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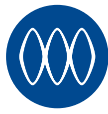

Milliman USA
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Benefits Perspectives
Current Issues in Employee Benefits

SUMMER 2002

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- Benefits and the Middle-Age Boom
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A Captivating Proposal for Employee Benefits

by Charles M. Waldron

Funding employee benefit programs via a captive insurance company can provide an employer significant advantages. Doing so not only can increase an employer's benefit cost controls, but also offers potential tax savings, spreads risks for the captive, and could potentially increase benefits for plan participants. The Department of Labor's (DOL) granting of a prohibited transaction exemption (PTE) for one employer and a pending application of a second, along with the DOL's recent streamlining of the PTE process, will pave the way for other employers to pursue funding of their employee benefit programs through their captive insurance subsidiaries.

This article provides information on the DOL's PTE process and explains how an employer—including one that self-insures benefits—may reap the advantages of using its wholly owned captive insurance company to fund its benefit programs.

ERISA, PTEs, and Captives

The Employee Retirement Income Security Act (ERISA), the federal law governing employee benefits, prohibits transactions between an employee benefit plan and a party in interest with respect to the plan. A transaction between or among subsidiaries of a parent company and its plan is prohibited. Thus, a transaction that allows an employer's captive insurance subsidiary to participate in the coverage of the qualified plan's liabilities would be considered a prohibited transaction that could result in the loss of the plan's qualified status.

Fortunately, ERISA provides that the DOL may approve exemptions to a prohibited transaction.

With regard to use of captive insurance for funding of employee benefits, some background is in order.

What is a captive insurance company? A captive insurance company is an insurance company formed as a subsidiary of the parent company (i.e., the employer with the benefits program to be funded through the captive insurer). In general, the captive insurer is restricted to writing insurance coverage for the parent and related companies. Traditionally, the coverage written by captives has been primarily casualty risks (e.g., auto, fire, general liability, and workers' compensation). Qualified employee benefits coverage (life, health, disability, and retirement) was not considered viable because of ERISA's prohibited transaction rules. And although nonqualified plans can be insured through the captive, few employers have done so.

What restrictions did the DOL place on use of captives for employee benefits? The DOL granted the first PTE for the use of a captive insurance company to Columbia Energy Corp. two years ago. Before then, for employee benefits to be part of a captive insurance program, 50% of the premiums paid to the captive company had to come from what the DOL referred to as "unrelated" exposures. For the DOL, calculating unrelated exposures required the parent company to exclude its own property, liability, and workers' compensation risks. Thus, if an employer put $10 million in employee benefits premiums and $20 million in property/casualty premiums into its captive insurance company, then it had $30 million in related premiums. Such an employer then had to find insurance risks/exposures amounting to an additional $30 million worth of unrelated premiums in order to put the $10 million of premiums for employee benefits in its captive insurance company. Unrelated premiums could include large catastrophic exposures or exposures with unknown loss potential, either due to lack of historical data or a lack of knowledge or sophistication on the part of the captive. The sheer magnitude of the 50% threshold usually made use of the captive insurance arrangement for employee benefits a nonstarter; and even if it could be achieved, the risk of significant underwriting losses was not worth the trouble.

Columbia Energy's PTE

In October 2000, the DOL granted Columbia Energy Corp. an individual PTE (PTE 2000-48) for the company's financial transaction involving its long-term disability plan covering employees and Columbia Insurance Corporation, Ltd., its wholly owned captive insurance company. The PTE eliminated the 50% threshold and adopted other safeguards designed to protect employee benefit plan participants:

- An employer is no longer required to produce any unrelated premiums. The sample employer described above does not have to find $30 million of premiums in other exposures to fund the employee benefits program through the captive. Consequently, in contrast to the DOL's prior position, the employee benefit plans are better protected because they will not be exposed to risks outside of the scope and control of the parent. Therefore, the benefits are more likely to be paid.

- The captive insurance company must be a US-domiciled captive or branch captive.

- Annual reviews of the captive insurer's reserves must be conducted by an independent firm of actuaries and reported to appropriate regulatory authorities.

- The captive insurance company must undergo an examination by an independent certified public accounting firm.

An employer must improve the benefits offered to participants in the plan. Beginning in the initial year of the transaction, there must be an immediate benefit to the plan's participants and beneficiaries in the form of increased benefits or lower employee contributions as a result of the transaction. The DOL has not indicated how much larger the benefits—or how much lower the employee contributions—must be, but presumably, the improvements should be material.

Independent Fiduciary Requirement

In granting a PTE along the lines of Columbia Energy Corp.'s, the DOL also requires that an independent fiduciary, representing the participants and beneficiaries of the plan, be appointed. The independent fiduciary must annually review the transaction and certify that certain specific requirements are met. This additional check-and-balance serves as another layer of protection to plan participants, allowing the DOL to remain involved in monitoring the arrangement and to take early enforcement action if necessary.

To be considered independent, the DOL requires that a fiduciary and any entity affiliated with the fiduciary (employer, spouse, subsidiary, partner, etc.) not be an officer, director, employee, or partner of any party to the transaction. The fiduciary and any affiliate of the fiduciary also may not derive more than 5% of their revenue from any party to the transaction.

The independent fiduciary must report on specific items; among them, the fiduciary must certify that:

- the formula used to calculate premiums for the plan is similar to formulae used by other insurers providing coverage under similar programs; and

- the premium charge calculated under the formula is reasonable and within the range charged by the marketplace providing similar coverage under comparable programs.

