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Regulating Public Pension Fund Investments: The Role of Federal Legislation

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During the first part of the last decade, pension funds both private and public were represented as being the nation's single largest source of capital. Presently state public pension funds have accumulated assets in excess of $700 billion. The most recent projection is that by 1995 state and local public pension funds will have assets exceeding $1 trillion.

The investment potential of these funds can influence both the local and national economies. The enormous capital in public pension funds has been viewed as a possible remedy for distressed state economies, and as a source of funds to achieve socially and politically desirable policy objectives. Therefore those entrusted with the investment decision making of these funds are being encouraged by state political leaders to invest in local real estate, the state's infrastructure, and even socio-political concerns like businesses started by women and

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5. Hutchinson & Cole, supra note 1, at 1340.
minorities.\textsuperscript{7} It has also been suggested that pension funds could provide a catalyst for economic activity within a particular state or region which could take the form of an increase in the availability of mortgages for state residents.\textsuperscript{8}

The economic power of pension fund assets has come under close scrutiny by policy makers, and a litany of concerns have been aired. It is believed that pension funds should widen their investment perspectives from the classic legal parameters of exclusivity of purpose and the maximization of returns, to encompass considerations of responsibilities to the society.\textsuperscript{9} In other words, public pension fund managers are considered duty-bound to consider the moral and ethical responsibilities to the economy which transcend the parochial focus of preservation of capital and maximization of return. The argument is that a narrow focus for fund performance denies constructive symbiosis of interests, since the growth and security of pension funds and public pension funds depend, to a large extent, on the sustained growth of the economy. Beginning in the early 1980s, public pension funds pursued investments that attempted to impact the economy of a specific locality or region, and although many states have enacted statutes permitting such "targeted investments," the question remains whether such legislation has gone far enough in the effort to promote these type of investments.

The main objective of this study is to examine the current legal status of economically targeted investments (ETIs) and to explore the advantages of a federal tax policy which would supplement the States' efforts to promote ETIs. To this end, the following issues will be discussed:

Part I - The implications of public pension fund investment in ETIs.

Part II - The fiduciary and policy issues under state and federal law.

\textsuperscript{7} Bartlett, \textit{supra} note 2, at D2. (Catherine Baker Knoll, the Pennsylvania State Treasurer, requested that the Pennsylvania public pension funds invest in business started by women and minorities. Pennsylvania public pension funds at the time had assets of $25 million.)

\textsuperscript{8} \textit{See generally LITVAK, supra} note 3.

\textsuperscript{9} For a recent example of this view, see \textsc{Mario M. Cuomo, Governor, Reports of the Governor's Task Force on Pension Fund Investment: Our Money's Worth (June 1989); Competitive Plus: A Study of the Feasibility of Implementation of Recommendations Made by the Governor's Task Force on Pension Fund Investment Policy (Feb. 1990)} [hereinafter \textit{Competitive Plus}].
I. THE IMPLICATIONS OF PUBLIC PENSION FUND INVESTMENTS IN ETIs

The term Economically Targeted Investments has most recently been defined as investments used to achieve a market rate of return at an appropriate risk level while targeting a specific public policy. State pension fund ETIs typically include venture capital, residential mortgage programs, small business development programs, commercial real estate and the purchase of certificates of deposits from local banks.

A. Public Benefits from ETIs

Proponents of ETIs maintain that many long-term interests, which result from a stable economy, are shared by beneficiaries of public pension plans and the community at large. These include economic opportunities through assistance to small businesses and job creation; the maintenance of a clean environment; assistance to economically distressed areas; the improvement and expansion of the infrastructure (roads, housing, health care and educational facilities); and the promotion of research and development and technological innovation. These shared benefits are urges as justification for the availability of public pension funds to revive and improve the economy.


11. STATE OF NEW YORK, COMMISSION ON PUBLIC EMPLOYEE PENSION AND RETIREMENT SYSTEMS, IN-STATE INVESTMENTS BY PUBLIC RETIREMENT SYSTEMS OF THE CITY AND STATE OF NEW YORK (May 31, 1988).

12. See generally INSTITUTE FOR FIDUCIARY EDUCATION, ECONOMICALLY TARGETED INVESTMENTS: A REFERENCE FOR PUBLIC PENSION FUNDS (Sept. 1989); COMPETITIVE PLUS, supra note 9; Bartlett, supra note 2, at D2; Alfred Rappaport, The Staying Power of the Public Corporation, HARV. BUS. REV., Jan.-Feb. 1990, 96, 100. The survey however reported that less than 4% of ETI programs failed to meet benchmark returns; 33% met the benchmark standard; 4% exceeded the benchmark; 37% did not have results and 22% did not respond. The data reveals that of the retirement systems studied 41% had the expected impact and 9% exceeded expectations. Fourteen percent had less than the expected effect.

13. COMPETITIVE PLUS, supra note 9.
B. The Return Trade-Off

In response to investment strategies that diverge from the basic goal of providing retirement benefits to plan participants and beneficiaries, some argue that such investment deviates from the literal strictures of state and federal fiduciary laws which reflect the traditional principles of prudence and loyalty.14 In order to appease these concerns, proponents of ETIs maintain that neither fiduciary standards nor the rate of return should be compromised when contemplating ETIs.15 The representatives of current and future beneficiaries of public retirement benefits urge that the sole concern of the fund trustees must be the fund’s financial condition and the investment’s economic yield. Indeed they maintain that public pension funds should not be available to subsidize the state, something that is the responsibility of the general public.16 This approach is somewhat short-sighted since the beneficiaries of public pension funds are themselves members of the general public, and the ultimate beneficiaries of a healthy economy. Furthermore, tax revenues remain available as a safeguard to pay promised benefits. Hence there exists an interdependence between the fund, its beneficiaries and the state’s economy.

