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Net Pension Liability of State Retirement Systems – Do the New Rules Allow Liability to be Shifted to an Entity other than a Participating Employer?

Background

What is "Net Pension Liability" and Why is it Important?

Under new Governmental Accounting Standards Board (GASB) Statements No. 67, "Financial Reporting for Pension Plans" (i.e., accounting at the plan level) and No. 68, "Accounting and Financial Reporting for Pensions" (for reporting by employers), many typical state retirement systems will come within the definition of a "cost-sharing plan" - a "multiple employer defined benefit pension plan in which the pension obligations to the employees of more than one employer are pooled and pension plan assets can be used to pay the benefits of the employees of any employer that provides pension through the pension plan".¹ For the first time, participating employers in such cost-sharing plans will generally have to show a portion of the plan's liabilities on their balance sheets. These new accounting rules will apply to the plans for fiscal years beginning after June 15, 2013, and to the participating employers for fiscal years beginning after June 15, 2014.²

Under GASB 67, net pension liability (NPL) for a cost-sharing plan is to be measured as the plan's total pension liability, net of the pension plan's fiduciary net position.³ The total pension liability is the portion of the actuarial present value of projected benefit payments that is attributed to past period of plan member service.⁴ Projected benefit payments, in turn, include all benefits to be provided to current active and inactive plan member through the pension plan in accordance with the benefit terms and any additional legal agreements to provide benefits that are in force at the pension plan's fiscal year-end.⁵ The entry age normal method is used to determine this, and it also includes COLAs that are substantively automatic, projected salary changes, and projected service credits.⁶

There is also projected the plan's "fiduciary net position" each year. To do so, the present value of the projected benefit payments is to be determined based on a discount rate blended using the long-term expected rate of return on pension plan investments that are

¹ Governmental Accounting Standards Board Statement No. 67, Paragraph 51, Glossary. A multiple employer plan under which each participating employer has a share of plan assets that can only be used to pay its own liabilities is an "agent" plan.

² GASB 67, para. 48; GASB 68, para. 136

³ GASB 67, paras. 35-46.

⁴ GASB 67, para. 36.

⁵ GASB 67, para. 39.

⁶ Id.

expected to be used to finance the payment of benefits to the extent that the plan's fiduciary net position is projected to be sufficient to make projected benefit payments, and to the extent it is not, using a yield or index rate of 20-year, tax exempt general obligation municipal bonds with an average rating of AA/Aa or higher.⁷

Observation: essentially, this allows public plans to use their own internal expected rate of return on assets for accounting purposes – but only for assets on hand and projected future contributions. To the extent those assets and projected contributions are not projected to be sufficient to meet future projected liabilities, the lower tax exempt bond-based rate must be used to present value the difference. Consequently, the more underfunded a public plan is currently, the greater the impact of the new GASB rules.

How Does Net Pension Liability Appear on the Financial Statements of a Participating Employer?

Under GASB 68, in the case of a cost-sharing plan, an employer is to recognize their "proportionate share" of the collective NPL. This proportion is determined as "the proportionate relationship of (1) the employer ... to (2) all employers...." The basis for the participating employer's proportion should be consistent with the manner in which contributions to the cost-sharing plan are determined. This is to be consistently applied period to period. The use of the employer's projected long-term contribution effort to the pension plan as compared to the total projected long-term contribution effort of all employers for this proportion "is encouraged".⁸ This is intended to offer flexibility in determining the method of proportioning. The "Basis for Conclusions" in Appendix B to GASB 68, at paragraphs 307-316, sheds further light on this, and mentions several alternatives, including current period contributions or current period payroll, average historical contributions or average historical payroll, single period forward looking contributions, and methods used internally by a pension plan to associate a portion of the unfunded pension obligation to individual employers. These do not appear to be safe harbors, though; presumably, accounting judgment must be applied to determine that any given method used is representationally faithful, and the basis for the proportion must be disclosed in the notes to the employer's statement.⁹ In addition, where different contribution rates apply to different employees, that can be taken into account.¹⁰

In addition to this liability, the GASB rules further require that cost-sharing employers recognize their proportionate share of pension expense and deferred outflows of resources and deferred inflows of resources related to pensions.¹¹ An extensive amount of additional information must be included in the cost-sharing employer's financial statements as notes to the statements or required supplementary information.¹² With the additional disclosure, accounting costs and complexity of financial statements seems likely to increase significantly.