These two certifications require the independent fiduciary to have the expertise to review the pricing of the benefits placed in the captive. Furthermore, the independent fiduciary must have a working knowledge of the insurance marketplace to be able to certify that the premiums are reasonable and within the range that other direct writers might charge. Some arrangements involving the captive will require the independent fiduciary also to have additional knowledge of both the self-funding of employee benefit plans and the reinsurance market available for the benefits.

Potential Tax Savings and Costs

The captive arrangement potentially offers the parent company an improved tax position. The IRS has issued little guidance in this area, but what it has published appears helpful and employers would be wise to seek advice from a tax professional.

Although the DOL defines the parent's property/casualty premiums and employee benefits premiums as *related*, the IRS apparently considers employee benefits as an exposure *unrelated* to the parent's scope of operations. Many companies that seek tax deductions for all of their captive insurance premiums and reserves try to achieve at least a 30% ratio of unrelated premiums. This ratio is an unofficial barometer in determining an amount of unrelated premiums needed for the deductibility of premiums and loss reserves.

Using the earlier example, a $30 million program consisting of $20 million of property/casualty premiums and $10 million of employee benefits would be considered by the DOL as 0% unrelated, but by the IRS as 33% unrelated. This would exceed the 30% threshold often assumed needed for IRS purposes. With the new DOL exemption rules, the addition of the employee benefits might create a tax deduction for the property/casualty premiums and reserves that were otherwise not

deductible before. Will the IRS take exception to this? Time will tell. Meanwhile, what might the tax benefit be worth?

If an employer structures its benefits and captive arrangements appropriately and is able to obtain a PTE along the lines of the one granted to Columbia Energy Corp., it is likely to incur some costs but also achieve some federal tax benefits. The additional costs—from improving plan benefits, new administrative requirements (e.g., fiduciary opinions and legal costs), and higher captive premium taxes—might be offset by tangible and intangible savings or benefits, including possible accelerated tax deductions, potential increased control over employee benefits costs (e.g., integrated disability benefits), and expected improved employee relations and morale (e.g., lower employee contributions or increased benefits).

Using the example above of an employer with $20 million in property/casualty premiums and $10 million in employee benefits, what is the potential savings if the incremental costs (legal, fiduciary, and premium taxes) are $600,000 ($390,000 after-tax cost, at an assumed 35% tax rate) based on the following:

- Plan benefits increase by $500,000 (after tax, $325,000);
- Annual administrative costs increase by $60,000 (after tax, $39,000);
- Illustrative state premium tax of 0.4% on the $10 million of employee benefits is $40,000 (after tax, $26,000);
- There is an existing captive insurance program; and
- Captive premiums are currently not deducted for federal tax purposes.

Milliman's research on the benefit of accelerated tax deductions indicates that, for a typical block of casualty lines (workers' compensation, general liability, and auto liability), the annual benefit is about 3.0% of the underlying premium. In this illustrative case, using $20 million in premium, the benefit is $600,000. Subtracting out the incremental costs of approximately $390,000 (after taxes), the net annual benefit of accelerated tax deductions to the corporation would be about $210,000 or approximately 1% of the captive's property/casualty premiums. This gain ignores any potential savings generated by increased efficiencies/control of costs. It focuses solely on federal taxes.

Looking Ahead

The DOL is now reviewing an application for a PTE from Archer Daniels Midland Co. (ADM) to fund improved basic and supplemental life insurance plans for employees through its captive insurance company. ADM's application for the PTE indicates that the arrangement is structured similar to the one granted to Columbia Energy Corp.

If the DOL grants the PTE to ADM, other employers contemplating such approaches will likely seek similar rulings. Moreover, they may find the DOL's PTE application process significantly streamlined. Effective July 3, 2002, the DOL modified its PTE process (PTE 96-62) to expedite consideration of routine transactions involving terms, conditions, and circumstances that are substantially similar to those described in two individual exemptions granted within the past 60 months. Being able to cite Columbia Energy Corp.'s PTE and, when granted, ADM's PTE, should facilitate other employers' applications.

Conclusion

The DOL's grant of a PTE to Columbia Energy and the pending application for ADM is a positive event for many employers. It may provide a powerful incentive to make employee benefits part of a captive insurance company program. How the IRS will view the matter remains to be seen, and many employers are cautiously optimistic about a favorable outcome. The potential for substantial savings at the corporate level exists, but participants in ERISA plans also significantly benefit.

For many employers' captives and benefit plans, the DOL's requirements are already being performed on an ongoing basis and present little or no additional costs. For other employers that self-fund their benefit plans, the requirement for an independent actuarial review of the reserves may present some new tasks and costs for the plan, but there still are compelling reasons—expense savings, risk spreading, and coordinated risk management—to consider the captive approach. And for the many employers with existing offshore captives, either a branch captive must be established or the domicile of the offshore captive must be transferred to the US to have a chance at obtaining a PTE along the lines discussed.

As a rule of thumb, an employer will need at least $1 million worth of insurance premiums to make its captive arrangement viable. But smaller employers could consider *sponsored* or *leased* captives, which involve several businesses in a shared captive arrangement—a discussion of which is beyond the scope of this article. Setting up a captive insurance company solely to fund qualified employee benefits may not be financially viable. However, the use of a captive insurance company for all of a company's business and financial risks could prove worthwhile and provide the catalyst to cash in on the advantages of including the qualified employee benefits programs in the captive.

