



Could VEBAs Work in Canada?

By: Steven J. Friedman, Andrea Jackson & Mark Newton

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**BENEFITS AND PENSIONS
MONITOR**

October 2008 Issue

In a bid to secure lifetime retiree health coverage for retirees and their dependents, the U.S. automaker's union – the United Auto Workers (UAW) – has agreed to the creation of trust funds that would allow each of the Big Three U.S. automakers (Chrysler, Ford, and GM) to shift their retiree healthcare benefits obligations to a UAW trust fund for less than 70 cents on the dollar.

The trust fund is known in the U.S. as a 'voluntary employees' beneficiary association' or a VEBA. This move effectively lowers the Big Three's retiree healthcare benefit liabilities from roughly \$89 billion to \$56 billion. Some have questioned why the UAW agreed to this. The answer likely is that the UAW is looking to secure funding for the retiree healthcare benefits owed its members in the event one or more of the Big Three goes bankrupt. Simply put: "something is better than nothing."

A VEBA is a special tax-free trust that is established to pay for future health and welfare benefits subject to the Employee Retirement Income Security Act (ERISA) such as retiree healthcare benefits. Contributions to a VEBA may be made by an employer and employees on a tax-free basis and remain tax-free when used to purchase benefits. A VEBA trust

pushed back hard during 2007 negotiations. Their position was the provision of retiree healthcare benefits must be reduced or eliminated altogether regardless of whether or not they were guaranteed under previous collectively bargained contracts. The UAW could have litigated this point in Federal Court, but the reality of protracted litigation combined with the spectre of bankruptcy (and the risk of a total loss of benefits) made that option untenable.

Instead, it chose to create the VEBA trusts, thereby removing liability for the benefits from each of the Big Three and effectively putting the UAW itself in the business of healthcare benefit administration.

Second, as stated above, the agreement permits the Big Three to shift their retiree healthcare benefit liabilities to the VEBA. Collectively, the Big Three are liable for approximately \$89 billion in retiree healthcare benefits. However, when the UAW agreed to accept about 70 cents on the dollar for that liability, the Big Three saved themselves \$32.2 billion. Theoretically, that savings will allow the Big Three to enjoy increased cash flow, earn a better credit rating thereby helping to decrease debt, increase their ability to become more efficient and competitive in the marketplace and, most importantly to the UAW, to remain solvent.



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is often established in conjunction with a collective bargaining agreement (CBA) entered into between a U.S. employer and a union. The VEBA ensures that the necessary funding for health and welfare benefits agreed to under a CBA is safe from negative financial events (bankruptcy, for example) that could force a company to reduce or terminate such benefits if they were paid from a company's general assets. Ideally, a VEBA begins fully-funded with cash upon its effective date.

This UAW VEBA is significant in two ways. First, the UAW has permitted the Big Three to shift responsibility for retiree healthcare benefits to another entity at a significantly reduced amount. The guarantee of lifetime retiree healthcare benefits for UAW members and their beneficiaries is a central component of the UAW's *raison d'être*.

For years, the UAW fought the Big Three against any reduction or elimination of these benefits. However, the rising cost of healthcare in the U.S. has made the provision of promised retiree healthcare benefits an overwhelming burden to an industry that routinely teeters on the brink of bankruptcy under acute financial stress.

The Big Three – citing rising costs and impact on the corporate bottom line –

The UAW VEBA

While establishment and funding of the VEBA began in early 2008, the VEBA will not be effective until 2010. Until that time, the Big Three agreed to continue paying for the provision of retiree healthcare benefits as promised under previous contracts. As stated above, the VEBA will not be fully funded upon its effective date. The Big Three will contribute through a combination of upfront lump sum cash payments, annual cash payments, a convertible note that may be converted to company stock, and a 'pension pass through' where the corporations will receive a special additional pension benefit that will be contributed to the VEBA.

The Big Three's total contribution to the UAW VEBA will be \$56.5 billion, approximately 64 percent of the automaker's total retiree healthcare benefit liabilities. UAW employees will make up the difference

in funding by contributing directly to the VEBA in various forms including the diversion of wage and cost-of-living increases from active UAW employees. While the UAW has assured current retirees that lifetime retiree healthcare benefits are guaranteed, the fact that the VEBA is not fully-funded raises legitimate questions about whether such ben-

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efits will be available to any future retirees. There is certainly precedent for these types of VEBAs to come up short. After all, in the recent case of Caterpillar, the VEBA ran out of funds after only six years.

