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Rebalancing Rhode Island's Balance Sheet

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INTRODUCTION

Rhode Island policymakers should consider an accounting mechanism that could materially alleviate the pension-funding crisis: Asset In-Kind Contributions (Asset Transfers)—the transfer of municipal assets to municipal pension funds. Asset Transfers have the potential to help rebalance municipal balance sheets by allowing municipal pension funds to account for the value of municipal assets, while maintaining public oversight of critical public infrastructure. This Comment explores whether some of Rhode Island's largest and most underfunded municipal pension funds have the governance structures necessary to make Asset Transfers a viable tool to improve pension funding.

While this Comment considers Asset Transfers as a viable tool for multiple Rhode Island municipalities, its most obvious application is to alleviate the billion dollar pension liability faced by the City of Providence.[1] If the Providence Water Supply Board were to be transferred from the city's balance sheet to that of the city's pension fund, it could offset a liability equal to its appraised valuation—estimated to be $400 million—improving the pension's

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* Candidate for Juris Doctor, Roger Williams University School of Law, 2020. Thank you to Professor Andrew Spacone, my fiancée Alicia Anthony and the Roger Williams University Law Review Editorial Board for their guidance throughout the writing and editing process.

1. Dan McGowan, *Treasurer Magaziner: Providence Pension Fund Is RI's "Biggest Financial Challenge,"* WPRI (Jan. 25, 2019 3:38 PM) https://www.wpri.com/news/dan-mcgowan/treasurer-magaziner-providence-pension-fund-is-ri-s-biggest-financial-challenge-/1725825488 [https://perma.cc/F6AZ-JZNK].

funding level from its current level, 26.3%, to over 50%.[2] Such a transfer has the potential to position the fund to negotiate meaningful reforms, but it is not, in and of itself, a silver bullet to the pension fund's cash flow challenges. However, an Asset Transfer would allow the city to use the value of the Providence Water Supply Board to help offset its largest liability while ensuring that the utility remains under public control, guaranteeing that any future increase in its value accrues back to the taxpayers rather than to a private third party.

Providence is not alone. Many of Rhode Island's cities and towns are on the brink of bankruptcy, driven to this precipice by the economy and politics.[3] The most burdensome of these pressures are the massive and growing financial liabilities created by a failure to properly fund the pensions promised to public employees.[4] Government accounting standards have continuously evolved over the past decade in an effort to highlight and quantify this burden.[5] While these standards now guide government to better reflect its *liabilities*, government has yet to maximize the accounting value of its *assets*. Asset Transfers should be considered as a tool to help municipalities leverage the value of their assets to improve the

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2. John Hill, *Providence Is Hoping the Scituate Reservoir Can Save Its Economy*, PROVIDENCE J. (June 4, 2018), https://www.providencejournal.com/news/20180601/providence-is-hoping-scituate-reservoir-can-save-its-economy [https://perma.cc/W4EQ-4HPP].

3. *See* Randal Edgar, *My Turn: Randal Edgar: Rhode Island's Other Pension Problem*, PROVIDENCE J. (Feb. 14, 2018), https://www.providencejournal.com/opinion/20180214/my-turn-randal-edgar-rhode-islands-other-pension-problem?template=ampart [https://perma.cc/Y67L-HT3Y]. *See also Economic Tsunami: Data Shows RI Cities & Towns Are Facing Peril Due to Unfunded Obligation*, GOLOCALPROV (Mar. 12, 2019), https://www.golocalprov.com/news/economic-tsunami-data-shows-ri-cities-towns-are-facing-peril-due-to-unfunde [https://perma.cc/G3B6-VXD2] [hereinafter *Economic Tsunami*].

4. *See Economic Tsunami*, *supra* note 3.

5. *See* GOV'T ACCT. STANDARDS BD., NEW GASB PENSION STATEMENTS TO BRING ABOUT MAJOR IMPROVEMENTS IN FINANCIAL REPORTING 1 (Dec. 2013), https://gasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828264598&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=145542&blobheadervalue1=filename%3DGASB_New_Pension_Statements_article_12-13.pdf&blobcol=urldata&blobtable=MungoBlobs [https://perma.cc/B5RX-LG6J]; Ted Nesi, *Study: Plans in 'Critical' Condition for 17 RI Cities, Towns*, WPRI (May 8, 2018, 8:55 PM), https://www.wpri.com/politics/study-pension-plans-in-critical-condition-for-17-ri-cities-towns/1167190242 [https://perma.cc/VK3U-YFNG].

funding levels of municipal pension funds.

