# Voluntary Employees' Beneficiary Associations Offer Substantial Benefits to Business

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# Voluntary Employees' Beneficiary Associations Offer Substantial Benefits to Business

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The author discusses what a voluntary employees' beneficiary association is, why it interests businessmen and how it operates in light of the final income tax regulations under Section 501.

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This article discusses voluntary employees' beneficiary associations ("VEBAs") in light of the final income tax regulations issued January 7, 1981.[1] Specifically, it discusses what a VEBA is, why it interests businessmen, the benefits available, who may participate and its mechanical application.

A VEBA is a separate entity, such as a trust, which may be formed by a company or its employees, to provide life, sick, accident or other benefits to its members and their families. Generally, the governing document establishing the trust will also include a plan. This plan is subject to pertinent parts of the Employee Retirement Income Security Act of 1974 (ERISA).

## Statutory Authority

Internal Revenue Code (all references are to the Code unless otherwise stated) Section 501(a) provides in pertinent part:

> An organization described in subsection (c) or (d) . . . shall be exempt from taxation under this subtitle unless such exemption is denied under Section 502 or 503.

[1] The initial proposed income tax regulations were issued January 23, 1969. They were withdrawn and reproposed July 17, 1980 (26 C. F. R. Part 1) and adopted in final form Dec. 30, 1980. (Vol. 46 *Federal Register* No. 4, Jan. 7, 1981). See Dunkle, "Final Regulations Stimulate Use of Section 501(c)(9) Trusts," 59 TAXES—*The Tax Magazine* 226 (1981).

Section 501(c)(9) describes the VEBA as an organization exempt from taxation, as follows:

> Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

Section 501, therefore, serves as the statutory basis for the VEBA's tax-exempt status, although other provisions of the Code and its regulations affect it.

## Why Does It Interest Us?

A VEBA offers numerous tax and economic advantages, including the following: contributions to the trust are deductible;[2] earnings on the accumulated trust funds are exempt from tax;[3] the membership in the trust can be restricted to a specified group of employees;[4] flexibility exists in weighting benefits among members;[5] ultimate distributions may be short or long term;[6] upon dissolution, payments may be made directly or by the purchase of insurance policies;[7] similar benefits may be provided for a member's dependents;[8] and upon a member's demise, as later discussed, death benefits may, under certain circumstances, pass to or in trust for his family unburdened by federal estate taxes.

## Covered Benefits

The following sets forth some of the benefits which may be provided members of the plan:[9]

(a) Death benefit—provided directly or through insurance;

(b) Major medical;

(c) Long-term disability;

(d) Short-term disability;

(e) Illness or personal injury;

(f) Vacation benefits;

(g) Recreational facilities for employees;

(h) Income maintenance payments in the event of economic dislocation;

(i) Temporary living expense loans and grants at times of disaster (fire, floods, etc.);

(j) Personal legal service benefits (from a legal trust as described in Section 501(c)(20));

(k) Educational or training benefits or courses for members (such as apprentice training courses); and

(l) Educational benefits to employees, their families and dependents pursuant to Section 302(c)(7) of the Labor Management Relations Act of 1947, as amended.[10]

Other benefits which are permissible include those that safeguard or improve the health of a member or his dependents or protect against a contingency that interrupts or impairs his earning power. Generally, the benefits to be covered usually relate to an unanticipated event.

Regulation § 1.501(c)(9)-3(f) sets forth the following examples of benefits that may not be covered:

(a) Payment of commuting expenses;

(b) Providing accident or homeowner's insurance for property damage;

(c) Providing malpractice insurance;

(d) Making loans (except in times of distress);

(e) Providing deferred compensation;

(f) Providing savings accounts or similar vehicles; and

(g) Providing any type of pension, profit-sharing, stock bonus or annuity plan.

Also, Revenue Ruling 74-18,[11] prohibits coverage of workmen's compensation benefits, since this "merely ensures the discharge of an obligation already imposed by statute upon the corporation" which formed the VEBA.

