CREATING A RETIREE MEDICAL TRUST:

A Fresh Look at a Proven Solution

How Employers and Employees Can Use Pre-Tax Dollars to Fund Their Retiree Medical Expenses

2022 Edition

National Conference on Public Employee Retirement Systems
The Voice for Public Pensions

National Conference on Public Employee Retirement Systems
The Voice for Public Pensions

CREATING A RETIREE MEDICAL TRUST:

A Fresh Look at a Proven Solution

How Employers and Employees Can Use Pre-Tax Dollars to Fund Their Retiree Medical Expenses

2022 Edition

TABLE OF CONTENTS

ACKNOWLEDGMENTS

This report is the result of many hours of work by several individuals. The National Conference on Public Employee Retirement Systems (NCPERS) appreciates the special contribution of Shana Saichek, Of Counsel with The Wagner Law Group. Ms. Saichek has nearly 40 years of experience providing legal advice to employee benefit plan sponsors in the public and private sectors. She is the leading attorney in establishing and developing the legal structure of retiree medical trusts and has assisted dozens of public sector entities in their implementation.

The Wagner Law Group (www.wagnerlawgroup.com) is one of the largest employee benefits law firms in the country, with nearly 50 lawyers and offices throughout the country. The firm counsels on all facets of employee benefits law, including fiduciary compliance, retirement plans, governmental plans, voluntary employee beneficiary associations, executive compensation, welfare benefit plans, retiree medical trusts, Taft-Hartley plans, Pension Benefit Guaranty Corporation and bankruptcy, and others. Many of the firm's attorneys have represented public and private sector benefit plan trustees for decades, advising fiduciaries on plans ranging from a small single union firefighters' retiree medical trust to multimillion-dollar multiemployer and governmental plans.

Additional thanks to Ms. Debra Cope of Cope Financial PR for reviewing the draft and providing her wordsmithing skills and to Mrs. Amanda Rok, NCPERS communications & social media manager, for shepherding this report through the publication process.

Hank Kim, Esq.
Executive Director & Counsel
April 2022

LEGAL DISCLAIMER

The information contained in this publication is provided as a service to NCPERS members and the public pension community, and it does not constitute legal advice. We offer quality, accurate information but make no claims, guarantees, promises, or warranties about the timeliness, completeness, or adequacy of the information contained in this publication. Because legal advice must be tailored to the specific circumstances of each case and laws are constantly changing, nothing provided herein should be used as a substitute for the advice of competent counsel.

INTRODUCTION

Retirement is a vulnerable time, and one of the biggest fears plaguing Americans is whether they will be able to meet health care costs in their later years. These concerns are well founded: The cost of health care has outstripped economic growth for several years, and experts expect this trend to continue for the foreseeable future (see chart 1 on page 8).

It's no surprise, then, that employers find managing the future healthcare costs of retirees to be a vexing challenge.

State and local government pension systems, many of which offer retiree health care as a cornerstone benefit, continue to wrestle with the implications. Rapidly rising healthcare costs could compromise the pension benefits of current and future retirees and destabilize the very retirement security that pensions strive to provide. As risks mount, public pension systems intensify their search for solutions.

One existing solution, retiree medical trusts (RMTs), has already proved attractive to many public sector employers and unions as a way to provide meaningful help to retirees. RMTs serve as a tax-favored method to help employers and employees earmark savings for eventual healthcare needs. Like pensions, RMTs harness the power of collective investing to provide income in retirement—in this case, for the specific purpose of defraying medical expenses.

Fifteen years have passed since the NCPERS Task Force on Health Care Benefits first declared RMTs a sound method for managing medical costs. The 2006 report "Creating a Retiree Medical Trust" identified RMTs as a single, cost-effective solution to the issue of rising retiree medical costs.

Taking Care of Retiree Health Expenses: A Timeline

1990s Local police associations in California establish retiree medical trusts (RMTs), funded by contributions negotiated through collective bargaining.

