Current Health Plan Funding Opportunities

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I. Review of Funding Vehicles

A. Health Reimbursement Arrangement (HRA)

1. The IRS defined an HRA in Notice 2002-45 and Rev. Rul. 2002-41 (June 2002) as:

a. An arrangement to provide reimbursement for medical expenses of employee and family

b. That is paid for solely by the employer

c. That allows the carry forward of unused amounts from one coverage period to the next

2. Notice 2005-24 (April 5, 2005)

a. Clarifies that it is acceptable for an employer to base the level of its HRA contributions for retiring employees on the value of unused sick/vacation leave, and also reinforces the IRS position that HRA funds may never be converted to use for a non-medical purpose without adverse tax consequences

3. An HRA is subject to COBRA

a. An employer can charge premium for continuing HRA participation

b. An employer can require employees to elect COBRA for health insurance policy to continue HRA coverage

c. If employee does not elect COBRA, spend down of HRA is permitted

B. Health Savings Accounts (HSAs)

1. Enacted as part of the "Medicare Prescription Drug, Improvement and Modernization Act of 2003" (December 8, 2003)

2. HSAs effective for plan years after 12/31/03

3. HSA rules are in new section 223 of the Internal Revenue Code

4. Trust or custodial account used to accumulate funds on a tax-preferred basis

5. Available to individuals covered by a high deductible health plan and no other non-high deductible health plan, except for certain "permitted" insurance or coverage

6. Contributions may be made by an employer, eligible individual, or other individual

7. May be offered through a cafeteria plan

C. VEBAs

1. A VEBA is a tax-exempt organization meeting the requirements of section 501(c)(9). Form 1024 and 990s required

2. Employer contributions to a reserve under a VEBA for retiree medical benefits are subject to deduction limits under section 419A (for those employers interested in deductions; see below)

3. Generally, all of the gross income of the VEBA reserve, less directly connected deductions, is subject to current taxation. Thus, tax-free buildup of funding amounts is not possible unless the VEBA invests in life insurance, tax-exempt bonds, or other tax-exempt investments

4. The value of medical coverage provided through a VEBA is not includible in the income of retirees or their dependents

5. Amounts in a VEBA generally would be treated as a plan asset for FAS 106 purposes

6. A collectively bargained VEBA is not subject to the section 419A deduction limits

D. 401(h) Accounts

1. Service has consistently refused to allow qualified plan benefits to provide tax-free retiree medical benefits except through a 401(h) account under a qualified defined benefit plan

2. Tax requirements

   a. Separate account is required for recordkeeping purposes. Except for 420 transfers (below), no transfers between the 401(h) account to the rest of the plan are permitted

   b. Restrictions on key employees (as defined in 416(i) – up to 50 officers may be key employees) include that individual separate accounts must be maintained and are subject to the 415(c) (defined contribution plan) limits. Consequently, most 401(h) plans exclude key employees

   c. The 401(h) account must define what benefits it will provide and who is eligible. Presumably, this means that employer discretion is not permitted in the timing and amount of payments from the account. See, PLR 9834037

   d. Amounts not used for medical must revert to employer and cannot revert to the pension plan

   e. Employer's contribution must be reasonable and ascertainable; must be designated at time of contribution

   f. Account amounts cannot be diverted to non-medical purposes

   g. If an individual forfeits his or her interest in the medical benefit account, forfeiture must be used as soon as possible to reduce future employer contributions to fund medical benefits

   h. Must be "subordinate" to retirement benefits. Aggregate contributions to provide medical benefits and life insurance cannot exceed 25% of aggregate contributions other than contributions to fund past service credit (determined after the date the medical accounts are established)

i. The "subordinate" requirement limits the usefulness of such accounts for employers with well-funded pension plans

3. Provides assets effecting liabilities for accounting purposes since dedicated to retiree medical

4. 420 transfer of excess pension assets

   a. Contains so many requirements and limits that few employers use it. Scheduled to expire after 2013

   b. Must be of "excess pension assets." In most cases, this means assets in excess of 125 percent of current liabilities on a plan termination may be transferred

   c. Cannot intervene any other provision of law (such as government contacts law or a collective bargaining agreement)

   d. Transfer cannot exceed the amount reasonably estimated to pay during the taxable year for "qualified current retiree health liabilities"

   e. Can only be used to pay "qualified current retiree health liabilities" for the tax year of the transfer

   f. Pension benefits must become fully vested, with a 1-year lookback for recent termination of employment

   g. Only one transfer a year

   h. 420 rules may be loosened in proposed legislation

5. Deduction limitation (for employers concerned with deductions): cannot exceed total cost of providing retiree medical benefits, determined in accordance with any generally accepted actuarial method. For any year, the amount deductible generally may not exceed the greater of (i) an amount determined by distributing the remaining unfunded costs of past and current service credits as a level amount, or as a level percentage of compensation, over the remaining future service of each employee, or (ii) 10 percent of the cost that would be required to completely fund such benefits. This deduction limit is usually higher than the "subordinate" limit

