Financing Retiree Health Strategies in the Public Sector

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The National Conference on Public Employee Retirement Systems (NCPERS) is continually exploring ways to support the sustainability of retiree benefits for governmental employees. As health care is an important aspect of retirement, we are pleased to sponsor this white paper on prefunding retiree health coverage.

Retiree health coverage is quite prevalent in the public sector and is a valued benefit, especially among those who are well into their careers – as well as those who have already retired, of course. At the same time, rising costs, combined with the latest accounting standards from the Governmental Accounting Standards Board (GASB), have resulted in increased visibility for these provisions.

The following provides a glimpse into the current environment and then explores the varying strategies available for offering alternative or enhanced retiree health care financing arrangements.

CURRENT ENVIRONMENT

Retiree health coverage in the public sector is common, yet this coverage varies depending on the area of the country, the jurisdiction and the extent of collective bargaining, among other factors. Traditional arrangements offer coverage to both early and Medicare-age retirees, though in some cases employer-sponsored coverage is available to retirees only until they reach Medicare eligibility age. Moreover, it is not uncommon for the employer to pay a portion of the premium for the retiree, and in some cases the retiree’s spouse and/or family as well.

As baby boomers retire, the number of current and soon-to-be retirees covered under these programs is increasing. Adding in the effects of rising medical and pharmacy costs and increasing life expectancies, employer costs are expected to grow significantly.

Regardless whether the employer pays any portion of the premium, it is not uncommon (and in many states, legally required) for active and retired participants to be combined into one rating pool. Assessing this “blended” rate for retiree medical coverage results in rates that are artificially lower than what the retiree’s actual costs are (see figure below). While generally less substantial than an actual contribution toward a premium, this “implicit” subsidy also has the impact of increasing overall costs to the employer.
Under GASB – previously Statement 45, and now 75 (and related statements) – employers and retiree health plan sponsors are required to conduct actuarial valuations to determine their estimated liabilities associated with post-employment health care obligations, analogous to how pensions are valued. As these liabilities are estimated and disclosed, there is a heightened awareness of the evolving costs to the employer arising from these benefits.

Legal, Employee Relations and Human Capital Considerations

As public employers look to manage these escalating costs, they also are challenged to attract and retain talent in an environment with low unemployment. Thus, they are faced with the need to balance these increasing costs with the need to develop competitive compensation packages to attract and retain talent. Further, employers, whether because of moral, employee relations or legal considerations, must be sensitive to the implications of making any changes to their financial support for retiree health care.

Prefunding Retiree Health Care

These pressures and heightened awareness – combined with the reality that retiree health care costs are significant, regardless of how they are financed – are causing more employers to examine possible ways to set aside funds, whether contributed by the employer or the employee, in anticipation of future health care expenses. The advantages of implementing such an arrangement are numerous, and include the following:

- Spreading the cost more evenly from a cash flow perspective
- Reducing future liabilities through the realization of investment returns on the assets that are set aside
- Potential to maintain or enhance financial ratings
- Ability to secure funding and assets through formally designed structures and trust vehicles
- Reduction in overall costs (depending on program objectives and design)
- Tax efficiencies for employees and retirees

Prefunding Vehicles

There are a number of different mechanisms through which retiree health care expenses can be prefunded on a tax-efficient basis. In other words, funds go into the vehicle on a pretax basis, and proceeds are realized on a tax-free basis as well.
Voluntary Employee Beneficiary Association (VEBA)

VEBAs are vehicles created under IRC Section 501(c)(9). There are certain rules that a vehicle must meet in order to qualify as a VEBA. Elective employee contributions are permissible; however, any employee contributions must be made on an after-tax basis.

IRC Section 401(h)

If a defined-benefit plan is in place, the employer may create an arrangement as part of the defined-benefit plan for the purpose of accepting tax-qualified contributions for qualified health expenses. This arrangement requires that the funding for the retiree health program be “subordinate to” the overarching defined-benefit pension plan at all times.

While technically funded through employer contributions, the plan could further fund this program in whole or in part through a mandatory employee pickup arrangement, which is permitted under IRC Section 414(h).

Though they are beyond the scope of this publication, there are a number of important considerations that would need to be addressed (for example: legal, actuarial, administrative), should such an arrangement have applicability or merit.

State Grantor Trust

State grantor trusts (also referred to as integral part trusts) are allowed under IRC Section 115. In simple terms, the regulations allow public entities to establish trusts under state law as long as the trust can be considered “integral” to the purpose of the entity forming the trust. This arrangement offers plan sponsors the greatest latitude of the three arrangements. That said, clear governance and effective administration are critical to all these vehicles, to assure consistent, sustainable operations.

General Asset Account

Since public entities are tax-exempt, a governmental employer technically could prefund retiree health on a tax-favored basis without establishing any formal trust arrangement. However, such an arrangement is not advisable, for a number of reasons:

- The assets are not secure – they could be accessed for other purposes, and they would also be available to creditors.
- From an employee relations standpoint, such an arrangement would be very unattractive, especially if contributed funds are redirected or reconstituted forms of compensation.
- Since the funds are not in a vehicle that has legally isolated them to be used for the exclusive benefit of its participants, GASB would limit the magnitude of the discount rate that could be assumed for assets that are offsetting liabilities.

