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Title: Solutions for Funding OPEB in View of GASB's New Reporting Obligations

by

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Introduction

Recent estimates indicate that governmental entities across the United States have a total unfunded liability of $1.4 trillion with respect to costs and obligations for postemployment benefits other than pension benefits (called other postemployment benefits, or "OPEB"). In order to address this growing obligation, the Governmental Accounting Standards Board ("GASB") issued two new reporting and disclosure standards: Statement 43 and Statement 45. The statements set forth by GASB require all state and local governmental agencies, including school districts, public utilities, hospitals and universities, to report costs and obligations for OPEB in their financial statements.

Financial reporting, in compliance with GASB, plays an important role in fulfilling a government's duty to be accountable to public employees, legislative bodies and those who finance that government. GASB Statements 43 and 45 require governmental employers to report the annual cost of OPEB in the same manner pension obligations are reported. In addition, prudence suggests that governmental entities make arrangements to pay promised benefits in accordance with such promises. While GASB Statements 43 and 45 do not require that governmental entities actually fund OPEB, those that do not are in danger of becoming underfunded and may suffer lowered credit ratings, making it much more expensive to borrow money. In addition, governmental entities that choose to fund OPEB may use a more favorable discount rate in calculating total unfunded OPEB liabilities. Consequently, governmental entities should consider establishing a mechanism to fund OPEB.

Overview of GASB Statements 43 and 45

GASB Statement 43 describes financial reporting for other post-employment benefit (OPEB) plans that are pre-funded or administered through a separate trust, whereas GASB Statement 45 describes financial reporting for sponsors of OPEB plans. OPEB benefits can include medical, dental, vision, hearing and other health-related benefits, whether provided separately or through a pension plan, life insurance, disability, and long-term care plans. OPEB benefits do not include severance pay and unused sick leave credits.

From an accounting perspective, as with the cost of pension benefits, GASB Statements 43 and 45 require that the cost of OPEB be associated with the period in which the exchange of benefits occurs. Therefore, GASB Statements 43 and 45 require that OPEB benefits be recognized currently rather than when the OPEB benefits are actually paid. "Pay-as-you-go" reporting, however, does not (i) recognize the cost of benefits when the related services are received by the employer, (ii) represent future potential demands on the employer's funds and (iii) disclose to what extent benefits have been funded. As a result, all current and future OPEB costs and obligations are to be recognized and disclosed in financial statements to more accurately report a governmental entity's liabilities.

In order to comply with the requirements of GASB Statements 43 and 45, governmental entities must obtain an actuarial valuation of the normal cost, unfunded liability and annual required contribution for OPEB. The normal cost is the future cost of OPEB being earned in the current year. The unfunded liability is the accrued liability allocated to previous years for OPEB costs, less the current OPEB assets. Finally, the annual required contribution (ARC) is the normal cost plus the portion of the unfunded liability that is being paid in the current year. The ARC is the actuarially determined amount that must be reported as a liability on an annual basis to fund current and future OPEB obligations.

The frequency of actuarial valuations to compute OPEB obligations for plans with 200 or more total members is at least every 2 years, and for plans with fewer than 200 members, at least every 3 years. If a change occurs that significantly affects costs, a valuation must be done that year. Plans with fewer than 100 members can use an alternative "simplified" method to compute OPEB obligations.

Although many governmental entities may contend that they do not provide retiree health care because they pass along the full cost of health care to retirees, an implicit rate subsidy could create future OPEB obligations. An implicit rate subsidy is created if retirees and current employees are insured together and retirees pay a lower than age-adjusted premium. The additional cost of including retired employees often results in a rate subsidy being paid by the employer and/or active employees because the cost of health care for active employees is less than the cost for retirees (and active employees bear a portion of the additional cost for retiree benefits). This implicit rate subsidy must be recognized under GASB Statements 43 and 45.

The potential consequences of GASB Statements 43 and 45 non-compliance are increased future expenses (including the risk of increased costs associated with medical care and an increased number of future retirees), and large unfunded liabilities. There also can be a credit rating impact for non-compliance.