1999 Washington State Council of Firefighters establishes statewide trust for any firefighter local to join.

2002 NCPERS establishes Task Force on Health Care Benefits.

2001-2002 Several general employee unions of cities form citywide RMTs for all unions of the municipality.

2003 NCPERS Task Force issues *first report* on health care benefits, defining the challenges from the public perspective and making 25 specific recommendations.

2004 NCPERS Task Force issues second report on health care benefits, including findings of a member health benefits survey.

2004 Community college in California creates RMT for participation of any colleges in the state.

2006 NCPERS publishes "Creating a Retiree Medical Trust," and encourages plan sponsors to investigate every responsible strategy to manage healthcare costs.

2006 Nurses union in New England starts RMT.

2007 Plan design of RMTs evolves to allow monthly benefit plus an individual account for sick leave transfer.

2008 Peace Officers Research Association of California establishes statewide RMT for any member police association to join.

2010s Many public sector unions and cities in California create or join RMTs. Mergers occur between smaller RMTs to form regional RMTs for economies of scale. One statewide trust in California offers participation to any cities in the state for public safety and non-public safety.

2016-2019 Police unions in Midwest and New England start RMTs.

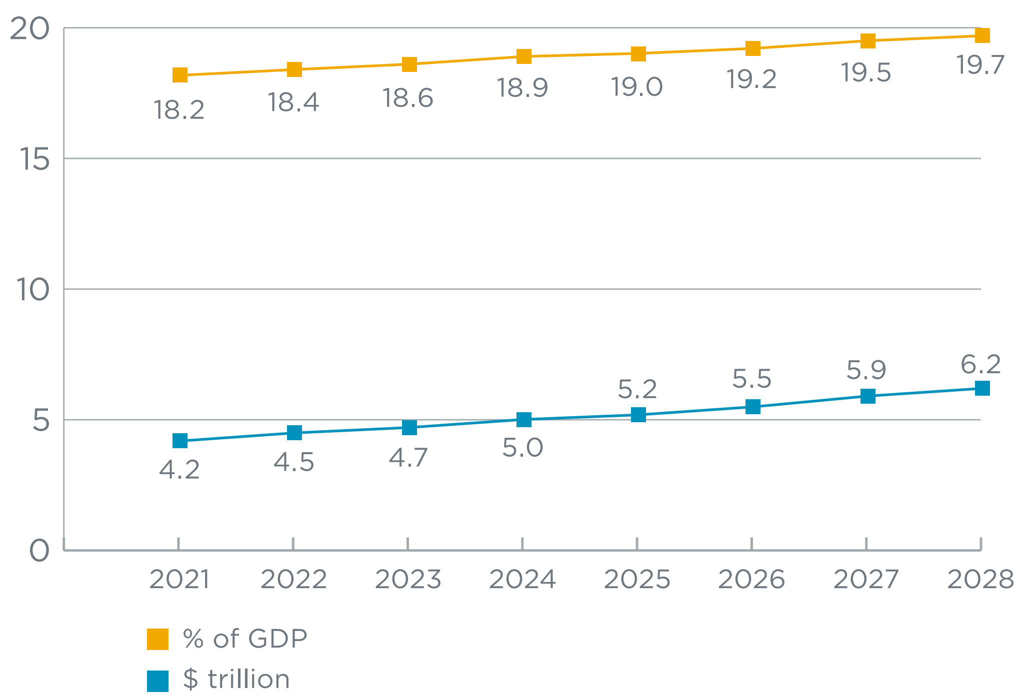
2021 By this time, most trusts (except those just implemented) are paying benefits to retirees, ranging from $150 to $1,270 per month, depending on level of contributions, investment earnings, plan design, etc.

The cost of health care has outstripped economic growth for several years, and experts expect this trend to continue for the foreseeable future.