In order for this VEBA to be established, the UAW must establish the VEBA trust, gain approval from federal courts and the U.S. Securities and Exchange Commission (SEC), and appoint a board of trustees to oversee the trust. Because the VEBA trust has not been fully funded, the board will be tasked with managing the investments in such a way that they grow faster than the current rate of inflation while providing retiree healthcare benefits at levels that were promised. If the board cannot successfully manage the investments and the VEBA funds fall short, it could conceivably trigger a decrease in the level of retiree healthcare benefits through higher premiums and cost sharing mechanisms (co-pays and co-insurance), higher contributions from current UAW employees, or even the termination of promised retiree healthcare benefits to future retirees. This is precisely the situation the UAW sought to avoid in the first place.

As of August 30, 2008, the Big Three have received approval of the VEBA agreements from Federal Courts. SEC approval is pending and the Big Three continue to work out the details of actual funding of the VEBA. For its part, GM has deferred \$1.7 billion of its promised VEBA payments citing liquidity issues. No doubt liquidity will continue to be an issue for the Big Three, perhaps making VEBA payments a low priority. Notwithstanding Wall Street concerns, the UAW remains committed to providing its members with what they had come to rely upon – affordable healthcare for life. It remains to be seen whether the UAW VEBA will be able to generate the funds necessary

to sustain the VEBA in light of the rising cost of healthcare in the U.S. and fulfill the promises made to UAW retirees and dependents.

While VEBAs, like the UAW VEBA, may serve a purpose with respect to large U.S. corporations with union employees and retiree healthcare benefits, it is unlikely that corporations without collectively bargained agreements will establish VEBAs to fund retiree healthcare benefits. This is because in the absence of a CBA, a U.S. employer generally may unilaterally reduce or terminate retiree health benefits. This is a trend that has taken place over the last 20 years and there is no reason, given the current volatility of U.S. markets, to believe it will not continue.

Implications For Canada

The auto workers in Canada are represented by the Canadian Auto Workers (CAW), which is separate from the UAW. While the CAW certainly pays attention to the bargaining in the U.S. between the UAW and the Big Three, CAW settlements are in no way patterned after those in the U.S. In fact, the CAW has not expressed much interest in VEBAs, even if they were available in Canada. Furthermore, while there could be the same financial incentives for the automakers in Canada to establish 'Canadian VEBAs,' there are some regulatory constraints.

The closest trust vehicle in use in Canada for the funding of benefit plans for unionized employees and retirees is a 'Health and Welfare Trust' (HWT). HWTs are used extensively in both single employer and multi-employer unionized contexts. However, there are certain restrictions placed on HWTs, under administrative guidelines of the Canada Revenue Agency (CRA).

Under CRA's Interpretation Bulletin IT-85R2, all monies contributed to HWTs must be used exclusively to provide health and

welfare benefits and only for the employees (and retirees) of the employer(s) for whom it was established. No assets may revert to the employer. More importantly, however, are the following:

- ◆ CRA does not generally recognize or permit funding of HWTs beyond providing for current obligations. Additional contributions to provide for a large contingency reserve, as in the U.S. VEBAs, would not be tax deductible. (This may not be an issue for employers in a tax-loss position.)
- ◆ HWTs are not tax-exempt vehicles. Investment earnings in HWTs each year are taxable, after netting out benefits paid from the trust and expenses incurred to earn the income. VEBAs, on the other hand, are tax-exempt trusts, just like pension funds. Investment income in a VEBA is not subject to tax, making them much more cost-effective than taxable trusts.

If the experience in the U.S. among the Big Three with VEBAs is positive from both the automakers' and the retirees' perspectives, there may be sufficient impetus in Canada to adopt a 'Made-in-Canada VEBA.' This could be a very constructive step the federal government could take to provide an economic stimulus to the auto industry and other industries in the union sector with retiree benefits.

If VEBAs are not successful in the U.S., they will undoubtedly remain south of the border. ■

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