The implementation of GASB Statements 43 and 45 is staggered based on a governmental entity's annual revenues. If annual revenues for fiscal years ending after June 15, 1999 are $100 million or more, the effective date for GASB 43 would be the fiscal year beginning after December 15, 2005, and the effective date for GASB 45 would be the fiscal year beginning after December 15, 2006. If annual revenues were at least $10 million but less than $100 million, the effective date for GASB 43 would be the fiscal year beginning after December 15, 2006, and the effective date for GASB 45 would be the fiscal year beginning after December 15, 2007. And if annual revenues were less than $10 million, the effective date for GASB 43 would be the fiscal year beginning after December 15, 2007, and the effective date for GASB 45 would be the fiscal year beginning after December 15, 2008.

Because of GASB Statements 43 and 45, governmental entities are faced with benefit adjustment and administrative reform alternatives to manage the potential impact on financial statements. Among the benefit adjustment options available to governmental entities is the ability to increase cost sharing between the governmental employer and employees and retirees. Alternatively, governmental entities may decide to change their current health insurance benefit structure. Under the pay-as-you-go approach currently utilized by many governmental entities, costs could soar in future years based not only on the increased cost of health care but also the increased number of expected retirees over the next 20 years. As a result, many employers may request that employees and retirees bear more of the OPEB costs on a going forward basis. In addition, many governmental entities have only promised benefits, rather than guaranteeing OPEB benefits. In order to comply with the GASB Statements, many governmental entities may choose to forgo providing OPEB. Alternatively, governmental entities could pursue administrative reform options such as creating a GASB trust or issuing bonds to raise revenue to fund future OPEB obligations.

Funding Mechanisms

There are several alternatives governmental entities may consider to fund OPEB. Funding OPEBs will allow governmental entities to offset higher future costs associated with a greater number of future retirees and the increased cost of health care. This paper will focus on two of the available alternatives: Internal Revenue Code ("Code")[1] Section 115 Trusts, and Voluntary Employees' Beneficiary Association (VEBA) Trusts. Both Code Section 115 Trusts and VEBA Trusts provide a tax-exempt mechanism for funding and accumulating benefits. Moreover, if payments from Code Section 115 Trusts and VEBA Trusts are used exclusively to pay for accident or heath coverage of retired employees and their spouses and dependents, the distributions are excludable from the gross income of such retired employees and their spouses and dependents.

Code Section 115 Trust

To comply with GASB Statements 43 and 45, trusts must be irrevocable, and assets must be dedicated to providing benefits to retirees and beneficiaries and legally protected from creditors. One vehicle that can be structured to accomplish these requirements is a Code Section 115 Trust.

Section 115(1) of the Code provides that gross income does not include "income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision thereof." In order to establish a Code Section 115 Trust, several requirements must be met.

[1] Unless otherwise stated, all section references herein are to the Internal Revenue Code of 1986 as amended, and the regulations thereunder.

The first prong of Section 115(1) requires that a Code Section 115 Trust's income must be derived from a public utility or the "exercise of an essential government function." In P.L.R. 200606007, a county-level agency ("Agency") established a trust to pre-fund medical benefits to its retired employees, spouses and dependants who were eligible to participate in Agency's health plan. The IRS determined that as a political subdivision of a state, Agency's provision of medical benefits to former employees, their spouses and dependants, as specified in the Trust document, constitutes the performance of an essential government function within the meaning of Section 115(1).[2]

In addition, the IRS requires that no private interests participate in or benefit from the operation of the Trust.[3] The IRS stated on the application of Section 115:

> To qualify under Section 115, it must be established that the income does not serve private interests such as designated individuals, shareholders of organizations, or persons controlled, directly or indirectly, by such private interests. Thus, even if the income serves a public interest, the requirements of Section 115 are not satisfied if the income also serves a private interest that is not incidental to the public interest. The basic principle underlying Section 115 is that property (including any income thereon) must be devoted to purposes which are considered beneficial to the community in general, rather than particular individuals.[4]

In P.L.R. 200606007, the IRS indicated that no private interests participated in nor benefited from the operation of Agency's trust aimed at pre-funding medical benefits.