C. Molding the Two: Reciprocity and Inseparability

ETIs may therefore be justifiable on theories of reciprocity and inseparability. The public pension systems absorb a large share of state and city revenues. A case in point is the city contributions which comprise the majority of the total revenues funding the New York City Public Pension systems.17 Indeed the state and cities’ financial difficulties would clearly affect the ability to continue payments to the pension system. The security of retirement benefits for public employees (and the interests of beneficiaries) is inextricably linked to the state’s economy and to the taxpayers who remain the ultimate guarantors of public employee retirement benefits.

15. COMPETITIVE PLUS, supra note 9.
There are five major ETI categories; the most common are residential housing loans and venture capital. They represent approximately seventy-five percent of the reporting retirement system's ETIs. Other real estate investments, small business loans and CD's, private placements and other equity programs are the remaining ETI categories and comprise the remaining twenty-five percent. Current data has indicated that in certain instances ETI's have achieved their targets while at the same time realizing competitive returns.

II. THE FIDUCIARY AND POLICY ISSUES UNDER STATE AND FEDERAL LAW

A. The Fiduciary Issues

Public pension funds are governed by the laws of fiduciary administration embodied in both state and federal legislation. At the federal level, the Internal Revenue Code of 1991 (IRC) is the only federal statute to regulate public pension funds. In order to qualify for tax favored status, all public pension plans must comply with certain provisions of the IRC, including the requirement that the plan must be for the exclusive benefit of the employees and beneficiaries. Compliance with, inter alia, the exclusive benefit rule of the IRC confers numerous tax benefits on public employees and their pension plans. These benefits include exempting pension fund earnings from federal income tax, allowing employer contributions to accrue tax-deferred to the employee and permitting certain kinds of favorable distribution treatment.

1. Compliance with state common and statutory law

In determining whether to make an ETI, a public trustee must also consider the need to comply with state common law.

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18. INSTITUTE FOR FIDUCIARY EDUCATION, supra note 12.
19. BALDWIN ET AL., supra note 1 at 128.
or statutory fiduciary rules. The obligations of public pension fund trustees under common law standards are measured by two prominent rules of trust law: the prudent man rule and the duty of loyalty.  

a. The prudent man and the duty of loyalty standard. The common law prudent man rule, formulated in 1830 in *Harvard College v. Amory*, requires the trustee “to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.” These rules were elaborated on in the 1869 New York case of *King v. Talbot*, which provided that the trustee must act with “sincere and single intention to administer the trust for the best interest of the parties beneficially interested, and according to the duty, which the trust imposes.”

b. The prudent investor standard. Six states have adopted the prudent investor standard as opposed to the prudent man standard. The prudent investor rule requires,

the exercise of reasonable care, skill and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

The revisions have two major effects. First, the formulation of the basic rule gives more latitude for exercise of judgment by the trustee than had been thought permitted by the formulation that it replaces, with particular emphasis on a specific investment’s position in the trust’s portfolio and overall strate-


27. Id. at 461.

28. 40 N.Y. 76, 85 (1869).

29. Id. at 85-86. See also Ormiston v. Olcott, 84 N.Y. 339 (1881); Coyne v. Weaver, 84 N.Y. 386, 391 (1881); Matter of Weston, 91 N.Y. 501, 511 (1883).

30. The six states which have adopted an updated rule of prudent investing are California, Delaware, Georgia, Tennessee, Minnesota and Washington. Restatement (Third) of Trusts General Notes, at 70 (Proposed Final Draft 1990).

gy rather than viewing it in isolation.\textsuperscript{32} Second, revisions in the prudent man standard allow “expert trustees to pursue challenging, rewarding, nontraditional strategies when appropriate to the particular trust.”\textsuperscript{33}

ETIs may represent one of the nontraditional investment strategies which the prudent investor standard was designed to accommodate and might be appropriate for public pension funds. The prudent investor rule also does not make any investment imprudent per se.\textsuperscript{34} As pointed out in the comments to the Restatement 3rd of Trusts, social or political considerations “may properly influence the investment decisions of a trustee to the extent permitted by the terms of the trust or by consent of the beneficiaries.”\textsuperscript{35} By allowing the consideration of social factors the prudent investor standard appears almost to support public pension funds desiring to invest in ETIs.

2. The role of ERISA

Some statutes specifically incorporate the fiduciary rules of the Employee Retirement Income Security Act of 1974 (ERISA).\textsuperscript{36} However, public pension plans are regulated by ERISA only to the extent the relevant statutes specifically incorporate ERISA’s fiduciary rules.\textsuperscript{37} The fiduciary rules set forth in Section 404 of ERISA have three main elements: The exclusive purpose rule,\textsuperscript{38} the prudent man rule\textsuperscript{39} and the diversification requirement.\textsuperscript{40} The exclusive benefit rule of ERISA (to the extent ERISA is incorporated in state statutes), and the exclusive purpose rule of the IRC present a challenge to the public plan investor. ERISA’s concept of prudence requires

\textsuperscript{32} Restatement (Third) of Trusts Forward (Proposed Final Draft 1990).

\textsuperscript{33} Restatement (Third) of Trusts Introduction (Proposed Final Draft 1990).

\textsuperscript{34} Id.

