[COMMITTEE PRINT]

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

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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I. SUMMARY

Since 1975, private credit markets have been closed to the City of New York. In order to meet the City's seasonal financing needs and therefore forestall a possible bankruptcy, Congress enacted in 1976 two laws: P.L. 94–143, "the New York Seasonal Financing Act of 1975," which provided Federal seasonal loans to the City through June 1978, and P.L. 94–236, which permitted five New York City pension funds to purchase under certain conditions city obligations without regard to certain restrictions in the Internal Revenue Code through the end of 1978.

While the City has made progress in reducing the excess of current expenditures over revenues, it is apparent that an operating deficit will occur over the next several years, which, if not financed, could lead to a possible bankruptcy. Accordingly, in early 1978, the City prepared a four-year budget plan which would result in a balance of current expenditures and revenues in fiscal year 1982. The plan is contingent on among other things, Federal loan guarantees, and further bond purchases by the five City pension funds and four State pension funds, as well as bond purchases by local financial institutions.

On May 22, 1978, the House passed H.R. 12426, the "New York City Financial Assistance Act of 1978", which provides for long-term Federal loan guarantees of obligations issued by or on behalf of New York City for the period 1978–82. On June 15, the Senate Banking Committee passed a series of amendments to the House bill.

Before the Finance Committee is a proposal which would permit five New York City pension funds and four New York State pension funds to buy obligations issued by or on behalf of New York City under a series of specified conditions.

II. PRESENT LAW REQUIREMENTS FOR STATE AND LOCAL GOVERNMENTAL PENSION PLANS

Present law provides substantial tax benefits to employees covered by tax-qualified pension plans.[1] The tax benefits provided for governmental employees under qualified plans are sufficient to encourage many governmental units to establish such plans.[2]

Under the code, a qualified plan must be for the *exclusive benefit* of employees or their beneficiaries. 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 could 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 self-dealing. The Employee Retirement Income Security Act of 1974 (ERISA) tightened the self-dealing prohibitions, but these ERISA rules are applied to governmental plans. Therefore, the self-dealing rules 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 self-dealing loses its tax exemption (sec. 503(a)(1)(B)). For this purpose, a trust violates the self-dealing rules if it engages in any transaction in which the trust lends any part of its income or corpus, without the receipt of adequate security and without receipt of 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 self-dealing 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 self-dealing 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.

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[1] Covered employees defer payment of tax on employer contributions made on their behalf until they receive plan 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.

[2] Governmental employers are exempt from tax and do not benefit from tax deductions for contributions to plans or the special tax-exempt status accorded to trusts under qualified plans.

III. PREVIOUS CONGRESSIONAL ACTION WITH RESPECT TO NEW YORK CITY PENSION FUNDS; PUBLIC LAW 94-236

A. Background to Enactment of Public Law 94-236

In 1975, the City of New York was unable to sell short a long term obligations in private credit markets. Subsequently, a series of measures were taken by the State of New York, City of New York, commercial banks, certain pension and sinking funds, and the Federal Government to help the City of New York to achieve an orderly rationalization of its finances.

To secure additional financing, the City entered into an agreement on November 26, 1975, with 11 New York commercial banks,[1] five pension funds, four sinking funds, and the Municipal Assistance Corporation. The agreement of November 26, 1975,[2] generally provided 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 included enactement by the State Legislature of legislation (which was enacted on December 4, 1975) which indemnified 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 was conditioned on a favorable ruling by the Internal Revenue Service, or the passage of legislation by the Congress so that the purchases would not adversely affect the tax-qualified status of the pension funds.

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

In December 1975, the Congress provided direct loan 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 could not exceed $2.53 billion at any time. The New York Seasonal Financing Act of 1975 (Public Law 94-143) took effect December 9, 1975, and terminates June 30, 1978.

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[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.

[2] The agreement may be found on pages S 21308-S 21310 of the Congressional Record of November 26, 1975.

