SCPP · 2016 Merger Study

LEOFF 1/LEOFF 2 MERGER ANALYSIS

December 7, 2016

LEOFF 1/LEOFF 2 Merger Study

FINAL REPORT
By Steve Nelsen
Executive Director
360-586-2320
steve.nelsen@leoff.wa.gov

ISSUE STATEMENT

A financial merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds raises a number of issues for plan members and retirees, LEOFF employers and the State related to funding policies, governance, and potential budget impacts. These issues should be studied by LEOFF 2 trustees.

OVERVIEW

A merger of the LEOFF 1 and LEOFF 2 retirement funds could affect all current and future member participants and annuitants in LEOFF Plan 1 and LEOFF Plan 2. According to the Preliminary 2015 Actuarial Valuation Report, as of June 30, 2015, LEOFF Plan 2 had 17,019 active participants and 3,710 annuitants; LEOFF Plan 1 had 82 active participants and 7,507 annuitants.

The Law Enforcement Officers' and Fire Fighters' (LEOFF) Retirement System is a cost-sharing multiple-employer retirement system. Membership includes all full-time, fully compensated, commissioned law enforcement officers, and firefighters. There are two tiers in the LEOFF system referred to as LEOFF Plan 1 and LEOFF Plan 2. Both LEOFF Plan 1 and LEOFF Plan 2 provide defined retirement benefits which are financed from a combination of investment earnings, employer and employee contributions, and contributions from the State.

The LEOFF Plan 1 retirement fund and the LEOFF Plan 2 retirement fund are separate trust funds. The assets of each fund may be used solely to pay for the liabilities of the associated retirement plan. The funds are commingled for investment purposes but they are accounted for separately and reported separately in both annual financial reports and annual actuarial valuations.

There have been several legislative proposals since 2010 to merge State public pension plans, including the Law Enforcement Officers' and Fire Fighters' Plan 2 (LEOFF Plan 2), in order to save the State money by reducing State contributions to the new plan. The debate over these proposals has raised questions of whether the proposals are legal under state or federal law; how the merger impacts the State budget; and how the merger affects member benefits, plan governance and plan funding.

The Supplemental Operating Budget passed by the Legislature in 2016 included a proviso (2016 3rd sp.s. c 4 s 106) for the SCPP to work with the LEOFF Plan 2 Board, DRS, and OSA to study the legal, financial and policy issues raised by merging the LEOFF Plan 1 Retirement Fund with either the LEOFF Plan 2 Retirement Fund or the Teachers' Retirement System (TRS) Plan 1 Retirement Fund.

This report will provide an explanation of the issues raised by a merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds. The analysis of these issues will not be specific to any past legislative proposal. Rather, the goal of this report is to increase understanding of the general principles that would apply to any merger of these plans.

BACKGROUND & POLICY ISSUES

Benefit Administration and Investment of the Retirement Funds

The Law Enforcement Officers' and Fire Fighters' (LEOFF) Retirement System was created in 1970 by merging a number of separate city and county retirement plans into one state-wide plan. The LEOFF Retirement fund was established to pay for the liabilities of this new retirement system. The administration of the LEOFF Retirement System and the investment of fund assets was initially the responsibility of the Public Employees' Retirement System (PERS) Board.

The responsibility for administering the LEOFF Retirement System benefits was transferred from the PERS Board to the newly-created Department of Retirement Systems (DRS) in 1977. DRS continues to administer LEOFF member benefits to this day. On October 1, 1977, the original LEOFF system (Plan 1) was closed to new members and a new tier of benefits, LEOFF Plan 2, was established for all new LEOFF members. LEOFF Plan 2 currently remains open. The PERS Board continued to invest the LEOFF Retirement Systems fund, which included assets and liabilities of both LEOFF Plan 1 and LEOFF Plan 2, until 1981 when the Board was abolished and investment authority for the fund was transferred to the newly-created Washington State Investment Board (WSIB) where it remains today.

The Pension Funding Act of 1989 (c. 272, laws of 1989) split the assets and liabilities of the LEOFF Retirement System into separate funds for LEOFF Plan 1 and LEOFF Plan 2. Both funds are commingled for investment purposes as part of the Commingled Trust Fund managed by the SIB but assets and liabilities are accounted for separately.

The WSIB has the responsibility for investing all the state administered pension funds, including both the LEOFF Plan 1 retirement fund and the LEOFF Plan 2 retirement fund. The statutory mandate for the WSIB is to maximize return at a prudent level of risk.[1] The retirement funds collectively are called the Commingled Trust Fund (CTF). Established on July 1, 1992, the CTF is a diversified pool of investments including fixed income, public equity, private equity, real estate and tangible assets.

The CTF return was 4.93 % for the 2014-2015 fiscal year. The net assets held in trust for all the pension and benefit funds in the CTF totaled $80.5 billion as of June 30, 2015. The net assets held in trust for LEOFF Plan 2 was $9.83 billion or approximately 12% of the total pension and benefit funds in the CTF. The net assets held in trust for LEOFF Plan 1 was $5.61 billion or approximately 7% of the total pension and benefit funds in the CTF.

LEOFF 1 Contributions

LEOFF Plan 1 is a cost-sharing multiple employer retirement system which has been funded by a combination of contributions from three parties: the employers, the employees, and the state. Initially, the contribution rates for LEOFF Plan 1 were set at 6% of salary for both employees and employers and totaled approximately $266 million. State contributions were made by ad hoc legislative appropriations unrelated to employee salaries and totaled approximately $1,801 million. The relative historical share of contributions to the Plan 1 fund from the three parties is: 77% from state appropriations, 11.5% from employer contributions, and 11.5% from employee contributions.

