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POSTRETIREMENT HEALTH BENEFIT FUNDING

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Recorder: ETHAN E. KRA

- Corporate-owned life insurance (COLI)
- Trust-owned life insurance (TOLI)
- Settlement contracts
- 401(h)
- Pension plan asset transfers
- Other

MR. ETHAN E. KRA: I thought it was appropriate that this session was scheduled for Las Vegas, because the objective in the design of any retiree medical funding or financing vehicle is to go up to the one-armed bandit, hit the button, and come up with three gold bars: tax deductible contributions, tax-free investment buildup, and tax-free benefits to employees. The problem is that we're unable to go up to the one-armed bandit, hit the button, and come up with three gold bars every time. That is why we're in this room: to figure out what the options are and how close they come to that beautiful target.

Adam will go through some of the issues relating to employee options and how employees are being involved in the process to save for retiree medical. Afterwards I will discuss the employer options.

MR. ADAM J. REESE: This is my six bucks approach for funding retiree health care benefits. You can fund before or after retirement, and there are three components: company, employee, and government. We've structured the presentation such that I'm going to be looking at the employee column and Ethan's going to be looking at the company column.

But before we do that, let's understand what the government column's all about, because that's really important. For the postretirement piece, Medicare is the real big beast, looking after most health care expenditures. If we didn't have Medicare, I doubt if we'd be having as many retiree health care plans as we currently have.

Clearly, retirees are involved through deductibles, copayments, and any portion of the retiree costs that they're paying through premiums. Companies are involved through pay-as-you-go. The main focus is the government's involvement in inducing employee-employer savings through tax deductions and tax-deferred accumulations: we'll be going into details on how that's going to affect employee contributions and company contributions.

I very briefly want to go over the range of funding vehicles. Then I will review in detail three case studies of companies that have already chosen their funding vehicle for saving for postretirement medical benefits. This broadly gives the list and range of the funding options that we can look at: Voluntary Employee Beneficiary Association (VEBA); Section 401(h) accounts, which are subaccounts inside of pension plans (and

you can only have them if you have an employer-sponsored, defined-benefit plan); Section 401(k) accounts, which are defined-contribution accounts; and some nonqualified approaches, where the focus isn't so much on initial tax deductions but on some other elements of saving. There are of COLI, VOLI, and TOLI (Corporate-owned life insurance, VEBA-owned life insurance, which combines a 501(c)(9) trust with life insurance product, and trust-owned life insurance). And, last, we have Employee Stock Ownership Plans (ESOPs).

The first case study is American Airlines. I think it is a very interesting example from which we can learn a lot in terms of some features that would probably be useful to consider when designing any health care plan funding structure. The key element of the American Airlines' plan, I think, is the buy-in from employees. In order to be eligible for health care coverage after retirement, employees have to fund preretirement. This is a good way to get the message across that this is a partnership.

The employees and employers have a contract and a responsibility in order to receive/deliver those benefits. Employees pay premiums into a VEBA while they're active, and then after they've retired, American Airlines takes care of essentially 100% of their health care costs. So this is employee funding preretirement only. The advantage to American Airlines is that the fund balances contributed by the employees offset American Airlines' obligation. When American Airlines introduced this, it didn't radically change the retiree medical program. It focused on funding as the key element to control what it wanted to do. When American set the plan up, it really set up two VEBAs, one for the union and one for the nonunion people, which is a clear difference that's needed to insure that the correct tax is paid on any trust income.

Employee contributions are accounted for in individual accounts. This is not so much to say when you retire this is the amount of money that you have to spend on health care needs, but rather, that if you leave American Airlines and are not eligible for retiree health care benefits, then the individual account will come into play, which would be received as a severance benefit.

In retirement, this accumulated money is then handed back over to the company. As you appreciate, if somebody works at American Airlines through age 55, that individual hasn't contributed very much in premiums. So it really is worthwhile to be in the plan and receive health care coverage from age 55 onwards. But Bob Seaman at American Airlines was concerned about what would happen the other way around: if somebody stays on till age 70, and has an account balance of $30,000, which is substantially more than the value of the health care benefits that the individual is likely to receive. It turns out that one of the rules is that you have to contribute 10 continuous years before retirement, so in the above situation with an account balance of $30,000, an employee could elect not to contribute for the last couple of months of his employment and, therefore, would not be eligible for retiree health care benefits but would be able to receive the funds back as a severance benefit.

Here are the eligibility conditions. You can't start contributing until you are at least age 30 and have one year of service. You can't retire unless you're age 55 and have been in the active medical plan for 10 years. However, the most important condition

is that you've funded continuously for 10 years before retirement. Somebody who joins American Airlines at age 30 might not be thinking about retiring yet. If that person doesn't know how long he will be at American Airlines and, for example, waits until age 45 to begin funding, that person is going to be subject to a different premium structure than employees who begin funding at age 30.

American Airlines has a set of monthly premium rates that applies to all employees regardless of age when they first set up the plan. In 1990, it was $10 a month. This fixed schedule of monthly contributions for the first few years was $10, $12, and $14, and now will rise in line with American Airlines retirees' health care costs per capita trend rate. The premium is very much tied to the experience of the retirees of American Airlines.

Let's take those 30-year-olds who decided not to contribute $14 a month as soon as they were eligible. Well, when they come back into the plan, let's say at age 45, they're going to be subjected not to a $14 a month premium, but something more like a $50 or $60 a month premium. This is very much like a whole life level premium, which rises with age. The idea is to have equity between people who have been in the plan for 10 years and people who have been in the plan for 30 years from age 25 on.

One important thing to note is that the employee contributions going into both the union and the nonunion VEBA are after-tax contributions. So maybe, following Ethan's slot machine analogy, I think it's not a cherry, cherry, cherry for the tax deductions; this is more like lemon, cherry, cherry. American Airlines looked at this program and came away with it as absolutely the best thing for the company. It meets American's needs, because the company has a strong very well-identified work force. People stay with American Airlines for a long time.

It's also interesting to note that, if you're doing a FAS 106 valuation of American's postretirement health care plan and you have a 35-year-old employee of American Airlines who's not contributing, then he's not currently eligible or shouldn't be included in the group of eligibles for valuing the FAS 106 obligation. This is a way for American Airlines to identify those employees who have signed into the contract for postretirement health care benefits. Clearly, when you do that valuation, you can take into account the present value of the future employee contributions and use that to offset the liability.

