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ORPHANED VEBAS – AN APPROACH TO MAXIMIZE VALUE AND DISTRIBUTE WEALTH

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Over the past few years, several companies have been able to spin-off Voluntary Employee Beneficiary Associations[1] (VEBAs) and the associated retiree medical liabilities for a negotiated amount.[2] These arrangements create "orphaned VEBAs" in which the investment risk is transferred to participants. This fact combined with the tax advantages associated with retiree medical benefits allows us to clearly define a framework that maximizes value for participants in aggregate while providing the flexibility to allocate wealth among individual participants in various ways.

Individuals should make investments decisions within the context of their total portfolios. Thus, investments held within an orphaned VEBA should impact how participants allocate their other wealth (e.g., investing in bonds in the VEBA allows participants to hold less in bonds outside of the VEBA). This combined with the fact retiree medical benefits are the most tax efficient form of deferred compensation[3] should lead participants to want orphaned VEBAs to hold highly-taxed assets (e.g., fixed income, hedge funds) to help maximize their wealth on an after-tax basis.

Furthermore, plan design and investment risk dictate how wealth is allocated among participants of orphaned VEBAs. As the percentage of annual cost paid by the orphaned VEBA decreases and (or) investment risk increases, wealth is shifted to younger participants.

SIMPLE MODEL

Participants bear the investment risk from an orphaned VEBA making it effectively an aggregated savings account. Thus, participants should view the orphaned VEBA assets similarly to assets in any tax-advantaged savings plan and make investment decisions within the context of their overall portfolio. For simplicity, we will assume there is only one participant receiving benefits to illustrate two key points: (1) investment risk taken in the VEBA should be reflected in participants' personal portfolios, and (2) highly-taxed assets should be held in an orphaned VEBA.

We will assume the participant's target portfolio is 50 percent fixed income and 50 percent equity. In Figure 1, we have illustrated two potential allocations of VEBA assets—100 percent equities versus 100 percent fixed income—and the corresponding allocation of personal savings required to achieve the target allocation. This simply demonstrates how investment risks taken in an orphaned VEBA impacts participants' ability to take investment risks within their personal savings. If less investment risk is taken in an orphaned VEBA, it allows participants to take more risk with their personal savings while maintaining a target level of risk.

Retiree medical benefits offer distinct tax advantages. Unlike defined benefit and 401(k) defined contribution income that is taxed upon distribution, retiree medical payments are tax-free so "retiree medical savings" is more tax-efficient than other

FIGURE 1

Participants' Holdings	Orphaned VEBA: 100% Equity	Orphaned VEBA: 100% Fixed Income
Indirect holdings: through orphaned VEBA		
Equity	$1,000	$0
Fixed Income	0	1,000
Total	$1,000	$1,000
Direct holdings		
Equity	$4,000	$5,000
Fixed Income	5,000	4,000
Total	$9,000	$9,000
Participants' combined holdings		
Equity	$5,000	$5,000
Fixed Income	5,000	5,000
Total portfolio	$10,000	$10,000

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savings. This is important because not all assets are taxed in the same manner – long term capital gains (e.g., stock and real estate appreciation, qualified dividends) are taxed at a lower rate than ordinary income (e.g., interest payment on treasury and corporate bonds, nonqualified dividends). Consequently, participants should prefer highly-taxed assets to be held in an orphaned VEBA. Figure 2 illustrates how having highly taxed assets (e.g., fixed income) in an orphaned VEBA improves tax-efficiency. As shown in the example, shifting the assets of the orphaned VEBA to all highly taxed assets resulted in an increase in the participant's after-tax income from $590 to $595.

COMPLICATING ISSUES

Orphaned VEBAs have numerous participants and do not contain individual accounts; this complicates how value is distributed among the participants. Value distribution is governed by decisions regarding two key issues: (1) annual cost sharing, and (2) investment risk.

FIGURE 2

Orphaned VEBA: 100% Equity	**Participant Holdings**		**Return**		**Investment Income**		**1 - Tax Rate**	**After-tax Income**
Orphaned VEBA								
Equity	$1,000	×	10%	=	$100	×	(100% - 0%)	$100
Fixed Income	0	×	5%	=	0	×	(100% - 0%)	$0
Total	$1,000				$100			$100
Direct holdings								
Equity	$4,000	×	10%	=	$400	×	(100% - 15%)	$340
Fixed Income	5,000	×	5%	=	250	×	(100% - 40%)	150
Total	$9,000				$650			$490
Total portfolio	$10,000				$750			$590

