Tom Breaden, CFA

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HYAS GROUP

PUBLIC SECTOR OPEB TRUSTS

SUMMARY

- Like pensions, Other Post-Employment Benefits (OPEB) present a long-term liability to many public sector employers.
- This liability can be reduced by establishing and funding an OPEB trust.
- This paper seeks to inform plan sponsors of the process and benefits of doing so.

INTRODUCTION

Other Post-Employment Benefits (OPEB) are the healthcare, insurance, and other welfare benefits due to retired employees and their beneficiaries. Public sector OPEB costs have drawn increasing attention as changes in financial reporting standards put forth by the Governmental Accounting Standards Board (GASB) require municipalities to estimate and include them in their financial statements[1]. Akin to pension benefits, OPEB represents a liability whose future cost an employer may wish to offset by establishing and funding an OPEB trust. Establishing an OPEB trust is a moderately involved endeavor entailing several considerations and external professional parties. This paper seeks to help public sector employers understand the scope, benefits, and ongoing responsibilities of doing so.

PURPOSE OF AN OPEB TRUST

A trust that is remote from creditors, funded by irrevocable contributions, established under appropriate sections of the Internal Revenue Code (IRC), and dedicated solely for the benefit of applicable participants and beneficiaries can qualify as an OPEB trust and offset the sponsor's liability. Under this model the monies invested are assumed to grow at the rate of return that reflects the trust's asset allocation. OPEB liabilities that are matched by such assets are discounted at that same rate, effectively reducing their net present value (liabilities beyond the assets' expected depletion date are discounted at a lower rate that is reflective of a highly-rated municipal bond's yield). The extent that an OPEB trust is funded with assets whose expected return exceeds that of highly-rated municipal bonds reduces the sponsor's outstanding liability and ongoing contribution requirements. Ratings agencies and lenders who rely on their information also may take a positive view on the establishment and funding of an OPEB trust as it demonstrates commitment to pay a future liability in a manner that may reduce and more evenly distribute the organization's healthcare costs over time.

[1] The most recent being GASB 74 and 75, whose various requirements include biennial valuation of OPEB liabilities, display of the net OPEB liability on the entity's balance sheet, and specifications for discounting liabilities based on any OPEB trust funding.

In addition to financial benefits to the sponsor, there are tax advantages (or at least a lack of tax penalties) to maintaining an OPEB trust. Contributions from plan sponsors and their associated income is exempt from income taxation. On the participant side, sections 105 and 106 of the IRC allow for reimbursements paid from such a trust for medical expenses as defined under section 213(d) to not count towards the participant's gross income.

MAIN TYPES OF TRUSTS

The two most common forms of public sector OPEB trusts come from sections 115 and 501(c)(9) of the IRC[2]. While operationally similar, these two versions of OPEB trusts are fundamentally different enough to warrant consideration. This paper does not endorse one option over another, but rather seeks to inform sponsors of their primary structure, purpose, and differences.

A 115 trust exists to serve an essential government function such as, but not limited to, providing health and welfare benefits to current and former employees. Section 115 of the IRC states that income incurred from performing such essential government functions is excluded from the agency's gross income. Essentially, the money invested in a 115 trust and any gains thereon are simply a means by which the agency meets the costs of its fundamental operations. This treatment, re-iterated in several Private Letter Rulings (PLRs) by the IRS[3], reflects a general intention of Congress to not restrict states from participating in ventures useful to their missions. Under this model the employer will appoint an oversight board to administer the trust. 115 trusts are not required to file tax returns. Any assets remaining in the 115 trust after its liability is settled may revert to the sponsoring agency, regardless of if the trust was funded with participant contributions.

A 501(c)(9) trust (a "Voluntary Employees' Beneficiary Association" or "VEBA") essentially has the same tax exemptions for public sector employers as a 115 trust. A VEBA however is an independent pass-through entity rather than an extension of a governmental agency's essential functions. As an individual agency, a VEBA must meet the requirements stated in sections 501(c)(9)-1 through 501(c)(9)-8 of the IRC, including the requirement that membership be voluntary (or mandatory if not detrimental to members), that the VEBA be an employees' organization, and that virtually all of the association's operations take place to provide eligible benefits to members. VEBA membership can be based on geography, employment categorization, or other fairly-applied and objective criteria which can allow for multiple employers to participate. The VEBA must be controlled by its members, independent trustees, or outside fiduciaries appointed by its membership to act on their behalf. So long as the VEBA's membership does not extend to non-governmental employees, it is not required to file tax returns. Assets in a VEBA trust cannot revert to the employer upon termination. Per 501(c)(9)-4(d) of the IRC, any leftover assets may be used to purchase additional health and welfare benefits on a tax-free basis so long as it is done in a member-equitable manner.