Policymakers, both in Rhode Island and nationally, typically chip away at budget challenges by pulling the traditional financial levers of government: raise revenue (taxes) or cut costs (services, infrastructure, pensions).[6] In the decade since the financial crisis, a climate of austerity has dominated public budget decisions, stunting lawmakers' willingness to enact additional taxes to raise revenues.[7] Complicating matters further, relatively stagnant revenue growth has left government unable to keep pace with inflation, forcing policymakers to focus on *whom* to cut, rather than in *what* to invest.[8] Eventually global events, like the Great Recession, exacerbate this dilemma, and bankruptcy proceedings replace budget negotiations, as evidenced by such proceedings in Detroit, Michigan, and Central Falls, Rhode Island.[9]

As that turning point is reached, public officials, in an effort to maintain control rather than ceding it to the courts, often revert to extreme measures, including the sale or long-term leasing of assets—despite the absence of provisions allowing courts to force liquidation of essential service assets in a chapter nine municipal bankruptcy.[10] Every year municipalities enter into billions of dollars of long-term leases or sales of their assets—water and wastewater systems, bridges, toll roads, museum and art collections, airports, lottery systems, even streetlights.[11] Rising to

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6. Paul Burton, *How In-Kind Asset Contributions Could Ease Connecticut's Pension Funding Woes*, BOND BUYER (Sept. 11, 2018, 11:07 AM), https://www.bondbuyer.com/news/connecticut-mulls-in-kind-asset-contributions-for-pensions [https://perma.cc/9X5T-ZWSN].

7. Max Ehrenfreund, *U.S. Austerity Was Even Worse than We Thought, Data Suggests*, WASH. POST: WONK BLOG (July 31, 2015), https://www.washingtonpost.com/news/wonk/wp/2015/07/31/wonkbook-u-s-austerity-was-even-worse-than-we-thought-data-suggest/?utm_term=.013840713b33 [https://perma.cc/47K9-5NMS].

8. Hilary Russ, *Bankruptcy Saves Tiny Rhode Island City, but Leaves Scars*, REUTERS (Sept. 3, 2012, 8:10 PM), https://www.reuters.com/article/us-usa-rhodeisland-centralfalls-bankrupt-idUSBRE88300220120904 [https://perma.cc/5DN6-MM4C].

9. *Id.*; Jenna Carlesso, *Detroit, Central Falls Leaders Share Pitfalls, Advantages of Bankruptcy*, COURANT COMMUNITY (Oct. 17, 2017, 10:00 AM), https://www.courant.com/community/hartford/hc-news-hartford-bankruptcy-panels-20171017-story-html [https://perma.cc/633T-RXD5].

10. Kristen M. Dejong & Beth A. Dougherty, *Municipal Bankruptcy: A Primer on Chapter 9*, NUVEEN (Sept. 10, 2018), https://www.nuveen.com/municipal-bankruptcy-a-primer-on-chapter-9 [https://perma.cc/4PH8-CBNQ].

11. *The Promise and Pitfalls of Privatizing Public Assets*, ECONOMIST (June

this opportunity, Wall Street has proven adept at connecting cash-strapped municipalities with investors seeking the stable returns generated by municipal assets.[12] Ironically, the one investor largely absent from the domestic infrastructure market is the one most in need of a stable return: municipal public pension funds.

The absence of public pension funds as investors in the domestic infrastructure market is likely due to a combination of the lack of readily available infrastructure investment opportunities and an unwillingness to veer from public pension funds' traditional investment strategies. A typical public pension fund seeks an annual investment return of seven to nine percent, by investing in a combination of fixed income, equities, and alternative assets like real estate and private equity.[13] Despite this targeted return and asset mix, pension funds often fall short: of the top thirty-four municipal pension funds in Rhode Island, only one averaged returns over ten years in excess of its investment target for Fiscal Year 2016.[14] This shortfall forces funds to reach for higher returns through riskier investments—a strategy with a clear downside. Infrastructure offers a relatively stable and reliable alternative to these other asset classes. While this Comment focuses on the immediate funding, governance, and tax benefits of Asset Transfers, the match between typical returns on infrastructure investments and the returns targeted by pension funds is compelling and should not be overlooked.

This Comment contains four parts. Part I provides an overview of the pension crisis facing many of Rhode Island's largest municipalities. Part II explains Asset Transfers and provides examples of their historic use by private corporations and their emerging use by government. Part III focuses on the key financial benefit of Asset Transfers between public entities: the ability to

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22, 2017), https://www.economist.com/united-states/2017/06/22/the-promise-and-pitfalls-of-privatising-public-assets [https://perma.cc/WM9H-8ZYN].

12. *Id.*

13. Lisa Abramowicz, *5% is the New 8% for Pension Funds*, BLOOMBERG BUSINESSWEEK (Aug. 2, 2017, 2:00 PM), https://www.bloomberg.com/news/articles/2017-08-02/5-is-the-new-8-for-reliable-returns-for-pension-funds [https://perma.cc/3VW6-96EK].

14. *See* STATE OF R.I. OFFICE OF THE GEN. TREASURER, REPORT OF THE ADVISORY COUNCIL FOR LOCALLY ADMINISTERED PENSION PLANS 44 (May 2018), https://d10k7k7mywg42z.cloudfront.net/assets/5aec622223f812647e07433b/2018_Report_of_the_Advisory_Council_for_Locally_Administered_Pension_Plans.pdf [https://perma.cc/RC5K-MKX4].

continue to invest in capital improvements for the asset on a tax-exempt basis. Finally, Part IV addresses important public oversight and governance matters by considering the composition of the municipal boards that manage the pension assets of some of Rhode Island's largest municipalities, and weighs whether the Internal Revenue Service (IRS) is likely to consider them instrumentalities of government. This final determination both ensures continued public oversight over critical infrastructure and preserves the tax exemption described in Part III.

