OPTIONS FOR FINANCING RETIREE HEALTH BENEFITS
Staff Paper #2: VEBAs and 401(h)s:

prepared by
Sheri S. Heffelfinger, Research Analyst
Montana Legislative Services Division
for the
SUBCOMMITTEE ON DISABILITY AND RETIREE HEALTH CARE of the State Administration, Public Retirement Systems, and Veterans' Affairs Interim Committee
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Please note: This paper is a summary by general legislative staff based on research and analysis of various readily available, but sometimes conflicting, sources. The information provided is for legislative subcommittee use for general discussion purposes. Staff does not purport to be technically proficient in this topic or to possess expertise in this field.

Introduction

The first staff paper on financing retiree health benefits summarized background from the previous legislative interim and introduced the Subcommittee to two methods of financing health benefits for public retirees: Voluntary Employee Benefit Associations (VEBAs) and Internal Revenue Code section 401(h) accounts.

This paper:

- summarizes policy issues;
- describes in greater detail each type of account;
- examines some advantages and disadvantages of VEBA and 401(h) accounts; and
- presents options for the Subcommittee's consideration.

Summary of policy issues

One, if not *the*, most critical issue confronting working people is how to afford retirement when escalating health costs consume ever larger portions of expected retirement income. Investment earnings on pension funds cannot keep pace with the inflation of health care costs. Without postretirement health benefits, these medical expenses, including insurance premiums, must be paid out-of-pocket, after taxes.

The key policy question, therefore, is how can Montana public employers help its employees prepare for postretirement health care costs? One way is to set up a financing vehicle so that during an employee's working career money can be set aside, invested, and, after retirement, used to pay medical expenses. In February, the Subcommittee decided to further examine postretirement health benefits for public employees and now must look at plan design and plan funding issues.

In addressing these issues, the Subcommittee will want to keep in mind employer and employee concerns. Public employers will be concerned about how to afford retiree health benefits in addition to salary, health benefits, and retirement plan obligations for active employees. Active employees will be concerned about how to pay today's bills if more money from their take home pay is set aside to pay for future benefits.

Thus, it seems that the bottom line for policymakers, employers, and employees may well be how to turn existing taxable resources into a tax-free health benefit. Both VEBA and 401(h) accounts offer opportunities for accomplishing this objective.

VEBA and 401(h) accounts in review

The first staff paper on retiree health benefits briefly introduced the Subcommittee to VEBA and 401(h) accounts and reviewed discussions from last interim's committee meetings. To recap that information: VEBA trust accounts and 401(h) are vehicles for financing "employee welfare benefits" and are the same in that:

- both allow employer contributions to be made on a tax-free basis, which for public employers means no employment taxes are paid on the amounts contributed;

- both are trust accounts where assets are managed in a fiduciary manner and invested to accrue tax-free earnings; and

- both pay employee welfare benefits that are not taxable. Welfare benefits include any tax deductible medical expenses, such hospitalization, physical examinations, diagnostic procedures, and treatment therapies, as well as supplemental insurance premiums, such as Medicare B premiums or supplemental disability insurance premiums, etc. that would otherwise have to be paid out-of-pocket (after taxes).

However, there are also significant differences between these two approaches and each offers a different mix of advantages and disadvantages.

<u>A more detailed look at VEBA welfare benefit plans</u>

As presented in Staff Paper #1, VEBAs are tax-exempt organizations set up by an employee association. A trust fund is used to pay specified benefits to eligible trust fund members, i.e., active employees, retirees, their dependents, and their beneficiaries. A VEBA welfare benefit plan established for Montana public employees might, for example, involve the following:

< An employee association would be created under Internal Revenue Code section 501(c)(9) with membership determined through a common association, such as "all school district employees" , "all employees of the Department of Administration", "all state employees", "all general classified employees belonging to the MPEA and the MEA", etc.

< The employee association would craft a written document establishing a formal trust organization under Internal Revenue Code section 509(c)(9), and an independent board of trustees would be elected or appointed according to the trust organization's by laws. The VEBA trust and board of trustees would have to be operationally independent so it could not to be controlled by an employer or an employee union.

< If the association involved state agency employees or the legislature wanted to establish statewide policy guidance, a new state law would be crafted providing basic parameters establishing VEBAs. The legislation would authorize agency participation.