Since that report in 2006, RMTs have been adopted on a limited scale, predominantly on the west coast. This 2022 update examines the advantages and mechanics of RMTs with a focus on the needs and concerns of public sector employers, union officials, pension plans, and plan administrators and trustees. In this report, we describe the basic operation and structure of RMTs, along with recent changes and new features.

This much is clear: RMTs throughout the country have grown and thrived, adding innovations and protections for retirees and providing powerful examples of success for pension systems that are weighing options. These trusts now pay monthly benefits ranging from roughly $150 per month to $1,300 per month (after 20 years of service) for life, plus a surviving spouse benefit. While these amounts might not be life changing and won't solve the underlying issue of controlling rising healthcare costs, they can provide public servants with added peace of mind about their ability to afford health care in retirement.

Chart 1. **Going Up: Projected National Healthcare Expenditures**



Source: 2019 National Health Expenditure Data, U.S. Centers for Medicare & Medicaid Services.

RETIREE MEDICAL TRUST: FEATURES AND BENEFITS

Definition and Features

NCPERS Task Force on Health Care believed that establishing an RMT is an effective approach to mitigating the escalating healthcare costs faced by government employers, public sector unions, and their pension systems. An RMT is a hybrid healthcare savings vehicle that has tax advantages and other features similar to both defined benefit and defined contribution pension plans (although legally an RMT is classified as a *health* plan). It can be established to help current employees, employers, or both to begin funding employee retirement medical needs. Here, we highlight some of the features of RMTs.

Fixed Contributions and a Lifetime Stream of Payment

In an RMT, employers and/or employees make fixed contributions to the trust during the active employment of participating employees. Both employer and employee contributions are permitted on a pre-tax basis so long as they are mandated for the entire bargaining unit or classification. (This is different from a cafeteria plan, which allows individual options related to participation and rates.)

RMT contributions are then pooled and held in a trust, which is a legally separate entity from the employees and the employer. The trust pays out, based on actuarial projections, a lifetime stream of monthly payments to reimburse the retiree for medical expenses, plus a benefit for the surviving spouse.

No Vesting

An RMT is a health plan, not a pension plan, and it will not be subject to pension rules. Also, unlike a pension plan, the benefit level is not vested but is variable. The trustees have the authority to raise or lower the monthly benefit level. We have seen small fluctuations, but nothing drastic, since benefit levels can be smoothed over years. Even in a time of stock market volatility, such as the 2008 stock market decline, benefit levels in RMTs dropped only about 5 percent. Moreover, these decreases were not permanent as benefit levels returned to pre-2008 levels in about two years. Even with some fluctuation, RMTs offer great value by providing benefit payments to retirees for healthcare expenses for life, similar to defined benefit pension plans.

Cover Medical Premiums and Expenses

RMTs give future retirees a lifetime of tax-free benefit payments for medical costs and insurance premiums. Insurance includes medical, hospital, vision, dental, and long-term care policies. The benefit payment can be used on individual or group medical policies, such as a spouse's group coverage and Medicare or Medigap policy premiums. Permissible expenses include any medically necessary costs incurred for the diagnosis or mitigation of disease, meaning any item deductible as a medical expense under Internal Revenue Code section 213.

Can Minimize or Avoid Government Accounting Standards Board Liability Reports

When established through consultation with the plan's accountants and attorneys, and carefully defining the contribution to the plan, employers might avoid reporting liability for the benefits under Government Accounting Standards Board rules. Even when such reporting may be advisable, the effect on financial statements can be minimized with an explanation that the benefits are not vested and can be reduced when necessary for the plan's financial soundness.

NCPERS Task Force on Health Care believed that establishing an RMT is an effective approach to mitigating the escalating healthcare costs faced by government employers, public sector unions, and their pension systems.

Unaffected by Internal Revenue Code 415 Limits

Because of their status as health plans, RMTs are not limited by Internal Revenue Code section 415 rules on the amount of annual contributions to such a trust. In general, RMTs avoid the myriad of rules applicable to pension plans such as funding, anti-cutback, and distribution requirements because of their health plan classification.