The assets of the LEOFF Plan 1 retirement fund came to exceed the total actuarial liabilities of the system during the late 1990s when there was an extended period of much higher-than-expected

[1] RCW 41.33A.110

investment returns. The state ceased making appropriations to the plan after June 30, 1999. Member and employer contributions were statutorily suspended in June 2000.

The Office of the State Actuary provides an Actuarial Valuation Report to the Pension Funding Council every two years and the Council has the authority adopt any changes to the state contribution rate for LEOFF 1 as may be required. There were approximately 82 active LEOFF Plan 1 members and 7507 annuitants as of June 30, 2015.

LEOFF 2 Contributions

LEOFF Plan 2 is a cost-sharing multiple employer retirement system which is funded by a combination of contributions from three parties pursuant to a statutory cost sharing formula under which the members pay 50% of the total annual required contributions, the employers pay 30%, and the State pays 20%.[2] These costs are charged to members, employers and the State as a percentage of the member's salary.

The cost of the plan is evaluated annually by the Office of the State Actuary in their annual Actuarial Valuation Report. The contribution rates are adopted periodically by the LEOFF Plan 2 Retirement Board[3] based on the current and projected costs of the plan, the current and projected funding status of the plan and three statutory funding goals:

- To fully fund the plan;[4]
- To establish long-term state, employer and member contribution rates which will remain a relatively predictable and stable portion of future state, employer and member budgets;[5]and,
- To fund, to the extent feasible, all benefits for plan 2 members over the working lives of those members so that the cost of those benefits are paid by the taxpayers who receive the benefit of those members' service.[6]

The LEOFF Plan 2 Retirement Board has adopted modifications to the second goal to include the additional objective of rate stability and to reflect the interests of employers and members, not just the State. The original statutory goal was simply, "To establish long-term employer contribution rates which will remain a relatively predictable portion of future state budgets."

Rates are also adjusted periodically by the LEOFF Plan 2 Retirement Board to reflect increased costs as a result of benefit improvements.[7] The current contribution rates adopted by the LEOFF Plan 2 retirement Board through June 30, 2017 are 8.46 percent member, 5.08 percent employer, and 3.38 percent State. There were approximately 17,019 active LEOFF Plan 2 members and 3,710 annuitants as of June 30, 2015.

Funding Policies

Both LEOFF Plan 1 and LEOFF Plan 2 are valued and funded according to a complex arrangement of actuarial funding methods, long-term economic assumptions, demographic assumptions and actuarial funding policies. Many of these policies are the same for both plans but there are some differences which are important to understand and consider in the context of a financial merger of the plans.

---

[2] RCW 41.26.725(1)
[3] RCW 41.26.725 and RCW 41.45.0604
[4] RCW 41.45.010(1)
[5] RCW 41.45.010(4)
[6] RCW 41.45.010(5)
[7] RCW 41.45.070

Actuarial Funding Method

A variation of the Frozen Initial Liability Cost Method is used in LEOFF Plan 1 to determine the normal cost of the plan and the actuarial accrued liability for retirement and other pension benefits. Under this method, the Unfunded Actuarial Accrued Liability (UAAL) is equal to the unfunded actuarial present value of projected benefits less the actuarial present value of future normal costs for all active members and is reset at each valuation date. The present value of future normal costs is based on the aggregate normal cost for LEOFF Plan 2 and the resulting UAAL is amortized by June 30, 2024 as a level percentage of projected system payroll. The projected payroll includes pay from LEOFF Plan 2 as well as projected payroll from future new entrants. There is currently a surplus for LEOFF Plan 1.

There is a statutory funding policy to fully amortize any unfunded liability which may emerge in LEOFF 1 no later than June 30, 2024.[8] Both the State and LEOFF employers are likely to incur increased costs if LEOFF Plan 1 comes out of fully funded status which would create a need for LEOFF Plan 1 funding policies to be developed and coordinated with LEOFF Plan 2 funding policies established by the Board.

The Aggregate Cost Method is used in LEOFF Plan 2 to determine the normal cost. Under this method, the unfunded actuarial present value of fully projected benefits is amortized over the future payroll of the active group. The entire contribution is considered normal cost and no UAAL exists.[9]

The LEOFF Plan 2 Retirement Board has used a variation of the Entry Age Normal Cost Method since 2009 to match contribution rates to the expected long-term cost of the plan.

Long-Term Economic Assumptions

In order to calculate the necessary current contribution rates for a plan, it requires projecting the future costs of paying out plan benefits, projecting the future value of current payroll, and converting these projections into present day values. These calculations require the use of long-term economic assumptions. The long-term economic assumptions for LEOFF Plan 2 are adopted by the LEOFF Plan 2 Retirement Board. The long-term economic assumptions for LEOFF Plan 1 are set in statute.

Assumption	LEOFF 2	LEOFF 1
Investment Rate of Return	7.50%	7.70%
Salary Growth	3.75%	3.75%
Inflation	3.00%	3.00%
Growth in Membership	1.25%	1.25%

Demographic Assumptions

Assumptions about future non-economic events are also an important necessary component of the overall funding policies for both LEOFF 1 and LEOFF 2. Key demographic assumptions include:

- Members' future rates of retirement and disability.
- Their total length of service.
- Their life expectancy after retirement.
- The life expectancies of their surviving spouses and other beneficiaries.