\textsuperscript{35} Restatement (Third) of Trusts § 227, General Notes, at 78 (Proposed Final Draft 1990).


\textsuperscript{37} An example of a statute permitting ETIs but relying on ERISA fiduciary rules is Arkansas. Ark. Code Ann. § 24-3-411a (Michie 1989). Fiduciaries of public retirement systems are required to conform to the prudent investor rule as interpreted and defined by ERISA.


fiduciaries to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims . . ." 41

In essence, these standards require the plan fiduciaries to discharge their duties "solely in the interest" of participants and beneficiaries and for "the exclusive purpose" of providing participants and beneficiaries with retirement benefits. 42 This requires that pension funds be held and administered with complete loyalty to the exclusion of all other interests and with undivided loyalty to the beneficiaries of the trust. A literal interpretation of the legal constraints would seem to preclude ETIs. However some observers have concluded that ERISA's fiduciary rules permit trustees of pension funds to take into account collateral and incidental benefits to participants and to the society in making investment decisions. 43

3. The incidental benefit concept

Courts have also endorsed the incidental benefit concept. In *Donovan v. Bierwirth*, 44 the court held that the exclusive benefit rule was not violated where the trustees action incidentally benefitted nonparticipants. 45 The hope is that ETIs will have an incidental benefit effect, assist specific targeted communities, possibly where beneficiaries reside, and also assist in the rejuvenation of the state's economy.

An analysis of the interrelationship between ETIs and the exclusive benefit rule is largely academic where ETIs generate market or in excess of market rate of returns. However where ETIs have a higher than normal risk and do produce less than the market return, the absolute prohibition of the duty of loyalty and the exclusive benefit rule proscribes the investment even if a targeted group or the state's economy could be assisted by the investment. Without a relaxation of fiduciary rules, public pension funds could make no sacrifice of return without

44. 680 F.2d 263 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982).
45. *Id.*
violating fiduciary obligations. This possibility could strike the death knell for ETIs during periods in which they can be most beneficial. In fact, participants are also unprotected if the tolerance of a sacrifice in violation of the exclusive benefit rule contained in the IRC, results in the loss of tax-exempt status. Therefore the relaxation of the rules to permit a carefully delineated sacrifice threshold for the permitted percentage of public pension funds that can be the focus of ETIs, also protects the participants. The degree to which the fiduciary rules should accommodate such relaxation, should be left to the legislatures in the same way that statutes carve out a percentage of public funds that can be used for ETIs.

B. The Policy Issues

A relaxation of fiduciary rules in the context of ETIs will in fact protect the beneficiaries from the tax impact of the violation of the fiduciary rules. ETIs may realistically entail some sacrifices from a risk/return analysis, and ETIs by their very nature have a dual mission. This differs from traditional investments which focus solely on a risk return analysis. Their goals are different and therefore the standards governing them should reflect this difference in order for ETIs to have their own “imprimatur.” When ETIs are being contemplated, the debate should address the possibility of higher risks and the possibility of less than market return. There is no current precedent allowing sacrifices in the context of ETIs.

The infusion of public pension funds to bolster a state’s economy can be accomplished either (1) during a period of financial distress as a therapeutic measure or (2) systematically as a possible prophylactic approach. Economically targeted investments are more systematic and maintenance-orientated and hence emphasize the latter approach to a state’s chronic economic condition.

1. Pension funds as a therapeutic measure

In Withers v. Teacher’s Retirement System, public pension funds were used as a therapeutic measure when New York City’s economy was facing imminent disaster. In Withers, retiree beneficiaries of the New York City School Teacher’s Pension Fund, the Teacher’s Retirement System (TRS), challenged the

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decision of the plan trustees to purchase $860 million of New York City Bonds as part of a plan to thwart the imminent bankruptcy of New York City in late 1975. The TRS trustees acknowledged in testimony that although the purchase was a legal risk, bankruptcy, and its inevitable sequel, was not a tolerable alternative, and therefore, on balance, the purchase of the highly speculative bonds was justified.

The court upheld the trustees’ action even though the bonds bore such a high risk of default that they would not have satisfied the prevailing prudent person standards, and the excessive purchase may have even breached the duty to diversify. The Withers court, however, justified the TRS purchase on the grounds that the trustee’s major concern was protecting the source of the plan’s funding, that is the city itself.

Although the court in Withers declared that the sole interest of the beneficiaries motivated the decision and neither the protection of the jobs of the city’s teachers nor the general public welfare were factors which spurred the trustees in their investment decisions, the inseparability of the interests of the economy and that of the beneficiaries precluded the interests of the beneficiaries from being the sole objective of the investment decision. In recognition of the potential violation of the exclusive benefit standards, legislation specifically permitting the investment and relaxing the fiduciary rules was enacted.

The rationale of the Withers case may not be directly applicable to ETIs since the Withers case arose in the context of an emergency. The response in the Withers case represents a therapeutic approach which included court-ordered use of the public pension funds coupled with distress legislation both at the federal and state levels to legitimize the investment.

2. Pension funds as a systematic approach

ETIs are designed to provide a program of systematic investment of a portion of public pension funds in a state’s economy as a possible prophylaxis against economic disaster. Relax-

47. Id. at 1258-59.
ation of the application of the exclusive benefit rule was allowed in *Withers* when the public plan's source of funds was tethering on bankruptcy. It seems that explicit legislation would be necessary to justify the systematic program of ETIs outside the context of imminent bankruptcy.

