

NATIONAL ASSOCIATION OF STATE PERSONNEL EXECUTIVES

“HR IN THE HEARTLAND”

2002 CONFERENCE

“HIGH PERFORMANCE PLANS”

***INNOVATIONS ON SERVICE PURCHASES,
RETIREE MEDICAL AND LEAVE CONVERSION***

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Employer Dollars

Defined Contribution
Qualified Plan
401(a)

Individual Accounts for Each
Employee

Cash Distributions to Retiree

Advantages

- Flexibility – account can be used for anything retiree wants, no limits on usage
- Can be structured to allow options for payout at terminal event, e.g., lump sum or installment payments.
- Will have market earnings (compounding) on account pre-retirement on tax-sheltered basis. May continue this tax sheltered compounding post-retirement if plan allows for installment option.
- Likely this plan can achieve higher earnings, especially if centrally managed portfolio
- Must be funded pre-retirement.

Disadvantages

- Distributions from plan will be taxable, regardless of usage, e.g., if retiree uses distributions for medical coverage, payments will still be taxable.
- Cannot be funded post-retirement.

- Formula for funding can be based on unused vacation days for year, or unused sick days for year, or combination thereof (or other factors if desired). Can use this as “accumulator” vehicle for sick leave conversion plan.
- Formula for funding can be match to _____ 457 plan contributions. Can limit match by \$ or by %.
- Can “vest” new plan account immediately or only at specified retirement times (e.g., Rule of 85, 60 + 15 or 65 + 10) or anywhere in between.
- Portability – under new federal laws, account can be rolled-over post distribution to variety of other retirement vehicles (e.g., 457 deferred compensation plan). Vehicle for EGTRRA (Economic Growth and Tax Relief Reconciliation Act of 2001) flexibility.

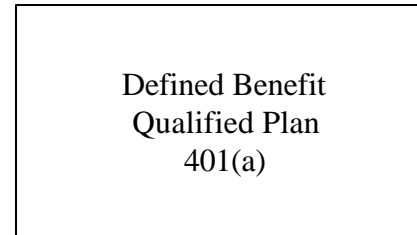
Process

- Determine whether statutory change is needed.
- Create new plan.
- Establish funding obligation.
- Determine how this fits with defined benefit plan and any existing deferred compensation or defined contribution plan.
- Potentially could utilize existing administrative structure.

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Employer Dollars

Employee Dollars



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Benefits to Employees

Advantages

- Unlimited usage – flexibility – benefits can be used for anything retiree wants, no limits on usage.
- Can be structured to allow various options for payout at retirement. Innovations in this area include partial lump sum options and deferred retirement options (DROP).
- May accommodate many innovative benefit “buy-ups” – allowing employees to purchase additional years of service or enhanced benefit formula, or earlier retirement _____

