NOTES

THE PENDING CRISIS IN EMPLOYER-PROVIDED HEALTH BENEFITS FOR RETIREES: ARE TAX BREAKS FOR EMPLOYERS THE ANSWER?

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INTRODUCTION

Although concern about health care in America is widespread and growing, few Americans are aware of the pending crisis in employer-provided retiree health benefits. As with the savings and loan fiasco, this crisis is an obscure, largely "hidden" problem, that could erupt in the next few years as a major scandal. While the savings and loan bailout could cost taxpayers a staggering \$500 billion,[1] the retiree health benefit crisis could cost as much as \$2

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1. Alton Bennett, *Lending Practices Forcing Decay of Neighborhoods*, STAR TRIB. (Minneapolis), Nov. 18, 1991, at 3D ("The S&L bailout cost is now up to \$500 billion, or about \$5000 per person."); Stephen Labaton, *Bank Regulator Makes Plea for \$70 Billion in U.S. Aid*, N.Y. TIMES, Nov. 26, 1991, at D1 ("The savings and loan bailout could cost taxpayers \$500 billion over 40 years."); Robert A. Rosenblatt, *Agencies Raise S&L Bailout Cost to \$190 Billion*, L.A. TIMES, Sept. 18, 1991, at D2 ("When interest costs are included, the S&L bailout is estimated to cost taxpayers more than \$500 billion during the next 40 years."); *cf.* Joseph P. Kennedy II, *We*

trillion.[2] If we are to effectively confront the pending crisis, we must not only recognize the problem, but understand its history and causes.

Employers began to offer health care plans as a fringe benefit to employees over fifty years ago.[3] Since 1954 employer-provided health benefits have been excluded from an employee's taxable income.[4] Such tax policy has strongly encouraged employers to provide health care coverage as a non-cash, tax-deferred element of compensation. The employees naturally preferred to receive tax-free employer-provided group health insurance rather than the equivalent taxable salary raise. Not surprisingly, by the late 1950s employers provided eighty percent of the work force with health insurance benefits.[5]

With the adoption of Medicare in 1965, many businesses began to offer retirement health coverage to their employees. This coverage, known as "Medigap," was intended to insure retirees for expenses not covered by Medicare. By 1986, roughly two-thirds of the work force participated in employer-provided retiree health plans.[6]

Companies initially provided Medigap insurance because they expected

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Should Pay as We Go for the S&Ls, WASH. POST, Oct. 29, 1991, at A23 ("The S&L bailout, which could cost well over a trillion dollars by the time it's over, is being paid for by a costly "borrow and spend" policy. . . . [That policy] could add as much as $900 billion in interest alone to the bailout cost."); *Dow Down*, USA TODAY, Oct. 28, 1991, at 1B ("The General Accounting Office says it still can't say how much the savings-and-loan crisis will cost despite months of trying to unscramble the books of the Resolution Trust Corp. The RTC is the agency created to clean up the crisis. The GAO said it suspects the price will keep climbing.").

2. *See infra* notes 10-13 and accompanying text.

3. GEORGE J. ANNAS, SYLVIA A. LAW, RAND E. ROSENBLATT & KENNETH R. WING, AMERICAN HEALTH LAW 19 (1990).

4. I.R.C. § 106 (West Supp. 1991) was introduced in the Internal Revenue Code of 1954, Pub. L. No. 83-591, § 106, 68A Stat. 1, 32 (1954). The provision was designed to promote equity between taxpayers in like positions. Under prior law, "amounts paid by employers as premiums for group employee accident and health insurance, or as contributions to State accident and health benefit funds, [were] not included in the gross income of the employees, however, amounts which [were] paid by employers as premiums for individual employee policies of accident and health insurance [were] includible in gross income." SENATE FINANCE COMM., 83D CONG., 2D SESS., SENATE FINANCE COMMITTEE REPORT, INTERNAL REVENUE CODE OF 1954 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4820.

5. ANNAS, LAW, ROSENBLATT & WING, *supra* note 3, at 19-20 ("In the 1950's, retirement plans became an accepted benefit for union employees. These negotiated benefits were generally derived through collective bargaining with the employer."); *see also* Charles S. Mishkind, *Implications of FASB's Exposure Draft on Employers' Accounting for Post-Retirement Non-Pension Benefits*, 18 TAX MGMT. COMPENSATION PLAN. J. 111 (1990).

6. By 1986, 95% of employees of medium and large firms had employer-sponsored health care benefits. "About three-fourths of the participants were in health plans extending coverage into retirement. These plans nearly always covered retirees up to age 65, and generally provided the same benefits given to active employees. In nine-tenths of the cases, retirees remained insured after 65. Again, there was commonly no change in benefit levels, apart from coordination with Medicare." JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 415 (1990) (quoting U.S. DEP'T OF LABOR, BUREAU OF LABOR STATISTICS, EMPLOYEE BENEFITS IN MEDIUM AND LARGE FIRMS: 1986 27 (1987)). "About 72% of the elderly have private insurance either purchased directly or paid for by their former employers as part of pension benefits." Peter J. Ferrara, *Medicare and the Private Sector*, 6 YALE L. & POL'Y REV. 61, 65 n.25 (1988).

the cost to be relatively low and predictable.[7] Furthermore, since the benefits were not then considered entitlements, the companies believed they could terminate them at will.[8] However, over the years employers have found that the cost of providing retirement health benefits has become exorbitant — often exceeding pension plan liabilities. Several factors have contributed to the rising costs: cuts in Medicare funding; the inflation of health care costs; court intervention in employers' attempts to modify or terminate retiree health benefits; and the failure of employers to fund the promised future benefits.[9]

The estimated aggregate cost to employers of providing retiree health benefits ranges from "$100 billion to $2 trillion, plus increases of some $100 billion each year in the future."[10] While many employers have been promising these retirement health benefits to their employees for twenty-five years or more, few have put aside funds to cover the enormous expense of fulfilling their promises.[11] Most employers have treated retiree health benefit costs similarly to current employee health benefit costs — i.e., on a "pay as you go" basis[12] — with the result that "the post-retirement health care liability for the 'Fortune 500' industrials considerably exceeds their total assets."[13]

Section I of this Note briefly addresses the non-tax factors which have contributed to the pending crisis in employer-provided retiree health benefits. Section II enumerates the tax-based factors leading to this crisis — the currently available, tax-favored methods that employers use to fund their retiree health liabilities. Finally, section III provides a critique of one commonly proposed solution to the crisis in employer-provided retiree health benefits: al-

7. *Health Benefit Costs for Retirees Seen Pressuring Businesses*, J. ACCT., Apr. 1987, at 34, 35 [hereinafter *Health Benefit Costs*] (quoting Betty Malroy Stagg, health-care specialist); Jane F. Greenman, *Funding Retiree Medical Plans*, 321 PRAC. L. INST./TAX 61 (1991); *see also* Milt Freudenheim, *Company Expenses for Retirees Soar*, N.Y. TIMES, Sept. 9, 1985, at A1 ("Businesses that began to pay medical costs for retirees nearly 20 years ago are seeing their commitments soar to hundreds of millions of dollars, far beyond what most had envisioned.").

8. Lee A. Sheppard, *AGE Explores Retiree Health Liability Problem*, 40 TAX NOTES 557 (1988) [hereinafter *Retiree Health Liability Problem*].

9. Vincent Amoroso, *Tax-Advantaged Financing Options for Post-Retirement Healthcare Benefits*, 65 J. TAX'N 242 (Oct. 1986).

10. *Proposed FASB Standard to Have "Awesome" Effect, Symposium Told*, 16 Pens. Rep. (BNA) 884 (1989) (quoting Dale E. Gerboth, Arthur Young & Co.), *quoted in* LANGBEIN & WOLK, *supra* note 6, at 416; *see also* Sheppard, *supra* note 8, at 557. The GAO estimated the cost at only $227 billion in accrued liabilities and an additional $175 billion in future accruals for current employees. GOVERNMENT ACCOUNTING OFFICE, COMPANY ACTIONS TO LIMIT RETIREE HEALTH COSTS 1 (1989); *see also U.S. Employers Have $227 Billion in Accrued Liabilities, GAO Finds*, 16 Pens. Rep. (BNA) 1034 (1989).

