

THE VEBA SOLUTION

Recent studies have determined that a typical married employee will have to fund an average of \$260,000 in post-retirement medical expenses over the balance of the employee's and spouse's lifetime. The expenditures include the costs of Medicare premiums, Medicare supplemental coverage, Medicare deductibles and co-payments and long term care expenses. These amounts are typically funded from retirement vehicles such as pension plans and individual retirement accounts (IRAs). However, retirement income from these sources is fully taxable to the employee. Is there a better way to fund these medical expenses?

A health reimbursement arrangement (HRA) is a tax-advantage program that allows employees and former employees to be reimbursed for medical care expenses incurred by the employee, as well as the employee's spouse and eligible dependents. Employers are increasingly using HRAs as a vehicle to provide additional medical benefits to their employees, perhaps to offset increasing employee contributions to the cost of group health coverage. HRAs are often maintained in tandem with premium-only cafeteria plans and flexible spending accounts to provide employees additional ways to pay medical care expenses with pre-tax dollars.

HRAs are usually "unfunded," which means benefits are paid from an employer's general assets on a pay-as-you-go basis. However, HRAs can be combined with VEBAs to provide a tax-exempt funding vehicle (a VEBA medical reimbursement plan) to cover medical expense

reimbursement for employees and their dependents during the course of employment and after termination of employment.

A VEBA is a “voluntary employees’ beneficiary association” recognized as tax-exempt under Section 501(c)(9) of the Internal Revenue Code. As such, a trust holding VEBA assets can accumulate, tax-free, financial resources for the payment of sickness, accident and health benefits. Pre-tax contributions are employer funded at no tax cost to employees, in some cases based on employees’ accumulated vacation or “PTO” time.

A case in point is a tax-exempt organization that is concerned with its liability for the generous amounts of vacation and PTO accumulated by its employees. These amounts escalate in value as an employee’s compensation increases over the course of the employee’s entire career. Employers are not in a position to simply eliminate benefits that have been earned. An alternative which can be offered is medical reimbursement benefits during the course of employment, or even following termination of employment. Although these amounts are funded by the employer with pre-tax dollars, the contributions will not be subject to Social Security and Medicare withholding taxes like cash compensation, which cannot in any event be paid through a VEBA medical reimbursement plan (the only cash that can be paid to employees from a medical reimbursement plan is to reimburse them for substantiated medical care expenses).

Participants can take tax-free reimbursements at any age without penalty to pay for qualified medical care expenses. These expenses include uninsured medical, dental and vision expenses (including deductibles and co-payments) and post-retirement insurance premiums (COBRA, Medicare Parts B and D, Medicare supplements and qualified long term care premiums).

With post-retirement medical expenses for a couple age 65 estimated at \$260,000, a VEBA medical reimbursement plan offers the *only* way to fund those expenses with pre-tax dollars that accumulate tax-free and are paid out to reimburse qualified expenses on a tax-free basis. Tax-free contributions, tax-free accumulation, and tax-free distributions make the VEBA medical reimbursement plan a unique and timely approach to funding every employee's "\$260,000" in post-retirement medical expenses.

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Andrew S. Williams has practiced in the employee benefits and ERISA arena since ERISA was passed in 1974. He has been recognized by his peers through a survey conducted by Leadings Lawyers Network as among the top 5 percent of Illinois lawyers in Small, Closely and Privately Held Business Law and Employee Benefits Law. He maintains a website at www.benefitslawgroupofchicago.com with additional updates, commentary and analysis of benefits and employment topics.

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