Pension Funding Strategies: Close Loopholes First

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Examples of Prevailing Strategies to Close Pension Funding Gap

- Cut Benefits
- Increase Employee Contributions
- Convert Defined Benefit Pension Plans into Do it Yourself Defined Contribution Plans
- Cut Cost of Living Adjustments for Retirees
Instead of pursuing the strategies that not only harm members to whom pensions were promised, but also harm local businesses and economies, why not close tax loopholes first.

I’ll speak about what these loopholes are, how they work and what you can do as you work toward preserving and enhancing public pensions.
Who Pays Taxes in Louisiana?

Small Business and People pay Taxes.

Individual Income Tax rates are between 4% and 6%.

Corporate EFFECTIVE tax rates are below 1%.

Insurance Companies pay no income tax.

There are special breaks for car companies, coal companies, banks, airlines, oil companies, and many others.
Is Big Business Paying a Fair Share?

In 2010, 2230 companies doing business in Louisiana made more than $815 billion in Federal Taxable income and did not pay one cent in Louisiana corporate income tax.

Those companies made $8.4 billion in Louisiana income. If that income was taxed at 6% it would produce almost $500 million in additional revenue.

In 2010, of the 109,970 corporations in Louisiana, 91,693, or 83% paid no corporate income tax.
Corporate profit/GDP is in double digits

Market Realist

Source: Trading economics
Profits Up, Wages Down

Companies Making BIG Money Pay Zero

↓ In 2010, of the 4871 corporations that made over $5 million in revenue, 45% paid zero Louisiana Corporate Income Tax.

↓ Of the companies making more than $10 million dollars, 43% paid zero Louisiana Corporate Income Tax.

↓ Of the companies making more than $25 million dollars, over 46% paid zero Louisiana Corporate Income Tax.
Of the largest 150 Louisiana corporations by payroll, 99 of them paid zero tax.
The Add-Back Gimmick: Shifting Louisiana Income To No-Tax States

PIC makes Dividend payment To West Coast Parent. Payment for trademark (deducted as expense)

Parent makes Dividend payment To Louisiana Company. Dividend Is tax free.
How much can they hide, and is this really a problem??

- In 2008, there were 437 companies in Alabama that made over $100 million in federal taxable income and paid zero Alabama income tax.
- Same year there were 97 companies that made over $500 million and paid no Alabama income tax.
- There were even 47 companies that made over $1 billion and paid no Alabama income tax.
  - Source: Alabama Department of Revenue.
Who is doing this and how much is it costing us?

In 2003 Exxon made $89 million in Alabama and paid Zero income tax.

- They deducted $418 million in payments to themselves.
- They deducted 6 times the Federal Depletion allowance.
- Deducting 6 times the Federal Depletion Allowance allows Exxon to deduct more than the oil and gas is worth.

Source: Records on file with the Alabama Department of Revenue from a publically filed challenge to tax assessments.
Are These Loopholes Widespread?

- **Lowes Inc.** deducted $833 million in payments to itself and reduced its Alabama income by $25 million.
- **McDonalds Corp.** deducted $500 million in payments to itself and reduced its Alabama income by 55%.
- **Abercrombie & Fitch** deducted over $200 million in royalty payments to itself and reduced its income by almost 90%.
- **Talbots** income tripled after add-backs by State auditors.
- **Rheem’s** income rose by 2200% after add-backs.

Source: Records on file with the Administrative Law Division of the Alabama Department of Revenue.
Is This Really Tax Avoidance or is There Some Business Purpose?

- In one case, nine related companies of the Limited, Inc. received payments from their affiliates of $423,098,963 in one year.

- The nine Limited companies had no employees, and shared office space, equipment, and supplies.

- The primary office space used by the nine Companies was also the primary office address for more than 650 other companies.
Using REIT Strategies to Avoid Louisiana Income Tax

Nevada REIT
- REIT makes Dividend payment To Related Company
- Rent paid to REIT (deducted as expense)

Louisiana Corporation
- Related Company makes Dividend payment To Louisiana Company. Dividend Is tax free.

Related Corporation in Delaware
Wal-Mart used the REIT Tax Shelter.

- In the late 1990’s Wal-Mart transferred ownership of its stores to Captive REITs and rented from those REITs

- REITs pay no corporate income tax

- In one four-year period, Wal-Mart saved $230 million in State Taxes, by paying rent to itself.

- Wal-Mart deducted the rent payments even though they never left the company.

Source: Wall Street Journal, Jessie Drucker, 2-01-07
Paying Taxes to the Boss

- 16 states allow companies to effectively keep their employees’ state personal income taxes
- 2,700 companies named in database
- Loss to states ~$700M/year
2015: Good Time for Closing Tax Loopholes

- State and local revenues still depressed
- No more stimulus relief
- Jobs issue highly politicized
- Taxpayers hungry for government transparency
WHAT ARE YOUR OPTIONS?

- Pass Combined Reporting.
- Examine Nexus and Apportionment Issues
- Oil and Gas Depletion and Severance Issues.
- High-income surcharges for $200,000 +
- Limit Loss deducts for Corps. and Indiv.
- Services Taxes (38 states do it).
- Digital Property definitions for sales tax.
MORE OPTIONS...