I. RHODE ISLAND'S MUNICIPAL PENSION CRISIS NEEDS TO BE ADDRESSED IMMEDIATELY

A. *Rhode Island's Largest Municipal Pension Funds are on the Brink of Insolvency, and Municipal Leaders Have Limited Options to Guarantee Future Solvency*

Rhode Island's municipal pension funds have an estimated collective unfunded liability of $2.5 billion—roughly $2,500 of liability for every resident of the state.[15] However, this burden is not evenly distributed. As of 2017, over a third of Rhode Island's thirty-four cities and towns have critically underfunded pension plans.[16] The metrics become even more concerning considering that the largest liabilities are from communities that form Rhode Island's economic core: Providence, Pawtucket, Cranston, Warwick, Woonsocket, Central Falls, and the urban towns of West Warwick and Johnston.[17]

The scale of the unfunded liability varies between these municipalities, but the dismal prognosis is consistent. Leading the above group is the City of Providence, whose open employee plan is only 26.2% funded.[18] The system is estimated to be underfunded by nearly one billion dollars, and experts have forecasted that, without major reform, this liability will place a debilitating burden on the city by 2026.[19] Cynics consistently tout bankruptcy as the

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15. *See* STATE OF R.I. OFFICE OF THE GEN. TREASURER, REPORT OF THE ADVISORY COUNCIL FOR LOCALLY ADMINISTERED PENSION PLANS 5 (Apr. 2019), https://d10k7k7mywg42z.cloudfront.net/assets/5cc74caa438fc35bcc11d181/LAPP_Report_FINAL_4_29_19.pdf [https://perma.cc/K9KA-M3ZC] [hereinafter PENSION PLANS].

16. *Id.*

17. *Id.* at 9, 21–22, 24–27, 29, 33–35, 44.

18. *Id.* at 20.

19. *City of Providence Ten Year Plan: Summary of Key Benchmarking*

remedy; however, reflecting on Rhode Island's one example—the City of Central Falls' restructuring in 2010—it is clear that such processes are not a panacea. While the restructuring, combined with an energetic and forward-thinking mayor, helped Central Falls regain its financial footing, unfunded pension liabilities continue to plague the city: only $9.99 million remains in its employee pension fund, leaving it 26.5% funded.[20] While this dollar figure is a fraction of the liability faced by Providence and other Rhode Island municipalities, Central Falls shows that the blunt cleaver of bankruptcy is not an end-all solution and that municipalities must consider all available financial tools.[21]

B. *While Cash Poor, Municipalities are Asset Rich*

The budget problems for many of Rhode Island's municipalities are rooted in their underfunded pension funds: liabilities greatly exceed the available assets.[22] This imbalance translates into cash flow problems when municipalities need to budget funds to make annual payments toward the unfunded liabilities. Poor investment returns, skipped payments, and changes in life expectancy continuously drive these payments upward, exacerbating ongoing cash flow problems. However, looking beyond the reported financials of government entities, municipalities are actually quite asset rich despite being cash poor.[23] Consider public buildings, utilities, highways, golf courses, even street lights—government owns great assets whose values are not accounted for on the part of its financials where they are needed most to offset liabilities. This would be like an individual, when determining their overall net worth, having to record the entirety of their projected retirement needs as a liability but not recording against it the value of her deeded share of the family beach house.

Take, for example, a typical government's most valuable assets: water and wastewater utilities. Almost every single one of Rhode Island's large municipalities with underfunded pension

Findings, CITY OF PROVIDENCE, 3, 13 (Apr. 11, 2016), https://data.providenceri.gov/Finance/City-of-Providence-Ten-Year-Plan-Summary-of-Key-Be/xiqd-5udr [https://perma.cc/A9RG-K4R4].

20. PENSION PLANS, *supra* note 15, at 9.

21. Russ, *supra* note 8.

22. *See id.*

23. *See* DAG DEETER & STEFAN FÖLSTER, THE PUBLIC WEALTH OF CITIES: HOW TO UNLOCK HIDDEN ASSETS TO BOOST GROWTH AND PROSPERITY 5–7 (2017).

funds also own and operate water or wastewater utilities. These municipalities carry two burdens: they pay the ongoing costs of utility employees' post-employment benefits (pensions and healthcare) and lose the property taxes from real estate occupied by these utilities. Surrounding suburbs are often served by these utilities, and while their users pay regulated rates for consumption, the above expenses and tax breaks provided by the host municipality serve as an ongoing subsidy.[24]

There is an accounting tool rooted in the basics of corporate finance that would allow municipalities to account for the value of these assets without surrendering public oversight and control: Asset Transfers.

