A Creative Use for Separation Pay: Postemployment Medical Expenses

When separating from service, many employees are entitled to a large lump sum of accrued sick and/or vacation pay. If made directly to employees, these payments are considered ordinary income, subject to federal, state, and local income and payroll taxes, and could total as much as 35% to 40% of the lump sum. Payroll taxes can add an additional 15.3%—7.65% each for the employer and the employee.

In the past few years, some employers have sponsored special pay plans (SPPs), which are often 401(a) plans. The amounts contributed are available to the employees after separation, can be used for any discretionary withdrawal (although withdrawals made before age 59½ may also be subject to a federal early-withdrawal penalty unless an exception applies), and are taxed as ordinary income in the year withdrawn. This arrangement allows both the employee and the employer to save the payroll taxes.

The SPP has proved to be a popular and successful strategy. However, another alternative not only provides the same payroll tax savings but also allows tax-free withdrawals for qualified medical expenses. This alternative employer-sponsored plan is a health reimbursement arrangement.

Health Reimbursement Arrangements

Contributions to a health reimbursement arrangement (HRA) are exempt from payroll taxes and the employee's income taxes. Earnings are exempt from taxation if the HRA assets are held in a tax-exempt trust, such as a voluntary employees' beneficiary association (VEBA) or a Section 115 trust. Amounts held for an employee can be withdrawn tax free for any qualified medical expense.

When an employee who does not participate in an HRA or SPP retires, a cash payment is the most common distribution option for unused leave pay. Cash payments are taxable to the employee and are subject to employer and employee payroll taxes. With an HRA or SPP, the employer and/or employee group can choose the option that best meets their needs and objectives, or they can choose a combination of the two options.

According to retirement plan specialist Larry Stein of AIG VALIC,

> "Retiring employees welcome the tax-deferred aspect of the special pay plan because they can use the funds throughout retirement for all types of expenses and pay income tax only on the amounts withdrawn each year. When they dis-

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Table 1. Comparing SPPs and HRAs

Feature	401(a) SPP	HRA
Employer-sponsored plan	✔	✔
Employer contributions only	✔	✔
Individual employee elections are not allowed	✔	✔
Contributions are exempt from payroll taxes	✔	✔
Accumulated earnings are tax-exempt		✔
Accumulated earnings are tax-deferred	✔	
Distribution can be received once the employee has met the employer's plan requirements		✔
Distributions are limited to postseparation	✔	
Distributions are limited to qualified medical expenses, such as retiree medical benefits, insurance, and Medicare supplements, and are excluded from taxation		✔
Distributions can be made for any purpose but are subject to taxation	✔	
10% early-withdrawal penalty sometimes applies	✔	
Subject to 415 contribution limits	✔	
No contribution limits		✔

cover that expenses related to health care, including certain insurance premiums, could be withdrawn income tax free from the HRA, their interest grows even more."

Both strategies serve the two common financial needs for retiring employees: making available discretionary spendable income and covering health care costs (see Table 1). Monies directed to an HRA are generally available for tax-free distribution when used for unreimbursed qualified medical costs. These costs, listed in Section 213(d) of the Internal Revenue Code, include doctor and hospital co-pays, deductibles, prescription drugs, LASIK surgery, weight-loss clinics, and much more (see Table 2). Monies directed to the SPP are taxed as ordinary income when distributed. There are no restrictions on the use of the withdrawn money.

SPP withdrawals are taxable in the year received; HRA withdrawals are tax free when received. Both funds are generally free from FICA and other payroll taxes for the employee and the employer. A split-fund approach may be ideal, dividing the retirement funds between both plans.

The implementation of a combination HRA and SPP will provide a systematic method for prefunding the unused leave pay liability, reduce taxes for the employer and employees, and provide an attractive addition to the employer's benefits program.

Until the Internal Revenue Service indicates otherwise, employees should not determine their own split. Many employers choose to predetermine the split for all employees within a given classification. For example, the teachers in a school district may have 100% of their separation check go to the SPP, whereas the administrators may have their separation pay split evenly between the two plans (subject to restrictions). The predetermined split can change from year

Table 2. Common Qualified Claims (partial list)

Premiums
Medical insurance
Dental insurance
Vision insurance
Long-term care insurance (tax qualified)
Medicare Part B
Medicare supplement

Most Common Expenses
Over-the-counter drugs
Office visit co-pays
Physician service co-pays
Prescription co-pays
Insurance plan deductibles
Insurance plan coinsurance

Other Miscellaneous Expenses
Alcohol and drug treatment center costs
Contact lenses
Eye exams (plus glasses, contact lenses, solutions, and enzyme cleaners)
Hearing aids and batteries
Laser eye surgery
Stop-smoking programs
Viagra
Wheelchairs
X rays