- Examine and End ineffective job subsidies.
- Decouple from new any Federal changes that lose you money.
- On-Demand Cable Taxes.
- Mobile Communications Taxes.
- Floor on Property Taxes—Examine 4 year or 2 year Appraisal in down years.
- PLAY DEFENSE!!!!!!
Comparison of Annual Employer Pension Contributions and Annual Cost of Corporate Tax Loopholes and Subsidies in Selected States

<table>
<thead>
<tr>
<th>State</th>
<th>Annual employer normal pension costs</th>
<th>Annual cost of corporate subsidies and tax breaks/loopholes</th>
<th>Annual pension costs as a share of subsidies + tax breaks/loopholes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arizona</td>
<td>$474,524,688</td>
<td>$552,108,211</td>
<td>86%</td>
</tr>
<tr>
<td>California</td>
<td>$6,822,294,460</td>
<td>$9,701,000,000</td>
<td>70%</td>
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<tr>
<td>Colorado</td>
<td>$179,560,282</td>
<td>$593,109,000</td>
<td>30%</td>
</tr>
<tr>
<td>Florida</td>
<td>$905,581,094</td>
<td>$3,810,902,291</td>
<td>24%</td>
</tr>
<tr>
<td>Illinois</td>
<td>$1,855,100,000</td>
<td>$2,400,796,000</td>
<td>77%</td>
</tr>
<tr>
<td>Louisiana</td>
<td>$348,471,694</td>
<td>$1,813,729,079</td>
<td>19%</td>
</tr>
<tr>
<td>Michigan</td>
<td>$586,592,328</td>
<td>$1,860,600,000</td>
<td>32%</td>
</tr>
<tr>
<td>Missouri</td>
<td>$427,300,226</td>
<td>$840,231,523</td>
<td>51%</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>$221,501,696</td>
<td>$479,033,081</td>
<td>46%</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>$1,395,509,900</td>
<td>$3,888,000,000</td>
<td>36%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$13,216,436,368</strong></td>
<td><strong>$25,939,509,185</strong></td>
<td><strong>51%</strong></td>
</tr>
</tbody>
</table>

Source: Good Jobs First, 2014
Subsidy Tracker

First-ever searchable national database of company-specific subsidy data

Website with Many Tools @

www.goodjobsfirst.org
Public Pension Funding Forum

Closing the Funding Gap without Dismantling Public Pensions
Pension Funding Strategies: Innovative Solutions from the Field

August 22, 2016
Presented by: Sean McNeeley
Discuss methods of addressing pension challenges that our clients have used:

- Dedicated Revenue Sources
- Pension Obligation Bonds
- Asset Monetization
- Pension Modifications
Overview

- State and local government pension plans declined from an aggregate total funded ratio of as high as 129% in 1999 to as low as 61% in 2011.
- Review of a large sample of plans demonstrated that the largest causes of declining funded ratios between 2001 and 2013 were lower than assumed investment returns and underfunding of required contributions, particularly for the lowest-performing plans.
- The PFM Group has supported numerous state and local governments in addressing pension funding shortfalls in a financial advisory or consulting capacity.

Sources: Federal Reserve Board, Financial Accounts of the United States; Center for Retirement Research at Boston College, How Did State/Local Plans Become Underfunded?, January 2015
Dedicated Revenue Sources

- Employer pension contributions are typically made from the General Fund budget
- In some instances dedicated, non-discretionary tax revenue sources are being used to supplement pension funding
- These dedicated revenue sources are being applied in multiple ways:
  - As a source of pre-funding to the pension trust fund, with the future stream of revenues counted as an asset (in some form)
  - As a source of pre-funding to the pension trust fund that is counted as supplemental funding beyond actuarial requirements
  - As a direct source of funding for pension benefits on a pay-as-you-go basis
State law enacted in 2009 required the City to increase the aggregate funded level of its pension plans to at least 50 percent by the end of 2010.

The City transferred reserve funds and explored asset monetization. Rather than use parking assets for a sale or long-term lease, the City rejected a $453 million 50-year lease in favor of dedicating annual revenue from parking tax revenue collections.

The present value of the parking tax revenue was considered as an asset for purposes of meeting the requirements of the state law:
- Not considered an asset for financial reporting
- The parking tax revenue is used as a supplement to the minimum contribution required by the state

Sources: PFM reports; Mockenhaupt Benefits Group, *Summary Actuarial Valuation Report for the City of Pittsburgh Pension Funds as of January 1, 2013*. 
The City’s pension fund was already stressed prior to the Great Recession, dropping from 77% funded in 2001 to roughly a 55% funded status in 2008.

Philadelphia is required by state law to balance five-year financial plans. Following the ‘08-'09 market downturn, the City faced $700 million of budget reductions for the FY10-FY14 plan in order to maintain the Minimum Municipal Obligation (MMO) pension funding requirements under state law.

