Voluntary Employees' Beneficiary Associations (VEBAs) and Retiree Health Insurance in Unionized Firms

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Summary

Voluntary Employees' Beneficiary Associations (VEBAs) are tax-advantaged trust funds created to finance many aspects of employee welfare, including retiree health insurance benefits. This report shows that, under some circumstances, using VEBAs to fund retiree health insurance can benefit both firms and workers. Because the tax treatment of VEBAs is most favorable when the VEBA has been created under a collective bargaining agreement, a unionized firm can use VEBA contributions to reduce or eliminate its retiree health insurance liabilities. The unionized workforce will be able to afford at least some retiree health benefits, because once the firm has contributed funds into the VEBA, the funds can never revert back to the firm. The funds always remain with the workers, even if the firm enters bankruptcy. However, if the firm is not in a financial position to contribute to the VEBA, the workers will not benefit.

The negotiations between each of General Motors, Ford, and Chrysler and the International Union, United Automobile, Aerospace & Agricultural Implement Workers of America (UAW) between 2007 and 2009, together with the retiree health VEBAs that became the source of the UAW members' retirement funding on January 1, 2010, illustrate many of the issues associated with implementing VEBAs. In particular, these VEBAs were first negotiated as part of a collective bargaining agreement and then modified during bankruptcy proceedings. They were funded by contributions from both the automobile companies and the UAW. It is, however, too soon to see whether the final automotive VEBAs will be successful in delivering health insurance benefits for all eligible beneficiaries.

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Introduction

Background on Retiree Health Benefits

Employee benefits for retired workers are of particular interest to policy makers because of the large number of retired and retiring baby-boomers. Nevertheless, fewer firms offered health insurance for retired workers, their surviving spouses, and dependents in the recent past than they did 20 years ago, leading to concerns about the health insurance coverage and ultimate health status of retirees.[1] The increasing cost (to firms and workers) of health insurance has undoubtedly had something to do with this decline in benefits offering.

Retiree health insurance is fundamentally different from private pensions and other annuities because firms do not have to "prefund" its expenses. The law requires firms to put away funds owed to the employees on retirement for pensions and other annuities. On the other hand, if a firm promises current employees that they will receive health benefits upon future retirement, the firm is not required to have funds available when the employees retire. Typically, ongoing retiree health insurance is paid for using general funds. In other words, there is no requirement for a company to set aside any money for its future retirees' health insurance.[2] In addition, many firms are free to revise their retiree health benefit policy; in times of financial hardship, firms might decide to eliminate these benefits altogether.[3]

Overview of Report

Voluntary Employees' Beneficiary Associations (VEBAs) are trust funds created to finance many aspects of employee benefits. VEBAs are tax-exempt entities defined under Internal Revenue Code (IRC) Section 501(c)(9). By law, the tax benefits of VEBAs are greater if they were created as part of a collectively bargained agreement between representatives of the firm's union and management. VEBAs can be dedicated to life insurance, accident benefits, child care facilities, disaster loans or grants, supplemental unemployment insurance, education and training, severance benefits, and retiree health benefits. Money in a VEBA may not be used for anything except the stated purpose of the VEBA. In addition, VEBAs may not be used to pay for pensions and annuities at retirement. This report focuses on the effect of VEBAs on funding retiree health insurance.[4]

[1] For example, among firms with 200 or more workers that offered health insurance to active workers, 46% offered health insurance to retired workers in 1991, while 29% offered health insurance to retired workers in 2009. For more information, see Kaiser Family Foundation and Health Research & Educational Trust, *Employer Health Benefits: 2009 Annual Survey*, 2009, p. 165.

[2] If retiree insurance is not prefunded, however, a liability for the amount owed will be listed on the firm's financial documents; see Financial Accounting and Standard Board (FASB) financial accounting standard (FAS) 106.

[3] The Employment Retirement Income Security Act of 1974 (ERISA, P.L. 93-406) requires companies with defined benefit pension plans to fully fund the benefits as they are earned. In other words, the employer bears the investment risk of income shortfalls in the pension fund because the employer is fully responsible for finding more money if the pension fund falls short. ERISA does not cover retiree health insurance or other post-retirement benefits. For more information, see CRS Report 95-118, *Pension Benefit Guaranty Corporation (PBGC): A Fact Sheet*, by (name re dacted).

[4] More specifically, this report focuses on independent VEBAs, or trust funds that are governed by their membership or an independent board of trustees that acts in the interests of the union members and not the firm.

