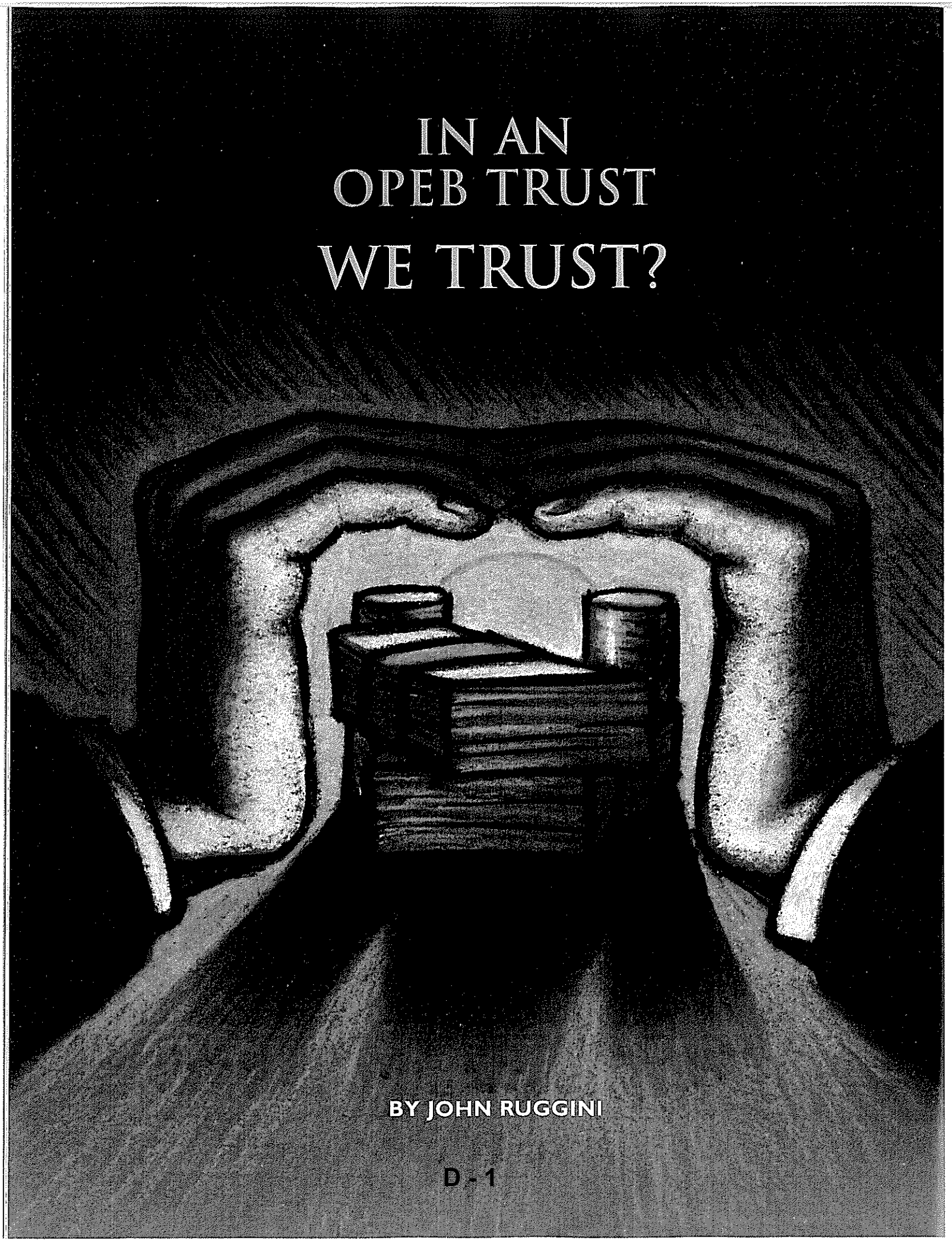
IN AN OPEB TRUST WE TRUST?