< Employers of the employees belonging to the VEBA would agree to make contributions to the VEBA trust fund (which funds could only be used for the exclusive benefit of eligible VEBA members).

< Employer contributions to the VEBA trust fund would be tax-exempt (no employment taxes would be paid on the amounts contributed). Employer contributions would be governed by Internal Revenue Code section 419 and 419A, which establishes definitions, limitations, and qualifications.

< If employer contributions are pooled to pay defined benefits (like in a defined benefit retirement plan), certain limitations on the payment of benefit claims would apply. For example, capital accounts would be limited to 17.5% of the previous year's claims for short-term disability benefits, 35% of the previous year's claims for medical benefits, and 75% of the previous year's claims for supplemental unemployment and severance benefits. *(*Recent federal legislation in this area may have altered these provisions, but staff research has not confirmed what, if any, changes were actually adopted.)*

< If employer contributions are made as a defined contribution amount and benefits paid depend on account balances (like in a defined contribution

retirement plan), many of the IRC limitations on claims paid could be avoided. Claims paid would simply be based on available contributions.

< Employer contributions could be structured so that employees could, in lieu of receiving a taxable cash out of unused sick leave or taxable cash severance pay, the employer would contribute that amount to the VEBA trust account. Or, employer contributions could be a percentage of salaries or a flat dollar amount.

< Employees could contribute to the VEBA trust fund on an after-tax basis. However, unanswered questions about IRS tax-qualification criteria have resulted in employee contributions being avoided.

< Depending on how the plan was structured, employees could be allowed to direct the investment of independent medical expense accounts. Or, the VEBA board of trustees could make the investment choices.

< The VEBA's board of trustees would likely contract for record keeping, claims processing, investment services, etc. Employers and employees would provide the vendors with the information necessary to maintain accurate records, manage investments, pay claims, etc.

< The VEBA trust funds could not be used to pay retirement or deferred compensation benefits. But, death benefits, severance payments, supplemental disability benefits, supplemental unemployment benefits, reimbursements for tax-deductible medical expenses, and long-term care benefits could be paid from a VEBA trust. The plan document could specify what benefits would be payable.

< Benefits could be paid to active and/or retired employees, their dependents, and their beneficiaries.

< The plan could be portable to the extent that the plan's design and contracted services support the portability.

< Investment earnings would accrue tax-free; and benefit payments would not be taxable, provided that the payments comply with applicable tax laws.

< To be a qualified plan for tax purposes, the VEBA welfare benefit plan would need an IRS determination letter and must meet certain qualification criteria, such as meeting nondiscrimination testing, protections against assets being diverted or encumbered, etc.

The Washington Public Employees Association VEBA Medical Expense Plan

Inception

In 1983, the Association of Washington School Principals, the Washington Association of School Administrators, and the Washington Association of School Business Officials formed a 501(c)(9) VEBA organization. These organizations together appoint six trustees that serve as the VEBA's governing board.

Plan design

Plan type--medical expense plan: The VEBA trustees established a trust fund and designed a medical expense plan that provides VEBA members with tax-free reimbursement of any medical expense that is tax-deductible under IRS laws (specifically outlined in IRS Publication 502).

Plan services--contracted: The VEBA Service Group of Wilkerson & Associates, Inc. in Spokane helped design and implement the plan, maintains two regional offices to service plan participants, and administers the plan's contracts for services. REHN & Associates Inc. provides benefit administration services. Plan service costs are paid by the trust fund.

The plan is entirely portable and an employee that belongs to the VEBA continues to have a VEBA account and may be paid benefits from the account even if the employee moves to another employer.

Defined contribution plan: The VEBA medical expense plan is structured as a defined contribution plan with individual member accounts. The plan recently provided that employees may direct investment of their accounts among three options: a fixed fund, a stable value fund, and a growth fund. The Dwight Asset Management firm acts as the trust's investment manager.

Participation and funding--voluntary by employee group, funded with sick leave rollover:
Washington state laws authorizes voluntary employer participation in the plan. Employees of each governmental entity may "get together" to form an association that "joins" the established VEBA. An employee of a group that chooses to join the VEBA cannot "opt out". If the employers of the employee group agree to participate, then the employers fund the plan through a rollover of unused sick leave.

