39. Regulation of Public-Sector Pension Plans

Introduction

Like their private-sector counterparts, public-sector pension plans are extensively regulated by the federal Internal Revenue Code (IRC), the common source of rules governing the deferral of taxation for each type of pension plan. In fact, this regulation has been significantly expanded in recent years. In exchange for the deferral of taxation and for certain other favorable tax treatment, the IRC sets forth certain pension plan requirements some of which apply to both government and private-sector plans and others from which government plans are exempt.[1]

In addition to IRC regulations, public-sector plans are extensively regulated and governed by state constitutional, statutory, and decisional law. These plans are, in fact, highly regulated, and in the past three decades the states have voluntarily adopted regulations, procedures, and practices— legal, actuarial, accounting, administrative, and investment— that have led to strong, responsible, and effective public employee retirement systems (PERS) across the country. Because of their well-developed benefit programs, the significant size of their assets ($1.5 trillion), and their large numbers of active and retired members (15 or more million), they are naturally the subject of interest to all stakeholders involved in their operation, including public employers; employer associations; plan members and employee organizations; taxpayers; legislators on the state, local, and federal level; and, last but not least, the beneficiaries.

Federal Regulation

Due to the unique nature of public pension plans, they are regulated largely by state and local law, while federal regulation of these plans has been evolutionary. When the Employee Retirement Income Security Act of 1974 (ERISA) was enacted,[2] Congress intentionally excluded government pension plans from some sections of ERISA because "additional time was considered necessary to determine the need for federal regulation of these plans."[3] ERISA called for a congressional study of several aspects of goverment pension plans, including the adequacy of their financing arrangements and fiduciary standards. The study, *The Pension Task Force Report on Public Employee Retirement Systems*, which was completed four years later, reported some deficiencies in public plans— including plans covering federal employees— in the areas of funding, reporting and disclosure, and fiduciary practices. However, the report found public pension plan terminations and insolvencies to be rare. (Later the same year, the federal government imposed reporting and disclosure requirements on pension systems for its own employees.) Based on the study, proposals partly or wholly paralleling ERISA were advanced for federal regulation of other public plans.

Many sections of ERISA do apply to public-sector plans, including Title III and significant sections of Title II. Government plans are exempt from ERISA's reporting, disclosure, and funding requirements (Title I) and plan termination insurance (Title IV). Although ERISA excluded public plans from several sections, public plans were required to comply with pre-ERISA requirements of the IRC.[4] These pre-ERISA requirements form the bedrock of plan qualification rules on which both private- and public-sector plans have been shaped.

While some observers continue to believe that state and local plans would benefit from the federal imposition of ERISA-like standards, state and local plans are financially sound. Even though some underfunded plans can still be found (primarily at the local level), public pension systems are generally well financed. A 1993 study by the Public Pension Coordinating Council concluded that, "To meet their pension obligations, the respondent plans have accumulated substantial assets and generally demonstrate strong financial health" (Zorn, 1994). According to the study, 75 percent of all systems conducted actuarial valuations on an annual basis, and 91 percent conducted them at least every two years (Zorn, 1994).

Tax Laws and Public-Sector Plans

The federal government continues to impose regulations on public pension plans. In recent years, especially since the Tax Reform Act of 1986 (TRA '86), public plans have increasingly shared more of the same IRC rules with private-sector plans, making the ERISA-nonERISA distinction largely irrelevant in the late 1980s.

Beginning in 1977, the Internal Revenue Service (IRS) observed a 12-year moratorium on disqualifying public retirement systems for violating applicable qualification rules.[5] In May 1989, the IRS lifted the moratorium on adverse qualification decisions based on discrimination requirements and determined that government and church plans must satisfy certain nondiscrimination requirements (Federal Register, 1989). Furthermore, in May 1990, rules issued by the IRS on coverage,[6] participation, and general nondiscrimination explicitly provided transition rules for government plans to give these units sufficient time to come into compliance (Federal Register, 1990). To date, these transition rules have not been issued by the IRS. This lack of guidance by the IRS has resulted in the agency extending the effective date to plan year 1999.

