# BEST PRACTICES FOR SCHOOL DISTRICTS

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DESIGNING, FUNDING AND PAYING POST-EMPLOYMENT BENEFITS

ESTABLISHING SCHOOL DISTRICT POST-EMPLOYMENT BENEFIT PLANS: A HOW-TO-GUIDE
Julie A. Lewis, J.D.

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# Best Practices for School Districts

## DESIGNING, FUNDING AND PAYING POST-EMPLOYMENT BENEFITS

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## INTRODUCTION

In the world of competitive hiring practices, strategic retention objectives and increasing legal and financial compliance obligations, a school district's compensation decisions should be data-driven and technically accurate. School districts offer post-employment benefits to attract and retain the best and the brightest educators and staff.

Post-employment benefits may comprise a major financial component of school district compensation plans including supplemental retirement income accounts, retiree welfare benefit plans, non-elective 403(b) contributions, deferred paid time off, Health Reimbursement Arrangements (HRA), Health Savings Accounts (HSA) and other tax qualified plans or programs. Post-employment plan design, account funding and benefit payment is regulated by federal and state law, governed by tax law and reported under GASB Statements 67, 68 and 73 (Pensions) and GASB Statements 74 and 75 (OPEB) for accounting purposes.

This three-part series will assist readers with understanding the various legal and financial obligations that presently shape post-employment benefit programs and provide guidelines to help school district business officials and boards of education navigate compensation decisions.

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*The first article* provides background on tax qualification, the Wisconsin Uniform Prudent Investor Act, COBRA continuation for post-employment medical plans and post-employment benefit reporting and documentation. *The second article* reviews the actuarial tools that support OPEB and Pension best practices including plan trend analysis; cash flow projections; proper planning for reserves and how to understand, use and rely on relevant actuarial data. *The third article* addresses OPEB and Pension plan funding – further considerations for pre-funding, fiduciary requirements and how to achieve a prudent balance of short and long-term funding objectives.

# Establishing School District Post-Employment Benefit Plans: A How-to-Guide

A school district's post-employment benefit plan may come in several varieties. Intended to provide financial assistance to retirees and former employees, post-employment benefit plans offer supplemental compensation (403(b), 457(b), 457(f), other TSA plans), help finance medical costs up to and after Medicare entitlement (post-employment Health Reimbursement Arrangements (HRA), Health Savings Accounts (HSA), deferred paid time off plans) and pay for other post-employment benefits (OPEB) like disability insurance, long term care insurance, life insurance and other non-pension retiree benefits.

Post-employment benefit plans must be established, reported and funded consistent with federal and state law and Government Accounting Standards Board (GASB) Statements 67, 68 and 73 (Pensions) and 74 and 75 (OPEB). The first article in this series, by Attorney Julie Lewis, examines the steps involved in establishing some common post-employment benefit plans. In the second article in this series, Linda Mont, CSRM, RHU and Senior Benefits Consultant with Key Benefit Concepts, LLC, will discuss the GASB requirements. In the third article, both authors will discuss the legal and financial reporting requirements related to funding post-employment benefit plans.

### Structure and Tax-Qualification

The value of any post-employment benefit plan is its special utility to the school district and to plan participants. Post-employment benefit plans may be adopted to reward the long-term service of retirees, facilitate early retirement, attract competitive job candidates or a combination of these objectives. Many of these benefits receive tax-deferred or tax-exempt status when they are properly structured and administered. As school districts do not pay income tax, the tax benefits are important for plan participants. If a plan lost its tax-deferred or tax-exempt status, the retroactive tax would be assessed against the plan participant.

**Post-employment compensation plans** – Employer-funded 403(b) plans are a common vehicle for post-employment compensation funding. Funds are taxed at distribution. Non-elective employer payments to 403(b) plans are not subject to employment tax; however, post-employment payments must be completed within five years of the last day of the taxable year the employee retired to remain exempt from employment tax.[1] Interest and earnings that accrue on pre-funded 403(b) non-elective contributions to a section 115 governmental or other qualified trust are exempt from federal income tax.[2]

A 403(b) plan must be described in writing in either the authorizing state statute, Board of Education resolution or policy, a plan document or an employment contract. The benefit that plan participants are eligible to receive must be described so that the benefit is "definitely determinable." Only school district employees may participate. Section 403(b) plans that include participants who are not school district employees (including board of education members, independent contractors and some charter school employees) may be disqualified.

The plan can offer different levels of benefits based on job classification. An age limit, however, could violate the Age Discrimination in Employment Act (ADEA) unless the school district can prove that inclusion of plan participants over a certain age would create an excessive cost burden for the school district. Employees who are hired within five years of the school district's normal retirement age and employees hired when they are older than the school district's normal retirement age can be excluded from plan participation without violating the ADEA.[3]

**Post-Employment HRAs** – Wisconsin school districts that have future retiree medical benefit obligations may add a post-employment HRA or replace a longstanding cash subsidy plan with a post-employment HRA. A post-employment HRA can be structured to the school district's chosen eligibility criteria – typically, a combination of years of service and full Wisconsin Retirement System (WRS) retirement. Graduated contributions based on prior collective bargaining agreement obligations, job classification, years of service or some other objective criteria are common.

An active employee HRA and a post-employment HRA are two different benefits with two different sets of legal requirements but both require a written plan. An active employee HRA is an employer-funded medical reimbursement plan that is intended to help an active employee pay for the employee's share of the cost of employer group health plan participation. Unused funds roll over from year to year until the employee terminates employment with the employer at which time any unused funds are forfeited to the employer. Forfeited funds may be contributed to the employee's post-retirement HRA as long as the contribution process avoids a cash-out to the retiree or former employee.

An active employee HRA must be integrated with an Affordable Care Act (ACA)-compliant group health plan and cannot be used to reimburse the employee's medical expenses incurred under an individual health plan such as those offered through Healthcare.gov. An active employee HRA is subject to COBRA continuation. Active employee HRA participants should receive a differentiated HRA-specific COBRA notice when a qualifying event occurs that results in a loss of active employee group health plan coverage.