11. Tamar Lewin, *Retiree Benefits Cast a Shadow*, N.Y. TIMES, July 21, 1987, at D2; Sheppard, *Retiree Health Liability Problem*, *supra* note 8, at 557; *Health Benefit Costs*, *supra* note 7, at 35.

12. *See* Louis R. Richey & Michael S. Stolbach, *Solving the Post-Retirement Employee Benefit Liability Problem — An Overview*, 16 TAX MGMT. COMPENSATION PLAN. J. 23 (1988); D. Gerald Searfoss & Naomi Erickson, *The Big Unfunded Liability: Postretirement Healthcare Benefits*, J. ACCT., Nov. 1988, at 29; Gene Steuerle, *Financing Postretirement Health Benefits*, 51 TAX NOTES 1451 (June 17, 1991); *Health Benefit Costs*, *supra* note 7, at 35.

13. Bruce D. Pingree, *Current Issues in Termination and Modification of Welfare Plans*, 14 TAX MGMT. COMPENSATION PLAN. J. 311, 312 (1986).

lowing employers to fully fund their retiree health liabilities on a tax-favored basis.

I
CRISIS-CONTRIBUTING FACTORS OUTSIDE THE TAX CODE

A. Demographics and Federal Policy

Retirees represent a rapidly growing portion of the population.[14] This growth trend can be attributed to longer life spans, earlier retirement, an aging baby-boom generation, and declining birth rates. Despite this trend, the federal government has consistently cut funding for federally-provided retiree health benefits under Medicare because of rising health-care costs,[15] a recessionary economy, and a federal budget deficit.[16]

Publicly-provided health insurance remains the major source of health care coverage for the elderly,[17] yet it fails to cover a substantial portion of the health care costs the elderly are forced to incur. The gap between the actual costs of health care for the elderly and the benefits provided to them under Medicare continues to widen with nearly every federal budget.[18]

The private sector now faces increasing pressure to close this gap. Congress has effectively abdicated responsibility for the rising costs of retiree health care by consistently reducing spending allocations for Medicare and by refusing to pass legislation to codify and regulate employer-provided retiree health benefit plans.

A pension plan defers income "from the years of employment to the years of retirement,"[19] whereas retiree health benefits are generally a promise of defined services on an as-needed basis (i.e., reimbursing the retiree only for actual expenses, such as all or part of any health care costs incurred but not covered by Medicare). Predicting the dollar amount of such benefits is difficult or impossible, due to changes in Medicare coverage, advances in medical technology, the inflation of health care costs, and other factors beyond the control of the plan provider.[20]

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14. Harold Dankner, *Health Policy Issues for the 1990s*, 43 NAT'L TAX J. 293, 295 (1990); Searfoss & Erickson, *supra* note 12, at 30; Sheppard, *Retiree Health Liability Problem*, *supra* note 8, at 558 ("Two-thirds of retirees retire before age 65.").

15. When Medicare was adopted in 1965, the nation's health care bill was $43 billion; in 1985, only twenty years later, medical expenses jumped to $387 billion. *Health Benefit Costs*, *supra* note 7, at 34, 35.

16. Human Resource Management Group, Alexander & Alexander, *Promises to Keep: Meeting Post-Retirement Welfare Benefit Commitments*, 13 TAX MGMT. COMPENSATION PLAN. J. 257 (1985).

17. Medicare alone covers over 95% of all noninstitutionalized elderly persons. Timothy J. Smeeding & Lavonne Straub, *Health Care Financing Among the Elderly: Who Really Pays the Bills?* 12 J. OF HEALTH POL., POL'Y AND L., Spring 1987, at 35, 37; *see also* Ferrara, *supra* note 6, at 62 (estimating the figure at 94%).

18. Sheppard, *Retiree Health Liability Problem*, *supra* note 8, at 558 ("Medicare compensates only half the cost of caring for people over age 65.").

19. LANGBEIN & WOLK, *supra* note 6, at 2.

20. Searfoss & Erickson, *supra* note 12, at 28.

No codified law prevents employers from unilaterally modifying or terminating their retiree health benefit plans as costs escalate.[21] In general, retirement plans are regulated by the extensive Employee Retirement Income Security Act of 1974,[22] commonly known as ERISA, which governs pension plan qualification, operation, administration, funding, vesting, and filing and reporting with the Internal Revenue Service. Title IV of ERISA created the Pension Benefit Guaranty Corporation (PBGC) to guarantee payment of benefits insured through PBGC when covered retirement plans terminate without sufficient assets to pay for promised benefits.[23] However, welfare benefit plans[24] are excluded from ERISA's key areas of coverage: vesting rules,[25] funding rules,[26] and termination insurance from PBGC.[27] No statutory law effectively regulates or insures the provision of employer-provided non-pension retirement benefits.

B. Intervention of the Courts

In 1971, the Supreme Court held that union retirees were neither members of a bargaining unit nor "employees" under the National Labor Relations Act.[28] Employers are thus not obligated to negotiate with retired employees over retirement benefits. Since unions are also not obligated to negotiate on behalf of retirees, active union employees are pressured to opt for present-day income over the protection of current and future retirement benefits.[29]

In the absence of statutory protection, disgruntled retirees and current employees looked to the courts to prevent employers from modifying or terminating their health benefits. In *International Union UAW v. Yard-Man Inc.*,[30] the court held that retiree medical benefits are, "in a sense 'status' benefits which, as such, carry with them an inference that they continue so long as the

21. In order to contain the costs of providing retiree health care coverage, employers commonly try to: "(1) require employee contributions, (2) increase the deductibles that must be satisfied by the employees themselves out of pocket, (3) remove certain "eligible" illnesses or injuries from the plan or program, or (4) require the use of health maintenance organizations (HMOs) rather than continue to reimburse employees or pay their employees' personal physicians directly." Jeffrey D. Mamorsky & Stacey Forin Zimmerman, *The Curtailment of Postemployment Welfare Benefits: A Legal Perspective*, 8 CORP. L. REV. 294, 294 (1985).

22. Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified at 29 U.S.C. § 1001).

23. E.R.I.S.A. § 4002(a) (West Supp. 1991).

24. In general, the term "welfare benefits" is slightly broader than the term "medical benefits" or "health benefits." Welfare benefits encompass such benefits as educational assistance, prepaid legal services, vacation benefits, severance pay, and day care centers as well as health care. *See* E.R.I.S.A. § 3(1) (West Supp. 1991) (providing the definition of "employee welfare benefit plan"). Health benefits, however, are by far the most important aspect of welfare benefits. LANGBEIN & WOLK, *supra* note 6, at 412.

25. E.R.I.S.A. § 201 (West Supp. 1991).

26. E.R.I.S.A. §§ 301, 302 (West Supp. 1991).

27. E.R.I.S.A. § 1302 (West Supp. 1991).

28. Allied Chem. & Alkali Workers of Am. v. Pittsburgh Plate Glass Co., 404 U.S. 157 (1971).

29. Mishkind, *supra* note 5, at 112; Mamorsky & Zimmerman, *supra* note 21, at 295.

30. 716 F.2d 1476 (6th Cir. 1983), *cert. denied*, 465 U.S. 1007 (1984).

prerequisite status [of retirement] is maintained."[31] Soon after, in *Hansen v. White Farm Equipment Co.*,[32] the court created a federal common law rule vesting retiree welfare benefit plans at retirement,[33] notwithstanding Congress' specific exclusion of welfare benefit plans from the statutory vesting requirements of ERISA. At about the same time, a New York district court took a slightly different approach to the issue. In *Eardman v. Bethlehem Steel Corp. Welfare Benefit Plans*,[34] the court held that Bethlehem Steel had failed to effectively reserve the right to modify its retiree welfare benefit plans where oral representations of the non-amendability and non-terminability of the plans were made to employees at exit interviews, and booklets describing the plan did not set forth a reservation or right to cancel or modify the plan.[35]

Since 1984, the courts have retreated somewhat from the protectionist view of those first few cases. The Sixth Circuit reversed the *Hansen* decision in *In re White Farm Equipment Co.*, discarding the idea of a federal common law vesting rule for retiree welfare benefits.[36] Various federal appellate courts have also limited the application of *Bethlehem Steel* by consistently upholding the right of an employer to modify or terminate a retiree health benefit plan where the employer expressly and unambiguously retains such a right in the applicable plan documents.[37] Where plan documents are unclear or a collective bargaining agreement suggests that the retiree health benefits are to outlive the agreement, the courts have generally followed *Bethlehem Steel* by declining to allow employers to amend or terminate the benefits for former employees who retired while the agreement was in effect.[38]

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31. *Id.* at 1482.