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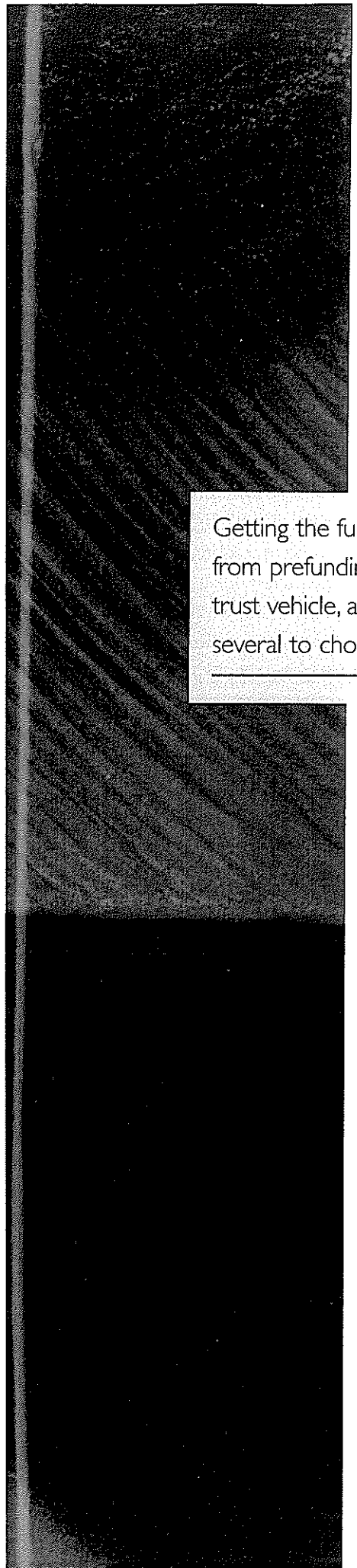

As public employers develop plans for managing their unfunded retiree healthcare liabilities, a key decision is how to fund the benefit. Prefunding, or funding the expense as employees *earn* the benefit, can pose significant advantages over pay-as-you-go, or funding the expense as retirees use the benefit. But getting the full advantage from prefunding requires a trust vehicle, and there are several to choose from. This article explores the defining characteristics of each trust option and examines the pros and cons of prefunding using an irrevocable trust.

The Governmental Accounting Standards Board (GASB) Statement Nos. 43 and 45 do not require prefunding; the calculation of the actuarially accrued liability is the same regardless of how assets are accumulated or held. Nor does prefunding presuppose or require the use of a trust — employers can prefund their other postemployment benefits (OPEB) by earmarking and setting aside funds each year. All the same, there are two important accounting and financial reporting advantages to establishing a trust. First, only amounts placed in trust qualify as *contributions* for purposes of financial reporting. Thus, failure to establish a trust will result in an employer having to report a liability for unfunded contributions (i.e., *net OPEB liability*) even if the employer is using some other means of advance funding. Second, employers are required to disclose in the notes to the financial statements their *unfunded actuarial accrued liability* (i.e., actuarial accrued liability less resources accumulated to pay benefits). For this purpose, only amounts in trust may be treated as resources accumulated to pay benefits. That is, without the benefit of a trust, the entire actuarial accrued liability will be reported as *unfunded*.

Getting the full advantage from prefunding requires a trust vehicle, and there are several to choose from.

TRUST REQUIREMENTS

GASB sets out the minimum requirements for a vehicle to be considered an irrevocable trust or equivalent arrangement. First and foremost, the trust must be for the exclusive benefit of plan participants and beneficiaries. In addition, once an employer contribution has been made, it cannot be recovered by the employer. The trust also has to be effectively a legally separate entity under the stewardship of a governing body, and its resources can be used only to pay benefits. Finally, trust resources must be sheltered from the claims of creditors, both of the employer and of the entity administering the arrangement.

A jurisdiction should also consider other trust characteristics that influence investment returns, maximize assets available for the benefit, and affect trust administration. These include:

- Allowing for a diversified portfolio of long-term and short-term investments.
- Allowing for sufficient funding (e.g., acceptable contribution limits).
- Ensuring that trust earnings are exempt from federal and state taxes.
- Ensuring that employer contributions to the trust are not taxable.
- Affording pre-tax treatment to employee contributions (through mandatory employer pick-ups and/or leave conversions).[1]
- Ensuring that benefit payments from trusts to retirees are not taxable.

