

ISSUES IN RETIREE HEALTH COVERAGE

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INTRODUCTION

The promise of retiree health coverage, long a mainstay through government and private – public sector employer support, is in rapid decline. For private employers the decline started in the 1990s with FASB 106 (Financial Accounting Standards Board). For public employers, it will be the GASB 45 (Government Accounting Standards Board) requirement that becomes effective in employer plan years after December 2006.

The need for retiree health coverage, however, has never been greater. Health care increases outstrip wage and CPI increases regularly. Retirees are most vulnerable because of their fixed incomes and numerous other critical factors:

- Retirees, age 65 and older, consume health care 3-4 times more than their preceding age group (55-64). New medical technology and pharmacological treatments represent the highest cost components of coverage.
- Coverages in rural areas often lack HMO options, have smaller provider networks and are less competitive for discounts.
- Retirees who relocate to other metropolitan areas outside their employer's area are unlikely to have HMO coverage even if HMO plans are available because of the dismantling of nationwide HMO networks.

The identification of health care as the new fourth leg of successful retirement planning by AARP is not coincidental. It recognizes the growing importance of accounting for retiree health coverage in total retirement planning.

BACKGROUND

After passage of Medicare in 1965, the growth of employer sponsored retiree health coverage expanded considerably during the years from 1965 to 1990. The 1973 HMO Act introduced more affordable options. The Medicare + Choice legislation expanded this trend by allowing health plans to compete with traditional Medicare, using less expensive HMO coverage. Early plan designs featured more benefits and less cost.

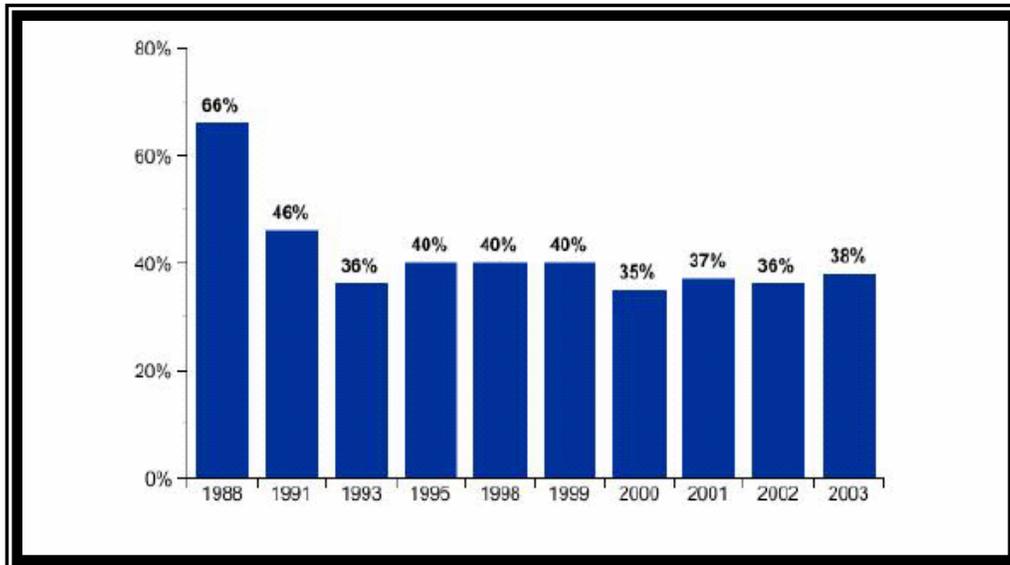
Unfortunately, advances were not sustained. The Balanced Budget Act of 1997 capped Medicare increases and drove health plans to reduce benefits, increase premiums and terminate coverage in less profitable (usually more rural) areas. In the period from 1997 to 2002, nearly 4 million retirees were forced back to Medicare.

TRENDS IN PRIVATE SECTOR EMPLOYER COVERAGE

The two primary culprits of reductions in retiree health coverage were: 1) escalating health costs and 2) FASB 106, which required private sector companies to “book” the actuarial liability

of employer paid retiree health coverage. Because of the cost, private sector organizations reduced or dropped retiree coverage entirely.

In the years between 1988 and 2003, 30% of employers terminated coverage or transferred primary financial responsibility to retirees.



Percentage of All Large Firms (200 or More Workers) Offering Retiree Health Benefits, 1988-2003 – Kaiser Family Foundation

TRENDS IN PUBLIC SECTOR EMPLOYER COVERAGE

Public sector employers maintained retiree health coverage partly due to labor's emphasis on retention and the absence of comparable accounting requirements.