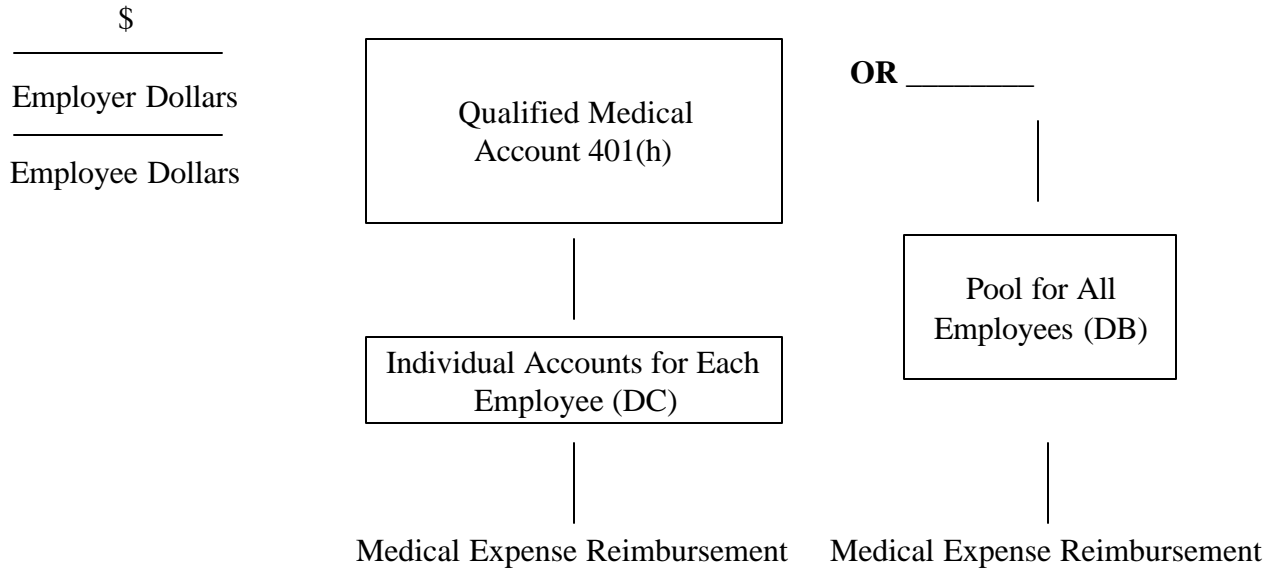
Disadvantages

- Long term commitment in funding.

- IRS has approved many “buy-ups” on pre-tax (picked-up) basis.
- Can allow direct transfers to purchase permission service credit from 457 plan or 403(b) program.
- Portability – under new federal law, certain distributions can be rolled over (from this Defined Benefit plan and to this Defined Benefit plan).
- Generally, centrally managed portfolio, which is generally best returns.

Process

- Review existing defined benefit plan.
- Consider possible desirable enhancements and cost thereon.
- Secure IRS ruling if design calls for pick-up of employee contributions to “buy-up.”
- Consider whether statutory _____ is needed.



Advantages

- The only method whereby a qualified pension plan can provide medical benefits.
- Can carry account balance from year to year – not on an annual “use it or lose it” basis.
- Does not have coverage issues that exist in VEBA.
- Can be invested with general pension fund assets (could produce lower administrative expenses and higher returns).
- Can allow for employee contributions.

Disadvantages

- Limited usage – distributions may only be made for qualified specified medical expenses. No 401(h) account monies may be used to fund retirement benefits.
- The benefits that are provided must be medical care (as defined in Code Section 213(d)(1)) for retirees, spouses, and dependents. Benefits may be provided under a self-insured arrangement or through the purchase of insurance contracts. The eligible dependents must be limited to those eligible to be claimed as a dependent on the retiree’s income tax return.

- Payments to and distributions from 401(h) account are not taxable to employee/retiree.
- Employer can fund pre-retirement.
- Would not need to integrate with existing health coverage/structure. Will need to integrate with existing retirement structure.
- Formula for funding could be based on number of factors (e.g., days unused each year)
- Contributions to the Code Section 401(h) accounts may be required from the employer, from the employee, or from both. Treas. Reg. § 1.401-14(b)(3). Contributions to the Code Section 401(h) accounts need not be made on a basis similar to those made to fund the retirement benefits portion of the plan. Id. It appears the commitment to fund could be structured as a flexible annual decision, which would allow an employer to make contributions in one year but not in another.
- The benefits must be described in the plan, and the plan must also contain provisions for determining the amount to be paid. Treas. Reg. § 1.401-14(c)(1). The IRS has ruled that the terms of the plan must also specify the time period with respect to which the benefits will be paid. PLR 9652021.
- Retirees may not elect to receive cash in lieu of medical benefits.
- Unlikely to have employee investment direction on these accounts.

- IRS imposes limits on funding 401(h) accounts. Benefits, when added to any life insurance protection provided for under the plan, must be “subordinate” to the retirement benefits provided by such plan. Code Section 401(h)(1); Treas. Reg. § 1.401-14(c)(1)(i). The benefits will be treated as being subordinate to the retirement benefits if at all times the sum of the aggregate actual contributions for medical benefits (made after the date on which the plan first includes such medical benefits) and the actual contributions for life insurance protection under the plan does not exceed 25% of the total aggregate actual contributions to the plan (made after such date other than contributions to fund past service credits. (See also PLR 9652021 and PLR 98340371.
- Code Section 401(h) benefits are available only for retired employees, their spouses, or their dependents. Treas. Reg. § 1.401-14(b)(1). An employee is “retired” if he/she either is eligible to receive retirement benefits provided under the plan or has been retired by the employer due to permanent disability.