32. 42 B.R. 1005 (N.D. Ohio 1984), *rev'd*, 788 F.2d 1186 (6th Cir. 1986).

33. *Id.* at 1021-22.

34. 607 F. Supp. 196 (W.D.N.Y. 1984). Both the decision in *Bethlehem Steel* and the reversal in *White Farm* signaled a shift in approach by the courts towards a focus on the intent of the parties and their contractual relations. For a discussion of this trend, see *Retirees Do Not Have Federal Common Law Right to Welfare Benefits Under ERISA*, 14 TAX MGMT. COMPENSATION PLAN. J. 185, 186 (1986).

35. *Bethlehem Steel*, 607 F. Supp. at 209-15; *see also* Michael S. Melbinger & Marianne W. Culver, *FASB Issues Statement on Employers' Accounting for Post-Retirement Medical Benefits*, 19 TAX MGMT. COMPENSATION PLAN. J. 115, 120 (1991).

36. *In re* White Farm Equip. Co., 788 F.2d 1186 (6th Cir. 1986).

37. *See, e.g.*, Musto v. American Gen. Corp., 861 F.2d 897 (6th Cir. 1988); Moore v. Metropolitan Life Ins. Co., 856 F.2d 488 (2d Cir. 1988); DeGeare v. Alpha Portland Indus., 837 F.2d 812 (8th Cir. 1988); Anderson v. Alpha Portland Indus., 836 F.2d 1512 (8th Cir. 1988); Etherington v. Bankers Life & Casualty Co., 747 F. Supp. 1269 (E.D. Ill. 1990). Where the language in the plan documents is ambiguous and evidence of a promise to provide non-union retiree welfare benefits can be found, a court will likely look to the employer's past practice and the oral and written representations made by the employer to establish the duration of the promised benefits. Melbinger & Culver, *supra* note 35, at 121.

38. United Steelworkers of Am. v. Connors Steel Co., 844 F.2d 1499 (11th Cir. 1988); United Paper Workers Int'l Union v. Muskegon Paper Box Co., 704 F. Supp. 774 (S.D. Mich. 1988); Jansen v. Greyhound Corp., 692 F. Supp. 1029 (N.D. Iowa 1987); UAW v. Park-Ohio Indus., 661 F. Supp. 1281 (N.D. Ohio 1987).

C. Financial Accounting Standards

Employers have historically promised retiree health benefits without setting aside funds to cover the long-term costs of the plans.[39] This means that employers have treated employee benefits on a "pay as you go" basis, paying the liabilities as they arise without planning in advance for future costs. This presents a marked contrast with pension benefits in that federal law requires employers to pre-fund future benefit payouts.[40] The failure of employers to set aside funds specifically for retiree health benefits is problematic because the present-day cost of funding years of promised benefits to retirees in the future could range as much as fifty times the amount employers are now spending on retiree health benefits.[41]

Until recently, accounting standards did not discourage the "pay as you go" method for funding retiree health benefits. Employers were not required to recognize future retiree health liabilities in their financial reports. Retiree health liabilities were effectively "hidden" liabilities.

In 1990, after several years of debating the problem, the Financial Accounting Standards Board (FASB)[42] adopted Financial Accounting Standard 106 (F.A.S. No. 106).[43] F.A.S. No. 106 requires companies to report retiree health benefit liabilities in their financial reports on the accrual method rather than the cash method. The cash method allowed employers to recognize only current benefits paid and to merely footnote the existence of future liabilities.[44]

39. *See supra* notes 12 & 13 and accompanying text.

40. Essentially, employers have treated their retiree health obligations in the same manner as their current employee health care costs: employers have recognized only actual benefits paid.

41. Stephen R. Miller, Michael S. Melbinger & Nicholas Giampietro, *Postretirement Medical Benefits Plans: An Analysis of Funding and Termination Issues*, 12 J. PENSION PLAN. & COMPLIANCE, Fall 1986, at 193, 195 ("Unfunded liabilities range from 4 to 50 times the amount that employers are now paying annually for postretirement medical coverage."); *see also* Edward J. Emering, *Retiree Medical Benefits: Facing the Issues*, 17 J. OF PENSION PLANNING & COMPLIANCE, Summer 1991, at 52, 53 (explaining that the current costs of a postretirement plan "can produce a misleading impression of its actuarial cost, which could easily be 20 to 30 times greater than the cash flow in its early years").

42. The Financial Accounting Standards Board (FASB) was organized in 1973 as a part of the American Institute of Certified Public Accountants (AICPA), a professional group that is responsible for establishing uniform accounting principles and standards for publicly-traded companies (a duty delegated by the Securities and Exchange Commission under the Securities Act of 1934). GEORGE H. SORTER, MONROE J. INGERMAN & HILLEL M. MAXIMON, FINANCIAL ACCOUNTING: AN EVENTS AND CASH FLOW APPROACH 11 (1990).

43. FINANCIAL ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 106, EMPLOYERS' ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS (1990) [hereinafter F.A.S. No. 106].

44. Ellin Rosenthal, *FASB Makes It Official: Financial Statements Must Reflect Liability for Nonpension Retirement Benefits*, 50 TAX NOTES 8 (1991). The prior practice of employers was based on guidelines provided in FINANCIAL ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 81, DISCLOSURE OF POSTRETIREMENT HEALTH CARE AND LIFE INSURANCE BENEFITS (1984). In its findings for F.A.S. No. 106, the Financial Accounting Standards Board noted that "[e]mployers have generally recognized the obligation and related costs arising from the exchange [of benefits in the future for services rendered today] as the obligation was satisfied rather than when it was incurred." F.A.S. No.

Accrual method accounting requires quantifying and recognizing *future* liabilities, such as retiree health benefit liabilities, on *current* balance sheets.[45]

F.A.S. No. 106 is expected to have a large impact on the bottom line of many companies. A study that applied the new FASB Standard to twenty-six varied companies indicated that they would "experience a decrease in pretax income of 2% to 20%, depending on benefit coverage, demographics, current health care claims experience and actuarial assumptions."[46] Concern over the impact of F.A.S. No. 106, which became effective after December 15, 1992,[47] has helped to fuel discussion of ways to fund retiree health liability reserves.[48]

The business community has responded to F.A.S. No. 106 with considerable alarm.[49] The FASB defended F.A.S. No. 106 on the basis that, "like pensions, other postretirement benefits are a form of deferred compensation . . . [and] should be recognized in a company's financial statement when they are earned by the employee."[50] Some employers contend that future retiree health benefits are not liabilities since employers can cancel retiree health benefits at will. They further contend that even if future liabilities for retiree health benefits exist, the amount of the obligation is not measurable and cannot be quantified or accounted for under the accrual method.[51] Others expressed worry that American businesses would lose precious ground in terms of international competitiveness, because foreign governments, rather than businesses, provide national health care in many competitor nations.[52] Most businesses agreed that the liability exists, and some even felt that F.A.S. No. 106 might "have the salutary effect of making employers, employees, and the

106, *supra* note 43, ¶ 142. For an extensive and detailed description of the provisions of F.A.S. No. 106, see Melbinger & Culver, *supra* note 35, at 115-20.

45. This definition is a simplified version of that provided by SORTER, INGERMAN & MAXIMON., *supra* note 42, at 48-49, 459.

46. Glenn Alan Cheney, *Special Report*, J. ACCT., Aug. 1989, at 15, (citing FINANCIAL EXECUTIVE RESEARCH FOUND., RETIREE HEALTH BENEFITS: FIELD TEST OF THE FASB PROPOSAL (1989)).

47. F.A.S. No. 106, *supra* note 43, ¶ 108.

48. Ellin Rosenthal, *Taxwriters Draft Section 89 Bill, Business Offers Proposals*, 43 TAX NOTES 120 (Apr. 10, 1989) (quoting David M. Walker, Assistant Secretary of Labor for Pension and Welfare Benefits).