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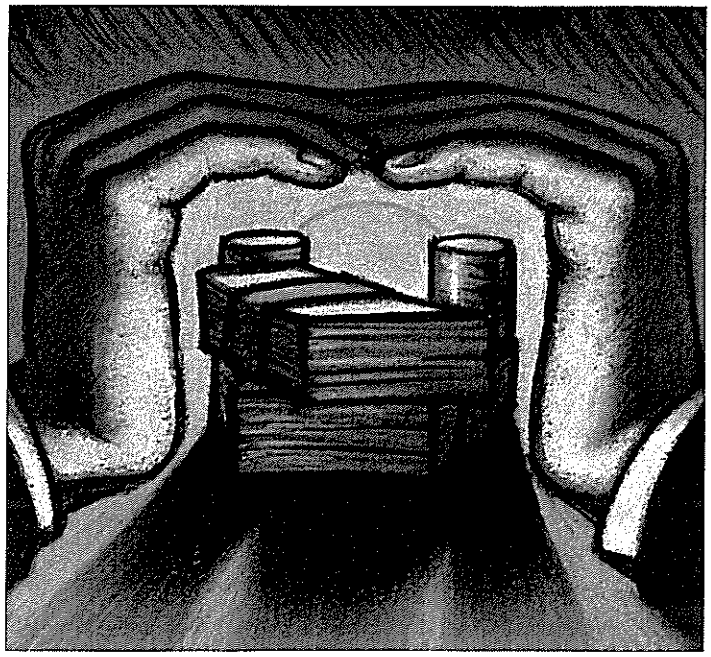
- Protecting funds from creditors of the employees, as well as the employer.
- Minimizing administrative complexity and cost.
- Ensuring that excess funds can be used to reduce normal cost payments.

TRUST OPTIONS

Based on the preceding criteria, there are three main trust options that public employers will want to consider (see Exhibit 2).

401(h) Trust. A 401(h) trust is a separate account that a qualified defined benefit or defined contribution plan can establish for non-pension benefits, including retiree health-care costs. The trust is considered subordinate to the pension plan, meaning that contributions for medical benefits and life insurance cannot exceed 25 percent of total contributions to the plan. Thus, a jurisdiction's ability to prefund its OPEB liability through a 401(h) trust would be restricted if it has a relatively small pension obligation as compared to its retiree benefits, or if it wishes to make a large one-time contribution to the 401(h) subaccount.

Section 115 Trust. A local government can create a Section 115 trust for the express purpose of providing for essential governmental functions. Like a 401(h) account, it allows for a diversified investment portfolio (although there may be state-by-state limitations). A Section 115 Trust offers a great deal of flexibility because it has no limitations on eligibility or participants, no restrictions on funding, and no express restrictions on benefits. However, a jurisdiction should make sure the trust can in fact be established as an entity separate from the plan sponsor (i.e., not part of the government, even though the trust will be used for providing essential government functions).



Voluntary Employees' Beneficiary Association (VEBA). A VEBA is a separate, tax-exempt legal entity allowed under Internal Revenue Code section 501(c)(9) since 1928 for the provision of benefits. Its membership is determined by a common association, but this classification can be very broad and can include both retired and active members as well as their spouses and dependents. VEBAs allow for funding up to 100 percent of a jurisdiction's OPEB liability, although expected increases in health costs may not be permitted in determining limits on funding. These limitations would not restrict most employer's contributions for many years.

TRUSTS AND ALTERNATIVE PLAN DESIGNS

While most governments currently offer retiree health care by paying the premium or a portion thereof, there are other designs. The plan sponsor can guarantee a monthly income, based on years of service, that retirees can use for health-care expenses. Alternatively, an employer can set an amount that will be regularly contributed on behalf of the employee — much like a 401(k) — so contributions and their investment earnings accumulate over the employee's career and can then be withdrawn tax-free for retiree health-care premiums and expenses.