The abbreviation VEBA is used differently by different authors. Some consider a VEBA the association and its members, who go on to open a trust, leading to the phrase "VEBA trust." This report, however, subsumes the trust into the word VEBA, making a single word encompass a group of employees and its associated trust fund.

The report shows that, under some circumstances, using VEBAs to fund retiree health insurance may benefit both firms and workers. A unionized firm can use VEBA contributions to reduce or eliminate its retiree health insurance liabilities. The unionized workforce will be able to afford at least some retiree health benefits, because once the firm has contributed funds into the VEBA, the funds can never revert back to the firm. The funds always remain with the workers, even if the firm enters bankruptcy. On the other hand, a VEBA without sufficient funding offers few benefits to the workers.

The individual negotiations between General Motors (GM), Ford, and Chrysler (together known as the Detroit 3) and the International Union, United Automobile, Aerospace & Agricultural Implement Workers of America (UAW), together with the retiree health VEBAs that became the source of the UAW's retiree health funding on January 1, 2010, illustrate many aspects of VEBA implementation. The terms governing these VEBAs were agreed upon during the 2007 contract negotiations and were then revised during 2009, when first Chrysler and then GM entered chapter 11 bankruptcy.[5]

The next section of this report covers the funding of retiree health insurance from the perspective of the firm, the workers, and the VEBA. The third section discusses the role of VEBAs in chapter 11 bankruptcy reorganization, and the fourth section provides an overview of the benefits and risks associated with VEBAs in unionized firms.[6] The fifth section discusses legislative issues. The Detroit 3 VEBAs serve as examples throughout the report. GM receives a special emphasis in the report because, as a public company, its financial information is more readily available than Chrysler's financial information. Although Ford is not emphasized in the report because it did not enter bankruptcy proceedings, it too renegotiated its 2007 retiree health VEBA with the UAW in 2009.[7]

The Mechanics of VEBAs

VEBAs historically belonged to a single firm. More recently, however, some VEBAs are structured as a trust independent of the firm. These trusts are sometimes termed independent VEBAs, new VEBAs or stand-alone VEBAs. An independent VEBA must be controlled by its membership, by independent trustees, or by other fiduciaries designated by the membership.

[5] For a recent history of the automotive industry, including its retiree health benefits, see CRS Report R41154, *The U.S. Motor Vehicle Industry: A Review of Recent Domestic and International Developments*, by (name redacted) and (name red acted).

[6] Chapter 11 bankruptcies permit firm reorganization under the guidance of the bankruptcy laws and court, with the expectation that the firm will emerge from bankruptcy as a profitable business.

[7] At least two topics common to most discussions of retiree health insurance are not relevant to the discussion of VEBAs. First, whether the employees retire early (between ages 55 and 64) or not early (65 and over) does not affect the mechanics of VEBAs. Second, the Patient Protection and Affordable Care Act of 2009 (PPACA, P.L. 111-148) treats health insurance plans funded through a VEBA identically to employer-sponsored health insurance.

Trustees chosen by a collective bargaining agreement are considered designated by the membership.[8] In all cases, the trust acts in the interest of the workers.

The Detroit 3 VEBA is an independent VEBA. The automobile companies have had no say in its operation since it became the active source of retiree health funding for the three firms on January 1, 2010. Like many independent VEBAs, the specific details of the Detroit 3 VEBA were negotiated between the firms and the union. Beginning with GM, UAW and management representatives bargained over the amount of funding needed to pay for health insurance for all (eligible) present and future retirees, their spouses, and their dependents for the remainder of their lifetimes. The parties also bargained over the sources of the funding.

Retiree Health Insurance: The Firm

As mentioned above, the firm does not have to prefund retiree health insurance in the same way it must prefund pensions. Indeed, the firm may not want to tie up large amounts of money for many years. Perhaps as a consequence, the recent unfunded liabilities for post-retirement health care have been quite large. A commonly cited Credit Suisse/First Boston study estimated that the total unfunded post-retirement benefits liability (excluding pensions) of the Standard & Poor's 500 companies was $336 billion at the end of 2005.[9]

VEBAs, as tax-exempt instruments, provide the firm incentives to prefund health benefits. More specifically, contributions to the VEBA are tax deductible, and the investment income grows tax-free.[10] Tax law regulations, however, impose several constraints on funding levels associated with most VEBAs[11]:

- In calculating expected expenditures over the life of the VEBA, no allowance can be made for medical inflation (i.e., future medical inflation must be assumed equal to zero).
- The levels to which certain VEBAs may be funded are limited.
- If these levels are exceeded, the VEBA must pay the Unrelated Business Income Tax (UBIT) on the amount over the limit.