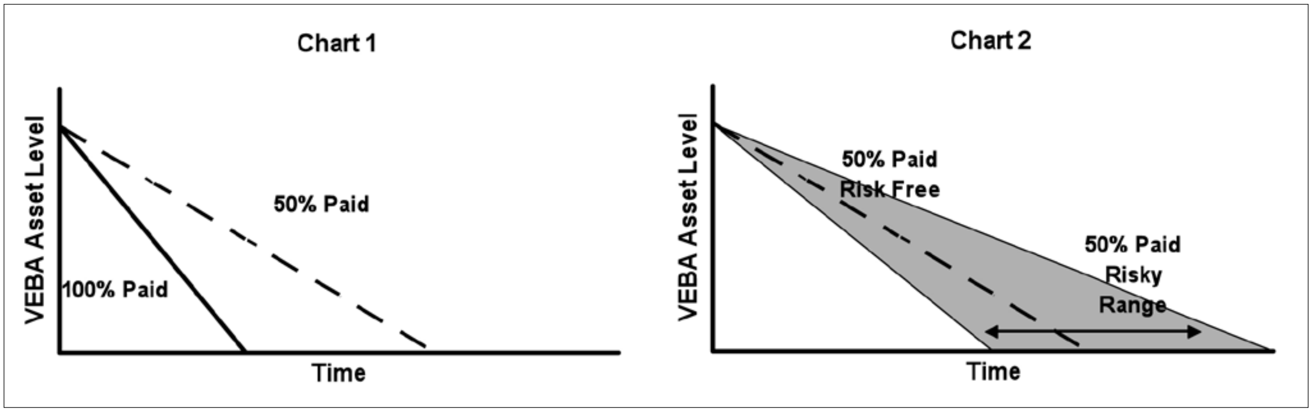
Orphaned VEBA: 100% Fixed Income	**Participant Holdings**		**Return**		**Investment Income**		**1 - Tax Rate**	**After-tax Income**
Orphaned VEBA								
Equity	$0	×	10%	=	$0	×	(100% - 0%)	$0
Fixed Income	1,000	×	5%	=	50	×	(100% - 0%)	$50
Total	$1,000				$50			$50
Direct holdings								
Equity	$5,000	×	10%	=	$500	×	(100% - 15%)	$425
Fixed Income	4,000	×	5%	=	200	×	(100% - 40%)	120
Total	$9,000				$700			$545
Total portfolio	$10,000				$750			$595

> "...EXAMINATION OF DISTRIBUTION IN THE VEBA IS SIMPLEST, AND IN OUR OPINION, BEST ACCOMPLISHED ON A RISK-FREE BASIS, ELIMINATING ANY EXTRANEOUS REALLOCATION OF WEALTH DUE TO INVESTMENT RISK."

Cost sharing could vary by participant based on numerous factors (e.g., years of service). For simplicity, we will assume the same cost sharing percentage is used for all participants. Chart 1 illustrates how assets would be depleted over time if VEBA assets were used to pay 100% versus 50% of retiree medical costs. Given younger participants would be expected to receive benefits longer than older participants; increasing cost sharing (i.e., lowering the percentage of cost paid by the VEBA) would be expected to lower value distributed to older participants and increase value distributed to younger participants.

Investment risk not only impacts how participants' should allocate assets in their savings plans but also can impact how value is distributed among participants. Chart 2 illustrates the projected depletion of assets when 50% of retiree medical costs are paid by the trust under two scenarios: (1) risk-free investment strategy (straight line for illustrative purposes), and (2) a risky investment strategy (range of potential asset drawdowns depending on asset performance). In the first case, the orphaned VEBA would be expected to be depleted of assets before some younger participants would be expected to commence benefits. These younger participants would then require investment risk to even have a chance of having retiree medical coverage. Thus, increasing investment risk shifts wealth to younger participants (Chart 2).

Distributing value in a VEBA is a complicated process involving various factors such as participant contributions, future benefit changes, Medicare coverage, etc., not to mention any number of special provisions a VEBA may have in place to protect subgroups of participants. Therefore, examination of distribution in the VEBA is simplest, and in our opinion, best accomplished on a risk-free basis (or at least a low risk basis), eliminating any extraneous reallocation of wealth due to investment risk. Furthermore, "defined dollar retiree medical



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benefits" would provide an addition level of precision (relative to benefits dependent on contingent factors) when allocating value from an orphaned VEBA.

CONCLUSIONS

The investment strategy developed for orphaned VEBAs needs to reflect that investment risk is borne by participants and also to reflect the tax-efficiency of retiree medical benefits. These facts should lead those responsible for investment strategy to limit the allocation to highly-taxed assets.

Given orphaned VEBAs do not contain individual accounts; the value distributed to each participant is driven by cost sharing and investment decisions. As the percentage of annual cost paid by the orphaned VEBA decreases and/or investment risk increases, wealth is shifted to younger participants. We believe the examination of distribution in the VEBA is simplest, and in our opinion, best accomplished on a risk-free basis (or at least a low risk basis), eliminating any extraneous reallocation of wealth due to investment risk.

Treasuries and most non-municipal fixed income investments are taxed at ordinary income rates, so they satisfy both the highly-taxed consideration and can be used to structure a low risk portfolio allowing for a straightforward distribution of wealth among participants.

END NOTES

1 A VEBA is a form of tax-exempt welfare plan, first established in 1928 in response to demands from workers' association. Under Internal Revenue Code section 501(c)(9) a VEBA is "organized to pay life, sick, accident, and similar benefits to members or their dependents, or designated beneficiaries if no part of the net earnings of the association inures to the benefit of any private shareholder or individual." Throughout the 1970s and early 1980s, VEBAs were abused by the wealthy as a tool for tax deduction. In 1984, VEBA use became limited due to the Deficit Reduction Act, but to this day, VEBAs remain as powerful tax shelters when used to provide employee benefits.

2 This sometimes includes predefined or contingent future contributions which could be considered "receivables".

3 Participants are never taxed on these benefits.

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