Over-the-Counter Medications
Antacids
Pain relievers
Cold medicines

Table 3. Comparing HRAs and HSAs

Feature	HRA	HSA
Availability	Any size employer (some limitations in the for-profit market)	Any individual who meets the eligibility requirements • Individual must be covered by a high-deductible health plan (HDHP) with at least a $1,000 deductible for self only or at least a $2,000 deductible for full family coverage. • Individual cannot be covered by any other health plan that is not an HDHP (including certain HRAs). • Individual cannot be a dependent of anyone else for tax purposes. • Individual cannot be eligible for Medicare.
Contribution source	Employer	Employee or employer
FICA savings	Yes	Maybe
Maximum contribution	No limit Employer decides	Individual: lesser of $2,600 or the HDHP's annual deductible Family: lesser of $5,150 or the HDHP's annual deductible
Tax deductibility—employee	Contribution has no impact on current-year earned income	Employee contributions are pretax if offered through an IRS Section 125 plan or tax deductible (through IRS Form 1040) if contributions are made independent from employer.
Carryover from year to year	Yes	Yes
Portable after termination	Employer plan design decision	Yes
Withdrawals for nonqualified medical expenses	Not allowed	Yes, but will be included in gross income and subject to 10% excise tax, unless made after death, disability, or age 65.

to year. Allowing each employee to choose between an HRA and other forms of compensation/benefits could result in the HRA losing its tax-exempt status.

Health Savings Accounts

Another plan making headlines these days is the health savings account. The HSA provision of the Medicare Prescription Drug Improvement and Modernization Act of 2003 allows virtually anyone with a high-deductible insurance plan (at least $1,000 for single coverage and $2,000 for couples and families) to open an HSA. The HSA is used for current employees and is integrated into the group medical plan. The IRS limits the ability to use HSAs and HRAs together.

With regard to funding separation payments, the HRA is considered superior. The HSA can be used only if there is a high-deductible health care plan, whereas the HRA has no such limitation. The HSA has low contribution limits that are capped at the lesser of the deductible or $2,600 for an individual and $5,150 for a family.

The HSA is an employee account and the employer can exert no control over the timing or types of withdrawals from the account. With an HRA, on the other hand, the employer has some control over the plan design for such matters as vesting, eligibility, and timing of withdrawals. The employer can also limit the use to health care premiums or some other such subset of qualified medical expenses as defined in Section 213(d) of the Internal Revenue Code.

Table 3 compares an HRA with an HSA.

The Smart Investment

The source funding for postemployment medical costs concerns all Americans, as do the rising costs of health care. Employers are looking for ways to help their retirees deal

with those costs without exhausting their retirement funds. For those employees who have an accrued unused sick or vacation account, or any terminal pay fund, a tax-favored HRA and SPP can be a worthwhile option. "We build our retirement nest egg to do the things we want to do," says Stein. "For those inescapable medical expenses, why tap into your retirement funds when the IRS provides a tax-free source?" ■

Glossary

HDHC (high-deductible health care) plan. An HDHC is often used in tandem with an HRA or an HSA, which gives the employee an opportunity to carry over unused balances from year to year.

HRA (health reimbursement arrangement). Defined by the Internal Revenue Code as an arrangement that is funded by the employer and reimburses employees only for medical care expenses incurred by the employee or the employee's spouse or dependents. Contributions to an HRA are not subject to federal income tax or FICA tax. Earnings credited to an HRA held in a VEBA or other tax-exempt trust are not subject to tax, and benefits paid out for qualified medical expenses to participants or their spouses or dependents are generally also excluded from tax.

HSA (health savings account). A provision of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 that allows virtually anyone with a high-deductible insurance plan (at least $1,000 for single coverage and $2,000 for couples and families) to open an HSA.

Section 115 trust. Also called an integral part trust. Another form of tax-exempt trust available to government employers that can be used to hold assets for an HRA program.

SPP (special pay plan). A term often used for a defined contribution retirement plan whereby special forms of compensation can be contributed, such as accumulated sick and vacation pay, to save FICA taxes and defer income tax. Upon separation from service, withdrawals can be made for any purpose and are taxed at the participant's current marginal income tax rate.

VEBA (voluntary employees' beneficiary association). A tax-exempt trust authorized by Internal Revenue Code Section 501(c)(9). A VEBA is one form of trust that can hold assets for a health reimbursement arrangement. See **HRA.**

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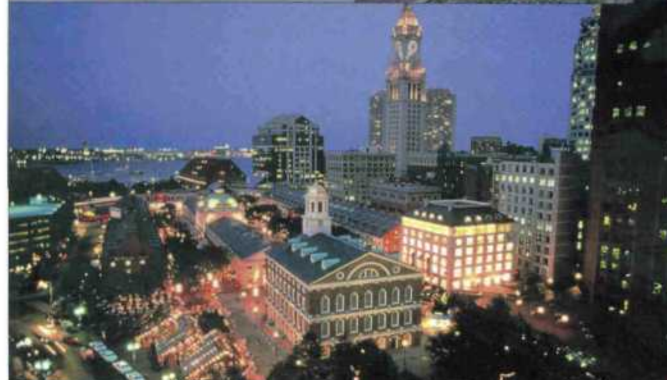

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