Order Code RL33361

CRS Report for Congress
Received through the CRS Web

Employer-Sponsored Retiree Health Insurance: An Endangered Benefit?

April 13, 2006

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Summary

The coverage offered by employer-sponsored retiree health insurance plans has been shrinking. Although high retiree health care costs were the root cause for cutbacks in coverage, changes in accounting requirements were the triggering event. The trend towards reducing coverage began in the private sector in 1990, when the Financial Accounting Standards Board (FASB) released Statement of Financial Accounting Standards No. 106 (SFAS 106). The trend in cutbacks to employer-sponsored retiree health insurance could spread to state and local governments. The Government Accounting Standards Board released Statement 45 in June, 2004. This accounting standard will require accrual accounting for postretirement health insurance plans sponsored by state and local governments. Many state and local governments may decide to trim retiree health insurance plans in an attempt to control costs reported under the new accounting standard. In addition, FASB has undertaken a project for revision of accounting requirements for private sector retiree health insurance plans that may have further repercussions for the coverage provided by such plans.

This report summarizes the current coverage levels for retiree health insurance for private and public sector retirees. It outlines the provisions of SFAS 106 and GASB Standard 45 that govern employer accounting for postretirement health insurance plans as well as the new FASB project for revision of private sector accounting for such plans.

Prefunding of a postretirement health benefit plan increases benefit security for plan participants and reduces the accounting cost for the plan. This report summarizes the prefunding options available to private and public sector employers under current tax law. The report includes data that demonstrate the low level of prefunding and low employer credit ratings for some of the largest retiree health insurance plans in the private sector. The combination of limited prefunding and strained employer finances is likely to lead to further cutbacks in retiree health insurance benefits for some of these plans.

Cutbacks in retiree health benefits cause considerable distress to those already retired and to older employees close to retirement. This report describes the public policy options that have been considered and others that might be considered by Congress to address the problems created by the erosion of employer-sponsored retiree health insurance plans. It does not include a list of specific legislation. Such a list is included in CRS Report RL32944, *Health Insurance Coverage for Retirees,* by Hinda Ripps Chaikind and Fran Larkins.

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Introduction

The coverage offered by employer-sponsored retiree health insurance plans has been shrinking. Although high retiree health care costs were the root cause for cutbacks in coverage, changes in accounting requirements were the triggering event. The trend towards reducing coverage began in the private sector in 1990, when the Financial Accounting Standards Board (FASB) released Statement of Financial Accounting Standards No. 106 (SFAS 106). The percentage of large employers (500 or more employees) offering retiree health insurance was 28% for pre-Medicare eligible retirees and 20% for Medicare-eligible retirees in 2004. The corresponding numbers were much higher at 46% and 40% respectively in 1993.[1]

The trend towards reduction in coverage could spread to the public sector. The Governmental Accounting Standards Board (GASB) released Statement 45 in June, 2004. GASB 45 applies to accounting by state and local governmental employers for retiree health insurance plans and will become effective beginning in 2007.[2] Many state and local governments that have evaluated the postretirement health benefit costs that must be reported under GASB 45 have reported large increases compared to the costs currently reported.[3] Many state and local governments are likely to consider cutting back retiree health benefit coverage in an effort to control the postretirement health benefit cost.

This report focuses on accounting developments and how these are likely to influence employer decisions regarding retiree health coverage. The report does not attempt to provide a complete picture of retiree health coverage and design trends. CRS Report RL32944, *Health Insurance Coverage for Retirees*, by Hinda Chaikind and Fran Larkins provides a more comprehensive analysis of these issues.

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[1] *Mercer 2004 National Survey of Employer-Sponsored Health Plans*

[2] The FASB and GASB are not governmental agencies, and they do not have enforcement authority to require private sector entities (in the case of FASB) or state and local governments (in the case of GASB) to comply with their standards. However, compliance with FASB or GASB standards is required for accounting statements to be considered to conform with Generally Accepted Accounting Principles (GAAP). When certified public accountants issue opinions on financial statements, they are required by auditing standards to test whether the statements are fair presentations, in all material respects, of financial information in conformity with GAAP.

[3] Retiree health insurance plans are also called retiree health benefit plans or postretirement health benefit plans. In this report , we have used these terms interchangeably.

Employer decisions regarding the level of retiree health benefit coverage for over-65 retirees may be influenced by the availability of Medicare benefits. Effective January 1, 2006, a new voluntary prescription drug benefit was added to Medicare under the Part D program. In order to provide an incentive to employers to continue to offer prescription drug benefits to their Medicare-eligible retirees, the law provides for payment of subsidies to those employers who offer qualified retiree prescription drug coverage. For a complete discussion, see CRS Report RL33041, *Medicare Drug Benefit: Retiree Provisions*, by Jennifer O'Sullivan.

