# Retiree Health Coverage: Leveraging the Affordable Care Act in the City of Modesto

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## Introduction

In 2011, while still reeling from the Great Recession, the City of Modesto faced $104 million in unfunded liability for retiree health care, of which $32.5 million was attributable to retirees' current and future health premium costs. Modesto was not alone, as numerous municipalities throughout California provide this expensive benefit but have failed to fully fund its future costs.

Also in 2011, on a seemingly unrelated stage, the Patient Protection and Affordable Care Act ("ACA")[1] was in its first year of enactment, overcoming growing pains and working through its complex and multi-stage implementation for different classes of employers.

In addition to complying with the ACA, Modesto considered if it could find an opportunity with the ACA-created health insurance market to potentially reduce the City's unfunded liability for current retirees so that it could eventually afford funding the benefit for future years.

## What Does the ACA Require of Employers?

While much of the media attention surrounding the ACA has focused on the "individual mandate," the ACA also contains an "employer mandate" that requires employers with over 50 full-time employees to offer access to health coverage for essentially all of its full-time employees and dependents. Most public agencies meet this size requirement and are therefore required to comply with the ACA's mandates for coverage.

The penalties for non-compliance can be harsh. An extensive analysis of this employer mandate is beyond the scope of this article. But generally, the government has codified two penalties that may be assessed on employers.[2] The first penalty applies if an employer offers coverage to less than 95 percent of full-time employees or excludes dependents, and at least one employee receives subsidized coverage through the State Exchange.[3] This annual penalty is $2,000 per full-time employee minus the first 30 employees. The second penalty applies when an employee receives subsidized coverage through the State Exchange because the employer offered coverage that did not provide minimum value or was not affordable to that employee.[4] This annual penalty is $3,000 per employee that received subsidized coverage through the Exchange, but the amount payable by the employer cannot exceed the amount that could be charged under the first penalty - $2,000 per employee minus the first thirty (30).

Most employers have spent the past two years ensuring compliance with the ACA to avoid these penalties. Generally, to avoid these penalties, employers must offer access to coverage to full-time employees and dependents (excluding spouses). This coverage must be of minimum value (covering 60 percent of cost of services) and affordable (employee contribution for individual coverage must be 9.5 percent or less of gross taxable W-2 wages). The government has also designed various "safe harbors" and provided lengthy regulatory information regarding compliance with the employer mandate.[5] While the government provided transition relief for 2014, most employers will need to comply with the ACA's requirements for the start of the employer's 2015 health plan year.[6] Employers with 50 to 99 full-time employees will have until 2016 to comply.[7]

The ACA might be less onerous for public employers. Most agencies likely already comply with the employer mandate because most offer health benefits that exceed the affordability and minimum value requirements of the ACA for employees and, although not required

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1 Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010).

2 Internal Revenue Code (I.R.C.) § 4980H (added by ACA § 1513).

3 I.R.C. § 4980H(a).

4 I.R.C. § 4980H(b).

5 *See, e.g.*, I.R.S. Notice 2011-36, 2011-73, and 2012-17.

6 *See* 26 C.F.R. pts. 1, 54, and 301 (U.S. Dept. of Treasury, *Shared Responsibility for Employers Regarding Health Coverage*); 79 Fed. Reg. 29 (Feb. 12, 2014).

7 Republicans in the House of Representative have recently challenged these delays, but in the meantime, employers should prepare to comply with the ACA requirements for the 2015 health plan year. *See* http://www.speaker.gov/sites/speaker.house.gov/files/documents/130709_lettertopotus.pdf.

by law, for retirees. In 2018, however, public agencies will be subject to an excise tax, also known as the "Cadillac Tax," if they offer coverage for a plan with a monthly premium that costs at least $850 per individual or $2,292 per family. This requirement is a few years off, providing public agencies with time to review and adapt health plans.[8]

### Health Exchanges

The ACA establishes, or allows states to establish, a State Exchange that provides a regulated Internet marketplace to purchase health coverage.[9] While employers have devoted much attention to complying with the various and complex requirements of the ACA, some have considered whether the State Exchange would provide an opportunity to get out of the health care business altogether. Prior to the ACA, the marketplace for individual health plans seemed too restrictive and cost-prohibitive for most individuals seeking coverage.

