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Funding Post-Retirement Health Benefits With A Welfare Benefit Trust

There is perhaps no issue so prevalent in recent business news as the healthcare crisis faced by America's retired workers. While the problem is not new, it was not until the recent steel industry bankruptcy filings and the announced termination of post-retirement health benefits for 200,000 retirees and their dependents that Americans of all ages woke up to the reality that a company's insolvency could impact workers years after their retirement.

For active workers the picture is equally bleak. US Airways and United have forced employees to accept major concessions on benefits while corporate executives bail out with millions. The promise of "lifetime" benefits really means for the life of the employer!

The saddest part of all this is not the loss of health benefits, but the fact that it was totally preventable. The problem lies in the manner in which post-retirement benefits have been funded. Historically, companies would provide retiree health benefits on a pay-as-you-go basis. Under such a funding mechanism, the future availability of benefits is directly related to the company's ability to fund in the future.

Recent history has demonstrated that even the largest blue chip compa-

nies are susceptible to collapse. Keep in mind that in bankruptcy a company's obligation is primarily to creditors and secondarily to shareholders—employees are far down on the totem pole. In a recent survey of more than 400 large companies offering retiree health benefits, 22 percent of the firms said they are likely to eliminate subsidized health benefits for future retirees.

The situation is even more acute for small to mid-sized companies, most of which do not even offer health insurance benefits for retirees. The main reason? Cost. The pay-as-you-go model is the most inefficient method of funding benefits. We all know that it is more expensive to pay for something in future real dollars than with discounted and tax-advantaged, present-value dollars.

Most small businesses would probably fund for post-retirement health benefits if they only knew how to do so in a tax-deductible and cost-effective manner. Strangely enough, the tax code provides a tax-deductible and cost-effective manner for providing retiree healthcare benefits. Furthermore, this funding mechanism protects the benefits even in the event of an economic downturn or the employer's bankruptcy.

The plan—known as a Section 419(e)

welfare benefit trust (WBT)—allows small employers to fund retiree benefits over the working life of the employee. The contributions, which are made on a tax-deductible basis, allow the employer to use pre-tax dollars on an annual basis to fund a reserve account that will be used to provide benefits when the employee retires. Since the contributions are held in a WBT, they can never revert back to the employer, and therefore are protected from the employer's creditors.

By utilizing a fully insured WBT, as opposed to an unfunded or self-funded plan, the promise of lifetime benefits can be fulfilled. Although many small employers may be unable to afford to provide retiree health benefits for all employees, a WBT is discriminatory except to the extent prohibited by IRC Section 419A(e). Under this section the employer may not take into account a reserve for a covered employee unless the plan meets the nondiscrimination provisions of Section 505(b) with respect to the benefits provided. Thus, while the plan cannot discriminate with regard to benefits, the employer is free to determine which employees will be entitled to benefits.

Moreover, there is no "vesting" with regard to welfare benefit plans. Although a 419(e) WBT is funded over the working lives of all employees, few will continue working long enough to be entitled to benefits.

This is in stark contrast to the nondiscrimination rules which apply to voluntary employee beneficiary associations (VEBAs). VEBAs are required to comply with all of the nondiscrimination rules imposed by IRC Sections 501(c)(9) and 505(b), including the prohibition against discriminating as to eligible employees.

In fact, one must wonder why a

business would even consider using a VEBA and complying with the nondiscrimination rules when a more comprehensive and flexible benefit could be provided with a non-VEBA plan under Section 419(e). The distinction between a VEBA and a non-VEBA Sec-

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tion 419(e) plan must be made clear, as there remain a lot of misconceptions in the marketplace.

A VEBA is a tax-exempt trust which can be used to provide employee benefits. As a tax-exempt entity, it is subject to significant qualification and reporting rules with the IRS as well as the nondiscrimination rules of IRC Section 505(b). The only significance of being a VEBA is the trust itself does not have to pay income taxes on its income. The tax-exempt status, however, does not make the company's contributions to the VEBA tax deductible.