Survivor Benefits

RMTs can be designed to continue benefit payments to surviving spouses and dependents, all on a tax-free basis.

Lifetime Stream of Payments

An RMT can be set up to resemble either a defined contribution plan with individual accounts (IAs), or a pooled plan with lifetime benefits. However, the pooled plan design has advantages like a defined benefit pension, such as a monthly payment for life, rather than an IA, which could run out of money when it is most needed. Actuarial studies have consistently shown that plan participants receive greater benefits, in the aggregate, from a pooled plan than from an IA plan that received the same level of contributions over time.

Benefit Levels of Current RMTs

Chart 2. **Retiree Medical Trust Contribution & Benefit Levels**

Association	Monthly Contribution During Employment	Monthly Benefit During Retirement with 25 Years Contributions	Monthly Benefit During Retirement with 30 Years Contributions	Reduction at Medicare Eligibility	Surviving Spouse Benefit[1]
Public Safety Assoc. No. 1	Average $128	$630	$756		50% for 2 years (prior to age 53), 50% age 53–65
Public Safety Assoc. No. 2	$150	$517	$621		50%
Public Safety Assoc. No. 3	Average $192	$852	$1,023		50% for 2 years (prior to age 55), 50% at age 55
Public Safety Assoc. No. 4	Average $193	$579	$695		50% for 2 years (prior to age 50), 50% age 50
Public Safety Assoc. No. 5	$375	$1,125	$1,350	50%	100% for 2 years, 50% age 50
Public Safety Assoc. No. 6	4% of pay Average = $553	$1,100*	$1,100*		100% at age 50
Public Safety Assoc. No. 7	$120 plus approximately. $250K from annual fundraiser	$1,260*	$1,260*	50% for spouse	48% at age 45
Public Employees Assoc. No. 1	2% of pay Average = $142	$447	$537	25%	50%
Public Employees Assoc. No. 2	$217	$630*	$630*		100%
Public Employees Assoc. No. 3	5% of pay Average = $330	$782*	$782*		50%

[1] Surviving spouse benefits are generally payable for the lifetime of the surviving spouse, subject to the rules of the Plan, except as indicated in this column. Note that many plans have a so-called bridge benefit, which is paid upon the death of the employee for a short period and then resumes at the plan's normal retirement age.

* These plans cap benefit levels at 20 years of service; there is no increase after that point.

° Confidential and proprietary information, not for distribution without written permission of The Wagner Law Group. Calculations are based on data of actual clients of The Wagner Law Group, ranging from 6/1/20 to 8/1/21, and subject to change.

Source: The Wagner Law Group 2020. Boston, MA.

RMTs have been established by employers, employee organizations, or both, and these trusts are already helping active employees save for future medical costs in several jurisdictions. The chart on page 11 provides 10 examples of currently operating RMTs and their actual benefit levels. It also shows contribution levels and spousal benefits.

Benefits for Laterals

Although the benefits shown in chart 2 on page 11 are for career employees (25 years or more), RMTs also provide a benefit for employees who do not spend their entire careers at one employer. Generally, there will be a pro rata reduction of the benefit level for less than 25 years of service.

Governance and Legal Structure

Trust Administration

The trust is controlled and administered by a board of trustees composed of employee and/or employer representatives. Responsibilities of the board may include designing the RMT plan, selecting a professional investment manager and investment vehicles, deciding on distribution options, and other duties and authorities generally held by pension plan trustees.

The basic structure of an RMT is like that of a public pension plan. The RMT is established as a trust, a separate legal entity from the employer, employee associations, or unions. Composition of the governing board is left to the discretion of the settlor—the party that set up the trust (the employer, the union, or both). Options for board composition include the following:

- All labor representatives
- Joint labor–management representatives on the board
- All employer representatives on the board
- Any of the above, plus a professional trustee (e.g., a paid fiduciary or a bank trustee)

Tax Status of Trust

Tax-exempt status of the RMT is a key ingredient to the growth of the benefit level. If the trust maintains its tax-exempt status, then every dollar not spent in taxes will increase the monthly benefit level. There are two ways RMTs can obtain tax-exempt status:

1. Voluntary Employee Beneficiary Association (VEBA). An RMT established by a public sector union routinely obtains tax-exempt status as a VEBA, under Internal Revenue Code Section 501(c)(9).