The State Exchange in California, known as "Covered California," has over a dozen health insurance plan options and provides individuals with a menu of choices through which to purchase coverage, including government subsidies, if they qualify. In 2013, more than 5.3 million Californians were estimated to be eligible for coverage through Covered California, and more than 2.6 million may be eligible for tax subsidies to help pay for coverage.[10] By March 31, 2014, 1.4 million California's enrolled in Covered California, and 1.2 million of those individuals were eligible for tax subsidies.[11]

In light of this new and robust marketplace of options, some employers have considered whether to simply pay the applicable penalty and offer additional compensation to give the employees themselves the option and flexibility to purchase individual health insurance through Covered California. However, granting employees additional compensation, unlike health coverage, is not a pre-tax benefit, so an employer would need to offer a higher amount of compensation to make this an enticing benefit. Consequently, most employers have realized that it makes more sense to continue offering health benefits directly to employees.[12]

### Challenges (or Opportunities?) of Public Retiree Health Coverage

For public employers, the challenges of implementing the ACA presented an unexpected opportunity to address another issue occupying recent news headlines: retiree health coverage. The majority of public agencies providing retiree health benefits defer funding these benefits until after the tenure of current employees. Coupled with the rising costs of retiree health benefits, this practice has led to huge unfunded liabilities. And since most public employees retire well before Medicare kicks in, public employers were providing a high cost benefit to retirees under 65.[13] In addition, a decade-old requirement by the Governmental Accounting Standards Board ("GASB") requires agencies to account for the unfunded liability costs of these retirement benefits.[14]

Some public agencies, dealing with major fiscal difficulties in recent years, have taken drastic measures to reduce the cost of this benefit, causing expensive legal battles and labor strife. Other agencies are wary of making significant changes to the retiree health benefit, despite the escalating costs of providing this benefit.

### The City of Modesto: A Case Study

The City of Modesto developed a strategy to address the challenges of changing public retiree benefits while taking advantage of the Exchanges established under the ACA. The City's goal was to restructure its retiree medical program to ensure future economic sustainability and affordability. The City worked with its stakeholders to create an optional benefit for retirees

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8 Many public agencies in California offer Cadillac plans. CalPERS currently offers four Cadillac plans in the Bay Area.

9 ACA §§ 1311(b) and 1321(b); *see also* 45 C.F.R. pts. 155, 156, and 157; 77 Fed. Reg. 59 (Mar. 27, 2012).

10 Covered California *Health Plans & Rates for 2014: Making the Individual Market in California Affordable* (Mar. 23, 2013).

11 Covered California *Health Insurance Companies and Plan Rates for 2015: Keeping the Individual Market in California Affordable* (July 31, 2014), *available at* http://www.coveredca.com/PDFs/CC-health-plans-booklet-2015.pdf.

12 Some private employers have opted to stop providing health insurance and instead send employees to the Exchange for coverage because the Exchange provides employees with a wider array of options than those offered by the employer. Other private employers continue to provide coverage to employees, but have discontinued coverage for spouses and retirees. The ACA does not penalize employers that do not offer coverage to spouses and retirees.

13 Pre-Medicare retirees are traditionally one of the most expensive groups to insure.

14 *See* GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (June 2004).

that was attractive enough to encourage them to leave the City's health plans and join the Exchange.

In 2011, Modesto faced $32.5 million in unfunded liability for retirees' current and future health premium costs. The City's retiree health benefit was calculated by converting eight hours of unused sick leave to one month of City contribution to the health premium, at the same level the City contributed for active employees. Thus, this benefit was only available to employees with accrued and unused sick leave at retirement. While this provided some retirees with no retiree health coverage from the City, others had nearly the equivalent of 20 years of coverage after converting sick leave hours to monthly premiums.