These strategies have advantages and disadvantages for both the employee and employer. Any of the three trusts discussed above may be utilized in this fashion,[2] including establishing individual accounts (in which case a health reimbursement arrangement is used in addition to the trust). When employed this way, all three trust vehicles discussed allow for the conversion of unused leave into credits that can be used as part of the retiree health benefit. This conversion can be done on a pre-tax basis, as opposed to paying it out in a fully taxed lump sum. The Denver Employees Retirement Plan offers one example of an alternative approach, described in the sidebar on page 39.

Trust Type

Trust Characteristic	401(h)	Section 115	VEBA
Satisfies GASB criteria	Yes	Yes[1]	Yes
Eligible beneficiaries	Pension plan participants only. Spouses and dependents	Active and retired employees of an affiliated government. Spouses and dependents	Active and retiree members of a common association. Spouses and dependents
Diversified investment portfolio	Yes	Yes[2]	Yes
Benefits paid tax exempt	Yes	Yes	Yes
Trust earnings tax exempt	Yes	Yes	Yes
Employer contributions tax exempt	Yes	Yes	Yes
Employee contributions afforded pre-tax treatment	Yes, if contributions are mandatory and picked up by the government. IRS approval strongly recommended.	Yes, but only if contributions are mandatory. May contribute "use-it-or-lose-it" sick/vacation time on tax-exempt basis.	Yes, but only if contributions are mandatory. May contribute "use-it-or-lose-it" sick/vacation time on tax-exempt basis.
Funds protected from creditor of employer and employee	Yes	Yes	Yes
Administrative complexity	Low	Moderate	Moderate
Investment infrastructure	Can use infrastructure already established for pension plan	Must establish	Must establish
IRS approval	IRS determination letter may be required, and statutes or plan documents may need to be amended.	Not required, but private letter ruling strongly recommended	Required
IRS reporting requirements	None	None	IRS 990 may be required, and 5500 is required
Treatment of excess funds	Revert to employer	Revert to employer	Transferred to another VEBA providing similar benefits to the same group of members
Contribution limits	Must be subordinate to pension benefit, and 25 percent subordination limit applies to contributions.	None	Up to total OPEB liability (but expected health-care cost increases may not be factored in)

Notes

1. Since the assets in a Section 115 trust are reported on the government-wide financial statements, whether or not this type of structure can be considered separate and apart may depend on state statute. This point does not apply if the organization is able to receive a separate tax identification number for its Section 115 trust.
2. For the same reason as above, investing in a diversified, pension-style portfolio may be dependent on statue statutes, limiting the types of investment options available.

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Public employers can also consider leveraging pension investment expertise as an alternative to setting up their own trusts. Many retirement plans have been investing pension assets with high rates of return for many years, and organizations that have limited investment expertise or smaller asset bases may want to contract with one of these more experienced plans. In this set-up, the smaller organization's assets are held in a separate account for accounting purposes but are invested along with the larger retirement fund's assets. Interest income then accrues proportionally to the account, net an administration fee. Currently, the California Public Employees' Retirement System offers such a program, and several state associations, including the New York Association of Counties and the Georgia Municipal Authority, offer pooled trusts. In many cases, economies of scale make the administrative fee associated with these programs less expensive than establishing and maintaining a separate investment architecture. The ability to pursue such a strategy is largely dependent on state statute and the availability of such expertise.

IMPLEMENTATION CONSIDERATIONS

There are other important considerations for organizations that are considering establishing a trust. The first is to make sure the legal authority for doing so is set out in state statutes. Regardless of which trust an organization decides to use, it must make sure state law specifically allows for the investment of the trust assets for the purpose of funding retiree health care.