II. Asset Transfers Are Important and Effective Tools

A. *The Success of Asset Transfers in the Private and Public Sectors Proves They are an Effective Tool Rhode Island Should Consider Using*

Asset Transfers move the ownership of a non-cash asset from a sponsoring entity to its pension fund.[25] Unlike a monetization, where an asset is sold or leased to an outside entity in return for a cash payment, no cash is exchanged—ownership of the asset is simply transferred to the pension fund, and the fund receives a credit equal to the appraised value of the asset. Unlike other monetization methods—i.e., a lease or sale—Asset Transfers keep control of the asset in the same corporate family, allowing the asset's value to offset liabilities. The transfer is analogous to one's parents moving into a nursing home and signing over the title of the now empty house to their children—the parent is able to keep

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24. The best example of this is the Providence Water Supply Board (Providence Water), which provides drinking water to sixty percent of Rhode Island. Its facilities are exempt from Providence municipal taxes; its employees are city employees who accrue city pension benefits. *See Real Estate Tax Statement 125 Dupont Drive (Providence Water Central Operating Facility)*, CITY OF PROVIDENCE (2018), https://billpay.providenceri.com/(S(vf1s2kkudhfaadxl4h50lbf2))/Report/Web_Report_CrystalViewer.aspx?REPORTNAME=C:\eGov\Reports\PRV_WEB_TX.rpt&ReportParameter=YEAR_ID=2018;P_ID=18528;CURRENT_YEAR_ID=2018 [https://perma.cc/9MXP-5DZP].

25. Michael Bennon et al., *In-Kind Infrastructure Investments by Public Pensions: The Queensland Motorways Case Study*, STAN. GLOBAL PROJECTS CTR. 1, 7 (June 5, 2017), https://ssrn.com/abstract=2981707 [https://perma.cc/N895-VF6U].

the home in the family, while allowing the children to realize the benefit of ownership.

For decades, corporations have used Asset Transfers to leverage the value of their assets to improve the funding of their employees' pension funds, while maintaining control of the asset within the same corporate family.[26] For example, Pan American World Airways staved off bankruptcy by transferring its terminal leases at John F. Kennedy Airport to its employees' pension fund; United States Steel Corporation contributed over a hundred thousand acres of timberland to its pension fund; and General Motors moved securities from the balance sheet of a subsidiary to its employees' pension fund to improve its fiscal health.[27] Because the asset is transferred rather than acquired with a cash payment, the financial benefit is multifold. First, the value of the asset is immediately recordable against the unfunded pension liability. Second, any increase in revenues or operating efficiency generates a cash return for the fund rather than paying the debt service from the acquisition.

In the case of a government Asset Transfer, there is the additional benefit of tax-exemption. Because the transfer is a partnership between public entities, future investment in the asset and any revenue growth can likely remain tax-exempt so long as the entity is an instrumentality of government, as described further in Part III of this Comment.

Consider, for example, the traditional monetization of a hypothetical water utility with an annual operating budget of $25 million and assets and a customer base valued at $100 million. Pre-acquisition, consumer rates are set to cover the annual operating budget and requisite maintenance. If the utility was acquired at the its assessed value, the purchaser would need to raise consumer rates or find efficiencies sufficient to cover both the $25 million in annual operational expenses *and* the debt payments for the $100 million it borrowed to acquire the asset (or the return on equity expected by investors who provided the $100 million to acquire the asset). In addition, there could be tax implications for what were previously non-taxable income and assets. The result is that

26. Jill Eicher, *Public Pensions and the Assets that Could Sustain Them*, GOVERNING (Mar. 14, 2017), http://www.governing.com/gov-institute/voices/col-public-pensions-transferred-assets-dedicated-funding.html [https://perma.cc/CYU5-LHHY].

27. *Id.*

ratepayers would now be paying twice for the same service despite giving up control: the acquisition costs of the purchaser in addition to operational expenses.

Conversely, if the asset were transferred from the municipality's ledger to the pension fund using an Asset Transfer, the municipality could immediately record the asset's valuation against its pension liability, and any future appreciation in value would accrue to the benefit of the pension fund, and ultimately, the municipality and its taxpayers.[28] Thus, a government Asset Transfer offers the benefit of maximizing the accounting impact of the asset's value, without the involvement of a third party who would need to derive a return on the system to, at minimum, pay for the acquisition.

One of the biggest criticisms of monetizing municipal infrastructure is that it removes public oversight of critical public infrastructure.[29] A key difference with an Asset Transfer is that many public pension funds are considered instrumentalities of government, thereby preserving public oversight.[30] Keeping essential public assets under public control is good public policy, and pension funds have proven to be good managers of public assets.[31] Importantly, while the public maintains governance oversight through pension boards, moving the asset out from under the direct umbrella of government affords management greater autonomy to pursue efficiencies, while also maintaining tax benefits.[32] Such transfers align the interests of labor—maximizing the efficiency and value of an asset that helps fund their pensions—and taxpayers who appoint the majority of the pension board managing the asset.[33] The rise of public Asset Transfers in the past decade highlight these financial, governance, and political benefits, and are the focus of recent legislative initiatives.[34]

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28. Bennon et al., *supra* note 25, at 16.
29. Elizabeth Douglass, *Towns Sell Their Public Water Systems—and Come to Regret It*, WASH. POST (July 8, 2017), https://www.washingtonpost.com/national/health-science/towns-sell-their-public-water-systems—and-come-to-regret-it/2017/07/07/6ec5b8d6-4bc6-11e7-bc1b-fddbd8359dee_story.html?utm_term=.244b1e67fe2a [https://perma.cc/6HVA-26J9].
30. *See infra* section IV.
31. Eicher, *supra* note 26.
32. *See infra* section III.A.
33. *See* Eicher, *supra* note 26.
34. *See infra* section II.A.