Getting employees on board and participating in funding their retiree health care benefits is a real good message. This is a participatory contract for health care benefits, and it really does underscore the employer commitment. The employer's going to be around to take care of the health care needs of its retirees. It's much harder for American Airlines to pull the plug on this plan because it has had employees in there paying contributions for a good number of years. Because employees are putting in after-tax money, the ability to receive those funds back as a Supplemental Unemployment Benefit (SUB) or severance benefit means that the employees really aren't going to be losing out by contributing or participating in this contract.

Let's look at the disadvantages. First, the employee funding isn't pretax, so this isn't the most tax advantageous approach that you could come up with. It would be

good if that were so, but I would argue that the fact employee premiums are paid post-tax pretty much mirrors the levels of field. If you take something like a pension benefit, the employee or employer contributions are tax deductible, and you have tax-deferred growth in the investment vehicle, so when the benefits are paid out, they're taxed. In VEBA, it's really the other way around. These are posttax contributions going in this tax-deferred growth vehicle, but when the retiree receives the health care benefit, it's not included in income. The retiree doesn't have to pay tax on the value of the benefit. So it's really a kind of leveling of the field.

One other disadvantage of the American Airlines approach: the company really didn't fix the FAS 106 obligation. It didn't cap future health care inflation. American still stayed with what I called the defined-services approach, which may be a term that you're not familiar with. You might have heard of defined-contribution plans, where the employer's commitment is very much defined up-front. A defined-benefit plan, however, fixes the projected benefit in terms of salary or service into a known, quantifiable benefit. In retiree health care plans, it defines the services offered -- whether the plan is going to provide medical, dental, vision, and so on. Then, within that structure, however, much the plan costs in a given year is the company's obligation. The company is going to have to pay for that benefit.

Globally, looking at the range of contribution rates we mapped out a little while ago, the employee contributions aren't going to fully fund this benefit. They're only going to pay for a little under a third of the health care costs. The downside of having the employees participate in this plan is that it really does make it difficult for American Airlines to substantially modify or terminate this plan in the future. Nevertheless, I think there's one other advantage that we didn't mention, and that is cash flow. Let's look at what's happening here: American Airlines is taking employee money, putting it into the VEBA trust, and drawing it down to pay for postretirement health care benefits for current retirees. So it's improving cash flow for satisfying those current retirees. By doing so, American Airlines therefore is not building up a large asset. If you look at the VEBA by itself, it clearly has these postretirement health care obligations it needs to fund. It also has the SUB and severance benefits for those employees who terminate. If you're drawing down the employee funds that come in by paying out retiree health care benefits, you can get to a position where the VEBA has very little assets. They will be less than the expected value of the SUB and severance that they will pay out to terminating employees. So you have an underfunded VEBA here. Employee contributions would therefore have tremendous cash-flow advantages for American Airlines.

Now, let's look at American Airlines medical plan. It's a regular comprehensive medical plan, with a fairly affordable deductible, $150 single/$400 family, and a fairly small out-of-pocket maximum if you compare it with some other recently redesigned plans. American uses the Medicare carve-out approach so that employees pre-65 and post-65 are cost-sharing the same amount in terms of deductibles and out-of-pocket maximums. Within the industry, the plan has a fairly low lifetime maximum of $50,000. Enrollment in the plan initially was automatic; you had to sign a waiver to say that you weren't going to be in it. Not only the employee had to sign, but also if married, the spouse had to sign off as well. Of all American Airlines employees, only 200 didn't enroll in the plan. Bob Seamans, the Director of Human Resources at American Airlines, was concerned since the company had spent a lot of

time and effort trying to communicate that the plan was a good deal and that employees really ought to buy into it. So to find out why there wasn't 100% participation, he got his secretary to phone the 200 people who had not enrolled. It turns out that the company had communicated the plan very well; all 200 had already made plans to leave American Airlines.

Let's move on to the other way of getting around the country, which is on wheels. Chrysler Corporation has modified its retiree health care plans for its salaried employees. This isn't a change to the union United Auto Workers (UAW) contract. Chrysler had already put into place some health care options for its employees and wanted to mirror them in how it was approaching its retirees. In addition, Chrysler was very concerned about its FAS 106 obligation. If you compare it to the retained earnings of the company, you would realize that there isn't a company, and that the union and the salaried employees own the net worth of the company. So Chrysler had a critical need to get rid of the defined services approach and come down to something that was affordable on a cash basis and affordable on a FAS 106 basis as well.

Chrysler set up what I call a kind of flexible benefits plan, where it defined the dollars of credit granted to each retiring employee. The plan credits are based on one of the choices for the active health care plan, which has a $200 deductible, and although the price will grow over time, the key here is the credits will be pegged at today's prices. This gives Chrysler the ability, at some point, to come in and raise the support level, but it really gets rid of future health care inflation from an accounting standpoint.

In addition to just providing those credits, Chrysler also wanted to link benefits to length of service and an employee's support level. Somebody retiring at age 60 with 30 years of service will get sufficient credits to buy back into Chrysler's $200 deductible plan, while somebody with only 10 years of service would only get sufficient credits for half of today's cost. In order to give the employees an opportunity to save for the obvious retiree premiums that they're going to have to make, as the price increases in line with inflation and the credits remain fixed, Chrysler set up a new VEBA and modified its existing 401(k) plan. It permitted employees to save from one to four percent of pay and to designate that saving into a retiree health care savings vehicle. The choices were VEBA, which would be an after-tax contribution or 401(k) which would be pre-tax.

I think it is interesting to note how this is really a step beyond what American has done. Chrysler is giving employees choices, and it's important to understand the different options available on the back-end of these funding vehicles. In addition, as an incentive for employees to contribute, Chrysler decided it is going to match these contributions 60 cents on the dollar. So any pretax contributions going into VEBA, from 1-4%, will be matched by Chrysler at 60 cents on the dollar. While funds are invested in the VEBA, employees will have up to three investment choices for allocating funds.

In the 401(k), this would be a pretax contribution. Chrysler has precut its 401(k) into two pieces: regular 401(k) and retiree health care. The retiree health care piece receives the match, but the interesting thing is that the match doesn't have to stay in a 401(k). The match could be set up as an account in the VEBA. So employees

contribute pretax into the 401(k), get the match in the VEBA and are able to use the VEBA for health care benefits later on.