During December 1975, 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.

In early 1976, the Congress enacted P.L. 94–236 which permitted the 5 New York City pension funds to acquire and hold City and MAC debt without violating requirements of the tax law.

B. Description of Public Law 94–236

The law 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) would not be considered in violation of the exclusive benefit rule or the self-dealing rules of the code merely because it: (1) enters into the 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 obligation 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 could continue to hold any obligation acquired or held under the agreement after the expiration of the agreement. As a result, the law ended uncertainty as to whether these acts (or forbearance) violated the exclusive benefit rule or the self-dealing rules.

The law provided 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 law, and is relevant in determining whether the exclusive benefit rule or the prohibited transaction rules of the code are satisfied, for purposes of the law the amendment is considered a part of the November 1975 agreement on the date it is submitted directly to the Secretary of the Treasury. However, if the Secretary (not including a delegate) determines, within 30 days after the amendment or waiver is submitted to him (or, if later, within 30 days after the date of enactment of the law) that the amendment or waiver is inconsistent with a balanced policy of protecting the security of employee benefits and improving the financial condition of the City of New York, for purposes of the law, the amendment could be considered a part of the agreement at any time.

These amendments were not to be inconsistent with the policy of maintaining the ability of the City to make future contributions to the plans and trusts and to satisfy the City's future obligations to pay pension and retriement benefits to members and beneficiaries of the plans and trusts. Also, an amendment would not be inconsistent 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 under a special New York law apply to waivers of requirements of the agreement.

Also, the law provided that the pension plans and trusts were 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 with, the first fiscal year in which there were no obligations with respect to which the exemption provided by the law applied. These reports were 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 law provided that the plans were to furnish the Secretary of the Treasury with such additional reports and information as he might reasonably require. The additional reports and information could be required at more frequent intervals than the reports to the Insurance Department. A copy of each report and information furnished to the Secretary of the Treasury was 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 law becomes effective on and after August 20, 1975.

C. Implementation of Public Law 94–236

In February 1977, the New York State Supreme Court found the Emergency Moratorium Act for New York City to violate the New York State constitution.

In August 1977, Treasury, the city and the pension funds discussed a proposed amendment to the November 1975 agreement, to provide a restructuring and extension of the debt holdings of the pension funds. An exchange by the pension funds of short-term city securities purchased pursuant to P.L. 94–236 for longer-term MAC securities was proposed. The advantage to the city of such a restructuring was a leveling of debt service costs and an easing of short-term budgetary problems.

The proposed amendment was submitted to Treasury on August 18, 1977, and approved on September 14, 1977. The Secretary's determination was based, in part, upon a judgment that although the amended Agreement would leave the pension funds with longer-term debt, the new debt would bear a higher interest rate and would be more marketable so that the pension funds would be able to reduce their holdings of city debt. The exchange of debt was consummated shortly after the pension funds were advised of the Secretary's position. As a part of the exchange, the pension funds paid a premium for the higher yield bonds.

In November 1977, the City of New York attempted to place in the private market debt similar to that which was rolled over by the pension funds. However, due to an adverse credit rating, the debt was not marketed.

IV. PROBLEM

The basic problem facing New York City is its inability to enter private credit markets to finance its short-term financing needs and its long-term capital needs. Most municipalities need short-term credit because their pattern of tax receipts and other revenues (fees, State and Federal grants-in-aid) does not coincide with their expenditure pattern. In access to such short-term credit can lead to default on payment of outstanding bonded indebtedness as well as failure to meet payroll or contract obligations.

Since 1975, New York City has made progress in reducing its operating deficit, and adherence to its 4-year plan (for 1978–82) and the fulfillment of the underlying expenditure and revenue assumptions is expected to result in a balance between operating expenditures and receipts by the close of fiscal year 1982. However, without Federal assistance to encourage creditors to purchase City obligations, and without concurrent permission for New York pension funds to purchase New York City obligations, the City is threatened with bankurptcy.