The state legislature authorized Philadelphia to:

- Defer a portion of the MMO, to be repaid with interest at the rate of the pension earnings assumption
- Collect an additional 1% sales tax for five years to offset increased pension contributions and balance the plan, and to pay the interest on the deferral, which was repaid a year early

The legislature then made the sales tax permanent:

- A fixed amount was dedicated to school funding, with the remainder dedicated to pension funding
- The additional revenue is being as a supplement to the MMO, as in Pittsburgh

The City of Portland Charter authorizes a special property tax levy to generate the amount of revenue required to pay all estimated expenses for its Fire and Police Disability, Retirement and Death Benefit Plan.

The Plan reports $2.9 billion in unfunded liability because it is not prefunded.

The Charter authorizes a range of levies, with a minimum and a maximum. If expenses exceeded the maximum, the City would have to fund the difference from other sources.

- Simulations as of June 30, 2014 indicated a 4% possibility of reaching the maximum levy rate prior to 2034.

Disadvantages:
- Intergenerational equity
- Opportunity cost of investment returns
- Potential for funding gaps

Advantages:
- Simplicity/transparency
- Reduced risk and volatility
- Significant history of reliably maintaining complete funding

The current Mayor of Jacksonville is pursuing a plan to dedicate sales tax revenues to pension funding when the current authorization for the tax expires in 2030
  - Approved by the Florida Legislature and Jacksonville City Council
  - Voter referendum on August 30

The plans for how to benefit from the future tax revenues are unclear:
  - Borrow against the future revenues
  - Seek ability to count future revenues as an asset
Pension Obligation Bonds

- Issuers of Pension Obligation Bonds ("POBs") issue debt in the taxable fixed rate markets and deposit the proceeds into their pension system.
- POBs are a risk-bearing arbitrage strategy between the cost of financing and the return on investment.
  - Investment rates that are greater than borrowing costs will achieve net savings to the pension obligation.
  - POB proceeds should be invested in asset classes that provide the best risk/return trade-off (i.e. Equities).
- POBs replace a ‘soft liability’ with a ‘hard liability.’
• The County evaluated POB options for its Employee Retirement System from 2006-2008, and obtained state legislation in 2007 to allow additional flexibility in the deal structure
• The county sold $400 million of POBs on March 19, 2009
  – On March 9, 2009 the Dow Jones Industrial Average closed at 6,547, a post 1997 low, which was 53.8 percent below its October 2007 high.
  – This is a prime example of the “benefit bonds window” – issuing when market conditions increase the likelihood of short-term success
• The plan had a funded ratio of roughly 80% at 1/1/15
• Positive arbitrage on the POB is estimated at roughly $140 million through FY14
Asset Monetization as a Funding Strategy

- Many governments own significant assets that provide a stable and long-term source of cash-flows.
  - Governments may sell or lease these assets to match long-term cash-flows with the long-term liabilities associated with retirement systems.

**Scranton, PA** is currently seeking regulatory approval for a $195 million sale of its water and wastewater system. The net proceeds of the transaction are expected to be applied towards the pension system, which was roughly 25% funded in aggregate at 12/31/14. The City then hopes to emerge from the state’s fiscally distressed status that has been in for 24 years.

**Allentown, PA** leased its water utility for 50 years to a public authority in return for $211.3 million, of which $160 million was used to reduce the unfunded pension liability. Future rate increases were limited and there was no initial cost to taxpayers. As a result, Standard & Poor’s revised Allentown’s ratings outlook from stable to positive.

**Chicago, IL** monetized its on-street parking enterprise for $1 billion, but used the proceeds to fund a current operating deficit. The City continues to struggle with low pension funded ratios and dramatic increases in required contributions.
Pension Modifications

- A comprehensive approach to reform will produce the most lasting improvements if plan modifications become necessary:
  - Enhanced statutory employer funding commitment
  - Review and update actuarial assumptions for fit with current conditions and future sustainability
  - Introduce flexibility and risk management mechanisms that allow the plan, if stressed, to be sustained without further redesign/new tiers
The Lexington Policemen’s and Firefighters’ Retirement Fund had a funded ratio of 59% and historical statutory contributions were actually not sufficient to amortize the liability.

A new calculation would have required the City’s contribution to more than triple and consume over 10% of the entire budget.
The Mayor convened a Task Force consisting of City representatives, employees (police and fire), legislators, and citizens. The parties came to a consensus that was ratified by both active and retired police and fire union members. The consensus changes included:

- Increasing the City’s contribution to a minimum of $20 million – more than the historical contribution of around $11 million but less than the preliminary calculation of $38 million under the prior plan
- Reforming an automatic cost of living adjustment to be based on pension amounts with a trigger for the overall funded ratio of the plan, for existing retirees and actives as well as new hires
- Increasing the active employee contribution, reducing the disability pension, and reducing the pension multiplier for new hires from 2.5% to 2.25%
- Instituting a minimum age requirement of 50 to receive the pension
- Reducing the earnings assumption and instituting a conservative level dollar closed amortization

These changes were projected to reduce the unfunded liability by 45% or $134.8 million. Of the 1,487 retired and active police officers and firefighters who voted on the proposal, 76% supported it. The bill enacting these changes passed both Kentucky legislative bodies and was signed into law.
Questions