Nevertheless, these constraints to tax deductibility do not apply to VEBAs created by a collectively bargained agreement. In this case, VEBA fund managers use the actuarially standard level of medical inflation rather than assume no medical inflation; this distinction is especially important when forecasting the value of future claims to a retiree health VEBA. In addition, the UBIT is never owed, and VEBAs used to fund retiree health insurance do not have deductibility limits. These differences make the tax advantages of retiree health insurance VEBAs in unionized

[8] For more information, see Aaron Bernstein, *Can VEBAs Alleviate Retiree Health Care Problems?* Harvard Law School, Pensions and Capital Stewardship Project, Capital Matters, No. 1, April 2008, pp. 7-10.

[9] David Zion and Bill Carcache, *The Magic of Pension Accounting, Part III*, Credit Suisse/First Boston, 2005.

[10] In the most general case, deductions are limited to the sum of qualified direct costs and additions to qualified asset accounts, minus VEBA after-tax net income; see IRC Sections 419 and 419A. Also, the firm may not care about the investment income of an independent VEBA because it does not receive any of this income.

[11] For more information on VEBA tax laws and regulations, see U.S. Congress, Senate Committee on the Budget, *Tax Expenditures*, committee print, prepared by Congressional Research Service, 109th Cong., 2nd sess., 2007, pp. 547-554.

workplaces far greater than the tax advantages of some other types of VEBAs. The remainder of this report is restricted to VEBAs in unionized firms.

In addition to these tax advantages, VEBAs can improve a firm's financial position. Firms are required by the Financial Accounting Standards Board (FASB, which establishes financial and reporting standards for private-sector U.S. firms) to use accrual accounting when calculating liabilities for retirement health; in other words, the liability increases as the number of employees eligible for benefits along with the expected amount of these benefits increases.[12] This liability must be reported on the firm's balance sheet, where a particularly large value can depress the firm's market value.[13] Transferring the firm's liability for current and future benefits to a VEBA can sometimes increase the market value of the firm.

Retiree Health Insurance: The Workers

Historically, employees participating in a VEBA have worked for the same firm. Nevertheless, employees can work for different firms, as long as they share a "common bond," or an employment-related characteristic that unites the group.[14] For example, the automotive industry retiree health VEBA negotiated by the UAW includes workers from each of the Detroit 3. The workers may be active workers or retirees; their spouses and dependents may also have their health insurance funded by the VEBA.

A primary advantage of a VEBA to the worker is a reduction in the risk associated with actually receiving promised current and future retiree benefits. If the firm has already deposited funds into a dedicated retiree health VEBA, these funds must go to their intended recipients. They may never revert back to the firm. In many instances without a VEBA, the workers have no recourse if the firm lacks the funds to pay for promised retiree health benefits. If the firm falls short, or simply decides to place its money elsewhere, no law or regulation compels the firm to honor past promises.

The presence of a VEBA, however, does not automatically remove the risk associated with the worker, because the VEBA itself must have money. For current and future retirees to receive promised benefits, there must be sufficient money in the VEBA to cover the benefits' costs. A VEBA that contains sufficient funds to cover the expected costs of the retiree benefits is known as a fully funded VEBA.

Finally, VEBAs offer tax advantages to the workers. As with conventional employer-sponsored health insurance, the firm's contributions to a retiree health VEBA are not included in the worker's gross income. Generally, benefits from VEBAs are taxed when distributed; health insurance benefits, however, are not taxed provided they are used for tax-qualified medical care.[15]

[12] Under accrual accounting, matching revenues to expenses occurs when the transaction occurs rather than when payment is made or received.

[13] A balance sheet is a summary of the financial balances (assets, liabilities, and ownership equity) at a specific date, such as the end of the financial year. It is a snapshot picture of the firm's financial condition.

[14] Formally, the IRS defines a common bond as "a common employer, common benefits under collective bargaining agreements, or a labor union affiliation." See http://www.irs.gov/pub/irs-tege/eotopici81.pdf.

[15] See IRC Section 104 and Section 105.