A government that chooses to set up an OPEB trust should ensure that it is providing sufficient time, training, and resources to establish this infrastructure. This step is especially important for jurisdictions that don't have experience or expertise with long-term investments. It is essential that governments develop an investment policy that determines the desired asset allocation, establish a governance body to oversee the investments, and consider hiring investment advisors to manage the money. In addition, OPEB intricacies are different from pension liabilities and funding policies; it's a good idea to seek advice from competent OPEB advisors to help with plan structure. A jurisdiction should also consider formally documenting the substantive plan (determined as part of complying with GASB Statement Nos. 43 and No. 45) to clarify which benefits the trust assets can be used for. This plan should be drafted by an employee benefits attorney, and eligibility, continuation, and termination of benefits should be clearly and specifically documented.

Once the trust is established, it should be funded sooner rather than later — the sooner a government funds the trust, the sooner interest income can begin to accrue and the higher discount rate can be applied to its liability. This will result in a lower overall liability and annual required contribution.

THE ADVANTAGES

One of the main advantages to prefunding through a trust is not being required to report an OPEB liability in financial statements. The only way to avoid reporting an OPEB liability is by paying the actuarially determined annual required contribution in full each year (i.e., prefunding the liability) to an trust. (See "OPEB in Perspective: GASB Statement No. 45, Four Years Later," in this issue, for details on accounting for OPEB liabilities.)

One of the main advantages to prefunding through a trust is not being required to report an OPEB liability in financial statements.

Another significant advantage to prefunding through a trust is that it is almost always less expensive than the pay-as-you-go method over the long term. That's because prefunding through a trust allows an employer to treat the money similarly to pension assets and invest it in diversified, long-term assets such as equities, which typically have higher returns than short-term bonds and would therefore further lower the annual required contribution. As a result, employers that prefund using a trust can typically assume higher investment returns than employers that don't, so anticipated investment income *reduces* the amount ultimately reported as the *unfunded* actuarially accrued liability. As noted above, not all states allow employers to invest OPEB trust assets in diversified strategies.

There are additional advantages that are available whether the OPEB liability is prefunded through a trust or by some other means. Most jurisdictions that switch to prefunding their OPEB liabilities find that the annual required contribution cost is three to six times (or more) the amount they had been paying on an annual, cash basis for their retiree health-care expenses.[3] Over the long term, however, prefunding is usually

more cost-effective than the pay-as-you-go method because of health-care inflation rates and the compounding nature of the investment returns. To maximize the cost-effectiveness of a prefunding strategy, a jurisdiction must be able to invest in diversified, long-term assets. As explained above, the ability to do so usually requires a trust, depending on state statues.

Another benefit of prefunding in general is that it promotes the principle of intergenerational equity, which says that governments should strive to finance costs in the period in which they occur so that tomorrow's taxpayers are not paying for today's expenses. Prefunding allows money to be set aside today for benefits earned today, even though the payments are not due until the future.[4]

Prefunding also guarantees funds for promises made to employees. Retiree health-care benefits are a form of deferred compensation. Prefunding this promise to employees in a trust ensures that the money needed to pay for these benefits is not diverted to other commitments. Prefunding also creates a more stable annual expense because regular payments tend to be more predictable than pay-as-you-go allocations, and they also reduce the possibility of spikes in future contributions that can result from chronically underfunding the liability.[5]

THE DISADVANTAGES

There are disadvantages to prefunding through a trust, however, that should be taken into account. One major drawback is the additional governance and investment infrastructure required. Establishing the trust typically entails upfront consulting, legal, and possibly filing fees. And once created, a trust requires trustees, an investment policy, and sometimes a third-party firm to manage the investment portfolio and provide ongoing administration. These outlays add an extra burden and, for jurisdictions that have very small liabilities, the cost of establishing and maintaining a trust may not be worth the expense.

Reduced budgetary flexibility is another consideration. Since the trust is irrevocable, any money committed to it is no longer available for other obligations. However, that constraint must be weighed against the importance of maintaining the promised benefit and maximizing revenue to support that benefit.

There is also a perception that trusts can't accommodate potential changes such as reduced benefit levels or federal universal health care. If properly designed, however, most trust structures will allow assets to be used for other eligible health plans or other employee benefit plan costs, or allow the money to be returned to the employer if the primary purpose is no longer valid.

