[COMMITTEE PRINT]

APPLICATION OF PENSION PROVISIONS TO NEW YORK CITY'S FINANCIAL PROBLEMS

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

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A. Recent Events Relating to New York City's Financial Difficulties

Since March, 1975, a series of measures have been taken by the State of New York, City of New York, commercial banks, certain pension and sinking funds, and the Federal Government to allow the City of New York to achieve an orderly rationalization of its finances. In early April, the State provided an advance payment of $400 million to the City for welfare payments due in June, 1975. In May, the State advanced the City an additional $400 million advance payment for welfare funds due in 1976. In June, however, it became apparent that the City would be unable to market its securities. The State created the Municipal Assistance Corporation for the City of New York (MAC) with the authority to use $3 billion of its securities to finance the purchase of City notes. In the course of providing the City with a source of credit, MAC also rolled over much of the short-term obligations of the City into longer term MAC bonds with maturities of up to 15 years. MAC securities debt service payments are financed by receipts from the City's stock transfer and sales taxes. Also, MAC securities are backed by the "Moral obligation" of the State.

In mid-July, 1975, MAC was experiencing difficulties in marketing its securities. Faced with almost certain default by the City, the State legislature passed the Financial Emergency Act which put together a $2.3 billion financing package to meet the City's financing needs through December, 1975. The legislation also created a seven-member Emergency Financial Control Board to administer the City's finances. The Board must adopt a three-year financial plan which moves the City toward a balanced budget by the end of the fiscal year (June 30) 1978. The Board must approve plans for decreasing the City's dependence on short-term borrowing to finance operating expenditures in the capital budget, for controlling growth in expenditures, and, if necessary, for freezing employee wages. In late October, 1975, the City presented to the Emergency Financial Control Board the three-year financial plan which was subsequently accepted.

By early November, 1975, it became apparent that Federal assistance would be a necessary ingredient to achieve complete and orderly restructuring of the City's finances. Also, it became apparent that temporary relief from short-term debt payments would be necessary. On November 14, 1975 the State legislature passed the Emergency Moratorium Act for New York City which established a conditional three-year moratorium on enforcement of outstanding short-term obligations of the City. The moratorium became effective only for those holders of City notes who are first offered an opportunity to exchange their short-term obligations for long-term MAC bonds.

To secure additional financing, the City entered into an agreement on November 26, 1975, with 11 New York commercial banks,[1] five

[1] First National City Bank, Banker's Trust Company, U.S. Trust Company of New York, Chase Manhattan, Marine Midland Bank—New York, National Bank of North America, Morgan Guaranty Trust Company, Irving Trust Company, The Bank of New York, Manufacturers Hanover Trust, and Chemical Bank.

pension funds,[2] four sinking funds,[3] and the Municipal Assistance Corporation. The agreement of November 26, 1975, generally provides for purchases and exchanges of certain securities under specified conditions.

The pension funds agreed to purchase $2.53 billion of serial bonds of the City according to a schedule in the agreement and under certain conditions. In particular, these conditions include enactment by the State Legislature of legislation (which was enacted on December 4, 1975) which indemnifies the trustees and others from financial loss arising from any suit resulting from the purchase by the funds of the securities, or resulting from the sale of assets held by the funds to purchase the securities. Also, their participation is conditioned on a favorable ruling by the Internal Revenue Service, or the passage of legislation by the Congress so that the purchases do not constitute prohibited transactions or otherwise adversely affect the tax-qualified status of the pension funds.

Participation of other parties to the agreement, most importantly the 11 commercial banks, is conditioned on participation of the pension funds.

Last December the Congress also provided assistance for New York City. After discussions with the Administration, the Congress provided for direct Federal loans which would be repayable at the end of each year to smooth the normal seasonal fluctuations of the City's budget receipts in each fiscal year. These loans cannot exceed $2.3 billion at any time. The bill, H.R. 10481 (Public Law 94–143) took effect December 9, 1975, and terminates June 30, 1978.

During December, the Internal Revenue Service twice provided restricted "letters of intent to rule." Several of these New York City pension funds relied on these letters of intent to purchase New York City securities.

B. Present Law Requirements for State and Local Governmental Pension Plans

Present law generally provides qualified plans with substantial tax benefits. Employers, within certain limits, are permitted to deduct contributions made to these plans for covered employees; earnings on the plans' assets are exempt from tax; and covered employees defer payment of tax on employer contributions made on their behalf until they actually receive the benefits, generally after retirement when their incomes and as a result applicable tax rates tend to be lower. Also, special 10-year income averaging is allowed for lump-sum distributions, and certain estate tax and gift tax exclusions are provided. The employers, which are governments in the case in point in this legislation, are tax-exempt and therefore obtain no benefit from tax deductions or the special tax-exempt status accorded trusts under qualified plans.