*A retiree HRA* is an employer-funded account to which an employer can make tax-exempt contributions to pay for qualified medical costs incurred by the employee, spouse and qualified dependents after retirement. Retiree HRA eligibility criteria is established by the school district and may include years of service, certain job classifications, full retirement from the school district as provided by Board of Education policy (*e.g.*, timely written notice) and full WRS retirement. Although the school district may engage a third-party administrator to process claims, the school district, as the plan sponsor, remains responsible for plan oversight and administration.

School districts can pre-fund retiree HRAs; however, retiree HRA funds would not be contributed to the retiree's HRA account or debit card until the retiree meets the plan's eligibility requirements. The eligible retiree can then draw on the retiree HRA to pay for qualifying post-employment medical costs including costs that the retiree may incur under the school district's retiree group health plan (if offered), Medicare supplemental coverage including Parts C and D, or coverage under an outside health plan including a spouse's group health plan. A retiree HRA can be funded with scheduled employer contributions, deferred paid time off or a combination of these options.

If the plan allows, a retiree HRA may include a survivorship benefit that allows a surviving spouse and/or qualified dependents to continue to draw on the account funds to reimburse their qualified medical expenses. If funds remain in the retiree HRA after the retiree passes away and after the surviving spouse either passes away or remarries and after eligible dependents age out of the plan or otherwise become ineligible for coverage, the remaining funds are forfeited to the employer. Remaining retiree HRA funds may not be cashed out to the retiree's beneficiaries or heirs. Once the account funds have been used, the retiree HRA terminates. There is no right to COBRA continuation for a retiree HRA.

## Plan Adoption

In addition to meeting Board of Education policy requirements for the OPEB or post-employment benefit plan, a plan should be evaluated by the Board of Education's Finance Committee and presented to the full Board for adoption in open session. Once the plan is adopted, benefits can be paid currently from general operating funds or prefunded as provided under federal and state tax law. If prefunded, Wisconsin law also sets out related school board duties.

## Wisconsin's Investment Enabling Legislation

Wis. Stat. § 66.0603 enables school districts to invest pre-funded OPEB and other post-employment benefits outside of the State of Wisconsin Investment Board options.[4] This enabling legislation requires school boards to:

- Invest as authorized in the Wisconsin Uniform Prudent Investor Act, Wis. Stat. § 881.01;
- Hold funds in separate trust accounts;
- Post, as a separate Board of Education meeting agenda item, notice of any discussion or vote on OPEB and post-employment investments;
- Delegate investment authority only to a registered Investment Manager as defined by statute;
- Annually renew the investment agreement and annually review the performance of the Investment Manager under the Wisconsin Uniform Prudent Investor Act requirements;
- Publish an annual written report on the status of school district funds in trust.

Section 66.0603 mandates a specific procedure for school boards that choose to invest OPEB and other post-employment funds with an outside Investment Manager.[5] A discussion or vote on OPEB and post-employment investments must be noticed on the Board of Education's agenda as a separate item. Similarly, Boards of Education must review the school district's investment agreement, including the investment policy statement, and review the performance of the selected Investment Manager on an annual basis. Further, the Board of Education must publish an annual written report that provides information on the amount in the trust, the investment return, total disbursements from the plan and the name of the Investment Manager.[6]

## Uniform Prudent Investor Act

When a school district elects to invest OPEB and post-employment funds with an outside investment manager, the Board of Education's OPEB and post-employment benefit oversight is also governed by the Wisconsin Uniform Prudent Investor Act which sets out the local government's statutory fiduciary requirements as they apply to the school district's investments.[7] The Wisconsin Uniform Prudent Investor Act establishes the "prudent investor rule" which governs a Board of Education's OPEB and post-employment benefit oversight and administration. The "prudent investor rule" says that the Board of Education "shall invest and manage assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances" of the OPEB or post-retirement benefit. "In satisfying this standard, the [Board of Education] shall exercise reasonable care, skill, and caution."[8]

When considering post-employment fund investment management choices, a Board of Education shall consider general economic conditions, the possible effect of inflation or deflation, the expected tax consequences of the investment decisions, the role that each investment plays within the overall portfolio, the expected total return from income, other resources of the plan participants, the need for liquidity, regularity of income and preservation or appreciation of the principal investment.[9]

Boards of Education that have invested OPEB and post-employment funds with an investment manager also have the duty to confirm that the investments are diversified, a duty of loyalty to invest and manage the investments only for the benefit of plan participants and beneficiaries and a duty of impartiality with respect to the Board's investment and management decisions.[10]

What does this mean for Boards of Education that have decided to prefund their OPEB and post-employment liabilities? Fund investment should be managed with a Uniform Prudent Investor Act checklist and the Board's compliance actions should be well-documented. Although the prefunded benefit does not "vest" or otherwise belong to the employee until all of the benefit's eligibility criteria are met (*e.g.,* typically documented retirement from the school district), the promised benefit is a reported financial obligation and, possibly, a contractual requirement once the precedent conditions are met. The benefit may also be a matter of Board of Education policy.

Some post-employment benefits are prefunded well into the future when circumstances can change. Annual, recurrent legal compliance documentation is the best defense against a claim of illegal, improper or unfair Board of Education decision-making. The Uniform Prudent Investor Act addresses this compliance documentation requirement by charging the Board of Education with the obligation of making "a reasonable effort to verify facts relevant to the investment and management of assets."[11]

Two final, but very important, Board of Education duties under the Uniform Prudent Investor Act relate to investment costs and to the duties for the delegation of investment and management functions. The Wisconsin Uniform Prudent Investor Act makes the Board of Education responsible for ensuring that invested OPEB and post-employment funds incur only costs that are appropriate and reasonable in relation to the fund assets.[12] Before a Board of Education can ensure that investment costs are appropriate and reasonable, the Board must know what the costs are, obtain an appropriate benchmark comparison and conduct a regular (annual) cost review. Investment costs come in many varieties and are not always easy to identify. Costs may include wrap fees, administrative fees, 12b-1 fees, transaction charges, expense rations, "load" fees, commissions and purchase/redemption fees. The school district's trust agreement and/or investment manager agreement should include a contractual requirement for full, regular cost disclosure to the Board of Education.