On the legislative level, a series of tax laws enacted in the mid and late 1980s modified the legal framework for benefit plans, and many of their provisions– unlike those of ERISA– were made applicable to government plans. Amendments made by TRA '86, in particular, added new requirements that apply to public plans as well as private-sector plans.

For example, the IRC sec. 401(a)(17) limit on compensation ($150,000 in 1996, indexed) applies to governmental plans through a grandfather rule. The regulations governing the sec. 401(a)(17) annual compensation limit generally took effect on January 1, 1996. There have been efforts to exclude governmental plans (e.g., sec. 403(b) annuities) from the nondiscrimination requirements because the regulations written for the private sector are unworkable within the unique structure of public plans. The IRS has delayed the effective date of most of the pension nondiscrimination regulations under 401(a)(4) due to an inability to create workable regulations for IRC sec. 403(b) tax-sheltered annuity plans and for qualified retirement plans maintained by governmental employers.[7]

Most public employee retirement plans are contributory, and TRA '86 replaced a special "three year recovery" of contributions rule that had applied primarily to public employees. Where public employees had earlier been granted up to three years of tax-free benefit payments to recover their own post-tax investment in pension plans, TRA '86 stipulated that their benefits were to be treated as partly taxable and partly tax free, based on an "exclusion ratio." Furthermore, if those employees received a preretirement starting date distribution, even if the distribution equaled their accumulated contributions, it would be treated as partly a tax-free return of contributions and partly a taxable distribution. The ratio of the tax-free to the taxable part of the distribution would reflect the ratio of the total employee contributions to the total value of the plan's expected benefits.

TRA '86 recognized that public employee plans provide normal retirement benefits at an earlier age, on average, than most private-sector plans due to the inclusion of public safety employees. The IRC sec. 415(b) benefit limitations apply,[8] although sec. 415 (b)(2)(F) provides special protection for governmental employees by substituting age 62 for the Social Security normal retirement age. Specifically, governmental plans were allowed to remain under pre-TRA '86 sec. 415 limits regarding maximum benefits and actuarial reductions for retirement before a specified age. Because retirement at younger ages is common in the public sector, compliance with the new, more severe sec. 415 rules would have forced some public jurisdictions to reduce benefits to current employees below promised amounts, violating pension plan law and in some cases constitutional law that prohibits cutbacks in public employees' benefits. Special sec. 415 rules were also enacted for police and firefighters, who typically retire at younger ages than other public workers. Because some state and local plans had promised benefits even beyond those allowed under pre-TRA '86 limits, an additional option was provided under the Technical and Miscellaneous Revenue Act of 1988. This law allowed jurisdictions to "grandfather" and excuse any sec. 415 violations resulting from benefit payments made to employees who became plan members before January 1, 1990, although the jurisdiction had to apply the new sec. 415 limits applicable to private plans to all future plan members.

State and Local Regulation

In addition to federal regulation, governmental plans are governed by state constitutional law and statutory law. Constitutional and contractual law guarantees, which may be expressed in state statutes and decisional law, afford members of public employee retirement plans many of the protections granted to members of ERISA-regulated plans by federal statutory law. In fact, it is safe to say that the public employees have stronger protection than private-sector employees today. A private-sector company can simply do away with its pension plan, subject to Pension Benefit Guaranty Corporation rules; merge; or terminate. This does not happen in the public sector because of the strong legal guarantees in place.

In those instances where ERISA rules are not applicable to public plans, such as reporting and disclosure, it is interesting that public plans are adopting the rules (through their state legislatures) on a voluntary basis. State statutes most often spell out benefit formulas, age and service requirements, and vesting and contributions and typically include ancillary provisions such as disability and death benefits. These statutes constitute a "plan document" that contains the plan provisions of a private-sector plan.

Many states have also established pension commissions. In fact, New York had established a successful commission as early as 1971, and by the late 1980s, permanent pension commissions and legislative retirement committees had been formed in 21 states, temporary commissions had been formed in 3 states, and legislative committees with pension activities had been formed in 3 states. These commissions and committees were formed for the purpose of providing "guidance to public executives, administrators, and legislators in developing public retirement objectives and principles, identifying problems and areas of abuse, projecting costs of existing systems and modifications to those systems, and designing and implementing pension reform programs" (Foster Higgins, 1988). In some cases, the pension commissions also oversee nonpension benefit programs (e.g., studying the costs of providing postretirement medical coverage for public employees) and serve as a buffer between the legislature and special interest groups.

