Health care costs continue to rise, forcing a commensurate rise in the cost of traditional group insurance. Employers continue to seek affordable benefits for their employees in an effort to maintain a productive and competitive workforce. Inspired entrepreneurs enter the market to supply low-cost programs to meet this demand. Many of these programs qualify as insurance. Yet some program promoters seek to avoid compliance with the various state laws regulating the business of insurance, such as laws requiring that insurers obtain appropriate licensure or demonstrate exemption from licensure, submit biographical materials concerning the persons who will manage these programs, file rates and forms for approval, follow mandated benefit requirements, observe prohibitions against discriminatory underwriting, achieve statutory solvency levels and prescribed investment practices, and comply with other measures of consumer protection applicable to the business of insurance.

Some unauthorized insurance promoters, wary of the administrative burden and cost of insurance regulation, seek to avoid state regulation of these products as insurance. They do so by cloaking these programs as "exempt" from regulation by flawed reference to federal law, such as the Internal Revenue Code or the Employee Retirement Income Security Act. In some instances this activity may be the result of unwary or erroneous professional advice. This article will review the manner in which two frequently used federal devices fall short of achieving the desired sanctuary of total exemption. To enhance this review, this article will provide a general overview of the intended advantages and limitations of these distinct federal provisions.

**VEBAS**

A voluntary employees' beneficiary association (VEBA) is a tax-advantaged welfare benefits funding vehicle defined under the Internal Revenue Code (IRC). The operations of a Veba are substantially devoted to providing for the payment of life, sickness, accident, or other benefits to the Veba's members and their dependents and beneficiaries. When properly organized under IRC Section 501(c)(9), a Veba will be exempt from federal income taxation.1 The mere offering of benefits in connection with a Veba will not, alone, cloak benefits otherwise constituting insurance from regulation as insurance. The establishment of a Veba to fund employee benefits, thus, serves no applicable purpose for effectively exempting a program from regulation as insurance.

Indeed, the IRC neither specifically authorizes nor prohibits the funding of employee benefits through a Veba. Employees are simply eligible to associate themselves with a Veba. Unlike traditional retiree health care in which employers agree to provide a certain level of benefits, employers make specific contributions to the Veba. Employees also contribute on either a voluntary or mandatory basis. Employees are entitled to participate in the Veba because of their employment status and because they have a common employment-related bond, such as coverage by a common employer or under one or more collective bargaining agreements or by virtue of membership in a labor union.

A company typically will use a Veba for the collection and disbursement of monies related to the
administration of the company's self-funded health care benefits plan. A VEBA offers several tax advantages to the company. For example, contributions to the VEBA are tax-deductible, while investment income earned on those contributions is tax-free; and funds, such as for the payment of claims, can be withdrawn tax-free.\(^3\)

The fact that a VEBA can be used only for the funding and payment of benefits creates accountability for the company to maintain finances to support the benefit plan which, in turn, provides security to participating employees. Thus, the VEBA helps the company manage cash flow related to its health care plan, which it self-funds. Due to the volatility of claims experience, the company may also procure a financial backup in the form of specific or aggregate stop-loss insurance from a licensed carrier.

Certain criteria apply for a VEBA to retain the tax-exempt status for which it is designed. A VEBA can be established in a number of forms, such as a trust or a corporation, organized under state law. The trust or corporation must exist independent of the member employees and their employer.\(^4\) The organization must be controlled by its membership, independent trustees, or trustees designated by, or on behalf of, the members.\(^5\) Money paid into a VEBA trust cannot revert back to the company.\(^6\) Withdrawals are allowed only for benefit-related expenses or to purchase insurance that provides employee benefits. These tax regulatory restrictions correlate with a central premise for exempting VEBAs from federal taxation, so that the net earnings of the VEBA cannot inure to any private shareholder or individual other than from the payment of benefits.\(^7\) Moreover, with a bona fide VEBA trust, the plan administrator is treated as a common-law trustee. Like a common-law trustee, a plan administrator is accorded a certain level of discretion and deference to the extent legally permissible under governing program documents. In return, a plan administrator assumes the fiduciary duties of care and loyalty to its beneficiaries. These characteristics further help to mitigate against certain structural conflicts which may arise with the distribution of benefits. For example, an employer likely will be interested in ensuring that benefits are paid fairly to its employees for a productive workforce. A direct distribution, though, will directly affect the employer's operating budget; thus, arguably, fostering a competing financial incentive to deny claims. As such, courts tend to be wary of according unfettered fiduciary deference when the structure of a plan gives an administrator financial incentives to act against the participants' interests. The establishment of a bona fide segregated trust helps to mitigate against the structural conflict which may arise with the direct payment of benefits out of the employer's operating budget.\(^8\)

A company may utilize an alternative risk transfer program, in combination with a VEBA, to further control health benefit costs. Subject to approval by the federal Department of Labor (DOL), the IRS, and other agencies with a jurisdictional interest, a company may use funds that it contributes to a VEBA trust to purchase accident and health insurance from an admitted carrier. In turn, the carrier may reinsure the policy through a captive formed by the company. Generally, captive benefits funding can reduce administrative costs while improving access to claims data. Also, investment gains on contributions made to the captive can be paid out as dividends to the parent. Such an arrangement can retain the tax advantages of funding employee benefits through a VEBA while maintaining flexibility in the manner in which those benefits are provided. Notwithstanding the manner in which VEBA funding and cost-containment occurs, the potential for regulating the underlying plan benefits as insurance remains the same.