Process

- A separate account must be established and maintained for Code Section 401(h) benefits. Code Section 401(h)(2); Treas. Reg. § 1.401-14(c)(2). This separation requirement is for record keeping purposes only – there is no requirement of a separate account for each employee. Treas. Reg. § 1.401-14(c)(2). Code Section 401(h) monies may be invested with retirement plan monies. However, investment earnings must be allocated on a reasonable basis.
- Secure updated IRS determination letter request on amended structure.
- Code Section 401(h)(5) and Treas. Reg. § 1.401-14(c)(5) require that upon the satisfaction of all liabilities under the plan to provide Code Section 401(h)(5) benefits, any amount remaining in the Code Section 401(h) accounts must, under the terms of the plan, be returned to the employer.

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Employer Dollars

Health
Reimbursement
Arrangement (“HRA”)

Individual Accounts for Each
Employee

Medical Expense Reimbursement

Advantages

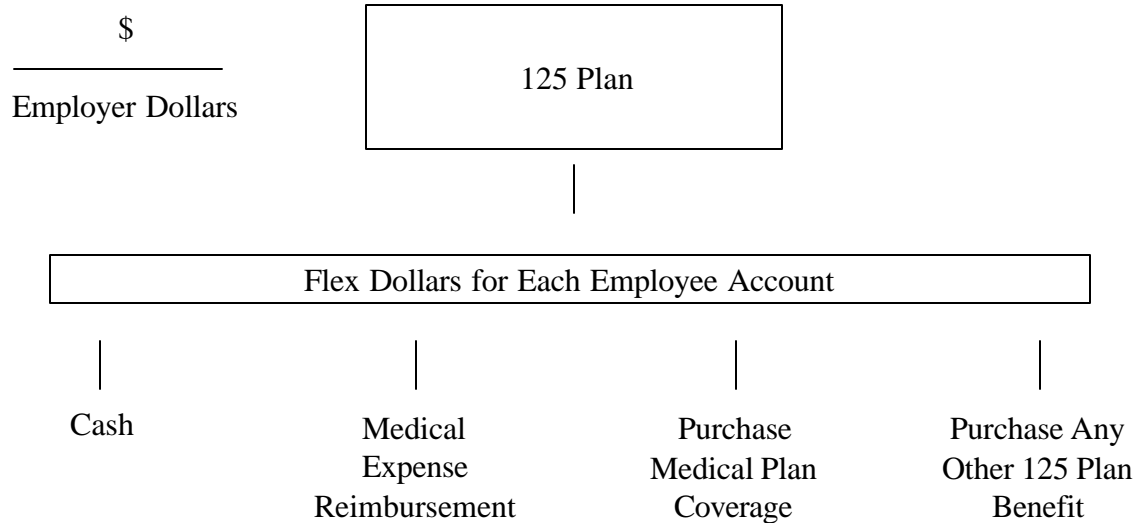
- Payments to HRA are not taxable to employee. Benefits from HRA are not taxable to employee when paid.
- Many carry HRA unused balance over from year-to-year. Not on a “use it or lose it basis”.
- Can also be maintained after termination or retirement.
- Can pre-fund during working career.

Disadvantages

- Limited usage-distributions may only be made for substantiated qualified medical expenses. May be used for premiums for accident or health coverage for current employees, retirees and COBRA beneficiaries.
- May not be used to fund general retirement benefits and may not be cashed out.
- Need maximum dollar amount that may be used in a “coverage period”.
- Will be subject to COBRA requirements.

Process

- Newest approach requirements set out in IRS Revenue Ruling 2002-41 and IRS Notice 2002-45 (June 26, 2002).
- Would need to coordinate with group health program.
- Check statutory changes needed.
- Determine best administrative structure.



Advantages

- Payments to 125 Plan are not taxable to employee. Benefits from 125 Plan would be taxable only if retiree elected cash, rest would be non-taxable.
- Flexibility – allows retirees with flex dollars to receive cash if they do not need other 125 Plan benefits, or to use for other 125 Plan benefits (not necessarily limited to medical).
- May have “deemed” elections for employees (Revenue Ruling 2002-27).