Coverage

In 2002, the proportion of early retirees (generally those under 65) covered by employer-sponsored retiree health insurance was 28.7%, while the proportion of Medicare-eligible retirees covered by employer-sponsored retiree health insurance was 25.5%.[4] On account of the erosion of retiree health insurance plans in the private sector, and the likelihood of cutbacks in state and local government plans in response to GASB 45, the proportions of future generations of retirees covered by employer-sponsored retiree health plans will certainly be much smaller. Fidelity Investments has predicted that the population with access to employer-sponsored health care in retirement will decrease by 25% to 50% as more companies see health care as too great a liability.[5] In addition, the proportion of individuals retiring early may decline since individuals may not be able to afford retirement without employer-sponsored retiree health coverage.

Table 1. Employment by Category for U.S. Civilian Workforce, 2003[6]

	Numbers in millions	Percentage
Private Sector	116	84%
State Governments	5	4%
Local Governments	14	10%
Federal Government - Civilian	3	2%
Total	138	100%

Source: Total U.S., federal, state, and local employment figures from Statistical Abstract of the United States: 2006, Tables 451, 496, and 576. Private sector employment determined as the difference between total employment and governmental employment.

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[4] Employee Benefit Research Institute analysis of data from the Survey of Income and Program Participation (SIPP), 2001 Panel. The SIPP is conducted by the U.S. Census Bureau and is based on a sample of all U.S. households.

[5] "For Retired Couples, Coverage for Health May Mean $200,000," *The Wall Street Journal*, Mar. 7, 2006.

[6] 2003 is the latest year for which such data is available.

Note: Table excludes self-employed persons, private household workers, unpaid family workers, agricultural workers, and armed forces.

As may be seen from **Tables 1** and **2**, although the vast majority of Americans is employed by the private sector (84%), among current retirees entitled to employer-sponsored health insurance, only 39% owed the benefit to a private sector employer. Another 39% of current retirees owed their retiree health insurance coverage to prior service with a state or local government (**Table 2**). The majority (61%) of current retirees with employer-sponsored retiree health coverage are former governmental employees.

Table 2. Current Retirees Covered by Employer-Sponsored Health Insurance in 2005

(numbers in millions)

	Age < 65	Age 65+	Total - Number	Total - Percent
Private Sector	1.1	2.7	3.8	39%
Public Sector - State and Local	1.2	2.6	3.8	39%
Public Sector - Federal	0.3	1.9	2.2	22%
Total	2.6	7.2	9.8	100%

Source: Analysis of data from 2005 Current Population Survey by the Employee Benefits Security Administration Division of the Department of Labor.

Note: Excludes dependents of retirees.

Retiree health benefits constitute the primary form of Other Postemployment Benefits (OPEB).[7] Statement of Financial Accounting Standards No. 106 (SFAS 106) requires private sector firms to quantify annually their OPEB obligation.[8] In the private sector, the obligation for retiree health benefit coverage is concentrated among a few very large employers. As may be seen from **Table 3**, at the end of 2004, the OPEB obligation for the Standard and Poor's 500 (S&P 500) companies was $420 billion, for which they had set aside only $84 billion in assets. **Table 3** shows key information for the ten largest OPEB plans in the S&P 500, based on their OPEB obligation at the end of 2004. The OPEB obligation for the ten largest plans in the S&P 500 was $219 billion, or 52% of the OPEB obligation for the S&P 500 companies.

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[7] Other examples of OPEB benefits are life insurance and tuition assistance.

[8] The OPEB obligation, also called the Accumulated Postretirement Benefit Obligation, is defined by SFAS 106 as the actuarial present value of benefits attributed to employee service until the measurement date. Pages 5-7 of this report describe the requirements of SFAS 106.

The credit rating of a company provides an assessment of the company's capacity to pay interest and repay principal on its debt and can be used as a rough measure of the ability of the company to pay retiree health benefits as promised under its plan. According to S&P, the debt of companies rated at BBB or below is considered to be speculative grade and indicates vulnerability to default. General Motors, Ford, and Lucent fall in this category. Delphi is in a worse financial position, having filed for Chapter 11 bankruptcy on October 8, 2005. The OPEB obligation for the above four companies together is $132.7 billion, 31% of the total OPEB obligation for the S&P 500 companies. These four companies are under financial pressure and are likely to cut back retiree health benefits in order to free up cash for other needs.

