Guest Article

Can Peter's Sponsor Borrow From Peter To Pay Peter?

By Alvin D. Lurie
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Whose skin is in the game when pension plans make loans to plan sponsors to pay pension contributions, and is the answer different if the plan sponsor is a government body?

Those questions come to mind on learning that last year the highest elected officials in New York State authorized financially distressed local governments in the state to use a problematic borrowing scheme to defer a portion of their pension liabilities, by, in effect, borrowing from the state pension system to satisfy significant percentages of contributions owed to the pension trust for the retirement benefits of their respective employees. In fact, more than just permitting its municipalities to engage in this financing scheme, the state itself went to that same window to cover a portion of its own pension liabilities. Some observers have called it "irresponsible." The more pressing question is whether it is legal or just a skin game.

Check Kiting: New Style

If a plan sponsor owes $100x for its current pension contribution to the sponsor's pension plan, but the sponsor can't make the contribution because it has neither the cash nor the borrowing capacity to raise the funds from bank sources, and so the plan writes a check to the sponsor, which endorses the check back to the plan, which puts it in its vault, has the sponsor made a contribution? Has the plan received one? Has the plan obtained anything of value that improves its position in any way over what it would have been had the sponsor just defaulted?

Either way the plan holds the plan sponsor's debt, and the quality of that debt is no different because its own check comes back to it with the sponsor's endorsement.

Of course, were the sponsor to have executed some kind of a meaningful security instrument to back up its endorsement, such as a mortgage on the town hall, the plan's posture would then be improved. In an early tax classic, *Taxable Income*, Professor Magill cites the economist's view that income is received if there has been a net accretion to economic power. Nothing like that has apparently occurred in the arrangement being employed here—not even the ceremonial exaction of a pound of flesh. Does that save it from being considered a skin game?

Is anything changed if the sponsor agrees that in subsequent years it will raise the contributions it was committed to make under the present terms of the plan, by an amount determined as the equivalent of interest on the amount of the circularly routed check whose path was described above? Suppose the amount of those promised future raised contributions was determined *without* reference to an interest element, and could in fact be valued as worth much more than an interest equivalent. No doubt a real interest component can be devised that would affect the treatment of the arrangement; but again that does not appear to be the situation. Moreover, given that the localities in this case will have continuing pension obligations that will be impacted by budgetary and revenue considerations, as well as collective bargaining negotiations, in such later years, what significance can be accorded to illusory promises of earmarked future make-ups for present contribution shortfalls?

Debt Cancellation: Old Style

Suppose that, in lieu of the above shuttling of a check between plan and sponsor, that essentially meaningless roundabout is dispensed with and the parties agree that the plan will simply forbear enforcement of the required contribution, or even forgive it entirely. What is actually happening is now laid bare, but the economic reality has not been altered. It is true that the forgiveness is easily seen as debt cancellation, normally an income tax triggering event; and if the debt is not forgiven but enforcement of it is forgone, and interest is not charged or is set at a below-market rate, again imputed income may inhere in the arrangement. But we are dealing here with government entities, hence not taxpaying bodies; so the postulated income tax event is a moot point.

The plan sponsors actually involved were cities like Yonkers, and instrumentalities of government like the New York Public Library, and, as noted, even New York State itself, as sponsor of the plan for its own employees. All have one thing in common: they are government plan sponsors of the New York State Pension System for the benefit of their respective employees, and they all engaged last year in this unprecedented borrowing plan, to satisfy substantial portions of their pension liabilities to the state pension system—they and scores of other municipalities and counties all around New York State, to the tune of $750 million. The total is expected to top $1 billion this year. It's all legal, according to a position taken by the previous governor of New York, and the then-state comptroller, and was even approved by the public sector unions according to reports in the public press. The present governor, Andrew Cuomo, has signed on to the arrangement, proposing to borrow nearly $800 million under his budget for the current fiscal year.