As another example, several companies may join together to fund their group health benefits by utilizing VEBAs and a risk retention group (RRG) owned by the companies. Under the arrangement, each company sets up and funds a VEBA. Employers receive an immediate tax deduction for their VEBA contributions, while VEBA assets earn tax-free interest. In turn, VEBA assets must be used to pay for benefit-related expenses, such as health care claims. When claim payments cause VEBA assets to fall below a certain level, the employers make new contributions to their VEBAs. Then, the employers are reimbursed through policies issued by the RRG. The RRG, in turn, may be reinsured. Since the employees' health coverage is not issued by a commercial insurance company, the policies may not be required to provide coverage in line with state mandated benefits laws. The linkage of a VEBA, stop-loss insurance, and a captive insurer or RRG, may help address various issues employers face when desiring to fund their health care obligations in advance. Here again, though, the funding of employee benefits through a VEBA should not be confused with the distinct
activity required for compliance with applicable state insurance regulation or an express exemption to regulation as insurance.

An example of one such exemption may be found in the Michigan Insurance Code. That Code indicates that, "This code shall not apply to: ... Voluntary associations of employees which provide death, accident, or sickness benefits to persons employed by the same employer."9 Thus, under Michigan law, a trust which qualifies as a "voluntary association of employees" will find exemption from regulation as insurance in Michigan. The Michigan statute is silent as to whether the exemption contemplates that the association will qualify as a VEBA under the IRC. Certainly, qualification of the association as a VEBA should demonstrate compliance. However, one must remain mindful that the Michigan exemption contemplates a narrower form of association than a VEBA, limited to associations of employees "employed by the same employer."

ERISA-COVERED PLANS

A program which qualifies as an employee welfare benefit plan under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) may legally avoid state regulation as insurance by the specific manner in which federal ERISA preempts state law. However, the program must constitute the type of "employee welfare benefit plan" designed for ERISA preemption and cannot neglect to file the various forms and reports with the DOL required under ERISA. Simply, an ERISA-covered plan must comply with ERISA.

ERISA preemption analysis begins with the presumption that Congress did not intend for ERISA to supplant state law.10 With ERISA, Congress intended "to minimize the administrative and financial burden of complying with conflicting directives among States or between States and the Federal Government."11 Thus, state laws which mandate a specific employee-benefit structure or certain plan administration, or provide alternate enforcement mechanisms, must succumb to the various provisions of ERISA reserved for ERISA-covered plans.

ERISA indicates that it "shall supersede any and all state laws insofar as they may now or hereafter relate to any employee benefit plan."12 A state law "relates to" an employee benefit plan and is subject to preemption whenever it "purports to regulate, directly or indirectly, the terms and conditions of employee benefit plans."13 The central issue thus becomes whether the program constitutes an "employee benefit plan" within the meaning of ERISA. An ERISA-covered "employee welfare benefit plan" is defined as "any plan, fund, or program ... established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise ... benefits."14 A prerequisite of an ERISA-covered employee welfare benefit plan, therefore, is that the plan must be established or maintained by an employer, and that the employer must have a certain intent: a purpose to provide benefits to its employees. ERISA defines an "employer" as any person acting directly as an employer, or indirectly in the interests of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such a capacity.15 A third-party likely will not act directly as an employer in relation to an employee benefit plan when no employment or economic relationship exists between the third-party who established the plan and the employees of the third-party's client companies. Second, the third-party likely will not act indirectly in the interests of its client companies; rather, it likely will tend to act for itself in relation to the plan. Regulators tend to equate these third-parties with entrepreneurial ventures formed to market benefit plans to unrelated employers, with the primary interest in profiting from such activity. Such a third-party program likely will not qualify as an "employee benefit plan" within the auspices of ERISA. A regulator will be prone to connote such a program more with the transaction of insurance than an ERISA "employee benefit plan" per se.