Hence, there are no objective guidelines to determine the level of danger on a continuum of decline in a state's economy that will justify a court's decision that an investment to preserve the state's economy is prudent, albeit risky. Therefore, reliance on a court order may not be a viable strategy. The systematic investment of a limited percentage of assets by public pension funds in ETIs should not only be encouraged but should receive explicit sanction under the rules of loyalty and prudence. ETIs could be prudent investments provided fund managers determine that they are not excessively risky, would not result in radically reduced returns and would benefit targeted communities, while protecting the ability of the state to ultimately provide the promised retirement benefits. The fact the ETIs may not always provide the same risk and return as traditional investments must be specifically addressed and accommodated.

*a. Accommodating less than market returns under a systematic approach.* In *Brock v. Walton*, the court held that although ERISA trustees were required to charge a reasonable rate of interest on loans to pension plan participants, an interest rate below market rate did not violate that directive. Some facts that were central to the court's decision include the fact that the trustees researched interest rates thoroughly before making the decision, sufficient safeguards like mortgage insurance were in place, and the loans were a small part (less than ten percent) of the fund's portfolio. Likewise, a below market rate for ETIs may be defensible where the investments are thoroughly screened and represent a de minimis part of a fund's portfolio. Adequate safeguard lies in the taxing power available to assist public funds in meeting their obligation to provide retirement benefits.

*b. Other considerations under a systematic approach.* Currently, the interrelationship between ETIs and the fiduciary rules remain unclear. It is difficult, indeed impossible, for a trustee to safely reconcile the responsibilities of

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49. 794 F.2d 586 (11th Cir. 1986).
50. Id. at 588.
the duty of loyalty while at the same time maintaining sensitivity to the economic condition of the state. Statutory authority to consider a more diversified menu of investment options and objectives, including ETIs coupled with adherence to the traditional fiduciary concepts, are contradictory and pose a real dilemma. On the one hand, specific legislative encouragement is granted to consider state economic development in the investment decision making process. On the other hand, ETI proponents maintain that these investment objectives in no way compromise the traditional legal investment standards of prudence and loyalty (the exclusive benefit rule).51

In the 1980s, New York State encouraged its public pension funds to invest in the State's economic growth.52 However without legislative certainty concerning the application of the fiduciary rules to ETIs, such investments may be more risky from a legal perspective.

Permissive legislation promoting ETIs may not achieve the desired goals without some liberalization of the exclusive purpose rule within a narrow context. Since violation of the exclusive benefit rule under the IRC may lead to loss of tax-exempt status which will impact on the beneficiaries themselves, a federal policy towards ETIs should be addressed in the IRC. All parties will benefit from a clear definition of the applicability of the fiduciary rules with respect to the percentage of public pension funds which some states permit for ETIs. The exclusive benefit requirement precludes consideration of the health of the state in investing public pension funds. Therefore, statutes should provide that in making ETIs, a fund trustee's consideration of the economic health of the state will not necessarily violate the exclusive benefit rule. Clarification of the fiduciary standards was deemed necessary to justify certain risky investments to maintain the economic viability of New York City.53 Such legislation would be even more imperative for systematic ETIs. Statutes that permit ETIs but maintain that the traditional standards of prudence and loyalty must be adhered to can therefore operate at cross purposes to create uncertainty in the investment process.

The exclusive benefit rule should be modified to accommo-

51. See COMPETITIVE PLUS, supra note 9.
52. See N.Y. RETIRE. & SOC. SEC. LAW § 177(7) (McKinney 1987).
53. N.Y. RETIRE. & SOC. SEC. LAW § 179(a) (McKinney 1987) (declaring MAC bonds to be a prudent investment).
date the permitted percentage of ETIs contained in many statutes. Such modifications would create legal certainty if considerations of the economic health of the state are considered pertinent and are used as criteria for public fund investment. This would also protect the fund manager if the ETI results in a sacrifice in terms of economic return on the investment.

C. Implication of These Factors for The Internal Revenue Code

Certain provisions of the Internal Revenue Code reinforce the common law fiduciary principles that apply to public pension plans. The tax benefits that flow to the beneficiaries of a public pension plan are conditioned on the plan being maintained for the exclusive benefit of the employees or their beneficiaries. The Treasury Regulations reinforce this mandate by providing that "purposes other than for the exclusive benefit of his employees or their beneficiaries" includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust.

An Internal Revenue Service ruling has interpreted the exclusive benefit rule to permit some collateral benefit to others provided the investments have the primary purpose of benefiting employees or their beneficiaries. The ruling however requires that: the cost must not exceed the fair market value at the time of purchase; a fair return commensurate with the prevailing rate must be provided; sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan; and the safeguards and diversity that a prudent investor would adhere to are present.

Although it may appear that economically targeted investments which meet the requisites of the aforementioned ruling would not run afoul of the exclusive benefit rule of Section 401(a), revenue rulings do not have the authority and general applicability of a statute or regulation. In addition, ETIs may not always measure up to the conditions of the ruling even though they may be justifiable from an economic perspective. Investing money in long term projects at a rate of return that may not be commensurate with the risk in the hope that improvement of the local economy indirectly benefits plan benefi-

ciaries may compromise the "primary purpose" standard of the ruling. In addition, most public pension plans are under-funded and therefore do not maintain sufficient liquidity to permit distributions in accordance with terms of the plan at all times. It is not enough for ETIs to be pursued with the notion that such investments will not be challenged. Amendments are necessary in order for ETIs to be pursued in a secure and certain context.

