

Employee Welfare Benefit Plans

Employee welfare benefit plans have enjoyed some increase in popularity in recent years. This increase has resulted from some legislation that in some cases allows them to be used similarly to their use prior to 1984. Voluntary Employee Beneficiary Associations (VEBAs) are entities through which small employers can enjoy the benefits of Employee Welfare Benefit Plans. The purpose of this summary is to put the benefits and risks of VEBAs as they are currently marketed to small businesses into simple terms.

To understand VEBAs we must first understand why Employee Welfare Benefit Plans exist in the first place. These plans are in essence self-insurance vehicles. They were originally designed for large employers or multiple employer groups to self-insure certain risks. They were used abusively by small employers to create discriminatory retirement savings vehicles. Subsequently, laws were changed to make it clear that these uses were not permitted.

A few years ago another law was passed to allow VEBAs to be used by groups of 10 or more employers in which none of the 10 contributed more than 10 percent of the total funding. To comply with this requirement a few “employer groups” sprang up to allow small employers to enjoy some of the benefits of old VEBAs.

These plans have been marketed as ways to buy life insurance and provide severance benefits with before-tax dollars. Naturally these efforts have pushed the limits of the law to provide maximum benefits to selected individuals.

These plans can be very useful where there is a true desire to create a self-insurance vehicle. However, they are used most often to provide discriminatory benefits to the owners and highly compensated employees of small businesses. Here we are speaking to the use of these plans by small businesses. “Discriminatory benefits” may sound like a bad thing but it is really a good thing for those in whose favor the discrimination works. Discrimination is the objective of a lot of retirement plan and executive benefit planning. The question is whether VEBAs are effective vehicles for creating this favorable discrimination.

The biggest problem with the use of a VEBA as a retirement planning tool has its roots in the original intent of the Multiple Employer Benefit Plan. The concept is to create a small insurance company. An insurance company is a risk transfer vehicle. Multiple individuals (employers) contribute and specific individuals (employees) receive payments based on need. One participant may make much greater contributions than they receive in benefits while another has the reverse experience. This is the nature of insurance. You pay a premium to transfer risk.

For VEBAs there exists a rule to make sure that a multiple employer benefit plan has this basic characteristic. There must be a “substantial risk” the contributions of one employer could be used to pay claims for the plan as a whole.

This is a huge risk from the standpoint of a small employer attempting to use a VEBA as a retirement funding vehicle. It means that the retirement savings of the employees of one employer could be paid to the employees of another employer. In fact, this requirement was made for the purpose of preventing VEBAs from being used as retirement funding vehicles. Small businesses using VEBAs as retirement funding vehicles are taking a huge risk that either some of their contributions will be used to fund the claims of other employers or that their tax-advantaged nature will be challenged in the future.

Experts disagree about the severity of this risk. Some say that it is clear that these plans do not work as currently marketed. They say that if you attempt to use a VEBA in this way and your return is examined, the deduction will be disallowed. Others say that the “substantial risk the contributions of one employer could be used to pay the claims for the plan as a whole” requirement is met through some limited provisions that are never intended to come into effect. They say that this is similar in concept to the “substantial risk of forfeiture” requirement of deferred compensation plans.

For the moment, let’s give these plans the benefit of doubt and assume that there is a reasonable chance that they will provide the benefits they are represented to provide. The next question is whether the benefits are meaningful. Compared to qualified retirement plans, the economic advantage is dramatically reduced by two factors.

First there are costs associated with using these plans beyond normal investment costs (legal and accounting fees and insurance product costs). These costs reduce your rate of return. We could present dueling spreadsheets; one showing VEBAs as almost as effective as qualified retirement plans, the other showing them as nowhere near as powerful. The comparison depends on numerous assumptions. In any event, the economic advantage is debatable.

Second, distributions from qualified retirement plans can be rolled into IRAs at retirement and the tax deferral benefits can be extended for many years. When a VEBA is terminated, the entire accumulated balance must be distributed and taxed as ordinary income. The ability to roll qualified retirement plans into IRAs dramatically enhances the advantage of the tax deferral. While VEBAs are often marketed as providing similar benefits to qualified retirement plans, their economic advantage is no where near as strong even under the most favorable assumptions.

Persons marketing VEBAs generally concede that qualified retirement plans are more powerful unless you consider the cost of making contributions on behalf of employees. VEBAs are generally sold to small businesses either wishing to exclude employees from their benefit plans or who have made the maximum contribution to their qualified retirement plan. Therefore the real issue is whether such businesses should pay bonuses or dividends to key employees and owners for them to invest on their own or use a VEBA.

Compared to individual investing, VEBAs may have an economic advantage under certain assumptions. However, this advantage is usually shown with unrealistic assumptions and therefore dramatically overstated. The two most unrealistic assumptions are equal rate of return and 100 percent taxation of individual investing. The rate of return for the VEBA will be lower since the costs are higher. Individual investors enjoy some tax benefits. A significant portion of individual investing is often tax deferred through growth. This growth is often taxed at a lower rate as long-term capital gains. In addition, individual investors may invest in municipal bonds, which may have a higher after-tax return than would be implied by reducing an assumed rate of return by the maximum tax rate.

Here again we could prepare comparative analyses that could show VEBAs as having some economic advantage over individual investing. Whether this advantage actually exists and the magnitude of the advantage depends on numerous assumptions that are difficult or impossible to predict.

VEBAs are similar to many tax savings schemes. They use a legitimate planning tool for a purpose for which it was not designed. Conceptually, anytime you do this you are taking tax risk. The IRS is not bound by the literal interpretation of tax law. There is a judicial system designed to interpret the law. So called "loopholes" are usually not clear loopholes. If you stick your head in one, it may tighten-up and turn into a noose.

In summary, VEBAs have significant tax risk and debatable economic advantage when they are not used as true self-insurance vehicles. In addition, they add a level of complexity to the affairs of a small business owner. Therefore, we do not believe their use as a retirement funding vehicle is prudent.