In 2011, the state government of Queensland, Australia, made an Asset Transfer of its toll-road network to its state pension fund.[35] The initial transfer offset $3.8 billion Australian dollars of pension liabilities. The pension fund's management then made substantial investments to build out the infrastructure, which more than doubled its value in just three years.[36] Rather than a private investor booking that return, the Queensland government's pensioners received the benefit.[37]

In the United States there have been several Asset Transfers.[38] In 2017 the New Jersey Legislature signed a "memorandum of contribution," contributing the New Jersey Lottery to its pensions for a thirty-year term.[39] The transfer offset nearly $13.5 billion dollars in pension liabilities, and the legislative action received resounding support from both of New Jersey's legislative chambers.[40] In 2010, Pittsburgh, Pennsylvania, irrevocably dedicated parking revenues to the city's pension funds, contributing to an upgrade in the city's credit rating by Fitch, a municipal credit ratings agency.[41] The City of Hartford, Connecticut, as part of its efforts to address its fiscal woes, transferred ownership of a 600-acre public park to its pension fund, and credited $5 million against its unfunded pension liability.[42] While the public policy implications behind each of these Asset Transfers differ substantially—a cash generating lottery is admittedly much different than a public park—it is clear that models for domestic Asset Transfers are being formulated as the benefits become better known.

Several states have initiatives focused on studying Asset Transfers. On the heels of its lottery transfer, New Jersey's

35. Eicher, *supra* note 26.
36. Bennon et al., *supra* note 25, at 16.
37. *Id.*
38. *See* Robert Steyer, *New Jersey Approves Budget, Shifting State Lottery to Pension Fund*, PENSION & INV. (July 5, 2017, 3:06 PM), https://www.pionline.com/article/20170705/ONLINE/170709972/new-jersey-approves-budget-shifting-state-lottery-to-pension-fund [https://perma.cc/VA64-4JZR].
39. *Id.*
40. *Id.*
41. Eicher, *supra* note 26.
42. Marc E. Fitch, *What Does a Pension Fund Do with a Park?*, YANKEE INSTITUTE FOR PUB. POL'Y (Apr. 28, 2017), http://www.yankeeinstitute.org/2017/04/what-does-a-pension-fund-do-with-a-park/ [https://perma.cc/K8SL-V84D].

Economic & Fiscal Policy Workgroup committed to "[d]evelop legislation to lay the framework for any future public asset transfer," and has undertaken an effort to create an inventory of public assets suitable for such transfers.[43] In Illinois, the Illinois Finance Authority, the state's primary vehicle for infrastructure investment, is considering the creation of a trust to facilitate Asset Transfers.[44] The State of Connecticut's Pension Sustainability Commission is also discussing the establishment of a similar trust to manage Asset Transfers of municipal assets.[45]

Before investing in a similar such inquiry, determining the potential governance and tax implications is an essential gating issue and is the focus of the balance of this Comment.

III. TAX-EXEMPTION MAXIMIZES THE PROFITABILITY OF AN ASSET IN KIND CONTRIBUTION

A. *Asset Transfers Between Government Entities Can Allow the Asset to Remain Tax-Exempt, Which, In Turn, Maximizes an Asset's Profitability and Minimizes the Cost of Future Operations and Maintenance*

It is crucial that the tax-exempt status of municipal assets be preserved through an Asset Transfer. Tax-exemption ensures that both the ratepayer and the municipality enjoy a low cost of capital for operations, maintenance, and improvement. To finance these capital improvements, municipal entities typically issue bonds, either backed by the municipalities' general obligation promise to repay the lender from tax revenues or by a security interest in the revenues of income producing assets, like water utilities.[46] The benefit of tax exemption is that lenders and investors who purchase

43. *Leveraging Assets to Stabilize Pension System*, PATH TO PROGRESS NJ, http://pathtoprogressnj.org/proposals/leveraging-assets-to-stabilize-pension-system/ [https://perma.cc/9ZB8-L354] (last visited Mar. 9, 2019).

44. *See* ILL. FIN. AUTH., REGULAR MEETING OF THE MEMBERS, Feb. 8, 2018, https://www.il-fa.com/sites/default/files/board-documents/02-08-18-board-minutes.pdf [https://perma.cc/8P53-JMQK].

