Presentation to House Committee on Pension & Benefits

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PENSION FUNDING BONDS

- In recent years, many states and local governments have issued billions of dollars in taxable pension bonds to make deposits to significantly underfunded pension systems. States who have recently issued pension bonds include Illinois, Connecticut, Wisconsin and Oregon.

- Most Pension Funding a/k/a Pension Obligation Bonds are issued as taxable bonds, meaning that the interest on the bonds is included in gross income for federal tax purposes, although they still may be issued as state tax-exempt. Federal income tax law imposes significant restrictions on the issuance and use of tax exempt bonds, including the use of tax-exempt bonds to directly finance a deposit to a retirement plan. (The U.S. Supreme Court determined in the 1988 case, *South Carolina v. Baker* that the right to determine whether obligations issued by state and local governments may be issued as federally tax-exempt is reserved to Congress).

- This is the case because most POBs are issued for the express purpose of making a deposit of bond proceeds into a pension system account, with the goal of investing the bond proceeds in higher yielding investments; Congress through the enactment of the Internal Revenue Code of 1986 characterizes this type of bond as "arbitrage bonds", and because the proceeds are invested rather than spent as defined by tests set forth in the Code, the bonds are also characterized as hedge bonds. If the bonds are issued as tax exempt, any investment earnings higher than the yield on the bonds must be paid as arbitrage rebate to the federal government.

- Certain strategies are available which would permit the issuance of tax-exempt bonds to fund eligible activities, these include:

- <u>Tax-Exempt Yield Restricted Bonds</u>: Tax-exempt bonds could be issued to directly fund a deposit to a retirement plan only if the deposited bond proceeds were invested in tax-exempt obligations such as state & local government securities (SLGS) or other investments designed to generate returns at or below the yield on the pension

funding bonds. This restriction on investment raises fiduciary and economic issues for plan administrators who are seeking to maximize yield on pension investments.

- Cash Flow Deficit or Working Capital Financing: this involves issuing short-term tax-exempt bonds to fund an operating deficit in one or more the State's funds that arose in part because of an extraordinary one-time deposit to the State's retirement plan. The aggregate amount that could be borrowed under this approach would be limited to the maximum operating deficit for the year, plus a reasonable operating reserve for the fund. The maximum term for these cash-flow deficit financing bond would need to be limited to two years. Subsequent cash-flow deficit financing bonds may be issued as well subject to new tax rules in effect at the time of issuance.

- Capital Project Financing: Long term tax-exempt bonds could be issued to fund capital project costs that the State would otherwise finance from tax revenues or other sources. Under this approach, the borrowing again, "frees-up" other available monies to fund the one-time deposit to the retirement plan. The bonds therefore finance capital assets eligible for tax-exempt financing under the Code. Example: the State issues $1B of tax-exempt bonds to finance KDOT or other State capital improvement projects and amortizes the bonds over 20 years. The State sweeps an equivalent amount of revenue that would otherwise flow to KDOT or other agencies to make a deposit to the pension system. The State pays the debt service on the tax-exempt bonds.

- Transition Cash Payments: Tax-exempt bonds possibly could be issued to make cash payments to buy out non-vested employees. This approach, however, would likely result in significant adverse tax ramifications for the employees. Tax-exempt bonds could be issued to make a one-time cash payment to individual employees, in exchange for their agreement to release the State from future pension funding obligations or in satisfaction and settlement of any claims unvested employees may have. A critical requirement for this financing is that each individual employee must be free to spend or invest the money however they may choose. An additional challenge in structuring this type of bond would be establishing an appropriate repayment term for the bonds. In general, federal tax rules require that tax-exempt bonds issued to finance a large extraordinary one-time payment be repaid as fast as possible from available revenues.