[8] RCW 41.45.010(2)
[9] 2009 LEOFF Actuarial Valuation Report, Office of the State Actuary p. 36

The Office of the State Actuary performs an experience study at least once every six years to determine at what rate the above factors have actually occurred in the retirement systems.[10] The experience study compares actual experience to the assumptions and consider future trends or expectations. OSA makes adjustments, if necessary, to the rates for future actuarial valuations. For LEOFF Plan 2, any changes recommended by OSA must be adopted by the LEOFF Plan 2 Retirement Board.[11]

The most recent demographic experience study was published by the Office of the State Actuary in September, 2014. The study covered experience from 2007-2012. The study reported experience in LEOFF 1 separate from LEOFF 2 and developed different assumptions for each plan. One of the recommendations of that study was to modify mortality assumptions to take into account projected future improvements in life expectancy. These recommendations were adopted by the LEOFF 2 Board and incorporated into actuarial assumptions for LEOFF 2. The recommendations were adopted by the Pension Funding Council for LEOFF Plan 1.

Actuarial Value of Assets v. Market Value of Assets ("Smoothing")

For the actuarial valuation report, the Office of the State Actuary calculates the actuarial value of assets using an asset smoothing method adopted by the Legislature in 2003. The asset smoothing method applies to both LEOFF Plan 1 and LEOFF Plan 2. Each year OSA determines the amount the actual investment return deviates from the expected investment return and smooths that year's gain or loss over a period of up to 8 years according to how much the actual gain or loss differs from the assumed gain.

Asset Value Corridor

Additionally, to ensure the actuarial value of assets maintains a reasonable relationship to the market value of assets, a 30% asset value corridor was statutorily adopted in 2004.[12] This means that the actuarial value of assets may not exceed 130% nor drop below 70% of the market value of assets. The asset value corridor applies to both LEOFF 1 and LEOFF 2. On June 30, 2015, the asset value ratio for LEOFF 2 was 95% and for LEOFF 1 was 96%

The Funded Status of LEOFF 1 and LEOFF 2

The funded status of a plan is calculated by comparing the plan's assets to the present value of earned pension benefits of the plan's members. A plan's funded status can vary significantly depending on the assumptions and methods used to determine the value of the plan's assets and liabilities. The Office of the State Actuary has historically reported the funding status for both LEOFF 1 and LEOFF 2 by comparing the actuarial value of assets (AVA) to the liabilities of the plan calculated using the Projected Unit Credit (PUC) actuarial cost method and the long-term earnings assumption. OSA now uses the Entry Age Normal Actuarial Cost Method to calculate the funded status.

Governance

LEOFF Plan 2

Effective July 1, 2003, the LEOFF Plan 2 Retirement Board was established by Initiative 790 to provide governance of LEOFF Plan 2. The Board's duties include adopting contribution rates, actuarial assumptions, and actuarial methods. The Board is also responsible for studying pension issues and recommending policy changes to the Legislature for the LEOFF Plan 2 retirement plan.

---

[10] RCW 41.45.090
[11] RCW 41.26.720
[12] RCW 41.45.035(3)(a)

LEOFF Plan 1

In 2003 the Select Committee on Pension Policy (SCPP) was established by the Legislature to study pension issues, develop pension policies, and make recommendations to the Legislature.[13] The SCPP is a 20-member committee composed of elected officials, stakeholder representatives, employer representatives, and the Directors of the Department of Retirement Systems and the Office of Financial Management. Prior to 2003, the Joint Committee on Pension Policy (JCPP) performed these duties.

The SCPP meets during the legislative interim. Its specific areas of interest include benefits design, retirement eligibility requirements and pension funding methods. The SCPP receives the results of actuarial audits administered by the Pension Funding Council, and reviews and makes recommendations to the Pension Funding Council regarding changes to retirement assumptions or contributions rates. Under current law, the SCPP may form a public safety subcommittee to study pension issues affecting members of LEOFF, the Public Safety Employees Retirement System (PSERS), and the Washington State Patrol Retirement System (WSPRS).[14]

Legislative History

House Bill 2097 in 2011 proposed merging LEOFF Plan 2 with LEOFF Plan 1 and temporarily reducing the State contribution to the merged plan. That bill did not pass the legislature.

Section 105 of the 2011 budget required the Office of the State Actuary to study the issue of merging LEOFF plans 1 and 2 into a single fund. The results of the study were reported to the ways and means committees of the House of Representatives and the Senate in December, 2011.

House Bill 2350/Senate Bill 6563 in 2012 proposed merging LEOFF Plan 1 with LEOFF Plan 2 and reducing the State contribution to the merged plan. That bill was recommended by the LEOFF Plan 2 Retirement Board did not pass the legislature.

Senate Bill 6668 in 2016 proposed merging LEOFF Plan 1 with the Teachers' Retirement System (TRS) Plan 1 and reducing the State contributions to pay the unfunded liability in the merged plan.

The Supplemental Operating Budget passed by the Legislature in 2016 included a proviso (2ESHB 2376, sec. 106) for the SCPP to work with the LEOFF Plan 2 Board, DRS, and OSA to study the legal, financial and policy issues raised by merging the LEOFF Plan 1 Retirement Fund with the LEOFF Plan 2 Retirement Fund or the Teachers' Retirement System (TRS) Plan 1 Retirement Fund.

Senate Bill 6166 in 2001 proposed terminating LEOFF Plan 1 and using some of the assets of the fund for state purposes as well as for the cost to "restate" the plan and pay for a one-time payment to LEOFF Plan 1 beneficiaries. The bill did not pass the legislature.