Chuck Waldron is a consulting actuary in Milliman's Hartford office and is the independent fiduciary for both Columbia Energy Corp. and ADM. This article was peer reviewed by Joel Chansky, a consulting actuary in Milliman's Boston office.

Catching Up to Retirement

by Michelle L. Judge

With the enactment of last year's Economic Growth and Tax Relief Reconciliation Act (EGTRRA), eligible 401(k) plan and other retirement plan participants may be able to save more money on a tax-deferred basis in their plans through a *catch-up* contribution. This option, however, is available only if the plan is amended to include the catch-up provisions.

For plan sponsors, implementing a catch-up feature for participants aged 50 and older entails several issues that must be considered carefully. This article provides answers to key questions and examples, where appropriate, of EGTRRA's catch-up rules.

What is a catch-up contribution?

A catch-up contribution is an employee elective deferral that exceeds the limits applicable to a retirement plan. Catch-up contributions are treated similarly to an elective deferral: They cannot be made on an after-tax basis or made after the close of the calendar year; they are subject to the same distribution rules; and catch-up amounts are reported to participants in the total of elective deferrals on their W-2 forms.

What plans are eligible?

Catch-up contributions may be permitted in 401(k) plans, 403(b) tax-sheltered annuities, and 457 deferred compensation arrangements sponsored by state and local governmental entities. In addition, Savings Incentive Match Plans for Employees (SIMPLE) plans may allow for catch-up contributions.

What are the catch-up contribution limits?

EGTRRA statutorily set the regular elective deferral limits for the 2002 through 2006 taxable years and specified the dollar catch-up limits, as shown below:

TABLE 1

Taxable Year	401(k), 403(b), Gov't 457 Catch-Up Limits	401(k), 403(b), 457 Regular Deferral Limits
2002	$1,000	$11,000
2003	$2,000	$12,000
2004	$3,000	$13,000
2005	$4,000	$14,000
2006	$5,000	$15,000

Catch-up limits on SIMPLE plans are half the catch-up limits for other plans.

For taxable years after 2006, the catch-up limit is subject to cost-of-living adjustment increases in multiples of $500. At this time, Congress has not enacted legislation to extend EGTRRA's retirement provisions beyond 2010. Thus, employers' ability to give employees the opportunity to make catch-up contributions may expire.

Total elective deferrals (regular deferrals plus catch-up contributions) may not exceed the employee's compensation for the year.

***Example**: Sue earns $10,000 in 2003. She is not permitted to defer more than $10,000 in total elective deferrals.*

Who is eligible to make catch-up contributions?

Participants who will attain age 50 or older before the end of the calendar year and who are eligible to make regular deferrals to the plan may make annual catch-up contributions. Employees who turn age 50 during the calendar year are deemed to be age 50 as of January 1 of that year. Participants who terminate employment (including via death) in the year they attain or would have attained age 50 are eligible to make catch-up contributions.

***Example:** John's 50th birthday is 12/15/2002. John dies on 12/10/2002. John had already made elective deferrals of $12,000 in the 2002 calendar year. $1,000 of his elective deferrals is a catch-up contribution.*

How is a contribution determined to be a catch-up?

For an elective deferral to be considered a catch-up contribution, it must exceed one of the three following limits:

Statutory limits—the regular deferral limit and the "annual additions limit" set by the IRS. For 2002, the regular deferral limit is $11,000 for 401(k), 403(b), and 457 plans and is $7,000 for SIMPLE plans. The annual additions limit is the lesser of 100% of compensation or $40,000.

Actual Deferral Percentage (ADP) limit—the highest regular deferral dollar amount a highly compensated employee (HCE) can keep in the plan as a result of nondiscrimination testing. The plan sponsor determines the catch-up contribution amount after calculating the proper contribution amount.

Employer-provided limits—the plan language may establish limits on regular deferrals that are different than the statutory limits. Prior to 2002, regular deferral limitations were common to prevent participants from exceeding the statutory limits or causing ADP failures.

Example: *The plan provisions limit regular deferrals to 15% of compensation. Joe, who is 56, has compensation of $50,000. His plan limit for regular deferrals is $7,500 ($50,000 x 15%). Joe may defer an additional $1,000 in 2002 as a catch-up contribution, bringing his total elective deferrals to $8,500 for the year.*

What if an employer-provided limit changes during the year?

If the employer-provided limit changes mid-year as a result of a plan design change (typically to increase the regular deferral limit allowing participants to save more towards retirement), there are two options available to determine the total elective deferral limit. The catch-up amount may be calculated as the excess of either:

- the sum of the dollar limits for each period; or
- the average percent weighted over time.

The two options can produce different results. In the following Option 1 example, regular deferrals in excess of $4,500 become catch-up contributions; and Option 2 produces a catch-up amount if regular deferrals exceed $4,375.

Example: *Plan XYZ has an employer-provided limit of 10% for regular deferrals for the first six months of the plan year and 15% for the second half. Sally earns $15,000 in the first six months and $20,000 in the second six months.*

Option 1: *Sally's employer-provided deferral limit for regular deferrals for the year is ($15,000 x 10% = $1,500) plus ($20,000 x 15% = $3,000) for a total of $4,500. Deferrals in excess of $4,500 (up to the $1,000 limit for 2002) are catch-up contributions.*

Option 2: *The average percent is 12.5% (10% + 15% = 25% / 2). Deferrals in excess of $4,375 ($35,000 x 12.5%) become catch-up contributions.*

When are catch-up contributions determined?

