

Recent Developments Spark Renewed Interest in Tax Exempt Benefit Trusts *(VEBA Trusts and Section 115 Trusts)*

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Recent changes in financial accounting reporting obligations have caused many employers, both public and private, to re-examine the overall economics of pre-funding retiree medical benefits. These changes, mandated by Financial Accounting Standards Board ("FASB") Statement No. 106 for the private sector and Government Accounting Standards Board ("GASB") Statement No. 45 for the public sector, require employers to report the unfunded cost of future retiree medical obligations on their balance sheets. In an effort to counter this potential adverse balance sheet impact, many employers, both public and private, are re-examining their health plan design - often considering a tax-favored trust for benefit funding.

Another significant catalyst is the recent trend to create stand-alone VEBAs as the sole source of funding for certain collectively bargained benefits. One recent study indicates that at least four such VEBAs exist with assets in excess of \$500 million each, and at least two of these have over 100,000 participants¹. These developments, combined with the rise of defined contribution health care arrangements (e.g., health reimbursement arrangements or "HRAs") and access to benefits through health care debit cards have given rise to a resurgence in VEBA (and Section 115 for governmental employer) trust adoption.

This article provides a high-level overview of VEBA compliance requirements and how these requirements may fit within a defined contribution health care approach.

Background on Retiree Medical Benefit Funding

The Employee Income Retirement Security Act ("ERISA"), the federal law that governs employer funding for qualified retirement plans such as 401(k)s, does not require employers to pre-fund retiree medical plans; moreover, certain tax advantages that were previously available for pre-funding such plans are no longer as beneficial for most employers. Consequently, many employers fund retiree medical plans on a pay-as-you-go ("PAYGO") basis. Where benefits are provided on an unfunded, PAYGO basis, the balance sheet recognition of retiree medical costs, as is now required by FASB and GASB, can have a potentially severe negative impact on financial statements.

In an effort to mitigate the negative financial effect of otherwise unfunded retiree medical obligations, many employers are turning to an old, somewhat familiar, tax-advantaged funding mechanism to pre-fund retiree medical obligations - the voluntary employee beneficiary association (or VEBA) trust. Although some of the tax

What is a VEBA?

VEBA is the acronym for a "voluntary employee beneficiary association", which is a type of trust established in accordance with the requirements of Section 501(c)(9) of the Internal Revenue Code ("Code").

A VEBA must meet the following requirements:

1. It must be a voluntary association of employees;
2. The VEBA must provide for payment of life, sick, accident, or other benefits to members or their dependents or designated beneficiaries and substantially all of its operations must be for this purpose; and
3. VEBA assets and earnings may not inure to the benefit of any private individual or shareholder other than through the payment of benefits described in (2) above.

VEBA beneficiaries must consist of individuals who are employees (which may also include retirees) who have an employment-related common bond. This common bond may be a common employer (or affiliated employers), or coverage under one or more collective bargaining agreements, membership in a labor union, or membership in one or more locals of a national or international labor union. Except for certain collectively bargained plans, a VEBA will not be tax-exempt unless the related benefit plan meets certain nondiscrimination requirements (generally, this means that the VEBA cannot discriminate in favor of certain types of high-ranking, highly compensated individuals). Finally, a VEBA will not be treated as tax exempt unless it gives timely notice to the IRS that it is applying for recognition of such status (i.e., by filing a Form 1024 application for tax exempt status) and receives IRS approval.

1. See Segal study "Retiree Health VEBAs", Winter 2008 at <http://www.segalco.com/publications/surveysandstudies/2008VEBAs.pdf>.



benefits of VEBA funding were diminished by changes enacted in the 1980s, VEBAs are enjoying a resurgence in popularity for another reason—the assets in a VEBA trust (and the similar Section 115 trust for governmental employers) can be used to offset some of the financial obligation that must be disclosed under FASB and GASB, thereby reducing the impact on the balance sheet.

VEBA Tax Attributes

Prior to 1984, VEBA trusts were widely utilized by employers to fund retiree medical benefits on a tax-advantaged basis. However, changes in the Code in 1984 substantially curtailed the tax advantages associated with pre-funding benefits through a VEBA for all but a limited number of employers (i.e., employers with a significant amount of collectively bargained benefits). With certain exceptions (e.g., employer contributions under a collectively bargained plan), employer deductions for VEBA contributions are limited to an amount necessary to fund current year benefits, plus a limited amount for incurred but unreported claims (IBNR). An additional (albeit limited) deduction is allowed for amounts pre-funded for retiree medical, life, and disability benefits under Section 419A of the Code. These amounts must generally be amortized (i.e., deducted on a pro-rata basis) over the projected working lives of retirees. A recent important Tax Court decision (Wells Fargo) allows immediate funding for all current retirees.

