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Tax and Fiduciary Consideration of Pension Obligation Bonds

prepared for

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presented by

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History of Pension Obligation Bonds

- First issued by City of Oakland in 1985.
- Bonds were initially treated as tax exempt.
- Congress changed law in TRA '86 to make taxable under theory that investment arbitrage deprived the federal government of tax revenue.

Mechanics of POBs

- State/City with funding obligation directly issues or enables instrumentality to issue bonds.
- Instrumentality may be necessary due to constitutional or statutory debt limitations
- Bonds issued and proceeds deposited in Fund
- Bonds rates (even if taxable) are (theoretically) less than Fund's assumed rate of return.

- Essentially an arbitrage play with the assumption that over the life of the bonds the net return will exceed the debt service.
- Has impact of “fixing” the liability by moving from a plan funding obligation to a sponsor debt obligation.
- Bond payments secured by taxing authority or other pledged funding stream (e.g., tolls, liquor sales, utility fees).

IRC issues

- Use of Section 115 Trust
- May recommend to hold bond proceeds for some duration until investment by fund.
- 115 Trust is tax exempt as “government related,” thus shielding income from taxation during period pending investment.

Exclusive Benefit Rule

- IRC Section 401(a)(2) provides:

A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section

- . . .

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries. . .

Exclusive Benefit Rule

- Bond proceeds typically include bankers, custodial, legal fees;
- Such fees relative to the fundraising must be taken prior to the deposit into the trust; and
- Timing is crucial.

Potential Prohibited Transaction

- Public Plans exempt from 4975
- Plans are subject to 503 of IRS

Under Section 503(b) of the Code, a “prohibited transaction” means any transaction in which an organization—

- (1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;
- (2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;
- (3) makes any part of its services available on a preferential basis to;

- (4) Makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;
 - (5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or
 - (6) engages in any other transaction which results in a substantial diversion of its income or corpus to;
- the creator of such organization (if a trust) . . .

- Prohibited transactions (3) and (6) are of greatest concern in a POB.
- A POB could be structured in which the Fund provides services to the Issuer and/or the bond holders.
- Must assure that if fund is involved, in any capacity, it receives adequate compensation.

- Prohibited transaction (6), “substantial diversion” is parallel to “exclusive benefit”.
- Various vendors are paid from bond proceeds but such payment must be made before proceeds are allocated to qualified trust.
- Similarly, once proceeds are deposited, they cannot be diverted to bondholders regardless of circumstances.

Danger Zones

- Fund as Issuer of Bonds.
- Board as fiduciary to Bondholders.
- Disclosures to Buyers.
- Interference from Issuer once bond proceeds invested.
- Failure to delineate “settlor” and “fiduciary” functions.

Questions?

Pre-Funding Retiree Health Obligations
for a Governmental Entity with a Code Section 115 Trust:
Some Important Considerations

Don Wellington
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- I. Background
 - A. Similar to private sector, the pre-funding of OPEB obligations driven largely by accounting rules (in this case, GASB); goal is to avoid taxation of earnings
 - B. Options available to both private and governmental employers to avoid taxable earnings
 - 1. 401(h) Account in Pension Plan
 - 2. Voluntary Employees' Beneficiary Association (VEBA)
 - C. Additional option available to governmental employers – Code Section 115 trust
 - 1. Code Section 115(1) 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.”
 - 2. In Rev. Rul. 77-261, the Service determined that income from a fund established for the temporary investment of cash balances of a state and its participating political subdivisions was excludable from income under Code Section 115(1)
 - 3. Similarly, in Rev. Rul. 90-74, the Service determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks arising from obligations related to public liability, workers' compensation, or employees' health was excludable from gross income under Code Section 115.
 - 4. Now there are scores of private letter rulings permitting the use of a Code Section 115 trust to pre-fund retiree health obligations
 - 5. Service typically looks at following factors: (a) the income of the trust accrues to a political subdivision of a state, (b) no private interests participate in, or benefit from, the operation of the trust, other than as providers of goods or services, (c) the benefit to retired employees of the political subdivision is incidental to the public benefit, (d) upon termination of the trust, any remaining assets would be used to provide

health benefits to retirees pursuant to the entity's health plans, and (e) in no event would trust assets be distributed to any entity that was not a state, a political subdivision of a state, or an entity the income of which is excluded from gross income under Section 115

II. Advantages of Section 115 Trust

- A. Over 401(h) Account – fewer operative restrictions (e.g., no subordination rule) and no risk to qualified status of pension fund for failures
- B. Over a VEBA – fewer operative restrictions and no need for annual filings

III. Important Considerations in Adopting a Code Section 115 Trust

- A. Participating employers need to be political subdivisions or other Section 115 entities
 - 1. Interplay with definition of governmental plan
 - 2. No de minimis rule?
- B. Governance of Section 115 trust should be majority governmental appointees
 - 1. This can be a problem if equal representation by employers and representatives elected by employee groups
 - 2. Self-perpetuating governing board a potential problem
 - 3. Might instead consider a VEBA if these are issues
- C. Trustee generally should be replaceable (exception if state statute dictates identity of trustee)
- D. Cost-sharing by employees can raise issues if not done properly
- E. Deciding whether to seek a private letter ruling - Internal Revenue Service ruling process is efficient (but relatively pricey)
- F. Lack of formal correction program in case of failures