A 419(e) welfare benefit trust, on the other hand, is a taxable trust. In-

come taxes, however, are only payable on taxable income. It is for this reason that a fully insured 419(e) WBT invests in life insurance and municipal bonds only, neither of which generate taxable income. Thus, for all practical purposes a 419(e) trust does not pay income tax in any event. The 419(e) trust, funded with life insurance, would not need to worry about unrelated business income taxation (UBIT) under IRC Section 512.

Contributions made to either a VEBA or a 419(e) trust are only deductible if they are ordinary and reasonable expenses under IRC Section 162. In the case of *Schneider vs. Commissioner*, T.C. Memo 1992-24, Dr. Schneider wanted to provide employee welfare benefits to his employees (his secretary and himself). He filed an application with the IRS to have his WBT granted tax-exempt status as a VEBA.

The IRS denied the VEBA application with the result that the trust was deemed to be taxable. However, in upholding Dr. Schneider's \$1.2 million in tax-deductible contributions to his trusts, the Court stated that the doctor was entitled to the deduction because the expense was ordinary and necessary under IRC Section 162. In this regard, the Court also noted that the tax deductibility of the contributions does not depend upon the tax treatment of the trust.

The *Schneider* case was the first judicial recognition that an employer could receive a tax deduction for welfare benefit contributions made to a taxable welfare benefit trust. In 1984 Congress recognized this as well when it enacted IRC Section 419(e). Business owners would be well advised to avoid any so-called VEBA "gurus" and "experts" who suggest that you need to be a VEBA to get the tax deduction.

The sizeable tax deduction which Dr.

Schneider received in 1983 would only be allowed today if he participated in a multiple employer welfare benefit trust as described under IRC Section 419A(f)(6) (e.g., see "How 419A(f)(6) Trusts Help Business Owners Save Taxes," by Daniel E. Carpenter, Esq., *Broker World*, April 2001). This is because Dr. Schneider was primarily funding death benefits and the enactment of Sections 419 and 419A in the 1984 Tax Act limited the amount of deductions available to employers utilizing sole employer trusts as in the *Schneider* case.

Section 419(e) WBTs, which are established as single employer trusts, provide a number of benefits for small employers seeking to fund post-retirement health benefits. Small employers can still get significant tax deductions for the current cost of funding their current healthcare expenses plus a 35 percent safe harbor "over funding" for a claims reserve. Additionally or separately, an employer can also establish a reserve for the funding of post-retirement health benefits funded over the working lives of the employees. As a single employer trust, the business owner is secure in knowing that all contributions will inure solely to the benefit of its employees.

In a recent decision the Tax Court upheld, over objection of the IRS, the right of a taxpayer to fully deduct the current cost of pre-funding post-retirement health benefits provided through a single employer WBT. *Wells Fargo & Co. vs. Commissioner*, 120 T.C. 5 (February 13, 2003). In a series of key rulings the Court held that:

- For the purposes of Section 419A(c)(2) the phrase "reserve funded over the working lives of the covered employees" means that assets necessary to satisfy the employer's liability may be accumulated no more rapidly

than over the working lives of the covered employees. In other words, the reserve with respect to an employee can be fully funded no earlier than upon retirement of that employee.

- The accrued liability should be computed independently of the plan assets.

- The maximum amount of the liability that may be satisfied by the reserve is an amount, together with future normal costs and interest, that will be sufficient upon retirement to pay future medical claims of the employee.

- The actuarial present value of the projected benefit for each covered employee should be allocated on a level basis each year commencing with the year in which the allocation is first recognized and ending with the year the employee is expected to retire.