Generally, the plan determines whether an elective deferral is a catch-up contribution as of the last day of a plan year. If an employee exceeds the statutory limit, the determination of catch-up is made at the time the employee makes the deferral.

May a plan sponsor match catch-up contributions?

The plan sponsor has the option to match or not match catch-up contributions. If the plan sponsor decides to provide a match on catch-up contributions, the sponsor should bear in mind that the matching amounts are subject to limits and testing.

Example with no match on the catch-up contribution and match on regular deferrals of 50% up to 6% of compensation: *In 2002, Joe earns $200,000 and defers 5.5% of his compensation as regular deferrals and an additional $1,000 as a catch-up contribution. Joe will receive a 50% match of $5,500 on his regular deferrals of $200,000 x 5.5% = $11,000. Joe does not receive a matching contribution on his $1,000 catch-up contribution since the plan sponsor has elected not to match catch-up contributions. The match on regular deferrals of $5,500 is subject to actual contribution percentage (ACP) testing.*

Example with a match on the catch-up contribution and match on regular deferrals of 50% up to 6% of compensation: *Same facts as above, but the plan matches catch-up amounts. Joe will receive a 50% match of $6,000 on his regular deferrals of $200,000 x 6% = $12,000. The entire match of $6,000 is subject to ACP testing because the match on catch-up contributions is subject to ACP testing.*

Are catch-up contributions included for testing purposes or applying limitations?

Catch-up contributions are not subject to many of the limits and tests that apply to regular deferrals. This means that participants can make the full catch-up contribution without affecting their other contributions and benefits under the plan. Catch-up contributions are not included in the following:

- Elective deferral limits
- Deduction limits
- Nondiscrimination testing, including ADP
- Annual additions limit
- Top-heavy testing (the current year's catch-up amounts are not included, but the prior year's catch-up amounts are included)
- Average benefit testing (the current year's catch-up is not included, but the prior year's amounts are, if the prior year's allocations are taken into account)

Annual Additions (415) Limit Example: *The 2002 defined contribution annual additions limit is the lesser of $40,000 or 100% of pay. In 2002, Betty, age 54, earns $200,000 and receives $41,000 in contributions. Betty has exceeded the $40,000 limit by $1,000, which becomes a*

catch-up contribution since catch-up contributions can be made in addition to 415 limit amounts.

What if more than one plan is involved?

If an employer permits catch-up contributions, it must make the option available to all eligible employees in all of its applicable plans. Under this universal availability rule, each applicable plan of the employer must add the catch-up provision by October 1, 2002, if the employer intends for catch-up contributions to be permitted in 2002. However, if the plan is a governmental 457 plan or a newly acquired plan during a "coverage transition period," it is exempt from the universal availability requirements.

In cases where an employer sponsors more than one plan, deferrals are aggregated. Aggregated catch-up contributions cannot exceed the catch-up limit.

***Example:** An employer sponsors two 401(k) plans. If in 2002, a 54-year-old participant defers the maximum regular deferral of $11,000 in one plan and $1,000 as catch-up in both 401(k) plans, she has contributed a total of $13,000, which is $1,000 more than the maximum deferral allowed. The $1,000 is an excess contribution that must be returned to the participant.*

However, there is an exception for government 457 plans. The catch-up contribution in a government 457 plan is not aggregated with other plans. Therefore, in 2002 an eligible participant could defer a $1,000 catch-up contribution in a 403(b) or 401(k) plan and defer a $1,000 catch-up contribution in a government 457 plan.

If the situation involves an employee covered by separate plans of multiple employers, the participant should treat deferrals that exceed the IRS limit as a catch-up contribution.

***Example:** Jill is 53 years old and works for two different employers, making deferrals in both employers' 401(k) plans. If Jill defers $6,000 in each plan in 2002, neither plan treats any of the deferred amounts as catch-up contributions. Jill, however, can treat $1,000 as a catch-up contribution and does not require any refunds since she did not exceed the overall $12,000 limit on deferrals.*

What if the plan year is not a calendar year?

Catch-up contribution limits are based on a calendar year. Because deferrals in excess of the IRS limit are determined when deferrals are made and because the ADP limit and plan limit are determined at the end of the plan year, calculating the maximum amount of contributions for a participant can be confusing.

***Example:** Jack is 55 and participates in a 401(k) plan that has an 11/30 year end. The plan allows for catch-up contributions and has a contribution limit of 10%. Jack earns $70,000 from 12/01/01 to 11/30/02. Jack contributes $1,500 between 12/01/01 and 12/31/01 and $7,500 between 01/01/02 and 11/30/02. Jack's contributions for the plan year equal $9,000 ($1,500 + $7,500). The plan limit is $7,000 ($70,000 x 10%) and the 2002 catch-up limit is $1,000. The additional $1,000 is an excess contribution.*

State Conformity

For a state to permit tax deferrals of catch-up contributions, it must adopt EGTRRA's catch-up contribution provisions to conform the state's tax code to the federal Internal Revenue Code. If a plan permits catch-up contributions in a state that does not conform to EGTRRA, the employer should track catch-up contributions separately because the catch-up amount will be taxable for state income tax purposes (but still excludable for federal tax purposes). There is a risk that a plan in a nonconforming state could be disqualified by the IRS for permitting catch-up contributions. Plan sponsors in nonconforming states should weigh the risk of offering a catch-up contribution with the benefits it provides to participants. As of mid-August 2002, there are less than a handful of nonconforming states, but most anticipate full conformity with EGTRRA by the end of 2002 or retroactively to the start of 2002.

