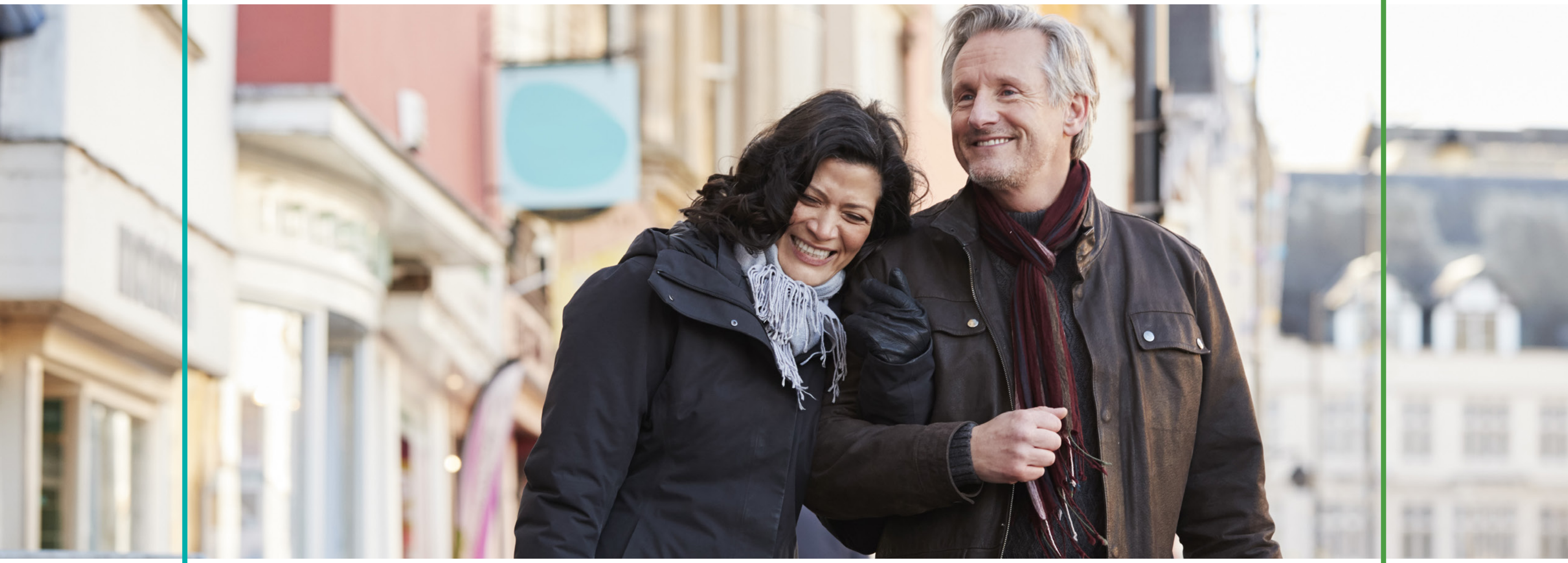
Accumulated Leave Payouts



Meaningful Savings for a Healthy, Financially Secure Retirement

MidAmerica

The Current Situation

Upon their retirement, public sector employees often receive significant payouts of accumulated vacation time, sick leave, and other retirement incentives. These hard-earned benefits recognize a career of dedicated service to community, and are a uniquely lucrative feature of public sector employment not widely replicated in private industry. Status quo is for retiring employees to receive these payouts in cash at the time of their retirement. But large cash payments incur significant tax liability for both employer and employee—and fail to maximize the power of these payouts to provide for a financially and medically secure retirement.

Understanding the **issues** to find the solutions.

Problem 1

Employees need a health care solution to bridge the Medicare gap.

Imagine a typical public sector employee preparing to retire. He or she has no doubt calculated the value of their pension benefits, accumulated leave payout, and expected Social Security payments to the cent. But many employees are shocked to learn that, in order to retain their employer-provided health insurance in retirement, they often must pay an unsubsidized, "full freight" monthly premium—on the order of $650 for single employees, on average.* Employees hence incur significant out-of-pocket health insurance costs prior to becoming Medicare eligible at age 65, and thus need to maximize their ability to pay for health care.

Problem 2

Cash accumulated leave payouts are NOT tax-efficient.

Consider an employer that pays out approximately $40,000 in accumulated leave and other incentives for each retiring employee. Assuming an average salary at retirement of $60,000, the following Federal tax liabilities are incurred upon leave payout at retirement:

Employer	
Payroll Tax Due (FICA & Medicare)	$3,060
Net Tax Liability to Employer	**$3,060**

Employee	
Payroll Tax Due (FICA & Medicare)	$3,060
Federal Income Tax (22% Assumption)**	$8,800
Net Payout to Employee	**$28,140**

What can be done to save on taxes and bridge the Medicare gap?

Two Plans:
Powerful Alone, Even **Better Together**

A pair of tax-advantaged alternative benefit plans—easily deployed and widely utilized among public sector agencies—can effectively maximize the value of accumulated leave payouts for both employer and employee.

