Dynamic Chiropractic

YOUR PRACTICE / BUSINESS

Tax Saving Strategies Using VEBAs

When highly compensated small business owners have tapped all the available tax saving options through the use of a qualified pension plan (SEP, money purchase plan, 401(k)) VEBAs (voluntary employee benefit associations) may be the answer for further tax sheltering strategies.

A VEBA also known as a 501(c)(9) tax exempt trust, allows a business with two or more employees (a business owner's spouse who is on payroll can qualify as a second person) to accumulate retirement and life insurance benefits with pre-tax dollars. Depending on the business owner's tax bracket this can be a significant savings. This money also accumulates tax deferred, and if the VEBA is properly structured, is creditor-proof, as well as not included in the business owner's estate for estate tax purposes.

Life insurance is the preferred funding vehicle which allows for a death benefit to be paid to an irrevocable trust (this keeps the policy death benefit out of the decedent's estate for estate tax purposes) for the benefit of the decedent's family, and while living allows the contributor's funds to accumulate in the policy's cash value tax deferred. Given its tax advantaged status and the ability to purchase a flexible life policy offering cash values that accumulate within a variable contract (with mutual fund or bond-like performance if so chosen), this presents a powerful reason to consider VEBAs in your financial plan. This is one of the only ways to acquire life insurance with pre-tax dollars.

If properly structured, your heirs can receive the policy's often-sizable death benefit distributed through the trust on a tax-free basis. Most all other retirement plan assets besides being part of one's taxable estate for estate tax purposes are also subject to income taxes. For someone in a high tax bracket and with a sizeable estate this double tax can be devastating to one's heirs, consuming as much as 75 percent of a plan assets.

VEBAs have been around since 1928, and when working with your financial advisor you should be entering into one of the five thousand VEBAs that already have a letter of determination from the IRS acknowledging it's tax exempt trust status. The trustee for these 501(c)(9) trusts is usually an independent bank trust department.

Additional advantages of a VEBA besides its tax advantages are:

- no employee vesting;
- strict requirements for employee eligibility;
- depending on funding source, can fluctuate or skip payments in some years;
- no set monetary limit such as $30,000 as in some pension plans;
- no penalty for withdrawal of funds prior to age 59 1/2;
- no penalty for leaving funds in after 70 1/2.

A VEBA must comply with some employee retirement income security act rules including the 505(b) nondiscrimination requirements. To be eligible for benefits one must have up to three years of service, be a full time employee, be at least 21 years of age, and not be part of a collective bargaining agreement.

These strict requirements will eliminate many employees who aren't eligible. Also, since the preferred funding method is with life insurance, in most cases a physical will be needed. This will eliminate even more employees who are eligible to participate but don't want to go through the inconvenience of a physical. Also, like in many other retirement plans, income is capped at $160,000 for evaluating VEBA benefits: an example would be a physician making $200,000 a year, with his only employee making $40,000, can offer a VEBA funded by life insurance at 10 times salary. For himself, including salary cap maximum of $160,000, the policy would be for $1,600,000; for the employee, the policy would be for $400,000). He can fund his portion of the VEBA with a cash value policy, which will accumulate high cash values if properly funded. Besides being funded with tax advantaged pre-tax income, insurance cash values also accumulate tax-deferred. Because the employer is funding the VEBA, employees would like to keep this cost as low as possible. In that case term-life insurance would be more appropriate, since this can cost several times less than a cash value policy.

Policy proceeds are not part of the business owner's estate because he has no incidents of ownership (this is important, since estate taxes for those who die with an estate worth $625,000 or greater in 1998 run from 37%-60%; upon one's death this can place a large burden on the decedent's heirs. The VEBA he joined is the policy owner with the bank as the appointed trustee. The beneficiary of choice is usually an irrevocable trust for the benefit of his or her family. The employer can cancel the plan at any time and the VEBA benefits (often high policy cash values) are only distributed to remaining company employees. Since VEBA benefits are based on income and years with the company, the company owner receives the lion's share of the benefits (in small firms often as much as 90%). VEBAs are available to sole proprietors, partnerships, LLPs, LLCs, C-corporations, and S-corporations.

VEBAs are a sophisticated tax-planning tool for high-income small business owners like physicians who usually have very small staffs, and have tapped out their qualified plans and are looking for additional tax and retirement planning strategies.

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MARCH 1998

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