Nevertheless, continued increased health costs have placed nearly unsustainable burdens on public employers. The implementation of GASB 45 will further erode public employers' ability to provide coverage. These changes come on the heels of serious state and federal political pressure on public sector employers to replace defined benefit with defined contribution retirement plans.

The likely result of all these trends is reduced government and employer support for retiree health and increased importance of individual preparedness for retiree health financial planning. Individuals are likely to need to be responsible for both retiree health and pension planning.

GROWTH OF RETIREMENT HEALTH ACCOUNT MODELS

Numerous models may assist employers and retirees with the accumulation of assets for retiree health expenses. Most existing models incorporate post employment use. New models are also emerging to help address the issue. The following is a sample of employer options and the characteristics of the models.

TYPES / CHARACTERISTICS OF MODELS

There are various plan types that can be used for retiree health expenses. Each of these plans has differing characteristics, and each plan document from employer to employer contains varied language. While Archer Medical Savings Accounts (MSAs) and Rabbi Trusts fall into this category, we will not discuss them as they are relatively rare in the public sector marketplace, and MSAs are only for employers with less than 50 employees.

The existing models include:

- **Voluntary Employee Beneficiary Association (VEBA)**
- **401(h) Qualified Health Accounts**
- **Section 115 Integral Trust**
- **HRA – Health Reimbursement Arrangement**
- **HSA – Health Savings Account**

VEBA – Voluntary Employee Beneficiary Association

There is nothing voluntary about VEBAs. The purpose of a VEBA is to allow tax-free contributions to be made by the employer to a trust for the benefit of an eligible employee to be used for the reimbursement or payment of qualified medical expenses when an eligible employee has satisfied the employer's retirement age and service requirements. VEBAs are generally set up within the meaning of Internal Revenue Code Section 501(c)(9). It is common for funding to come from a mandatory percentage of pay for all participants as negotiated between the employer and a union as well as accumulated sick leave and vacation pay upon separation from service.

VEBA characteristics include:

- Employer contributions are on a pre-tax basis
- Employee contributions are mandatory based upon eligibility on a pre-tax basis
- Voluntary employee contributions may be allowed on a post-tax basis
- No limits on annual contributions
- Distribution
 - Eligible medical expenses, usually as defined in Section 213(d), are tax free
 - No ineligible expenses can be paid from the plan or the plan will be invalidated
 - In-service distributions may be allowed
- At Death
 - The individual account can be used to pay eligible medical expenses of beneficiaries (who are usually Section 152 tax dependents)
 - After beneficiaries die, all remaining assets in the plan go back to the plan

Section 401(h) Qualified Health Accounts

Section IRC 401(h) plans are generally associated with funding of retiree health benefits through a defined benefit plan. While Section 401(h) plans can be part of defined contribution plans, they are the only method of providing medical benefits in a pension plan. Section 401(h) plans

generally follow the characteristics of a VEBA, however funding of the Section 401(h) plan is limited by the funding of the pension benefit to the defined benefit plan.

Section 401(h) characteristics include:

- Contributions are limited to 25% of total contributions or 33-1/3% of Section 401(a) retirement plan contributions
- Employee contributions are mandatory based upon eligibility and are pre-tax
- Voluntary employee contributions may be allowed on a post-tax basis
- Funding is generally limited to 25% of normal cost with a catch up feature
- Distribution
 - Eligible medical expenses, usually as defined in Section 213(d), are tax free
 - No ineligible expenses can be paid from the plan or the plan will be invalidated
 - No in-service distributions are allowed
 - In a defined benefit model, usually only health insurance premiums are paid
- At Death
 - The individual account can be used to pay eligible medical expenses of beneficiaries (Section 152 tax dependents)
 - After beneficiaries die, all remaining assets in the plan go back to the plan

Section 115 Integral Trust

This option has been very attractive to public sector employers. Flexible funding has been the hallmark of these plans; employees are allowed to make an irrevocable election to participate in the plan, eliminating the need for mandatory participation by eligible employees.

Section 115 Integral Trust characteristics include:

- Contributions are made pre-tax if the employee irrevocably elects to participate
- Voluntary employee contributions may be allowed on a post-tax basis
- Distribution
 - In-service distributions may be allowed
 - Eligible medical expenses, usually as defined in Section 213(d), are tax-free
 - De minimis distribution may be in the plan document, however, the IRS has recently ruled that de minimis distributions may not be allowed
- At Death
 - The individual account can be used to pay eligible medical expenses of the surviving spouse and dependents
 - After the surviving spouse and dependents die, all remaining assets in the plan go to the named beneficiary on a taxable basis. (Note: Based on the recently-issued Revenue Ruling 2005-24, it may no longer be acceptable for death benefits to be paid to named beneficiaries.)