Special Pay Plan

The Special Pay Plan—typically housed within a 401(a) or 403(b) plan, as appropriate—allows for tax-deferred payout of accumulated leave and other retirement incentives. With this benefit, employers and employees permanently save up to 7.65% on payroll and FICA taxes—a substantial amount considering the often high-dollar amounts of accrued leave payouts. Much like a traditional IRA, Special Pay funds are paid out pre-tax, enjoy tax-deferred investment growth, and do not incur Federal, state, or local income tax liability until they are withdrawn. Once withdrawn, Special Pay funds can be used for any purpose. Take a look to see how the Special Pay plan generates sizable savings on employee retirement payouts:

Employer	
Payroll Tax Due (FICA & Medicare)	$0
Net Tax Liability to Employer	**$0**

Employee	
Payroll Tax Due (FICA & Medicare)	$0
Federal Income Tax (22% Assumption)**	$8,800
Net Payout to Employee	**$31,200**

Health Reimbursement Arrangement (HRA)

The Health Reimbursement Arrangement, or HRA, allows for tax-free payout of accumulated leave and other retirement incentives. With this benefit, employers and employees permanently save up to 7.65% on payroll and FICA taxes. Additionally, employees never owe Federal, state, or local income tax on payouts made to their HRA. Finally, all earnings on invested HRA funds are untaxed, making the HRA a triple tax-free benefit. HRA funds can be used for any eligible medical expense as defined in IRS regulations, including health insurance premiums. With this benefit, employees can extend the value of their health care dollars, providing a natural bridge between retirement insurance needs and Medicare eligibility. What's more, the HRA is a benefit that can be used by both a spouse or eligible dependents, even after the employee has passed away. Take a look to see how the HRA provides unmatched value, for employer and employee alike, on accumulated leave and other retirement incentive payouts:

Employer	
Payroll Tax Due (FICA & Medicare)	$0
Net Tax Liability to Employer	**$0**

Employee	
Payroll Tax Due (FICA & Medicare)	$0
Federal Income Tax (22% Assumption)**	$0
Net Payout to Employee	**$40,000**

Implementing the Benefits: **Flexibility & Value**

Tax-advantaged "qualified" benefit plans are subject to an IRS provision known as constructive receipt. Under the doctrine of constructive receipt, employees cannot be afforded the choice between different levels of taxation within a qualified plan. This means that participation in both the Special Pay Plan and the HRA are mandatory for employee groups—with employee groups typically defined as either an entire workforce or as specific bargaining groups within an employer. Unlike voluntary retirement savings accounts, employees cannot choose to participate (or opt out) of the Special Pay Plan or HRA.

Finding a plan structure that works for you and your employees.

Because the Special Pay Plan allows immediate and unrestricted access to funds along with permanent FICA tax savings, most employees are eager to gain access to the benefit, even on a compulsory basis. Since some employees may not desire that employers direct the full balance of their payouts to an HRA, unique benefit structures can be designed to maximize the appeal—and value—of these plans.

The Best of Both Worlds

The Special Pay Plan and HRA can be combined into one valuable retirement benefit, with percentage allocations of accumulated leave/incentive payouts directed to each plan based on the desires of the employer and/or bargaining group. This provides the "best of both worlds"—tax-deferred funds that can be used for anything, and tax-free funds to pay for health care. Payouts can even be dollar-capped to keep contributions to a particular plan below a desired threshold.

Customizing to Fit Your Needs

Employees receiving health coverage outside the employer's plan—for example, from a spouse's plan or other source of insurance (i.e. TRICARE)—can automatically receive a lower percentage of HRA contributions through a simple plan design provision.

Application **Examples**

Let's examine how a combination Special Pay/HRA plan, with variable HRA contribution based on availability of spousal insurance coverage, might be deployed in practice. We again assume an employee receiving a $40,000 leave payout at an average annual salary of $60,000, with $650 in monthly health insurance premiums. Note how far a smart plan design can go in maximizing employee benefit value:

Case 1: Employee Health Coverage from Spouse or Alternate Insurance in Retirement

75% Contribution to Special Pay Plan

FICA Tax Savings (permanent): **$2,295**

25% Contribution to HRA

FICA Tax Savings (permanent): **$765**

Federal Income Tax Savings (permanent): **$2,200**

Complete Benefit Breakdown

Total Additional Benefit: **$5,260**
(Over Cash Payout)

Percent Increased Benefit: **19%**
(Over Cash Payout)

Months of Health Insurance Paid For: **15**
(HRA)

Application **Examples, cont.**

Case 2: Employee Health Coverage from Former Employer in Retirement

25% Contribution to Special Pay Plan

FICA Tax Savings (permanent):
$765

75% Contribution to HRA

FICA Tax Savings (permanent):
$2,295

Federal Income Tax Savings (permanent):
$6,600

Complete Benefit Breakdown

Total Additional Benefit: $9,660
(Over Cash Payout)

Percent Increased Benefit: 34%
(Over Cash Payout)

Months of Health Insurance Paid For: 46
(HRA)

We deliver.

As is clear, two simple, yet versatile plans can work seamlessly in concert to maximize employer savings, put more money in retiree pockets, and leverage triple tax-free funds to stretch health care dollars farther than ever before. To learn how these plans can work for your agency's unique situation, simply contact us to schedule a free consultation. We're always happy to help!

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**2019 average single retiree premium (MidAmerica survey)*
***Based on 22% Federal Tax assumption. Consult your tax advisor for the actual tax rate that would apply to you.*

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