49. As one commentator put it, "[i]n the minds of some corporate managers, the only thing worse than having a huge, uncontrollable, unfunded liability hanging out there is having to tell the public securities market about it." Lee A. Sheppard, *Chandler Proposes Limited Deduction for Retiree Health Care Plans*, 36 TAX NOTES 126, 127 (1987).

50. *FASB Defends Postretirement Ed*, J. ACCT., Apr. 1989, at 15, 17 (quoting FASB Project Manager Diana Scott). For a criticism of the FASB's " 'deferred compensation' theory," see Mishkind, *supra* note 5, at 111.

51. Stan Martens & Kevin Stevens, *Special Report: Business Reacts to FASB's Proposal for Nonpension Retirement Benefits*, J. ACCT., June 1990, at 21, 21. Most of the criticism by businesses of F.A.S. No. 106 concerned the FASB's determination of when an employee earned these benefits, i.e., when, rather than whether, a company had to recognize the liability for those earned benefits. *Id.*

52. *Id.*; *see also* Sheppard, *Retiree Health Liability Problem*, *supra* note 8, at 560 (quoting Beach Hall, Assistant Director of Health Care Benefits at General Motors, as complaining that "Nissan has a $1 per hour cost advantage over GM solely by reason of retiree health costs"); F.A.S. No. 106, *supra* note 43, ¶ 145.

public more aware of the true cost of providing health care."[53] One certain effect of F.A.S. No. 106 will be to discourage businesses from providing, or continuing to provide, retirement health benefit programs.[54]

Analyzing the non-tax factors behind the pending crisis in retiree health benefits leads to several insights. First, the knee-jerk response of simply forcing employers to abide by their promises will not solve the problem of financing those promises. Second, assigning blame for the crisis to any one party is not only unfeasible, but fruitless, for it furthers no interests and focuses debate on the past rather than the future. Third, government health care policy and the pending crisis in employer-provided retiree health benefits are clearly interrelated. Any effective proposal for solving the crisis must take into account the vagaries and motivations of both the government and the private sector.

II
TAX-BASED FACTORS CONTRIBUTING TO THE CRISIS: THE TAX-FAVORED FUNDING METHODS

The inability to set aside funds on a tax-favored basis may explain why most employers have not pre-funded their retiree health plans. Unlike pension plans, retiree health plans generally cannot be fully funded in a tax-favored manner. Several tax-favored funding methods are available to and are used by employers, but all are greatly limited in scope because of restrictions imposed by Congress or the Internal Revenue Service.

Employers currently have six methods for tax-favored funding of retiree health obligations: VEBAs;[55] COLI/VOLI;[56] § 401(h) accounts;[57] HSOPs;[58] § 420 transfers;[59] and defined contribution plans.[60] Although none of these methods was specifically designed for the funding of retiree health care on a

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53. Martens & Stevens, *supra* note 51, at 21.

54. Glenn Kramon, *Cuts Sought in Retirees' Health Costs*, N.Y. TIMES, Aug. 22, 1988, at D1 ("A growing number of companies, anticipating that rapid growth in medical costs will continue, are seriously considering ways to limit their obligations for retired workers' health costs."); Sheppard, *Retiree Health Liability Problem*, *supra* note 8, at 560 (quoting economist Robert Vatter, a vice president of the Metropolitan Life Insurance Company: "[T]he most likely employer response to court decisions forbidding cuts in health benefits to current retirees would be to cut or eliminate the retiree health benefits of active employees and new hires"); Ellin Rosenthal, *Treasury Official Warns Employers To Ease Off on Push for Long-Term Care Tax Breaks*, 48 TAX NOTES 945 (1990) (stating that F.A.S. No. 106 "has [employers] scrambling for ways to lower their unfunded liabilities"); *see also Employers Redesign Health Plans to Require More Employee Cost-Sharing*, 5 TAX MGMT. FIN. PLAN. J. 376 (1989).

55. Voluntary Employees' Beneficiary Association. *See infra* notes 61-87 and accompanying text.

56. Corporate-Owned Life Insurance/VEBA-Owned Life Insurance. *See infra* notes 88-106 and accompanying text.

57. *See infra* notes 107-21 and accompanying text.

58. An HSOP is a combination of an employee stock ownership plan (ESOP) and a section 401(h) account within a money purchase pension plan. *See infra* notes 122-26 and accompanying text.

59. *See infra* notes 127-32 and accompanying text.

60. *See infra* notes 133-38 and accompanying text.

tax-deferred basis, any one of these methods alone *could* be designed to allow for full, tax-favored pre-funding of retiree health benefits. However, the federal government repeatedly manifests its ambivalent attitude toward tax-favored pre-funding of retiree health benefits by first providing a funding method and then imposing restrictions so as to make that method of minimal real value in solving the retiree health care liability problem.

To understand and analyze retiree health plan funding alternatives, one must consider five key distinguishing factors: (1) benefit security; (2) plan termination insurance; (3) fund investment risk; (4) health care cost inflation risk; and (5) third-party costs and other administrative and incidental expenses. Benefit security refers to the extent to which employers can modify or cancel benefits at will. The employer's desire for flexibility and control in planning for the future typically works counter to the employee's wish to rely on promised benefits in planning for retirement. Plan termination insurance refers to the extent to which benefits are protected in the event of the employer's insolvency or bankruptcy. Today's high incidence of business failures makes this issue of growing significance. The fund investment risk concerns two issues between the employer and employee: who evaluates the risk of investment and who bears the risk that the investments will not provide a sufficient return to cover the retiree health liability. In a similar vein, the health care cost inflation risk element refers to whether the employer or the employee bears the risk that health care costs will continue to escalate. Finally, the costs of implementing the different methods of funding retiree health plans can vary widely depending on such factors as the use of third parties, such as insurance companies, administrative costs, and incidental expenses.

A. VEBAs

A "Voluntary Employees' Beneficiary Association" (VEBA) is a tax-exempt organization which accumulates income-producing reserves tax-free to pay life, sick, accident, or other benefits (including retiree health benefits) for active and retired employees, as well as their dependents and beneficiaries.[61] As the name implies, VEBA membership must be voluntary,[62] although em-

61. Treas. Reg. § 1.501(c)(9)-2(b)(2) (1991).

62. Eligibility for membership is defined by reference to objective standards that constitute an employment-related common bond among the individuals. Such a common bond arises whenever participants share:

1) a common employer,
2) affiliated employers,
3) one or more collective bargaining agreements,
4) membership in one or more locals of a national or international labor union, or
5) one or more employers engaged in the same line of business in the "same geographic locale."

Treas. Reg. § 1.501(c)(9)-2(a)(1) (1991). The "geographic locale" rule was invalidated by the court in Water Quality Assoc. Employees' Benefit Corp. v. United States, 795 F.2d 1303 (7th Cir. 1986). The "employment-related common bond" requirement for membership may be satployers are allowed to require membership as long as members do not incur any detriment (such as automatic payroll deductions) from participation.[63] Membership is treated as "voluntary" even when it is required by a collective bargaining agreement or consequent to membership in a union.[64]

Although, in theory, a VEBA would seem to provide an ideal method for an employer to fund a retiree health liability, the Deficit Reduction Act of 1984 (DEFRA)[65] greatly curtailed the advantages offered by a VEBA. Internal Revenue Code sections 419 and 419A, adopted under DEFRA, imposed limits on deductible contributions to welfare benefit funds, added reporting requirements, and revised the unrelated business income tax rules to restrict accumulations — all of which discourage employers from using VEBAs to fund their retiree health benefit liabilities.

A VEBA sponsor, the employer, is only allowed to deduct "qualified costs" incurred by the VEBA for that year.[66] "Qualified costs" consist of "qualified direct costs" of the VEBA *plus* annual additions to the VEBA's "qualified asset account" *less* the VEBA's "after-tax income."[67] The "qualified direct costs" of a VEBA for any year consist of the amount of benefits and administrative expenses that would have been deductible that year if those benefits were provided directly by the employer and the employer used the cash method of accounting.[68] "Qualified direct costs" thus do not include contributions to fund a reserve for future retiree health costs.