45. Burton, *supra* note 6. The concept of creating a state-managed trust, which manages assets on behalf of municipal pension funds, offers great potential from the perspective of a fiduciary duty, and, considering the potential management of multiple similar entities under one umbrella—regionalization. *Id.*

46. NEIL O'HARA, THE FUNDAMENTALS OF MUNICIPAL BONDS 1 (6th ed. 2012).

these municipal bonds do not pay tax on the interest income they receive and are therefore willing to offer a lower interest rate to the borrower, resulting in a lower cost of funding for capital projects.[47] This lower cost of funding means that a publicly owned enterprise is able to borrow, build, and expand at a fraction of what it would cost a private entity.[48]

Consider the following hypothetical to demonstrate this benefit. A private water company and a public water utility each seek financing to build a mile of water mains in new neighborhoods at a cost of $1 million for each project. Both entities go to the same lender seeking the $1 million, to be repaid in one year. The lender needs to receive an average of 5% interest on the loans it makes and is in a 30% interest tax bracket. This means the private company will borrow at a 5% interest rate. However, the public entity will borrow from the same lender at a tax-exempt interest rate of 3.5% because public borrower's interest payments will be tax-exempt income for the lender, saving the lender $15,000 in taxes it would have otherwise paid. After one year, the private water company will end up paying $50,000 in interest, whereas the public water utility will pay only $35,000 in interest, allowing the municipality to operate and expand at a substantially lower cost. This differential is further compounded by the fact that these types of assets are not financed over a year, but rather over a period of up to thirty or even forty years.[49] This lower cost of financing is a major reason why the government typically spearheads large public infrastructure projects.

Traditionally, part of the logic behind exempting government bonds from taxes is that the benefit of a lower cost to build and maintain the asset is passed along to the public in the form of lower fees for service, or a higher operating margin for the entity. Where allowed, this higher operating margin is often be used to

47. *Id.* at 30–32.

48. Maria Crawford Scott, *Munis vs. Taxables: How to Determine the Taxable Equivalent Yield*, AM. ASS'N OF INDIVIDUAL INV'RS. J. (2009), https://www.aaii.com/journal/article/munis-vs-taxables-how-to-determine-the-taxable-equivalent-yield [https://perma.cc/ALK7-2E8Q]; O'HARA, *supra* note 46, at 1–2. The cost of borrowing is lowered even further by the ability to solicit lenders ranging from individuals investing their retirement income, to sophisticated institutional investors, through competitive sales of their bonds into this $2.9 trillion dollar capital marketplace. *See generally id.*

49. *See* O'HARA, *supra* note 46, at 25.

supplement other municipal revenue sources—i.e., taxes.[50] For an asset transferred to a pension fund, the ability to borrow and operate on a tax-exempt basis provides a major benefit of helping to drive a substantially higher rate of return for the fund while minimizing the impact on the ratepayer.

In addition to the public benefit, the limitation on the power of the federal and state governments to tax one another also has a legal foundation: the constitutional doctrine of "intergovernmental tax immunity," rooted in the United State Supreme Court's decision in *McCullough v. Maryland*.[51] Subsequently, there have been numerous efforts by Congress to curtail the tax-exempt benefit of municipal borrowings; however, state and local government bonds largely remain exempt from federal, and often state, taxation.[52] As such, interest payments made to state and local governments' lenders are tax-free income.[53]

However, the government aggressively curtails the use of tax-exempt bonds through the Internal Revenue Service (IRS) under the Internal Revenue Code (IRC).[54] Section 115 of the IRC allows the IRS to determine if the income of government operations is tax exempt.[55] When a municipality owns and finances a public asset that provides a public function, the determination of its taxability is clear; however, debt that is not directly issued by a state or local government entity, or a designated 501(c)3 organization, with very few exceptions, is not tax exempt.[56]

One of those exemptions is for an "instrumentality" of government. An instrumentality of government is an entity used to provide a traditional public function, but which may not technically fall under the definition of a state or a political subdivision.[57] Examples provided by the IRS include schools,

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50. Julia Kagan, *Budget Surplus*, INVESTOPEDIA (Jan. 17, 2018), https://www.investopedia.com/terms/b/budget-surplus.asp [https://perma.cc/FLT3-BESF].

51. *See generally* 17 U.S. 316 (1819). O'HARA, *supra* note 46, at 226.

52. O'HARA, *supra* note 46, at 29, 229.

53. *Id.* at 30–32.

54. *Id.* at 230.

55. I.R.C. § 115.

56. *See* I.R.C. §§ 103, 115.

57. WHAT ARE GOVERNMENT ENTITIES AND THEIR FEDERAL TAX OBLIGATIONS?, IRS, https://www.irs.gov/government-entities/federal-state-local-governments/government-entities-and-their-federal-tax-obligations [https://perma.cc/L7YX-PDMC] (last updated June 28, 2018) [hereinafter GOVERNMENT ENTITIES].

libraries, and hospitals.[58] The IRS carefully notes that whether or not an organization qualifies as an instrumentality of government depends on certain facts and circumstances.[59] The IRC provides almost no guidance on this matter.