Legal Framework

Under federal law, the assets of a tax-qualified retirement plan such as LEOFF Plan 1 and LEOFF Plan 2 may be used only for the exclusive benefit of members of the plan.

There is a body of state case law across the country regarding plan mergers which may be illustrative of potential issues in evaluating a merger but there is no similar case law in Washington. Additionally, there is a significant body of Washington case law defining members' rights to retirement benefits and to have their retirement plan funded on a sound actuarial basis.

---

[13] RCW 41.04.281
[14] RCW 41.04.278(2)(a)

POLICY ISSUES

What is a "merger" of LEOFF Plan 2 with LEOFF Plan 1?

A merger of the LEOFF Plan 2 Retirement System with the LEOFF Plan 1 Retirement System would combine all of the assets and liabilities of each system into one new system. In its simplest terms, a merger is a purely financial transaction.

Why would anyone want to merge LEOFF Plan 2 with LEOFF Plan 1?

Past merger proposals have included a temporary reduction in State contributions to the new plan. If the funding status of the new plan is improved compared to the current status of LEOFF Plan 2, then that would decrease the risk of poor investment experience in the future creating a need to increase contributions to LEOFF Plan 2 members, employers and the State. The member demographics of the plans, and the fact that LEOFF Plan 2 is an open system while LEOFF Plan 1 is a closed system, may also present opportunities for risk mitigation.

But, a merger also can create new risks so it is prudent for LEOFF Plan 2 Retirement Board members to inform themselves of these risks and take steps to mitigate those risks as part of any merger since Board members have a fiduciary duty to the plan.

How much is the surplus in LEOFF Plan 1?

The results of the 2015 Actuarial Valuation prepared by the Office of the State Actuary indicate that as of June 30, 2015, LEOFF Plan 1 had $4.307 billion in liabilities and an actuarial value of assets of $5.404 billion for a surplus of $1.097 billion. However, any evaluation of the LEOFF Plan 1 surplus in the contest of a LEOFF 2/LEOFF 1 merger must consider three important questions:

1. What is the surplus as of today?
2. How does the market value of assets (MVA) differ from the actuarial value of assets (AVA)?
3. How does the calculation of LEOFF 1 liabilities differ from LEOFF 2?

Today's Value: The current Actuarial Valuation Report (AVR) prepared by the Office of the State Actuary (OSA) is based on asset and liability information as of June 30, 2015. The Washington State Investment Board (WSIB) updates the market value of plan assets monthly. OSA prepares annual projections of liabilities and actuarial value of assets for LEOFF Plan 1. The most recent investment report from the WSIB (July 2016) indicated a market value for LEOFF Plan 1 of $5.387 billion which is lower than the actuarial value of assets in the 2015 AVR.

It is also important to note how investment performance since June 2015 has differed from the projections used to calculate future liabilities in the 2015 AVR. LEOFF Plan 1 is expected to earn 7.7%/year. However, actual investment returns for the 2015/16 fiscal year were just 2.65%.

Market Value/Actuarial Value: The Actuarial Value of Assets (AVA) is calculated by smoothing investment gains and losses over a period of up to 8 years depending on how much the actual investment returns differ from the projected investment returns. The AVA for LEOFF Plan 1 as of June 30, 2015 was $5.404 billion. The Market Value of Assets (MVA) is the actual value of assets in the fund as of a certain date. The MVA for LEOFF Plan 1 as of June 30, 2015 was $5.610 billion. So, as of June 2015 there were $206 million in deferred gains in LEOFF Plan 1.

Using a "smoothing method" is an appropriate and accepted method of reducing the effect of investment return volatility on contribution rates. But, using a "smoothed value" of assets may not be as appropriate for purposes other than rate-setting. For instance, if the legislation merging LEOFF 2 with LEOFF 1 includes "spending" some of the surplus assets in the form of contribution rate reductions, then it would be appropriate to consider the impact on the fund using both the actuarial value and the market value.

Calculating LEOFF 1 liabilities: The long-term economic assumptions used by both LEOFF Plan 2 and LEOFF Plan 1 are identical in most respects and both systems have adopted the expected improvements in life expectancy recommended by the Office of the State Actuary (OSA). However, there is one main difference related to the expected future return on investments. The LEOFF Plan 2 Retirement Board has adopted the 7.5% earnings assumption recommended by OSA. The investment assumption for LEOFF Plan 1 is 7.7%.

It would be important to know how the financial risks of a LEOFF 2/LEOFF 1 merger would differ using a 7.5% investment return assumption.

Who does the LEOFF Plan 1 surplus belong to?

All the assets in LEOFF Plan 1 are held in trust for the exclusive benefit of the beneficiaries of LEOFF Plan 1. The fact that LEOFF Plan 1 may have a "surplus" or more assets at a point in time than it is projected to need does not affect the legal status of any of the assets in the fund.

The idea that "surplus assets in the fund belong to the plan sponsor" is a concept related to closing or terminating a plan and is discussed later in this report. Neither the existence of a surplus nor a merger allow for fund assets to be distributed or diverted to a plan sponsor.

How does a merger affect LEOFF Plan 2 benefits?

A merger does not require that all members of the new plan receive the same benefits. Typically, the new plan continues the same benefits previously provided to members and beneficiaries as separate tiers of benefits.

State law prohibits a merger from reducing benefits provided to members. Benefits can be increased in the same piece of legislation that merges plans but any benefit increase is separate and distinct from the merger itself.

How would a LEOFF 2/LEOFF 1 merger impact the State budget?