In 1975 and 1978, when the New York State and City pension plans were in jeopardy, investments beneficial to the City posed a threat to the tax-favored status enjoyed by participants and beneficiaries, and consequently accommodating legislation was enacted. In order to bring investments within the exclusive purpose rule of section 401(a) federal legislation made it clear that purchasing the securities issued by New York City and the Municipal Assistance Corporation (MAC) for the City of New York, was not violative of the exclusive benefit rule of section 401(a). Similar legislation is needed to promote and legalize systematic uses of ETIs.

III. CONGRESSIONAL POWER TO REQUIRE PUBLIC PENSION PLAN INVESTMENT IN ETIs

In analyzing the effects of a federal tax policy to promote ETIs, certain constitutional issues must be addressed. The principal federal regulations applicable to state and local government pension plans are those contained in the Internal Revenue Code. Tax-exempt status is conditioned on adherence to these rules. In general, the disqualification of a pension plan results in the employer losing immediate deductibility of contributions to the plan. The trust income then becomes taxable, and employees are taxed on employer contributions made on


58. Such special legislation was enacted in 1976 and in 1978. Act of March 19, 1976, Pub. L. No. 94-236, 90 Stat. 238; Act of Oct. 21, 1978, Pub. L. No. 95-497, 92 Stat. 1665; The statutes provide that if certain New York State and City pension funds, including NYCERS, took certain action they nevertheless would not be deemed to have failed to satisfy the requirements of § 401(a) or to have engaged in prohibited transactions under § 503(b) of the IRC. These actions include entering certain securities purchase agreements and purchasing, under such agreements, securities of the City and MAC.

their behalf to the extent they are vested. A public plan's tax qualification status, however, essentially only benefits only participants and beneficiaries, because States and their instrumentalities are not subject to direct federal taxation. 60 It is axiomatic that tax exemptions and deductions are matters of "legislative grace," 61 and a form of tax subsidy, 62 which no citizen can claim as a matter of constitutional right. If the exercise of the taxing power is itself constitutional, an exemption from the tax conditioned on compliance with Congressional mandates that are not in themselves constitutionally offensive would a fortiori be constitutional. 63 The issue to be discussed in this section is whether Congress can constitutionally link the portion of public funds designated by states as acceptable for ETIs to its tax qualification status. Congress would be regulating the investment of ETIs by using its taxing power to create an incentive for such investments. This would depoliticize the issue at the state level and be of uniform applicability.

The power of Congress to tax and spend for the general welfare is plenary. 64 "Congress ... has a substantive power to tax and to appropriate, limited only by the requirement that it shall be exercised to provide for the general welfare .... " 65 Not only does the power to tax "reach[ ] every subject" (except exports), 66 but also Congress has "especially broad latitude in creating classifications and distinctions in tax statutes." 67

[In taxation, even more than in other fields, legislatures possess the greatest freedom in classification .... [T]he presumption of constitutionality can be overcome only by the most explicit demonstration that a classification is a hostile and oppressive discrimination against particular persons and classes. The burden is on the one attacking the legislative

60. I.R.C. § 115 provides that gross income does not include "(1) income derived from any public utility on the exercise of any essential governmental function and accruing to a state or any political subdivision thereof ... " I.R.C. § 115 (1991).
64. U.S. CONST. art. I, § 8, cl. 1; see also New York v. United States, 326 U.S. 572, 582 (1946).
arrangement to negative every conceivable basis which might support it.\textsuperscript{68}

The Due Process Clause of the Fifth Amendment contains an equal protection component that limits federal legislative classifications in much the same manner as the Fourteenth Amendment restricts the States.\textsuperscript{69} But the Supreme Court has consistently upheld statutory classifications that are rationally related to a legitimate governmental purpose if they neither burden fundamental rights nor discriminate against suspect classes.\textsuperscript{70}

Income, whether deferred or not, is a legitimate object of federal taxation "without apportionment" and "without regard to any census or enumeration."\textsuperscript{71} The tax linkage contemplated in the proposal at issue would presumably not interfere with a state employee's exercise of fundamental rights any more than any other income tax does. Nor have state employees ever been held to constitute a suspect class. In fact the risk of pension benefit default is lower for state public employees than for their counterparts in the private sector,\textsuperscript{72} and the power to tax can be exercised on behalf of the public pension plan. Under traditional Equal Protection analysis then, the inquiry would be simply whether the classification was rationally related to a legitimate governmental purpose.

These differences favoring public plans could present a significant basis for a Congressional decision to expose a portion of public pension funds to a slightly higher degree of risk in their in-state investments in order to impact on a state's

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\textsuperscript{68.} Id. at 547-48 (quoting with approval Madden v. Kentucky, 309 U.S. 83, 87-88 (1940)).
\textsuperscript{69.} Bolling v. Sharpe, 347 U.S. 497 (1954); see also Regan, 461 U.S. at 542; Schweiker v. Wilson, 450 U.S. 221, 226 n.6 (1981).
\textsuperscript{71.} U.S. CoNST. amend. XVI; see also United States v. Basye, 410 U.S. 441 (1973); Howell v. United States, 775 F.2d 887 (7th Cir. 1985); Zweiner v. Comm., 743 F.2d 273 (5th Cir., 1984); Hogan v. United States, 513 F.2d 170 (6th Cir), cert. denied, 423 U.S. 836 (1975). As stated earlier, no one has a constitutional right to a tax exemption. See South Carolina v. Baker, 485 U.S. 505, 525 (1988) (holding that owners of state bonds have no constitutional entitlement not to pay taxes on income they earn from state bonds).
\textsuperscript{72.} See Hogan v. United States, 513 F.2d 170, 176 (6th Cir.), cert. denied, 423 U.S. 836 (1975) (finding rational basis for distinguishing federal civil service pension plan from private sector plans in the statutory commitment of the government to pay retirement benefits).
\end{flushleft}
economy. Linking the tax-favored status and tax subsidy of a percentage of funds designated as permissible by the states for ETIs can be justified as rationally related to the legitimate federal governmental purpose of ensuring the continued funding of state and local pension plans, and the security of a financially stable retirement for a significant part of the population. A federal policy reflected in using the current tax subsidy to create an incentive for public plans to commit a portion of their tax-free earnings to ETIs will ultimately benefit the plan participants.