2. 115 Trust. If the RMT is established by a public employer, it most likely will obtain tax-exempt status as a 115 Integral Part Trust under Internal Revenue Code section 115.[1]

Governing Law

RMTs may be regulated by federal or state law, depending on sponsorship, administration, and other factors. Under federal or state law, the RMT board of trustees is charged with fiduciary responsibility to administer the RMT for "the exclusive benefit" of the participating employees. If the trustees fail to do so, they are subject to civil and criminal penalties.

The Affordable Care Act

Since RMTs are structured to provide benefits only to retirees, they avoid many of the requirements of the Affordable Care Act since they qualify as "retiree-only" plans.

Tax Advantages

An RMT can offer several tax advantages, depending on how the plan and contribution obligation are structured. Generally, the trust can convert taxable salary into a non-taxable retiree medical benefit.

Employers

Employers are not required to pay payroll taxes on the RMT contributions, provided that the entire bargaining unit or group participates. Even employee contributions are made with pre-tax dollars if they are mandatory.

Employees

Employees avoids taxation if contributions are mandatory.[2] That is, the money contributed to the RMT will not be included in employees' taxable income. Further, earnings on contributions are tax-exempt if the plan is set up as an integral trust under Internal Revenue Code section 115 or as a VEBA under IRS section 501(c)(9). An employee benefit trust that gains IRS tax-exempt status can realize significant earnings, none of which are taxed.

Retirees

Because the benefit payments are used to reimburse medical costs, they constitute non-taxable income to the retiree under Internal Revenue Code Section 105. (Compare this to pension benefits, which are considered taxable

[1] 115 trusts are used to hold funds for other employee benefit plans as well as pension stabilization reserves. The implication of other uses for 115 trusts is beyond the scope of this article, but in either status, general fiduciary rules will apply to governance of the trust.

[2] See, e.g., IRS Rev. Rul. 750539 and PLRs 98400006 and 20073602

income in most jurisdictions.) This tax exclusion results from the requirement that benefits be spent only on medical costs. Tax-free earnings and compound interest allow significant appreciation on contributions. Actuarial projections indicate that plans can provide benefit levels at $300 to $400 for every $100 contributed.

Structure of Retiree Medical Trusts

An RMT may be structured as a pooled plan, which is similar to a defined benefit pension plan, or an individual account plan, similar to a defined contribution plan.

> An RMT may be structured as a pooled plan, which is similar to a defined benefit pension plan, or an individual account (IA) plan, similar to a defined contribution plan.

Pooled Plan Design

If an RMT is structured as a pooled plan, all contributions are pooled, and an actuary determines the monthly benefit after retirement. Benefits are not vested, and their levels may increase or decrease with market fluctuations. In practice, however, adjustments to RMTs have been minimal since they are actuarially smoothed over time. Thus, although many RMTs suffered a 30 percent drop in investments in 2008, it proved to be temporary and mostly recovered within two years. Benefit levels only dropped about 5 percent and later increased as the markets recovered.

These advantages make the pooled plan design, more attractive than an individual account plan.

Individual Account Plan Design with Annuitization

An individual account plan allows contributions to be credited to an account for each employee, on which he or she can draw after retirement for reimbursement of medical expenses. The problem with this design is that the balance often runs out during the retiree's lifetime and at an older age, when the money may be needed the most.