A VEBA may be associated with an ERISA employee welfare benefit plan. However, this coupling will not affect the fundamental regulatory analysis of whether the plan constitutes insurance or qualifies for
preemption under ERISA. Indeed, VEBA tax treatment differs conceptually from the plan benefits contemplated under ERISA. This difference is more pronounced, and perhaps worthy of suspicion, when no funds are accumulated in the VEBA. With a VEBA, the "risk" which an employee bears is commensurate with the employee's employment risk: that the employee may be terminated and cease to receive wages and other compensation. The VEBA trust, therefore, is not a plan covered by ERISA. To qualify a program as an ERISA plan, one must review the intended benefits, beneficiaries, source of financing, and procedures for receiving benefits. Thus, one of the factors in determining whether ERISA preemption applies is the source from which the employees' benefits are paid. As indicated above, for a plan to constitute an "employee welfare benefit plan" under ERISA, the plan must be established or maintained by an employer or employee organization. A VEBA is not an employer association if it is not composed of related employers and does not meet other relevant criteria. A VEBA may likewise not meet the definition of an employee organization. The fact that a VEBA has been recognized under the IRC does not mean that it will be recognized as an employee organization under ERISA. It is, therefore, not surprising that IRC regulations provide that VEBA are not coterminal with employee beneficiary associations within the meaning of ERISA.16

Further, a VEBA that is associated with an ERISA plan will likely meet the definition of a multiple employer welfare arrangement (MEWA) unless the plan is offered by a single employer or offered pursuant to an agreement that is found to be a bona fide collectively bargained agreement.17 ERISA includes a reverse preemption clause with regard to MEWAs, indicating that, "in the case of any other employee welfare benefit plan which is a multiple employer welfare arrangement, in addition to this title, any law of any State which regulates insurance may apply to the extent not inconsistent with the preceding sections of this title."18 Various states have taken this cue and promulgated legislation requiring the licensure and regulation of MEWAs.19

CONCLUSION

A program will draw regulatory attention for review as unauthorized insurance by utilizing descriptions such as "VEBA," "ERISA exempt," and similar reference to federal nomenclature while avoiding licensure as an admitted insurer or MEWA or registration as an RRG, or causing the transfer of benefit risk to an entity unauthorized to accept such risk. A program which boasts low rates and minimal or no underwriting will invite heightened regulatory attention. An "exempt" program which employs insurance agents to transact the program will ensure regulatory attention, even when the agents are characterized as "labor consultants" or "business agents" to "enroll" or "negotiate" with potential association or union members. Legitimate ERISA plans, if properly established, may avert state insurance regulation. The funding of a benefit program through a VEBA will not, alone, evoke similar federal preemption or state exemption unless provided by state law.

Endnotes

1. 26 U.S.C. § 419(e)(3)(A); 26 U.S.C. § 501(c)(9). Section 501 of the IRC deals with organizations that are exempt from federal income taxation. VEBA are described in IRC § 501(c)(9) as: "providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earning of such association inures (other than through such payments) to the benefit of any private shareholders or individual." The reader is cautioned that this article is not intended to provide any form of tax advice, or method for avoiding tax penalties, insurance regulation, or any other legal requirement. It is recommended that the reader seek the advice of an independent tax advisor or other qualified professional based on a program's particular circumstances.
2. 26 C.F.R. § 1.501(c)(9)-2(a)(1).

3. Despite its exempt status, a VEBA is still subject to taxation on its "unrelated business taxable income" pursuant to IRC sections 511 and 512. Unrelated business taxable income is defined as gross income derived from any unrelated trade or business activity regularly carried on by the entity in question. See 26 U.S.C. § 12(a)(1). For instance, a VEBA's investment income constitutes unrelated business taxable income that is subject to taxation. An issue which often arises concerns the rate that investment income should be taxed. A trust qualifying as a VEBA may argue that the lower "corporate" rate of taxation applies whereas the IRS may argue that the higher "trust" rate of taxation applies. Compare 26 U.S.C. § 11 (providing rate schedule applicable to the taxable income of corporations) with 26 U.S.C. § 1(e) (providing rate schedule applicable to the taxable income of trusts and estates).

4. 26 C.F.R. § 1.501(c)(9)-2(c)(1).

5. 26 C.F.R. § 1.501(c)(9)-2(c)(3).


7. 26 C.F.R. § 1.501(c)(9)-1.

8. See, e.g., Post v. Hartford Ins. Co., 501 F.3d 154, 164 n.6 (3d Cir. 2007) (indicating that "when the employer both funds and administers the plan, but pays benefits out of a fully funded and segregated ERISA trust fund rather than its operating budget, no structural conflict of interest is created"). However, even though benefits are not paid directly by the company, the company still has a financial incentive to keep claims experience under the plan as low as possible -- the less the trust pays out as benefits, the less the company will ultimately need to contribute to the trust to maintain its solvency. Thus, although the impact may be less direct, there is nonetheless a close relationship between benefits paid by the trust and the money the company must provide from its general assets to fund the trust.


10. The Supreme Court has opined that Congress' aim in enacting the preemption clause was "to avoid a multiplicity of regulation in order to permit the nationally uniform administration of employee benefit plans." New York Conf. of Blue Cross & Blue Shield Plans v. Travelers Ins. Co., 514 U.S. 645, 657 (1995).


19. See, e.g., Fla. Stat. §§ 624.436-624.446. See also NAIC Model Laws, Reg'ns & Guidelines 220-1 (model act requiring producers to make an informational filing prior to soliciting business or performing other services on behalf of specified MEWAs subject to state law).