LEOFF Plan 2 receives 20% of the cost of the plan from the State as an appropriation from the General Fund. That appropriation will be approximately $130 million in the 2015-17 biennium. The required biennial appropriation for 2017-19 has yet to be determined but is likely to increase due to projected growth in the LEOFF Plan 2 membership and salary base. LEOFF Plan 1 also has received a portion of its funding from the State in the past but no contributions have been required since 2001.

Past LEOFF 2/LEOFF 1merger proposals have included temporary reductions in state funding to the newly created plan in consideration of the very healthy funding status of LEOFF Plan 1. For example, if the State contributions to pay for LEOFF Plan 2 benefits in the new plan were reduced to 0% for the next two biennia, the State would recognize approximate budget savings of over $260 million. Any long-term state budget risks or benefits created by a merger should also be evaluated.

What legal issues are raised by a LEOFF 2/LEOFF 1 merger?

A merger of public retirement plans raises questions of both federal and state law. Public pension plans must be qualified under federal law in order for members and plan sponsors to receive favorable tax treatment for their contributions and earnings. So, when a merger creates a new plan, that new plan must be reviewed by the Internal Revenue Service to determine if it is qualified. The Internal Revenue Service recently issued notice that they will cease doing plan determination letters for existing plans. However, they will continue to issue plan qualification determinations for new plans including a new plan created by a merger. The current estimated turnaround time for a determination is six months.

The State Attorney General's Office is responsible for this evaluation. The firm of Ice Miller has been used as a Special Assistant Attorney General in the past to provide advice related to federal tax to the LEOFF Plan 2 Retirement Board, the Department of Retirement Systems, the State Senate and the Select Committee on Pension Policy.

One of the key requirements for a retirement plan to be qualified is that assets must be held in trust for the exclusive benefit of the plan beneficiaries. Some of the additional criteria used to evaluate a proposed merger include: are the plans open or closed to new members; do the plans have similar employers; are the plans over-funded or under-funded; and, are the plans demographics compatible?

A copy of the advice received from Ice Miller can be found in Appendix A.

Washington case law on pensions is based on the principle that pension benefits are part of a contract between the employer and employee which cannot be diminished by state law (*Bakenhus*). So, a merger cannot reduce benefits. Similarly, the courts have held that the funding which underlies the benefit promise is also subject to protection (*Weaver*). So, a merger that diminishes current or future plan funding needs to be evaluated according to these protections.

The State Attorney General's Office is responsible for this evaluation. The firm of K&L Gates has been used as a Special Assistant Attorney General to provide advice related to plan mergers to the LEOFF Plan 2 Retirement Board. A copy of the advice received from K&L Gates can be found in Appendix B.

How would a LEOFF 2/LEOFF 1 merger affect plan governance?

The Pension Funding Council adopts contribution rates for LEOFF Plan 1. The Select Committee on Pension Policy studies policy issues related to LEOFF Plan 1 benefits and recommends any changes to the Legislature. A merger would not require any changes.

The LEOFF Plan 2 Retirement Board adopts contribution rates for LEOFF Plan 2, studies policy issues related to the plan and recommends any changes to the Legislature. A merger would not require any changes.

Any changes to the governance of LEOFF Plan 2 would require careful consideration. For instance, how would a temporary State contribution rate reduction to LEOFF 2 fit with the role of the LEOFF Plan 2 Retirement Board to adopt contribution rates for LEOFF Plan 2?

Some state courts have held that the right of plan members to have their plan governed by an independent board of trustees who owe a fiduciary duty to the plan, such as the LEOFF Plan 2 Retirement Board, is a benefit of the plan subject to the same legal protections as other plan benefits. That question has not been decided by Washington courts.

Mergers in the private sector are typically arm's length transactions between two different plans with separate governing bodies and separate plan sponsors. The trustees of each plan have a fiduciary responsibility to ensure that a proposed merger is in the best interest of their plan's members and negotiate the terms of the merger accordingly. But, there are no governing boards for any of the state-administered public pension plans in Washington other than LEOFF Plan 2. The terms of any merger of LEOFF Plan 2 and LEOFF Plan 1 would be established by the State Legislature in legislation.

How would a LEOFF 2/LEOFF 1 merger affect plan funding?

LEOFF Plan 2 has a current funding ratio of 105%. LEOFF Plan 1 has a current funding ratio of 125%. When the assets and liabilities of LEOFF Plan 2 and LEOFF Plan 1 are merged, the funding ratio of the newly created plan would be approximately 112%.

The fact that the funding ratio of a merged LEOFF 2/LEOFF 1 system would be over 100% means that there would likely be no short-term change in funding policy required for either plan. The funding ratio of a system plays an important part in determining the ongoing funding policies of that system so the impact of a merger or any reductions in future contributions on the projected future funding status of the merged plans becomes an important consideration.

The costs of LEOFF Plan 2 are funded 50% by members, 30% by employers and 20% by the State. The required contributions are adopted as a percentage of member salary by the LEOFF Plan 2 Retirement Board. The rates adopted by the Board are currently 8.41% for member, 5.05% for employers and 3.36% for the State through June 30, 2017. The Board is scheduled to adopt rates for the 2017-19 biennium and the 2019-21 biennium at their July 27, 2016 meeting.

No State, member or employer contributions for LEOFF Plan 1 have been required since 2001 because of the positive funding status of the plan. Contributions to LEOFF Plan 1 could be reinstated if the plan's funding status decreased due to adverse investment or actuarial experience. Any potential future member contributions would not be significant due to the low number of members currently active in the plan so the responsibility for any potential future funding requirements would fall on LEOFF employers and the State.