However, a new idea has emerged that makes the individual account plan design more attractive than before in terms of social policy. The idea is to *annuitize* the individual account balance to provide the retiree with a lifetime benefit, just as in the pooled plan design. Nationally, there has been a growing recognition that individual account-type plans have not provided adequate funds for retirement. In the private sector, retirees are finding their 401(k) balances insufficient to meet their retirement needs. This has been a result of *leakage* (borrowing against it), poor investment choices, market downturns, increased life expectancy, and other factors. Often, the account zeroes out well before the end of life, when a retiree is in his or her 70s or 80s and has much more difficulty finding work to supplement Social Security. Accordingly, policymakers are encouraging the annuitization of the 401(k) balance so that it provides a fixed payment for life.

Likewise, an individual account RMT plan could adopt a design that requires annuitization of the account balance at retirement. Rather than being depleted in a few years, this individual account could last a lifetime at a set dollar amount (possibly with a cost-of-living adjustment built in).

As stated above, the pooled plan has the advantages of lower investment fees, professional investment management, and better returns. However, if the bargaining parties in a jurisdiction decide they want an individual account design, adding an annuitization feature could be considered.

FUNDING

RMTs offer a valuable benefit for groups willing to commit small amounts, all on a pre-tax basis, during active employment to save for post-retirement medical expenses. Contribution levels of established RMTs range from $50 per month to $450 per month. If the policy is jurisdiction-wide or negotiated in the labor agreement for the entire bargaining unit, the value of accumulated sick leave may be transferred to the employee's credit in the RMT; in this case, the employee would not be required to pay tax on the sick leave, as would be required for a cash-out.

COMPARISON WITH COMMERCIAL INDIVIDUAL ACCOUNT PLANS

Some insurance companies market individual account plans in which each employee has an account. In addition to the drawbacks to the individual account model discussed above, plans purchased from an insurance company are controlled by that company rather than a municipality or an employee group, and investments are selected by managers chosen by the municipality. Recent litigation indicates problems with the fees imposed in such plans, which may carry administrative costs that are buried in the investment structure, even when advertised as having minimal or no administrative costs.

IMPLEMENTATION

Plan Sponsorship and Administration of RMTs

RMTs provide a great deal of flexibility. These plans may be implemented by public sector unions acting independently, by unions in partnership with their employer, or by the employer alone. They can cover all employees of a public employer or be limited to certain classifications or bargaining units. The RMT can be sponsored by one jurisdiction alone, an association of jurisdictions, or a federation of unions.

The sponsoring parties select individuals to serve on a board of trustees that makes decisions regarding plan design, investments, benefit distribution rules, and all other matters.

Generally, an RMT is a result of collective bargaining. (There are, however, ways to establish an RMT outside of a bargaining environment, involving salary resolutions by the employer.) The bargaining parties negotiate a contribution to an RMT and agree to its establishment. Certain provisions are necessary to obtain the optional tax advantages. We counsel you to consult with an attorney experienced with employee benefits law and plans.

CONCLUSION

States and municipalities continue to encounter increases in the cost of medical coverage. Because retiree medical coverage generally is not vested, public sector employees and retirees can no longer assume that state, county, or local government will continue offering retiree medical coverage.

Although employers may use cutbacks in post-retirement health coverage to balance their budgets and avoid a significant GASB liability, Retiree Medical Trusts are a better option to balance fiscal realities with the needs of both current employees and retirees.

Rather than turning our backs on retirees and rewarding their hard work and years of service with little or no health insurance cost support, responsible public sector employers should help employees save for future medical needs through an RMT that benefits both employees and employers.

This report offers an introduction to the purpose, operation, and benefits of an RMT. To learn more about this topic and the creation of an RMT, contact the individuals and organizations listed in the Additional Resources section.

FREQUENTLY ASKED QUESTIONS

Q Who should read this report?

A Public sector employers, public pension plan administrators and trustees, and union officials who care about the rising cost of health care and its effect on retirees.

Q What benefits are available under an RMT?

