VEBA Rules Should Be Updated to Reflect Expanded Relationships

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In this article, Mazawey and Amin recommend changes to modernize the voluntary employees' beneficiary association rules to benefit VEBAs and their members and achieve sound benefit policy goals.

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The Treasury regulations governing voluntary employees' beneficiary associations described in section 501(c)(9) were published more than 40 years ago. Since then, evolving employment and family leave laws and policies have recognized that an employee's dependents may include many persons in the employee's extended family, as well as chosen relationships with those who aren't tax dependents or considered traditional family members.

Background

The VEBA is a mutual association of employees that provides benefits to its members and their designated beneficiaries. Established in the Revenue Act of 1928 as a tax-exempt organization, the VEBA was also in succeeding revenue acts, including the 1954 and 1986 Internal Revenue Codes.

In general, any group of employees with an "employment-related common bond" may participate in a VEBA. The VEBA organization, typically a trust, may be established by the employees, by their employer, or by a labor organization representing the employees.

Treasury and the IRS published an initial round of proposed regulations in 1969 that addressed some basic definitional issues for VEBAs. But it wasn't until the early 1980s that the regulations established specific parameters regarding the employment-related common bond and what types of

employee relatives can receive VEBA benefits.[1] Since then, the issue of identifying who may benefit from a VEBA has not received much attention.

While the VEBA membership rules have remained stagnant for 40 years, social policies in key areas have outpaced the VEBA limitations. For example, various state and federal laws recognize that an employee has social and family obligations to care for persons who may not fit the narrow categories of "dependent" in the regulations. And these relationships may well extend beyond the traditional "family" parameters.

VEBA Membership Rules

The VEBA rules provide:

> The life, sick, accident, or other benefits provided by a voluntary employees' beneficiary association must be payable to its members, their dependents, or their designated beneficiaries. For purposes of section 501(c)(9), dependent means the member's spouse; any child of the member or the member's spouse who is a minor or a student (within the meaning of section 151(e)(4)); any other minor child residing with the member; and any other individual who an association, relying on information furnished to it by a member, in good faith believes is a person described in section 152(a).[2]

The VEBA rules defining the term "permissible benefits" include (1) "life benefits" payable by reason of the death of a member or dependent (and include a life insurance contract purchased by a member from an employee-funded VEBA), (2) sick and accident benefits furnished in the event of illness or personal injury to a member or dependent, and (3) "other benefits" that are similar to life, sick, or accident benefits. Broadly speaking, the third item encompasses an array of benefits that are intended to safeguard or improve the health of a member or their dependents or that "protects against a contingency that interrupts or impairs a member's earning power."[3]

A Proposal to Expand VEBA Membership

Well-established VEBAs offering life insurance and other (nonsick and accident, such as long-term disability) insured benefits to their members would like to expand their potential beneficiaries to include various persons who are closely associated with their members but do not fit the narrow definitions of spouse; child who is a minor or student (under section 151(e)(4) (now moved to section 152(f)(2))); minor child residing with the member; or dependent under section 152(a)(1) who as of the end of the calendar year has not attained age 27.

The membership of these VEBAs may be smaller than in the past because of higher rates of retirement, reduced employer payrolls, and other employment and demographic trends. Expanding VEBAs to include additional beneficiaries may help stabilize insurance premiums and improve the VEBAs' overall financial health. Allowing a larger group of persons to purchase life insurance or similar benefits is appropriate as long as those persons have a reasonable relationship with the

member. And because they and their survivors have been provided for, the member may continue to work without taking extended leave to assist them.

It is important to note that allowing more individuals to purchase insured benefits through VEBAs does not raise the traditional concern that tax-exempt VEBAs are unfairly competing against taxable commercial insurance companies.

Examples of More Liberal Laws and Policies

The Family and Medical Leave Act of 1993 first recognized spouses, children, and parents of an employee as persons for whom the employee should be granted leave to provide for their care. Members of Congress have proposed legislation to expand the Family and Medical Leave Act in this area. Most recently, the "Caring for All Families Act" would:

- update the Family and Medical Leave Act's definition of family to include a domestic partner, parent-in-law, aunt, uncle, sibling, adult child, grandparent, grandchild, son- or daughter-in-law, and other significant relationship; and
- guarantee that parents and other family caregivers can take time off to attend a medical appointment or school function, such as a parent-teacher conference, without risk of losing their job.

While this proposed legislation (H.R. 789/S. 282 in the 118th Congress) has yet to be acted on, there are numerous cosponsors in the House and Senate.

In the past 10 years or so there has been a rapid expansion of the categories of persons who, while not "dependents" of an employee, are deemed to have relationships that would justify the employee taking time off from work to care for them. Indeed, more than 50 state and local jurisdictions have adopted their own criteria for this purpose. For example, the State of California has updated its family and paid sick leave law to allow employees to take protected time off to care for a designated person whom the bill defines as any individual related by blood or whose association with the employee is equivalent of a family relationship.[4] The designated person may be identified by the employee at the time they request the leave and does not have to be designated in advance.