Investment Practices

The investment policy of most of the $1.5 trillion public employee retirement systems is governed by state or local statute. Most states incorporate "prudent person" rules, which require that investments be made with the care of a prudent individual, solely in the interest of plan participants, echoing ERISA's definition of the prudent person principle. Many states also have "legal lists" of permissible or prohibited investments, percentage limits on certain types of investments, or rules covering diversification of pension assets. For example, some states limit the percentage of assets that can be invested in equities (perhaps to 50 percent or less), while other states permit allocation of a percentage of assets to in-state investments (occasionally defined as a percentage in residential mortgages). Other common investment restrictions include limiting the maximum amount of assets that can be placed in one company, in foreign stocks or bonds, or in real estate.

Public pension plans are leaders in corporate governance, sound investment policies, asset allocation, and international investments, while at the same time they tend to be more risk averse, on average, than private plans. During the last decade, many jurisdictions have broadened permissible investment opportunities for their pension plans, allowing them to prudently pursue a higher return for participants. While public pension funds invested 95 percent of their assets in bonds in 1950, this share had declined to 45 percent by 1994. Meanwhile, the investment in equities increased from 1 percent in 1950 to 43 percent in 1994 (Employee Benefit Research Institute, 1995).

Public pension plans have been largely successful in increasing returns through these changes. With a notable pool of assets, public plans are facing issues such as the propriety of using public pension fund investments to further social goals (e.g., bringing pressure on the South African government to end apartheid or a prohibition against investing in Northern Ireland munitions manufacturers); to shore up the local, state, or regional economy (targeted investing); or to finance such controversial measures as hostile takeovers and leveraged buyouts. The Bankruptcy Reform Act of 1994 gave state and local government pension plans seats on creditors' committees in corporate bankruptcies.

Conclusion

Public pension plans have been substantially strengthened by federal, state, and local laws and regulations over the past three decades. In many instances, these new rules have narrowed the gap between public- and private-sector plans. Ironically, due to their strong constitutional and statutory guarantees on the state level, employees' rights and benefits may have even greater protection today in the public sector than they have in the private sector. The cadre of professional pension administrators, informed legislators, and state and local government administrators involved in the public pension policymaking process on a day-to-day basis has, in fact, ushered in a new era for PERS.

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[1] Joseph G. Metz, *The Federal Taxation of Public Employee Retirement Systems: A Handbook for Public Officials* (Chicago, IL: Government Finance Officers Association, 1988).

[2] The Employee Retirement Income Security Act of 1974 established federal rules regarding private-sector pension plans, including funding; fiduciary standards; and reporting and disclosure of plan information.

[3] U.S. Congress, House, Committee on Education and Labor, *Pension Task Force Report on Public Employee Retirement Systems*, Committee Print, 95th Congress, 2nd Session, March 15, 1978 (Washington, DC: U.S. Government Printing Office, 1978).

[4] The Internal Revenue Code (IRC) speaks in terms of *governmental plans* rather than public pensions. A governmental plan is any plan established and maintained by a federal, state, or local government or by an agency or instrumentality of that government. The term also includes plans sponsored by certain international organizations.

[5] The Internal Revenue Service (IRS) has had the issue of whether and how to regulate public pension plans under study for some time. In 1977, it announced that it was going to reconsider application of IRS'qualification requirements to public plans, and until the reconsideration process was completed, qualification issues would be resolved in favor of the taxpayer or the governmental employer by continuing to treat the plan as if it were qualified. As of the start of 1982, public plans have no longer been required to file the annual pension plan information form that had been used as the basis for review of governmental plans for compliance with the tax qualification rules.

[6] Coverage rules govern the age and service requirements employers may set for allowing employees to participate in pension plans.

[7] For sec. 403(b) plans, the effective date of the nondiscrimination regulations has been delayed until January 1, 1997. In the case of governmental plans, the effective date has been delayed until 1999 or later.

[8] The Small Business Job Protection Act of 1996 modified the 415 limits in a manner that the 100 percent of compensation limit will not apply to government plans.