Table 3. Ten Largest Other Post-Employment Benefit Plans in the S&P 500, 2004
(amounts in illions)

Company	S&P Credit Rating	OPEB Obligation	OPEB Plan Assets
General Motors Corp	B	$77.47	$16.02
Ford Motor Co	BB-	39.12	6.76
Verizon Communications	A	27.08	4.55
SBC Communications	A	25.11	8.69
Bellsouth Corp	A	10.88	4.20
Delphi Corp	NA - in bankruptcy	9.61	0
General Electric	AAA	9.25	1.65
Boeing	A	8.14	0.07
Lucent Technologies	B	6.49	1.63
Intl. Business Machines	A+	5.89	0.05
Total (Ten Largest)		219.02	43.62
Total (All S&P 500 Cos.)		420.00	84.00

Source: OPEB obligation and plan asset data from Credit Suisse report "The Buck Stops Where?" by David Zion and Bill Carcache, February 15, 2006; organization credit ratings from Standard and Poor's website at [http://www.standardandpoors.com], accessed as of March 7, 2006.

Indeed, General Motors announced cutbacks to the retiree health plans of its hourly employees on October 17, 2005, and salaried employees on February 7, 2006, that would reduce its retiree health obligation by $15 billion and $4.8 billion

respectively.[9] Retiree health benefit cuts were also announced by Ford, and Delphi is in the process of negotiating benefit cuts with its unions as part of its bankruptcy reorganization. Lucent has made several cuts in its retiree health benefit plans in the last few years. With a retiree to active ratio of 10 to 1, Lucent still would face difficulty in paying retiree health benefits if it did not have a well-funded pension plan. Lucent and its employee unions, the Communications Workers of America and the International Brotherhood of Electrical Workers, have lobbied Congress to relax asset transfer rules under Section 420 of the Internal Revenue Code so that more of the excess pension assets can be employed for payment of retiree health benefits.[10]

Companies that are financially sound have also announced cuts in retiree health benefits. Citing competitive pressures from companies that do not contribute to retiree health premiums, Verizon eliminated retiree health benefits for managers with less than 15 years of service at retirement.[11] The above examples illustrate the continuing erosion of retiree health plans in the private sector.

State and local governments are currently much more likely to sponsor retiree health plans than private sector employers. All fifty states offer health benefits to their retirees in some or all age groups.[12] Some local governments offer retiree health benefits. State and local governments have started measuring their retiree health benefit liabilities and costs in preparation for the implementation of GASB 45. Confronted with the magnitude of the unfunded liabilities, many are likely to consider cutbacks in retiree health benefits.

Retirees fortunate enough to be covered by employer-sponsored retiree health insurance may be required to pay substantial premiums for the coverage. According to consultant surveys that provide a breakdown for under- and over-65 retirees, and private and public sector plans, of those employers that sponsor retiree health insurance plans, 30% to 40% provide "access only" plans in which retirees pay for the full cost of coverage.[13] Since it is often difficult for older individuals to find a reasonably priced plan in the individual health insurance market,[14] employees consider even "access" only plans to be valuable.

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[9] "GM, UAW Tentative Health Care Deal Expected to Save $1 Billion per Year," *BNA Pension & Benefits Daily*, Oct. 18, 2005; "General Motors to Freeze Health Care for Salaried Retirees, Alter Pension Plan," *BNA Pension & Benefits Daily*, Feb. 9, 2006.

[10] "Joint Union - Management Committee Devises Plan to Preserve Retiree Health Care Funding," *BNA Pension & Benefits Daily* , June 22, 2005.

[11] "Verizon Says it Will Freeze Pensions, Cut Retiree Health Care for Managers," *BNA Pension & Benefits Daily*, Dec. 8, 2005.

[12] *Retiree Health Care: A Growing Cost for Government*, California Legislative Analyst's Office, Feb. 17, 2006.

[13] See *Mercer 2004 National Survey of Employer-Sponsored Health Plans* and *Segal 2003 State Health Benefits Survey: Medical Benefits for Employees and Retirees*.

[14] See CRS Report RL32944, *Health Insurance Coverage for Retirees*, by Hinda Ripps Chaikind and Fran Larkins for information regarding the high cost of health coverage for older individuals in the individual insurance market.

Accounting for Employer-Sponsored Retiree Health Insurance

Private Sector Employers

SFAS 106. Since the early nineties, accounting standards have had a major influence on the level of retiree health coverage offered by private sector employers. In 1990, the FASB released SFAS 106 that dramatically changed accounting standards for postretirement health benefits provided by private sector employers. SFAS 106 stated that similar to pensions, retiree health benefits were to be considered a form of deferred compensation that created an obligation for employers as employees rendered service. Prior to SFAS 106, employers had shown the retiree health benefit cost for a year as the "pay-as-you-go" amount or the amount paid out for retiree health benefit claims for that particular year. SFAS 106 specified a new method for determining the postretirement health benefit cost.[15]

The postretirement health benefit cost determined under SFAS 106 required recognition of health care benefits to be paid not only to current retirees but also to future retirees. The postretirement health benefit cost determined under SFAS 106 was typically several times higher than the pay-as-you-go amount that it replaced on the employer's income statement. Higher costs lower an employer's profits and can lead to a lower stock price for a publicly traded company.