Any merger proposal must be carefully analyzed to evaluate the risk that insufficient contribution rates, underfunding, or poor economic or demographic experience in LEOFF 1 would impact the rates charged to LEOFF 2 members, employers or the State.

How would a LEOFF 2/LEOFF 1 merger affect investment policy?

The assets of all State-administered pension plans in Washington are currently part of the Commingled Trust Fund (CTF) invested by the Washington State Investment Board (SIB). The CTF uses the same investment policy for all plans regardless of the plan's funded status or beneficiary demographics.

A merger that included keeping the new fund in the CTF would mean no change in investment policy. A merger of two plans within the CTF into a new plan that remains in the CTF would not require any sale of assets that could create transactions costs for the new plan or other plans in the CTF.

Commingled Investment

There has been some consideration in the past as to whether LEOFF 1 assets should remain invested in the commingled trust fund or whether it would be more appropriate to invest these assets in a more conservative fund to minimize the risk of investment volatility since LEOFF 1 has been closed to new members since 1977 and the future benefits payments are more predictable, have a shorter duration and would be easier to immunize. However, there is a cost associated with a lower earning assumption.

Since LEOFF 2 is an open and ongoing plan, merging LEOFF 1 with LEOFF 2 would affect analysis of this issue.

What is a plan termination and how does it apply to a plan merger?

One question that often arises when discussing merger is what happens to any remaining assets in a fund when it closes? Federal case law has said that when a private plan is terminated and all the liabilities to beneficiaries have been satisfied, any remaining assets revert to the plan sponsor (*Hughes Aircraft*). It is unclear how that holding would be applied in the context of a public plan termination. Both LEOFF employers and the State contributed to LEOFF Plan 1 so both would have a sponsorship claim to any remaining assets. The State Senate proposed a termination of LEOFF Plan 1 in 2001 which included annuitizing existing LEOFF 1 liabilities and a distribution of surplus assets to the State, LEOFF 1 employers and a payment to LEOFF 1 beneficiaries.

A termination can also occur when the last beneficiary of a plan dies and there are no longer any benefits owed. The office of the State Actuary estimates that there will continue to be some LEOFF 1 beneficiaries for more than 40 years.

The principle that surplus assets in a terminated plan belong to the plan sponsor has sometimes been misapplied to discussions of a plan merger stated as a principle that all surplus assets in a fund belong to the fund sponsor(s). But, that is not accurate for several reasons. First, a plan “termination” is a separate process under federal law from merger and different legal requirements apply. A merger does not allow for fund assets to be distributed to the plan sponsors. Second, as long as a plan has beneficiaries, all assets in the plan are held in trust for the exclusive benefit of the plan’s beneficiaries. The possible disposition of any potential remaining assets if the plan is terminated in the future does not alter the legal status of those assets while the plan is active.

What is the history of plan mergers in Washington?

Plan mergers are more common in the context of private sector Taft-Hartley pension plans but there have been several mergers of public pension plans in the State of Washington. The Law Enforcement Officers’ and Fire Fighters’ (LEOFF) Retirement System was originally created in 1970 by merging some of the assets and most of the liabilities of the police pension plan of ten first-class cities with the fireman’s pension fund of 42 separate systems throughout the State. The prior plan sponsors were allowed to keep some assets to cover medical expenses. The prior plan sponsors remained liable for any retirement benefits beyond those provided in LEOFF Plan 1.

In 1972, the Statewide City Employers’ Retirement System was merged into the Public Employers’ Retirement System (PERS).

What would happen if LEOFF 1 has an unfunded liability in the future?

There is a statutory funding policy to fully amortize any unfunded liability which may emerge in LEOFF 1 no later than June 30, 2024.[15] If an unfunded liability emerges in LEOFF 1, this policy requirement could significantly impact funding requirements for LEOFF members, employers and the State in a merged plan. There is no funding policy for LEOFF 1 after June 30, 2024 so it is unclear what would be done if an unfunded liability emerges after that date.

LEOFF 1 Supplemental Rate

When an unfunded liability emerged in both PERS Plan 1 and TRS Plan 1, the State adopted a supplemental rate to cover this cost which is charged to employers as a percentage of salary of all PERS

[15] RCW 41.45.010(2)

or TRS employees, not just those in Plan 1. If an unfunded liability were to emerge in LEOFF Plan 1, the State could adopt a similar supplemental rate to cover that cost. The additional cost to LEOFF employers would likely be shared with LEOFF 2 members indirectly through the bargaining process since less money would be available for salaries, equipment and other expenses.

Financial Efficiencies

There are currently no required contributions to LEOFF Plan 1 from the State, employers or members and haven't been any required contributions for some time. Therefore, any increase in assets, such as from positive investment performance, will not decrease plan costs. Assets in the retirement fund are strictly protected under federal law for pension plans and cannot be withdrawn from the fund and used for any state or employer purpose.

A merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds could commingle both the assets and liabilities of each plan. Therefore, any increase in assets due to positive economic or demographic experience could decrease plan costs for LEOFF members, LEOFF employers and the State.

Risk Transfer/Sharing

The assets invested in the LEOFF 1 retirement fund are currently projected to be sufficient to meet the projected liabilities of the plan. Currently, the State (and possibly LEOFF employers) would be responsible for any increased plan costs and required contributions in the future. The two primary risks of increased costs are 1) less-than-expected investment returns; and 2) higher-than-expected inflation. A merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds could commingle the liabilities of both plans. So, an increase in LEOFF 1 costs could become the shared responsibility of LEOFF 2 members, LEOFF employers and the State.