Although a tax is primarily a means of securing revenue, the power to tax can involve a power to regulate. The taxing power can serve as a basis for governmental regulation with taxes serving as the sanction behind the regulatory scheme. The mere fact that a tax has a regulatory purpose and effect would not, without more, render it unconstitutional.

The Tenth Amendment of the Constitution of the United States provides that “[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” The Supreme Court’s most recent pronouncement on Tenth Amendment jurisprudence is to be found in Garcia v. San Antonio Metropolitan Transit Authority.

In Garcia, the Court overruled the decision it reached in National League of Cities v. Usery, and held that the Fair Labor Standards Act wage and hour provisions could constitutionally be applied to the San Antonio Metropolitan Transit Authority, a local government entity. In doing so, the Court rejected “as unsound in principle and unworkable in practice, a rule of state immunity from federal regulation that turns on a judicial appraisal of whether a particular governmental func-

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75. U.S. CONST. amend. X.
76. 469 U.S. 528 (1985).
77. 426 U.S. 833 (1976).
78. Garcia, 469 U.S. at 555-56.
tion is 'integral' or 'traditional.' The Court reasoned that the principal limitations on Congressional authority to regulate state activities must be found in the structure of the federal government itself. Absent a showing of some extraordinary failure of the national political process, "[s]tate sovereign interests are more properly protected by procedural safeguards inherent in the structure of the federal system than by judicially created limitations on federal power.

The Tenth Amendment, by itself, would apparently not pose an insurmountable hurdle to the proposed use of the current tax subsidy for public pension plans.

In the recent case of South Carolina v. Baker, the Court rejected a Tenth Amendment challenge to a federal tax on the interest earned on long-term publicly offered state bonds issued in unregistered form. Writing for the majority, Justice Brennan recognized that the purpose of the tax was to combat federal tax evasion "by providing powerful incentives to issue bonds in registered form." For the states, the incentive to issue bonds in registered form would presumably lie in the fact that the interest earned on registered bonds would remain exempt from federal taxation. Therefore, the bonds could be sold at a lower rate of return. South Carolina argued that because this incentive was so powerful, the statute denying exemption had to be treated "as if it simply banned bearer bonds altogether without giving States the option to issue non-exempt bearer bonds." The Court agreed. In its Tenth Amendment analysis, it assumed that Congress had "directly regulated States by prohibiting outright the issuance of bearer bonds." But even assuming direct Congressional regulation, Justice Brennan found "nothing in Garcia or the Tenth Amendment [that] authorizes courts to second-guess the substantive basis for congressional legislation."

The contention of the National Governor's Association

79. Id. at 546-47.
80. Id. at 550-52.
81. Id. at 552.
83. Id. at 515.
84. Id. at 509.
85. See id. at 511.
86. Id.
87. Id.
88. Id. at 513.
(NGA) did not fare any better. The NGA argued that the statute was "invalid because it commandeered the state legislative and administrative process by coercing States into enacting legislation authorizing bond registration and into administering the registration scheme." 89

FERC v. Mississippi, 90 a case decided before Garcia, had "left open the possibility that the Tenth Amendment might set some limits on Congress’ power to compel States to regulate on behalf of federal interests." 91 In FERC, the Court rejected a Tenth Amendment challenge to a federal statute that effectively required state utility commissioners to adjudicate federal rights, and either to consider the adoption of a variety of rate-making standards in accordance with federal notice and comment procedures or cease regulating in the field. 92 In the majority’s view, the central rationale for the decision lay in the fact that the field of utility regulation was pre-emptible. 93 Therefore, the fact that Congress conditioned continued state regulatory activity on compliance with federal requirements would not invalidate the act. 94 The Tenth Amendment was not implicated merely because Congress chose to allow the States to continue regulating in an otherwise pre-emptible area. 95

Justice Brennan was able to distinguish the situation in Baker from that in FERC on the grounds that the statute denying tax exempt status to unregistered bonds was in effect a direct regulation of state activities, and thus did not commandeer state regulatory machinery. 96 As such, it did not at all implicate the residual Tenth Amendment question left open in FERC. 97 The fact that state statutes had to be amended or that state officials had to implement a new registration system did not rise to the level of a commandeering of the state legislative and administrative process. 98 These were merely "inevitable consequence[s] of regulating a state activity." 99 Since the

89. Id.
90. 456 U.S. 742 (1982).
92. FERC, 456 U.S. at 769-771.
93. Id. at 769 n.32.
94. Id. at 765, 767-68 n.30.
95. Id. at 765-71.
97. See id.
98. Id. at 514-15.
99. Id. at 514.
statute at issue in *Baker* had already survived analysis under the standard set forth in *Garcia*, it was constitutional under the Tenth Amendment.100

Under the analysis used in *Garcia, Baker*, and *FERC*, the proposed use of tax-exempt status could arguably survive a Tenth Amendment challenge. The proposal to condition tax-exempt status of public funds on the investment of a portion in ETIs is a direct regulation which ultimately benefits the state and federal governments. Even if the proposed tax were deemed so coercive that it would be assumed to constitute a direct regulation of state activities, the same result might follow under *Baker*. There is no doubt that the power to regulate commerce already includes the power to extensively regulate public and private pension plans.101 Even if a statute that links tax-exempt status of those portions of public pension plans designated by states as reasonable for economically targeted investments could survive constitutional scrutiny, the proposed tax must be analyzed under the doctrine of intergovernmental tax immunity.