However, the tax benefits for government employees are sufficient to encourage the adoption of qualified plans by governmental units. As

[2] New York City Employees Retirement System, Board of Education Retirement System for the City of New York, New York City Fire Department Pension Fund—Article 1–B; Teacher's Retirement System for the City of New York, and the New York City Police Pension Fund.

[3] Sinking Fund of the City of New York, Rapid Transit Sinking Fund of the City of New York, the Water Sinking Fund of the City of New York, and the Transit Unification Sinking Fund of the City of New York.

a result, many governmental units have established retirement plans designed to qualify under the Internal Revenue Code.

Under the code, a qualified plan must be for the exclusive benefit of employees and their beneficiaries.[4] A plan or trust which breaches the exclusive benefit rule of the code is disqualified. If a government plan is disqualified, the special tax treatment for employees under qualified plans is denied. In such a case, the employees would be taxed currently on the value of their vested benefits, the special estate and gift tax exclusions would not be available, and no special treatment would be accorded to lump-sum distributions.

Under the Internal Revenue Code certain sanctions also are applied where a trust engages in a "prohibited transaction". The Employee Retirement Income Security Act of 1974 (ERISA) tightened the prohibited transaction requirements, but these new requirements are not applied to governmental plans.[5] Therefore, the prohibited transactions of concern here are only those which were already in existence before ERISA was enacted.

Under the rules applicable to government plans, a pension trust which engages in a prohibited transaction loses its tax exemption (sec. 503(a)(1)(B)). For this purpose, a prohibited transaction is any transaction in which the trust lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to the creator of the trust, to a person who has made a substantial contribution to the trust, or to certain other persons. A trust may also breach the prohibited transaction rules, for example, if it makes any substantial purchase of securities or any other property for more than adequate consideration in money or money's worth from such a person or if it engages in any other transaction which results in a substantial diversion of its income or corpus to such a person (sec. 503(b)).

Generally, the Internal Revenue Service has treated a transaction which violates the prohibited transaction rules as a violation of the exclusive benefit rule. As indicated above failure to meet the exclusive benefit rule also can cause the disqualification of the trust and the plan of which the trust is a part.

C. Problems

Several of the steps taken by the City of New York to remedy its financial condition involve City pension funds. Under present law, the ability of these funds to assist the City without endangering their qualified status depends on the application of the exclusive benefit and prohibited transaction rules. For example:

(1) Under the agreement of November 26, 1975, five New York City pension funds became obligated to retain certain securities of the City of New York and to purchase new debt of the City (and in some circumstances MAC). It may be argued that by entering into the agreement the funds violated the exclusive benefit rule.

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[4] Further, a trust does not qualify unless, 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. (Sec. 401(a).)

[5] The comparable provisions of ERISA administered by the Department of Labor are similarly inapplicable to governmental plans (ERISA sec. 4(b)(1)).

(2) The funds may also be found in violation of the exclusive benefit rule if they retain City securities as required by the agreement of November 26, 1975 because it can be argued that this retention is not for the exclusive benefit of employees. In order to permit the trustees of the pension funds to take factors other than the exclusive benefit of employees into account in determining fund investments, on December 4, 1975, the State of New York adopted legislation permitting the trustees to take into account for investment purposes the extent to which investments will maintain the ability of the City of New York (1) to make future contributions to the retirement systems and funds, and (2) to satisfy its future obligations to pay pension and retirement benefits to members and beneficiaries of those systems and funds. The legislation also authorizes the trustees to take into account the extent to which investments will protect the source of funds to provide retirement benefits for members and beneficiaries of the retirement systems and funds. If these factors are taken into account New York State law (but not Federal law) in effect permits them to depart from the exclusive benefit rule.

(3) The agreement of November 26, 1975, requires the funds to acquire New York City (and in some circumstances MAC).[6] To acquire the debt pursuant to the agreement, it is understood that the funds have been required to liquidate some of their investments under unfavorable market conditions. In addition, the liquidated investments may have been more advantageous to employees than the New York City or MAC debt. Under these circumstances, they may be violating the exclusive benefit rule.

(4) The New York City debt to be acquired by the funds is backed by the credit of the City. Questions may be raised as to whether the security for the debt is adequate in view of the City's present problems, especially since the Internal Revenue Service has taken the position that the pledge of an employer's general assets does not provide adequate security for purposes of the prohibited transaction rules.[7]

(5) In addition, funds available to pay off MAC bonds are limited to funds appropriated by the State of New York. At least two of the funds were created by the State of New York. If the MAC bonds are not backed by adequate security, their acquisition by these funds will violate the prohibited transaction rules.