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[2] Income Tax Regulation Sec. (hereinafter "Reg. §") 1.162-10; Revenue Ruling 69-478, 1969-2 CB 29; *Weil Clothing Co.*, CCH Dec. 17,297, 13 TC 873 (1949), acq., 1950-1 CB 5; Rev. Rul. 77-406, 1977-2 CB 56.

[3] Sec. 501(c)(9); but compare Sections 502, 503 and 511-514.

[4] Reg. § 1.501(c)(9)-2(a)(2).

[5] Reg. § 1.501(c)(9)-2(a)(2)(ii).

[6] Reg. § 1.501(c)(9)-3(b). For example, a death benefit may be in a lump sum or in the form of an annuity to the beneficiary.

[7] Reg. § 1.501(c)(9)-4(d).

[8] Reg. § 1.501(c)(9)-3(b).

[9] Reg. § 1.501(c)(9)-3.

[10] 29 U. S. C. 186(c)(1979). However, both the employer and the employees must be equally represented in the administration of the trust fund; the other operating mechanics set forth in that statute should also be noted. The commentary of the Office of Chief Counsel, IRS, to the final regulations refers to "collectively bargained trusts" providing for this benefit.

[11] 1974-1 CB 139.

## Death Benefits: Section 79 Applicability

Regulation § 1.501(c)(9)-3(b) euphemistically allows a "life benefit" (i.e., a death benefit) to be funded directly or through insurance. That regulation further states, with respect to such life benefit:

> It generally must consist of current protection, but also may include a right to convert to individual coverage on termination of eligibility for coverage through the association, or a permanent benefit as described in, and subject to the conditions in, the regulations under Section 79.

This allows a VEBA to provide "a permanent benefit" subject to the regulations under Section 79. Some practitioners, however, consider that if the employee has no interest in the policy, as he does in a typical Section 79 plan, no "permanent benefit" is being provided the employee. Therefore, Section 79 is not applicable.[12]

The commentary of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service, on the final Section 501(c)(9) regulations (hereinafter referred to as "commentary") states:

> Because of uncertainty on the point, it is specifically noted that the regulations as proposed and as adopted by this Treasury decision permit a section 501(c)(9) organization that receives employer funding to use insurance policies involving cash values *only* where the policies are part of a plan of so-called "group-permanent" life insurance subject to section 79 and the regulations thereunder. [Emphasis added.]

In light of the above discussion, the term "only" appears an unnecessary interpretation of that regulation.

## Who May Participate as a Member?

The regulatory interpretation of the law allows exclusion from membership, based upon objective conditions or limitations reasonably related to employment, any or all of the following employees:[13]

(a) Union employees, where the benefits were subject to good-faith bargaining;

(b) Employees in specified job classifications;

(c) Employees not proximate geographically;

(d) Employees not having a minimum period of service;

(e) Part-time employees;

(f) Seasonal employees;

(g) Employees in a comparable plan;

(h) Employees who do not pass a reasonable health standard; and

(i) Former member-employees who have terminated employment.[14]

There are other permissible restrictions, but the criteria for eligibility or benefits may not be applied to limit membership or benefits to officers, shareholders, or highly compensated employees.

It is also possible to provide coverage for members' dependents. This includes a "member's spouse, any child of the member or the member's spouse who is a minor or a student (within the meaning of Section 151(e)(4)), any other minor child residing with the member, and any other individual who an association, relying on information furnished to it by a member, in good faith believes is a person described in Section 152(a).[15]

It is significant to note that the commentary accompanying the final regulations states:

> Section 501(c)(9) organizations need not comply with antidiscrimination rules as stringent as those that apply to qualified pension trusts.

