



July 22, 2015

Individual Health Savings Accounts

INITIAL CONSIDERATION

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ISSUE STATEMENT

There is a gap in healthcare coverage for public safety employees from the time of retirement to when Medicare coverage begins.

OVERVIEW

Health insurance premiums have increased rapidly over the recent past, growing a cumulative 138% between 1999 and 2010 and outpacing cumulative wage growth of 42% over the same period.¹ Therefore, it's important for members to begin saving for healthcare costs in retirement, now.

LEOFF Plan 2 members have the opportunity to take a normal retirement at age fifty-three, or take an early retirement at age fifty. Some members have access to the retiree medical plans sponsored by the public employees' benefits board, however many local employers do not participate in the medical program, and retiree medical coverage can be hard to find and expensive especially before reaching Medicare eligibility generally at age sixty-five.

SB 6071 (Appendix B) was introduced in the 2015 session to help ensure access to retiree medical coverage for LEOFF Plan 2 members through the use of appropriate tax-authorized spending accounts or voluntary employee benefit accounts. These accounts would allow employees to contribute income now to help pay for their future medical premiums. As allowed by the IRS, these accounts may also allow employer contributions if bargained for at the local level. This bill did not receive a hearing.

BACKGROUND & POLICY ISSUES

There are different accounts available to help pay for post-retirement healthcare costs. A few of those options are:

¹ Kaiser Family Foundation/Health Research and Educational Trust, Employer Health Benefits 2010 Annual Survey.

Voluntary Employees' Beneficiary Association (VEBA)

A tax-free post-retirement medical expense account used by retirees and their eligible dependents to pay for any eligible medical expenses. The plan is funded by the amount of unused sick leave that an employee has at the time of retirement, which is contributed by the employer into the plan. The benefit of this plan is the amount of sick leave left at retirement is paid out in full to the plan and is not subject to tax, which would reduce the amount one would receive.

VEBA plans are considered welfare benefit plans under federal tax law and are tax-exempt under Section 501(c)(9) of the Internal Revenue Code. Contributions to a VEBA are therefore tax-deductible and the funds grow tax-deferred. There are no tax penalties for early distributions from the VEBA, and assets are protected from creditors.

The primary benefit of a VEBA is the tax savings on the initial deposit of funds into the account. Many individuals withdraw their VEBA funds very quickly to cover medical expenses. Others may wish to save the account for future use, and invest for long term growth.

If upon a members death there are unused funds in the VEBA, and the member is survived by their legal spouse or dependent children (or other dependents as defined by the IRS), they will be able to use the remaining funds in the account for their eligible health care expenses. If a member has no surviving spouse or dependent(s), any remaining funds will be forfeited and redistributed pro rata among the remaining participants.

Health Savings Account (HSA)

An HSA is a tax favored savings account that may be established for employees covered by a "high deductible health plan" (HDHP). An HSA may be funded by both employer and employee contributions, within IRS established limits, to finance health care costs. The contributions are invested over time and can be used to pay for qualified medical expenses, which include most medical care such as dental, vision and over-the-counter drugs. This was enacted as part of the Medicare Prescription Drug Improvement and Modernization Act of 2003 and the rules are found in Section 223 of the IRC. Contribution limits are relatively high, \$3,350 for an individual or \$6,650 for family coverage, but can be used at any time.

An HSA has three major tax savings: the money contributed into the account is tax deductible, it grows tax free, and certain withdrawals are tax free if they are for qualified medical expenses. To qualify for an HSA account, you must have coverage from a high-deductible health plan and you must not be enrolled in Medicare or be listed as a dependent on another person's tax return.

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.² 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 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

When 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

² <http://www.irs.gov/pub/irs-tege/chap801.pdf>

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).*³

³ <http://www.irs.gov/pub/irs-pdf/p11433.pdf>

IRC Section 115 Trust

A Section 115 trust is established by a state or local government plan to hold assets for paying employee benefits, and the earnings on the trust assets are excluded from federal income taxes.

Advantages

Establishing a 115 Trust is generally less expensive than a VEBA Trust because there are fewer IRS interpretations required (depending on the plan). The 115 Trust is established by a governmental unit, including a municipality, to set aside funds for paying employee benefits. The accumulation of funds is excluded from federal income taxes. A Section 115 Trust meets Government Accounting Standards Board (GASB) 45 requirements for pre-funding Other Post-employment Benefits (OPEB).

Disadvantages

Because the Trusts can be based on individual accounts, the balances are often depleted before a retiree's death. Individual employees have limited control over their accounts since Section 115 Trusts are established and maintained by the employer.