It should be noted that while the accrual accounting specified under SFAS 106 results in a higher cost in the year of implementation, the cost shows a more level pattern than under prior accounting practice. Under pay-as-you-go accounting, the postretirement health benefit cost typically increases year after year as the employee population ages.

Under SFAS 106, an employer is required to post each year the difference between the postretirement health benefit cost and the amount funded by the employer for postretirement health benefits, as a liability to the employer's balance sheet. The amount funded by the employer for postretirement health benefits is the amount put aside by the employer in an irrevocable trust for prefunding of the retiree health benefit plan, or the pay-as-you-go retiree health benefit amount if the employer is not prefunding the retiree health benefit plan.

SFAS 106 also required the obligation for postretirement health benefits to be disclosed in the footnotes to an employer's financial statement. The obligation was to be determined as the actuarial present value of future retiree health benefits to be paid to employees that were attributed to service provided by employees up to the

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[15] In this report, we have used the term postretirement health benefit cost to mean the same as the postretirement health benefit expense. The postretirement health benefit expense is the amount recognized in an employer's income statement. Usually this is the same as the postretirement health benefit cost.

measurement date. The obligation was not posted to the employer's balance sheet where it would have directly reduced shareholders' equity.[16]

For most employers, the effect of implementation of SFAS 106 was a higher postretirement health benefit cost on the income statement and the disclosure of a large postretirement health benefit obligation in the footnotes to its financial statement. The FASB's objectives in developing SFAS 106 were to improve the "representational faithfulness" of the employer's reported results in the income statement and the statement of financial position. The FASB succeeded in making the retiree health benefit promise much more transparent.

However, faced with new large costs on their income statements, many employers began cutting back on retiree health benefit plans. Beginning in the early nineties, private sector employers redesigned retiree health plans by instituting caps, reducing commitment based on the age at retirement or years of service of a retiree, increasing retiree premium sharing or eliminating coverage altogether for either future retirees or all retirees.

Some have blamed the FASB for the cutbacks in employer-sponsored retiree health benefits, although all that the FASB standard did was shed light on a promise whose magnitude was until then obscure. The underlying reasons for the high postretirement health cost under SFAS 106 are high health care inflation, increases in health care utilization, growing numbers of retirements, and increasing life expectancy. Employers point out that one of the factors in the high health care inflation is the cost shifting by health care providers for costs that they are constrained from charging the Medicare and Medicaid programs.

FASB's Proposed Revisions to SFAS 106. Although SFAS 106 improved the accounting of postretirement health benefit plans from the prior pay-as-you-go accounting, many investors and creditors believe that the current accounting requirements need to be further revised to make it easier to assess an employer's financial position and its ability to carry out the obligations of its plans. To address these concerns, the FASB has embarked on another project that will significantly affect the accounting for postretirement health benefit plans. In the first phase of the project, the FASB issued an Exposure Draft on March 31, 2006, that makes two major changes to current accounting procedures. The net funded status of a postretirement health benefit plan (fair value of plan assets less accumulated postretirement benefit obligation) would be moved from an employer's financial statement footnotes to its balance sheet. In addition, plan sponsors would be required to measure assets and obligations for the postretirement health benefit plan as of the balance sheet date. Currently, under SFAS 106, plan sponsors are allowed to measure plan assets and obligations up to three months earlier than the balance sheet date. Aligning the measurement date with the balance sheet date is intended to reduce some of the delayed recognition available under SFAS 106.

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[16] For a public corporation, the total assets less the total liability constitutes shareholders' equity. This is also called the book value of the corporation and is used as a rough guide as to whether the corporation's shares are reasonably valued.

FASB's goal is to make the changes proposed in the Exposure Draft effective for financial years ending after December 15, 2006. That would mean 2006 financial statements for firms on a calendar year reporting time table. The second phase of the FASB project is expected to be more ambitious and controversial. In the second phase, FASB will consider whether to eliminate "smoothing mechanisms," accounting rules that allow for delayed recognition of plan asset losses and increases in plan obligations. Those changes could sharply increase postretirement health benefit cost in certain years.