A VEBA may also deduct amounts contributed to a "qualified asset account," which may include assets set aside to provide future retiree medical benefits. However, contributions to the "qualified asset account" may not cause the total amount of assets in the account to exceed the "account limit."[69] A VEBA's "account limit" may be determined under two methods: either through the actuarial method or the safe harbor rules.[70] Under the safe harbor rules for postretirement health benefits, the employer may not deduct more than thirty-five percent of the "qualified direct costs" attributable to medical benefits (excluding insurance premiums) for the immediately preceding year.[71] Since last year's expenses will usually fall far shy of future ex-

isfied where at least 90% of the total membership of the VEBA consists of employees, former employees, and their spouses and dependents. Treas. Reg. § 1.501(c)(9)-2(a)(1) (1991). Thus, a VEBA may also benefit independent contractors, corporate directors, or self-employed individuals such as partners so long as these employees do not constitute more than 10% of the total VEBA membership.

63. I.R.C. § 501(c)(9) (West Supp. 1991); Treas. Reg. § 1.501(c)(9)-(2)(c)(2) (1991).

64. *Id.*

65. Pub. L. No. 98-369, 98 Stat. 494 (1984).

66. I.R.C. § 419(b) (West Supp. 1991).

67. I.R.C. §§ 419(c)(1), 419(c)(2) (West Supp. 1991).

68. I.R.C. § 419(c)(3) (West Supp. 1991).

69. I.R.C. §§ 419A(b)-(c) (West Supp. 1991).

70. I.R.C. § 419A(c)(5) (West Supp. 1991); *see also* Reid A. Stiefel & Paul J. Routh, *VEBAs Revisited as Funding Mechanisms — After DEFRA*, 2 BENEFITS L.J. 483, 489-90 (1989-90).

71. I.R.C. § 419(c)(5)(B)(ii) (West Supp. 1991).

penses for retiree health plans, this safe harbor represents a very limited tax break for employers pre-funding their health care liability through a VEBA.

Under the actuarial method, the "account limit" consists of three components: i) amounts necessary to pay claims incurred but unpaid for the taxable year;[72] ii) the administrative costs of these claims;[73] and iii) contributions to fund an additional reserve for future postretirement medical and life insurance benefits.[74] In determining the future costs of providing postretirement medical benefits, current medical costs must be used.[75] Due to the inflation of health care costs, the use of current medical costs to forecast future costs grossly underestimates the actual future costs and prevents employers from adequately pre-funding those future costs on a tax-favored basis. Furthermore, the additional reserve for retiree health benefits must be funded "over the working lives" of the covered employees.[76] While the term "over the working lives" seems clear, its application to current retirees who have no remaining working lives is unsettled. The most likely interpretation is that an employer may average together the working lives of active employees with the zero-remaining working lives of current retirees,[77] but any unsettled area of the law itself acts as a deterrent against the use of VEBAs.

While an employer's tax deduction increases by "qualified direct costs" and annual additions to a "qualified asset account," an employer's deduction is reduced by the VEBA's "after-tax income."[78] A VEBA's "after-tax income" means "the gross income of the welfare benefit fund"[79] (based only on contributions and other amounts received from employees, not from employ-

72. I.R.C. § 419A(c)(1)(A) (West Supp. 1991).

73. I.R.C. § 419(c)(1)(B) (West Supp. 1991).

74. I.R.C. § 419A(c)(2) (West Supp. 1991).

75. *Id.*

76. *Id.*

77. The phrase "over the working lives" leads to varying interpretations and controversy when applied to current retirees who have no remaining working lives. The most aggressive interpretation is that employers may fully fund the present value of their current retiree health benefit liability in a single year. A second view is that employers can average together the working lives of active employees with current retirees. The third and most conservative approach permits no deduction for any current retiree health benefit liability. Little guidance exists from the Treasury or the courts on how to interpret "working lives" in the context of current retirees. While the first alternative is most favorable to the employer because of the large tax deduction allowed, it also seems to be the least likely to gain acceptance from the Treasury. Such a large deduction for employers would contravene Congress' primary aim of reducing the budget through DEFRA. Second, "a basic tenet of tax law is that deductions are allowed only when permitted by Congress, and Code provisions 'allowing' deductions will be strictly construed." Stiefel & Routh, *supra* note 70, at 490. While Congress may not have intended to allow employers such a large deduction, Congress does seem to have intended to permit at least some deduction. Thus, the third alternative disallowing any deduction whatsoever also seems inconsistent with Congressional policy. In short, while no interpretation of "working lives" can be supported with certainty, the second alternative of averaging together the working lives of active employees with current retirees seems to be the most appropriate.

78. *See supra* text accompanying notes 66-68.

79. I.R.C. § 419(c)(4)(A) (West Supp. 1991).

ers[80]) *reduced* by both the sum of the amounts directly related to the production of that gross income (such as investment costs and attorneys' fees) and the amounts representing the unrelated business income tax imposed on the VEBA.[81]

The unrelated business income tax (UBIT) applicable to tax-exempt organizations is probably the greatest disadvantage of VEBAs.[82] This tax is assessed against the lesser of (1) the VEBA's income or (2) the excess assets in the "qualified asset account."[83] In other words, all assets set aside to fund a retiree health liability are taxed unless the total amount set aside is less than the VEBA's income which for UBIT purposes is equal to the VEBA's investment earnings less the expenses directly related to those earnings (excluding employee or employer contributions or benefit payments).[84] Due to the changes under DEFRA, any funds contributed to provide for future retiree health benefits will be taxed.[85]

A further disadvantage of VEBAs is that they fail to differentiate between retired and active employees. As F.A.S. No. 106 does not recognize reserves set aside for retiree health liability funds unless assets of current retirees are segregated from assets of current employees,[86] funding through a VEBA may not reduce the retiree health benefit liability on the balance sheet. Given employers' fears of heavy cuts to the bottom line due to F.A.S. No. 106, a funding vehicle that cannot minimize the impact of F.A.S. No. 106 will likely present little incentive for employers to pre-fund their liabilities.

Nevertheless, several advantages to VEBAs still remain. By eliminating insurance companies' participation through a VEBA, an employer is able to reduce the cost of providing benefits by avoiding the costs of the insurance company's profit margin and administrative expenses. The employer thus sees a greater return on its contributions. From an employee's point of view, VEBAs are attractive because the employer assumes the risk that employee claims will be unusually high or that the investment return will be insufficient to cover expenses. VEBAs also limit an employer's ability to terminate its retiree medical plan, a benefit security concern for employees.[87]

B. COLI/VOLI

As an alternative to establishing a separate organization to fund retiree health care, an employer may instead choose to borrow funds and purchase

80. I.R.C. § 419(c)(4)(B) (West Supp. 1991).
81. I.R.C. §§ 419(c)(2), 419(c)(4) (West Supp. 1991).
82. I.R.C. § 512 (West Supp. 1991).
83. I.R.C. § 512(a)(3) (West Supp. 1991).
84. *Id.*; Treas. Reg. § 1.512(a)-5T (1991).
85. *Id.*; *see also* Susan Katz Hoffman & Deborah M. Lerner, *Pension Funds and Exempt Organizations: Prefunding Welfare Benefits with VEBAs*, 8 J. OF TAXATION OF INV. 66, 70 (1990).
86. F.A.S. No. 106, *supra* note 43, ¶ 63.
87. Greenman, *supra* note 7, at 19.

life insurance on the lives of its employees and retirees, with the employer as beneficiary.[88] Unlike a VEBA, premiums or contributions to pay for corporate-owned life insurance (COLI) are not tax-deductible.[89] Instead, employers benefit from the leverage arising from the tax-free build-up of COLI income and tax-deductible interest and benefit payments.[90] Also unlike a VEBA, COLI is not subject to the deduction limitations of sections 419 and 419A,[91] and does not require the establishment of a separate organization, eliminating all the attendant administrative costs of such an organization.[92]

In terms of retiree benefit security, the disadvantage of COLI is that employers retain control over the assets and can revoke the policies or fail to renew them at will.[93] Because COLI remains an asset of the employer, it is unprotected from creditors' claims, corporate raiders, and changes in management and corporate policy.[94] Furthermore, if the COLI program is terminated prior to the death of the insured, or if the laws allowing tax-free build-up in COLI change, the employer will be taxed on the build-up as income.[95] Finally, and significantly, the employer gets no current deduction for the initial expense of purchasing the policies (only for interest expense on the debt incurred to purchase the policies),[96] and the funds invested will be unavailable to pay for benefits until after the employee's death. Thus, those employers in greatest immediate need of tax-favored funding for retiree health liabilities, such as those with mostly older employees or a large ratio of retirees to employees (i.e., "rust belt" industries), would probably not be able to take much advantage of COLI or VOLI, since the policies purchased would not build up a sufficient cash value to cover retiree health care costs before the insured retirees and employees died.

