

# Payment of Medical Expenses Preliminary Report

LEOFF Plan 2 Retirement Board

June 16, 2010

## Issue

- Part of the Base Contribution Rate and part of the Supplemental Contribution Rate will be used to pay for medical expense benefits
  - Survivor Medical - Base Contribution Rate
  - Catastrophic Disability Medical – Supplemental Contribution Rate (Fiscal Note)

## Current Situation

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- Survivors of L2 members killed in the course of employment
  - L2 pays for PEBB health care premiums
  
- Catastrophic Disability Medical
  - L2 pays for employer-provided medical insurance

## Timeline – Review & Adoption

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- Timeline - Medical Expense Contribution
  - Review Draft Rates – June 16 Meeting
  - Adopt Rates – July 28 Meeting

# Contribution Rate Review

PRELIMINARY MEDICAL EXPENSE CONTRIBUTIONS <sup>1</sup>			
LEOFF Plan 2			
Contribution Rates	PEBB Survivor Benefits <sup>2</sup>	Catastrophic Disability Medical	Total
Member	0.05%	0.04%	0.09%
Employer	0.03%	0.03%	0.06%
State	0.02%	0.01%	0.03%

<sup>1</sup> Contribution rates assume the 401(h) account will be invested within the CTF at an assumed 8% long-term annual return and use the same funding method and assumptions currently in place for the retirement plan. If a different set of methods or assumptions are adopted the rates listed here will change.

<sup>2</sup> These contribution rates have been removed from the Preliminary June 30, 2009, Actuarial Valuation Results.

# Payment of Medical Expenses

QUESTIONS?

# LAW ENFORCEMENT OFFICERS' AND FIRE FIGHTERS' PLAN 2 RETIREMENT BOARD

## Payment of Medical Expenses Preliminary Report

June 16, 2010

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### **1. Issue**

Part of the Base Contribution Rate and part of the Supplemental Contribution Rate will be used to pay for medical expense benefits as provided to Survivors of members killed in the line of duty and members who are catastrophically disabled in the line of duty.

### **2. Staff**

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### **3. Members Impacted**

There are 28 survivors whose payments of premium rates to the Washington State Health Care Authority are paid by the LEOFF Plan 2 trust fund.

### **4. Current Situation**

The LEOFF Plan 2 pension fund pays the cost of participating (premiums) in a PEBB health insurance plan by survivors of all LEOFF Plan 2 members killed in the course of employment.

The LEOFF Plan 2 pension fund also pays the premiums for employer provided health insurance for members who are catastrophically disabled in the line of duty.

## **5. Background Information and Policy Issues**

Federal law places a number of requirements on the payment of medical expenses out of a qualified pension plan in order for the payments to be non-taxed. The LEOFF Plan 2 Retirement Board (L2B), Department of Retirement Systems (DRS), Washington State Investment Board (WSIB), and Office of the State Actuary (OSA) have been cooperatively coordinating payment and accounting procedures to meet these federal requirements.

### **Legislative Background**

Legislation passed in 2006 (SB 6723) provided additional benefits to the surviving spouse and dependent children of LEOFF Plan 2 members who are killed in the line of duty by paying the Public Employees' Benefits Board (PEBB) health care premium rates to the Washington State Health Care Authority pursuant to RCW 41.05.080. RCW 41.05.080 allows for continued participation in insurance plans and contracts through PEBB for surviving spouses and dependent children of members killed in the line of duty.

The payment of the medical expenses for the surviving spouse and dependent children are currently paid directly out of the pension trust fund. These benefits are non-taxable as they are considered in the same nature as Workers' Compensation benefits.

Legislation passed in the 2010 Legislative session (SHB 1679) requires that the disability allowance of a LEOFF Plan 2 member that is catastrophically disabled in the line of duty include reimbursement for any payments made for employer-provided medical insurance. This includes medical insurance offered under the federal Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) and Medicare Parts A and B.

A catastrophically disabled member must, if eligible, be enrolled in Medicare Parts A and B in order to remain eligible for payment of medical insurance costs from LEOFF Plan 2.

### **Internal Revenue Code - 401(h) Accounts**

Federal law places a number of requirements on the payment of medical expenses out of a qualified public pension plan. Section 401(h) of the Internal Revenue Code (IRC) allows a pension or annuity plan to provide for payment of benefits for sickness, accident, hospitalization and medical expenses for retired employees (by definition this would include survivors), their spouses and dependents<sup>1</sup>. The contributions to a 401(h) accumulate tax-free. In addition to tax-free accumulation, the medical benefits provided through a 401(h) account are also tax-free.

### **IRC 401(h) Requirements**

A 401(h) is a qualified annuity plan set up under a defined benefit pension plan and can be used to pay various non-pension benefits, such as certain medical expenses. As a vehicle under the IRC that may be used for payment of tax-free medical expense benefits, there are

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<sup>1</sup> <http://www.irs.gov/pub/irs-tege/chap801.pdf>, 11/23/09

several requirements that the 401(h) account must meet. A high-level description of the 401(h) requirements is provided below.

**Benefits.** A pension or annuity plan may provide retiree medical benefits, through a section 401(h) account, including payment of benefits for sickness, accident, hospitalization and medical expenses. The plan must specify the medical benefits described in section 401(h) which will be available and must contain provisions for determining the amount which will be paid.