Let me show you one of the reasons why it's a good idea to do that. The 401(k) when paid out, is taxable, whereas the VEBA, when paid out, is nontaxable. So by taking the employer match and putting that into the VEBA, the employee is benefitting from the tax-favored treatment of the reimbursement or payments from the VEBA. Any employee VEBA contributions that went in were originally posttax and, therefore, come out nontaxable. The limitation here is that the VEBA can only be used for health care needs, whereas, the 401(k) could be used to buy a boat or something.

This isn't forcing employees to save for their health care needs, it's giving them a funding vehicle, where they can make some informed choices. You need to look at the employee. What's the benefit of putting his money in the VEBA versus putting it into the 401(k)? First, employees need employee contributions that go into the VEBA or the 401(k). The employee contributions are always 100% vested, but the employer match will only be vested in the 401(k) after employees have been contributing for five years. Any benefits that are paid out of the VEBA as a SUB or severance benefit would again be vested. That's true again of the 401(k). There's not much to be gained there except if the employees put their money into the 401(k) and leave within five years, they're going to get their own money back, but they're not going to get any of the employer match. One feature of the 401(k) is that employees can obtain some loans, although those are really dedicated for medical needs and necessities. Again, the structure reinforces the message that here is a vehicle for funding health care needs.

Chrysler's enrollment wasn't as strong as American Airlines. But, even so, I think Chrysler had good results for a group of salaried employees in an industry that is suffering hard times where these people might not be able to afford to save very much. I think enrollment of close to 50% is pretty good for Chrysler. Interestingly enough, employees are favoring the up-front tax deduction of putting money into the 401(k) substantially over the after-tax approach in the VEBA.

The last case study I want to get to is Ball Corporation, and its plan is outside of the 401(k), 401(h), or VEBA approach. Ball's is a nonqualified plan. It's a defined-contribution plan where employee benefits and employee premiums are put into a contract very much like a guaranteed investment contract (GIC). Again, like the American Airlines plan, there are after-tax employee contributions with a little bit of flexibility here. The employer could match those employee contributions at some point in the future. Apparently Ball Corporation hasn't.

One point is that any employer match would be included in current income, so although it's benefiting the employee by providing a larger account balance to be used postretirement, the employee would have to pay some sort of current tax. One way an employer can get around that, is to gross up the tax on the employer match to insure that there's no net decrease in after-tax employee compensation. This is, if you will, a lemon, cherry, cherry approach. After-tax contributions go in. But once the money is in, it accumulates tax free or receives interest in the GIC. After you

retire, the individual account balance can be drawn down to pay any retiree health care premiums, deductibles, or medical expenses under Section 106 of the Code.

I think the key here is that this is not a group plan. This is an individual plan. So it's very much getting the individual to do some kind of planning to work out what his postretirement health care expenses are going to be in terms of premiums and to fund for that as a target.

After the employee retires, he has a couple of choices of what to do with the funds. First, he can take funds out as an annuity. In that case he is going to have a portion of that annuity taxed; but the after-tax contributions formed a basis for nontaxable repayments. The key here is to receive tax-free reimbursement of medical expenses and that's the goal. If you look at somebody who is retiring under age 65, this is an excellent vehicle for that person to be able to make those substantial premium payments up to age 65 and then to use any funds that are left over to offset the expenses of medical expenses that aren't covered by Medicare. The design of this is pretty tricky.

The Ball Corporation's employee retirement medical account (ERMA) works very much like an IRA for medical benefits. It's tricky because there are pieces of the Code that restrict what you have to do for this to be a tax qualified insurance contract. There is a grid of restrictions that led the designers of this plan to conclude that you can't define that you're always going to get benefits out of this for health care. You have to annuitize it at some point, otherwise, it's going to fail one of those IRS restrictions. So Ball put into the plan that any individual account benefits left at age 85 will be converted into an annuity. However, if somebody's exhausted his individual account before then, he really has received the full value of the individual account on a tax-free basis.

Okay, what happens if somebody doesn't get to retirement, if he terminates? Well, he can receive a lump sum, and if he does, a portion of it will be tax free and the rest will be taxable. Alternatively, he can receive either an immediate or a deferred annuity. If he dies before retirement, his estate gets his money back as a lump sum. If he dies after retirement, the individual account can be used to pay the health care expenses for any surviving spouse. Alternatively, it could be used just to provide the lump sum. But I believe at some point in time, the lump-sum option after retirement is going to be taxed.

One of the advantages to the Ball Corporation is that ERMA has clearly shifted the open-ended, health-care-inflation, defined-services approach back down to a defined contribution. It has employee cost-sharing going in. It has the flexibility for the employer to come in at any point down the road and put in a match, while the plan is nonqualified. Thus, it escapes a lot of restrictions that might otherwise apply to key employees, and so on, or, in fact, on any funding benefit, like 415 limits.

What are the advantages to the employee? Well, employees have tax-free accumulation of funds. This is probably better than taking their after-tax money and putting it into a savings vehicle of their own. In addition, the individual accounts, when they're used for reimbursing medical expenses, are purchasing those medical benefits at 100 cents on the dollar, whereas, if employees just put the money into a savings account,

they would not be able to use it tax free. If they had a pension plan instead, they would have to pay tax on it.

Really, the last point here is flexibility. Ball Corporation has the ability later on to come in and say we're not able to attract the kinds of people we need. We still want to stay on a defined-contribution approach, so why don't we put in a 50% match on the employee contributions and, therefore, give people the incentive to save for their retirement?

MR. WILLIAM C. CUTLIP: You were talking about tax-free accumulation. I think the key point is how you use the individual account after retirement. If it's used for purchasing health care benefits, then it really is tax free. But if it's used as an annuity, then it's already somewhat tax deferred.

MR. KRA: I would like to focus initially on two dichotomies in the funding and financing of retiree medical benefits. One is the dichotomy between funding and financing. Funding is putting aside assets for a dedicated purpose to be used for something specific. Financing is creating the wherewithal, the cash flow, to enable the employer to provide for those benefits; but the employer can use those monies for anything else. Here are some examples: Funding: 401(h) -- You're putting money away that can only be used for retiree medical. Financing: leveraged COLI -- While the cash flows from leveraged COLI can be used to pay for retiree medical benefits, you could also use them to pay for the decommissioning of nuclear reactors, which is about as far afield as you get from employee benefits that I can come up with. The other dichotomy, which Adam started focusing on, was the employer versus the employee. Who pays? Adam discussed the employee initiatives; I'd like to focus primarily on employer initiatives.