The FASB Exposure Draft provisions apply to defined benefit pension plans in addition to OPEB plans.[17] Under the FASB proposal for balance sheet posting of funded status, the result will be reduced shareholder equity for many publicly traded companies. This could affect the cost of borrowing and credit ratings for such companies. An employer seeking to address the situation is more likely to cut retiree health benefits than pensions. Unlike pensions, there are few legal barriers to reducing retiree health benefits. Furthermore, retiree health benefit plans generally have larger deficits than pension plans; therefore, cutting them would have a more favorable impact on the employer's financial position. Credit Suisse has estimated that for the S&P 500 companies, as of year end 2004, the underfunded balance for Other Post Employment Benefits (consisting primarily of postretirement health benefits) is $336 billion, or 104% higher than the underfunded balance for pensions of $165 billion.[18]

Reflecting the funded status of OPEB and pension plans on the balance sheet would have the most dramatic impact on the balance sheets of old industrial, old economy companies with heavily unionized work forces. It is estimated that if the proposed FASB accounting rule had been in effect as of the end of 2005, the net worth of Ford and General Motors of $14 billion and $15 billion respectively would have been wiped out and each would have shown a net liability instead. Unfunded retiree health care benefits would be a bigger contributor to this swing than unfunded pension benefits.[19]

State and Local Governments

An accounting standard similar to SFAS 106 was released recently for retiree health plans sponsored by governmental employers. The Government Accounting Standards Board (GASB) released Statement 45 in June, 2004. This statement applies to states, counties, and municipalities. Other governmental entities covered by GASB reporting requirements may include school districts, public railroad and transit administrations, and public university and health care systems. GASB 45

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[17] The accounting standard that applies to private sector defined benefit pension plans is SFAS 87. The FASB Exposure Draft would make analogous changes to SFAS 87 as to SFAS 106.

[18] *Credit Suisse Report*, "The Buck Stops Where?" by David Zion and Bill Carcache, Feb. 15, 2006.

[19] "Shocks Seen in New Math for Pensions," Mary Williams Walsh, *The New York Times*, Mar. 31, 2006.

follows the broad principles established by the Financial Accounting Standards Board (FASB) for private sector employers a decade earlier.

GASB 45, like its predecessor SFAS 106, requires the cost of a postretirement health plan to be determined taking into account health care benefits to be paid not only to current retirees but also to future retirees. Currently most governmental employers record the postretirement health benefit cost for a year on a pay-as-you-go basis. The pay-as-you-go amount is the amount of health care benefits paid out for retirees in that year. The postretirement health benefit cost determined under GASB 45 is called the Annual Required Contribution (ARC). For large state and local governments, GASB 45 is effective for financial statements for periods beginning after December 15, 2006.

Though there are technical differences in the way the postretirement health cost is determined under SFAS 106 and GASB 45, the postretirement health cost determined under either standard is likely to be much larger than the pay-as-you-go cost recorded under prior accounting convention. The postretirement health cost under GASB 45 could be 5 to 10 times the pay-as-you-go cost. For example, in New York City, the retiree health benefit cost under current pay-as-you-go accounting is $911 million. This is expected to shoot up to between $5 billion to $10 billion under GASB 45.[20] For the state of Maryland, the retiree health cost under current accounting for the fiscal year 2006 is $311 million. The retiree health benefit cost using GASB 45 accounting would be $1.959 billion.[21]

Under GASB 45, the employer is also required to disclose the actuarial accrued liability, which, according to consultants, could be as large as 50 times the annual retiree health benefit claims. For example, for the state of Maryland, the unfunded accrued liability for retiree health benefits is estimated at $20 billion.[22] In addition, the employer must post the net postretirement health obligation to the balance sheet equal to the cumulative difference between the ARC and any contribution that the employer has made to an irrevocable trust for prefunding retiree health benefits.[23] If the employer does not set aside additional funds each year for the payment of retiree health benefits, the net postretirement health obligation is likely to grow rapidly. A large net postretirement health obligation is likely to adversely affect a state or city's credit rating and increase the interest rate it pays on borrowing.

There are two ways a state or local government can reduce the net postretirement health obligation: limit retiree health coverage or start prefunding the retiree health benefit plan by contributing monies to an irrevocable trust to be used

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[20] See "Huge Rise Looms for Health Care in City's Budget," *The New York Times*, Dec. 26, 2005.

[21] "Change in Financial Reporting Obligations May Affect State, Local Retiree Benefits," BNA Pension & Benefits Daily, Feb. 28, 2006.