VEBAs: Implementation

Internal Revenue Service Approval

Internal Revenue Service (IRS) approval is required in order to implement a (tax-exempt) VEBA. More specifically, an IRS 501(c)(9) determination letter must be obtained within 15 months after the trust documents have been executed. To receive the determination, IRS Form 1024 (Application for Recognition of Exemption Under Section 501(a)) and several other documents must be filed.[16]

Combining VEBAs

The VEBAs negotiated by the union with individual firms may be combined. After the UAW had reached separate agreements with GM, Ford, and Chrysler, it had the choice of managing three individual VEBAs, or combining the three into one larger VEBA. The VEBA's 11 trustees chose to combine the VEBAs from each firm, perhaps realizing savings from the financial institutions that would rather hold one larger VEBA than three smaller ones. Although there is only one VEBA, the monies deposited for each of the firms are not combined.[17]

Funding VEBAs

The amount of money necessary to fully fund the VEBA cannot be calculated easily.[18] For illustrative purposes, consider a firm that wanted to cover retiree health insurance for the 10,000 employees who were actively working on December 1, 2009, plus their surviving spouses and dependents. The actuarial calculation of the level of funding needed to meet such a guarantee typically involves forecasting the following variables:

- the expected date of retirement for each employee working on December 1, 2009;
- each worker's (and his or her covered family's) life expectancy;
- each worker's (and his or her covered family's) health care utilization over time;
- the rate of medical inflation over time;
- the return on the VEBA trust's assets over time; and
- changes in the tax code that would affect the value of the VEBA.

If any of these forecasts prove to be incorrect, then the amount of money needed to fully fund the VEBA over the course of its lifetime will be calculated incorrectly.

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[16] For more information, see http://www.irs.gov/irm/part7/irm_07-020-002.html, IRS Exempt Organizations Determination Letter Program.

[17] Phyllis Borzi, *Retiree Health VEBAs: A New Trust On an Old Paradigm—Implications for Retirees, Unions and Employers*, The Henry J. Kaiser Family Foundation, March 2009, p. 14.

[18] Ellen O'Brien, *What Do the New Auto Industry VEBAs Mean for Current and Future Retirees*, AARP Public Policy Institute, Publication #14, March 2008.

In addition, the calculation becomes more complicated if *future* workers (i.e., those who are not yet hired) are eligible for retiree health benefits funded from the VEBA. The number of such workers, together with the years in which they will start work and ultimately retire, must also be estimated. Calculating the fully funded level for a liquidated firm, which will never hire additional employees, is therefore easier than calculating the fully funded level for a financially healthy firm.

VEBAs can be funded in a variety of ways, with both firms and workers (through their unions) often footing some of the bill. Contributions are sometimes spread over many years. For example, both GM and the UAW contributed money to the retiree health VEBA. Active workers gave up a 3% wage increase and a 6% cost of living adjustment. GM contributed the funds in their existing General Motors Welfare Trust VEBA.[19] GM also agreed to contribute combinations of convertible notes, cash, second-lien notes, and contingent (or backstop) payments. Note that the actual value of a few of these financial instruments depends on the underlying value of the firm (as indicated by the firm's stock price).

In any case, there is no legal requirement that VEBAs be fully funded. In fact, GM and the UAW bargained over the percentage of the fully funded level for which GM would be responsible. These negotiations are like any other in a collective bargaining setting, with the union arguing for a higher percentage of the fully funded level, and the firm arguing for a lower percentage of the fully funded level.

Choosing Health Insurance Plans

The trustees of the VEBA do more than manage the funding; they also determine the choice of the health insurance plans. In some cases, union contracts require that the existing plans continue until some specified date. Once the trustees are free to change plans, however, they are solely in charge of selecting the plans and terms that are most favorable to the VEBA beneficiaries. The ability of the VEBA to fund retiree health insurance depends on the trustees' success in plan choice; the more cost-effective the trustees' choice, the more financially viable the VEBA.

VEBAs and Firm Bankruptcy

Although unionized employees and retirees may experience reduced retirement health benefits during a chapter 11 reorganization, benefits do not automatically end when a company files for bankruptcy.[20] The court may approve modifications to existing retiree health benefits, but may only do so after it has determined that

- the company has met the requirements for negotiating with an authorized representative of the affected retirees;
- the authorized representative has, without good cause, rejected the proposal made by the company; and

[19] This VEBA was established and owned solely by GM; in other words, it was not the type of independent VEBA discussed in this report.