D. Bill Before Committee

Mr. Rangel, together with Mr. Pike and Mr. Conable, has introduced a bill (H.R. 11700) permitting the five pensions funds to carry out the provisions of the agreement of November 1975, without being considered in violation of the exclusive benefit or the prohibited transaction rules.

More specifically, the bill provides that a pension plan or trust which, on December 5, 1975, was a party to the agreement of November 26, 1975 (and any trust forming a part of such a plan) will not be considered in violation of the exclusive benefit rule or the prohibited transaction rules of the code merely because it: (1) enters into the

[6] Beginning August 20, 1975, the funds acquired MAC debt which, as of November 26, 1975, amounted to $665 million.

[7] Rev. Rul. 70–131, 1970–1 C.B. 135. The ruling does not specifically refer to an employer which is a governmental unit.

November 1975 agreement or agrees to an amendment to the agreement, (2) forbears from any act prohibited by that agreement, (3) acquires or holds any bond or note the acquisition or holding of which is provided for by the agreement, (4) makes any election provided for by the agreement, (5) executes a waiver of any requirement of the agreement, or (6) performs any other act provided for by the agreement. In addition these plans or trusts can continue to hold any bond or note acquired or held pursuant to the agreement after the expiration of the agreement. As a result, the bill will end uncertainty as to whether these acts (or forbearance) violate the exclusive benefit rule or the prohibited transaction rules.

Even with respect to transactions not provided for by the agreement the requirements of present law as to the exclusive benefit rule and the prohibited transaction rules are set aside only to the extent these investments will maintain the ability of the City of New York to make future contributions to the plans and trusts and to satisfy its future obligations to pay pension and retirement benefits to members and beneficiaries of the plans and trusts. The bill would also authorize the trustees to take into account the extent to which the investments will protect the sources of funds to provide retirement benefits for members and beneficiaries of the plans and trusts. These factors, which correspond to the tests in the New York Act of December 4, 1975, require a balancing of the interests of the employees (and their beneficiaries) and the City.

The factors set out above may be taken into account during the period beginning August 20, 1975 (the date MAC bonds were first acquired by the trusts) and ending June 30, 1986. Also, the bill provides that the exclusive benefit rule and the prohibited transaction rules will not be violated if, after June 30, 1986, the trustees consider these factors for purposes of determining whether to retain investments held on June 30, 1986. Because the pension funds purchased MAC bonds before the date of the agreement, and these purchases were not provided for by the agreement, the bill additionally provides the acquisition or holding of MAC bonds on or after August 20, 1975, and before November 26, 1975, are to be considered acquisitions and holdings provided for by the agreement.

The bill provides special rules with respect to amendments of the agreement and waivers of requirements of the agreement. Under these provisions, if an amendment of the agreement relates to activity (or forebearance) described in the bill, and is relevant in determining whether the exclusive benefit rule or the prohibited transaction rules of the code are satisfied, the amendment is to be considered a part of the agreement described in the bill if within 30 days after the amendment is submitted to the Secretary of the Treasury (or 30 days after the date of enactment of the bill, if later), the Secretary of the Treasury finds that the amendment is not inconsistent with a balanced policy of protecting the security of employee benefits and improving the financial condition of the City of New York. Under the bill, any of these amendments must be consistent with the policy of maintaining the ability of the City of New York to make future contributions to the plans and trusts and to satisfy its future obligations to pay pension and retirement benefits to members and beneficiaries of the plans and trusts. Also, an amendment must be consistent with the policy of protecting the sources of funds to provide retirement benefits for members and beneficiaries of the plans and trusts. (These are the same factors which the plans and trusts may consider in making investment decisions.) Similar rules would apply to waivers of requirements of the agreement. Of course, the fact that the bill does not recognize these amendments and waivers without the approval of the Secretary of the Treasury does not prevent them from being effective for other purposes.

To limit the duration of the special rules provided by the bill, the bill provides that no amendment to the agreement which has the effect of extending the expiration date of the agreement to a date later than June 30, 1986, is to be recognized for purposes of the bill.

Also, the bill provides that the pension plans and trusts are to furnish to the Secretary of the Treasury a copy of their annual reports filed with the New York State Insurance Department for each fiscal year beginning after June 30, 1975, and ending before July 1, 1986. These reports are to be filed with the Secretary of the Treasury not later than 30 days after the date the reports are filed with the New York State Insurance Department. In addition, the bill provides that the plans are to furnish the Secretary of the Treasury with such additional information as he may reasonably require. The additional information could be required at more frequent intervals than the reports. A copy of each report and the additional information furnished to the Secretary of the Treasury is also to be furnished to the Chairman of the Committee on Ways and Means of the House of Representatives and the Chairman of the Committee on Finance of the Senate.

The bill will be effective on and after August 20, 1975.

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