[22] Ibid

[23] If the employer is not prefunding the retiree health benefit plan, the net postretirement health benefit obligation is the cumulative difference between the ARC and the retiree health benefit claims paid out.

for payment of these benefits. In a departure from SFAS 106, GASB 45 allows the use of a higher interest rate for determination of the postretirement health benefit cost if the ARC is set aside in a trust dedicated to payment of the retiree health benefits. Since the use of a higher interest rate lowers the cost and net obligation (a general rule of thumb is that a 1% increase in the interest rate reduces the ARC and actuarial accrued liability by 15%-20%), this provision will provide further incentive to state and local governments to prefund retiree health benefits.[24]

Although state and local governments are likely to evaluate plan designs with an eye on limiting liabilities, it is unlikely that they will cut benefits to the extent that private sector employers reduced benefits in the wake of SFAS 106. Changing retiree health benefits requires legislation for most states and also for some local governments. Employees in state and local governments are unionized to a larger extent than in the private sector and are likely to put up greater resistance to cuts in benefits.[25]

Prefunding Options

A sponsor of a retiree health benefit plan is not legally required to make annual contributions to a trust. Prefunding via an irrevocable trust makes the promised benefits more secure. Funds set aside for payment of retiree health benefits may not be accessed for other purposes by either the employer or creditors. Funding also lowers the accounting liability and cost for the retiree health plan. In many instances, funding may lead to a higher return on assets set aside in the trust compared to the return on the employer's general operating funds.

The tax code in general does not provide as favorable a tax treatment for prefunding of retiree health benefits as for pension benefits. With respect to assuring that benefits will be paid to employees as promised, an ideal funding vehicle for the prefunding of retiree health benefits would have the following characteristics:

- Sufficient contributions may be made to allow accumulation of adequate funds for payment of retiree health benefits.
- The rate of return on assets in the trust compares favorably to alternate uses of employer funds.
- Contributions made to the trust are tax deductible to the employer and tax free to employees.
- Retiree health care benefits paid out of the trust are tax free to retirees.
- Assets accumulated in the trust are not accessible to creditors of the employer in the event of employer bankruptcy.

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[24] For an example of the effect of the interest rate on ARC and the retiree health liability, see "Managing OPEB Costs under New GASB Rules," by Milliman Consultants and Actuaries, April 2005 at [http://www.milliman.com].

[25] 2004 CPS data for active employee and dependent populations indicates that for state and local governments, 50% of the population is unionized whereas for the private sector only 14% of the population is unionized.

- Trust assets are recognized as an offset to liabilities for accounting purposes.

If such an ideal vehicle for prefunding retiree health benefits were to be made available on a broad basis under the tax code, Congress might opt to add other legal requirements that are currently missing. For example, minimum standards for participation, vesting, and funding might be established. Congress might also consider adding an insurance mechanism to protect benefits in the event of termination of an underfunded retiree health plan.

We discuss below the primary prefunding vehicles currently available under the tax code.

Voluntary Employee Benefit Association

An employer may prefund a retiree health benefit plan via a Voluntary Employee Benefit Association (VEBA) trust organized under Section 501(c)(9) of the Internal Revenue Code (IRC). However, unless the VEBA has been established under a collective bargaining agreement or is an employee-pay-all-VEBA (contributions to the VEBA are made by employees only), the maximum allowable contribution is limited and may not take future health care inflation or utilization increases into account. Furthermore, investment income on the VEBA trust assets is subject to Unrelated Business Income Tax (UBIT) unless the VEBA is a collectively bargained VEBA, an employee-pay-all-VEBA, or a VEBA sponsored by a tax-exempt organization. Tax rates applicable to trusts are used to calculate the UBIT for VEBAs.

Certain types of VEBAs enjoy preferential treatment under the IRC. A VEBA trust established pursuant to a collective bargaining agreement for prefunding of retiree health benefits has favorable tax treatment. Investment income on the trust is not taxed, employer contributions to the trust are tax deductible, and adequate contributions may be made to the trust taking into account future health care inflation and utilization increases.

If contributions to a VEBA trust are made by a tax-exempt employer such as a state or local government or a non-profit entity, earnings on assets in the trust are not subject to tax. However, health care inflation or utilization increases may still not be taken into account in determining the limit on VEBA funding in a year.

Some employers have established employee-pay-all VEBAs for prefunding employee out-of-pocket health care costs in retirement. In this type of VEBA, employees make all of the contributions, with no contributions made by employers, and the investment income on the VEBA accumulates tax free. Employees can withdraw funds after retirement from the VEBA to pay health care costs without paying taxes on the withdrawals. However, current law poses some problems in the application of employee-pay-all VEBAs for saving for out-of-pocket health care costs in retirement. Amounts contributed by an active employee to the VEBA can not be refunded to the employee or his family upon job termination or premature death. In addition, although investment income on funds in an employee-pay-all VEBA is not

subject to UBIT, if employee and employer funds are commingled in the same VEBA, all investment income is subject to that tax.