As most governing boards would do, the board will delegate the day to day investment and management function to a custodian and investment manager.[13] In this case, the Board of Education must exercise reasonable care, skill and caution in its duties of (1) selecting an investment manager, (2) establishing the scope and terms of the delegation consistent with the terms of the OPEB or post-employment benefit plan, (3) periodically reviewing the scope and terms of the delegation consistent with the terms of the benefit plan, and (4) periodically reviewing the investment manager's performance and compliance with the contract between the school district and the investment manager. This obligation includes retaining a registered investment manager, making a fully informed decision when adopting an investment policy statement for the school district, ensuring funds are managed to maintain tax-exempt or tax-deferred status for plan participants, adopting a fee policy statement and engaging in the regular monitoring that Wis. Stat. §§ 66.0603 and 881.01 require in detail.

## Conclusion

School boards, district administrators and finance administrators must become current with the legal, financial and tax obligations that govern their OPEB and post-employment benefits. Technical mistakes can result in the imposition of excise taxes or loss of the benefit's tax-preferred status for employees and retirees. As with any obligation that requires detailed compliance, regular compliance schedules will provide both an accurate checklist and documentation of the Board of Education's actions. Although cyclical, there is an extra emphasis on the importance of these steps when OPEB and post-employment funds can benefit from strong market returns.

1/ I.R.C. § 3121(a)(5)(A), Treas. Reg. § 1.403(b)-4(d) says, "(1) (A former employee is deemed to have monthly includible compensation under section 415 for the period through the end of the taxable year of the employee in which he or she ceases to be an employee and through the end of the next five taxable years. Nonelective employer contributions for a former employee made after the five year window expires will be included in the former employee's gross income)."
2/ I.R.C. § 115.
3/ E.E.O.C. Regs. § 1625.10(f)(1)(iii)(A).
4/ Wis. Stat. § 66.0603(1m)(b)(2) and (3).
5/ Wis. Stat. § 66.0603(1m)(b)(4).
6/ Wis. Stat. §§ 66.0603 (1m)(b)(6), (2) and (3).
7/ Wis. Stat. § 66.0603 (1m)(b)(3); Wis. Stat. § 881.01.
8/ Wis. Stat. § 881.01(3)(a).
9/ Wis. Stat. § 881.01 (3)(c).
10/ Wis. Stat. § 881.01 (4), (6) and (7).
11/ Wis. Stat. § 881.01 (3)(d).
12/ Wis. Stat. § 881.01 (8).
13/ *See, Estate of Kugler*, 344 N.W.2d 160 (1984) (a fiduciary's duty to manage funds as a prudent person ordinarily includes a duty to reasonable invest funds not needed for claims or expenses. A court properly imposed a surcharge against a fiduciary who breached the duty by allowing funds to lie idle in a noninterest bearing checking account.)

# Understanding School District Post-Employment Benefit Plans

Post-employment benefits are any benefits provided to an employee after severance of employment – thus, the term "post-employment benefits." This may include payout of accumulated unused sick leave or unused vacation, dollars paid by the District to a former employee via a 403(b), 457(b), or other similar plans as well as continued health dental, vision, life, HRA, HSA or other similar benefits. There are also circumstances wherein termination benefits are provided. However, this is infrequent and would be confusing to address herein.

| GASB Statement | Type of Benefit | Description |
|---|---|---|
| 16 | Compensated absences | Payout of accumulated unused sick leave or unused vacation to a former employee |
| 67, 68, 73 | Pension | District contributions to a former employee via a 403(b), 457(b), 457(d) or other similar plan |
| 74, 75 | Other Post-Employment Benefit (OPEB) | District contributions to health, dental, vision, life, HRA, HSA, or other similar benefits in addition to implicit rate subsidy for continued health coverage. |

Note: There are circumstances wherein termination benefits (GASB 47) are provided. However, this is infrequent and would be confusing to address herein.

An actuarial valuation of post-employment benefits is a calculation of the expected value of the benefit to the District's actives and former employees as of a given point in time. It is based upon the census of actives and former employees at the time of the valuation. The valuation typically does not include a projection of additional benefits earned in the future nor does it include the impact of new employees hired on or after the valuation date (unless the valuation report includes the present value of future benefits (PVFB), which may be included but is not required).

### Implicit Rate Subsidy

The GASB guidelines require that the OPEB be based upon the value of the health care benefit. When the benefits are insured, the value above the premium cost of benefits must be determined. This applies to all classifications and arises from the value of benefits in excess of the payments made by the District during the guaranteed period. This amount is determined and incorporated in the actuarially-determined liability of the health care benefit.

Note also that since GASB guidelines require the OPEB to be based upon the value of the health care benefit, when an individual *self-pays* 100% of the premium cost (or for COBRA 102% of the premium). Thus, the valuation also includes the difference between the premium cost and the value of the benefit. This is known as the Implicit Rate Subsidy.

### Misconceptions Regarding Post-Employment Benefits

There are many misconceptions regarding these benefits. Below are some of the most common:

**All post-employment benefits are 'retirement' benefits.** Post-employment benefits may be retirement benefits – that is, the former employee must retire from the district to be eligible for the post-employment benefit. This is sometimes referred to as a retirement benefit. However, eligibility for the post-employment benefit may not require the former employee to retire from the district, but rather to meet other criteria including severance of employment to be eligible for the given benefit.

**All post-employment benefits are OPEBs.** Often post-employment benefits are addressed as OPEB, but when deciphering what is actually provided to former employees, it is discovered that more than continued health-related benefits are provided. This can cause confusion when asking for an actuarial valuation as some actuaries will only address the actual OPEB benefits in a valuation. When the report is provided to the auditor, it may be discovered that additional actuarial services are needed to address non-OPEB benefits.