However, a 1957 IRS Revenue Ruling provides a series of factors considered by the IRS in making this determination: (1) whether the organization is used for a governmental purpose and performs a governmental function; (2) whether the performance of the organization's functions is on behalf of one or more states or political subdivisions; (3) "whether there are private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner"; (4) "whether control or supervision of the organization is vested in public authority or authorities"; (5) "whether express or implied statutory or other authority is necessary" or exists for the creation and/or use of the organization; and (6) the organization's degree of financial autonomy and the source of its operating expenses.[60]

Given that an entity must serve a public purpose to qualify for tax-exempt status, the penumbra resulting from the combination of these six public purpose seeking factors commands that the composition of an entity's leadership be directly traceable back, and ultimately accountable, to the taxpayer.[61] Thus, when determining if an asset owned by a pension fund would be eligible for tax-exemption, the composition of a pension fund's governing board is a decisive factor in determining whether it is an instrumentality of government.[62] Frequently, the boards overseeing the management of pension assets are appointed by both elected officials and entities that are not democratically elected, but serve public purposes, specifically labor unions and retired pensioners.[63] For a municipal pension fund to be considered an instrumentality of government a majority of a pension fund's board should be comprised of individuals appointed by democratically elected officials, rather than non-governmental parties—i.e., labor unions.[64]

58. *Id.*

59. *Id.*

60. *Id.* (citing Rev. Rul. 57–128, 1957–1 C.B. 311).

61. *See id.*

62. *See id.*

63. *See* PROVIDENCE, R.I., HOME RULE CHARTER pt. 1, art. IX, § 908 (2006), https://library.municode.com/ri/providence/codes/code_of_ordinances?nodeId=PTIHORUCH_ARTIXPEDE_908REBO [https://perma.cc/J9UE-3YCA].

64. *See* Rev. Rul. 57–128, 1957–1 C.B. 311.

Rhode Island's major municipal pension funds are overseen by boards predominantly representing the public, likely making them instrumentalities of government well situated to maintain public oversight and the tax-exempt status of acquired assets.

IV. RHODE ISLAND PENSIONS ARE INSTRUMENTALITIES OF GOVERNMENT

A. *The Legal Structure of the Boards Governing the Management of Rhode Island's Municipal Pension Assets Ideally Situate Them to Execute Asset Transfers on a Tax-Exempt Basis*

Rhode Island's most vulnerable pension funds are well-situated to execute Asset Transfers on a tax-exempt basis while maintaining public oversight of the assets. Each municipality has structured the governance of pensioners' assets in a different way, however, all are instrumentalities of government; some are controlled by a retirement board specifically convened for such purposes, whereas others are managed by a city investment board that has the responsibility of overseeing a range of city monies.[65] The composition of these managing boards is the focus of the IRS's determination of whether or not a municipality's pension fund is an instrumentality of government.[66] Specifically, the IRS is concerned with whether the board is primarily controlled by the government directly, through individuals appointed by the democratically elected representatives of taxpayers—i.e., city/town council members or elected executives like mayors.[67]

The City of Cranston's pension funds are the clearest example of what the IRS would consider an instrumentality of government. In Cranston, the city's board of investment commissioners oversees municipal employees' pension assets.[68] This seven-member board is entirely comprised of individuals that were either democratically

65. *Compare* WOONSOCKET, R.I., CITY CHARTER ch. V, art. 1, § 3 (2018), http://clerkshq.com//Content/Woonsocket-ri/books/charter/woonch05.htm [https://perma.cc/SW65-TTEF], *with* PAWTUCKET, R.I., CODE ch. 11, art V, § 11-26 (21996), https://ecode360.com/8128241 [https://perma.cc/437Z-4BH6].

66. *See* Rev. Rul. 57–128, 1957–1 C.B. 311.

67. *See id.*

68. *See* CRANSTON, R.I., CODE OF ORDINANCES tit. 2, chs. 2.20.040, 2.28.040 (2018), https://library.municode.com/ri/cranston/codes/code_of_ordinances?nodeId=CO_TIT2ADPE_CH2.20POPEFU_2.20.040INTROOACNNRE [perma.cc/GM67-WFC5].

elected or appointed by the city's elected officials.[69] Notably, those responsible for running city government—the mayor, council members responsible for the budget, city treasurer, and city finance director—make up the majority of the board, and the remaining three members are appointed by the city's democratically-elected mayor.[70] The ex-officio membership majority, combined with the three members appointed by the city's executive, make it an instrumentality primarily controlled by the executive, with minimal oversight from the city council and none from labor.[71] This structure is by far the strongest of those surveyed when determining that the pension fund is an instrumentality of government.[72]

The City of Woonsocket's investment board membership is similarly well-situated to execute an Asset Transfer without tax complications or ceding public oversight. The pension assets of the city's retirees are managed by a city appointed investment board.[73] The five-member board is appointed by the city's elected council per the city's charter.[74] Even though the city's chief executive (the mayor) has less control over this membership structure, it is selected entirely by elected city officials, and the IRS is likely to view the board as an instrumentality of government as it is clearly convened to serve the city.[75]

While also well situated to be an instrumentality of government, the Town of Johnston's Retirement Board gives some control to non-democratically elected parties: two of its seven members appointed by public employee labor unions.[76] The Town's two labor appointed members are selected by the bargaining units themselves: the International Brotherhood of Police Officers, Local 307, and the International Association of Fire Fighters, AFL-CIO 1950, each select one of their members to serve on the Retirement

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69. *See* CRANSTON, R.I., CHARTER ch. 7, § 7.05(b) (2018), https://library.municode.com/ri/cranston/codes/code_of_ordinances?nodeId=CH_CH7DEFI_S7.05PODUTR [https://perma.cc/LA77-FWPF].