## Benefits to the Company

By self-funding health benefits ordinarily obtained through the purchase of insurance contracts, the company can eliminate insurance company overhead charges, reserves and premium taxes. However, reinsurance (stop-loss insurance) with a commercial carrier is recommended for self-funded trusts. Another advantage is that an advance deduction may be obtainable by the

[12] See 387 Tax Management *Group Life Insurance* A1, *et seq.* for an excellent discussion of the intricacies of Section 79. See Grayck, "Noninsured Death Benefits for Employees—An Unintended Fringe Benefit of the *Goldsmith* Case," 7 *Journal of Corporate Taxation* 163 (Summer 1980). On the includibility to the employee, there remains a question of whether the "Uniform Premium Table" under Section 79 or the lower of "P. S. 58" or term rules under Rev. Rul. 66-110, 1966-1 CB 12, applies.

[13] Reg. § 1.501(c)(9)-2(a)(2)(i).

[14] This may be helpful in avoiding the stigma of Section 83.

[15] Reg. § 1.501(c)(9)-3(a).

company.[16] The contributions paid into a tax-exempt trust compound at a favorable rate: for example, contributions of $25,000 annually for 10 years at 12.5%, compound to $505,647; and for 15 years, they compound to $1,091,650. An advance determination letter on the exempt status of the trust may be obtained from the Internal Revenue Service.[17]

## Prohibited Inurement: Continuing Plan

No benefits may inure disproportionately to the prohibited group. This group includes officers, highly compensated employees and shareholders. There is, however, flexibility in testing for disproportionality, as later discussed.

Payment to similarly situated members of benefits that differ in kind or amount constitutes prohibited inurement unless the difference is justified based on objective and reasonable standards. Generally, benefits paid pursuant to standards or subject to conditions that do not provide for disproportionate benefits to the prohibited group are acceptable.

## Prohibited Inurement: Plan Dissolution

The prohibition against disproportionate inurement also applies in the event of dissolution. Upon dissolution, net assets may be, according to the regulations, "applied to provide, either directly or through the purchase of insurance, life, sick, accident or other benefits," so long as the prohibited group is not disproportionately benefitted.[18] These regulations also allow a "distribution to a member upon the dissolution" of the trust. The amount distributed will not constitute prohibited inurement if it is determined based on objective and reasonable standards, which do not result in unequal payments to similarly situated members or in disproportionate benefits to the prohibited group. Upon inquiry to the Office of Chief Counsel of the IRS, it was learned that the distribution could simply be a cash payout.

## Prohibited Inurement: Proportionality

It is permissible to utilize a benefit standard that is proportionate to compensation. On the other hand, disproportionate benefits may be paid if pursuant to an objective and nondiscriminatory standard.[19] For example, a standard based upon voluntary contributions appears nondiscriminatory. Is, then, a standard based upon years of service, similar to that in a unit benefit pension plan, permissible? An official in the Office of Chief Counsel responded cautiously that this may be nondiscriminatory "depending on the facts and circumstances." In other words, a "years of service" standard is not universally acceptable now if the prohibited group had more years of service than the other members of the VEBA.

Moreover, certain benefits, such as disability, may be integrated with social security to prevent a company from twice paying an employee benefit. This is not considered prohibited inurement.

## Income Tax Treatment upon a Member's Demise

If funded by life insurance, death benefits received by beneficiaries are not subject to income tax.[20] It is not, however, clear whether death benefits to the extent self-funded are also exempt from income tax.[21]

The case of *Ross v. Odom*[22] involved a self-funded death benefit plan. The Court held that benefits paid from the Georgia Survivors' Benefit Fund to a deceased member's widow were "amounts received under a life insurance contract." Therefore, they were not taxable under Section 101(a). The Court reasoned that the arrangement constituted insurance and held as follows:

> . . . for tax purposes the critical factors in determining when the payment of death benefits constitutes insurance have histori-

[16] See Section 461; Reg. § 1.461-1(a)(2); Rev. Rul. 78-116, 1978-1 CB 143. See Greenblatt and Banoff, "Final Regs. increase the attractiveness of voluntary employees' beneficiary associations", 4 *Journal of Taxation* 194 (1981); *Zwicker Knitting Mills v. U. S.*, 80-2 USTC ¶ 9832 (Ct. Cl.).

[17] Form 1024, Department of the Treasury.

[18] Reg. § 1.501(c)(9)-4(d).