LEOFF 2 Board Request for State Actuary Study

The Office of the State Actuary (OSA) has been asked to provide analysis to assist the Board's report to the legislature. There are two clear financial risks associated with a merger. Part of understanding these risks is understanding how these risks are increased if LEOFF 1 assets are used for other purposes such as rate reductions for the state or benefit payments to plan members.

1) The risk that LEOFF 1 will dip below 100% funding at some time in the future and require additional contributions; and,
2) The risk that LEOFF 1 will go into "pay-go" status.

There is a perception that the demographics of LEOFF 1 (virtually all retirees, no active salary base) increase the sensitivity of the plan to near-term deviations from actuarial assumptions, particularly the investment return assumption which has a high degree of annual volatility. Can OSA perform sensitivity analysis to verify or refute that perception? For instance, a 7.7% earnings assumption may be reasonable in the long-term but may be challenging in the short-term due to low near-term inflation expectations.

What is the likelihood of the LEOFF 1 funding ratio going under 100%?

A. How does that likelihood change using a 7.5% earnings assumption?
B. How does that likelihood change using different economic scenarios?
C. How does that likelihood change if the CTF earns 5% on average for the next 10 years?
D. How does that likelihood change if LEOFF 1 annuitants receive $5000 each as an additional benefit?
E. What are the greatest risks to a LEOFF Plan 1 UAAL reemerging?
F. What are the consequences of a LEOFF Plan 1 UAAL reemerging? (State payments as a percentage of LEOFF 2 salary base? Employer payments?)

How has the "Pay-Go Risk" analyzed in the 2011 LEOFF Merger Study by OSA changed since the publication of that report? Can you provide an update of the chart from that report that overlays the future risk of going into "pay-go" status and the amount of projected cost?

What is the current annual projected amount of LEOFF 1 benefit payments into the future? This will be helpful to demonstrate how long LEOFF Plan 1 is expected to remain open.

When OSA did the fiscal note for the proposed TRS 1/LEOFF 1 merger during the 2016 legislative session, the actuarial data was updated from the most recent actuarial valuation to the date of the fiscal note. Can OSA do a similar estimate for a LEOFF 1/LEOFF 2 merger? What information would you require?

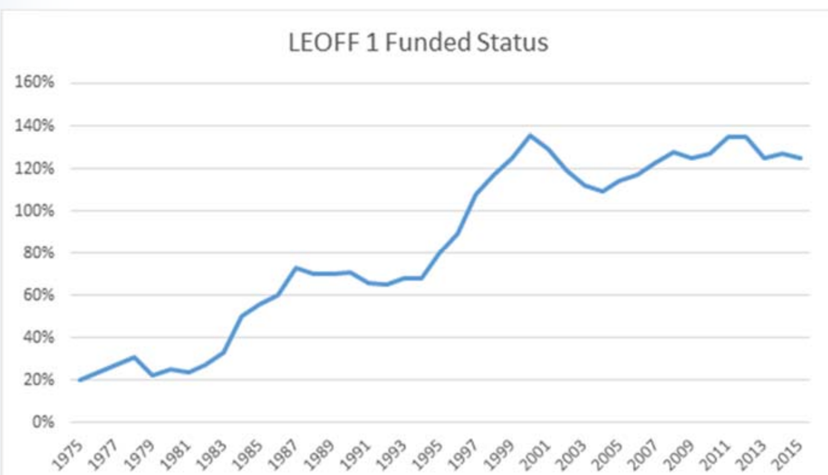
Is there a way to estimate the monthly changes to the LEOFF 1 "surplus" using the most recent monthly fund market value from the State Investment Board and an estimate of how much LEOFF 1 liabilities have changed since the most recent valuation? For instance, can you estimate the projected change in liabilities from June, 2015 to June 2016 and use 1/12 of that number as an approximation for the monthly change?

One other scenario that needs analysis is the impact of a rate holiday. Can you show the impact to funding ratio and contribution rates of a 0% state rate for 4 years on the merged plan? For instance, a merger will result in a new funding ratio for the merged plan. What would the impact on that new funding ratio be if the State contributions were zero for the next two biennia? Would a merger impact the current rates charged to LEOFF 2 members or employers? What impact would a 0% state rate have on the likelihood of future rate increases becoming necessary?

A copy of the analysis received from OSA can be found in Appendix C.

How has the LEOFF Plan 1 funding ratio changed over time?

The chart below demonstrates the reported funding ratio of LEOFF Plan 1 since the plan's inception.



The rapid increase in the plan's funding ratio from 1995 to 2001 is attributed primarily to extraordinarily positive investment return experience and large State contributions. State contributions at the time were calculated on an expected return of 7.75% per year and experience averaged over 20% per year during this period. The inflation assumption used at the time was 4.5% which also overstated the required contributions from the State. Member and employer contributions were fixed at 6% of pay per year.

What is the proportionate share of LEOFF 1 contributions from members, employers and the State?

The total contributions paid into LEOFF Plan 1 from its inception are:

- State- $1,801 million
- Employer- $266 million
- Employee- $266 million

The ratio of contributions would be 77.2% State, 11.4% employers, and 11.4% members. Applying this ratio to the projected surplus of $1.097 billion for LEOFF Plan 1 in the most recent actuarial valuation report would result in $847 million for the State, and $125 million for both employers and employees. Dividing the member share by the number of plan annuitants as of the date of the last valuation would be approximately $16,700/annuitant.

