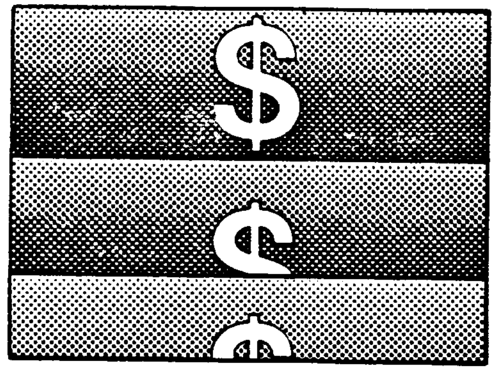
Voluntary Employee's Beneficiary Associations:

A newly enhanced business market technique



by Stephen M. Margolin

The VEBA may be insured or uninsured, but either way, it's a concept your business clients will want to know about, and one you can profit from by promoting.

New revisions in the law on voluntary employee's beneficiary associations (VEBAs) may make this concept quite attractive for your business clients.

A VEBA generally consists of a plan and a trust. The plan, formed to provide benefits to plan members and their families, can be funded with insurance. Whether funded with insurance or otherwise, it can provide dramatic benefits to businessmen.

Internal Revenue Code Section 501(c)(9) describes the VEBA as an organization which can provide "for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries. . . ." Additionally, "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," the VEBA as an organization is exempt from taxation.

Why Does It Interest Us? A VEBA offers numerous tax and financial advantages to a businessman. Contributions to the trust are tax-deductible; earnings on the accumulated trust funds are exempt from tax; trust funds may be used to purchase life, accident, disability or other health insurance coverage; membership in the trust can be restricted to a specified group of employees; flexibility exists in weighting benefits among members; ultimate distributions may be short-term or long-term; similar benefits may be provided for a member's dependents; and upon a member's demise, death benefits may pass to his family or may pass to a trust for his family's benefit unburdened by federal estate taxes.

Covered Benefits: These are some of the benefits which may be provided to members of the plan:

a. Death benefit (provided directly or through insurance);
b. Major medical;
c. Long-term disability;
d. Short-term disability;
e. Illness or personal injury protection;
f. Vacation benefits;
g. Vacation facilities;
h. Recreational activities such as athletic leagues;
i. Income maintenance payments in the event of economic dislocation;
j. Temporary living expense loans and grants in time of disaster (fire, flood, etc.);
k. Severance benefits;
l. Personal legal service benefits;
m. Education or training benefits, or courses for members such as apprentice training courses; and
n. Education benefits to employees, their families and dependents pursuant to Section 302(c)(7) of the Labor Management Relations Act of 1947, as amended.

Other benefits which safeguard or improve the health of a member or his dependents or which protect against a contingency that would interrupt or impair his earning power are also permitted. Generally, the benefits to be covered relate to an unanticipated event.

The following are examples of benefits which may not be covered:

a. Payment of commuting ex-

I/R Code: 2400.00 Employee Benefits

penses;

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

c. Providing malpractice insurance;

d. Making loans (except in time 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, workmen's compensation benefits cannot be paid through VEBAs, since this merely insures the discharge of an obligation already imposed by statute upon the corporation which formed the VEBA.

Death Benefits—Section 79 Applicability: A death benefit may be funded directly or through insurance. The regulations state that the death benefit "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 tax practitioners, however, consider that since the employee has no legal interest in the policy held by the VEBA (as he does in a typical Section 79 plan), no permanent benefit is being provided the employee and, therefore, Section 79 is not applicable.

Who May Participate as a Member? The law allows an employer to exclude employees from membership, based upon objective conditions or limitations reasonably related to employment. Any or all of the following employees may be excluded:

a. Union employees, where the benefits are subject to good-faith bargaining;

b. Employees in specified job classifications;

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c. Employees not geographically proximate;

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 their employment.

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 generally includes a member's spouse, any child of the member or the member's spouse who is a minor or a student, or any other minor child residing with the member.

It is significant that the commentary accompanying the final VEBA 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: A VEBA can be useful in saving a company money on its health insurance. By partially self-funding health benefits, the company can eliminate certain insurance company overhead charges, reserves and premium taxes. This feature is attractive to businessmen. (However, reinsurance—stop-loss insurance—with a commercial carrier is almost a must for self-funded trusts.)

A company can reap an important advantage in self-funding by deducting an advance deposit, but a businessman would rarely wish to make an advance deposit to an unrelated insurance carrier. However, that company could derive that same substantial tax benefit by making an advance deposit to its own VEBA for self-funding health insurance purposes.

This deduction is enhanced by another major attraction of the VEBA, the tax-exempt status of its trust. The contributions paid into a tax-exempt trust compound at a favorable rate. For example, contributions of $25,000 annually for ten years at 12.5 percent interest compounded grow to $505,647. In 15 years, the sum builds to $1,091,650.

Further, an advance determination letter on the exempt status of the trust may be obtained from the Internal Revenue Service.

Thus, not only does the businessman obtain deductible insurance but he is also provided with a trust in which he can deduct advance deposits and accumulate substantial funds exempt from taxation.