Let's look at the employer funding vehicles; we'll go through each one of these in detail. 401(h) is an appendix to a pension plan. A money purchase 401(h) just depends upon a money purchase pension plan. A leveraged ESOP, the so-called HSOP, the Procter and Gamble deal (we'll mention it but you can't do any more of them practically speaking) will be discussed. Single premium insurance policies, the settlements, the FAS 88 equivalent to FAS 106 are on the list. There are financing vehicles: using the pension plan to shadow fund or overfund the pension plan; profit-sharing plans; ESOPs; enhanced defined-benefit plans; leveraged COLI. Then there are vehicles that could be used for either, such as a 501(c)(9) trust. Finally the last item, which is really a subcategory of 501(c)(9) trusts, but because of its high visibility in the marketplace, we'll give it some separate attention: TOLI or VOLI.

The employee vehicles were already mentioned by Adam; including the ERMA, which he did cover in quite a bit of detail.

I'd like to just focus on a couple of other items before we go into employer strategies. Consider cafeteria plans. Many of you participate and many of your clients have plans in which the active employees are allowed to effect a salary reduction to cover active medical premiums -- premium conversion plans, flex plans, and 125 plans. They have flexible spending accounts. Nothing specific in the Code limits those plans to active employees. Depending on how aggressive you want to be in interpreting

the Code, you could apply those same Code sections to your defined-benefit pension payouts to your retirees.

How do you get there? Pension benefits are taxed under Section 402 of the Code, and 402 references Section 72 for annuity payouts. Section 72 of the Code starts as, "Except as otherwise provided in this Chapter." The chapter starts at Section 1 and ends at Section 1399. It includes the entire individual income tax rules, corporate tax rules, partnership tax rules, and life insurance company tax rules. It includes Sections 125, 105, 106, 104, and everything else that applies to the taxation of employee health care. The regulations use compensation as an example, but not the exclusive example, of funds that could be contributed under a cafeteria plan. The IRS does not like that interpretation, and IRS and Treasury people, when posed the question about using defined-benefit pension payouts to retirees, acknowledged privately that you could go through and dot every "I" and cross every "T" and do it. They don't like this answer but can't find the flaw in the logic.

The other part is using profit-sharing distributions, because profit-sharing plans are not subject to the 25% incidental benefit rule. Certain profit-sharing contributions could be used to pay for retiree health care benefits. The flip side is that you might also have to allow them to be used for COBRA benefits.

You could also allow employees to contribute to employee only 501(c)(9) trusts. If there were no individual accounts, then there would be no unrelated business income tax.

Moving to employers' strategies, which is where we'll focus for the rest of this session, what are the issues? You want tax deductible distributions, the first gold bar. You want tax-free investment buildup, the second gold bar. And you want the benefits to come out tax-free, the third gold bar.

Unfortunately, most of the time we're not going to be able to achieve all three, so we will have to analyze how much pain is inflicted by the IRS on each of the vehicles. We'd like to anticipate inflation in the funding, and we'd also like to know what the limits are on deductible contributions and if there are any penalties for exceeding those limits. Will there be any alternate minimum corporate income tax, especially in the later years, as there is a timing difference of tax deductions versus expense allowances under FAS 106? Finally, what is the duration of the liability?

Let's just go off on the side for a moment. We'll raise a question and then just leave it sitting there: On the pension side of the house, the duration of liability is about six or seven years for retirees. For active employees it is about six years plus the number of years to retirement. Now, if I'd like to immunize my investment, I can somehow buy bonds long enough so that, in most cases, any change in interest rates will affect equally the value of the investment and the value of the liability. What happens to retiree medical?

Well, if interest rates go up, that means inflation probably has gone up. There is usually a high correlation. There is also a high correlation between inflation and medical care costs, so to the extent that interest rates go up, in all likelihood the payout stream is also increasing. The present value may be relatively unaffected,

because the change in the discount rate very often will be offset by the change in the absolute level of the benefit payout stream. This can cause some significant difficulties in trying to set up an investment strategy for any invested funds.

Let's move on to a specific vehicle, the 401(h). The 401(h) was put into the Internal Revenue Code somewhere around the early 1960s. It wasn't used much for retiree medical until the early to mid 1980s. Why? Because you had 501(c)(9) rules, which were easier. The 401(h) is subject to nondiscrimination requirements; there's separate accounting required for pension benefits, but you do not need a separate trust. You do not have a 414(ℓ) issue. You do need separate accounts for key employees. In a larger company, that will generally be the top 50 paid officers.

If you do set up separate accounts for them, the only benefits that can be paid out to the key employees are from their separate accounts. That will create 415 problems. So effectively you have to exclude the top 50 paid officers from any 401(h) plan and pay them directly out of corporate assets. You pay their medical premiums or benefits directly from corporate cash flow.

You get a tax deduction for the contribution, tax-free investment income, and tax-free benefits to employees. So it seems like a triple gold bar. What's the catch? Well, the catch is there are limits on the deductible contributions. You have to spread them over future service. You also have to spread past service over 10 years. Technically, the regulations read 10%. However, in discussions with Treasury officials, they acknowledge that since the regulations predate ERISA, wherever it's written 10%, you should read that to say 10 years.

The toughest rule is the one-quarter of normal cost contribution or current service contribution rule. Effectively that's a one-third rule, because if you put in $3 for pension benefits, you can put in $1 for retiree medical; the $1 for retiree medical is one-quarter of the $4 total. But it's the only amount that you're permitted to contribute. Omnibus Budget Reconciliation Act of 1987 (OBRA 1987) implemented a tougher full-funding limit, and most of our clients are subject to full-funding limits or are very close to it. With OBRA 1989, if you have no deductible pension contribution, you're not going to have any deductible 401(h) contribution. However, if you do have deductible contributions, the choice of your pension funding method will affect the amount that's allocated to current service versus the amount allocated to past service. If you're using the aggregate cost-method, everything is current service. If you're using a unit credit cost-method, probably less of your contribution will be current service and more will be past service. You cannot base contributions to a 401(h) on past service contributions.