[2] Accounts established under section 401(h) of the IRC are also tax-exempt but are less commonly used as their funding strategies must be tied to those of the sponsor's pension.

[3] PLRs 77-261, 1977-2 C.B. 45; 90-74, 1990-2 C.B. 34; 200606007; and 201607025.

VEBA establishment requires the time and expense associated with acquiring a PLR attesting to its tax-exempt status and completion of IRS Form 1024[4] (items such as financial statements, proposed budgets, and articles of association must be included in the submission). 115 trusts in contrast do not require an IRS application and approval process. While there is no comparably explicit process for establishing a 115 trust, auditors will typically request validating documentation such as a board resolution and corresponding declaration of trust. The IRS generally considers government-established 115 trusts to be integral to government function though a final determination, if any, depends on the matter's facts and circumstances. As such, 115 trust sponsors may obtain a PLR, the caveat being that doing so may incur costs and the risk that the IRS rules against the trust's tax-exempt status. Once the OPEB trust (115 or 501(c)9) is established, its oversight board will wish to establish an Investment Policy Statement that translates the trust's liquidity, time horizon, risk-tolerance and return requirements into an asset allocation and systematic review policy. The actuary or investment consultant, whose roles are discussed later in this paper, will devise an expected return for the trust's asset allocation, which then serves as the discount rate for funded liabilities.

The ultimate selection of the type of OPEB trust should incorporate the desire for control over (and associated fiduciary oversight standards of) the assets by management versus beneficiaries. Employers may have preference for 115 trusts due to their ease of set-up, control, and ownership by the sponsoring entity. A VEBA option may be preferred in cases where beneficiaries wish to have direct control over the assets and access to any post-liability assets.

INVOLVED PROFESSIONAL PARTIES

When a sponsoring government decides to establish an OPEB trust, it will likely need to consult with several professional parties to complete the task. The entity's size, views towards fiduciary liability, and amount of internal resources may influence its willingness to perform tasks in-house or contract them out. For example, it is possible that the entity may use its internal legal and investment staff to perform the work of the attorney and investment consultant. Two other parties, the auditor and actuary, are likely to be already employed by the entity for financial reporting. At minimum, a custodian would need to be selected as an additional professional party. The following paragraphs describe the role of the involved parties in more detail. In terms of sequencing, the attorney and possibly investment consultant and actuary could be consulted first to draft appropriate documents and discuss funding strategies. The custodian can be engaged when the sponsor is ready to fund the trust.

ATTORNEY: The attorney to the trust may help in drafting or reviewing the letter of authorization, Declaration of Trust, and Investment Policy Statement, assist in obtaining a PLR if necessary, and providing ongoing counsel to the trust. The attorney should be versed in applicable IRC provisions and trust laws of the governing state and is generally considered a fiduciary (the role of a fiduciary is discussed in the following section of this document).

[4] This must be done within fifteen months of the VEBA's establishment.

ACTUARY: The actuary's responsibility is to estimate the present value of future OPEB liabilities and the amount the agency must contribute to finance them. In this endeavor the actuary will gather census data from the client including participant information such as age, gender, salary, date of hire, marital status, dependents, and others. The actuary will then incorporate assumptions about future demographics to estimate the benefits that employees will accrue and their correspondent present value. Such valuations must be done at least every two fiscal years. If the sponsor has established an OPEB trust to fund the liabilities, the actuary determines the ratio of such assets to total liabilities and the resulting contribution amount that will equate the two over time. Plan sponsors considering setting up an OPEB trust may utilize the information in their most recent actuarial report or the actuary's insights to develop a funding strategy. The actuary generally is not considered a fiduciary.