Earnings on VEBA assets for active employees are generally tax free (under Section 501(c)(9)). However, with the exception of earnings for collectively bargained benefits, earnings on amounts contributed for retiree medical benefits are subject to taxation as unrelated business income tax (UBIT) under Section 512 of the Code. While there are ways to minimize the UBIT tax (e.g., investing in tax exempt obligations) such approaches generally lead to lower returns and may even run afoul of ERISA's diversification requirements. Maintaining a VEBA for retiree medical benefits also requires that separate accounts be maintained for certain "key" employees (if they are eligible for benefits under the plan). As a result of these limitations and compliance issues, VEBAs have not been widely used to pre-fund retiree benefits (outside of the collectively bargained context).

Section 115 Trusts for Governmental Employers

Governmental employers can, under certain circumstances, adopt a tax-exempt trust to fund employee and retiree benefits. These trusts (so-called "Section 115 trusts" after the relevant tax Code section) can be more advantageous than VEBAs because the earnings on retiree medical assets kept in the trust itself can be tax-exempt (unlike a VEBA which is subject to UBIT). As a result of this tax-free status, and the recent GASB reporting requirements discussed below, Section 115 have become very popular for governmental entities.

Impact of VEBA or Section 115 Trust Assets on Financial Statements

As noted above, most private employers (as a result of FASB 106), and now public employers (as a result of GASB 45) are required to recognize the unfunded cost of future retiree medical obligations on their balance sheets, which can have a potentially severe negative impact on financial statements if the employer is paying benefits on a PAYGO basis. The driving force behind the resurgence in using a VEBA trust to pre-fund retiree medical benefits is that assets in these trusts dedicated to retiree medical benefits can offset the financial impact of retiree medical costs on their balance sheets. Because the trust assets can be used to offset some of the financial obligation, an employer can mitigate the negative effect created by the new accounting standards.

Convergence of VEBAs and Defined Contribution Health Care

In an effort to further reduce the potential negative impact of future retiree medical funding obligations many employers have curtailed or replaced their traditional "defined benefit" type of retiree medical coverage with a "defined contribution" approach such as a retiree medical spending account (RMSA) or other form of health reimbursement arrangement (HRA). The way a typical HRA works is that the employer credits an accrual to a participant's HRA "account"—which is really just a notional account. The participant can then use the account balance for reimbursement of certain qualified medical expenses (i.e., Code § 213(d) expenses). Because the "account" is merely a future promise to pay benefits, the participant is generally reimbursed from the employer's general assets. By plan design the employer can commit to accruing a certain pre-determined amount (the frequency of the contributions—monthly, annually, etc.—is also handled by plan design) to the HRA account or connect account accruals to satisfying certain wellness requirements. Unlike a health flexible spending account ("FSA"), HRAs are not subject to a "use-it-or-lose-it" rule, so amounts deposited in the account can continue to be available to a participant from year to year, so long as the participant continues to be eligible under the terms of the HRA plan. Amounts remaining in an HRA may not be "cashed out" when the participant becomes ineligible or dies.

Employers can contribute to HRAs on behalf of current or former employees, so if an employer establishes an HRA for its active employees, the employee, upon retirement, can continue to use any remaining funds (if the plan so provides), and the employer can continue to make contributions to the HRA on the participant's behalf (note that participants cannot contribute to their own HRA). HRAs also have flexible funding rules for employers looking to pre-fund retiree medical plans. Employers can, for example, contribute a certain amount to an HRA on a monthly or annual basis, but withhold the participant's right to reimbursement until

retirement. Subject to tax nondiscrimination rules, employers could also contribute a single lump-sum to the participant's HRA upon retirement, or continue to make periodic post-retirement contributions. Any combination of the above would also be acceptable.

The advantage of using an HRA to provide retiree medical benefits is that such arrangements assist employers in better projecting and managing their future retiree medical costs. This is because the employer's funding obligation is expressed as a fixed financial "contribution" to the HRA account instead of an otherwise open-ended obligation to fund future medical reimbursements. So, for example, if the retiree medical plan simply provides for a lump-sum contribution upon retirement, the employer can fairly accurately estimate its retiree medical obligations using actuarial data without regard to medical inflation rates.