One key item relating to the one-quarter test: it's a cumulative test. So, if you set up your 401(h) 10 or 15 years ago and you've put very little in over the years, that one-quarter has built up cumulatively. Even if today, you're in a full-funding situation, you may be able to make deductible contributions to your 401(h) accounts.

You are permitted to use an inflation assumption. But if you contribute more than you're permitted, there is a 10% excise tax on nondeductible pension contributions.

A money purchase 401(h) is the next step. Until recently everyone viewed 401(h) as being associated only with defined-benefit plans. Nevertheless, you can associate a 401(h) with a defined-contribution money-purchase plan, but not a profit-sharing plan. Well, how is that useful? How many employers sponsor money-purchase plans? Among larger employers, there aren't that many. What we can do is take your 401(k) match and put it into a money-purchase pension plan instead of into the 401(k) profit-sharing plan. Then, you can tack on a 401(h) kicker. So you could contribute one-third of the company match as an additional contribution to the 401(h). There are other issues though. As a money-purchase plan, as opposed to a pure 401(k) profit-sharing plan, monies are not available for in-service hardship withdrawals. In addition, on distribution, they are subject to joint and survivor annuity rules.

Another approach is to use a leveraged ESOP to finance retiree medical benefits. Procter and Gamble did one of these. It was about a $1 billion program spread over 30 years. Proctor and Gamble filed for a determination letter with its local IRS office, I believe in Cincinnati, and received a favorable letter because determination letters are prepared at the district level offices. The press found out, with the resulting wide distribution of the facts. The national office of IRS all of a sudden heard about it, not from Cincinnati, but from the news media. The national IRS said, 'whoa, we don't want this,' and issued an edict freezing all determination letters on HSOPs. Now, no one gets determination letters. The IRS hasn't withdrawn Procter and Gamble's, but it is not going to give anybody else that same comfort level. Proctor and Gamble I don't think will want to amend the plan and have to go in for another determination letter for the next 30 years. This strategy is probably not funding for FAS 106, because the monies could come out in other forms depending on the specific situations.

Single premium insurance policies are a very limited market. There is one major broker/consultant out on the West Coast, in Long Beach, California, that markets a product using one of the East Coast insurance companies. Whenever we've looked at it, we found the price to be astronomical. The assumption is that every retiree will hit that cap within a short period. It's a belt and suspenders insurance company. I hope I'm not offending any actuaries here who work for insurance companies, but, effectively, this insurance company is not selling insurance. It is taking the liability off the company's hands for a very steep price, in an extremely limited market, which often requires plan redesign. It will require inside limits, daily hospital limits, and lower lifetime limits. The insurance company will generally take on retirees only or people who are expected to retire within the year. There are some questions as to the tax deductibility: Do you get an immediate tax deduction, or does it have to be spread out over a number of years?

The market is generally geared to companies that are going out of business, so there is a means to continue providing benefits in the future. Or, in the context of a very large merger and acquisition deal, with retiree medical representing a very little pimple on the back of the elephant, nobody wants the deal to fail because of retiree medical, so you throw a few million dollars at a half billion dollar deal and the problem goes away. You may have overpaid, but at least the deal can go through.

The 501(c)(9) trusts were introduced into the Code back in the early 1960s or so. There wasn't much interest in using them for retiree medical until the early 1980s.

Why? Because until the late 1970s and early 1980s, the numbers weren't that large. The real focus started after TEFRA. When the 415 limits were cut back, some of the small mom and pop corporations were allowed reduced pension contributions. But nobody likes to pay more tax; so these corporations looked for another vehicle to shelter corporate income. Thus, they decided to set up retiree medical VEBAs for the employees of the professional corporation, and the doctors, the law firms and the accounting firms started socking away very significant dollars. Congress, in its wisdom, decided to close the loophole. But instead of using a laser beam, it used buckshot. And thus we were given the rules of the 1984 Tax Act.

What are some of these rules? You can combine many benefits. You can have dental, medical, life insurance, long-term disability, short-term disability and severance benefits. You can have actives and retirees. But note that you cannot set up a 501(c)(9) trust for retiree medical benefits unless the active employees also have medical benefits. Those active benefits, however, need not be provided through the trust.

If you just read the Code and the Committee Report, you could be led to believe that you have to put active benefits through the trust if you're going to prefund retiree medical. The Blue Book, the staffers' explanation of what they meant when they wrote the law, and the Committee Report clearly indicate that you do not have to flow active benefits through the trust if you want to prefund retiree medical. The only requirement is that active employees have comparable medical benefits and that the retiree medical program be a continuation of an active program (not that retirees have full medical benefits while the actives get a $10 hospital benefit).

As with 401(h), you're required to have separate accounts for key employees. So you're going to exclude the top 50 paid officers of the large company from a 501(c)(9) trust. There are nondiscrimination requirements, but with possibly greater flexibility than with 401(h). There are some limits on funding: You can prefund cash claims, plus administrative expenses, reserves for incurred but not paid claims, long-term disability, severance pay, retiree life capped at $50,000 and retiree medical based on current medical costs with no anticipation of inflation.

There are certain restrictions on funding methods: You have to amortize past service liabilities. Do you have to amortize retirees over the actives service or can you pay retirees immediately? If you have a 50-year-old, you could fund his or her past service liability over the 15 years to expected retirement. If you have a 60-year-old, you could fund it over five years. A 62-year-old could be funded over three years, a 64-year-old, over one year, and a 65-year-old, immediately. As far as funding retirees immediately; that's great, but it depends on how aggressive you want to be. The IRS doesn't like the idea of immediate funding. The IRS wants funding spread out. However, there are those who interpret the rules to mean you can do some very rapid funding, if you use individual funding methods.

No inflation assumption is permitted, which is the major problem with 501(c)(9) trusts. If the limits are exceeded, there's a deferral for tax deductions; but there are no penalties. There probably are no limits on funding a union only plan, however, that's based on the regulations. The IRS could take that away. In fact, one of the authors of the law who was a staffer back in 1984 indicates his firm belief that you

would be subject to unrelated business income tax (UBIT) even on a union only retiree plan. But that is a minority position. Not even current people at the IRS take that approach. Benefits do come out tax free to employees, and these rules also apply to insurance company reserves. You don't need a trust: just something that looks and smells like a trust. It gets taxed like a trust.