An employee-pay-all VEBA can be used effectively in an industry where an employee leaving one employer is likely to take up a job with another employer within the same industry. This is particularly true for employers that are not subject to tax. An example is a program called Emeriti Retirement Health Solutions that was recently marketed to academic employees of nonprofit colleges. The program allows employees to contribute on an after-tax basis to an employee-pay-all VEBA. Employee contributions earn tax-free interest. Each employer also makes annual contributions on behalf of employees to a separate VEBA up to the level it wishes to support, and these contributions accumulate tax free because the colleges are nonprofit entities. Upon retirement, employees withdraw funds tax free to pay premiums for one of several choices of health care plans.[26]

For employer-funded VEBAs, separate accounts must be maintained for key employees. Employers usually avoid the cumbersome procedures this imposes by excluding key employees from the VEBA, although not from retiree health coverage.

Under Section 4976 of the IRC, any reversion of VEBA assets to the employer is subject to a 100% excise tax. This has the effect of committing VEBA assets only for payment of the benefits for which the VEBA was funded.

401(h) Subaccount of a Defined Benefit Pension Plan

A limited amount of prefunding for retiree health benefits can be achieved through a subaccount of a defined benefit pension trust established under Section 401(h) of the IRC. Unlike a VEBA, future increases in retiree health care costs may be taken into account in determining the contribution to a 401(h) subaccount. However, retiree health benefits provided through a 401(h) subaccount must be subordinate to pension benefits, meaning that the employer's contribution to the 401(h) subaccount may not exceed 25% of the total employer contribution to the pension fund. Investment income on assets in the 401(h) subaccount accumulates tax free, and retiree health benefit payments made from the subaccount are not taxable to retirees.

Transfer of Excess Pension Assets to a 401(h) Subaccount

Section 420 of the IRC allows an "overfunded" defined benefit pension plan to transfer excess pension assets (defined as the excess of plan assets over the greater of the accrued liability under the plan's funding method, or 125% of the current liability of the plan) to a 401(h) subaccount for payment of retiree health benefits. The amount of transfer is limited to the amount of current retiree health benefits. In other words, such a transfer may not result in prefunding. If prefunding has been done for current retiree health benefits through a VEBA, then the amount of transfer permitted is limited to take into account VEBA prefunding.

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[26] Making Retiree Health Care Affordable," Jerry Geisel, *Business Insurance*, Jan. 23, 2006.

An employer that makes a Section 420 transfer must fully vest all employees in their pension benefits, including employees who terminated service one year before the date of transfer. In addition, there is a "maintenance of cost" requirement under which the employer may not reduce the per capita cost of the retiree medical plan for five years after the asset transfer.

Section 115 Trust

Governmental employers can establish a trust under IRC Section 115 to fund an essential government function, including providing retiree health benefits. Contributions to a Section 115 trust are not limited, unlike contributions to a VEBA or 401(h) subaccount. The investment income on a Section 115 trust is not taxed, and the benefits ought to be tax free to the retiree when received. However, the IRS has issued little guidance with respect to the use of Section 115 trusts for funding retiree health benefits. Consultants advise that governmental employers obtain an opinion from the IRS to confirm that benefits paid to retirees would be tax free before establishing a Section 115 trust for this purpose.

Other Prefunding Vehicles

VEBAs and 401(h) accounts of defined benefit pension plans are the most common funding vehicles used for prefunding of retiree medical plans. Employers have sometimes used both a VEBA and 401(h) account for the same retiree health plan in order to maximize prefunding. Some employers have also sought to maximize the after-tax investment income on VEBA assets by investing trust assets in Trust Owned Life Insurance or Trust Owned Health Insurance.

More esoteric funding vehicles that have been used by certain employers include 401(k) plan subaccounts, Health Stock Option plans, and 401(h) subaccounts of money purchase pension plans.[27]

Prefunding of Retiree Health Benefit Plans is Limited

Although tax policy with respect to prefunding of retiree health benefits is not as clearly favorable as for pension plans, a private sector employer so inclined could accomplish full prefunding for unionized employees and at least limited prefunding for non-union employees. However, very few private sector companies prefund the postretirement health obligation to any significant extent. According to Credit Suisse, of the S&P 500 companies, 331 offer OPEB (mostly retiree health benefits). Of these, 186, or 56%, have no plan assets, which makes payment of retiree health benefits dependent on availability of cash each year.[28] Prefunding of state and local government plans also appears to be limited.

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[27] For a more detailed description of prefunding vehicles, see "Design and Funding of Other Post-Employment Benefits," *Society of Actuaries Study Note,* Course 8, April 2000, by Dale H. Yamamoto.

[28] *Credit Suisse Report*,"The Buck Stops Where?" by David Zion and Bill Carcache, Feb. 15, 2006.