IMPLICIT RATE SUBSIDY

Employers also need to pay special attention to the implicit rate subsidy, which exists when public employers use the same premium amount for employees and retirees. From a funding perspective, the implicit subsidy has different characteristics from the explicit subsidy (i.e., retiree health care), so the case for prefunding should be madeseparately for each.

Denver Employees Retirement Plan

The Denver Employees Retirement Plan was established in 1963 to provide retirement benefits to employees of the City and County of Denver and the Denver Health and Hospital Authority. In 1991, a separately funded 401(h) subaccount was established to help members with the cost of health insurance by providing a monthly income stream that's applied to the cost of their premiums. Retired members and their spouses and dependents, as well as spouses and dependents of deceased active and retired members, are eligible. The benefit is based on the member's years of service with the employer.

For 2006, members younger than 65 received $12.50 per month per year of service to be applied toward their premiums, and members aged 65 or older received $6.25 per month per year of service. The amount of the reduction cannot exceed the total amount of premiums for which a member is responsible.

The funds may be applied to medical, dental, and/or vision insurance. All members are responsible for paying any remaining balance of the premiums. Most elect to have the balance deducted from their retirement benefits. The plan sends a monthly invoice to those who do not have a large enough retirement benefit to cover the balance due.

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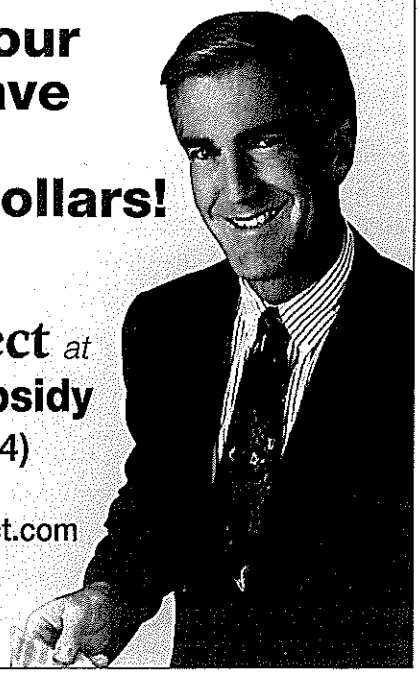

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This is particularly important for jurisdictions that have only an implicit subsidy, which may prefer to maintain a pay-as-you-go strategy for budgetary reasons. However, the implicit subsidy liability is a real liability, and governments that elect not to prefund it through a trust will incur a net OPEB liability on their government-wide statement of net assets, which may have bond rating implications, depending on its magnitude. The Government Finance Officers Association (GFOA) is looking into this matter and will be issuing a recommended practice.

CONCLUSION

While a public employer's decision about how to pay for retiree health-care benefits is crucial, that consideration goes hand in hand with ensuring the sustainability of the benefit itself. For more guidance, see the recent GFOA recommended practice, "Ensuring the Sustainability of Other Postemployment Benefits."[6] Successfully managing an OPEB liability requires multiple strategies, and prefunding is one that deserves consideration.

Notes

1. If eligible medical expenses of employees, former employees, and dependents are being reimbursed, employee contributions are prohibited under the rules for health reimbursement arrangements. The exception to this rule is mandatory employee contributions made on a nondiscriminatory basis and leave conversions.
2. For an excellent discussion of retiree medical trusts, see *Creating a Retiree Medical Trust* by the National Conference of Public Employee Retirement Systems at http://www.ncpers.org/Files/HealthCare/RMTreports_2Ed.pdf.
3. Fitch Ratings, *Old Promises, Emerging Bills: Considering OPEB in Public Finance Ratings* (New York: March 22, 2007) 3.
4. Stephen Gauthier, *An Elected Officials' Guide to Employer's Accounting for Pensions and Other Post-Employment Benefits (OPEB)* (Chicago, Illinois: GFOA, 2005) 20.
5. Ibid
6. Available at http://www.gfoa.org/downloads/sustainabilityopeb.pdf.

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