Section 115 Trusts can be structured to provide very different benefits

- Fixed contribution and fixed amount available for medical expenses per month for life.
- Fixed contribution and variable amount available for medical expenses per month for life (set annually).
- Actuarially determined contribution and fixed (or nonfixed) amount available for medical expenses for life.

SUPPORTING INFORMATION

Appendix A: Senator Hobbs' letter to the Board

Appendix B: SB 6071

Appendix A



Washington State Senate

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Senator Steve Hobbs
44th Legislative District

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March 12, 2015

LEOFF Plan 2 Retirement Board
P.O. Box 40918
Olympia, WA 98504-0918

Dear Washington State LEOFF Plan 2 Retirement Board Members,

This legislative session I introduced Senate Bill 6071, authorizing benefit funding accounts for members of the law enforcement officers' and firefighters' retirement system plan 2. While this bill was a good starting point, my hope is that it will lead to a discussion on how to best address this issue.

I am writing to request your thoughts and feedback on SB 6071, so that it may be improved before the 2016 legislative session. Any feedback or recommendations you have would be greatly appreciated. If you prefer to have a discussion in person, I would be happy to meet with you. This is the same bill that I dropped two years ago and that I have been discussing with public safety employees for several years now.

Thank you for your attention on this matter and please do not hesitate to contact me if I can answer any questions or if you would like further information. I am looking forward to working on this bill during the interim and hope for its passage next session.

Sincerely,

A handwritten signature in blue ink that reads "Steve R Hobbs".

Senator Steve Hobbs
44th Legislative District

Appendix B

S-1426.1

SENATE BILL 6071

State of Washington

64th Legislature

2015 Regular Session

By Senators Hobbs and Conway

Read first time 02/25/15. Referred to Committee on Ways & Means.

1 AN ACT Relating to authorizing benefit funding accounts for
2 members of the law enforcement officers' and firefighters' retirement
3 system plan 2; amending RCW 41.04.208 and 41.26.740; adding a new
4 section to chapter 41.26 RCW; and creating a new section.

5 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

6 NEW SECTION. **Sec. 1.** (1) Public safety employees, such as
7 firefighters, police officers, and corrections officers, participate
8 in the law enforcement officers' and firefighters' retirement system
9 plan 2 and have the opportunity to retire at age fifty-three or take
10 an early retirement at age fifty. Many members of the law enforcement
11 officers' and firefighters' retirement system plan 2 have access to
12 the retiree medical plans sponsored by the public employees' benefits
13 board, however many local employers do not participate in the medical
14 program, and retiree medical coverage can be hard to find and
15 expensive especially before reaching medicare eligibility generally
16 at age sixty-five.

17 (2) It is the intent of the legislature to help ensure access to
18 retiree medical coverage for the public safety employees listed in
19 subsection (1) of this section, especially for the nonmedicare
20 retirees, and to assist employees in planning for their retirement
21 and future medical benefit needs through the use of appropriate tax-

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1 authorized spending accounts that will allow employees to voluntarily
2 contribute to their benefit accounts to help pay for their future
3 medical premiums. As allowed by the internal revenue service, the
4 accounts may also allow employer contributions as bargained locally.

5 **Sec. 2.** RCW 41.04.208 and 2004 c 173 s 1 are each amended to
6 read as follows:

7 (1) Unless the context clearly requires otherwise, the
8 definitions in this subsection apply throughout this section.

9 (a) "Disabled employee" means a person eligible to receive a
10 disability retirement allowance from the Washington law enforcement
11 officers' and firefighters' retirement system plan 2 and the public
12 employees' retirement system.

13 (b) "Health plan" means a contract, policy, fund, trust, or other
14 program established jointly or individually by a county,
15 municipality, or other political subdivision of the state that
16 provides for all or a part of hospitalization or medical aid for its
17 employees and their dependents under RCW 41.04.180.

18 (c) "Retired employee" means a public employee meeting the
19 retirement eligibility, years of service requirements, and other
20 criteria of the Washington law enforcement officers' and
21 firefighters' retirement system plan 2 and the public employees'
22 retirement system.