Similar to COLI, VEBA-owned life insurance (VOLI) mimics the structure of COLI except that the VEBA takes the place of the employer as owner and beneficiary of the life insurance policies.[97] While VOLI is complicated by the restrictions imposed on VEBAs by DEFRA, life insurance policies purchased by a VEBA or assigned to a VEBA offer better protection for the plan beneficiaries, because "no part of the net earnings" of the VEBA can inure to the benefit of the employer.[98]

A crucial, unresolved issue deterring employer use of COLI and VOLI is uncertainty as to whether, under state law, the employer has an "insurable

88. Richey & Stolbach, *supra* note 12, at 24.
89. Greenman, *supra* note 7, at 23.
90. *Id.*
91. *Id.* at 20.
92. *Id.* at 22.
93. *Id.*
94. *Id.* at 23.
95. *Id.*
96. *Id.*
97. *See generally VEBAs May Use Employer-Funded Whole Life Policies to Fund Benefits*, 14 TAX MGMT. COMPENSATION PLAN. J. 57 (1986).
98. I.R.C. § 501(c)(9) (West Supp. 1991).

interest" in the lives of its retirees. "The lack of insurable interest could permit the insurance company to void the policy, and insured's survivors to seek a share of the proceeds on "equitable principles," while the IRS may argue that no insurance contract, and hence, no insurance contract benefits, exists."[99] Some states have specifically amended their laws to resolve this problem,[100] but most states provide little or no guidance on the issue.[101]

The principal advantage of COLI and VOLI is that the cash value buildup of the policy is tax-free when paid as death benefits.[102] However, a primary disadvantage is the relatively low return on employer contributions.[103] As amended by the Tax Reform Act of 1986,[104] section 264 of the Internal Revenue Code undercut the tax leveraging available from investment in COLI and VOLI by eliminating the interest deduction on loans in excess of $50,000 (per insured) on policies acquired after June 20, 1986.[105] In addition, in order to take full advantage of COLI in terms of tax leveraging, an employer needs to have a high marginal tax rate. Thus, recent tax reform which reduced the corporate rate also lessened the advantages of COLI. The limited interest deduction combined with the lower corporate tax rate results in a low return on the employer's contributions to COLI or VOLI.[106] Finally, the return on investment is further lessened by the third-party expenses of the insurance company, which must add its profits and administrative costs in the determination of premiums.

C. Section 401(h) Accounts

Internal Revenue Code section 401(h) allows all qualified pension or annuity plans to have a separate account for funding medical benefits.[107] The employer receives a current deduction for contributions to this section 401(h) account,[108] and the funds contributed accumulate tax-free. Employees also enjoy advantages: they are not taxed on the employer contributions to the

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99. Richey & Stolbach, *supra* note 12, at 26 (citations omitted).

100. Five states specifically allow an employer to have an "insurable interest" in its employees: ARK. CODE ANN. § 23-79-103(c)(4) (Michie 1989); CAL. INS. CODE § 10110.1 (West 1991); DEL. CODE ANN. tit. 18, § 2704 (1990); MICH. COMP. LAWS ANN. § 500.2210(2) (West 1991); N.C. GEN. STAT. § 58-58-75 (1990). In addition, two other states provide for an employer's "insurable interest" in (a) key employees or (b) non-key employees employed by a public corporation for twelve consecutive months: MD. CODE ANN., INS. § 366(c)(2) (1991); VA. CODE ANN. § 38.2-301(B)(3) (Michie 1991).

101. BRUCE D. PINGREE, *Retiree Health Benefits: Funding, Accounting and Cost Containment Issues, in* FUNDING RETIREE WELFARE BENEFITS 40, 55 (1991).

102. Greenman, *supra* note 7, at 21.

103. *Id.*

104. Pub. L. No. 99-514, § 1003, 100 Stat. 2085, 2388 (1986).

105. I.R.C. § 264(a)(4) (West Supp. 1991).

106. Greenman, *supra* note 7, at 22-23.

107. I.R.C. § 401(h) (West Supp. 1991). *See generally* Adam M. Shaw, *Use of Section 401(h) Accounts for Deductible Prefunding of Retiree Medical Benefits,* 6 TAX MGMT. FIN. PLAN. J. 331 (1990).

108. I.R.C. § 404(a)(2) (West Supp. 1991).

section 401(h) account[109] *or* on the benefits paid out after retirement.[110] Furthermore, section 401(h) accounts have the added protection provided by the extensive rules governing all qualified retirement plans.

In order for an employer's section 401(h) contributions to be deductible, the contributions must first qualify under a subordination test and then meet the requirements of section 404. The subordination test, or incidental benefit rule, requires section 401(h) benefits to be subordinate to the pension or annuity plan's retirement benefits.[111] This requirement is deemed to be met if the sum of section 401(h) account contributions and life insurance protection is less than, or equal to, twenty-five percent of all pension or annuity retirement account contributions.[112] An employer thus faces a ceiling on the amount of section 401(h) contributions it may deduct. Many corporations with fully funded pension or annuity plans cannot make contributions to fund separate retiree health accounts until the pension plans fall below the full funding limit. Even when an employer's pension plan is less than fully funded, an employer may contribute to its retiree health account only twenty-five percent of its total contribution to the pension or annuity plan[113] — an amount which, standing alone, would be insufficient to cover the liabilities of most retiree health plans.[114]

Under section 404, the amounts contributed to the section 401(h) account must constitute an ordinary and necessary business expense deductible either as a trade or business expense under section 162 or as an expense for the production of income under section 212. In other words, the employer's contributions on behalf of an employee, added to all other compensation made by the employer to the employee, must not constitute unreasonable compensation.[115] Moreover, the amounts deducted by an employer in funding a section 401(h) account[116] cannot exceed the total cost of providing such benefits.[117] However, unlike a VEBA, the total estimated cost of providing future medical benefits may be determined by any reasonable, generally accepted actuarial method.[118] Thus, an employer may consider the inflation of health care costs in figuring its level of contribution. As with COLI and VOLI, the amount and

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109. I.R.C. § 106 (West Supp. 1991).
110. I.R.C. § 105 (West Supp. 1991).
111. I.R.C. § 401(h)(1) (West Supp. 1991).
112. Treas. Reg. § 1.401-14(c)(1)(i) (1991).
113. *Id.*
114. *See supra* text accompanying note 9.
115. Treas. Reg. § 1.404(a)-3(f)(1) (1991).
116. Specifically, the amount deductible for any year cannot exceed the greater of:

> (i) an amount determined by distributing the remaining unfunded costs of past and current service credits as a level amount, or as a level percentage of compensation, over the remaining future service of each employee, or
>
> (ii) 10 percent of the cost which would be required to completely fund or purchase such medical benefits.

Treas. Reg. § 1.404(a)-3(f)(2) (1991).
117. *Id.*
118. *Id.*

timing of contributions is at the discretion of the employer, a cause for concern for security-conscious employees.