For purposes of paid sick leave, California's A.B. 1041 defines a designated person as one who is identified by the employee at the time the employee requests paid sick days. That definition does not require that the person be related by blood or affinity or have the "equivalent of a family relationship" with the employee. Similarly, the California legislation adds "designated person" to the list of family members an employee may request time off to care for under the state's paid sick leave law. There is no requirement that the person be related by blood or affinity or have "the equivalent of a family relationship."

More recently, on October 18, 2024, the Maryland Department of Labor published proposed regulations in the Maryland Register to implement the state's paid family and medical leave insurance law. Under that law, there is a long list of people who qualify as a "family member," including the child of the employee or their spouse, the spouse of a domestic partner, and the

employee's grandparent, grandchild, or sibling. Those include biological, adopted, foster, step, legal guardian, and *in loco parentis* relationships.

The federal government's Office of Personnel Management rules perhaps provide the most useful model for modernizing the VEBA rules to reflect today's notions of familial relationships.[5] These rules treat the following persons as family members of an employee:

- spouse and their parents;
- sons and daughters and their spouses or domestic partners;
- parents and their spouses or domestic partners;
- brothers and sisters and their spouses or domestic partners;
- grandparents and grandchildren and their spouses or domestic partners;
- domestic partner and their parents; and
- any individual related by blood or affinity whose close association with the employee is the equivalent of a family relationship.

The term "domestic partner" includes an adult in a "committed relationship" with another adult, for both same-sex and opposite-sex relationships.

Benefits of the Proposal for VEBA Participants and the IRS

Persons in any of the above classes should be allowed to qualify as family members of a VEBA member and be eligible to purchase life insurance, disability, or other nonsick and accident benefits through a VEBA in which the VEBA member participates. This expanded definition would help those persons and their survivors receive income to care for themselves, thus relieving the related-employee VEBA member of that burden, which could interrupt or impair the member's earning power.

Being able to serve a wider — but still reasonably limited — population also would benefit VEBAs in important ways. First, it would help compensate for reduced membership rolls resulting from smaller active workforces, including greater use of contractors. Second, it would diversify the risk of the VEBA populations by including more purchasers in various age groups — covering a spectrum from grandchildren to grandparents of VEBA members. Third, the proposal would facilitate compliance by VEBAs that sometimes allow participation by one of the above categories of family members (for example, domestic partners of members) in reliance on a de minimis concept reflected in numerous private letter rulings and indirectly under the current rules.[6]

Importantly, the proposal would help the IRS administer the rules, too, by providing clear guidance on who may benefit under VEBAs — without opening VEBAs up to an overly broad segment of the population. The guidance would be well defined and promote uniformity among VEBAs, consistent with sound tax administration. As noted, the guidance would modernize the regulations to bring them more in line with evolving family leave and similar laws at the federal and state levels.[7]

Finally, from a tax policy and revenue perspective, this proposed change is neutral because:

- The ability to purchase life, disability, and other insurance benefits through the VEBA does not provide a tax benefit to the purchaser. The insured purchaser and beneficiaries are treated the same for tax purposes as if the coverage were purchased outside of a VEBA. The premiums are paid with after-tax funds, and the scope of beneficiaries is not expanded by the insurance being purchased through a VEBA.
- The VEBA does not benefit from a larger base of assets merely because a larger group of beneficiaries are purchasing coverage through the VEBA. In general, the premiums are received and distributed in the same tax period.
- The insurance companies will pay tax on the additional premiums and otherwise will be treated the same as when insured benefits are purchased by traditional VEBA members.

This recommended update of the rules governing VEBA membership for insured benefits (other than medical benefits) is long overdue. All stakeholders — participants, their family members, VEBA administrators, and the IRS — would benefit from this change in VEBA membership rules.

FOOTNOTES

[1] 45 F.R. 47871 (July 17, 1980); T.D. 7750, 46 F.R. 1719.

[2] Note that since the VEBA regulations were finalized, there have been several changes in the law, including moving the definition of student from section 151(e)(4) to section l52(f)(2) and adding the following sentence to section 50l(c)(9) to reflect changes made by the Affordable Care Act: "For purposes of providing for the payment of sick and accident benefits to members of such an association and their dependents, the term 'dependent' shall include any individual who is a child (as defined in section 152(f)(1)) of a member who as of the end of the calendar year has not attained age 27." Reg. section l.501(c)(9)-3(a).

[3] Reg. section 1.501(c)(9)-3(d).

[4] A.B. 1041 (Sept. 29, 2022).

[5] 5 C.F.R. section 630.201.

[6] *See*, *e.g.*, LTR 201415011 (3 percent of total benefits paid during plan year); LTR 200537036 (3 percent of individuals covered). *See also* reg. section 1.501(c)(9)-3(a) (final sentence).

[7] *See* Khorri Atkinson, "Paid Leave Laws Expand to Reflect Evolving 'Family' Definition," Bloomberg Human Resources News, Jan. 8, 2025 (describing recent changes in the family leave laws of five states).

END FOOTNOTES