23 (2) A county, municipality, or other political subdivision that
24 provides a health plan for its employees shall permit retired and
25 disabled employees and their dependents to continue participation in
26 a plan subject to the exceptions, limitations, and conditions set
27 forth in this section. However, this section does not apply to a
28 county, municipality, or other political subdivision participating in
29 an insurance program administered under chapter 41.05 RCW if retired
30 and disabled employees and their dependents of the participating
31 county, municipality, or other political subdivision are covered
32 under an insurance program administered under chapter 41.05 RCW.
33 Nothing in this subsection or chapter 319, Laws of 2002 precludes the
34 local government employer from offering retired or disabled employees
35 a health plan with a benefit structure, copayment, deductible,
36 coinsurance, lifetime benefit maximum, and other plan features which
37 differ from those offered through a health plan provided to active
38 employees. Further, nothing in this subsection precludes a local
39 government employer from joining with other public agency employers,

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1 including interjurisdictional benefit pools and multi-employer
2 associations or consortiums, to fulfill its obligations under chapter
3 319, Laws of 2002.

4 (3) A county, municipality, or other political subdivision has
5 full authority to require a person who requests continued
6 participation in a health plan under subsection (2) of this section
7 to pay the full cost of such participation, including any amounts
8 necessary for administration. However, this subsection does not
9 require an employer who is currently paying for all or part of a
10 health plan for its retired and disabled employees to discontinue
11 those payments.

12 (4) Payments for continued participation in a former employer's
13 health plan may be assigned to the underwriter of the health plan
14 from public pension benefits or may be paid to the former employer,
15 as determined by the former employer, so that an underwriter of the
16 health plan that is an insurance company, health care service
17 contractor, or health maintenance organization is not required to
18 accept individual payments from persons continuing participation in
19 the employer's health plan.

20 (5) After an initial open enrollment period of ninety days after
21 January 1, 2003, an employer may not be required to permit a person
22 to continue participation in the health plan if the person is
23 responsible for a lapse in coverage under the plan. In addition, an
24 employer may not be required to permit a person to continue
25 participation in the employer's health plan if the employer offered
26 continued participation in a health plan that meets the requirements
27 of chapter 319, Laws of 2002.

28 (6) If a person continuing participation in the former employer's
29 health plan has medical coverage available through another employer,
30 the medical coverage of the other employer is the primary coverage
31 for purposes of coordination of benefits as provided for in the
32 former employer's health plan.

33 (7) If a person's continued participation in a health plan was
34 permitted because of the person's relationship to a retired or
35 disabled employee of the employer providing the health plan and the
36 retired or disabled employee dies, then that person is permitted to
37 continue participation in the health plan for a period of not more
38 than six months after the death of the retired or disabled employee.
39 However, the employer providing the health plan may permit continued
40 participation beyond that time period.

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1 (8) An employer may offer one or more health plans different from
2 that provided for active employees and designed to meet the needs of
3 persons requesting continued participation in the employer's health
4 plan. An employer, in designing or offering continued participation
5 in a health plan, may utilize terms or conditions necessary to
6 administer the plan to the extent the terms and conditions do not
7 conflict with this section.

8 (9) If an employer changes the underwriter of a health plan, the
9 replaced underwriter has no further responsibility or obligation to
10 persons who continued participation in a health plan of the replaced
11 underwriter. However, the employer shall permit those persons to
12 participate in any new health plan.

13 (10) The benefits granted under this section are not considered a
14 matter of contractual right. Should the legislature, a county,
15 municipality, or other political subdivision of the state revoke or
16 change any benefits granted under this section, an affected person is
17 not entitled to receive the benefits as a matter of contractual
18 right.

19 (11) This section does not affect any health plan contained in a
20 collective bargaining agreement in existence as of January 1, 2003.
21 However, any plan contained in future collective bargaining
22 agreements shall conform to this section. In addition, this section
23 does not affect any health plan contract or policy in existence as of
24 January 1, 2003. However, any renewal of the contract or policy shall
25 conform to this section.

26 (12) Counties, municipalities, and other political subdivisions
27 that make a documented good faith effort to comply with the
28 provisions of subsections (2) through (11) of this section and are
29 unable to provide access to a fully insured group health benefit plan
30 are discharged from any obligations under subsections (2) through
31 (11) of this section but shall assist disabled employees and retired
32 employees in applying for health insurance. Assistance may include
33 developing and distributing standardized information on the
34 availability and cost of individual health benefit plans, application
35 packages, and health benefit fairs.

36 (13) The office of the insurance commissioner shall make
37 available to counties, municipalities, and other political
38 subdivisions information regarding individual health benefit plans,
39 including a list of carriers offering individual coverage, the rates
40 charged, and how to apply for coverage.