Conclusion

There is a significant concern that retirees will not have saved enough money at retirement. Catch-up contributions provide a great opportunity for eligible employees to save more on a tax-deferred basis. To provide the catch-up feature to a plan for 2002, an employer generally must amend the plan to include the catch-up provision by the end of the year. Consideration should be given to testing and limitation issues with matching on the catch-up contributions and the challenges with noncalendar year plans.

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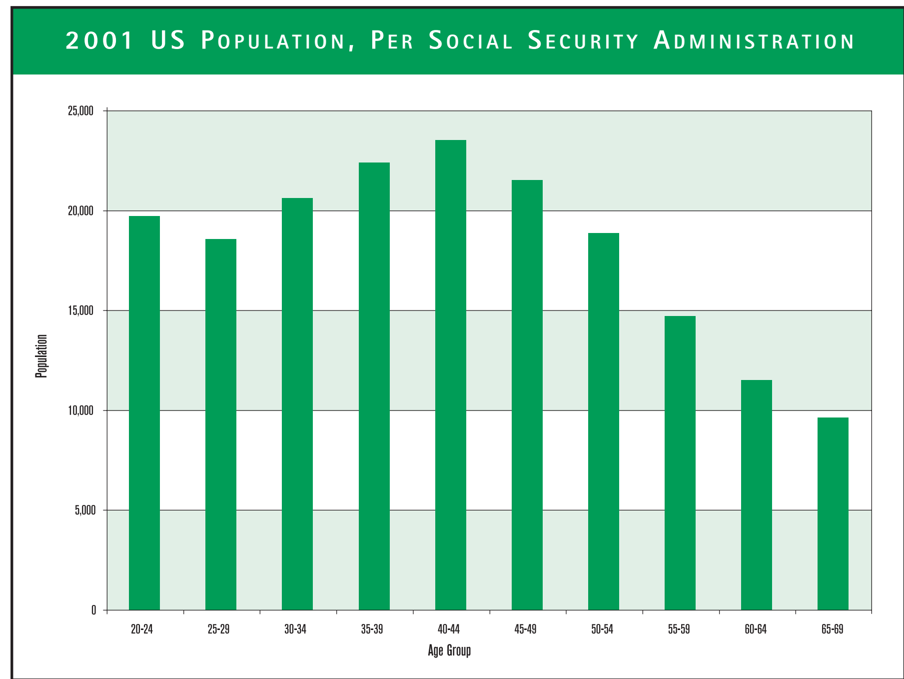
Benefits and the Middle-Age Boom

by Troy Pritchett

The baby boomers are now middle aged. But don't let all the concern and speculation about boomer retirements in future decades distract you from a simple fact: Before boomers can get old, they have to get older. The important demographic transformation of today is the increasing number of middle-aged adults in the workforce. For human resource and benefit managers, the effect of this shift will be substantial.

This article discusses how the physiological changes of middle adulthood taking place in such a large generation will affect employee benefit programs. Although demographics and human physiology are not perfect guides to the future, their substantial influence is worthy of careful consideration for employee benefits planning.

TABLE 1



Three Rules of Thumb about the Boomers

Age 50 in '05 plus or minus 10—The baby boom generation is usually identified as those born in 1946 to 1964, but you won't go too far wrong if you assume boomers will be age 50 in 2005, with the youngest about 40 and the oldest about 60.

One year for every three—The US population's average age increases about one year for every three calendar years. In other words, the population ages more slowly than an individual in a one-to-three ratio. Because a stable population would not change its average age over time at all, a 1/3-year annual change in the population's average age is significant.

Up 75%, down 25%—The baby boom group grew about 75% in births per year compared with the group older. The group that followed the baby boom has about 25% fewer births per year. So the first and larger effect of the baby boom is *more*—currently, more middle-aged adults. The second and smaller effect is *fewer*—currently, fewer young adults. Table 1 graphically shows the current age distribution of the population.

Changes in Middle Adulthood

From the perspectives of risk, benefit planning, and effect on the workforce, there are several noteworthy changes that take place during middle adulthood. One important key to understanding aging is that not everyone ages alike. One component of aging makes its presence known by slow, chronic effects on the vast majority of people. Other components—such as mortality, disability, or serious morbidity—work by increasing the size of the minority that is affected in a major way. In individuals, these factors can lead to a certain denial of the effects of aging because either they are happening slowly or they are happening, by and large, to other people. Human resource managers, on the other hand, do not have the luxury of not preparing for aging because they must cope with the significant, aggregate effects of all components.

Mortality

Baby boomers are not immortal. Yes, the US population in general is living longer than ever, but it still faces a significant risk of death in middle adulthood. In the ages of middle adulthood, the risk of death increases roughly 10% per year. This represents a doubling of mortality risk every seven years. For example, the risk of death is four times as great at age 54 as at age 40, doubling again to eight times as great at age 61.

Mortality improvements over the last 100 years are substantial. The speed of mortality improvement accelerated and slowed

down, with various age ranges, genders, and disease types taking turns at improvement. In general, a 1% decline in mortality per year is good progress, 2% per year, outstanding progress. At the level of individual aging and the aging of the baby boom cohort, aging still outpaces mortality improvement by five to 10 times.

Although there has been much discussion of the looming retirement boom and strain on social programs in the coming decades, a more immediate effect that society must prepare for is that nearly one in seven of the baby boomers alive in 2000 (ages 35 to 55) is expected to die before 2020, when the average age approaches 65.