[19] Reg. § 1.501(c)(9)-4(b).

[20] Section 101(a). CCH IRS LETTER RULINGS REPORTS No. 208, Private Letter Ruling 8107101 (Nov. 21, 1980) specifically considered this and concluded that death benefits paid pursuant to life insurance policies are excluded from the gross incomes of the beneficiaries. It further states, "This assumes that the trust acts as a mere conduit to pay the beneficiaries of the employees and does not retain any of the life insurance proceeds."

[21] The commentary to the final regulations states: "Several comments requested that a provision be added to state that death benefits paid by a self-funded plan are eligible for exclusion from the gross income of the beneficiary under Section 101(a) of the Code. This issue is not addressed in these regulations, which are intended to clarify the provisions of Section 501(c)(9) and not to resolve income tax or other issues that may arise under other sections of the Code."

[22] 68-2 USTC ¶ 9587, 401 F. 2d 464 (CA-5).

cally been the presence in a binding arrangement of risk-shifting and risk distribution. *Helvering v. Le Gierse,* 1941, 312 U. S. 531, 539, 61 S. Ct. 646, 85 L. Ed. 966, 999. This involves the payment of premiums or assessments by a number of individuals into a common fund out of which the payor's estate or beneficiaries will be paid a certain amount upon his death regardless of whether the amount is more or less than the decedent has paid into the fund. *Mary Tighe, supra,* 33 T. C. at 564.

The concept of risk-shifting and risk-distribution was further explained in *Commissioner v. Treganowan, supra,* 183 F. 2d at 291: "'Risk shifting emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and the insured each of whom gamble on the time the latter will die. Risk distribution, on the other hand, emphasizes the broader, social aspect of insurance as a method of dispelling the danger of the potential loss by spreading its cost throughout the group. . . .'" Note, The New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance, 59 Yale L. J. 780, 784.

In light of these general principles that have been developed over the years in considering life insurance both under the present § 101 and its predecessor . . . and the estate tax provisions relating to insurance, . . . we fully approve the Trial Court's holding that the $27,450 received by the taxpayer from the Georgia Survivors' Benefit Program constituted amounts received under a life insurance contract.[23]

On the other hand, if the program lacks other indicia of a life insurance program, such as a definitely determinable death benefit, it will not come within the purview of Section 101(a).[24] Thus, the proceeds will be includible in the gross income of the beneficiary.[25]

## Estate Tax Treatment upon a Member's Demise

If there is a death benefit funded by insurance, Section 2042 may apply. This section operates to include in the decedent member's gross estate insurance proceeds receivable by the estate. It also includes in his gross estate insurance proceeds receivable by his beneficiaries under policies in which decedent possessed "any of the incidents of ownership." Incidents of ownership include a right to change beneficiaries, to cancel or assign the policy, or to borrow against the cash surrender value of the policy. If the incidents of ownership are exclusively held by the trustees of the VEBA and isolated from the insured member, it is arguable that Section 2042 does not operate to include any insurance proceeds. This is particularly so if an independent person, such as a bank, is serving as trustee.

If the death benefit is not funded by insurance, although Section 2042 may be avoided, Section 2039(a) may apply to include the proceeds in the decedent-member's gross estate. In either event, the entire spectrum of the includibility sections under the estate tax provisions of the Code (Chapter 11, Subtitle B) merits consideration.[26]

## Mechanics of Implementation and Operation

The VEBA must be an entity, such as a trust or corporation, existing independently of its members or their employer.[27] Generally, a VEBA evidenced by a written document constitues an employee welfare benefit plan. This is because it provides for benefits in event of sickness, accident, disability, death, unemployment, etc.[28] As such it is subject to Parts 1, 4 and 5 of Subtitle B of ERISA. This means named fiduciaries must be designated, they must circulate summary plan descriptions to plan members (and to the Department of Labor), and they are subject to the fiduciary standards and enforcement provisions of ERISA. The named fiduciaries are responsible for filing the applicable Return/Report of Employee Benefit Plan (5500 series). Also, Form 990 must be filed in any year in which the trust has gross receipts exceeding $10,000.00.

