or (2) the amount by which the assets in the fund exceed the qualified asset account limits (excluding the reserve for post-retirement medical benefits). The account limit for a qualified asset account for any tax year is generally the amount reasonably and actuarially necessary to fund (1) claims incurred but unpaid at the end of the year, (2) administrative costs with respect to
those claims, plus (3) a reserve for post-retirement medical or life insurance benefits to covered employees. The reserve must be funded over the working lives of covered employees and actuarially determined in a level manner using assumptions that are reasonable in the aggregate.\(^8\)

Section 419A(c)(5)(A) requires that the account limit of a qualified asset account for any tax year not exceed the sum of the safe harbor limits for such year, unless an actuarial certification of the account limit determination is obtained. For medical benefit claims, the statutory safe harbor is 35% of the qualified direct cost (other than insurance premiums) of such benefits for the preceding tax year.\(^9\) Current practice is to use about two months, or about 16% of annual claims, as a guide for contributions.

Is a VEBA program right for your organization? This might be a question worth additional exploration.

---

1 Treas. Reg. § 1.162-10
2 As defined in Code §419(e)(1)
3 Code § 505(b)(7)
4 Treas. Reg. § 1.501(c)(9)-2(c)(1)
5 Treas. Reg. § 1.501(c)(9)-2(c)(5)
6 Treas. Reg. § 1.501(c)(9)-2(c)(4), Ex (4)
7 Treas. Reg. § 1.501(c)(9)-2(c)(4), Ex 2; PLR 8907033
8 Code Section 419A(c)(2)
9 Code Section 419A(c)(5)(B)(ii)