**If the District doesn't provide contributions to continued health coverage and/or limits continued coverage to COBRA, the district doesn't have an OPEB obligation. This can be true but is not always true**. Implicit Rate Subsidy exists when a district's former employees and current employees are covered together as a group wherein the premium rate or premium equivalent rate paid by the former employees may be lower than they would be if this group of individuals were rated separately. The final GASB Statements declare that even if the former employees pay 100% of the premium, without a contribution from the employer, the employer is required to treat the implicit rate subsidy as another post-employment benefit (OPEB) liability.

Since ACT 10, districts have been limiting the ability of all former employees to remain on the district's plan to the term of COBRA continuation. We would expect that COBRA would be limited to a very small group of former employees and would include a range of demographics, thus creating a minimal or immaterial implicit rate subsidy. However, this may not always be true. As part of the actuarial valuation, it is important to review the number and demographic make-up of COBRA continues - current, historical and future expectations.

Information regarding COBRA on HRA plans was noted in the first article. Additional information regarding COBRA is also provided later in this article.

## Data Collection and the Valuation Process

Actuarial methods and tools supporting OPEB and pension best practices include plan trend analysis, cash flow projections, proper planning for reserves and the ability to understand, use and rely on accurate and complete information from the District as well as relevant actuarial data.

The old saying "garbage in, garbage out" applies when performing an actuarial valuation. It is absolutely imperative that the complete and accurate eligibly and benefits are determined and agreed upon before the valuation begins. If this information is incomplete or incorrect, the results of the valuation may be impaired. Therefore, it is extremely important that before the valuation begins, the information provided (census, premium and claim history, etc.) is thorough and accurate.

Further, if the District is contemplating a change in eligibility or benefits, it is important to share this information with the actuary before the valuation occurs. Depending upon the complexity of the proposed modification and the expected timetable of the change, it may be included in the valuation as an option or the valuation may be postponed until the final decision is made. Noting this information allows the opportunity to discuss the situation and agree to an appropriate approach.

Actuarial Assumptions include:

- Discount and Inflation Rates
- Medical Trends
- Salary Merit Increases and Wage Inflation
- Decrement Assumptions (i.e. rates of retirement, turnover and disability)
- Mortality Rates
- Percent assumed to continue coverage
- Age Related Heath Care Costs or Factors used to determine Implicit Rate Subsidy (IRS)
- Marriage Assumption

Many assumptions are used in the valuation process to determine the obligation. A District should understand the assumptions used and agree to the reasonableness of the assumptions. While the assumptions of the valuation must fall within the actuarial standards of practice (ASOP) and follow GASB guidelines, some of the assumptions may be modified, within reason, based upon the District's historical information and reasonable expectations of benefit utilization in the future. To consider modifications, be prepared to provide data and justification to changes in assumptions you are requesting. While actuarial assumptions will differ by actuarial firms, as will the format of the report, each report should include the key elements of the obligation required to complete the financial statements (including but not limited to the Total Liability, Net Liability, and Actuarially Determined Contribution (ADC), if applicable).

### Timing of Actuarial Services

The actuarial valuation requires a thorough review of the benefits and data provided and may include conversations/correspondence with the district and possibly the auditor. Planning ahead is important so that the valuation or table updates can be prepared in a timely fashion, giving time for the process to be performed. Recent changes in the GASB guidelines regarding reporting of post-employment benefits has changed the timing of actuarial services including valuations. Valuations must be completed at least every 2 years regardless of type of benefit (OPEB or Pension) or number of active/former employees eligible. In addition, table updates are prepared by the actuary in the year following the valuation year. Thus, you will be talking to your actuary every year. Further the district's determined measurement date impacts when date for the next valuation or table updates will be available. It is important to discuss these items with the actuary and auditor and understand the timing, so you are able to meet deadlines with creating an undue hardship on your part or that of the actuary or auditor.

## Reportable Post-Employment Benefits

### Materiality

Financial statement items are material if they could influence the economic decisions of users.
An obligation isn't required to be identified if the net impact of doing so has such a small effect on the financial statements that a reader of the financial statements would not be misled. Determination of immateriality of an OPEB or pension benefit obligation should be determined by the auditor. However, the auditor is not able to make this decision unless/until they are aware of the amount of the liability. Two situations currently exist:

1. Since ACT 10 many Districts have made significant changes to their post-employment benefits which may cause the benefit and its related obligation to decrease significantly overtime and in some cases be eliminated after a number of years.

In this situation is it important that the District, auditor and actuary at least bi-annually review the number of employees/retirees remaining who are eligible for the benefit and the amount of the reducing obligation. As the obligations decreases, there may come a point when either the district and auditor are able to determine the remaining outstanding obligation (particularly if it is a defined contribution and only current retirees remain eligible) or the amount of the outstanding obligation is no longer material.

2. The second situation is the opposite of the first. Some districts have not been reporting a post-employment obligation (beyond their WRS obligations) since under GASB 27, 50 and 45, the ARC may have been immaterial and not itemized in the footnotes. Now, under newly issued GASB compliance, the OPEB Liability (accrued obligation) may be significant and require reporting. Thus, even though not reported in the past, and no changes have been made to the District's post-employment benefits, Districts may now need to value and report the obligation on their financial statements.

> The **materiality concept** is the universally accepted accounting principle that all material matters are to be disclosed. https://www.accountingweb.com/.../auditing-special-purpose-frameworks-materiality-lev...

### Continuation of health care benefits and COBRA

Districts whose post-employment benefits have been or become only the right to self-pay 100% of the continued health insurance coverage on the District's health plan continue to have an OPEB obligation in the form of implicit rate subsidy only.

