



# **Southern California Association of Financial Professionals**

## **Post-Retirement Medical Benefits The New Funding Dilemma**

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## Discussion of OPEB Funding



### ■ Discussion of FAS 158 Funding

- The FASB has announced it's plans to modify guidance on reporting of Pensions and other post-retirement benefit plans in financial statements by making information more useful and transparent for investors, creditors, employees, retirees and other users. The Board has tentatively decided on the following first phase issues.
  1. Employers would have to disclose the funded status of a plan directly on the balance sheet rather than (under current practice) in footnotes accompanying the financials.
  2. Employers would have to disclose the nature and amount of changes in plan assets and benefit obligations recognized in both net income and other comprehensive income of each period.

### ■ Discussion of FAS 158 Funding (continued)

3. In the post-retirement benefits footnote, employers would have to disclose the accumulated amount of changes in plan assets and benefit obligations that have been recognized in other comprehensive income and will be recycled into net income in future periods.
4. Employers would continue (with clarification provided by FASB) to segregate the current and non-current portion of post-retirement benefit plan assets.
5. Employers no longer would have the option of measuring plan assets and benefit obligations as of a date up to three months before the date of the financial statements. Instead, employers would have to measure these amounts as of the reporting date.

### ■ The Second Phase Drills Down on Specific Accounting Issues, such as

- Where to recognize and display the impact of these costs – earnings or other comprehensive income?
- Guidance with regard to metrics and assumptions in quantifying these benefit costs.
- Whether to consolidate trust's by plan sponsor or not?

*Phase 2 primarily addresses the much maligned “smoothing” opportunities.*

### ■ Reasons to Pre-Fund Retiree Medical Benefits

- Accelerated tax deductions,
- Reduced burden of future management to resolve liability,
- Reductions in accounting expense under SFAS No. 106,
- Potential higher investment returns, net of taxes,
- Improved employee goodwill due to enhanced benefit security, and
- Increased reimbursement from the government or other contractual agreements.

### ■ Key Characteristics of VEBA Funding Techniques

- 4 Pre-funding a portion of the liability
- 4 Tax deductible contributions
- 4 Taxation of trust assets
- 4 Minimal administration



### ■ Objectives

- To design the most efficient method of funding post-employment benefits for non-bargained employees.
- To maximize current tax deductions, wherever possible.
- To reduce the long-term economic cost of this benefit.
- To reduce the related charge to earnings.
- To accomplish the above without disturbing existing benefit programs.

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## Funding Alternatives



### ■ There are Typically Three Alternatives to Finance Retiree Medical Benefits

#### 1. Pay-as-you-go

#### 2. Formal Funding:

- » Section 401(h) Account
- » Section 501(c)(9) Trust - VEBA
  - ♦ Trust Owned Life Insurance
  - ♦ Trust Owned Health Insurance (TOHI)

#### 3. Informal Funding:

- » Captive/COLI Integrated Insurance Strategy

### 1. Pay-As-You-Go

- Features:
  - » Benefits paid from current operating income, or retained earnings.
  - » No monies earmarked or set aside in anticipation of benefit obligations.
- Advantages:
  - » Corporation continues to invest in its business where it often earns a superior after-tax rate of return.
  - » Minimizes initial cash flow.

### 1. Pay-As-You-Go (continued)

- Disadvantages:
  - » Deductions limited to amounts paid, no deduction for advanced funding.
  - » Risk of benefits being available is dependent on viability of business.
  - » No offset against SFAS 106 liability.
  - » Burdens future management/shareholders.

### 2. Formal Funding: Section 401 (h) Account

- Features:
  - » Retiree medical benefits funded as part of qualified pension plan.
  - » Contributions are tax deductible.
  - » Earnings on contributions accumulate tax-free.
- Advantages:
  - » Allows for tax-efficient funding for retiree benefits.
  - » Creates economic asset that can be used to pay retiree medical benefits.
  - » Will probably create a plan asset under accounting rules, resulting in decreased retiree medical expense and liability.
  - » Funding can take into account cost of medical inflation.

### 2. Formal Funding: Section 401(h) Account (continued)

- Disadvantages:
  - » Contributions must be subordinate to pension contributions; depending on specific circumstances, this may greatly reduce deductible amount.
  - » May create an implied promise of vesting retiree medical benefits, if not communicated and documented carefully.
  - » Due to various complications, key employees (usually the 50 highest paid) are generally excluded.
  - » May limit future flexibility if corporate objectives or tax laws change.