The Special Funding Situation/Nonemployer Contributing Entity Rules

The GASB rules contemplate that the apportionment of liability to participating employers in a cost-sharing plan can shift under certain circumstances. Though these provisions are not entirely clear and do not seem to have drawn

⁷ GASB 67, paras. 40-46.

⁸ GASB 68, para. 48.

⁹ GASB 68, App. B, paras. 313-315.

¹⁰ GASB 68, App. B, para. 316.

¹¹ GASB 68, paras. 52-57.

¹² GASB 68, paras. 108-117.

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much attention to date, it seems likely that they will receive more focus in coming years. To begin with, GASB 68 introduces a new concept of "special funding situations", which are

circumstances in which a nonemployer entity is legally responsible for making contributions directly to a pension plan that is used to provide pensions to the employees of another entity or entities and either of the following conditions exists:

a. *The amount of contributions for which the nonemployer entity legally is responsible is not dependent upon one or more events or circumstances unrelated to the pensions.* Examples of conditions that meet this criterion include (1) a circumstance in which the nonemployer entity is required by statute to contribute a defined percentage of an employer's covered employee payroll directly to the pension plan and (2) a circumstance in which the nonemployer entity is required by the terms of a pension plan to contribute directly to the pension plan a statutorily defined proportion of the employer's required contributions to the pension plan. In contrast, examples of situations in which the amount of contributions is dependent upon an event or circumstance that is unrelated to pensions include (i) a circumstance in which the nonemployer entity is required to make contributions to the pension plan based on a specified percentage of a given revenue source and (ii) a circumstance in which the nonemployer entity is required to make contributions to the pension plan equal to the amount by which the nonemployer entity's ending fund balance exceeds a defined threshold amount.

b. *The nonemployer entity is the only entity with a legal obligation to make contributions directly to a pension plan.* Special funding situations do not include circumstances in which resources are provided to the employer, regardless of the purpose for which those resources are provided.¹³ [emphasis added]

This apportionment is determined as of the measurement date for the governmental nonemployer contributing entity's fiscal year, consistently applied period to period.¹⁴ If the nonemployer contributing entity meets those requirements, then it recognizes its proportionate share of the plan's net pension liability

consistent with the manner in which contributions to the pension plan, excluding those to separately finance specific liabilities of an individual employer or nonemployer contributing entity to the pension plan, are determined. The use of the governmental nonemployer contributing entity's projected long-term contribution effort to the pension plan as compared to the total projected long-term contribution effort of all employers and all nonemployer contributing entities to determine the governmental nonemployer contributing entity's proportion is encouraged.

The Statement goes on to provide that:

For example, if the governmental nonemployer contributing entity's contribution requirements are defined by the plan terms to be 25 percent of the employers' total actuarially determined contribution, the governmental nonemployer contributing entity's proportion of the collective net

¹³ GASB 68, para. 15.

¹⁴ GASB 68, para. 97.

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pension liability should be considered to be 25 percent. For another example, if (a) the governmental nonemployer contributing entity's required contribution, consistently contributed, is defined in the pension plan terms to be the amount necessary to finance 100 percent of past service cost on the actuarial funding basis used by the employers and nonemployer contributing entities and (b) the employers' required contribution rate is defined in the pension plan terms to be an amount to satisfy the portion of the actuarially determined service cost of each period that is not offset by employee contributions, the governmental nonemployer contributing entity's proportion of the collective net pension liability should be considered to be 100 percent.¹⁵

Consequently, it would appear that the "nonemployer contributing entity" (such as a state) must (1) as of the measurement date for the fiscal year in question (2) have the legal responsibility to make contributions (3) directly to the pension plan, and (4) the responsibility must not be dependent upon one or more events or circumstances unrelated to pensions.

These provisions of the new rules have given rise to various ideas, including changing state law to provide that some nonemployer contributing entity (for example, the state itself), rather than participating employers, take on a legal duty to make contributions directly to the cost-sharing plan equal to the excess of liability payments over assets and employer contributions in any year. Note that this may not in itself shift all of the liability on to the nonemployer contributing entity, since it is not making 100% of contributions, but only some projected future payments to an underfunded plan. But it would appear to have a similar effect in that the present legal liability to make those contributions might then be taken into account in determining the projected cash flows from contributions "from employers and nonemployer contributing entities" to determine the current plan's fiduciary net position.¹⁶ Presumably, projecting such contributions by the nonemployer entity could zero out the difference between fiduciary net position and total pension liability, so that net pension liability of a participating employer would then be zero. This would not, though, appear to remove the necessity for participating employers to include the extensive information required in the financial statements, notes and supplementary information.