The historical experience of the group is typically the means to determine the number of retirees expected to continue coverage on the District's plan in the future. However, this is not the only factor to consider. Districts may provide a sick leave conversion provided via a health reimbursement arrangement (HRA) providing retirees the opportunity to use these funds for continued health coverage. While the sick leave is not an OPEB benefit, providing this benefit offers a means for the retiree to continue on the District's health plan and thus, may drive a higher percentage of employees electing to remain on the District's health plan.

While COBRA continuation of coverage is a federal requirement offered to all employees on the health plan at the time of termination of employment, districts may find a high percentage of those electing COBRA to be retirees. Thus, even if the District only offers COBRA continuation, it is possible that this benefit is impacting the amount of implicit rate subsidy experienced.

The reasoning behind addressing the implicit rate subsidy is because those employees/retirees age 55 to 65, from an actuarial perspective, have higher claims costs than younger employees. Since the medical trend, in most cases, is based upon the claims costs of the total group, districts may find that their health plan medical trends are driven by the cost of the retirees. This is also the reason many districts are limiting continued coverage to COBRA in an effort to reduce or control medical plan trend.

It is important to note that if the district does not offer COBRA at retirement (concurrent with any district-provided post-employment benefit), COBRA must be offered when the post-employment benefit is exhausted. Even if the retiree is Medicare eligible at that time, a COBRA election must be provided to his/her spouse and other eligible dependents who may be entitled to up to 36 months of COBRA on the district's health plan. Each district should have a policy (which is addressed in the district handbook) regarding when and how COBRA is offered to former health plan participants.

### Misconceptions in the Valuation and Report

There are also misconceptions regarding the valuation. Below are some of the most common:

**The valuation is only for current retirees or it only includes the liability of current retirees.** The valuation includes all active employees and former employees who are or will become eligible for the post-employment benefit. Even though they may not be fully eligible yet, if with their continued employment they can become fully eligible, the portion of the benefit earned to date is determined and included with the District's obligations. Of course, an assumption of the possibility of severance of employment (turnover) before eligibility is also included in the valuation.

**The actuary only needs the census of those eligible for the post-employment benefit.** At first glance, this sounds plausible. Why would you need to provide census information on those not eligible for the post-employment benefit? Well, in order to determine the difference between the cost (premium) and the value of the benefit, it is important to include all the employees that are eligible and participating in the District's health plan, since the insurance premium rates are based upon the spread of risk of this demographic group. Further, sometimes even though not offered a District benefit, there may be a reason to assume that a percentage of those not eligible for the benefit may self-pay, even for the COBRA period. Thus, the full census is important to assure accurate assumptions and calculations.

**If the plan is changing next year, I don't need to tell the actuary for this year's valuation.** Again, this is a very understandable thought, but not accurate. Since the valuation encompasses the portion of the benefit the active employees have earned toward the benefit they will receive post-employment, if the benefit they will receive is changing in the future, determining an obligation based upon an old benefit is inappropriate. If a decision for a revised benefit has been approved, it is important that the new benefit and its effective date be taken into account with the next valuation. If the District is in the midst of changing the benefits, it may call for a delay in preparing the valuation so that the appropriate benefits can be reflected in the study. The timing of the need for the valuation and the expected timing of approval of changes should be discussed with the actuary to provide for the most effective and efficient approach to move forward.

### Funding Post-Employment Benefits

How and when you fund the post-employment benefits are essential factors in the valuation process. When an irrevocable trust or account is established, districts should implement an investment policy and understand the requirements and limitations of funding the benefits via this arrangement (hereafter the use of the term 'trust' also means irrevocable account). Because funding benefits will be discussed in more detail in article three, the topic here is limited to some primary information necessary to work with the actuary in the valuation process.

**An investment policy** should address at minimum, the purpose of the investments (for funding OPEB, Pension, etc.), the types of investments acceptable and the expected rate at which these investments will fund the benefit. For example, the intent may be to fund the trust at a rate which provides for continued assets to cover future liabilities or it may be the intent to utilize the assets of the trust to cover immediate expenses and dissolve the trust in a given period of time. These are just examples. Of course, each district should review the investment policy and assure that it is in line with their intent and approved by the board of education (BOE). For more information, please refer back to the information found in the first article (Feb. 2018, *Taking Care of Business*) regarding Wisconsin's Investment Enabling Legislation and the Uniform Prudent Investor Act.

**An Actuarially-Determined Contribution (ADC)** is provided in the valuation when benefits are funded through an irrevocable trust. In the past it was referred to as the Annual Required Contribution (ARC) and was provided in every valuation. However, under the new guidelines, it is only provided when benefits are funded via an irrevocable account. If the district is funding the benefit wherein the pay-as-you-go amount is passed through a trust and the remaining trust balance is zero, it is still considered funded via a trust and requires the valuation to include an ADC. However, if this is the case, then the Department of Public Instruction (DPI) has suggested that the district should consider the purpose of the trust and decide either to a) begin funding more than the pay-as-you-go amount or b) dissolve the trust.

DPI has also indicated that categorical aid may only be applied to contributions to the trust that do not exceed the ADC. Thus, it is important to discuss the approach to determining the ADC with the auditor and actuary to assure that it is consistent with the investment policy so that the district is eligible to receive aid on their total contribution.

**Segregation of assets** (i.e., OPEB, pension, sick leave and any other types of benefit funded through the post-employment trust) is necessary to provide a proper valuation. Investment vehicles used for the benefits may vary by type of benefit being funded and subsequently impact the rate of return on investments. Thus, a different discount rate may be necessary depending upon what type of benefit is valued. Just as important, the value of the assets (Fiduciary Net Position, FNP) as of the valuation date must be identified within the tables and subtracted from the Total Liability to identify the Net Liability. Separated balances are necessary to avoid applying the value of assets set aside for one benefit to the liability of another.

## Conclusion

Districts should know the types of post-employment benefits offered and understand when to address the next valuation or table update as well as how long it will take. In the process, they should be sure to include the appropriate information and share any expected changes in eligibility or benefits that may be happening in the future. The district should work with the auditor and actuary to understand the elements and timing of the process. If the district has an irrevocable trust, make sure there is an up-to-date investment policy to share with the actuary. Further assure that the policy is meeting the needs and goals for which it was established and that the trust statements breakout the assets and investments between each type of benefit funded via the trust.