Some employers are evaluating combination HRA/VEBA arrangements for medical benefits whereby employees and retirees are provided an individual medical account - along with discretion to select investment options for their individual HRA account. Instead of funding the HRA from general assets on a PAYGO basis, the employer will set the funds aside by making a contribution on behalf of the participant to the VEBA. The participant will then have the discretion to invest the contribution made on his or her behalf in certain investment options. This may be particularly attractive for employers who wish to make periodic contributions to a retiree HRA during the working life of the employee and allow the employee to invest and grow those funds in anticipation of retirement. Subject to VEBA contribution limits these investments should accrue tax-free for coverage for active employees. In addition, in some cases (i.e., governmental and collectively bargained arrangements) the investment accruals can build up tax free for individual retirees on a tax excludable basis. These HSA "look-alikes" are already in place for many governmental employers and are immensely successful in engaging employees in monitoring their "investment" for future health care expenses. More recently such arrangements have been closely examined by newly created and funded collectively bargained VEBAs.

Eric Remjeske, President of Devenir, the national leader in providing such investment options sights "we are seeing a tremendous amount of interest implementation of such funded HRA and VEBA structures with self-directed investment options." Because the structure of these plans is complex, the guidance of an expert in the area of VEBA trusts is recommended.

Tax Implications for Participants

From the participant's point of view, the tax advantages are threefold: the employer contributions are not taxed as income,

the investment growth is not taxed (at least for active employee coverage, collectively bargained groups, and Section 115 trusts), and the individual is not taxed when he or she is reimbursed from the HRA/VEBA for qualified medical expenses. As noted above, tax issues may arise for some non-collectively bargained retirees. This is because earnings on amounts contributed for retiree medical benefits generally are subject to UBIT, but careful planning and communication to the participants about the tax consequences of various investment options can give participants more control over these consequences.

Use of Health Debit Cards in For VEBA Benefits

The IRS recently issued two pieces of much anticipated guidance for health benefit cards ("Cards"). This guidance substantially impacts how health benefit Cards are administered in 2008 and beyond to access funds in FSAs or HRAs. Indeed, the IRS' approval of a merchant-based inventory information approval system (or "IIAS") shifts the paradigm from third party administrator (TPA) based claims adjudication to merchant-administered adjudication. This approach greatly simplifies the administration of Card-driven claims adjudication. This section provides an overview of the IRS guidance and describes how Card technology can be integrated with VEBA-funded benefits.

The original 2003 IRS Card ruling allowed for funds to be disbursed from an employer's FSA or HRA at merchants that had a health-related merchant category code (MCC). In addition, if the transaction met one of three "auto-adjudication" requirements (a co-pay match, a real-time match, or a recurring transaction) the claim would be considered to be fully substantiated, and no further health care adjudication would be required. If one of the three auto adjudication standards was not met, the health plan had to subsequently (and typically manually) adjudicate the claim.

In a 2006 Notice the IRS allowed for auto-adjudication for an additional category of claims under the merchant based inventory information approval system (IIAS). Under such an arrangement, a real-time determination is made by the merchant at the point of sale of the amount of eligible medical expenses by comparing the items selected for purchase to a pre-approved list of medical items allowable under Section 213(d) of the tax Code. An amount corresponding to the charges for permissible medical expenses is then paid by the relevant FSA or HRA plan to the merchant when the Card is swiped. No additional substantiation is required as long as the merchant operates a compliant IIAS that compares the item or items to the pre-determined medical expense list. However, the employer (or its TPA) must have access to claims level detail in the event of a subsequent IRS audit.

In 2007 proposed regulations the IRS codified its earlier Card-related guidance. In addition, the proposed regulations clarify that



Card-related adjudication is permissible for ongoing health plan participation beyond employment termination - e.g., for retirees. This development opens the door for VEBA funded plans to utilize health benefit Cards to provide benefits to all participants (including retirees). In particular, VEBA-funded defined contribution health plans will find that access to prescription drug and over-the-counter (OTC) benefits through Card-related programs will greatly simplify plan administration because most Card claims can be adjudicated at the point-of-sale. The resulting reduction in claims administration costs should result in greater benefits for participants.

Conclusion

Rising health care costs have caused many employers to look for new alternatives to offering and funding health care benefits. Although previously overlooked, recent developments (FASB/GASB funding and the recent popularity of pre-funded VEBAs) has caused many employers to re-examine VEBA and Section 115 trusts as a preferred mechanism to fund medical (including retiree medical) benefits. These trusts fit well with defined contribution health care approaches because they can enable employees to take a stake in investing for their future healthcare expenditures. In addition, recent IRS guidance related to health benefit Cards enables VEBA funds to be accessed efficiently without a great deal of additional administrative cost.

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