In Washington, state employees, university system employees, and most school district employees are entitled to a 25% "cash out" of unused sick leave when they terminate employment. Instead of paying that money in a lump sum cash payment (that would be subject to payroll taxes), the money is contributed tax-free to the

VEBA trust fund. In some isolated cases, employee bargaining units that joined the VEBA bargained with the employers to reduce employee take home pay by 1% and the employer in turn contributed 1% to the employees' VEBA trust accounts. This allowed employers to reduce payroll costs (because they did not have to pay payroll taxes such as FICA) and, that amount was not taxable income to the employees.

Initially, VEBA medical expense plan covered only certain school districts that chose to participate at the start. Today, 220 out of 296 school districts in Washington participate. In 1993 (10 years after the VEBA's start) the state legislature decided to provide for state agency participation in a VEBA, but chose to establish the state plan separate from the already established school district plan.

The original state plan failed to meet IRS qualification standards, received an unfavorable determination letter, and was dropped. In 1999 (last September), the Washington legislature finally approved legislation authorizing state agencies to participate in the already established school district VEBA and has already found the VEBA to be very popular among state employees. More than 11,000 active employees currently participate in the plan and, since 1983, benefits have been paid to more than 20,000 participants.

Attached at Appendix A is a print out of the WPEA, Department of Revenue Chapter Internet web pages informing WPEA members about their VEBA medical expense plan.

Internal Revenue Code section 401(h) accounts

An IRC section 401(h) account is another vehicle that may be used to finance retiree health benefits. A 401(h) is a qualified annuity plan set up under a defined benefit pension plan and can be used to pay various non-pension benefits, such as retiree medical expenses. Eligible benefit recipients include the pension plan's retirees, their spouses, their dependents, and their beneficiaries. (*Staff is still researching whether 401(h) plans can be set up under defined contribution retirement plans.) The following are some features of a 401(h) plan that could, for example, be set up for members of the Public Employees' Retirement System:

< The plan would be created as a separate sub-account of the PERS defined benefit pension trust fund and be administered by the Public Employees' Retirement Board.

< Employer contribution amounts would be set and paid into the account tax-free. (Whether or not employee contribution could be made with pre-tax dollars remains an area of some controversy among tax analysts.)

- Funds in the 401(h) account must be, for accounting purposes only, separate from the pension funds, but would actually be co-mingled and invested with the DB retirement plan's assets.

- The account would be protected as a trust fund, similar to a pension plan, so that assets may not be diverted for any purpose other than for member benefits.

- Benefits payable would be similar to the benefits payable under a VEBA employee welfare benefit plan, except that only retirees (not active employees), their spouse, and their dependents may receive benefit payments.

- The plan would have to provide that after all benefit obligations are paid, any excess amounts would be returned (or credited) back to the employer.

- Contributions made to the 401(h) account would count against the limitations imposed on pension plan contributions.

- Funding of the 401(h) benefit obligations must be subordinate to the funding for retirement plan benefit obligations. (*Staff is still trying to ascertain whether this means that the pension plan must be fully funded and have no unfunded liabilities before benefits under the 401(h) are funded.)

- Excess pension trust funds (i.e., funds in the DB pension fund in excess of accrued liabilities) may be transferred to a 401(h) account.
- Like a VEBA plan or qualified pension plan, a 401(h) plan would have to meet certain tax qualification standards. But, unlike a VEBA plan, if the 401(h) plan fails to meet those IRS qualification standards, the tax-qualified status of the pension plan would also jeopardized.

A 401(h) case study

The actuarial benefits consulting firm Gabriel, Roeder, Smith & Company (GRS) recently published a company Benefits Research Report (No. 1999-1, April 1999) that examined 401(h), general asset, and VEBA accounts. As a case study of a 401(h) account, the report described how a public employer, who had been paying retiree health benefits on a pay-as-you-go basis from the general fund, commissioned GRS to conduct an actuarial study of liabilities and to make recommendations for helping the public employer begin to pre-fund these benefits.

The GRS study found, not surprisingly, that the pay-as-you-go approach would soon present costs beyond the reasonable means of the employer. The study also found that the pension trust fund experience had been favorable enough in recent years to provide a funding source for retiree health benefits. The GRS helped the plan sponsor design and implement, under IRC 401(h), a defined postretirement health benefit plan for retirees. "Excess" (staff is still researching how "excess" is defined) pension funds were transferred to the 401(h) account and used to actuarially fund postretirement health benefits. This allowed contributions to be invested and for contributions plus investment income to be used to pay retiree benefits. And, unfunded liabilities in the pension plan and 401(h) account plan could be amortized over a reasonable (actuarially sound) time horizon.