Disadvantages

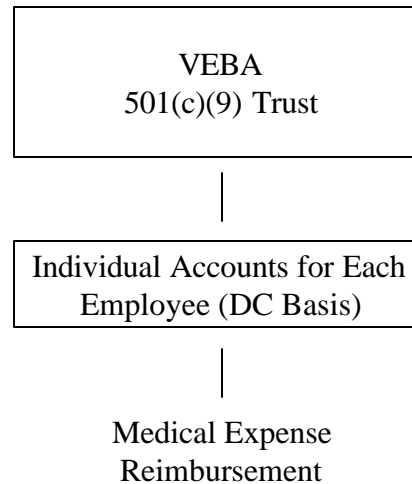
- Can only work on year-to-year basis – may not carry flex dollar account from year to year – “use it or lose it” requirement.
- Could not pre-fund during working career – can only fund on year-to-year basis.
- Amount going in on annual basis must be reasonably related to nontaxable benefits available under 125 Plan.
- Must be part of 125 Plan with active employees.
- Once flex dollars elected to medical reimbursement account, may only be used for medical expenses.

Process

- Amend existing 125 Plan to include retirees and employer “flex” dollars. [IRS does not permit a 125 Plan solely for retirees.]
- Check statutory changes needed.
- Determine best administrative structure.
- Need to consider securing IRS ruling on extension to retirees.

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Employer Dollars



Advantages

- Can carry account balance from year to year – need not be on an annual “use it or lose it” basis.
- Payments to and distributions from VEBA would not be taxable to employee/retiree.
- Employer can fund pre-retirement, but is not required to pre-fund retiree medical accounts.

Disadvantages

- Limited usage – may only be used for certain specified purposes (e.g., medical expenses). The benefits provided through the VEBA must be to safeguard or improve health, or to protect against a contingency that interrupts or impairs earning power. Treas. Reg. § 1.501(c)(9)-1(c) and 3(d).
- Retirees may not elect to receive cash.

- Formula for funding could be based on cash out value of certain accumulated days at retirement (e.g., Washington State). The IRS has held that unused sick, vacation or severance amounts may be contributed to a VEBA to fund post-retirement benefits. PLR 9507009 and PLR 9340054.
- In addition to contributions by an employer, employees may also make after-tax contributions, but they cannot be “picked-up” under Code Section 414(h). See PLR 9507009; Thrasher, et al., Options for Funding Retiree Medical Benefits Available to Tax-Exempt and Government Employers, ALI-ABA Course of Study, Washington, D.C., September 14-16, 2000.
- May need to include active population to some extent. However, the IRS has also ruled that a retiree-only plan may qualify if it provides benefits previously provided to retirees when employed, so long as the benefits are funded over their working lives. PLR 9151027. In any event, the VEBA would need to integrate with existing health structure.
- Account must be “vested” when funded, but only for limited usage purposes.
- Would likely need new administrative structure.
- Will have certain IRS filing and reporting requirements (see below).

Process

- Create new trust.
- Determine whether statutory change is needed.
- Note: assets may never revert to the employer, but may be transferred to another exempt VEBA which provides similar benefits to the same group of employees. See IRS General Counsel Memorandum 39052. Assets may be distributed to VEBA members upon termination of the VEBA if the allocation of assets is based on an objective, nondiscriminatory formula that does not disproportionately benefit highly compensated employees. Treas. Reg. § 1.501(c)(9)-4(d); PLR 8925091.
- Integrate with existing health coverage/structure.
- Secure IRS ruling on proposal. In order to obtain tax-exempt status, a VEBA must obtain IRS approval. Code Section 505(c). Consequently, the mere creation and funding of an organization designed to operate as a VEBA does not make the organization tax-exempt; rather, a VEBA must submit a properly completed and executed Form 1024 to the district director of the Internal Revenue Service for the key district in which the VEBA's principal place of business or office is located. Code Section 505(c)(1); Temp. Treas. Reg. § 1.505(c)-1T(A-6).
- A VEBA is also required to maintain various records regarding contributions and benefits, and, like other exempt organizations, must file an annual return with the IRS. Treas. Reg. § 1.501(c)(9)-5(a); Code Section 6033(a). However, there may be an argument that a governmental VEBA with exempt status under Code Section 115 could be exempt from the annual Form 990 requirement. PLR 9506037.
- Must consider unrelated business taxable income issues, Code Sections 419A, 511-514, PLR 9640025, PLR9507009, PLR9139003.