Of course, having an entity take on such liability in order to shift it from the participating employers on whose financial statements the cost-sharing plan NPL would otherwise appear could be difficult to enact. Presumably, too, the legal responsibility of the nonemployer entity for the contributions would have to be very clear, as well as not contingent on a circumstance unrelated to the payment of the pensions.

Another idea that has arisen is for the entire contribution obligation to the cost sharing plan to be statutorily shifted to the plan sponsor, for example, the state under a state retirement system, with participating employers paying contributions to the state, and the state in turn making contributions directly to the plan. This would seem to make the state's proportion of NPL 100% based on a literal reading of GASB 68, paragraphs 15 and 97, quoted above, so long as the state's obligation to pay to the cost-sharing plan was not contingent upon the participating employer making the contribution to the state (although a state presumably will have powers to enforce timely contributions). This view would seem to be consistent with the Statement's logic in the reverse situation that contributions paid by a nonemployer entity indirectly to the plan through the employer are considered employer contributions, not the contributions of the nonemployer. However, it is not clear that GASB contemplated the mirror image of that situation when drafting the Statement.

¹⁵ Id.

¹⁶ GASB 68, para. 41.

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Reduction in Liabilities

In the course of its decision-making on the new rules, GASB clearly rejected the idea that a cost-sharing plan itself was the entity that should recognize the liabilities of the plan – they believed that it should appear on the employers' balance sheet based on their view that the pension was in exchange for services for the employer. They considered, but rejected, the argument that the liability should fall on the plan sponsor, such as the state in the case of a state retirement system.¹⁷ The idea that the liabilities were essentially contained at the plan level, and that participating employers were only obligated to make the contributions by statute was often referred to as the "insurance company" model.

But one of the ideas underpinning the Board's view was that, under the current retirement systems they had considered, the amount of the pension would be paid in any event. (Unlike the federal Social Security program, for example, which the Board distinguished from state pension systems on the grounds that Social Security might not be paid in the future.) And in truth, while some examples were presented to the Board of state statutes that said such things as that employers would not have to contribute more than the statutorily required contributions,¹⁸ there did not appear to be any current state statutes that expressly stated that pension payments would be reduced to the extent of available funds.

Consequently, another idea that has arisen to reduce the amount of NPL on cost-sharing employer's financial statements is that of reducing the liabilities themselves. This may be impeded for any number of reasons, particularly in states where even future benefit accruals may be protected from change, such as on Constitutional impairment of contract grounds.¹⁹ However, this is a state by state determination, and an area where there is much ongoing litigation and not much certainty.²⁰

The concept, however, is that if the state law were changed to provide that benefit payments in a year would be reduced to no more than assets plus contributions for a year, then in a future year after the system ran out of money, projected benefit payments would not exceed projected future contributions. Total plan liability would be reduced to the extent necessary to not exceed fiduciary net position. Again, even if the NPL were effectively reduced to zero by such changes, it presumably still would not obviate the need for participating employers to continue to include the extensive information required by GASB in the financial statements, notes and supplementary information.

¹⁷ GASB 68, para. 176.

¹⁸ See, e.g., Nevada Revised Statutes section 286.110(4) ("respective public employers are not liable for any obligation of the [Nevada Public Employee's Retirement] System.")

¹⁹ See, e.g., Staman, Jennifer, State and Local Pension Plans and Fiscal Distress: A Legal Overview (Congressional Research Service March 31, 2011); "State Constitutional Protections For Public Sector Retirement Benefits", National Council for Public Employee Retirement systems paper available at <http://www.ncpers.org/Files/News/03152007RetireBenefitProtections.pdf>

²⁰ Id. See also Snell, Ronald, Highlights of State Pension Reform in 2012 (July 17, 2012), available at www.ncsl.org. Information on public pension litigation is also available at conferences of the National Association of Public Pension Attorneys (NAPPA, see www.nappa.org).

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Some Final Caveats

The ideas expressed in this article reflect GASB's statements as well as public discussions at the Board meetings at which they were hammered out. They are subject to professional judgment by the accountants who will be preparing the financial statements in question. Importantly, GASB has announced that it intends to prepare Implementation Guides before the effective dates of each of the new accounting standards (fiscal years beginning after June 15, 2013 for Statement 67, and fiscal years beginning after June 15, 2014 for employers to implement Statement 68). Any state retirement systems or other cost-sharing plans contemplating changes for their accounting effect might well wish to consider providing questions and comments to GASB staff on those Implementation Guides in the near future.

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