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[2] P.L.R. 200606007. The IRS cited two Revenue Rulings in reaching its conclusion:

> In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions is excludable from gross income for federal income tax purposes under Section 115(1). The ruling indicates that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of public utilities or the performance of some governmental function that accrued to either a state or municipality.
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> Rev. Rul. 90-74, 1990-2 C.B. 34, holds that the income of an organization formed, funded, and operated by one or more political subdivisions to pool risks (casualty, public liability, workers' compensation, and employees' health) is excluded from gross income under Section 115(1) of the Code.

Id. Other IRS rulings reason that "the investment of cash balances by a state or political subdivision thereof in order to receive some yield on the funds until needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes and other revenue to fund government expenses." P.L.R. 200626027 (citing Rev. Rul. 77-261, 1977-2 C.B. 45).

[3] P.L.R. 200606007.

[4] P.L.R. 8825027; *see also* U.S. Tax Rep. P 1154.01 (2006).

The requirement for Code Section 115 Trusts is that the income derived from any trust established under Section 115(1) must accrue to a state or any political subdivision thereof (the "Accrual Test"). In P.L.R. 200606007, the IRS pointed out factors that will satisfy this prong of Section 115(1). There, trust assets were to be used for expenditures in providing health care benefits to participants.[5] The IRS indicated that any payments made to an insurance company to either reimburse the insurance company for health care coverage provided to participants or pay administrative expenses of the insurance company in administering the Agency's plan were incidental to the public benefit of Agency's funding of health benefits to participants.[6] In addition, the IRS concluded that any benefit to the participating retirees, their spouses and dependants was also incidental to the public benefit.[7] Finally, the IRS stated that in order to satisfy the Accrual Test, upon termination of a trust satisfying Section 115, "any assets remaining in [the t]rust are to be used solely to meet [Agency's] obligations to provide health benefits to [] participants and to satisfy any other remaining debts or liabilities of Trust. *Any Trust assets remaining after meeting these obligations are to revert solely to [Agency]*."[8] Based on these factors, the IRS concluded that that the income from the Code Section 115 Trust accrued to Agency, a political subdivision of a state, and therefore accrued to a state or any political subdivision thereof within the meaning of Section 115(1) of the Code.[9]

If the three prongs of Section 115(1) are satisfied, the income accumulated by the 115 Trust is excluded from gross income. Moreover, contributions paid to a 115 trust and payments made from such trust that are used exclusively to pay for the accident or health coverage of retired employees and their spouses and dependants as defined in Section 152[10] are excludable from the gross income of the retired employees and their spouses and dependants under Section 106 of the Code.[11]

A major advantage of Code Section 115 Trusts is that an employer retains total control over the assets of the trust (i.e., the employer alone establishes investment strategies which ultimately affect contribution levels). In addition,

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[5] P.L.R. 200606007.
[6] *Id.*
[7] *Id. See also* Rev. Rul. 90-74.
[8] *Id* (emphasis added). Other sources stress this portion of the Accrual Test. Specifically, the Federal Tax Coordinator states:

> To satisfy [the A]ccrual [T]est, a distribution of assets upon dissolution requirement must be met. Specifically, upon its dissolution, the assets of the organization must be distributed to: (a) one or more states, (b) political subdivisions of states, (c) the District of Columbia, or (d) other organizations whose income is excluded under I.R.C. § 115(1).

F.T.C. § D-4109.1 (2006).
[9] *Id.*
[10] The definitions of spouse and dependant are determined without regard to Sections 152(b)(1), (b)(2), and (d)(1)(B), excepting certain individuals from the definition of spouse and dependant.
[11] *See* P.L.R. 200606007; Rev. Rul. 62-199, 1962-2 C.B. 38; Rev. Rul. 82-196, 1982-2 C.B. 53.

unlike VEBA Trusts (discussed below) no IRS approval is required to establish a Code Section 115 Trust (although a Private Letter Ruling is recommended).

VEBA Trust

A second vehicle for funding OPEB is a VEBA Trust. To be a VEBA, an organization must meet all of the following requirements:

(a) The organization (in this case, the trust and its associated employee welfare benefit plan) must be an employees' association.

(b) Membership in the association must be voluntary.