Until recently it was thought that the doctrine of intergovernmental tax immunity absolutely precluded the federal government and the states from taxing the incomes of the other’s officers and employees.102 The power of the federal government to tax the incomes of state employees is no longer in doubt.103 However, that power is not unlimited. Generally, intergovernmental tax immunity still bars taxes that are levied “directly on one sovereign by the other or that discriminate against a sovereign or those with whom it [deals]”.104

The purpose of intergovernmental tax immunity is “to protect each sovereign’s governmental operations from undue interference by the other.”105 As Justice Frankfurter stated in

100. See Id.
New York v. United States\textsuperscript{106}:

[T]he fact that ours is a federal constitutional system, as expressly recognized in the Tenth Amendment, carries with it implications regarding the taxing power as in other aspects of government. Thus, for Congress to tax State activities while leaving untaxed the same activities pursued by private persons would do violence to the presuppositions derived from the fact that we are a Nation composed of States.\textsuperscript{107}

The importance of the non-discrimination principle was most recently illuminated by Justice Brennan.

The nondiscrimination principle at the heart of modern intergovernmental tax immunity case law does not leave States unprotected from excessive federal taxation—it merely recognizes that the best safeguard against excessive taxation (and the most judicially manageable) is the requirement that the government tax in a nondiscriminatory fashion. For where a government imposes a nondiscriminatory tax, judges can term the tax "excessive" only by second-guessing the extent to which the taxing government and its people have taxed themselves, and the threat of destroying another government can be realized only if the taxing government is willing to impose taxes that will also destroy itself or its constituents.\textsuperscript{108}

In fact, every case upholding federal taxes on state activities or employees has expressly relied on the non-discrimination principle embodied in the intergovernmental tax immunity doctrine.\textsuperscript{109}

In the recent case of Davis v. Michigan Department of Treasury,\textsuperscript{110} the Supreme Court had occasion to reaffirm the contours of the doctrine of intergovernmental tax immunity. In Davis, a federal civil service pensioner brought suit to recover state taxes paid on his federal retirement benefits.\textsuperscript{111} At the

\textsuperscript{106} 326 U.S. 572 (1946).
\textsuperscript{107} Id. at 575-76 (citations omitted).
\textsuperscript{110} 489 U.S. 803 (1989).
\textsuperscript{111} Id. at 806.
time, the State of Michigan taxed all retirement benefits, except those paid by the State or its political subdivisions. The Court of Claims denied relief, and the Michigan Court of Appeals affirmed. It rejected the pensioner's claim that the doctrine of intergovernmental tax immunity prohibited the differential tax treatment of federal retirement benefits, and instead, upheld the discriminatory tax under a rational basis test.

Writing for seven other members of the Court, Justice Kennedy began his analysis by noting that civil service retirement benefits are deferred compensation. Therefore, the former federal employee could claim the benefit of the statutory immunity from discriminatory taxation embodied in 42 U.S.C. § 111. He then went on to find that the "immunity in § 111 is coextensive with the prohibition against discriminatory taxes embedded in the modern constitutional doctrine of intergovernmental tax immunity.

Michigan launched two arrows against this constitutional attack. It first asserted that the pensioner was not entitled to claim the immunity because there was no showing that the tax "interfere[d] with the Federal Government's ability to perform its governmental functions, [and thus] the constitutional doctrine ha[d] not been violated." While the Court recognized that the immunity doctrine exists to protect governments, it rejected out of hand the State's argument that "individuals who are subjected to discriminatory taxation on account of their dealings with a sovereign" could not on that ground alone claim the immunity. "Indeed," wrote Justice Kennedy, "all precedent is to the contrary." The Court saw "no reason for departing from this settled rule.

Next, Michigan argued that significant differences between the two classes of pensioners justified the discriminatory treatment. The State first suggested that the tax exemptions en-

112. Id. at 805.
113. Id. at 807.
114. Id.
115. Id. at 808.
116. Id. at 808-809.
117. Id. at 813.
118. Id. at 814.
119. Id.
120. Id.
121. Id. at 815.
abled it to attract and keep qualified employees. Secondly, The State argued that federal pension benefits were substantially more generous than those of the State, and therefore unequal treatment was justified.

Justice Kennedy dealt with these two arguments by first pointing out that traditional equal protection analysis was “inappropriate” in this context. In cases involving intergovernmental tax immunity, “the Government’s interests must be weighed in the balance.” The test in these types of cases is “whether the inconsistent tax treatment is directly related to, and justified by, ‘significant differences between the two classes.’” The first difference alleged by the State, its interest in having qualified employees, was simply a rational reason for discriminating. It did not go at all to the question of whether the classes were in fact significantly different. The second alleged difference, the relatively parsimonious nature of state retirement benefits, would also not justify the inconsistent tax treatment. If the exemption were directly related to this difference, the statute “would not discriminate on the basis of the source of . . . benefits . . . ; rather, it would discriminate on the basis of the amount of benefits received by individual retirees.” Therefore, the Court concluded that the Michigan tax “violate[d] principles of intergovernmental tax immunity by favoring retired state and local government employees over retired federal employees.” The case was then remanded with a “mandate of equal treatment.” Michigan could prospectively cure the constitutional violation either by extending the exemption to all retirees, or by eliminating it entirely, or more narrowly, by simply exempting federal retirement benefits to the same extent that those of state and local governments were exempted.