# OPEB and Pension Plan Funding Tools for the Future

In this final article in the series *Best Practices for School Districts When Designing, Funding and Paying Post-Employment Benefits*, we discuss some technical aspects of post-employment medical and OPEB plan funding and accounting. We also provide some plan funding options based on our experience working with public employers as they implement their benefit plans.

To recap, the first article in the series discussed tax qualification, school district obligations under the Wisconsin Uniform Prudent Investor Act and the requirements under Wisconsin law that apply to a Board of Education when adopting a post-employment medical or OPEB benefit plan. The second article defined a post-employment benefit, discussed misperceptions about post-employment benefits and described the actuarial reporting process.

In this third Article, we review plan funding mechanics and discuss in detail the roles of the different fiduciaries to the plan and the school district's funding and investment obligations. This article addresses group benefits and not negotiated compensation terms that may be established in an individual employment agreement.

### Plan Mechanics — Setting Up a Pre-funded Trust

Post-employment health and post-employment pension benefits require a benefit plan to establish plan eligibility and benefit terms for employees and to establish the characteristics required for tax-free or tax-deferred payments. The Wisconsin Department of Public Instruction (DPI) and the GASB Statement 75 require a biennial actuarial report to support funding levels for post-employment benefits funded through a separate, irrevocable government trust. The trust must meet the requirements of Internal Revenue Code section 115 to operate as a tax-free government trust. Fund investments are regulated by the Wisconsin public entity investment statute, Wis. Stat. § 66.0603, and the Wisconsin Uniform Prudent Investor Act, Wis. Stat. § 881.01.

Benefit plans describe the terms of the benefit for eligible employees and retirees. The benefit plan must communicate the terms of the benefit so that the benefit recipients understand their rights and responsibilities. If any aspect of the benefit is provided on a tax-free or tax-deferred basis, the plan must also establish the characteristics required under the Internal Revenue Code for this tax-preferred status.

Typically, the benefit plan is described in two primary documents: the employee handbook and the written plan document. School district administration will evaluate the school district's requirements for post-employment benefits and make a recommendation regarding benefit plan terms to the Board of Education. The benefit terms will depend on current benefit plan commitments, legal requirements, fiscal obligations and options that meet the needs of the school district. Benefit terms are adopted by the Board of Education after due consideration and are communicated to employees through Board policy and the employee handbook. In addition, the most common forms of post-employment benefit plans must be established in writing to qualify for a tax-deferred or tax-free status. The Internal Revenue Code requires a written plan document for retiree Health Reimbursement Arrangements (HRAs), non-elective 403(b) plans, section 401(h) pension medical accounts and deferred sick and vacation leave funded accounts.

In the past, public employers asked the IRS for a private letter ruling on their post-employment benefit plans. This process was expensive, time-consuming and understandably slow. Over time, the IRS has shifted responsibility to employers to know and implement the proper plan document for each benefit.

For example, IRS Rev. Proc. 2007-71 contains a pre-approved prototype 403(b) plan for public school districts. *See*, *https://benefitslink.com/src/irs/revproc2007-71.pdf* However, the school district remains the plan sponsor and is responsible for ensuring that the plan document accurately describes the school district's benefit.

### The Actuarial Report and Establishing a Trust

To establish a trust, the school district must have an actuarial valuation performed. This includes a valuation of the continued medical benefit, medical credit or HRA benefits provided in retirement by the school district for reimbursement of eligible premium or other expenses. In addition, the valuation will include determination of implicit rate subsidy from former employees remaining on the school district's health plan.

Should the school district provide a cash or cash equivalent benefit such as a contribution to a non-elective 403(b), then, in accordance with government accounting standards, a separate valuation of these pension benefits should be provided.

Note, however, that if the continued medical benefit or HRA contributions is the result of sick leave converted to a dollar amount, then the benefit itself is a compensated absence which should already be accounted for on the school district's financial statements. Thus, the OPEB benefit consists only of the implicit rate subsidy from use of such funds to remain on the school district's health plan.

Please note that the valuation does not include determination of liabilities for post-employment benefits wherein the District funds the benefit earned annually by individual (an actively-funded benefit) as it is expected the district will continue to fund the full amount earned each year in the year earned and amounts in the trust are identified by individual based upon amounts earned. Thus, there should never be an obligation in this trust 'bucket' that is greater than the amount of the fund balance. In this case, it is imperative that good recordkeeping exist and that the school district auditor confirm that all obligations are being funded to date annually.

When a trust exists or is being established, the valuation will also include an actuarially determined Contribution (ADC) for those benefits funded via an irrevocable trust. The ADC (or ADC schedule) provides the school district with an indication of the amount of funds to contribute to the trust annually to fund the obligation in accordance with the investment policy. If there is both an OPEB benefit and a supplemental pension benefit, then there will be two separate valuations and two separate ADCs.

The actuarial valuation is based upon numerous assumptions. An important assumption to review is the discount rate. It may be based upon a) the rate of return of the trusts investments of the specific post-employment benefit (OPEB or pension), b) the 20-year AA tax exempt municipal bond rate as of the measurement date of the valuation and/or c) A combination of a. and b., depending upon the amount of assets in the trust, the investment

OPEB Trust Requirements:

- A legally compliant Trust Agreement must establish an irrevocable Trust.
- Trust assets must be physically segregated from the school district's assets.
- The school district must obtain a legal opinion confirming that the Trust complies with Wisconsin and federal law.
- A copy of the Board of Education's resolution adopting the Trust Agreement must be provided to the Wisconsin Department of Public Instruction (DPI)
- Actuarial valuation following GASB guidelines (standard or alternative method) using the acceptable cost method to determine the actuarially-determined contribution.
- Contribution must be made by July 30 with a physical deposit from the school district's account to the Trust Account.

holdings and the School district's investment policy. The school district should be aware of the assumptions used and address any concerns with the valuation before it is finalized and used in the financial reporting.