The administrative costs of implementing a section 401(h) account are high. The rules governing qualified pension plans are complex and often inconsistent with the design and character of retiree medical plans.[119] The employer must maintain separate accounts for each key employee and then a general account for all other employees.[120] In addition, section 401(h) account assets cannot be transferred from or to a pension plan or VEBA. This characteristic offers retirees some benefit security, but it also restricts an employer's ability to transfer assets in the event of adverse future changes in the law — a disadvantage for both the employee and the employer.[121]

D. HSOPs

An HSOP is a recent innovative hybrid funding vehicle which combines an employee stock ownership plan (ESOP) and a section 401(h) account within a money purchase pension plan.[122] HSOPs are attractive because they create, in a single transaction, a "pool of assets both (1) eligible to grow on a tax-free basis, and (2) immediately available to offset the accounting liabil-

119. Greenman, *supra* note 7, at 24.

120. I.R.C. § 401(h)(6) (West Supp. 1991). A separate account must be established and maintained for the funding of retiree health benefits. *Id.* In addition, key employees must have their own individual section 401(h) accounts, and any benefits provided for such key employees can only be paid from such separate accounts. *Id.*

121. I.R.C. § 401(h)(4) (West Supp. 1991). This plan is in accordance with regulations only if, prior to satisfaction of all liabilities under the plan, it is impossible for any funds from the 401(h) account to be diverted for any purpose other than providing retiree medical benefits. *Id.*

122. *See, e.g.*, Lee A. Sheppard, *Retiree Medical Benefits: Will the IRS Question P&G's Billion-Dollar Baby?*, 49 TAX NOTES 1165 (1990) [hereinafter Sheppard, *Retiree Medical Benefits*]. One commentator described an HSOP as follows: "Responding to new accounting requirements that will force employers to reflect liabilities for retiree health costs on their financial statements, Procter & Gamble has melded an ESOP to a § 401(h) retiree medical account to produce the "HSOP," a means of shifting the anticipated cost burden away from the company to a qualified retirement plan." *ESOP + § 401(h) Account = HSOP: Procter & Gamble Plan to Fund Retiree Medical Costs Stirs Controversy*, 19 TAX MGMT. COMPENSATION PLAN. J. 42 (1991) (including reprint of Procter & Gamble's plan document).

The creation of an HSOP generally begins by amending a current savings plan, such as a pre-existing ESOP, to qualify as a money purchase plan. Second, the employer inserts a section 401(h) account into the money purchase plan. The account is initially unfunded, but no minimum funding requirements apply to a section 401(h) account. Third, the ESOP within the money purchase plan borrows funds in order to buy company shares, perhaps from a specially-tailored convertible preferred issuance. The shares purchased are then held in two suspense accounts, one for pension benefits and one for retiree health benefits. As the debt is paid, from deductible share dividends and other deductible employer contributions, one fourth of the shares are allocated from the retiree health benefit suspense account to the individual accounts of employees eligible to receive retiree health benefits. The incidental benefit rule restricts contributions to retiree health to 25% of the total retirement account contribution, hence only one fourth of the shares may be allocated to employees' individual retiree health benefit accounts. Sheppard, *Retiree Medical Benefits*, *supra* this note, at 1166.

ity."[123] An HSOP essentially combines all the best attributes of ESOPs and section 401(h) accounts:

- deductible contributions
- tax-free build-up of assets
- tax-free distributions to retirees
- deductible ESOP dividends
- assets to offset F.A.S. No. 106 liability
- cash on hand for general corporate purposes
- retirement benefit security for employees

For many large corporations with fully funded pension plans and little use for conventional accounts, the HSOP presents a means of achieving the tax advantages of a section 401(h) account while avoiding the pitfalls of section 401(h) contribution limitations.[124]

Given an HSOP's advantages, it is not surprising that the IRS has curtailed the use of HSOPs pending further investigation and consideration of the issues and policies involved.[125] Because the widespread use of HSOPs would lead to significant revenue losses in a time of perennial budget deficit concerns, the IRS has suspended the issuance of determination letters on HSOP proposals.[126] Without a determination letter from the IRS to assure an employer of the tax consequences of a plan, no employer is likely to adopt an HSOP to fund its retiree health liability.

E. Section 420 Transfers

Under the Omnibus Budget Reconciliation Act of 1990,[127] Congress allowed employers to transfer a portion of their excess pension assets from overfunded defined benefit plans to a retiree health benefit account.[128] Such a plan theoretically allows tax-free funding of retiree health benefits on a par with pension benefits through the use of excess pension funds rather than corporate revenues or other sources. In reality, the harsh restrictions imposed on these transfers discourage their use by employers.[129] Eight limitations and requirements, including vesting and minimum cost requirements, must be met for a section 420 transfer of pension assets to a retiree health account.[130]

123. Thomas Christensen, Jr., *Planning Perspectives: HSOP Issues and Observations*, PENSION AND PROFIT SHARING REPORT, Dec. 14, 1990, at 4.

124. Sheppard, *Retiree Medical Benefits*, *supra* note 122, at 1167.

125. Apart from obvious revenue concerns, many key questions remain concerning the implementation of an HSOP. For instance, whether the leveraged ESOP portion of an HSOP satisfies ESOP tax-qualification rules, and whether stock distributions from retiree medical accounts in an HSOP count as health benefits provided by the employer. THE MERCER REPORT, No. 10, 5-6 (1990); *see also* Sheppard, *Retiree Medical Benefits*, *supra* note 122, at 1166-67.

126. Sheppard, *Retiree Medical Benefits*, *supra* note 122, at 1165.

127. Pub. L. No. 101-508, 104 Stat. 1388 (1990).

128. I.R.C. § 420 (West Supp. 1991).

129. Stuart M. Lewis, *Employee Benefit Items: Employee Benefit Provisions of the Omnibus Budget Reconciliation Act of 1990*, 7 TAX MGMT. FIN. PLAN. J. 117 (1991).

130. I.R.C. § 420 (West Supp. 1991).

This method is attractive to employers because it allows them to raid already-accumulated funds rather than current profits; the prospect is especially appealing given the "approximately $2 trillion sitting in excess pension funds."[131] As section 420 transfers allow the diversion of pension funds without requiring the prior approval of employees, they raise the issue of who holds entitlement to (and thus control over) excess pension assets.[132] Under the theory that retirement benefits are a form of deferred compensation, employees arguably should themselves receive any excess pension assets. Employees are, in a sense, losing some of their deferred income when those assets are diverted to offset an employer's liability for other benefits.

F. Defined Contribution Plans

Defined contribution plans, such as profit-sharing plans or money purchase pension plans, are "relatively simple but limited method[s] of funding retiree health obligations."[133] Under a defined contribution plan, each employee has an account specifically reserved for retiree medical expenses.[134] The employer allocates to this account a portion of every tax-deductible contribution it makes.[135] Employers may either use their discretion with respect to the amount of the contributions (i.e., profit-sharing and stock bonus plans) or refer to a mandated formula, usually based on the participants' compensation or the profits of the employer.[136] The build-up in employee accounts grows tax-free. Upon an employee's retirement, the assets in the account become available to pay for health benefits.[137]

In a defined contribution plan, the employee implicitly assumes the risks of health care inflation and poor investment return — a significant disadvantage.[138] The employer promises only a defined contribution, not a defined benefit; hence, if contributions do not build sufficiently, the employee must bear the cost of the difference between contributions and expenses.

III
ARE TAX BREAKS FOR EMPLOYERS THE ANSWER?

At first blush, employer tax breaks appear to be an attractive answer to the pending crisis in employer-provided retiree health benefits. As the Financial Accounting Standards Board noted, a post-retirement health plan is much

131. Ellin Rosenthal, *Pension and Employee Benefit Advocates Ask Congress to Give Money, Not Tax It*, 42 TAX NOTES 1417, 1417 (1989).

132. Thomas Christensen, Jr., *Planning Perspectives: Using Excess Pension Assets to Pay Retiree Medical Benefits*, PENSION AND PROFIT SHARING REPORT, Nov. 21, 1990, at 8.

133. Greenman, *supra* note 7, at 45.

134. Peter T. Scott, *A National Retirement Income Policy*, 44 TAX NOTES 913, 919-20 (1989).

135. *Id.*

136. *Id.*

137. I.R.C. § 414(i) (West Supp. 1991).

138. Scott, *supra* note 134, at 920.

like a pension plan — both involve long-term obligations that are paid out at retirement. By allowing employers to set aside money for employees on a tax-free basis to cover their retirement health expenses, Congress would merely be instituting a policy mirroring tax-free pension plan funding under ERISA. Through such a plan, employers would likely be able to keep their promises to former employees who relied in good faith upon those promises. The impact of the liability and F.A.S. No. 106 on the market could be greatly reduced and might even help encourage growth in the market by partially equalizing the costs of American businesses with the costs of competitors in nations with national health care systems. Tax breaks for employers would also maintain and reinforce the American tradition of private health care financing and the link between health benefits and employment. Nonetheless, problems with this approach are multifold.