*Section 401(h); Treas. Regs. 1.401-1(b)(1)(i), 1.401-14(a) and (c)(1).*

**Coverage.** The plan must provide that medical benefits are only provided for retired employees, their spouses and dependents. To be "retired" for purposes of eligibility to receive medical benefits described in section 401(h), an employee must be eligible to receive retirement benefits provided under the pension plan, or else be retired by an employer providing such medical benefits by reason of permanent disability. For purposes of the preceding sentence, an employee (even one who is past normal retirement age) is not considered to be "eligible to receive retirement benefits provided under the plan" if he is still employed by the employer and a separation from employment is a condition for receiving the retirement benefits.

*Section 401 (h); Treas. Regs. 1.401-14(a), (b) (1) and 1.401(a)(4)-1(c)(14).*

**Separate Accounts.** Where medical benefits described in section 401(h) are provided under a qualified pension or annuity plan, the plan must provide that a separate account must be established and maintained with respect to contributions to fund such benefits. The separation required by this section is for recordkeeping purposes only. Consequently, the funds in the medical benefits account need not be separately invested.

*Section 401(h)(2) and Treas. Reg. 1.401-14(c)(2).*

**Reasonable and Ascertainable Contributions.** The contributions for medical benefits provided by the section 401(h) account must be reasonable and ascertainable, and the plan must contain provisions for determining the amount which will be paid. These requirements will not be satisfied unless the terms of the plan specify the amount of benefits and the time period with respect to which benefits will be paid. Where there are other potential sources of payment of medical benefits such as a welfare benefit fund or the general funds of the employer, the plan must be specific as to how the benefits payable from the section 401(h) account are coordinated with benefits payable from other sources. The plan may not allow for employer discretion in the timing and amount of benefit payments. The employer must, at the time a contribution is made, designate that portion of such contribution allocable to the funding of medical benefits.

*Section 401(h)(3) and Treas. Reg. 1.401-14(c) (1) and (3).*

**Non-Diversion.** A plan may not permit funds in the retiree medical benefits account to be used for any retirement benefits. A plan allowing such a payment does not satisfy the requirements of section 401(h) and will not qualify under section 401(a). However, the

payment of any necessary or appropriate expenses attributable to the administration of the medical benefits account does not affect the qualification of the plan.

*Section 401(h)(4) and Treas. Reg. 1.401-14(c)(4).*

**Reversion.** The plan must expressly provide that any amounts that are contributed to fund medical benefits described in section 401(h) and that remain in the medical benefits account upon the satisfaction of all liabilities arising out of the operation of the medical benefits portion of the plan are to be returned to the employer.

*Section 401(h)(5) and Treas. Reg. 1.401-14(c)(5).*

**Forfeiture.** The plan should provide that in the event an individual's interest in the medical benefits account is forfeited prior to termination of the plan an amount equal to the amount of the forfeiture must be applied as soon as possible to reduce employer contributions to fund the medical benefits.

*Treas. Reg. 1.401-14(c)(6).*

**Employer or Employee Contributions.** Contributions to provide the medical benefits described in section 401(h) may be made either on a contributory or noncontributory basis, without regard to whether the contributions to fund the retirement benefits are made on a similar basis. Thus, for example, the contributions to fund the medical benefits may be provided for entirely out of employer contributions even though the retirement benefits under the plan are determined on the basis of both employer and employee contributions or vice versa.

*Treas. Reg. 1.401-14(b)(3).*

**Transfers.** The plan must contain provisions that meet the requirements of section 401(h) in order for the plan to meet section 420 on the transfer of assets to retiree health accounts. Code section 420 permits a "qualified transfer" of pension assets of a defined benefit plan, subject to several requirements on when and how much may be transferred.

*Section 420(e)(3).<sup>2</sup>*

## **Additional Duties and Future Actions**

Implementing an account to pay for medical expenses from the pension plan requires new duties and future actions by the LEOFF Plan 2 Retirement Board (L2B). Such an account requires coordination with strategic partners including Department of Retirement Systems (DRS), Washington State Investment Board (WSIB), and Office of the State Actuary (OSA). The implementation and administration of medical expense account will be coordinated by an interagency agreement.

Issues to coordinate would include, for example, setting-up and administering the account, investment policy for the account assets, and measuring and reporting plan assets and liabilities. A key responsibility of the L2B is adopting the contribution rate to fund the medical expense account.

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<sup>2</sup> <http://www.irs.gov/pub/irs-pdf/p11433.pdf>

## Medical Expense Contribution Rate

A key requirement of establishing the account to pay for medical expenses is that a separate (from the pension contribution rate) contribution rate to fund the medical expense account must be reviewed and adopted by the L2B. The timeline for review and adoption of the medical expense account contribution rate is discussed below.

The **review** period for the medical expense account contribution rate begins at the **June 16, 2010 Board Meeting**. The L2B will review the medical expense account rates in addition to the Base Contribution rates that will be presented by OSA as part of the Preliminary Actuarial Valuation Results. The preliminary medical expense contribution rates are shown in the table below.

PRELIMINARY MEDICAL EXPENSE CONTRIBUTIONS <sup>3</sup>			
LEOFF Plan 2			
Contribution Rates	PEBB Survivor Benefits <sup>4</sup>	Catastrophic Disability Medical	Total
Member	0.05%	0.04%	0.09%
Employer	0.03%	0.03%	0.06%
State	0.02%	0.01%	0.03%

The **adoption** of the medical expense account contribution rate is expected to occur at the **July 28, 2010 Board Meeting**. The Board will also be expected to adopt the Base Contribution rates at the same meeting.

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<sup>3</sup> Contribution rates assume the 401(h) account will be invested within the CTF at an assumed 8% long-term annual return and use the same funding method and assumptions currently in place for the retirement plan. If a different set of methods or assumptions are adopted the rates listed here will change.

<sup>4</sup> These contribution rates have been removed from the Preliminary June 30, 2009, Actuarial Valuation Results.