Practical Aspects Of Self-funded Health Plans

by Stephen M. Margolin

A Voluntary Employees' Beneficiary Association (VEBA) comprises a plan and trust exempt from tax. It may be formed by a company to provide life, accident, health, welfare, disability, vacation or other benefits to its employee-members and their dependents.

In an earlier article (*Life Association News*, April 1982), we reviewed the benefits to a company which utilizes a VEBA. This article discusses practical aspects of self-funded health and welfare plans. In particular, we will discuss the meaning and reason for self-funding, the merit of utilizing a VEBA in this connection, the team players involved, and other practical matters.

Meaning of Self-Funding

We refer to these health and welfare plans as self-funded. This generally means that the employer company or its VEBA is ultimately responsible for the administration and disbursement of all benefits. However, to protect its fiscal integrity, the VEBA prudently will secure excess loss coverage from a commercial insurance carrier. Excess loss coverage is broadly referred to as stop-loss insurance or reinsurance. It includes specific coverage to cap the exposure to the VEBA arising from claims of a member (and his dependents) and aggregate coverage to cap the exposure to the VEBA from claims of many or all members (and their dependents).

Why Self-Funded?

A traditional insurance carrier will provide administrative services (including processing claims), establish reserves to pay those claims from employer's premiums, and finally distribute funds to employee-claimants.

Self-funding is a product of unbundling those multiple functions of a traditional insurance carrier. Many employers sense economies in having their own VEBA performing these functions, and retaining its own reserves.

Assume a businessman employer pays an insurance carrier $10,000 per month, or $120,000 in premiums per year. He thinks this amount is too high. He prefers to place this same quantity of funds in a VEBA trust, which accumulates income tax free. He knows there is a time lag between claims and payouts. Some of these funds—which are known as reserves—will be retained in the VEBA. In other words, funds an insurance company would otherwise retain as reserves (and not pay earnings on those funds to our employer), will instead be retained by the employer's VEBA and accumulate income tax free.

Funds retained in the VEBA accumulate for the employer's benefit. Funds get into the VEBA in two ways: The first by employer contributions, the second by earnings on funds retained in the VEBA. The more the earnings, the less the contributions, the lower the cost to the employer.

If the claims experience of the VEBA is not extraordinary, there could be a claims surplus at the end of the year. A crucial difference is that by self-funding, the employer is rewarded by favorable claims experience. This is because his reserves remain intact. On the other hand, if his claims experience is disasterous, he is protected by excess loss coverage.

An employer may prefer the control of having his own agent (third party administrator) processing claims rather than an insurance carrier. The employer's power to hire or fire his third party administrator allows him to choose a more liberal

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or more restrictive administrator, according to his discretion. He may thus consider a third party administrator more responsive to his wishes in processing claims.

The Self-Funded Team

The self-funded team consists of the insurance agent, the lawyer, the third pary administrator, the plan administrator-trustee, the accountant, and the actuary.

The insurance agent is generally responsible for obtaining the excess loss coverage. He frequently, together with the employer and attorney, assembles the remainder of the team.

The function of the attorney is to design and implement the plan, in accordance with current law, and to determine the tax and legal impact on the parties. He is responsible for preparation of the plan, the trust, the minutes, the summary plan description, the notice to employees, and Form 1024, Application for Recognition of Exemption under Section 501(a). He is also responsible for submission of documents through the Internal Revenue Service. This is to obtain a favorable determination letter that the trust is exempt from income tax under Internal Revenue Code Section 501(c)(9).

The third party administrator usually is involved with the determination and payment of benefits and premiums, enrollment of new participants, preparation and distribution of membership certificates, communication with participants, and providing benefit claims processing. The third party administrator provides coordination of benefits, that is, making sure that there is no duplicate coverage. He also arranges for peer review to assure that medical fees are in line. An important job of his is handling and settling employee claims and deflecting employee criticism from the employer. In other words, he is the buffer between the employer and the employee-claimant.

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The accountant is in charge of processing the form work. This consists of Form 5500 C or R (Annual Report of Employee Benefit Plan) and Form 990 (Return of Organization Exempt from Income Tax—for organizations normally receiving in excess of $25,000 annually). Processing of governmental forms may be handled by the third party administrator instead.

The plan administrator is the ultimate responsible party for the functioning of the plan. His duties entail, for example, interpreting and construing the plan, and ultimately deciding disputes and claims. One or more key executives may be the plan administrator.

The trustee is the trust fiduciary, in general charge of trust administration, as opposed to the plan administrator in charge of plan administration. His responsibilities include receiving, investing and distributing trust funds. One or more key executives may be the trustee. The reasons for using one or more key executives as plan administrator or as trustee or both are simplicity, economy and convenience. A bank or other independent party could, of course, be trustee.

The trustee, or an investment manager appointed by him, may invest the funds in any prudent investment (treasury bills, money market, stocks, bonds or any other prudent investment). Code Section 501(c)(9) regulations are explicit in denying the trustee the right to make participant loans, except in cases of disaster (such as fire or flood).

Conclusion

A prudent businessman is interested in cost cutting. Because of the unbundling of insurance services, cost economies are often achieved. When coupled with a tax exempt VEBA as a respository of reserves, this self-funding process provides a businessman a powerful tool to brake runaway health and welfare costs. ☐

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