70. *Id.*

71. *See id.*

72. *See* Rev. Rul. 57-128, 1957-1 C.B. 311.

73. *See* WOONSOCKET, R.I., CITY CHARTER ch. V, art. 2, § 3 (2002), http://clerkshq.com//Content/Woonsocket-ri/books/charter/woonch05.htm#_CPA8 [https://perma.cc/L8YA-B94E].

74. *Id.*

75. *See* Rev. Rul. 57-128, 1957-1 C.B. 311.

76. *See* JOHNSTON, R.I., CODE pt. 1, ch. 47, §§ 47-39(2)–(3) (2018), https://ecode360.com/16068236 [https://perma.cc/5ESS-L5HY].

Board.[77] Despite these two appointees, the clear majority of the Retirement Board membership is appointed by Town officials, leaving it largely under the Town's control and therefore likely to be considered an instrumentality of government by the IRS.[78]

The City of Pawtucket's pension board contains a more substantial mix of labor appointed members and city appointed members.[79] Specifically, four of the nine members are appointed by their respective labor groups: two firefighters are elected and confirmed to serve by current and retired firefighters, as are two police officers from and by their respective current and retired members. Because the balance of the membership (five members) is appointed by the mayor or council, the body continues to be primarily government controlled, and should still be considered an instrumentality of government.[80]

The City of Warwick's city controlled pension funds are invested by its municipal retirement board.[81] Similar to Pawtucket and Johnston, this eleven member retirement board handles the investment of pension assets and is comprised of a mix of government and labor appointees, with four selected by the pensioners rather than elected officials.[82] Of these four appointees, the president of the municipal employees bargaining unit serves as one, and the remaining three are elected from and by the city's retirees and current employees in accordance with specific parameters.[83] The overwhelming majority of board members, however, are appointed by the city's democratically elected mayor (as either members of the public or his administration) and the city council.[84] This structure situates the city's pension funds as

77. *Id.*

78. *Id.* §§ 47-39(1), (4)–(5).

79. *See* PAWTUCKET, R.I., CODE ch. 11, art. V, § 11–26 (1996), https://ecode360.com/8128241 [https://perma.cc/R4EK-3F3M].

80. *See* Rev. Rul. 57-128, 1957-1 C.B. 311. The presence of labor appointees can be problematic in regard to the ruling, which states that a determining factor regarding whether an entity is an instrumentality of government can depend on "[w]hether control and supervision of the organization is vested in public authority or authorities." *Id.*

81. WARWICK, R.I., CODE OF ORDINANCES, pt. 1, ch. 30, § 30-3(b) (1971), https://library.municode.com/ri/warwick/codes/code_of_ordinances?nodeId=PTIICOOR_CH30INFU_S30-3DEINCOHAPEFU [https://perma.cc/V3DT-EMF2].

82. *Id.* ch. 6, art. IX, div. 1, § 6-242.

83. *Id.* § 6-242(6).

84. *Id.* §§ 6-242(1)–(5).

government controlled, likely making it an instrumentality of government.[85]

In contrast to the other surveyed municipalities, the composition of the City of Providence's retirement board is on the line of maintaining public control, with half of its twelve members appointed by labor.[86] As a home rule municipality, the Retirement Board's membership composition is defined under Providence's Home Rule Charter, which includes specific parameters and processes for the selection of both government and labor members.[87] The mechanics include a combination of appointment and election, but the end result is the same: half of the members are appointed or elected by democratically-elected municipal officials, and the other half are elected by labor groups consisting of past and present city employees.[88] The city can make a strong argument that, because the management of the actual investment duties is handled within City Hall rather than through an outside entity, the pension fund remains an instrumentality of government.

CONCLUSION

The next recession threatens to push many of Rhode Island's cities and towns to the brink of insolvency, and Rhode Island municipalities should consider Asset Transfers as one of the tools available to position their pension funds to negotiate meaningful reforms to reach healthy funding levels. Municipal insolvency threatens both the basic services relied upon to sustain the state's economic core, and the pensions owed to hard working public employees.[89] Bankruptcy and privatization are not the only answers. Public assets should remain under public control and can if transferred to public pension funds. While additional matters need to be explored—ranging from the mechanics of deriving cash from a contributed asset to the optimal management structure—it is clear that under the current tax regime, Rhode Island municipalities should seriously consider pursuing Asset Transfers

85. *See* Rev. Rul. 57-128, 1957-1 C.B. 311.

86. *See* PROVIDENCE, R.I., CODE OF ORDINANCES pt. 1, art. IX, § 908(a)(1) (2006), https://library.municode.com/ri/providence/codes/code_of_ordinances?nodeId=PTIHORUCH_ARTIXPEDE_908REBO [https://perma.cc/LT4C-QMJE].

87. *Id.*

88. *Id.*

89. *See* Russ, *supra* note 8.

as a tool to improve the funding of their respective municipal pensions. If government must account for its liabilities like the private sector, it should consider doing the same in how it accounts for its assets, by using Asset Transfers. It's time Rhode Island's municipalities rebalance their balance sheets.