AUDITOR: Though not necessary for OPEB trust establishment, auditors may be a useful source of information. The auditor must determine if and how an OPEB trust may be presented in the sponsor's financial statements. This includes a determination of the nature of the trust, its tax status and qualifications, and its market value. This information is combined with the actuarial valuation, which the auditor must obtain supporting documentation of, to determine the net OPEB obligation to be shown on the agency's balance sheet. If there is an OPEB trust, the auditor will need substantiation of the actuary's methods for determining the funding position and discount rate. Accounting for trust assets and cash flows themselves are typically not of great complexity so long as reliable market values are readily available.

CUSTODIAN: The sponsoring agency will need to contract with a custodian to hold the assets, process contributions and distributions, implement investment instructions, track cash flows and investment returns, provide account statements, and perform other related services. While set-up protocols may vary, a board resolution authorizing the trust's creation and a declaration of trust generally suffice in order to contract with a custodian, regardless of the trust's particular IRC status. Only authorized persons (such as the trustee, investment manager, or appointed claims administrator) can transact with OPEB trust assets meaning that participants cannot draw directly from the trust. Though it requires monitoring, the custodian's role is relatively simple and typically does not command high expenses. Custodians are generally not considered fiduciaries.

INVESTMENT CONSULTANT: The sponsor may choose to engage an investment consultant in either an advisory (non-discretionary) or managerial (discretionary) capacity; in either case the investment consultant acts as a fiduciary to the trust. The investment consultant's role will include developing investment policy, selecting underlying investments to use, monitoring performance and investment expenses, and recommending or implementing changes.

FIDUCIARY RESPONSIBILITIES

Sponsors should have a sound understanding of their fiduciary responsibilities for ongoing OPEB trust management. Generally, a fiduciary is required to act on behalf of and in good faith with another person or party in a manner consistent with the terms of their engagement. State law sets forth fiduciary standards and liability for OPEB trust management (applying equally to 115 and VEBA trusts) and most states have adopted the Uniform Prudent Investor Act (UPIA) as a fiduciary standard of care. UPIA stipulates, among many things, that trustees must be loyal and act solely in the interests of beneficiaries (and impartially between them), make informed, skillful, and cautious decisions based on the trust as a whole, pay only reasonable expenses, and diversify investments unless it is clearly prudent not to. The Supreme Court has referenced UPIA as a basis for trust law[5]. A fiduciary found to be in damage-causing breach of UPIA (as it is translated into state trust law) may be required to make reparations to the trust.

In terms of mitigating fiduciary liability, trustees may delegate investment functions to qualified agents who then become fiduciaries to the trust. The investment consultant typically serves this purpose either by advising the sponsor on investment decisions (in which case they become co-fiduciary to the trust) or by determining, implementing, and periodically reporting them back to the sponsor (in which case the sponsor is relieved of liability for their actions so long as they are prudent in selecting the investment manager and regularly review their actions). In addition to diffusing liability, appointing an investment professional as fiduciary may help improve overall performance due to the fact that fiduciaries in possession of expertise (such as investment knowledge) are required to use them on the trust's behalf.

It is possible that state courts may look to the Employee Retirement Income Security Act of 1974 (ERISA), a Federal Act setting forth fiduciary standards for management of retirement and healthcare benefits for private sector sponsors, for guidance. Section 3(21)(A) of ERISA defines a person as a fiduciary to the extent that they exercise discretionary control over plan assets, render investment advice for a fee, or have discretionary authority and responsibility over plan administration. Fiduciary duties per ERISA are of similar nature as in UPIA, with section 404(a) of ERISA stating that fiduciaries must act solely for the benefit of participants and beneficiaries, defray expenses, and perform their duties at the skill level of a prudent expert.

As another point of reference for public sector sponsors of OPEB trusts, the Government Finance Officers Association (GFOA) provides best practice recommendations for fiscal officers of governmental agencies. Though these recommendations are not legally binding, the GFOA's statements that trustees of OPEB funds are bound by the fiduciary duties of loyalty (act solely in the benefit of participants and beneficiaries), care (efficient and correct administration), and prudence (administer the trust reasonably) echo those of UPIA and ERISA. The GFOA additionally recommends the trustees create a governance manual, diverse and representative governance boards, and a code of ethics to guide the behavior of trustees[6]. In sum, there are a variety of formal sources