The importance of the *Wells Fargo* case for small businesses is significant. Government reports indicate that the current cost for funding post-retirement health benefits for a 65-year-old male is between \$1 and \$1.5 million. The actuarially determined present value cost to fund such a benefit for a 39-year-old man, assuming a 4 percent rate of return, is \$21,250 per year. Thus, an employer can contribute and deduct \$21,250 annually over the employee's working life to prefund the post-retirement health benefit. Additionally, an employer can take a full \$1 million deduction to prefund benefits for a retired employee.

Against this backdrop, let's look at an example of Sample Company, which has 50 employees. While the actual employee census will contain workers of varying ages, we will assume for our purposes an average age of 39. Based upon this information, our actuaries, using the government's own studies, could justify tax-deductible contributions of \$1,062,500 annually for

the next 26 years. If we assume that all workers stay with Sample Company until retirement at age 65, the WBT will have accumulated over \$50 million. Obviously, that funding level is the maximum deductible amount and smaller contributions would be permitted each year.

We know, however, that all 50 employees will not stay with Sample Company for the next 26 years. Since these workers will be replaced, the funding level in our example will remain unchanged. **Once the 419(e) WBT is established, the best funding vehicle for the reserve or WBT fund is some form of trust owned life insurance (TOLI).** Upon the death of covered employees, the death benefits will be payable to the trust, thus further increasing the fund. The use of TOLI as a funding mechanism also allows for the tax-free growth of the fund even though a taxable trust is utilized.

TOLI is similar to the COLI used by Dow Chemical to fund its own workers' health benefits. See *Dow Chemical vs. United States*, 2003 U.S. Dist. LEXIS 4880 (March 31, 2003). In *Dow*, the District Court upheld the right of the taxpayer to take a deduction for interest payments on policy loans used to pay premiums for COLI. Dow's actuaries had found that the use of COLI as a funding mechanism for post-retirement healthcare benefits was the most economically feasible means.

The critical feature leading to the success of the taxpayer in *Dow Chemical* is the fact that the life insurance was used to fund a legitimate employee welfare benefit. Thus the use of COLI (or TOLI in our case) for funding benefits, must be distinguished from other cases in which the courts have found that the taxpayers use of COLI served no legitimate purpose besides tax avoidance. See *American*

Electric Power, Inc. vs. United States, 136 F.Supp.2d 762 (S.D. Ohio, 2001) and *Winn-Dixie Stores, Inc. vs. Commissioner*, 113 T.C. 254 (1999).

Similarly, TOLI accumulates tax free and provides a large payout to the fund upon death. The use of such a funding mechanism makes it economically feasible for small employers to provide post-retirement health benefits. But remember, the actuarial calculations for the funding level and the choice of investment vehicle for the sinking fund are two different decisions.

Thus, returning to Sample Company, of the 50 employees on whose behalf we are making the \$1 million-plus annual funding contribution, we could purchase TOLI policies on five key executives or 20 to 25 employees to get

guaranteed issue, or on all 50 if we wanted to have coverage on everyone. While there can be no discrimination with regard to the benefits provided (anyone employed at retirement receives the same benefits), there are no restrictions on the funding mechanisms, investments of the trust, or the number of lives insured.

Since there is no vesting of the employee's post-retirement health benefit, someone could have been at the company for 20 years and then decide to leave. Or an employee could die of a heart attack at age 62. Beyond the use of a 419(e) WBT for funding post-retirement health benefits is the fact that as a welfare benefit plan the Trust will be building up a large effective "tax-free" reserve fund that can be used to

fund other employee benefits as the company's needs change. These can include group health insurance for the employees, some form of split-dollar for the executives, or death benefits for all the employees.

The key for small to mid-sized businesses is the proper design, installation and administration of such a plan. There are a number of potential landmines and pitfalls in navigating through the intricacies of the Tax Code, ERISA, regulatory rulings and judicial decisions. However, for companies that are seeking an innovative, cost-effective, and tax-advantaged means for retaining employee loyalty while meeting the growing cost of employee benefits, a 419(e) sole employer welfare benefit trust may be just the ticket. □