Now, for the four letter word: UBIT. Any reserves that are set up for retiree medical benefits are subject to UBIT on the investment income. Now there are some strategies to avoid UBIT. You can aggregate various VEBAs. If you have an underfunded VEBA for long-term disability, then you can take some of those retiree medical reserves and deem them to be long-term disability reserves and get favorable tax treatment on those investment earnings. The IRS said, we're going to set up just so many tax goodies that you can have, and we don't care where you put them. This flexibility is the limit on tax goodies. You may structure them differently for your own fiduciary issues or your own management of liabilities, but this is the maximum tax goody. So if you have other VEBAs that are not fully funded, you can take dedicated retiree medical reserves and deem them to be elsewhere in calculating UBIT.

The other means to avoid UBIT is to get a tax-free investment vehicle, such as municipal bonds or the product many brokers out there are pushing: life insurance or universal life, single premium universal life, or variable life. It's called TOLI. I question, however, whether TOLI really is viable for most companies or even an attractive alternative.

Let's run through the example. The left side of Table 1 shows a trust. We put in $1 million of corporate cash into the trust. What do we get? We get a $1 million tax deduction. Assuming a 40% tax bracket, it costs the company $600,000 after tax to make that deposit. The company puts $1 million in the trust. The trust then buys life insurance policies on the beneficiaries and gives the full $1 million to the insurance company.

Table 1
501(c)(9) - Retiree Medical - TOLI

•Trust		• No Trust	
- Premium:	$1,000,000	- Premium:	$ 600,000
- After tax:	600,000	- After tax:	600,000
- Matures at:	2,000,000	- Matures at:	1,200,000
- Claims paid:	2,000 000	- Claims paid:	2,000,000
		- Tax savings:	800,000
		- After tax cost:	1,200,000

Any insurance program, when you cut and slice it apart, can be viewed as a premium that comes in and a death payment that goes out -- because every policy ends ultimately in death, provided you don't surrender it. You can take that policy and cut it up into slices by when the premiums come in. So, if you slice and dice the premiums coming in and death benefits paid out, you can effectively look at every transaction as a premium paid that generates some death benefit at a future date.

Let's theoretically assume we've put in a $1 million premium that will translate into a death benefit and matures at death, some number of years later, for $2 million. Lo and behold, we have $2 million worth of medical claims to pay for retirees that year. The death proceeds from the insurance company go to the trust as tax-free death proceeds of $2 million. The trust then takes the $2 million and pays retiree medical claims of $2 million. There is no taxable event. So, for $600,000 after-tax dollars today, the company is covered for $2 million worth of retiree medical claims in the future.

Let's peel away the layers of the onion. Eliminate the trust. Keep the investment vehicle. There's no tax deduction today. A company pays $400,000 in taxes. It only has $600,000 after-tax dollars to invest; so it buys the same investment, but only 60% of every policy. It gives $600,000 to the insurance company and buys life insurance -- nonleveraged, universal, variable, or universal life type products -- on its employees. Since it only bought 60% of every policy, when the employees die, it only collects 60% of the death proceeds or $1.2 million. It still has $2 million worth of retiree medical claims to pay that year, so it pays them out of the corporate till. So what happens? The company gets $1.2 million tax-free and pays out $2 million tax deductible. Assuming the same tax bracket, it costs $1.2 million after-tax at that future date to pay those retiree medical claims, exactly equaling the cash flowing in from the insurance policy. So by eliminating the trust but keeping the same investment vehicle, the company is in a wash position. The $600,000 after tax today pays $2 million worth of retiree medical claims some 10 years from now.

Now, what happens if tax rates change? Table 2 on the right, without the trust and, on the left, with the trust, assumes a uniform tax bracket over time. How many people would expect corporate rates will be lower 10 years from now? The record will show we had no takers. How many people expect that corporate rates may be higher 10 years from now? We seem to have a majority. That's good, because now we assume a 50% bracket 10 years from now. Well, with the trust, when was our taxable event? It's today, not 10 years from now. There's no taxable event 10 years from now. So the left side of the chart does not change. No difference in cash flow.

Table 2
501(c)(9) - Retiree Medical - TOLI

• Trust		• No Trust	
- Premium:	$1,000,000	- Premium:	$ 600,000
- After Tax:	600,000	- After tax:	600,000
- Matures at:	2,000,000	- Matures at:	1,200,000
- Claims paid:	2,000,000	- Claims paid:	2,000,000
		- Tax savings:	1,000,000
		- After tax cost:	1,000,000
Remainder	0	Remainder	200,000

But on the right side of the chart, without the trust, when is the taxable event? Well, I paid tax today. I'm still in the 40% bracket. I only have $600,000 to invest. I get

$1.2 million tax free from the insurance company, but when do I get my deduction? I get my deduction ten years from now. I deduct the $2 million worth of claims when I pay those retirees. What does it cost me then? Because I'm in a 50% tax bracket 10 years from now, it costs me $1 million. So I pay $1 million after tax for retiree medical benefits. I collect a $1.2 million from the insurance company, so I'm ahead of the game by $200,000.

If I expect corporate rates to go up over time, the trust is negative in the financial equation. It is a negative in my discounted cash flow. So, I'm better off without the trust.

What are some of the other issues? With the trust, I lack flexibility. I have discrimination requirements. Nevertheless, it still works and is appropriate for certain types of employers. Some employers may find the reasons to fund so compelling that they overcome the negative issues on the tax rate increase.

Moving on to overfunding the pension plan. This is purely shadow funding. Typically, for a union-type plan, you have an hourly plan in a nonunion environment and a benefit that goes from $10 a month per year of service to $12 to $15. Over time you develop an unfunded current liability in the pension plan. For a large employer, one with over 100 employees in pension plans in the controlled group, you are permitted to fund up to current liability. Generally, you are not going to put in that much. You are going to fund in some normal, managed strategy.

Instead, what you do is take the money that you would like to use for prefunding retiree medical and use it as an extra pension contribution. You build up the credit balance in the funding standard account and then 10 or 20 years from now, when you would like to use that money for retiree medical benefits, you use up the credit balance in the funding standard account, contributing less to the pension plan, and use those cash-flow savings to pay for retiree medical benefits.

What you do is to contribute more to the pension plan now and less in the future. When you contribute less, you use those monies for retiree medical. It's shadow funding.