One becomes a member of a VEBA by an affirmative act. Membership, however, may be imposed upon an employee if he does not incur a detriment. The regulations cite deductions from his pay as such a detriment.[29] Therefore, an employer may not impose a membership upon

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[23] Id., at 467.

[24] Compare *Davis v. U. S.,* 71-1 USTC ¶ 9264, 323 F. Supp. 858 (D. C. W. Va.) and *All v. McCobb,* 321 F. 2d 633 (CA-2, 1963).

[25] The proceeds should be exempt to the extent of $5,000 under Section 101(b).

[26] Compare Sections 2035, 2036, 2037 and 2038. See Solomon, "Estate Taxes and the Employee Benefit Plan," 38 *NYU Institute on Federal Taxation* 37-1 et seq. (1980).

[27] Reg. § 1.501(c)(9)-4(d).

[28] ERISA Sec. 3(1).

[29] Reg. § 1.501(c)(9)-2(C)(2).

an employee by involuntarily withholding on his salary and paying over to a VEBA.

A VEBA must be controlled by its membership, independent trustees (a bank), or by trustees or fiduciaries, some of whom are designated by or on behalf of the membership.[30] A VEBA is considered controlled by independent trustees if it is an "employee welfare benefit plan" under ERISA.[31] Generally these plans are such; therefore, the independent trustee requirement is satisfied even though members of the prohibited group are the trustees. The reason that any person, even if a member of the prohibited group, is considered an independent trustee is that the reporting and disclosure requirements of ERISA are designed so that members are informed of the status of the VEBA, and the fiduciary standards otherwise protect their interests.[32]

What is more important, no part of its assets may at any time revert to any contributing employer.[33] Nor may a VEBA provide a pension, annuity, or similar benefit, except that a death benefit may be settled in annuity form.[34]

## Employment Related Bond

Some commentators criticized the July 17, 1980, proposed regulations because they did not allow national trade associations to utilize VEBAs. This restriction was retained in the final regulations, ostensibly because to allow such associations to provide insurance benefits through a VEBA "would simply facilitate circumvention of the unrelated trade or business income tax otherwise applicable to such organizations." [35] In essence, the final regulations provide that VEBAs apply to associations of employees who enjoy some "employment related bond." [36] Generally, membership is defined by objective standards that constitute an employment related common bond. Typically, membership is defined by reference to a common employer (or to affiliated employers), to membership in a labor union, to coverage under one or more collective bargaining agreements, or to membership in one or more locals of a national or international labor union.

Not all members need be "employees" in the strict sense. For example, the proprietor of a business whose employees are members could participate. The regulatory test is that 90% of the total membership of the VEBA on any one day of each quarter of its taxable year must consist of employees.[37]

The term "employee" includes a person defined as such under Subtitle C of the Internal Revenue Code (Employment Taxes). The term also includes a person defined as such under a collective bargaining agreement (regardless of local law) or a former employee.[38]

## Conclusion

A VEBA may be implemented by a company to provide either self-funded or insurance-provided life, sick, accident or other benefits to a justifiably selected group of participating members and their dependents. The company contributions are deductible, the funds in the VEBA accumulate tax free, and an advance determination letter may be obtained from the IRS on its tax-exempt status. The funds may at some later date be paid out to members or their beneficiaries upon the occurrence of the covered event (death, disability, etc.) or upon dissolution of the VEBA. ●

[30] Reg. § 1.501(c)(9)-2(C)(3).
[31] Commentary of the Office of Chief Counsel, IRS, to the final regulations.
[32] Commentary of the Office of Chief Counsel, IRS, to the final regulations.
[33] Reg. § 1.501(c)(9)-4(d).
[34] Reg. § 1.501(c)(9)-3(b).
[35] Reg. § 1.501(c)(9)-2(a)(1).
[36] Id.
[37] Reg. § 1.501(c)(9)-2(b).
[38] Id.