A In general, an RMT would reimburse participating retirees toward the cost of post-retirement healthcare expenses. Healthcare expenses are broadly defined and could include

- out-of-pocket healthcare-related costs;
- health insurance premiums (including Medicare, Medigap, and long-term care insurance);
- costs of dental care, vision care, or hearing aids; and
- prescription drug expenses.

Q Who receives RMT benefits?

A RMT benefits are paid to retired employees who participated in the RMT program during active employment. RMTs also can be set up to provide benefits to surviving spouses and children.

Q How much are RMT benefits?

A RMT benefit amounts vary depending on several factors, including

- the amount of contributions,
- the length of time in which contributions are made,
- investment income, and
- administrative expenses.

Once the trustees define these factors, they can assign benefit levels. Currently, RMTs provide monthly benefits up to $1,300 per month, for life, to career employees (20 years of service).

Q When do RMT benefits begin?

A RMT benefits begin after participants have retired and have met the specific eligibility rules outlined in the RMT plan document.

Q How long do RMT benefits last?

A RMT trustees can choose from several options for the duration of benefits. RMTs can be designed so that the benefits last for the life of the participant and the surviving spouse; this is by far the most common plan design and the distinguishing and most valuable aspect of RMTs. However, the plan could be designed to offer benefits for a shorter period, such as until retirees reach Medicare eligibility age.

Q Can individuals elect whether to participate in an RMT, like a cafeteria or 401(k) plan?

A No. An entire eligible employee group or bargaining unit must elect to participate in an RMT to take advantage of all the tax benefits.

Q Is it permissible to transfer sick or vacation leave to an RMT?

A Yes. However, to transfer accumulated sick leave, your bargaining unit must negotiate a transfer of all or part of that sick leave to this plan upon retirement. That amount will then not be considered taxable income. Retirees could draw the sick leave transfer for spouses as needed.

Q What are the tax advantages of RMTs?

A There are three distinct tax advantages:

- Employee contributions are made with pre-tax money, which means it will not count as taxable income.
- The RMT itself accrues earnings on a non-taxable basis.
- The RMT benefits are tax-free to the retiree (unlike pension benefits, which are taxable).

This means that the money contributed to an RMT is never taxed. It is a tax *avoidance* program, not tax deferred like a pension plan. Retirees generally pay taxes on their pension benefits, but RMT benefit are not taxable income.

Q What is the legal structure of RMTs?

A RMT assets are held in a trust, legally separate from the employees and the employer. The trust is controlled and administered by a board of trustees, composed of employee and/or employer representatives. The board designs the RMT plan, selects a professional investment manager and investment vehicles, and decides on distribution options.

Q Are RMTs regulated by federal law?

A Yes, RMTs are regulated by federal law and also may come under state law, depending on structure. In either case, the RMT trustees are charged with fiduciary responsibility to administer the RMT for "the exclusive benefit" of the participating employees. If the trustees fail to do so, they are subject to civil and criminal penalties.

ADDITIONAL RESOURCES

For more information about retiree medical trusts, contact the following:

National Conference on Public Employee Retirement Systems
1201 New York Avenue NW, Suite 850
Washington, DC 20005
202-601-2445
info@NCPERS.org
www.NCPERS.org

Ms. Shana Saichek, Esq., Of Counsel
The Wagner Law Group (San Diego office)
8677 Villa La Jolla Drive #888
La Jolla, CA 92037
Work: 619-232-8702
Cell: 619-616-0935
ssaichek@wagnerlawgroup.com
www.wagnerlawgroup.com

Ms. Neelam Chandna, Esq., Partner
The Wagner Law Group (Los Angeles office)
Cerritos Towne Center
17777 Center Court Drive N., Suite 613
Cerritos, CA 90703
Work: 562-459-4500
Cell: 562-476-0717
nchandna@wagnerlawgroup.com

The Voice for Public Pensions

National Conference on Public Employee Retirement Systems
1201 New York Avenue, NW, Suite 850, Washington, DC 20005
202-601-2445 | 202-688-2387