Some of the benefits are you save PBGC risk-related premiums, and you will show some better financial results for FAS 87, probably a little worse under FAS 106. But remember: pension plans are subject to more stringent requirements on termination, so your liability structure for banking and other officials may look better because you have better funded pension liabilities than retiree medical liabilities. It is shadow funding, it's not real funding. It's a financing device. By the way, the 401(h) asset transfer under OBRA 1990 (the Section 420 rules) is actually negative funding. It's defunding retiree medical obligations. It is taking money out that was put aside for future benefits and using it to pay current benefits.

Another financing device is a profit-sharing plan. This is really a benefit change. What you do is increase profit-sharing benefits for active employees, while reducing their future retiree medical benefits. You are exchanging one benefit promise for another. Of course, you have to deal with the grandfather issues for those people close to retirement. You are effectively transferring all risks to employees: the

investment risk, the early retirement risk, the longevity risk, and the medical inflation risk. All risks are on the employee. Effectively you are saying that you are going to provide so much money for retiree medical benefits. You get a tax deduction as an employer, so you have tax deductible contributions, and the investment income builds up tax free. Benefits may or may not be taxable, depending on how you structure the distributions.

If you try using a 125-type concept or a premium conversion type concept for distributions, you may be able to avoid taxation on benefit payouts to retirees. Fidelity has looked at this. It has structured a program that it believes will allow retirees to get significant amounts out on a tax-free basis. You still have 415 issues that may create problems in prefunding benefits for senior executives. Again, it is a financing device. It is not a FAS 106 device. In fact, you're eliminating significant parts of your FAS 106 liability by transferring them to employees and giving them a portion of the wherewithal to provide for them.

An ESOP is just a variation where you tie all the benefits to stock performance. You're putting all the employee's eggs in one basket, his job and his retiree medical benefits. There's no diversification. But a leveraged ESOP does provide some additional tax benefits.

An enhanced defined-benefit pension is a strategy for pre-Medicare retiree medical benefits. In a defined-benefit pension plan, a social security supplement is any benefit that would be paid pre-age 65 as a supplemental benefit. It cannot exceed what social security would provide when someone reaches the social security retirement age. So, you could pay for anywhere up to $1,000 as a monthly benefit for people who go out pre-age 65 as a supplemental bridge benefit, until they are eligible for social security.

These are ancillary benefits under the Code; in most instances, an enhanced defined-benefit pension is not subject to vesting, not subject to accrual rules, and might even be eliminated from the plan even for people in pay status.

What we can do is eliminate the retiree medical benefit pre-age 65 from the company's program. We'll make it available on an employee-pay-all basis. We'll also offer employees a social security supplement. We will only offer the social security supplement to those people who actually elect retiree medical benefits on the employee-pay-all basis. And we'll tie the amount of the supplement to the premiums. So, effectively, pre-Medicare, employees get an additional pension benefit and have a retiree medical contribution exactly equal to it. If we go through the 125 concept, we can probably even do this on a tax-free basis.

Then the pension plan has an additional obligation, which is subject to funding rules, allowing us to prefund an increasing benefit. As social security goes up, we can anticipate those increases, so we can prefund the pre-Medicare benefits. This would not work for post-Medicare because anything after age 65 is subject to vesting and accrual rules. We get tax deductible contributions, tax-free reinvestment income, and benefits that may or may not be taxable to retirees, depending on how we structure the plan. You may have to deal with discrimination issues, and you may want to

limit benefits to only those people who are not highly compensated employees -- but that is still a significant liability.

Let's discuss COLI, specifically leveraged COLI. Leveraged life insurance has been marketed for a number of years, subject to the four out of seven rule. There are a whole slew of requirements for full leveraged COLI. Does it work? Yes. Conservative leveraged COLI programs that comply even with the 1984, the 1986, the 1988 Tax Acts can still generate, in today's economic environment, internal rates of return of 16 and 17%. Those are belt and suspenders programs. Aggressive programs can easily generate internal rates of return in excess of 30% on up, but they require slightly aggressive interpretations of the Code.

COLI is a mismatch of cash flow versus liability payouts, which is difficult, if not impossible, to synchronize. It's not funding. Nevertheless, the aggressive approaches generate phenomenal internal rates of return.

So why doesn't everyone buy it? There are a number of issues. Consider tax law change: You hope it's going to be grandfathered. President Bush's tax message to Congress, accompanying his State of the Union message, effectively would have denied leveraged COLI tax deductions to corporations for any interest accrued on or after February 1, 1992, including all policies in force on that date, even those issued 10 and 20 years earlier. So there is the risk of tax-law change.

Up until now, every time tax law has been changed, policies issued prior to some cutoff date have been fully grandfathered, but there is a risk that will not continue. In doing your analysis, your assumptions are a key. Don't use the 1980 CSO mortality table. That may be an appropriate standard for insurance company solvency, but it's not an appropriate standard to measure how quickly employees in major groups of employees die, unless we're dealing with people who are underground uranium miners, stunt men, or other equally risky occupations.

The other assumption is that the overall economic assumption should be appropriate for the corporation. You have to worry about the effects of ultimatum corporate income taxes. Foreign tax credits might be lost by a company buying leveraged COLI.

Then there are the qualitative issues, such as carrier financial stability. One of the largest issuers of leveraged COLI is in receivership. Legal issues need be dealt with, such as situs of the contracts and insurable interest. Will the broker be around for 50 years to 70 years? These are all very long-term programs.

The type of product is important. There are group, individual, and multiple-employer trust products. My preference leans towards the individual product, because if there's going to be grandfathering under tax law change, I'd want the product to look like, smell like, walk like, feel like, and taste like the product that a blue collar employee buys for himself from the debit agent off the street. That's the product that's most likely going to be grandfathered. Congress and the IRS are not going to worry about grandfathering corporate boutique products.

Who should fund? A regulated utility, which can pass the cost on to rate payers; defense contractors; and government cost plus contractors might consider funding. Other candidates are companies for whom the lessening of both assets and liabilities improves the balance sheet. Many banks will have better balance sheets if they take a dollar out of both assets and liabilities because funding does not change equity, but it reduces the FAS 106 accrued liability and it reduces cash, since you have to put up the money. But in total, the net equity has not changed. Now, if the companies have a smaller balance sheet by deleveraging the balance sheet via funding, their equity ratios have been improved. So, some banks may find it attractive to fund. Those companies for whom a shift in expense from operations to interest, which would help their perception by Wall Street, will want to fund. Many leveraged buyouts are judged on earnings before interest and taxes (EBIT).