The proposed linking of tax-exempt status of that percentage of funds designated as permissible by the states for ETIs

122. Id. at 816.
123. Id.
124. Id.
125. Id. (quoting Philips Chem. Co. v. Dumas Indep. School Dist., 361 U.S. 376, 385 (1960)).
126. Id. (quoting Philips, 361 U.S. at 383-85 (emphasis added)).
127. Id.
128. Id. at 817.
129. Id.
130. Id. (quoting Heckler v. Matthews, 465 U.S. 728, 740 (1984)).
131. Id. at 818.
would operate best if applied to all public pension funds to the extent permitted by the laws that govern them. Public pension funds are different from private pension funds since public funds do have guarantors in the taxpaying public. The current interpretation of the intergovernmental tax immunity prohibits the federal government from taxing the states directly. Utilizing the taxing power to assist a state in regulating and promoting ETIs by public pension plans is not a direct tax on the states by the federal government. The federal government would be merely assisting states in achieving goals they have already declared as laudable. However, by linking the tax-exempt status of a percentage of public funds permitted or required by states for ETIs would increase ETI investment. Such regulatory appeal was not deemed constitutionally offensive in Garcia where it was conceded that the effect of the legislation would be to eliminate the issuance of bearer bonds. The doctrine of intergovernmental tax immunity would not create an insurmountable hurdle to the proposed legislation. States need new initiatives in order to increase the availability of capital needed to maintain a strong economy.

There are recent examples of the intervention of the federal government into the affairs of an entity in distress. The Federal Deposit Insurance Corporation (FDIC) has set up an unwritten policy "called 'too big to fail' — since it bailed out Continental Illinois in 1984." This policy was exercised when the Federal Deposit Insurance Corp. (FDIC) gave special treatment to big depositors at Bank of New England in Boston.

If the Federal Government, through the FDIC, is unwilling to allow "big banks" to fail it is unlikely that it would allow states to fail with public pension fund assets in excess of $362 billion. It has been proposed that if the banks are to be rescued then the government should more strictly regulate the industry. Likewise if public pension funds would be res-
cued it is reasonable to regulate their investment. The House Banking Committee stated that "more than $50 billion in taxpayer funds will be needed [to bailout the industry]." 138 It would undoubtedly be just as costly for the Federal Government, and in turn taxpayers, to bailout states and consequently public pension funds. If a state's economy ends in financial ruin this would mean that the public pension fund would also be bankrupt in the sense that it could no longer meet its financial obligations. On December 9, 1975, President Gerald Ford signed legislation authorizing the federal government to loan New York City $2.3 billion annually until June 30, 1978. 139 Prior to the passage of the bill New York was expected to default on payment of loans due December 11 if they did not receive the federal funds. 140 In October, New York had also been rescued from financial doom by the pension funds of a teachers' union. 141

Under ordinary circumstances, the puritans would be right to insist that the city go through the wringer to pay for 10 years of fiscal mismanagement and the well-intentioned but foolish attempt to redistribute income by providing expensive services when it did not have the resources. But... such a purge could start a financial panic. 142

As a condition of the federal loans, Congress placed numerous restrictions and demands upon New York City, New York State and their officials. "The city would be required to balance its budget within two or three years. To insure that city finances are in order, the State would be expected to monitor city spending, revenue and bookkeeping." 143

The federal government has an interest in ensuring that all pension plans operate to provide bona fide protection for citizens in their retirements. That can be ensured only if the state's economy is healthy. It might be wise to thwart potential disaster before it begins by requiring some federal regulation of


138. Id.
140. Id.
public pension investment in ETIs.

Appropriate legislation could require that the fixed percentage of public pension funds required or permitted by states to be invested in ETI should be done as a quid pro quo for continued tax-exempt status of that percentage, with an appropriate amendment to IRC Section 401(a) to accommodate these ETIs as they relate to public pension plans.

IV. CONCLUSION

ETIs should be the subject of a federal policy reflected in amendments to Section 401(a) which both links the tax-exempt status of the portion of public funds permitted or required by states to be invested in ETIs and relaxes the exclusive benefit rule embodied in the Code, for this purpose. In addition to the certainty that the proposed amendments to existing legislation would create, there are efficiency gains inherent in federal legislation that has uniform applicability. Current state statutes should more explicitly accommodate these types of investments by public pension funds by stating the level of sacrifice that can be tolerated in their return, since it is unreasonable to expect that all ETIs should produce market returns at all times. The long term benefit of the investment may outweigh any immediate sacrifice in the return. The linking of tax exemption to the portion of public funds required or permitted by the states for ETIs will promote the investment in ETIs to the levels permitted and hopefully impact on states economies. Beneficiaries and retirees will be protected against the tax consequences of possible violations of the exclusive benefit rule if ETIs receive specific accommodation within the fiduciary rules. Fiduciaries of public trust funds would also be immunized from the full panoply of legal, equitable and injunctive relief available for violation of their duties.