(c) The organization must provide for the payment of life, sick, accident or other benefits to its members.

(d) No part of the net earnings of the organization can inure, other than by payment of the benefits referred to in (c) above, to the benefit of any private shareholder or individual.

Treasury Regulations Section 1.501(c)(9)-2(C)(3) requires that an organization must be controlled (i) by its membership, (ii) by independent trustee(s) (such as a bank), or (iii) by trustees or other fiduciaries at least some of whom are designated by or on behalf of the membership. Whether such control by or on behalf of the membership exists is a question to be determined with regard to all the facts and circumstances. Private sector plans get the benefit of a special rule which states that "an organization will be considered to be controlled by independent trustees if it is an employee welfare benefit plan, as defined in Section 3(1) of the Employee Retirement Income Security Act of 1974 (ERISA), and, as such, is subject to the requirements of parts 1 and 4 of Subtitle B, Title I of ERISA." Public sector plans, however, are not subject to ERISA Section 3(1), and consequently must demonstrate acceptable control under Treasury Regulation 1.501(c)(9)-2(C)(3).

The leading case on this control requirement is the Court of Claims decision in *Lima Surgical Associates, Inc. Voluntary Employees' Beneficiary Association Plan Trust v. U.S.*[12] The decision in *Lima* is very explicit in terms of enumerating what provisions in the trust refuted control by an independent bank trustee:

(1) Employer retained power to direct the trustee in the exercise of any of the powers otherwise granted to the trustee.

(2) Employer could appoint an investment manager to direct the trustee relative to investing trust assets.

[12] 20 Ct. Cl. 674 (1990).

(3) Employer retained "omnipotent control," including the power to dictate the disposition of all or any part of the trust fund, the investment of the trust fund, pledge of trust assets as collateral, settlement of claims, exclusion of instruments, retention of uninvested cash, and employment of agents.

(4) Employer controlled disbursements from the trust fund.

(5) Employer indemnified trustee against any liability for action taken under direction of employer.

(6) Employer could engage trustee as employer's agent without an additional fee.

(7) Employer had right to amend or terminate the trust at any time.

(8) Employer had right to discharge trustee.

Consequently, one feature of VEBAs is that it must be controlled by its membership or independent trustees. Because the ability to invest the assets in the VEBA Trust controls the ARC, the governmental entity will lose control over funding under this alternative.

In addition, Code Section 505(b) establishes complicated nondiscrimination rules for VEBAs. Specifically, in order to remain exempt from tax, a VEBA must satisfy the requirements of Code Section 505(b).[13] In the case of any benefit for which a provision of the Internal Revenue Code contains specific nondiscrimination rules, Code Section 505(b) does not apply and the Code Section 505 general nondiscrimination rules will only be met if the nondiscrimination rules so provided are satisfied with respect to such benefit.[14]

Under Section 505, the coverage of a VEBA must be nondiscriminatory and benefits must be provided on a nondiscriminatory basis.[15] Each class of benefits must be provided to a classification of employees, and in a manner, that does not discriminate in favor of highly compensated individuals.[16] The classification must be described in the plan and the IRS must determine that it does not discriminate.[17]

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[13] I.R.C. § 505(a).
[14] *Id.* at 505(b)(3).
[15] *Id.* at 505(b)(1).
[16] *Id.* "A life insurance, disability, severance pay, or supplemental unemployment compensation benefit shall not be considered to fail to meet the requirements of [this subparagraph] merely because the benefits available bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of employees covered by the plan." *Id.*
[17] In testing whether the benefits are available to a nondiscriminatory classification of employees, employees who decline to make required contributions must be considered.[17] On the other hand, in

The nondiscrimination rules associated with VEBAs can be extensive and complicated. Coupled with the lack of employer control associated with VEBAs and the need to obtain a determination letter, a Code Section 115 Trust may present a better alternative for governmental entities.