By funding, we've put up money in the trust, or a similar vehicle, generating interest earnings. Those interest earnings reduce FAS 106 expense, which reduces compensation expense, which reduces operating expense. But those monies that you put into the vehicle came from somewhere. You had to borrow them from some place. So now you have an expense that you've shifted from operating expense to corporate interest expense. The bottom line hasn't changed, but you've shifted the nature of your expense. For some companies that may be attractive.

What are the criteria for your decision making? Cash flow, cost of capital, and capital structure. Right now, retiree medical is an unfunded benefit. It is one of the lowest ranked obligations of the company; it's one of the junkiest obligations of the company. It ranks below all of the secured bond holders, all of the high credit bond holders. It's a junk bond obligation. By funding, you're now jumping it ahead -- leapfrogging retiree medical to the top of the heap. It becomes a trusteed obligation, with everybody else moving down a notch in the corporate capital structure. This may increase your cost of capital. It's something you should consider.

Tax structure is another issue. When do you want your tax deductions? Then there are accounting and human resource issues. Does funding help generate positive employee reactions or create additional employee expectations? What's the expectation for change in the economic, tax or legal environment or even for the government to provide the benefits? One thing we can be sure of is that nothing will be stable over time. We're going to see change.

What's your action plan? You're going to need an inventory of what you have. Review it. See what you can change. Collect the data. Do the FAS 106 calculations. Consider various plan design alternatives. See where you want to be in your design. Then figure out how you'd like to fund.

MR. WILLIAM V. HOGAN: Adam, on the American Airlines plan, you mentioned the cash flow. American is paying current medical claims with the employee contributions. I guess I was curious as to what implications there might be down the road, in the event of plan termination, in terms of reimbursing account balances and that kind of thing.

MR. REESE: I think if the plan is terminated there will be enormous hues and cries. But if the plan is terminated and American Airlines is ongoing, American will take whatever cash and assets it has on hand and take care of severance benefits.

MR. HOGAN: Ethan, I just want to confirm on the 401(h) account that the 25% limit you mentioned for funding of that account is cumulative, so you can fund based on past contribution amounts?

MR. KRA: It's cumulative from the date you establish the 401(h) subaccount. If you establish the 401(h) today, you cannot look back. If you established the 401(h) 10 years ago, but have been putting in very little, that 25% limit is cumulative. However, you're subject to two limits. One is the 25% limit, which is a cumulative limit. If you've done very little for the past 10 years, but you've had a 401(h), you can do it all at once. The second is the regular ongoing spreading of costs. There is a double calculation. You have the spreading over future service with 10-year amortizations. That's an independent limit, and you've got to satisfy both.

MR. HOGAN: Okay, irrespective of full-funding problems, if your pension is currently fully funded with a zero contribution, if you've got that leeway from five years ago from not funding the 401(h), can you still do that?

MR. KRA: I would interpret that you could, because the full-funding limits for this year is calculated at 25% of zero, or zero, which then gets added to your carry-forward.

I have a quick question for Adam on Chrysler with its VEBA. What was the taxation of the investment earnings in the accounts attributable to employer matching contributions?

MR. REESE: That's a good question. I haven't got it with me. I'll let you know.

MR. GERARD C. MINGIONE: I have a couple questions for Adam about the American Airlines approach. I was a little confused as to how it would work if you had employee money going into a nonbargaining VEBA and the employee money was sufficient to pay about 30% of the benefits down the road. Would there be any capacity left for the employer to fund, given that it's a noninflationary medical target? I think my second question might be linked, so I should ask that, too. I couldn't figure out how the employee contribution could accumulate on a tax-deferred basis. At least as I understand it, it would appear that UBIT would apply but I'm not certain.

MR. REESE: To answer the first question, basically American Airlines is continuing its retiree medical plan and paying the postretirement health care costs, whatever the defined-services cost is.

MR. KRA: Adam, isn't the key that American Airlines is not putting company money in?

MR. REESE: No, American is not funding the plan. American Airlines is not putting employer money into the VEBA. American is staying on a pay-as-you-go basis. And your second question was on what's the taxation basis?

MR. MINGIONE: Yes, whether UBIT would apply in that VEBA?

MR. REESE: I can't see there's anything wrong with American Airlines granting an 8% return on invested assets. It doesn't have to look to whatever the return was on those assets, and so if American has grabbed 8% interest and it's then taxed on severance benefits, it's still a decent return. So American could use a savings and loan rate if it wanted.

MR. KRA: Well, how about the actual return that's going in the trust? What's happening with that – UBIT's being applied?

MR. REESE: No, I think that American is managing the cash flow to insure that the assets in the VEBA are less than the incurred but not reported (IBNR).

MR. KRA: So, effectively, American is not using the VEBA as a prefunding vehicle; American is using it as a cash-flow vehicle.

MR. REESE: Currently. But I think down the road American is going to have more assets from employee contributions than an IBNR limit, so there will be an increasing proportion of the assets that are subject to taxation.

MR. JARMON WELCH: I want to ask a question about the philosophy that FASB has behind recognizing the liability when employees pay 30% of the medical claims. For example, FAS 87 and FAS 106 mirror each other, even though one is pension and one is medical. There are many similar provisions between them. But if you have a pension plan, you would determine the unfunded. Let's say there were a $100 million unfunded. The fact that employees contributed to it wouldn't really make any difference because your employee contributions would be deemed to be a prospective thing against normal cost. Is it really true in the medical evaluation that if employees paid for, say 30% of the premium, they can determine their liability on the balance sheet that you would take 70% of the liability today by using that kind of basis? In that basis the pension and the medical would differ dramatically.

MR. REESE: I think I agree with you, although when the folks up in Connecticut drafted FAS 106, they tried to stay very close to the principles in FAS 87. Only by looking at some thing explicitly do they realize maybe some of the decisions made in FAS 87 weren't the best ones, but they felt that they had to stay very close to it. If you read the beginning preface of FAS 106, it says this is the beginning. This is not the end of the accounting for postretirement benefits. So you do have some discontinuities, where you have employee contributions purchasing a piece of pension benefit and cost-sharing postretirement on the portion of the premium.