Since so few employers have earmarked assets to an irrevocable trust for payment of retiree health benefits, employees are vulnerable. In addition, retiree health benefits can generally be reduced or terminated by an employer at any time, as long as the employer has reserved the right to modify the retiree health plan and there is no bargaining agreement in effect with an employee union. An employer in Chapter 11 bankruptcy reorganization may not terminate a retiree health benefit program without first negotiating proposed modifications with representatives of retirees, and second, seeking and receiving court approval to make the modifications.[29] However, many employers undergoing a Chapter 11 reorganization do end up eliminating or dramatically reducing retiree health benefits.

Public Policy Implications

Over-65 retirees without employer-sponsored retiree health insurance have access to fairly comprehensive health insurance through Medicare, even though payment of significant Medicare premiums is required. In 2006, the monthly Medicare Part B premium is $88.50 and the average monthly premium for the Medicare Part D Prescription Drug program is $32.[30] However, Medicare coverage has many gaps. The most notable of these are the lack of hospital coverage for very long stays and the so-called "doughnut hole" in Medicare Part D coverage for prescriptions. Medicare does not cover any prescription costs that fall in this hole. In 2006, for example, Medicare Part D provides no coverage for prescription costs between $2,250 and $5,100. In addition, a Medicare beneficiary is responsible for payment of many deductibles, coinsurances, and copayments. An employer-sponsored retiree health insurance plan would typically fill some of the gaps in Medicare coverage.

Cutbacks in over-65 retiree health insurance benefits would increase the Medicare beneficiaries' share of out-of-pocket health care costs and strain the limited resources of these retirees. Legislation has been introduced in the 109th Congress that would prohibit profitable employers from making any changes to retiree health benefits once an employee has retired.

Elimination of employer-sponsored retiree health insurance for under-65 retirees and older employees close to retirement can cause even greater distress. Under-65 retirees who lose employer-sponsored health insurance are put in a bad position since the marketplace does not offer many alternatives for reasonably priced individual health insurance. Employees who had planned to retire before age 65 can find themselves unable to do so without access to reasonably priced health insurance.

Legislation introduced in the 109th Congress attempts to provide solutions. One policy option that has been discussed would expand provisions of the Consolidated

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[29] For more on the treatment of retiree health benefits in bankruptcy, see CRS Report RL33138, *Employment Related Issues in Bankruptcy*, by Robin Jeweler.

[30] [http://www.cms.hhs.gov/apps/media/press/release.asp?Counter=1557], accessed on Mar. 23, 2006.

Budget Reconciliation Act (COBRA) to allow individuals who retire before reaching age 65 to purchase health insurance coverage through their employers until age 65. Another policy option would increase health insurance coverage for younger retirees by allowing individuals to purchase Medicare prior to attaining age 65. Yet another would allow individuals aged 55- 65 who do not have health insurance to buy into the health insurance program for federal employees and retirees. For a detailed discussion of policy options and legislation introduced in the 109th Congress, see CRS Report RL32944, *Health Insurance Coverage for Retirees*, by Hinda Ripps Chaikind and Fran Larkins.

Some are advocating the use of Health Savings Accounts (HSAs) for accumulating assets to pay out-of-pocket health care costs in retirement. Although HSAs could possibly be put to this use in future, it would take ten or more years for an individual to accumulate a meaningful amount to be used for payment of out-of-pocket retiree health care costs.[31] The Bush Administration has proposed increasing the maximum amount of contribution allowed into an HSA. If the proposal is enacted into law, it would allow for accumulation of larger HSA balances that could be used for payment of out-of-pocket health care costs in retirement.

A more direct way to promote employee savings for retirement health care costs might be to modify the current laws and regulations that apply to VEBAs. Although employee-pay-all VEBAs can be used to accumulate funds for out-of-pocket health care costs in retirement, current law does not allow payment of an employee's VEBA balance upon termination or premature death. Allowing such payments or allowing rollover of VEBA balances to a tax-free health retirement account for the employee or spouse would make an employee-pay-all VEBA a more useful savings vehicle for accumulation of funds for an individual's out-of-pocket costs in retirement.

Congress may also consider allowing investment income on an employer-funded VEBA to accumulate tax free to promote increased prefunding by employers.

As state and local governments evaluate unfunded retiree health liabilities under GASB 45, some of them are likely to join the private sector in reducing retiree health care benefits. This will lead to renewed calls for national level solutions to the problem of lack of access to reasonably priced health insurance.

GASB 45 is likely to lead many states and local governments to begin prefunding retiree health benefit plans. Some state and local governments may reduce outlays for other programs, whereas others may increase property taxes, sales taxes, or other taxes.

As employers cut back retiree health benefit coverage, many older employees are likely to choose to work a few years longer in order to retain health insurance

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[31] For numerical illustrations of HSA accumulations, see EBRI Issue Brief No. 271, July 2004.