Pre-funded post-employment benefit contributions must be held in a separate, irrevocable trust overseen by a trustee who is a fiduciary over the plan assets. The trust can be a Voluntary Employee Beneficiary Association (VEBA) plan with a joint employee-employer board of trustees, a section 115 government trust held by a bank or other established trustee or a 401(a) trust held as part of a pension plan. The State of Wisconsin offers OPEB trust options to public employers under the 401(a) model.

Section 115 government trusts are the most common form of post-employment benefit trust. Under the Internal Revenue Code, Wis. Stat. § 66.0603 and the Department of Public Instruction's Fund 73 requirements, the school district must establish the trust as a separate legal entity to hold the prefunded post-employment benefit accounts. The funds may not be held in a Fund 73 account in lieu of a trust. Contributions to the trust must be actual irrevocable cash contributions from the school district's general assets to the separate trust entity. Notational or netted deposits are not allowed.

Earnings and interest can accrue tax-free in the trust only if the trust is exclusively used to carry out an integral government function. The trust must hold post-employment benefit plan contributions and distribute post-employment benefit plan assets according to the plan terms.

Funds held in a post-employment benefit account within a section 115 government trust cannot be used for any purpose other than the designated government function and cannot benefit a private interest. The school district can pay reasonable administrative costs from the trust. Service provider fees (*e.g.,* third party administrators, recordkeepers, plan consultants, investment advisors) should be benchmarked against regional public employer standards to demonstrate reasonableness.

## The School Board's Investment Process

A Board of Education can invest or reinvest post-employment health benefits held in trust as provided by the Wisconsin Uniform Prudent Investor Act, Wis. Stat. § 881.01. Before discussing or establishing a trust for post-employment benefit funds, the school board must provide notice of the discussion and/or vote as a separate item on the school board's meeting agenda.

A school board may delegate its investment authority to a state or national bank or trust company that is registered to do business in Wisconsin if the bank or trust company is an authorized trustee under Wisconsin law. The school board may also delegate its investment authority for post-employment benefit funds held in trust to a registered investment advisor who meets the qualifications and requirements of the school district's investment policy statement. The school board must renew the investment agreement and review the trustee or investment manager's performance annually.

> The written annual investment report must state:
>
> a. The amount held in trust
> b. The investment return since the previous year's report was published.
> c. Total disbursements made from the trust since the previous year's report was published.
> d. The name of the investment manager who managed the school district's post-employment funds held in trust during the reporting year.

A school board that delegates its investment authority to a bank, trust company or registered investment advisor must publish a written annual investment report.

## Fiduciary Obligations

The Wisconsin public investment statute, Wis. Stat. 66.0603, enables boards of education to invest funds held in trust for post-employment health care and other OPEB employee benefits as provided under the Wisconsin Uniform Prudent Investor Act, Wis. Stat. 881.01. The first article in this series, *Establishing School District Post-Employment Benefit Plans – A How-to Guide,* discusses a school district's obligations under the Uniform Prudent Investment Act in detail.

A fiduciary is the person or entity that is entrusted with the legal responsibility for assets that belong to or are intended for another. A fiduciary relationship can be created by statute, by operation of law, or through a trust agreement, or other contract. A fiduciary obligated to provide a set of special duties to the asset beneficiaries including the duties of loyalty and prudence and the duty to carry out the fiduciary role with reasonable care, skill and caution. The fiduciary role can be limited by contract or statute.

As the post-employment Benefit Plan Sponsor, the school district is the Plan fiduciary. When Plan assets are held in trust to pay Post-employment Benefit Plan liabilities, the school district remains the Plan fiduciary. The public authority investment enabling statute authorizes the local governing board to delegate investment management authority to a bank, trust company or registered investment advisor. Even after delegation, however, the local governing board must exercise active oversight of all investments and publish annual reports on investment status.

When the school district sets funds aside to pay post-employment benefits, the school district will typically enter into a Trust Agreement with the bank or trust company that will hold the funds. The bank or trustee that holds the school district's funds as trustee is a fiduciary with respect to the funds it holds in the trust account. The Trustee acts as a fund custodian and is responsible for ensuring the funds in the trust account are secure and are held or disbursed in accordance with the Trust Agreement. The bank or custodian is a "directed trustee." This means the bank or trust company is responsible for following the school district's directions.

The Securities and Exchange Commission's regulations make registered investment advisors fiduciaries for retail (*i.e.*, individual) investors but not for institutional investors. Similarly, the federal Department of Labor's Employment Retirement Income Security Act (ERISA) regulations impose fiduciary regulations on investment managers who manage retirement plan assets for private, but not public, employers.

ERISA 3(16) fiduciaries are directed fiduciaries. They are obligated to follow the plan sponsor's directives regarding the investment of plan assets; therefore, their fiduciary responsibility is limited to following the employer's investment instructions. The plan sponsor selects the investment funds for the plan.

ERISA 3(38) fiduciaries are discretionary fiduciaries. They use their discretion to invest plan assets under the general guidance of the plan sponsor's Investment Policy Statement. A 3(38) fiduciary makes the day to day investment decisions and provides regular reports to the plan sponsor regarding investment performance.

School districts and other local governments are not covered by ERISA; therefore, ERISA's fiduciary standards 3(16) and 3(38) do not apply to a school district's delegated investments by operation of statute. Nothing, however, in the Wisconsin public authority investment statute, Wis. Stat. §66.0603 or the Wisconsin Uniform Prudent Investor Act, Wis. Stat. §881.01 prevents a school district from retaining an Investment Manager to operate as a Plan Fiduciary on a discretionary basis by contract. School districts may prefer to delegate their investment authority to a knowledgeable investment manager, rather than trying to invest funds on their own.

It is important to note that delegating investment authority to an investment manager does not transfer the school district's fiduciary obligations over the investments unless the school district negotiates 3(38) fiduciary status with the Investment Manager in the Form ADV or other investment management agreement.