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1 (14) Counties, municipalities, and other political subdivisions
2 that employ public safety employees participating in the law
3 enforcement officers' and firefighters' system plan 2 must set up tax
4 appropriate flexible spending accounts or voluntary employee benefit
5 accounts that allow employees to contribute and accrue savings for
6 retiree medical premiums. The tax accounts must be consistent with
7 existing state law, the internal revenue code, and the regulations
8 adopted by the internal revenue service. To the extent allowed by the
9 internal revenue code, accounts may be authorized to accept
10 contributions from employers.

11 NEW SECTION. Sec. 3. A new section is added to chapter 41.26
12 RCW to read as follows:

13 (1) The department, in consultation with the law enforcement
14 officers' and firefighters' retirement system plan 2 board, shall
15 assist employers of law enforcement officers and firefighters in the
16 formulation and adoption of a plan, policies, and procedures designed
17 to guide, direct, and administer the voluntary employee benefit
18 account established in RCW 41.04.208 for public safety employees. The
19 program and plan documents must be developed in consultation with the
20 employers of law enforcement officers and firefighters.

21 (2) A plan document describing the requirements shall be adopted
22 and administered by the department and be available as a template for
23 local employers. The department shall represent the state in all
24 matters concerning the administration of the plan. The state may
25 engage the services of a professional consultant or administrator on
26 a contractual basis to serve as an agent to assist or perform the
27 administrative functions necessary in carrying out the purposes
28 necessary to establish the voluntary employee benefit account or
29 alternative internal revenue service authorized spending account.

30 **Sec. 4.** RCW 41.26.740 and 2003 c 92 s 7 are each amended to read
31 as follows:

32 (1) All expenses of the department and the office of the state
33 actuary related to the implementation of chapter 2, Laws of 2003
34 shall be reimbursed from the law enforcement officers' and
35 firefighters' retirement system expense fund under RCW 39.34.130.

36 (2) All expenses of the department and the office of the state
37 actuary related to the implementation of the accounts required in
38 sections 2 and 3 of this act shall be reimbursed from the law

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1 enforcement officers' and firefighters' retirement system expense
2 fund under RCW 39.34.130.

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Issue

There is a gap in healthcare coverage for public safety employees from the time of retirement to when Medicare coverage begins.

Overview

Health insurance premiums have increased rapidly over the recent past

- Growing a cumulative 138% between 1999 and 2010
- Outpacing cumulative wage growth of 42% over the same period.

It's important for members to begin saving for retiree health costs

Overview

SB 6071

- Introduced in the 2015 session to help ensure access to retiree medical coverage for LEOFF Plan 2 members through the use of appropriate tax-authorized spending accounts or voluntary employee benefit accounts
- These accounts would allow employees to contribute income now to help pay for their future medical premiums

Background

There are different accounts currently available to help pay for post-retirement healthcare costs.

- Voluntary Employees' Beneficiary Association (VEBA)
- Health Savings Account (HSA)
- IRC 401(h) Account
- IRC Section 115 Trust

VEBA

- A VEBA is funded by the amount of unused sick leave that an employee has at the time of retirement
- The amount of sick leave left at retirement is paid out in full to the plan and is not subject to tax
- Upon a members death, if there are unused funds in the VEBA, and the member is survived by their legal spouse or dependent children, they will be able to use the remaining funds in the account for their eligible health care expenses
- If a member has no surviving spouse or dependent(s), any remaining funds will be forfeited and redistributed pro rata among the remaining participants

HSA

- An HSA is a tax favored savings account that may be established for employees covered by a “high deductible health plan”
- An HSA may be funded by both employer and employee contributions
- The contributions are invested over time and can be used to pay for qualified medical expenses
- This type of account was enacted as part of the Medicare Prescription Drug Improvement and Modernization Act of 2003
- Contribution limits are relatively high, \$3350 for an individual or \$6650 for family coverage, but can be used at any time

IRC 401(h) Account

- 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
- The plan must provide that medical benefits are only provided for retired employees, their spouses and dependents
- The plan must provide that a separate account must be established and maintained with respect to contributions to fund such benefits

IRC Section 115 Trust

- A Section 115 trust is established by a state or local government plan to hold assets for paying employee benefits
- Earnings on the trust assets are excluded from federal income taxes
- A section 115 Trust meets GASB 45 requirements for pre-funding other post-employment benefits (OPEB)
- Because the Trusts can be based on individual accounts, the balances are often depleted before a retiree's death
- Individual employees have limited control over their accounts since Section 115 Trusts are established and maintained by the employer

Questions?

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