### 2. Formal Funding: Section 501(c)(9) Trust - VEBA

- Features:
  - » Tax-deductible contribution is actuarially calculated.
  - » Actuarial calculation cannot take into account health care cost inflation.
  - » Trust earnings are generally subject to tax at the trust rate (which is the highest individual rate).
- Advantages:
  - » Creates economic asset that can be used to pay retiree medical benefits.
  - » Company receives current tax deduction for future retiree medical benefit payments.
  - » Create a Plan asset under accounting rules, resulting in decreased retiree medical expense and liability.

### 2. Formal Funding: Section 501(c)(9) Trust - VEBA (continued)

- Disadvantages:
  - » Investment income in trust is generally subject to taxation (except for collectively bargained VEBA's):
    - ♦ For this reason, investments permitting tax-free or tax-deferred accumulation of earnings are favored (e.g. trust owned insurance).
  - » 100% excise tax on amounts reverting to the company.



### 2. Formal Funding: Section 501(c)(9) Trust - VEBA: Trust Owned Life Insurance

- Features:
  - » Trust is owner and beneficiary of policies covering employees.
  - » Trust pays premiums.
  - » Tax-free cash value build up.
  - » Tax-free mortality proceeds.
- Advantages:
  - » Asset manager and investment manager may be selected by the company.
  - » Cash flows can be structured to approximate benefit payment stream.
  - » Investment grade pricing and performance.
  - » Cost recovery of Plan liability.

### 2. Formal Funding: Section 501(c)(9) Trust - VEBA: Trust Owned Life Insurance (continued)

- Disadvantages:
  - » No acceleration of deductions if not in trust.
  - » Negotiated fee structure.



### 2. Formal Funding: Trust Owned Health Insurance

- Features:
  - » Trust is owner and beneficiary of a cash accumulation group health policy.
  - » Retirees are the only covered insureds.
  - » Amounts invested accumulate tax deferred in variable investment accounts.
  - » Insured amounts are predetermined each year:
    - ♦ i.e.; \$1,000 deductible and 100% of claims from \$1,000 to \$3,000 for each insured retiree.

### 2. Formal Funding: Trust Owned Health Insurance (continued)

- Advantages:

- » Asset allocation may be selected by company – generally index funds.
- » Insurance amounts predetermined each year.
- » Investment grade pricing.
- » Benefits are not taxed to Trust or Retiree.

- Disadvantages:

- » Corridor of coverage might not be 100%.

### 3. Informal Funding: Captive/COLI Strategy

- Features:
  - » Corporation is owner and beneficiary of life insurance policies.
  - » Company pays premiums to primary insurer.
  - » Tax free cash build-up.
  - » Tax free mortality proceeds.
  - » Primary insurer reinsures a portion, or all, of the mortality and investment risk to company's captive.
  - » Captive assumes responsibility for a portion of the insurance obligation to the primary insurer.

### 3. Informal Funding: Captive/COLI Strategy (continued)

- Advantages:
  - » Asset management controlled by company.
  - » Company receives tax benefits for funding of retiree's liabilities.
  - » Ratifies viability of captive by reinsuring a third party insurers liability.
  - » Captive may receive tax benefits from establishment of reserves.
- Disadvantages:
  - » DOL approval may be needed for a prohibited transaction exemption.
  - » No tax rulings on strategy.
  - » Letter of credit required.
  - » May need to enhance benefits for DOL and retiree approvals.

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## Considerations



- **How much is the pension plan funded and what is the funding strategy?**
- **Has a VEBA been established and what is its jurisdiction?**
- **What is the cash position on the balance sheet?**
- **Can other benefit liabilities take advantage of funding alternatives?**

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## Suggested Funding Approach

### Select Study Group

- ◆ Human Resources
- ◆ Finance
- ◆ Legal

### Step 1

Discuss corporate objectives

Solicit input from study group and selected executives

Analyze and understand FAS 106 challenges

### Step 2

Analyze funding, financing, and tax issues. Evaluate funding vehicles based on:

- ◆ IRR
- ◆ Cash flow
- ◆ P&L impact
- ◆ Product risk
- ◆ Security design

### Step 3

Final funding structure of plan based on decisions from earlier steps

### Step 4

Administration:

- ◆ Set up system
- ◆ Record keeping
- ◆ Benefit and reimbursement projections