[5] Tibble v. Edison International, 2015

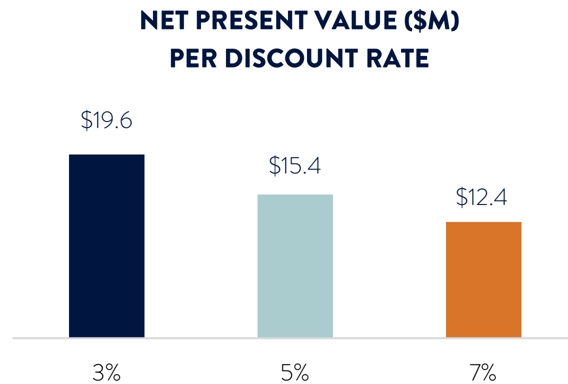
[6] Governance of Public Employee Postretirement Benefit Systems, 2010.

compelling trustees to prudently oversee OPEB trusts in a manner that comports with fiduciary best practices of loyalty, prudence, and care.

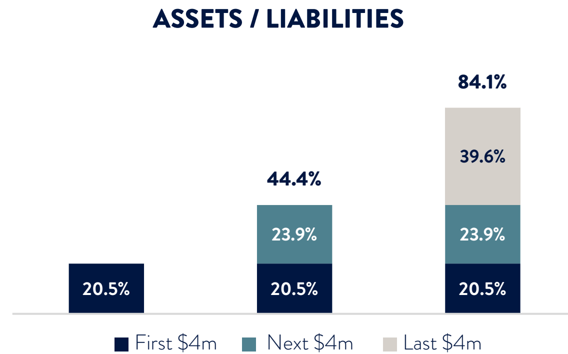
Concerning the need for financial coverage in case of fiduciary or other type of breach, OPEB trusts are not obligated to be insured (in contrast to the bonding requirements put forth by ERISA). However, fiduciaries should contemplate the prudence of holding fiduciary, errors and omissions, fidelity, and cyber coverages especially as the trust grows or involves participant-specific data.

FUNDING CONSIDERATIONS

The financial benefits a sponsor may reasonably hope to incur by funding an OPEB trust depend on the degree to which it is funded, the expected return on funded assets (versus the discount rate of unfunded liabilities), and the time at which liabilities are expected to come due. To illustrate how future liabilities are reduced when discounted at a higher rate due to the existence of an OPEB trust, we compare the net present value of an annual liability stream of $1 million for the next thirty years, discounted at rates of 3%, 5%, and 7% (reflecting approximate rates of liabilities that are un-funded, half-funded, and fully funded respectively). In this simple scenario, a fully-funded liability is valued at approximately 37% lower than an unfunded one, effectively improving the sponsor's balance sheet.



There is an exponential benefit for every additional dollar of trust funding, as incremental contributions have a longer time horizon to compound. Consider for example, one-time, lump sum deposits of $4 million, $8 million, and $12 million used to fund the thirty-year liability stream discussed above. Assets are assumed to grow at 7% annually minus each year's $1 million liability. For the purpose of estimating funding status, assumed investment gains on larger amounts will be of greater dollar value, reducing the amount of principal depletion and extending the assets' time horizon. The "Assets / Liabilities" chart illustrates the increasing impact on funding status from up-front investments of equal incremental value. In this example, the second $4 million has an incremental funding benefit of 16% over the first deposit. The impact of yet another $4 million is 66% higher than the second! While each municipality's finances will dictate their funding resources, consideration of long-term compounding



benefits will help inform any investment decisions[7]. Normally, only the market value of OPEB trust assets, as of the date of measurement of liabilities, can be used to offset them. However, if the sponsor has made a binding resolution to fund the trust at a specific rate or amount, those expected future contributions can be added to the trust's assets, increasing its funding status and lowering the necessary contribution amount[8].

CONCLUSION

This paper has sought to spell out with specificity the process, requirements, and benefits of establishing and maintaining an OPEB trust. While set-up may be the most involved aspect of the experience, doing so in an organized and informed manner can help the sponsor establish sound investment, funding, governance, and other such policies for the long-term financial benefit of the agency, its beneficiaries, and the general public.

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[7] Calculations in this paper are for general illustrative purposes only, not as a representation of specific valuation methods.
[8] The actuary may also request documentation that the funding schedule has been adhered to.