Prohibited Inurement—Plan Dissolution: Upon dissolution of the VEBA, according to VEBA regulations the net assets may be "applied to provide, either directly or through the purchase of insurance, life, sick, accident or other benefits," so long as the prohibited group does not benefit disproportionately.

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 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 Internal Revenue Service, I recently was informed that the distribution could simply be a cash payout.

Prohibited Inurement—Proportionality: In designing a VEBA, it is permissible to utilize a benefit standard that is proportionate to compensation. On the other hand, disproportionate benefits may be paid if they are based on an objective and nondiscriminatory standard. For example, a standard based upon voluntary contributions appears to be nondiscriminatory.

Moreover, certain benefits (such as disability) may be integrated with Social Security to prevent a company from paying an employee benefit twice. 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. It is not clear, however, whether self-funded death benefits in a VEBA are also exempt from income tax.

The case of *Ross v. Odom*, 401 F.2nd 464 (5th Cir. 1968), involved a self-funded death benefit plan. The Court held that benefits paid from the Georgia Survivors' Benefit Program 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 (at 466-467), as follows: ". . . for tax purposes the critical factors in determining when the payment of death benefits constitutes insurance have historically been the presence of a binding arrangement of risk-shifting and risk distribution. *Helving v. Le Gierse*, 1941, 312 U.S. 531, 539, 61 S.Ct. 646, 85 L.Ed 966, 999 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.

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"The concept of risk-shifting and risk distribution was further explained in *Commissioner v. Treganowan*, supra, 183 F.2nd 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 Law Journal* 780-784.

"In light of these general principles that have been developed over the years in considering the life insurance both under the present Section 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."

On the other hand, if the plan lacks other features of a life insurance program, such as a definitely determinable death benefit, the proceeds will be includable in the gross income of the beneficiary. However, the proceeds should be exempt to the extent of $5,000 in any event.

A businessman, therefore, has an advantage in funding death benefits with life insurance, since the proceeds are not subject to income tax.

Estate Tax Treatment Upon a Member's Demise: If there is a death benefit funded by insurance, Code Section 2042 may apply. This draws insurance proceeds receivable by the estate into the deceased member's taxable estate. It also includes in his estate any insurance proceeds receivable by his beneficiaries under policies in which the 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 held exclusively by the trustee of the VEBA and are isolated from the insured member, it is arguable that Section 2042 does not operate to include any insurance proceeds in the deceased member's estate. This is particularly so if an independent entity, such as a bank, is serving as trustee.

If the death benefit is not funded by insurance, Code Section 2039(a) may apply. This operates to include death benefits in the deceased member's estate if he possessed the right to receive any part of the benefit during his life. To prevent this, a plan that offered death benefits could be limited to that benefit. Other benefits could be offered in a separate plan, so that it could not be said that he possessed the right to any benefit connected with the death benefit.

Mechanics of Implementation and Operation: The VEBA must be an entity, such as a trust or a corporation, existing independently of its members or their employer.

Generally, a VEBA is established by a written document and then, because it provides for benefits in the event of sickness, accident, disability, death, unemployment, etc., it would be judged to constitute an employee welfare benefit plan and, thus, is covered by the Employee Retirement Income Security Act of 1974 (ERISA). As such, it is subject to Parts 1, 4 and 5 of Title I-B of ERISA. This means fiduciaries must be designated, they must circulate summary plan descriptions to plan members (and the U.S. 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.

One becomes a member of a VEBA by an affirmative act. Membership, however, may be imposed upon an employee if membership does not involve any detriment. Forced deductions from his pay would be considered a detriment; therefore an employer may not impose membership upon an employee by withholding from his salary against his wishes and paying the withheld monies to the VEBA.

A VEBA must be controlled by its membership, independent trustees (a bank, for instance) or by fiduciaries, some of whom are designated by or on behalf of the membership. A VEBA is automatically considered to be controlled by independent trustees if it is an "employee welfare benefit plan" under ERISA. Generally these plans are "employee welfare benefit plans." Therefore, the independent trustee requirement is satisfied even though members of the prohibited group are trustees.

The reason that any person, even 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.

Importantly, no part of its assets may at any time revert to any contributing employer. Nor may a VEBA provide a pension, annuity or similar benefit, except that a death benefit may be settled in the form of an annuity.

Employment-related Common Bond: National trade associations, acting as such, may not utilize VEBAs. According to the final regulations, this is because allowing 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." VEBAs apply to associations of employees who enjoy some "employment-related common bond."

Generally, membership is defined by objective standards on what constitutes an employment-related common bond. Typically, membership is defined by having a common employer (or affiliated employers), by membership in a labor union, by coverage under one or more collective bargaining agreements or by 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 ninety percent of the total membership of the VEBA on any one day of each quarter of its taxable year must consist of employees.

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.

Conclusion: Because of its particular features, a VEBA may be useful to many of the businessmen encountered by the life underwriter. A VEBA may be implemented to provide life, sick, accident or other benefits to a justifiably selected group of participating members and their dependents. The plan may be self-funded or funded through insurance. Company contributions are deductible and funds in the VEBA accumulate tax-free. The funds may be paid out to members or their beneficiaries upon the occurence of the covered event (death, disability, etc.) or upon dissolution of the VEBA. □

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