[20] Some of this section was written by (name redacted). The source is 11 U.S.C. §1113.

- the proposed modifications are necessary for successful reorganization; the treatment of all affected parties, including creditors and the company, is fair and equitable; and the balance of equities clearly favors the modification.

Thus, modification of retiree health benefits under chapter 11 is possible but is neither automatic nor easy.

A strong protection for retiree health benefits, even in a financially troubled firm, is therefore a funded VEBA. Although funds pledged for contribution by the firm to the VEBA can be reduced in bankruptcy, funds that are already in the VEBA are beyond the reach of the firm's creditors.

VEBAs in Unionized Firms

Forming and funding a VEBA can benefit both the firm and its workers. The firm improves its financial statements by reducing an unfunded liability. The worker receives a guarantee that he or she will get (at least some percentage of) promised benefits, even if the firm enters bankruptcy. It is not often that a financial instrument may improve the position of both the firm and its workers at the same time.[21]

Any such improvement, however, is inherently risky in that the level of funding available in each year in the VEBAs cannot be predicted with certainty. For example, if technological innovations in the product being produced increase the stock price of the producing firms, the value of the VEBA will increase with the stock price. On the other hand, if consumer demand for the product dries up, the value of the VEBA will decrease with the stock price (assuming some of the VEBA's assets are in company stock). Even if the revenue and expenditure forecasts are perfect, the collective bargaining process ultimately determines the VEBA's funding level. The current and future retirees can never be sure that the VEBA will have enough money to fund their expected benefits over the lifetime of the VEBA.

It is also important to remember that the firms must have the money to contribute to the VEBA. The various collective bargaining agreements dictate what contributions are required and how much flexibility the firms have in the payment schedule. At the same time, the firms cannot contribute money they do not have.

Another source of uncertainty concerns tradeoffs for retirees between the next few years and the distant future. For example, the automotive VEBA was intended to last 80 years. The money currently in the VEBA will likely be able to pay for retiree health benefits in the near future. At some point before 80 years, however, the funds will probably dry up, given that the VEBA is not fully funded. This situation sets the stage for conflicts between current retirees, who will receive benefits, and future retirees, who are contractually obligated to receive benefits, but for whom there may be no funding. The VEBA trustees must then decide how to raise additional funding and, if desired or necessary, how to reduce the cost of the benefit package.

[21] In the language of economics, forming a VEBA can be *Pareto improving* because the firm can increase its profits without making the workers worse off, and the workers can increase their guaranteed benefits without making the firm worse off.

Legislation Dealing with VEBAs

As part of their financial restructuring, GM and Chrysler together received more than $80 billion in assistance from the Troubled Asset Relief Program.[22] The Department of the Treasury now owns nearly 61% of the new GM and nearly 10% of the new Chrysler. The federal government therefore has joint roles as a monitor of TARP funding in GM and Chrysler and as part owner of GM and Chrysler. Some observers consider these joint roles to be an inherent conflict of interest.[23]

The following legislation regarding VEBAs has been introduced to the 111th Congress.

- Representative Tim Ryan introduced H.R. 3455 on July 31, 2009, and Senator Sherrod Brown introduced S. 1663 on September 11, 2009. These identical bills would provide up to $3 billion from the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) to fund a VEBA for former employees of the Delphi Corporation.
- Representative John Boehner introduced H.Res. 591 on June 26, 2009. Among other provisions, this resolution would request that President Obama transmit to the House of Representatives details of the role of the Presidential Task Force on the Auto Industry in any aspect relating to the levels of and reductions in the benefits of GM's employees and retirees.

Conclusion

In theory, establishing a VEBA to fund retiree health insurance gives workers more control over both health insurance funding and plan design. The success or failure of the VEBA, however, can only be measured years after its implementation. Many factors influence whether the workers in fact end up better off. The financial health of the firm influences whether it makes the agreed upon deposits into the fund. The ability of the VEBA trustees to invest the funds for maximum interest affects the available monies. The trustees also must select cost-effective health insurance plans for the retirees.

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[22] (name redacted) and (name redacted), *op. cit.*

[23] For more information, see U.S. Congress, House Committee on Oversight and Government Reform, Subcommittee on Domestic Policy, *Trouble Asset Relief Program*, Statement of Orice Williams Brown and A. Nicole Clowers, 111th Cong., 1st sess., December 16, 2009.

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