Section 115 Trusts

Considerations for Public Agencies for Funding OPEB Obligations

Across the country, public agencies, corporations, and individuals face the challenges of funding increasing retirement benefit costs. One of the major reasons that retirement benefit costs continue to rise is due to lower expected future investment returns. Although there are many approaches and tools to address retirement benefit costs for public agencies, in this summary we will focus on how a **Section 115 Trust** can be used as a tool to meet the challenges of increasing retirement benefit costs for other post-employment benefits (OPEB) and pension costs.

OPEB obligations are benefits other than pensions that a state or local government employee receives as part their retirement package. Retiree medical benefits are the most common type of OPEB, but they can also be utilized to prefund other benefits such as life insurance. According to the Reason Foundation's February 2021 Survey of State and Local Government Other Post-Employment Benefit Liabilities, state and local governments have $1.2 trillion of net OPEB liabilities, primarily health care commitments for retired public sector workers[i]. In 2019, the Pew Charitable Trust estimated a $1.28 trillion state pension plan funding deficit (the difference between a state retirement system's assets and liabilities.) One tool to help prefund these commitments, potentially minimizing the costs, is a Section 115 Trust directed toward funding these liabilities.

> *By placing funds in a Trust, public agencies can potentially earn a higher rate of return on the Trust assets with the goal of lowering long-term debt.*

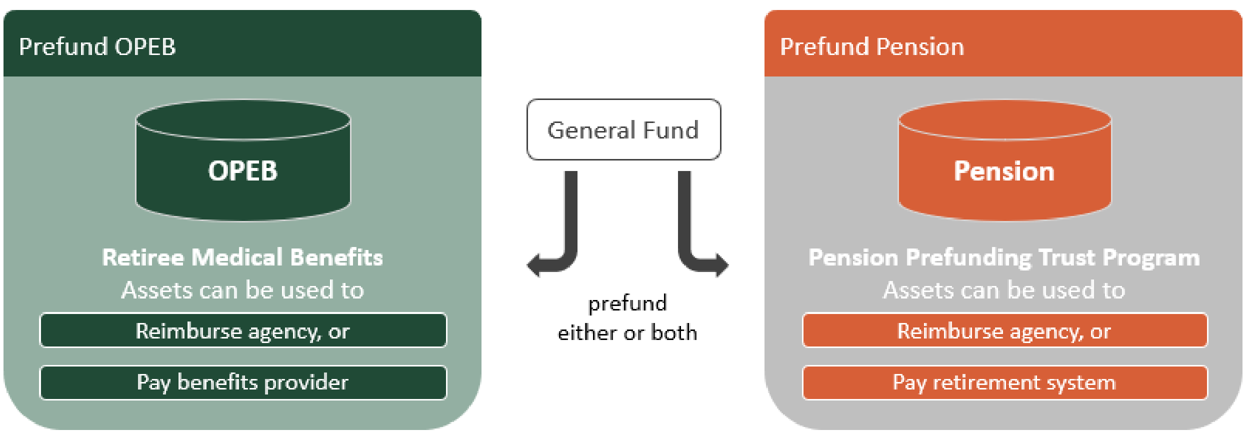
What is a Section 115 Trust?

A Section 115 Trust (Trust) gets its name from Section 115 of the United States Internal Revenue Service Internal Revenue Code (IRC). These Trusts are established for the exclusive purpose of funding public agencies' employee benefit obligations, and are entitled to certain tax benefits, particularly exemption from income tax. Trusts have been historically used for funding OPEB obligations, but since 2015 they have become popular vehicles to fund retirement benefit obligations using a pension rate stabilization trust (PRST) and in some cases incorporating both the OPEB and PSRT into one document. The Trust is irrevocable, which means that the Trust, along with any funds contributed, cannot be changed, reversed, or recovered. In addition, all assets held in a Trust are legally protected from creditors of the employer and are not subject to income taxes. Since the funds in the Trust are irrevocably committed, they can be invested in accordance with the rules governing the special purpose accounts, which in many cases allows for a broader universe of permitted investments.