It is important to know who the fiduciaries are and the purpose they serve, because, as explained later in the article, fiduciary status carries a high level of responsibility and an equally high level of potential liability.

### Plan Assets and Earnings on Plan Assets

A Section 115 Trust must be maintained at all times as a separate legal entity that is carrying out a governmental purpose for the exclusive benefit of the Trust beneficiaries. Note the following regarding plan assets:

- *Vested Plan Assets.* Employee contributions held in trust are always vested in the employee; therefore, the employee is a beneficiary of the Trust for those assets. Similarly, school district contributions that are vested with the employee through an employee benefit plan document, Board of Education or employee handbook policy or individual employment agreement are held in trust for the employee and not the school district. Earnings and interest belong to the employee who is the Trust beneficiary under these circumstances.

- *Non-vested Plan Assets.* Employer non-elective contributions made pursuant to a funding schedule, deferred sick and vacation leave pay and accounts earmarked by employee along with earnings and interest are school district assets until the employee has retired and met the benefit plan's applicable eligibility criteria –typically, a certain number of years of service and the plan's designated retirement age. The school district is the Trust beneficiary although the assets are being held in trust ultimately for the eligible plan participants. In this situation, the Plan may maintain the earnings and interest to offset the plan expenses and future payments or the Plan may pass the earnings on to the employees as an additional contribution. Either way, the Plan document should explain the policy of the Plan.

- *Pre-funded Assets.* When the school district pre-funds its accrued net liability under GASB Statements 74and 75, the funds can be held in the OPEB Trust earmarked by employee, but the assets, earnings and interest belong to the school district until they are disbursed to the employee who has retired and met the benefit plan's eligibility criteria.

Earnings and interest accrued in a school district's post-employment benefit section 115 government trust must accrue within the Trust and cannot be withdrawn for other purposes. Earnings and interest can only be used for the exclusive government purpose for which the trust was established – in this case, to pay the school district's post-employment benefit liability.

Earnings and interest, if any, are assets of the school district until the employee vests in the benefit at retirement. The earnings and interest can be used to offset the school district's net liability for the benefit. Most often, school districts accrue earnings and interest in the trust and use any surplus over net liability to "smooth" the pre-funded benefit (i.e., maintain benefit funding levels) as the investment value fluctuates with the market. This use of the earnings and interest is consistent with the designated government purpose of the trust – to fund post-employment benefit liability – and, therefore, retains the trust's tax-free status.

Some school districts include earnings and interest that accrue within the trust as part of the retiree's benefit. School districts that offer this benefit term may prorate earnings and interest within the trust and report the accrued earnings and interest in a regular employee post-employment benefit statement. As a retention tool, an accrued earnings statement can be an effective incentive. It is important to be clear, however, that the reported earnings and interest will fluctuate over time, that the amounts are school district assets until the employee retires and that, due to market fluctuations, earnings and interest can be lost –only the principal benefit amount is guaranteed.

There are in inherent risks in funding a trust. An underfunded post-employment benefit plan carries the obvious risk of the inability to pay benefits when the liability accrues. A school district could be obligated to levy funds or implement budget cuts to meet plan obligations. This risk can be challenging to manage because the actual retirement rate in a given year is dependent on outside factors and cannot be precisely predicted.

An overfunded plan is inefficient. Funds that the school district could be using for other compensation purposes are not "working" for the school district. In addition, state aid is not available on overfunded amounts.

A Section 115 Trust is qualified under the Internal Revenue Code to hold assets and accrue earnings and interest on a tax-free basis. The Trust will be qualified only if it is a separate legal entity that holds income derived from the exercise of an essential government function and no private interest participates in or benefits from the Trust. A Section 115 Trust that does not satisfy these requirements could be disqualified, resulting in taxation to employees and retirees. The tax status of a section 115 Trust could be examined as part of an IRS employment tax audit or a lawsuit alleging improper plan administration.

## Breach of Fiduciary Duty

School districts, like universities and colleges, are subject to breach of fiduciary duty claims. Claims could be brought for violation of the public authority investment enabling statute, the Wisconsin Uniform Prudent Investor Act, for violation of a plan document or in equity. Claims could include failure to monitor funds held in trust or delegated to an investment manager, failure to monitor returns and earnings, improper plan administration, failure to adequately select or monitor plan service providers, or excessive fees paid to service providers from the Trust.

Although school district officials and administrators have statutory immunity under Wisconsin law for duties they perform within the scope of their responsibilities, financial officers should confirm that the school district's liability insurance includes coverage for acts performed as a benefit plan fiduciary.

## Conclusion

Decisions regarding the structure and funding of post-employment medical and other OPEB benefits can have a significant budget impact over the long term. Good plan mechanics will help maintain funding equilibrium as plan liability fluctuates. The components of good plan mechanics include a legally compliant written benefit plan document, an accurate actuarial valuation, a properly structured section 115 government trust, investment management oversight and well-understood fiduciary designations. When these tools are properly aligned, the school district should be able to offer efficient, effective post-employment medical and other OPEB benefits to employees and retirees.

## Author Biographies

**Julie A. Lewis, J.D.** practices employment, employee benefits and compensation-related tax law in Wisconsin and Minnesota. She advises school districts and other government entities on post-employment plans, employee benefits, compensation and related matters. Julie is the owner and principal of Lewis Law Office, LLC. www.jlewislawoffice.com

**Linda R. Mont, CSRM, RHU** is an employee benefit consultant and licensed insurance agent, registered health underwriter and certified school risk manager. She consults with government entities throughout Wisconsin regarding actuarial valuations of post-employment benefits and related GASB Statements, active and post-employment benefit review and plan redesign/restructure, HIPAA privacy and security compliance, benefit regulations and compliance, benefit plan audits and creating a culture of wellness. Linda is the founder and managing member of Key Benefit Concepts, LLC. www.keybenefitsonline.com