Like most public employers, Modesto was only able to fund the pay-as-you-go (a.k.a. "pay-go") costs of retiree health each year - i.e., the costs of paying the employer share of premiums for current retirees. The City was unable to fund the Annual Required Contribution ("ARC") of $12 million for the benefit in future years for future retirees. If the City did not start funding the ARC, it would see its pay-go costs escalate dramatically from $3.6 million in 2012 to $7.9 million in 2020. The City needed to make changes, but it did not want to leave retirees in a lurch and unable to find affordable health coverage.

In light of these concerns, the City and unions negotiated a reduction to the benefit for future retirees (i.e., current employees). The negotiated benefit included freezing the current employees' sick leave balances so that the number of sick hours available for conversion to retiree health premiums did not continue to grow. The City then provided a more modest defined contribution going forward. This reduction provided some relief and, in 2013, the City's overall unfunded liability dropped from $104 million to $78.2 million.

However, with the population of retirees continuing to grow, $34 million of the unfunded liability was now attributable to the health benefit costs of current retirees. This amount will continue to grow. Moreover, concerns arose that the value of health insurance provided to current retirees was not competitive with that offered on the open market. The City was convinced that it could find an opportunity with the ACA while addressing the challenges of modifying health coverage for current retirees. After months of reviewing options for legal and actuarial viability, the City rolled out a draft of the new program in 2013 for consideration by labor unions and current retirees. This program provided retirees with a one-time cash out option of the retirees' converted sick leave. The City would provide cash to employees, through a tax-sheltered Health Reimbursement Arrangement[15] on an annual basis based on the number of months of coverage the retiree had from sick leave conversion. Retirees could then seek health coverage in the private market or through the State Exchange. Because retirees still have an offer of coverage through the City, retirees would not qualify for subsidized coverage through the State Exchange. The City determined, however, that the new program provided options as affordable as those offered by the City while providing more variety.

## Modesto Roll Out

The City's Human Resources Department contacted all retirees and held numerous small group meetings to explain the new program. Staff spent hours with retirees plugging in their individual information to the Covered California website to determine what they could afford on the Exchange with the new cash option. In most circumstances, retirees were pleasantly surprised with the options available through Covered California.

In 2015, the City will roll out this optional benefit for retirees. This new program does not provide a sweeping across-the-board change for retirees. Rather, it provides each retiree with the option to receive pre-tax contributions to shop for health coverage outside the City's plan. This is an incremental approach, but the program is projected to reduce the City's unfunded liability because it provides a fixed contribution that is not subject to increases based on negotiations with current employees. At the same time, the City projects that it will provide an opportunity for retirees to purchase insurance through the private market or the State Exchange that was as good as or better than that previously offered by the City.

While the labor unions do not represent current retirees, their support was critical to getting the retirees on board. Now, not only have the unions helped the City implement this new program, most have negotiated or are negotiating with the City to provide the same benefit for current employees upon retirement.

## Lessons Learned

Modesto's approach is not a one-size-fits-all because it may not translate effectively for another employer's unique benefit, insurance market, and retiree population. Moreover, Modesto's program took years to

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15 I.R.C. §§ 105 and 106.

develop as it considered numerous models, consulted experts, requested legal opinions, and crunched numbers.

But the possibility of finding opportunity in the new insurance market makes Modesto's approach worth exploring for both private and public employers already providing retiree health coverage. The optional buy-out should reduce the City's annual pay-go costs for 2015 and will likely also reduce the City's unfunded liability for retiree health benefits. These savings, along with significant concessions employees have already made to this benefit, will allow Modesto to continue providing retiree health benefits in a more affordable manner.

Other public employers offering retiree health benefits might consider whether the benefit offered is cost-effective or whether the type and cost of health plans offered through the Exchange would better suit the needs of both the employer and retirees. Offering an optional "buy-out" might provide incremental cost-savings for those agencies dealing with huge unfunded liabilities. If an employer decides to pursue offering retirees an opt-out benefit, it is important to keep retirees informed and provide them with timely information about their options to access benefits. This requires employers to keep up-to-date with the frequent changes to the ACA regulations or to the ACA itself. Finally, for unionized employers, it is important to engage bargaining units early and often by obtaining their input and working collaboratively on any changes to future retiree benefits. And although bargaining units do not represent current retirees, it is still beneficial to include them in the process of rolling out a plan to provide an optional benefit to current retirees.

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