E.. "Integral Part" and Section 115 Trusts of Governmental Employers

1. Governmental entities are exempt from tax, but so are their integral parts and separate entities subject to Code section 115

2. "Integral part" analysis relies principally on control by the governmental entity. Rev. Rul. 87-2

3. Section 115 provides that "gross income does not include… income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia"

4. Trust separate from but created and controlled by a governmental entity have been ruled to qualify. Statutory authority and decision-making by governmental officials are key

5. Can be applied to trusts which are controlled by a consortium of political subdivisions. See, e.g., PLR 9050055

6. Though private benefit must be incidental, the Service has interpreted that not to preclude pension and welfare benefit trusts for individual employees. See GCM 34,704 (Dec. 2, 1971), (public employees' retirement fund exempt under 115) PLRs 200012084 (city welfare retiree benefits trust exempt under 115), 200521005 (state trust holding funds used for health care coverage of retired police officers, firefighters, and for their spouses and dependents exempt under 115), 2002210025 (trust to fund payment of life insurance premiums to cover disabled employees exempt under 115; 419 and 419A did not apply to cause trust income to be taxable)

F. Tax exempt employer "integral part" welfare trust

1. Trust is treated as an integral part of the 501(c)(3) and thus under the tax exempt employee's tax exemption

2. See letters from IRS to the Yale University Retiree Health Benefits Coverage Trust and Georgetown University Retirees Welfare Benefits Trust, both dated July 29, 1997. ("In order to attract and retain employees to carry out the educational and scientific research missions of the University, you will engage primarily in providing

employee welfare benefits to retirees employed by the University. We find your operation to be performing essential services to the University, and thus, you are operated as an integral part of its activities in furtherance of its exempt purposes.")

3. Individual exemption letters advisable

II Key tax issues

A. Ability to make pre-tax contributions

1. HRAs

a. HRA can be offered with a health insurance policy that is paid for by employees through a cafeteria plan

b. HRA amounts must be solely employer-paid; not funded with pre-tax salary reduction elections

c. Notice 2002-45 contains several tests for determining whether salary reduction amounts will be attributed to the HRA

2. HSAs

a. May be offered through a cafeteria plan

b. Contributions may be made by an employer are excluded from the eligible individual's income under Code section 106(d)

c. After-tax contributions by the eligible individual or any other person are deductible by the eligible individual

3. VEBAs

a. Employer contributions to a reserve under a VEBA for retiree medical benefits are subject to deduction limits under section 419A (if the employer is concerned with deductions)

(1) The reserve is funded over the working lives of covered employees. A "reserve" may be deemed not to exist unless the contributions are separately accounted for and restricted to use for retirees. See General Signal Corp.,

103 T.C. 216 (1994), affirmed 142 F.3d 546 (2d Cir. 1998)

(2) The Tax Court has upheld the pro-taxpayer position that liabilities for already retired employees may be immediately funded and deducted. Wells Fargo & Co. v. Comm'r, 120 T.C. No. 5 (2003)

(3) Funding is actuarially determined on a level basis, using assumptions that are reasonable in the aggregate. (PLR 9522054 contains a discussion of some acceptable funding methods)

b. Generally, all of the gross income of the VEBA reserve, less directly connected deductions, is subject to current taxation. Thus, tax-free buildup of funding amounts is not possible unless the VEBA invests in life insurance, tax-exempt bonds, or other tax-exempt investments

4. 401(h) accounts – "Subordinate" limit is fairly restrictive. Pre-tax contributions can be made as nonelective contributions by the employer. Any employee contributions would have to be nonelective for tax purposes in order to avoid being treated as a cash or deferred arrangement.

5. Section 115/tax exempt trusts. Pre-tax contributions can be made as nonelective employer contributions, but there is little authority on what is elective versus nonelective, and the Service is studying the area.