Under each of these scenarios, funds may be used only for qualified health expenses. Each vehicle is ultimately funded by “employer” assets, although certain elements of employee compensation can be redirected, if handled correctly, thereby being reconstituted as employer funds. Moreover, the plan sponsor may define how and when funds are accessible, as well as what are considered eligible expenses for reimbursement.

Under any of the scenarios, the tax-favored aspect of the disbursements is enabled under what is referred to as a health reimbursement arrangement (HRA), as permitted under IRC Section 105(h). As a result, all the rules associated with provisions under this section of the tax code must be met in order for the vehicle to be allowed to realize the tax-qualified treatment. Among the key requirements are the following:

- The exclusive source of funding must be from the employer.
The proceeds must be available only to reimburse qualified health expenses, as outlined in the tax code.

Nondiscrimination rules under IRC Section 105(h) must be addressed.

Health Savings Accounts

In addition to the above vehicles, the advent of qualified high-deductible health plans (HDHPs) has introduced health savings accounts (HSAs) into the mix. These accounts can be funded by the employer and/or employee and enjoy the same tax-qualified status as HRAs. However, there are a number of differences between these two vehicles:

- An HSA can only be created and funded by someone enrolled in a qualifying HDHP. Therefore, if an employer has not introduced an HDHP, or if not all medical options offered can be considered an HDHP, an HSA will not be available to employees not enrolled in an HDHP.
- There are limits to and rules regarding the nature of any employer contributions.
- Because an HSA is “owned” by the employee and not the employer, the employer has no ability to limit access to the assets in the HSA. Thus, while the employee can choose to limit the use of the assets to offset retiree health expenses, the employer has no control in limiting such access.

POSSIBLE SOURCES OF CONTRIBUTIONS

Since all the vehicles above, other than HSAs (and in a limited case, VEBAs), require that the sole source of funding come from the employer, what sources might be considered? Thinking holistically from a total rewards perspective suggests a number of possible sources. The source that is viable will, of course, vary from entity to entity, and from situation to situation, based on any number of considerations. Regardless, unless there is some type of unique, one-time outlay, any sources that are to be contemplated should be budgeted as ongoing. Examples might include the following:

- New funding: For example, no retiree health provisions exist today, but the need or value is determined sufficient to warrant a new benefit provision.
- Redesign:
  - Salary: For example, instead of a 3 percent overall salary increase, an increase of 1.5 percent is established, along with a 1.5 percent contribution into the retiree health fund.
  - Retirement: If a defined-benefit plan is very well funded, rather than reducing contributions or increasing benefits, the plan could direct the “margin” to prefund retiree health. Similarly, under a defined-contribution arrangement, a decision could be made to convert from an employer contribution of 8 percent to a retirement contribution of 6.5 percent and a retiree health contribution of 1.5 percent.
  - Current retiree health contributions, along with embedded eligibility/plan design, could be reengineered, in line with philosophical, human resources and financial objectives.
- Unused leave: While such a provision cannot (generally) be elective, some agreed-upon value of unused leave could be restricted to funding an HRA.
- Reengineering paid time off: A more broad-based approach for repurposing the value of leave might entail a holistic reengineering across the paid-time-off continuum. Such a strategic approach would also allow an employer to design a program that potentially moves from a traditional system of separately bucketed vacation and sick leave programs to a more contemporary paid-time-off program, complemented by short-term disability and long-term disability coverage.
- Issuance of bonds dedicated to the funding of the post-employment health benefit obligations.
- Government-owned life insurance, similar to the notion of corporate-owned life insurance.
KEY CONSIDERATIONS

The considerations for any approach and vehicle will be unique to each entity. That said, some of the key considerations that often arise include the following:

- What are the goals and objectives? Is there alignment from an overall human resource and total rewards perspective? Establishing and gaining buy-in to key goals and objectives is critical, as is the identification of key parameters and/or constraints.
- What are the state and local legal and regulatory constraints? Do certain laws or regulations exist that preclude or limit a potential approach? If so, can they be changed?
- What underlying retirement programs are currently in place? What is the amount of funding? How well are they funded? How well are they meeting the overarching objectives?
- Is the entity subject to collective bargaining? If so, how will those dynamics be addressed or managed?
- What cohorts are you seeking to address: Current retirees? Soon-to-be retirees? Mid-career hires? This will dictate the form and structure of the benefit – for example, a defined-benefit (e.g., a designated monthly amount paid toward the premium per year of service) versus a defined-contribution arrangement.
- What are the administrative requirements and implications inherent in each alternative, and do they pose any obstacles?
- If prefunding retiree health is not the primary goal, is it a solution that can align with other pressing challenges and concerns? In other words, is prefunding an opportunity to address other needs?
- Do we have in place – or where do we find – appropriate levels of expertise to advise on the various legal, financial, insurance, and administrative considerations inherent in any potential solution?

SUMMARY

Retiree health costs continue to be on the minds of elected leaders, governmental management personnel, finance officials, unions, employees, and retirees. Further, public entities are entering an environment where recruiting and retention needs will require creative yet budget-conscious solutions as they compete for talent with the private sector. Prefunding retiree health care is one strategy that could help some entities address these challenges.

Note: There has been substantial jurisprudence on constitutional protection for retiree health care, and those rights remain in flux. While mindful of the unsettled legal status of this important benefit, the focus of this paper is on funding solutions.

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