HRA – Health Reimbursement Arrangement

HRAs have been available for several years as an option generally associated with employers' health plan self-funding models. The most common health plan design incorporates the use of a "high deductible health plan" (HDHP); however there is no requirement for a HDHP.

HRA characteristics include:

- Employer contributions only; no contributions can be made on a mandatory or voluntary basis by employees
- Distribution
 - Eligible medical expenses, usually as defined in Section 213(d), are tax-free
- At separation of service, all assets will revert back to the employer
- No limits on annual contributions
- The amount of employer contributions is usually limited to the health plan deductible by the employer

HSA – Health Savings Account

Health Savings Accounts were authorized by the Medicare Modernization Act of 2003. This Act is more notable for the Medicare prescription drug benefits, Medicare Part D. HSAs have been a radical departure from the other models mentioned above, primarily because the government has recognized a need for individuals to fund for future medical expenses today. As discussed above, it is clear that retiree health care costs are expanding exponentially and government's ability to keep up with the pace is unrealistic. Therefore, the introduction of HSAs has been subject to enormous help from the Department of Treasury and is a further sign that the current administration is using the tax code to promote individual medical savings.

HSA characteristics include:

- Use of "high deductible health plans" (HDHP) except for preventative coverage
- Employer and employee contributions are permitted
- Provides another way to pay current and/or future medical expenses
 - Accepts only cash contributions
 - Only for minimum HDHPs of \$1,000 Individual / \$2,000 family and maximum HDHPs of \$2,650 Individual / \$5,250 Family for 2005. (NOTE: These amounts are indexed annually for inflation.)
 - HDHP Out-Of-Pocket Expenses Capped at \$5,100 Individual / \$10,200 Family* for 2005
- HSA Qualified Expenses
 - Medical Expenses defined under Section 213(d)
 - The only health insurance premiums that qualify are:
 - COBRA continuation premiums
 - Qualified Long Term Care premiums
 - Medicare premiums for Medicare enrollees (except for Medicare Supplement plans)
 - Retiree medical premiums under an employer sponsored plan
 - No required distribution – assets may be passed on to beneficiaries
- If over age 55, additional contributions to the HSA of \$600* annually are allowed as a catch-up provision.

- HSA Taxation
 - Employee contribution is tax deductible without itemizing
 - Employer contribution and salary reductions are not subject to Federal Income Tax or FICA (individual states may not recognize HSA contributions)
 - Earnings on the accumulation of account balances is tax free
 - Qualified medical expense distribution is tax free
 - Non-qualified distributions are subject to taxation in addition to a 10% excise tax unless the employee is age 65 or older
 - Many state laws do not conform with the federal HSA taxation rules and, therefore, distributions may be subject to individual state taxation

**RETIREMENT HEALTH ACCOUNT MODELS
HIGHLIGHTS OF CHARACTERISTICS**

Characteristics	VEBA	§401(h)	§115 Trust	HRA	HSA
ER and/or EE pre-tax contributions?	EmployER	EmployER	EmployEE	EmployER	EmployER: pre-tax EmployEE: tax-deductible
Pre-tax contributions—Group or individual decision?	Group	Group	Individual and irrevocable	Group	EmployER: group EmployEE: individual
EE post-tax contributions allowed?	Yes	Yes	Yes	No	Yes (tax-deductible)
Funding Limit	None	25% of DB plan contributions	Limited to 25% of total contributions or 33-1/3% of 401(a) retirement plan contributions	None	Capped at \$2,650 for individuals, \$5,250 for families in 2005. Inflation adjusted annually
Distributions—In-service or post-employment?	Both	Post-employment	Post-employment	In-service	Both
Funds “belong” to...	EmployEE	EmployEE	EmployEE	EmployER	EmployEE
At participant’s death, assets...	...may be used for beneficiaries’ eligible expenses	...may be used for beneficiaries’ eligible expenses	...may be used for spouse and dependents’ eligible expenses	...revert back to the employER	Continue to designated beneficiaries

TOWARD A NEW MODEL

Each of the models discussed above has various strengths and weaknesses. The new features that should be incorporated into health coverage for the future need to address the inflexibility that current active employees have to save for their current and/ or future medical needs.

The current federal administration and Congress have recognized the need for individuals to save for these future expenses and the lack of government funding that is going to be available. The latest model, HSA, has been aggressively promoted by the Department of the Treasury. This is another indicator that by using personal tax incentives to promote current and future medical expenses, employees will be more likely to save for their own benefit.

Acknowledgments:

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