First, a retiree health plan differs from a pension plan in several key respects that reveal the analogy to ERISA to be imprecise. Pension plan benefits can be predicted with monetary precision, but retiree health plan benefits and costs are largely unpredictable because services, rather than specific dollars, are being promised. The cost and extent of those services depends upon constantly changing factors such as the state of medical technology, health care cost inflation, and the politics of Medicare. Furthermore, under ERISA, pension benefits vest with each employer for whom an employee renders substantial service;[139] concomitant vesting of retiree health benefits would require a coordination among employers that would be nearly impossible. While a retiree who has vested pension plans with several employers can cash checks from all of them, a retiree who has several vested retiree health plans has no such easy option. The medical profession is currently overwhelmed by insurance paperwork; the bureaucracy necessary for multiple employer vesting of retiree health plans boggles the mind. Finally, if the ERISA-like plan were to be complete, it would need to include termination insurance similar to the insurance that PBGC offers for pension plans. The practical implication of such action would be an unfair sort of guaranteed "Medicare" coverage for only a portion of the retired population, including a portion under the sixty-five year age limit established by Congress for Medicare coverage.

Second, the end-result of a tax break is effectively the same as that of a direct expenditure by the government. If Congress gives employers a tax break, either taxpayers (employees) have to pay more taxes to make up the lost revenue or the government must substantially reduce other programs and expenditures to reflect a lower budget. Tax breaks cost money. The key then, is whether this tax break for employers would be money well-spent.

If we endorse a program of tax breaks for employers, we must consider whether the measures would address the retiree health cost problem in the long run, or whether they would only be last-minute, stop-gap efforts to ameliorate a pending crisis too long ignored. In the recent savings and loan crisis,

139. E.R.I.S.A. § 202(a) (1991); *see also* LANGBEIN & WOLK, *supra* note 6, at 426.

which it is estimated will cost taxpayers approximately $500 billion,[140] the government bailed out savings and loans to protect innocent depositors who relied on federal deposit insurance protection. In the retiree health benefit crisis, the government would be again intruding into the private sector, this time to protect innocent retirees.

The protection of retiree health benefits must be distinguished from the protection of bank deposits. The government does not operate a public bank, but it does operate a public health care system for retirees. Retirees cannot claim to have relied on federal guarantees of employer-provided retiree health benefits in the same way that depositors relied on federal depository insurance and federal regulation of the banking industry. Perhaps it is not appropriate for taxpayers to shoulder the burden for promises Congress specifically chose not to guarantee. Establishing tax breaks for funding employer-provided retiree health benefits arguably adds a second government system with the same goals as Medicare.[141] Given that the combination of our public pension program, Social Security, with the ERISA-regulated private pension system is strained and riddled with troubles as it is, perhaps we should question whether it is wise to institute a similar system combining tax-favored employer-provided health care with Medicare. Our money may be better spent in expanding Medicare for all retirees, rather than expanding a type of "Medicare" coverage for only those who were promised retiree health benefits by their employers. Finally, it hardly seems to be a sound budget policy to cut Medicare benefits while at the same time spending money to reinforce retiree health benefits for only some retirees through tax breaks for employers.

Third, much of the retiree health liability employers face today arises from their policies encouraging early retirement.[142] Most early retirement plans include employer-provided health insurance until and beyond age sixty-five.[143] Since Congress, in administering Medicare, has made the determination that the government should only intrude into the American standard of private health insurance when an individual reaches age sixty-five, it would seem inconsistent for Congress to endorse a program that indirectly offers further coverage for some, but not all, retirees under the age of sixty-five. To be equal and fair, and to reduce the cost of tax breaks for employers, perhaps Congress should provide tax incentives for employers to fund retiree health plans only for those retirees over the age of sixty-five. The policy decision of the government, in setting the retirement age at sixty-five, seemingly conflicts with the needs of the economy and the business world, which has found it advantageous to encourage the early retirement of its workers. If businesses

140. *See supra* note 1 and accompanying text.

141. Commentators have noted a similar duality between the social security program and the private pension system. *See, e.g.*, ALICIA H. MUNNELL, THE ECONOMICS OF PRIVATE PENSIONS 7, 13-19 (1982), *excerpted in* LANGBEIN & WOLK, *supra* note 6, at 31.

142. Gene Steuerle, *Public Policy Toward Private Retirement Health Benefits*, 51 TAX NOTES 1585, 1585 (June 24, 1991); *Health Benefit Costs*, *supra* note 7, at 34.

143. Melbinger & Culver, *supra* note 35, at 115.

have been operating on a sound economic theory, perhaps Congress should respond by recognizing and funding the need to allow for retirement under the age of sixty-five. However, the institution of early retirement programs by the business community may have been a response in part to the reduced demands on business and employees fostered by the government's involvement in providing retirement income and health benefit security; in this case, the government's changes would simply exacerbate a perpetuating problem.

Finally, full coverage of medical expenses upon retirement may simply be unrealistic. If Medicare is an experiment doomed to failure,[144] then spending money through tax breaks which fill the gaps left by Medicare will solve little in the short run and accomplish nothing in the long run. A country that rises in "public outrage when a hospital turns away a delivering mother or an injured person"[145] cannot in good conscience support a system that guarantees some level of health insurance for the elderly when at the same time increasingly large numbers of workers and their families are left uninsured.[146] If "fussing with the accounting and legal issues surrounding retiree health benefits is akin to rearranging the deck chairs on the Titanic,"[147] perhaps our money would be better spent in re-evaluating our priorities and expectations, as well as the qualified success of both Medicare and the traditional private financing of health care.

> The present system [of health care] is wasteful in many respects. We have spent little on evaluating medical technology, and there is much uncertainty about its efficacy. . . . There is considerable duplication and excess capacity in our medical facilities. . . . The uninsured obtain much of their primary care in the outpatient departments and emergency rooms of public hospitals, instead of in the much less costly setting of a primary care physician's office. . . . The lack of prenatal care can lead to very costly premature delivery and the birth of children with handicaps.[148]

If we choose to spend health care dollars on tax breaks for employers to encourage funding of their retiree health liability, then on what are we choosing

144. Based on "pessimistic projections," Medicare will be unable to pay for promised benefits as early as 1996. Ferrara, *supra* note 6, at 66; *see also* Sheppard, *Retiree Health Liability Problem*, *supra* note 8, at 559.

145. Alain Enthoven & Richard Kronick, *A Consumer-Choice Health Plan for the 1990s*, 320 NEW ENG. J. MED. 29, 30 (1989). "House Majority Leader Richard A. Gephardt, D-Mo., . . . pointed out that 22 million of the 37 million uninsured are employed." *Thumbs Up for Senate Democrats' Health Care Bill; Simplification Season Blooms; IRS Updates*, 51 TAX NOTES 1347 (1991).

146. Enthoven & Kronick, *supra* note 145, at 29. "[R]oughly 35 million Americans have no financial protection from the expenses of medical care — no insurance or other coverage, public or private. This number is substantially larger than it was 10 years ago, as increasing numbers of employers find ways to avoid supplying coverage for employees and their dependents." *Id.*

147. EMPLOYEE BENEFITS RESEARCH INSTITUTE, EMPLOYEE BENEFITS NOTES 4 (Nov. 1988) (quoting Alain Enthoven), *cited in* LANGBEIN & WOLK, *supra* note 6, at 428.

148. Enthoven & Kronick, *supra* note 145, at 30.

not to spend our health care dollars? Perhaps we cannot afford to look at retiree health care issues in isolation.[149] Solving the employer-provided retiree health care crisis with a tax break for employers may only result in a boomerang effect by worsening the problems of a system whose efficacy and efficiency are already under question.

Before we embark on the road of providing tax breaks for employers in an effort to encourage funding of employer-provided retiree health plans, we need to carefully consider our options. Once such a plan begins to take effect, it would be both difficult and costly to ever back out. Whatever the answer to the pending crisis in employer-provided retiree health benefits, it can only successfully come from a national consensus on health care policy that reflects the considered weighing of our options and the costs of those options, for both today and into the future.

149. "We need to look at the big picture and stop looking only at each individual health issue. They are all interrelated. We need to take a hard look at the medical delivery system and determine what we can afford." Sheppard, *Retiree Health Liability Problem*, *supra* note 8, at 559 (quoting David Walker, Assistant Labor Secretary for Pension and Welfare Benefits Administration).