Echoes From the Past

Can it really be legal? One might reasonably ask. The lawyers among readers might more pointedly ask, What about ERISA's minimum funding standards, or prohibited transactions, or fiduciary responsibilities, or other legal protections of workers' pensions that might get the attention of the IRS, or the U.S. Department of Labor, or New York State's law enforcement and regulatory bodies?

Some few might vaguely recall that New York City had dealings with the IRS when it wanted to borrow from its uniformed employees pension plans back in the 70's, as the city hovered at the precipice of bankruptcy. New York City tried to borrow enough money from its pension plans to meet its payroll, because its banks had completely shut down its credit lines, and it had no other place to go for funds.

I certainly recall that. I was in the National Office of the IRS at the time, as Assistant Commissioner (Employee Plans & Exempt Organizations), when I got a call on a Wednesday afternoon from a lawyer with the firm serving as bond counsel to NYC, requesting an emergency meeting to seek IRS approval for New York City to borrow just enough money from its municipal pension funds for police, firefighters and teachers to cover a shortfall of several hundred thousand dollars, without which it would be unable to cut payroll checks due that very week.

Needless to say, I acquiesced, and, at 8 A.M. the following morning, a troop of NYC lawyers and other professionals met with an IRS team I had hastily assembled. A 20-hour nonstop meeting ensued, at the end of which I handed the city's lawyer a memo to be delivered that afternoon to the city's banks that amounted to a letter of *intent* to issue a ruling insulating the parties to the transaction from IRS sanctions for a specifically designated loan from the pension plans of a sum enabling the city to repay bridge loans which the banks had agreed to make—while the meeting was in progress—to cover the following day's payroll. The banks' agreement was explicitly conditioned on the Service's assurance that such a ruling would be issued as soon thereafter as the city satisfied the Service as to the loan conditions (e.g., security, interest and repayment) to be fulfilled by the city relating to the pension plan loans, inasmuch as the city was not prepared to specify such conditions at the time of our meeting. Hence the resort to the letter-of-intent technique. (No, Virginia, the IRS Manual does not provide for that stratagem.)

There was a lot more to the story that need not be detailed here. Suffice it to say, it established an interim mechanism that enabled the city to pay the wages of its employees for a brief period, while avoiding the wages of its sinful financial misdeeds, pending a series of permanent salvage measures thereafter to be put into place by federal and state authorities as a precondition to the city becoming able to reenter the bond markets. (Some readers may recollect that the actual debt instruments came to be called "Big MACs" because the issuer was not actually the city itself, but an agency named the Municipal Assistance Corporation established for the purpose.)

On its surface that tale of one city bore similarities to the current program described above that is now being pursued by New York State and its political subdivisions and instrumentalities in order to meet their obligations to the New York State Pension Fund. But the differences are more substantial than the similarities. For one thing, the lender now is the state pension fund, where the lenders in 1975 were a collection of New York City pension funds covering its police, firemen, transit workers and teachers. The debtor then was a destitute New York City, unable to meet a payroll, which had been turned away by the banks. By contrast, the current debtors, struggling to meet steadily rising pension costs with falling tax revenues, have been driven to this "budgetary sleight-of-hand," as critics have candidly characterized it, even though not actually bankrupt (although some municipalities have been reported close to that).

There is also quite a different character to New York City's borrowing in 1975 —which, as has been noted, was solely to cover its current payroll for a short period before the banks replaced the borrowed funds by restoring the city's credit line—as contrasted with the current borrowing to enable the borrowers to technically meet their obligated current pension liabilities by way of makeups years later, in the form of future years' increased contributions. Moreover, the current arrangement, far from being only a temporary expedient, is already slated to be repeated this year in increased amounts and, almost assuredly, by increased numbers of counties, municipalities, libraries, *et al.* around the state. Who among them will be able to resist this *deus ex machina*? We at IRS, by contrast, made it very clear that the arrangement devised at the spur of the moment to avert the clear and present bankruptcy event was a one-off.