Summary

The following pages outline some advantages and disadvantages of the VEBA and 401(h) approaches and includes a summary table comparing the major features and issues of each type of plan.

Advantages and disadvantages

In addition to the general advantages shared by both the VEBA and the 401(h) approach (i.e., tax free contributions, investment earnings, and benefits), each approach also has its own set of advantages and disadvantages.

Voluntary Employee Benefit Associations

Advantages

- flexibility for trustees to specify what benefits are paid under the plan

- benefits are not limited to retirees

- the account does not need to be dependent on employment with the employer and may be made entirely portable

- employee groups may choose to participate

- administration is independent of employer or unions

- contributions to the VEBA do not count against pension plan contribution limits

Disadvantages

- requires establishment of a new employee organization and board of trustees (independent of employer or union control)

- individual employees of a group that joins a VEBA may not "opt out"

- requires IRS qualification (determination letter); and, some analysts are concerned that the tax laws are not well enough defined to take the "risk" of an unfavorable IRS determination

IRC 401(h) Accounts

Advantages

- plan is administered under an existing board of trustees (i.e., the pension plan board) so no new administrative structure is needed

- excess pension plan assets may be

Disadvantages

- contributions to the plan count against contribution limits to the pension plan

- benefits obligations are subordinate to the pension plan obligations

used as a funding source	- tax qualification issues related to the 401(h) accounts may jeopardize qualification of the entire pension plan

Summary table comparing VEBA and 401(h) trust accounts

FEATURES/ISSUES (Similarities/Differences)	VEBA	401(h)
Governance of Trust Fund (different)	- IRC sections 501(c)(9) and 419 - applicable state law - set up as separate trust funds for members of an *employee group* - administered under its own board of trustees, must be independent from employer control	- IRC 401(h) - applicable state law - set-up under and *subordinate to a defined benefit* (DB) pension plan - administered by the DB plan's board of trustees
Employer contributions and tax advantages (same)	- Employer contributions made pre-tax (no FICA) - Earnings accrue tax free - Benefit payments not taxable	- Employer contributions made pre-tax (no FICA) - Earnings accrue tax free - Benefit payments not taxable
Employee contributions (different)	After tax	After tax — *unless* IRS rules that employer "picks up" the contribution under IRC 414(h)
Coordination with pension plan (different)	No	Yes - contributions count against pension plan limits

FEATURES/ISSUES (Similarities/Differences)	VEBA	401(h)
Accounting and investment of funds (similar, but?)	- Individual medical expense accounts - Employees may direct investments among options (like a DC plan or 457 deferred comp plan) (Staff has not answered: Can *employers* control investments?)	- Individual medical expense accounts for accounting purposes only - Assets are be pooled and invested with DB plan assets (Staff has not answered: Can *employees* control investments in a DC arrangement?)
Benefits payable (same)	- expenses related to sickness, accident, hospitalization, and other eligible medical expenses, *including Medicare B premiums and premiums for life or medical insurance* (if premium is not paid for by employer benefit package)	- pays benefits related to sickness, accident, hospitalization, and other medical expenses *(presumably insurance premiums, too*)
Who is eligible for benefit payments? (different)	Active employees, retirees, spouses, dependents, and beneficiaries	Retirees and their spouses, dependents, or beneficiaries
Other allowable contributions (different, ?)	Value of unused sick leave or termination pay may be contributed to the VEBA instead of employee receiving a taxable lump sum cash out	Excess DB plan assets may be transferred to the 401(h) trust under certain circumstances. *Staff has not ascertained whether unused sick leave or termination pay could be rolled into the 401(h)

Options

If the Subcommittee would like to move forward in its examination of retiree health benefits, a few options may be worthy of consideration:

<u>OPTION A</u>: Hire a consultant this interim or next interim.

OPTION B: Ask an agency to develop legislation this interim or next interim.

OPTION C: Ask staff to continue to research the Subcommittee's questions.

March 31, 2000: *Subcommittee elected to pursue OPTION A, subject to SAIC Chairman's approval, to ask a consultant to talk to full SAIC and to give more detailed information on VEBA, 401(h), or other options available for financing retiree health costs.*