Structuring a Section 115 Trust

Once the Trust is established, public agencies typically utilize the services of external service providers to administer the program. Three service providers are required for a successful program – *the Trust administrator, custodian, and investment advisor*. The Trust administrator can either be an internal employee of the public agency, or external consultant responsible for implementing the directives of the governing body and coordinating other tasks related to the administration of the program. The custodian holds the assets of the Trust, collecting, accounting, and reporting on the assets and any activity in the account. The custodian is typically a regulated bank and should be independent of the investment advisor. Although investing the assets can be done internally, most public agencies outsource this responsibility to an independent investment adviser who develops an investment strategy to meet the goals of the public agency while adhering to the Trust. This includes developing an investment policy for the funds placed into the Trust. There is also greater local control of the investment strategy for the assets and the ability to make changes along the way. Start-up costs for single employer Trusts are typically higher, but ongoing costs may be lower as the assets grow, and the fixed costs are spread across a larger base of assets. Careful evaluation of the Trust and the costs related to the program are essential before contracting for these services to ensure the program will achieve the goals of the public agency.

How Can a 115 Trust Be Structured?



Types of Trusts

Typically, there are two types of 115 Trusts: *single employer* and *multiple employer trust*. It is important to understand the advantages and disadvantages of each when establishing or joining a 115 Trust.

Single employer trusts allow the employer to have more local control over the creation and structure of the Trust document. With a single employer Trust, a public agency has greater flexibility in hiring of service providers at inception as well as during the engagement. If a change to one of the providers of the Trust is required, they can be added or removed without affecting the other providers. There is also

A **multiple employer Trust** typically has a lower startup cost with several established turnkey program providers offering solutions. There is little to no local control in creating the Trust document, which lowers the startup costs but limits ongoing flexibility. Some providers of multi-employer turnkey programs have a Trust in place along with an IRS Private Letter Ruling (PLR). Although a PLR provides a level of assurance that the Trust is written in a manner consistent with its purpose, it is not a requirement. Trusts are so common, and the IRS has issued so many formal rulings that it is no longer issuing PLRs for this type of Trust and it is not required to implement the program.

Typically, these programs also have less flexibility related to influencing service providers used in the program and have prearranged investment options to choose from. Careful evaluation of the Trust and the fee for a turnkey program is essential before contracting for this service to ensure it aligns with the public agency's goals.

In Summary

The challenge to fund and manage retirement benefit costs for public agencies across the country will continue to be with us for the foreseeable future. The goal of this whitepaper is to shed some light on some available options to help address and mitigate these challenges. Funding retirement benefits is a complex problem and Section 115 Trusts are a tool, in a broader array of decisions and actions, that can be taken to mitigate the effect of rising retirement benefits costs on a public agency's financial condition. As with all complex decisions, it is recommended that public agencies research the topic and seek out advice from peers, professional associations, and legal counsel to help secure the benefits of their employees.

Jayson Schmitt, CFA
Deputy Chief
Investment Officer

Questions?

Please contact Chandler at info@chandlerasset.com, or toll free at 800-317-4747 with any questions or to learn about investment management solutions for public entity investment programs.

Resources

1. http://focusonpublicbenefits.com/using-a-section-115-trust-to-help-manage-pension-obligations/
2. https://www.gfoa.org/materials/establishing-and-administering-an-opeb-trust
3. https://www.csmfo.org/wp-content/uploads/2018/03/b4U14ZD7gWZoPVH1advFchmPZ5fn7Tz9DZVZ.pdf
4. https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2020/06/the-state-pension-funding-gap-2018#:~:text=At%20%241.24%20trillion%2C%20the%2050,due%20to%20strong%20investment%20performance.

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[i] https://reason.org/policy-study/survey-of-state-and-local-government-other-post-employment-benefit-liabilities/