Enabling Legislation

Many states have "cash basis" and "budget" laws that prevent governmental entities from incurring indebtedness in any year in an amount exceeding the income and revenue derived in such year, plus any unencumbered balances from previous years. In addition, governmental entities are often limited to investing in certain debt instruments. In order to establish a Code Section 115 Trust or a VEBA Trust, many states must adopt enabling legislation providing the ability to fund a retiree benefits fund to pay OPEB and the ability to invest in equity securities. In other words, the legislation must allow governmental entities to establish trusts to fund retiree health benefits in the same manner that most governmental entities currently fund pensions.

In Kansas, for example, legislation was recently passed addressing the ability to fund OPEB and to create a Code Section 115 Trust (Senate Bill No. 232). Senate Bill No. 232 provides an exemption from the cash basis and budget laws for funds established to pay OPEB. In addition, Senate Bill No. 232 permits contributions to a fund established to pay OPEB to be invested in accordance with the terms of the OPEB plan and the prudent investor rule. You can review Kansas Senate Bill No. 232 at *http://www.kssos.org/pubs/register/2007/Vol_26_No_15_April_12_2007_p_465-496.pdf*. *See also e.g.*, Alabama Senate Bill No. 3, Act 2007-16 (authorizing the creation of OPEB trusts); Delaware Senate Bill No. 136, Ch. 70 (establishing an OPEB fund); Georgia Senate Bill No. 156, Act 23 (authorizing the creation of OPEB trusts); Louisiana House Bill No. 759, Act No. 202 (authorizing the creation of OPEB funds).

Alternatively, other states may require a constitutional amendment to permit governmental entities to establish a retiree benefits fund to pay OPEB. For example, in Missouri, Article VI, Section 26(a) of the Missouri Constitution limits the indebtedness of a county, city, incorporated town or village, school district or other political corporation or subdivision to an amount not greater than the income and revenue provided for such year plus any unencumbered balances from previous years. In addition, annual budgets adopted pursuant to Article VI,

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testing for discrimination, certain employees who are not covered by a plan may be excluded from consideration. These employees are those who:

(1) have not completed three years of service with the employer;
(2) have not attained age 21;
(3) are seasonal or less than half-time employees;
(4) are included in a collective bargaining unit (if the benefits involved have been the subject of good faith bargaining); and

(5) are nonresident aliens who receive no U.S.-source earned income from the employer. *Id.* at § 505(b)(2).

Section 24 of the Missouri Constitution generally prohibit expenditures from exceeding revenues, with limited exceptions.[18] While Article VI, Section 25 of the Missouri Constitution authorizes payment from any public funds into a fund or funds for paying benefits upon retirement, it is limited to persons employed in educational services. Consequently, Missouri would need to expand the scope of Article VI, Section 25 of the Missouri Constitution (or adopt a new constitutional amendment) to permit governmental entities not engaged in educational services to establish a retiree benefits fund to pay OPEB.

Finally, at least one state has decided to side-step GASB reporting obligations all together. Recently, the Texas House passed a bill permitting state and local governments in Texas to opt out of GASB Statement 45. The Texas Senate eventually passed the bill in May of 2007, and the Governor signed the bill in June. The new law allows Texas governmental entities to choose whether or not to comply with the GASB standard. In support of the new legislation, Texas legislators have argued that governmental entities must still report the information required by GASB, but that governmental entities are not required to report future OPEB obligations as a liability. In other words, Texas legislators are arguing that transparency is the important part, not how the obligation is ultimately reported. In addition, many Texas governmental entities have only promised to provide OPEB for a fixed number of years (e.g., two years) and may discontinue the benefits at any time. Consequently, there is the possibility that employees of governmental entities in Texas will not receive the OPEB originally promised to them. *See also e.g.*, http://www.webcpa.com/article.cfm?articleid=24424 (discussing a bill before the Connecticut senate that aims at bypassing GASB's requirements).

While many states have already enacted legislation to permit governmental entities to fund OPEB, others must do so before governmental entities can begin to fund OPEB in a fiscally responsible manner. Without enabling legislation, governmental entities will not be able to explore all funding mechanisms for OPEB (e.g., Code Section 115 Trusts and VEBA Trusts). As a result, governmental employees run the risk of not receiving OPEB originally promised to them, and governmental entities run the risk of decreased credit ratings that could affect the ability to borrow money.

[18] *See e.g.*, Mo. Rev. Stat. § 67.010.