Disability

Similar to the case of mortality, there has been progress over time in reducing the incidence of disability. Nonetheless, the probability of becoming disabled increases rapidly with age and is a significant risk for middle-aged adults.

The percentage of people becoming disabled under Social Security increases about 8% per year from age 45 to age 65. For short-term disability benefits, the cost rises similarly to the incidence of disability. For long-term disability plans that pay benefits to age 65, the total cost peaks before age 60 because of the decreasing number of years that disability benefits will be paid.

The aging of the workforce will bring an increased workload for disability plans in terms of qualifying for benefits and case management. To be effective, return-to-work programs must focus on the perspective of older workers.

Morbidity

Healthcare costs are currently in a fast-growth period. Over the decades, periods of fast growth have alternated with periods of slower growth. The increased incidence of disease, or morbidity, of our aging population is a steady force that will reliably add to healthcare costs in both the fast- and slow-growth periods.

Before the baby boomers begin to swell the size of Medicare, they will increase the cost of employer plans. Seeing employers' healthcare costs increase annually at double digit rates above inflation and understanding that the baby boom is just beginning to reach its high-cost years can produce a certain amount of astonishment.

Despite all the predictions of major change in benefit plans and the healthcare system, employers are generally doing what they

TABLE 2

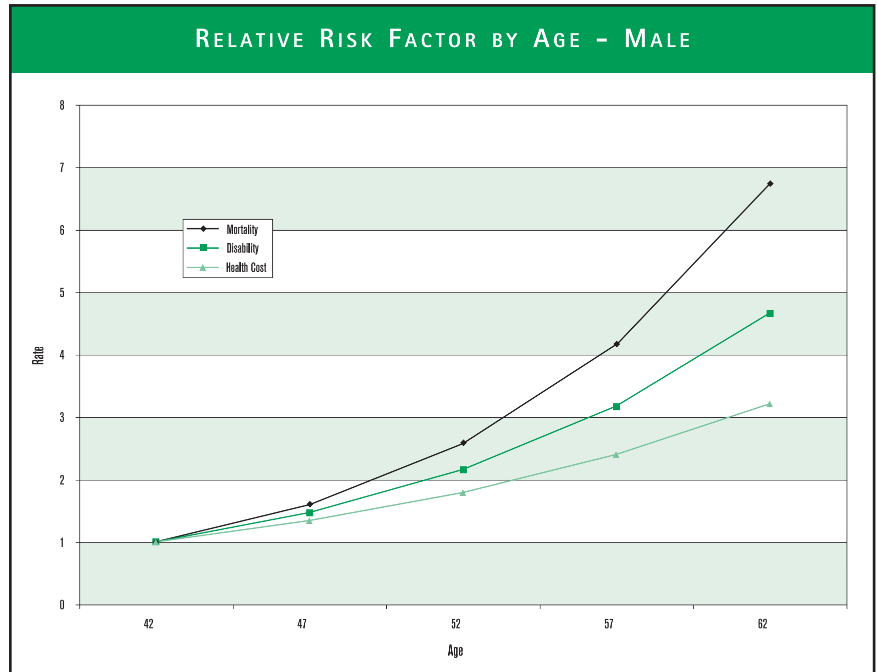
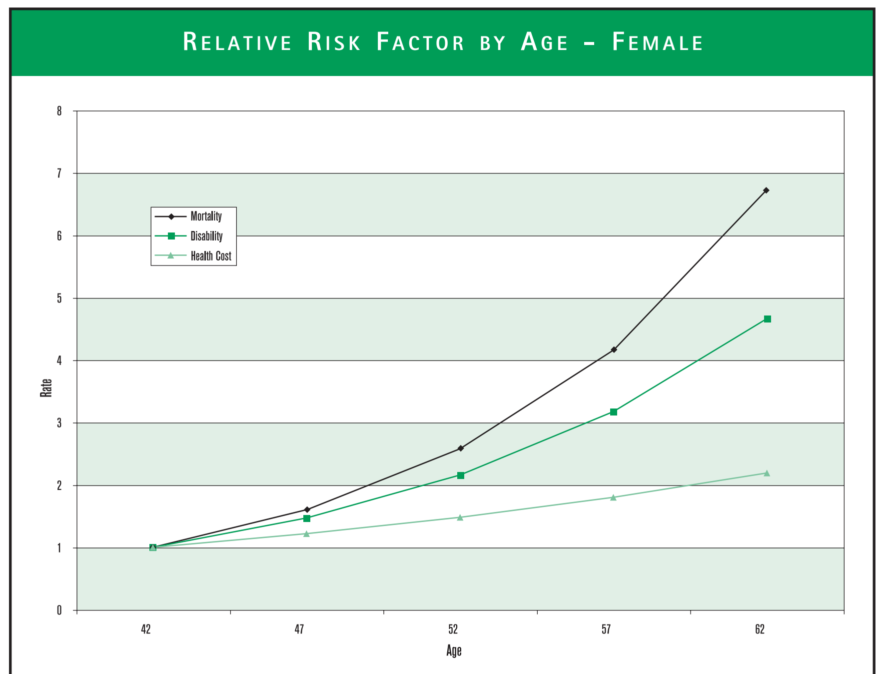


TABLE 3



have long been doing in healthcare: coping. Employers offer health plans largely for two reasons: employees want them and the tax system promotes them. The aging of the baby boom indicates that neither of these conditions will soon change.