A Scent of Politics

Another significant difference is to be noted: relief to New York City in 1975 was sought and derived from an independent agency of the federal government, the IRS, albeit a part of the Executive Branch, whose supreme head, the President, was famously quoted in a newspaper thusly: "Ford to New York—Drop Dead." The quoted presidential remark, it should be noted, had nothing to do with the application to the Service for approval of the short-term pension loans, and carried no weight in our deliberations.

Quite differently, this current arrangement was approved in 2010 by former Governor Paterson and backed by the state comptroller's office— obviously far more hospitable to the would-be borrowers than the Washington establishment at that earlier time, to which New York City was forced to plead its case. In New York the state comptroller oversees the state pension funds. His rationale was reported in one paper: "Amortizing pension costs is an option for some local governments to manage cash flow and to budget for long-term pension costs in good times and bad." (In that same news account it was noted that the comptroller "prefers to call the borrowing a form of amortization" but one can assume that unacknowledged political considerations also had some influence on his views.)

The relief sought from the IRS in 1975 was based on the long-standing rule in the Internal Revenue Code designed to prevent employers from engaging in "prohibited transactions" with pension plans that they sponsor; and one such transaction is the borrowing of money by the employer from its plan unless adequate security and an appropriate interest rate is obtained by the plan. This was not the prohibited transaction rule introduced in ERISA in 1974, with its much more elaborate restrictions that barred such transactions entirely, unless preceded by a formal exemption procedure, including application for a waiver, and expressly concurred in by the IRS and the U.S. Department of Labor, after formal hearings and certain specifically spelled-out findings. The ERISA rules did not (and still do not) apply to government plans, for which ERISA provides an explicit exclusion, so the only prevailing authority applicable to New York City's 1975 application appeared in the Internal Revenue Code, with sparse statutory language and minimal published regulatory guidance from the Service at that time. The Service therefore has, even now, considerably more leeway in dealing with the prohibited transaction issue in case of government pension plans; and it also does not now—as it did not then—share its jurisdiction with the DOL, which has no regulatory authority over government pension plans under ERISA, let alone under the Internal Revenue Code.

Inconvenient Legal Principles

While the situations in 1975 and now are obviously vastly different, there are some common underlying legal issues. If one can equate a legal obligation to contribute to a public pension, that is deferred in return for an agreement to make greater contributions in future years than the plan presently calls for, to a kind of borrowing, prompted by the financial difficulties (if not in fact inability) of the plan sponsor to meet its current obligations, there inheres in the transaction a potential prohibited transaction, as well as the issue of whether the plan trustees and other fiduciaries (including the plan sponsor itself in its role as fiduciary) have failed to serve the plan beneficiaries "with an eye sole" (in the quaint language of trust law) to the interests of beneficiaries. It would be hard to believe that no one currently having responsibilities in this matter has considered these issues; but no hint of that has surfaced.

That might not be the end of the matter. The scheme is apparently presently being employed just in New York State. It is only a matter of time —doubtless very little time—before it spreads across the country, indeed around the world. We in America did not invent pensions—that is credited to Bismarck—and the problems of funding pensions are not ours alone. This New York export—borrowing from Peter to pay Peter—is destined to have universal appeal in cities and states across the country and in nations around the world whose unfunded pension liabilities dwarf those in New York.

New York might even be able to monetize the scheme, as a patentable "novel" and "nonobvious" pension funding device entitling it to royalties from users near and far. In fact, if the prior art can be traced to that action by the IRS in 1975, the federal government might be able to assert a claim to a modest portion of the royalties thus collected by New York. But, of course, the Supreme Court would have to first adjudicate the dispute between the U.S. and New York.

(Readers take note: every word in this article is true, except for the last paragraph, no word of which is true. -- ADL)

Author's note: This is an expanded version of an article that originally appeared on the web site of Leimberg Information Services.

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