IRC Section 115 Trusts and Pension-Related Financial Stress

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Key Points

- Section 115 trusts are tools that can allow states and municipalities to set aside extra resources for pension funds at reduced investment risk
- Section 115 trusts can be used to help smooth volatility from year-to-year fluctuations in annual required contributions (ARCs)

Public pension plans

States and municipalities often commit to pay employees post-retirement income. To ensure those promises are kept, public sector employers (or plan sponsors) set up pension funds. Pension funds have liabilities, the present value of future payments to retirees, and assets, the money set aside today to pay for those future payments.

Many people think the money set aside should equal the estimated value of future payments. They believe that if a pension fund does not have sufficient assets on hand to pay all promised benefits—irrespective of future contributions to the pension fund—there is a risk that retirees will not be paid what they are owed. To increase transparency and accountability by plan sponsors, in 2017, Michigan passed Public Act 202, *Protecting Local Government Retirement and Benefits Act*, a law that requires plan sponsors to report to the state Treasurer the funded status of sponsored plans and pension contributions.

If the funded ratio of a pension fund, the assets relative to the liabilities, is below 60 percent, the pension fund is deemed underfunded. Likewise, if employer contributions to the pension fund comprise over 10 percent of governmental revenues, the pension fund is deemed underfunded. In each case, plan sponsors with underfunded pension funds are required to file additional reports with the state Treasurer and to submit a "corrective action plan" to a Municipal Stability Board.

On a routine basis, professional actuaries estimate how much must be contributed to a pension fund. The result is the annual required contribution (or "ARC") to be paid by the employer. In addition to employer contributions made by the plan sponsor, pension funds receive money from employee contributions (usually a fixed percent of payroll) and investment income. Since the employer contribution is, in part, a function of investment income, more investment income means less money is needed from employers.

To earn more investment income, pension funds have taken on more risk. In decades past, pension funds typically invested in bonds and relied on earned interest for investment income. Since the 1980s, however, bond yields have fallen and pension funds have shifted investments from a conservative allocation of mostly bonds to a riskier allocation of mostly stocks and alternative investments (real estate, commodities, private equity, etc.). But the more a pension fund's assets are invested outside of cash, cash equivalents, and short-term marketable securities the more a pension fund's assets are subject to market upturns and downturns.

As the market rises and falls, so too do employer contributions rise and fall. Consequently, plan sponsors can find themselves in a position where ARCs fluctuate wildly, as market underperformance must be made up by the plan sponsor.

Section 115 trusts and ARC volatility

Section 115 trusts ("trusts") have the potential to be a truly innovative mechanism to smooth out volatility in ARCs. The trusts are permanent and irrevocable. And Section 115 specifically refers to a provision in the Internal Revenue Code (IRC) that, for tax purposes, excludes the income earned from money set aside by a municipality when that money is used for the "exercise of any essential governmental function."

Plan sponsors may set up trusts to receive, hold and invest money restricted for future deposits to pension funds. The idea is that municipalities may set aside money for pension funds, keep it conservatively invested, separate from pension fund assets and therefore at less risk for market losses.

To further the trust's usefulness, plan sponsors can estimate a mean/median ARC based on historical data. From there, plan sponsors can set a policy for trust contributions and withdrawals that corresponds to that estimated mean/median. In times when market returns are bountiful and as a result the ARC for that year is lower than the mean/median, the plan sponsor can contribute the amount of the incremental difference to the trust. Then, when market returns are poor, withdrawals from the trust may be used to smooth out what will likely be an ARC above the mean/median.

Trusts and smart policy offer financial stability. Financial stability is, in part, the reason that states and municipalities inadvisably issue bonds and use the proceeds for pension contributions. Under this scheme, money owed to pensioners is swapped for money owed to bondholders. The difference, however, is that the amortization of bonded debts is knowable, and that is preferable to ARCs that can fluctuate year to year. However, bonds issued to make ARCs are speculations. For the scheme to be profitable, the bond proceeds contributed to the pension fund must earn more than the interest expense related to the bonds' issuance.

Similarly, extra pension contributions or amounts contributed to a pension fund above the ARC are also speculations. If the pension fund earns a return, the plan sponsor appears judicious. However, if market losses are sustained, the plan sponsor lost more money than had it contributed only the required amount. For this reason, a trust or "side fund" may be a better alternative, in that extra resources are secured for the pension fund but are not subjected to the same level of investment risk as the pension fund's assets.

Lastly, reserves of any sort are likely to help a plan sponsor cope with pension-related financial shocks. Shortly after its bankruptcy, the City of Detroit set up a Section 115 trust called the Retiree Protection

Trust Fund (RPTF). Between FY 2017 and FY 2023, the City plans to contribute $335 million to the RPTF. RPTF assets will be spent down from FY 2024 onward as the City makes pension contributions that are scheduled to accelerate under the City's bankruptcy settlement.

The City of Detroit was credited for its reserves by both Standard and Poor's and Moody's in recent analyses. If other states and municipalities were to set up a Section 115 trust with well-considered policies for contributions and withdrawals, those entities may see improvement in their market reputation and lower interest expense over time. (Even if a municipality does not set up a Section 115 trust, plan sponsors can set aside reserves or restrict fund balance for the same purpose.) For these reasons, Section 115 trusts can be used to improve a plan sponsor's financial condition and ensure pension fund solvency.

Sources and Additional Information

- Warren Ruppel, *GAAP for Governments* (Hoboken: Wiley, 2020), 529–65.
- Mark A. Sarney, "State and Local Pension Plans' Equity Holdings and Returns," *Social Security Bulletin* 63, no. 2 (2000): 12–16.
- Ronald L. Rose, "The City's Response to the Increased Pension Liability," Detroit Financial Review Commission Report No. 5 (Detroit: Detroit Financial Review Commission, 2017), 4–5.

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This memo is part of a series of memos in the Local Government COVID-19 Fiscal Strategy and Resource Guide, available at closup.umich.edu/COVID-19. CLOSUP has partnered with public finance experts from universities, consulting firms, and research institutions from around the state to provide local governments up-to-date information as well as a set of ideas and tools that will help them strategically navigate the new fiscal landscape.

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