The increase in health benefit costs per year of aging is less for females than for males, about 4% for females and 6% for males. The average cost for males and females in middle adulthood is quite similar when compared with younger ages, where females are more expensive.

Tables 2 and 3 show the relative cost of health benefits by age, as compared with the relative factors for mortality and incidence of disability. These relative cost factors are for all costs before deductibles and employee cost sharing.

The relative cost factors for ages over 40 in relation to employees younger than 40 increase as the deductible increases. High deductible plans produce a one-time decrease in employer costs but do not change cost trends resulting from aging. In fact, the cost trend from aging is more likely to be greater under a high deductible plan.

Retirement Preparation

There are many predictions about the effect of the baby boom retirement. Undoubtedly, maintaining retired boomers in the style to which they have become accustomed will require lots of money. However, given the time lag involved, by the time the boomer retirement effects are realized and each retiree discovers whether preparations were sufficient, the employer-provided retirement benefits for this group will be more or less set. It is hard to change 401(k) plan deferrals at age 35 once one reaches 80.

Research data on retirement can be helpful for benefit planners. For example, data on age-related behavioral changes in 401(k) plans show that deferrals are about 2% of compensation greater for people in their 50s than those in their 30s. This increase at older ages is particularly pronounced for the non-highly compensated employees.

The threshold for investment risk and the style for retirement planning tend to be stable parts of an individual's personality that do not change. Planners plan, the risk averse avoid equities, and the spenders spend without a great amount of change across ages. It is important to keep this segmentation of financial planning preferences in mind when judging employee interest in retirement planning. While some employees may never show an interest, rapidly approaching retirements will lead others to act.

Vitality and Attitude

There is an important difference between increased risks as people age and capability and job performance. Many studies show that there is little decline and even areas of improvement in intellectual functioning and job performance well past the typical retirement age of 65. One notable study that began in 1958, the *Baltimore Longitudinal Study of Aging*, shows that personality changes little after age 30. People who are cheerful at age 30 remain so at age 80. The study also indicates that older people cope with stress as effectively or better than younger people, and that psychological well-being depends more on personality traits than on good or bad circumstances.

The baby boom generation is too large and valuable for employers not to carefully manage as vital human capital. Companies skilled at managing older employees will have a significant advantage in the years to come.

Conclusion

Employers should take a step back now and assess their human resource needs for the immediate future. The middle-aged boomers are in their prime working years and have a material influence on benefit programs and the work environment. Key actions to focus on are:

- Prepare your benefit plans for an aging workforce. Measure the cost effects, administrative load, and employee satisfaction with your benefit programs under the strain from a larger increase in older workers.

- Pay attention to the perspectives of today's older workers. They will be more prevalent in the future. Segment age as a component of employee surveys or focus groups.

- Implement or improve programs to keep employees healthy and productive as they age. Options to explore include an extension of disease and disability management programs or a new program that focuses on future trends.

Troy Pritchett is a consulting actuary in Milliman's Salt Lake City office. Lorraine W. Mayne, a consulting actuary also in the Salt Lake City office, peer reviewed this article.

A Tax Incentive to Save for Retirement

by Milliman USA's Employee Benefits Research Group

Low- and moderate-income workers have been given a new reason to contribute toward their retirement plans: a tax credit created under last year's tax law (the Economic Growth and Tax Relief Reconciliation Act, EGTRRA). The temporary "saver's tax credit" for voluntary contributions to individual retirement accounts (IRAs) and employer-sponsored retirement plans might not benefit all or most low- or moderate-income workers, but it may offer sufficient incentives to take the initial step of securing retirement income for those who can benefit. Retirement plan sponsors should consider communications efforts to educate employees about the saver's tax credit.

TABLE 1

Tax Credit (% of the amount contributed)	Adjusted Gross Income Based on Filing Status		
	Joint Return	Head of Household	Single/Married Filing Separately
50%	Up to $30,000	Up to $22,500	Up to $15,000
20%	$30,001 to $32,500	$22,501 to $24,375	$15,001 to $16,250
10%	$32,501 to $50,000	$24,376 to $37,500	$16,251 to $25,000
0%	Over $50,000	Over $37,500	Over $25,000

The saver's tax credit was touted by its congressional proponents and others as a significant incentive for increased retirement savings for the segment of the population that saves the least. At the same time, many critics claimed that the benefit was illusory because the tax credit is nonrefundable–meaning that if a taxpayer does not owe taxes to begin with, the credit offers nothing.

Incentive to Save

To determine whether the saver's tax credit truly offers an incentive to save or is merely a benefit with extremely limited application, a brief listing of the basic rules is in order:

- *Temporary application*–The credit is only available from 2002 to 2006
- *Maximum contribution per year subject to the credit*–$2,000
- *Eligibility*–The taxpayer must be 18 or older by the end of the year, not be claimed as a dependent on another tax return, and not be a full-time student
- *Plans eligible*–IRAs, qualified retirement plans (profit-sharing, 401(k), money purchase, defined benefit, etc.), 403(b) annuities, and 457 deferred compensation plans
- *Types of contributions*–Voluntary, pre-tax (e.g., elective deferrals to a 401(k)) or after-tax amounts (mandatory contributions are not eligible for the credit)
- *Offsets for distributions*–Certain taxable distributions from a plan or an IRA reduce the amount of contributions otherwise eligible for the credit
- *Minimum taxes*–The tax credit may not be used to reduce taxes calculated under the alternative minimum tax
- *Adjusted gross income limits*–The saver's tax credit ranges from 10% to 50%, depending on the participant's adjusted gross income, as shown in Table 1

"Adjusted gross income" (AGI) includes compensation from an employer (net of elective deferrals and other pre-tax deductions such as for flexible spending accounts), investment income, capital gains, business income, and alimony received. Net investment losses of up to $3,000, business losses, student loan interest, deductible contributions to an IRA, and moving expenses are deducted from compensation before arriving at AGI.

