

# Local governments and unions find creative solutions for retiree healthcare plan financing

## Healthcare cost is everyone's problem

The rising cost of medical care has become a national issue if not obsession over the last decade, as well it should. One part of the problem is the increasing number of retirees every year and the inevitable questions concerning the adequate funding of Medicare. In response, many unions, cities and school districts have been working in collaborative and innovative ways in focusing on the issue of affordable, post-retirement medical coverage. Many are implementing plans that are funded through a contribution negotiated at the collective bargaining table in order to provide a **lifetime stream** of monthly payments to pay for retiree medical costs such as insurance premiums and certain medical expenses. Note that unlike some "account" programs or similar, this type of plan provides **lifetime benefits**, an extremely important aspect of retirement planning.

Retiree medical reimbursement plans offer a valuable new tax-favored benefit for employee groups. These plans have gained increasing popularity over the last five years, particularly in the public sector where employees often stay with the same employer (*e.g.*, the same school district or the same municipality) for many years, an important consideration for plan funding *and* retirement planning.

## Plan design

The plan can be designed to cover the following types of expenses:

- ♦ Premiums: Reimburses the retiree for health care premiums, *e.g.*, health insurance, dental insurance, Medicare supplement policies, vision care, or prescription drug insurance policies.
- ♦ Medical expenses: Reimburses the retiree for miscellaneous medical expenses, *e.g.*, eyeglasses, hearing aids, deductibles, or drugs, generally those expenses set forth in IR publications, such as [IRS Publication 502](#).

## Operation, features and GASB liability considerations

Contributions are made into a trust fund during employment of active employees. Usually, this is done through collective bargaining or a special agreement with the employer; the parties agree that a defined contribution will be made to a retiree medical fund. Sick leave cashouts on retirement could also be deposited in an individual account, tax-free. After retirement, employees can draw on the fund for payment of medical expenses or premiums. The trust is controlled and administered by a Board of Trustees, composed of members of the sponsoring employer or employee organization. The Board designs the plan, selects investment vehicles, decides on distribution options and the like.

Note that through participation in a retiree medical trust, a local government may very well avoid the reporting obligations for a defined benefit retiree health plan under the Government Accounting Standards Board Statement No. 45.

### **Maximum tax advantages**

A retiree medical plan can offer one or more of the following tax advantages, depending on how it is structured:

#### **Employers**

Local governments and other employers may avoid payroll taxes on the contributions, which they generally would be required to do if the amount were paid in salary, unless of course the group is not participating in Social Security.

#### **Employees:**

Contributions can generally be deposited pre-tax and earnings on the contributions may be tax-exempt. As with any employee benefit trust that gains tax-exempt status under the Internal Revenue Code, these funds can realize significant investment earnings, none of which are taxed. This makes the plan an attractive alternative to an individual employee's own savings plan, where the earnings generally are taxable.

#### **Retirees:**

Benefits received from the plan may be tax free to the retiree. When the retiree eventually takes benefits from the plan to pay for premiums or miscellaneous medical expenses, the plan can be structured so that the money (although usually received as cash) is not taxable income to the employee.

In effect, a small portion of pre-tax salary is designated to be used *after* retirement for *non-taxable* medical benefit payments from the plan. These arrangements are often called "salary conversion" plans, because the employee is converting a piece of salary into a retiree medical benefit. The tax savings and long term earnings often produce an average lifetime benefit distribution amount of roughly four times the amount contributed to the plan, per employee, over the course of an average retirement.

### **Special considerations**

No individual choice is permitted in participation. Note that a retiree medical plan differs from a cafeteria plan where each employee can elect whether to take certain salary amounts, either in cash or in tax-favored benefits.

*Instead, the entire employee group must participate in the retiree medical plan.*

### **Individual account option**

Although all members of the bargaining unit must participate in the plan, it can nonetheless be designed so that individuals can maintain their own accounts. This is most appropriate when the bargaining agreement includes a sick leave cashout provision on retirement. Such amounts can be contributed to an individual account set

up specifically for that retiree. There is no “use-it or lose-it” rule as in a cafeteria plan. Instead, a carryover of the account balance, from year to year, is allowed.

### **Survivor benefits**

The plan may allow continuation of the health reimbursement benefits to surviving spouses, domestic partners and children. However, note that a death benefit of unrestricted cash is not allowed and could jeopardize the tax breaks described above.

### **More information**

Details on this innovative type of benefit can be obtained by contacting one of our partner consultants, Shana Saichek, at: [saichek@carneylaw.com](mailto:saichek@carneylaw.com) or at 800 551-4174.



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