Examples and Assumptions

Table 2 shows various types of taxpayers and the effect, if any, of the saver's tax credit. In these examples, the following are assumed:

- The taxpayers take the standard deduction.
- The contributions are pre-tax amounts (note, however, that the same analysis would apply to after-tax contributions, although there would be no reduction in the income taxes before the credit).
- The contribution for each taxpayer is 6% of pay up to a maximum of $2,000 (the maximum eligible for the saver's tax credit).

TABLE 2

	ELIGIBLE FOR THE 10% CREDIT		ELIGIBLE FOR THE 50% CREDIT					
	Married (filing jointly with 2 children)		Married (filing jointly with 2 children)		Married (filing jointly, no children)		Single	
	No contrib	With contrib	No contrib	With contrib	No contrib	With contrib	No contrib	With contrib
Income	$50,000	$50,000	$30,000	$30,000	$30,000	$30,000	$15,000	$15,000
Pre-tax Contribution	$0	$2,000	$0	$1,800	$0	$1,800	$0	$900
AGI	$50,000	$48,000	$30,000	$28,200	$30,000	$28,200	$15,000	$14,100
Deduction/Exemptions	$19,850	$19,850	$19,850	$19,850	$13,850	$13,850	$7,700	$7,700
Taxable Income	$30,150	$28,150	$10,150	$8,350	$16,150	$14,350	$7,300	$6,400
Income Tax	$3,923	$3,623	$1,015	$835	$1,823	$1,553	$795	$660
Other Credits	$1,200	$1,200	$1,015	$835	$0	$0	$0	$0
Net Before Saver's	$2,723	$2,423	$0	$0	$1,823	$1,553	$795	$660
Saver's Tax Credit	$0	$200	$0	$0	$0	$900	$0	$450
Net Taxes	$2,723	$2,223	$0	$0	$1,823	$653	$795	$210
Take-home Pay*	$47,278	$45,778	$30,000	$28,200	$28,178	$27,548	$14,205	$13,890
Net Out-of-Pocket Amount	$1,500		$1,800		$630		$315	
Immediate "return" on Out-of-Pocket Amount**	$500 (33%)		$0 (0%)		$1,170 (186%)		$585 (186%)	

* Income minus contributions minus taxes. ** Excess of contributions over net Out-of-Pocket amount.

The chart also factors in "other credits" (e.g., dependent credits ($600 each), dependent care credits, and the earned income credit). Although the earned income credit can exceed tax liability, resulting in a negative net tax, for illustration purposes these credits are limited to the tax liability. It is assumed that only the dependent credits are applicable to the 10% example. And, although not illustrated, the head-of-household filing status (i.e., single parent with children) has an identical result as the married-with-children example. The chart shows only one illustration of the 10% credit because all situations produce the same result.

Analysis of Examples

Taxpayers eligible for the 50% tax credit (i.e., low-income groups) are unlikely to claim the credit if they have children. Because their tax liability is already zero, they are not getting a tax benefit for pre-tax contributions, even without the credit. The only incentive for this group to contribute to a retirement plan is an employer match. But those with similar AGIs and no children have a significant incentive to contribute, despite having incomes so low that they probably cannot afford–even with the added incentives–the small, net out-of-pocket amount necessary to benefit.

For taxpayers eligible for the 10% tax credit (i.e., moderate-income groups), nearly everyone will have a marginal tax rate of 15% (unless their deductions are sufficiently larger than the standard deduction, bringing them down to the 10% tax rate). If the deduction under a 15% tax rate was not enough to push them to contribute in the past, there will still be many in this group who will not be driven by the additional 10%. Still, there will certainly be some who will contribute for this additional incentive.

Taxpayers of an in-between group (not illustrated) who are eligible for a 20% saver's tax credit are more difficult to draw conclusions on than others. In general, those with children might already have zero tax liability because of the other tax credits available, especially the earned income tax credit, which is in addition to the $600 per dependent credit. The additional 20% tax credit from the saver's incentive on top of the 10% or 15% marginal tax rate that they would save may be enough to change their mind about contributing.

Conclusion

The biggest impediment for very low-income workers to use the saver's tax credit is that it is a nonrefundable credit. For taxpayers who do not already owe taxes, the credit is not available.

There are many moderate-income participants who will make use of the credits. Some will do so if their employers make an effort to educate employees about the saver's tax credit. Others who were already contributing might increase their contributions if their employers embark on a similar communications campaign. But the worst scenario would be if taxpayers who contributed to their retirement plans fail to take advantage of the credit when they file their tax returns. The perceived lack of public awareness about the saver's tax credit makes this a very real possibility.

Increases in contributions to a retirement plan by anyone eligible for the credit will help employer-sponsored retirement plans pass nondiscrimination tests, allowing highly compensated employees to contribute more than they otherwise could. Therefore, communicating the availability of the saver's tax credit to employees helps to provide retirement income to all employees, not just the group targeted for the credit.

Milliman USA's Employee Benefits Research Group is based in the Washington, D.C. office.

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