In addition to contributions, the State paid approximately $13.3 million in benefit payments to LEOFF Plan 1 retirees immediately following the inception of the plan. “For the first two years of the system, LEOFF is funded on a pay-as-you-go basis. The State of Washington has assumed the obligation to fund the present unfunded liability (estimated to be $400 million) over a period of not more than 40 years, and current costs which are not covered by the 12% contribution paid by employees and employer.” [16]

Can “excess assets” in LEOFF 1 be used to pay for retiree health care?

Internal Revenue Code Section 420(b) allows defined benefit pension plans that would remain funded above 125% to use assets for retiree medical costs or life insurance through 2025. LEOFF Plan 1 had a funding ratio of 125.47% as of June 30, 2015 according to the most recent actuarial valuation. The excess of 0.47% when applied to the fund value would be just over $25 million.

SUPPORTING INFORMATION

Merger Study Budget Proviso (2016 3rd sp.s. c 4 s 106)

During the 2016 legislative interim, the select committee on pension policy shall study Senate Bill No. 6668 (LEOFF 1 & TRS 1 merger) and report on the tax, legal, fiscal, policy, and administrative implications. In conducting the study, the select committee on pension policy shall also update its 2011 study of law enforcement officers' and firefighters' retirement system plans 1 and 2. In preparing this study, the department of retirement systems, the attorney general's office, the law enforcement officers' and firefighters' retirement system plan 2 board, and the office of the state actuary shall provide the select committee on pension policy with any information or assistance the committee requests. The committee shall also receive stakeholder input on the bill as part of its deliberation. The select committee on pension policy shall submit this report to the legislature by January 9, 2017.

[16] Comparison of Public Employee Retirement Systems in the State of Washington, Institute of Governmental Research in cooperation with public pension commission, December 1970.

APPENDIX

Appendix A – Ice Miller Memo: Federal Tax Considerations and Questions Raised by Stakeholders related to a Potential Merger of LEOFF 1 / LEOFF 2

Appendix B – K&L Gates Memo

Appendix C – OSA Analysis: LEOFF 2 Board Request For Analysis of LEOFF 1 Risks

IceMiller
LEGAL COUNSEL

MEMORANDUM

Via Electronic Mail

TO: **Steven N. Nelsen, Executive Director**
Washington LEOFF Plan 2 Retirement Board

FROM: **Mary Beth Braitman and Robert L. Gauss**
ICE MILLER LLP

MBB

CC: **Tor Jernudd**
Washington State Office of the Attorney General

DATE: **November 28, 2016**

RE: **Federal Tax Considerations and Questions Raised by Stakeholders related to a Potential Merger of LEOFF 1 / LEOFF 2**

This Memorandum follows-up to our meeting on October 24, 2016 and our discussions at the recent Select Committee on Pension Proposals ("SCPP") hearing.

In particular, this Memorandum will address the federal tax considerations of a potential merger between LEOFF Plan 1 and LEOFF Plan 2 (collectively referred to as the "Plans"). In this regard, this Memorandum will address the federal tax considerations of a merger between two qualified governmental defined benefit plans in accordance with the Internal Revenue Code ("Code") and applicable Treasury Regulations. Last, this Memorandum addresses certain legal questions which were submitted to the SCPP by stakeholders related to a potential merger involving LEOFF Plan 1.

I. EXECUTIVE SUMMARY

As will be discussed in greater detail in this Memorandum, under the Code and applicable Treasury Regulations, the term "merger" means the actual merger of assets and liabilities of more than one qualified plan into a single plan where the assets and liabilities are "usable" across the spectrum of merged plans. In order for a merger to be considered "legal" or "valid" for purposes of federal tax law, each participant in the merging plans must receive benefits on a termination basis from the plan immediately after the merger which are equal to or greater than the benefits the participant would have received on a termination basis immediately before the merger. Code §§ 401(a)(12) and 414(l). In this regard, a plan member who has reached normal retirement age or reached other vested status under the merging plans must be vested in his/her accrued benefit as of that date. Finally, in order for a merger to be valid it must comply with the exclusive benefit rule under Code § 401(a)(2). Accordingly, as part of the merger, it must be impossible for any part of the corpus or income of the merged plans to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries before there has been a complete satisfaction of all liabilities with respect to employees and their beneficiaries under the Plans. Although there is not a current legislative

I\11055295.1

proposal for the merger of LEOFF Plan 1 and LEOFF Plan 2, based upon our review of Senate Bill ("SB") 6668, we believe that if such a proposal contains the same features as in SB 6668, then it would be drafted to comply with the Code requirements for a valid merger.

In order to confirm that the merger would be approved by the Internal Revenue Service ("IRS"), we would normally strongly recommend that DRS and/or the Plans seek a new determination letter on the new merged plan in order to ensure its qualified status under the Code. Unfortunately, the Plans' ability to obtain a new determination letter will be limited by the IRS' new procedures for determination letters for individually designed plans (*see* Revenue Procedure 2016-37). There may be a way to structure the merger – *i.e.* a new plan created by the two existing plans coming together – which would allow a determination letter request to be submitted. We would intend to discuss this with you in more detail if this proceeded. Regardless, we also recommend that the Plans and/or DRS seek a PLR to confirm that the merger does not result in any tax consequences for any affected members.

II. CONSIDERED MATERIALS

For purposes of this Memorandum, this will confirm that we have reviewed and considered the following information and legal opinions previously submitted to either the Office of the State Actuary ("OSA") or others regarding previously proposed mergers involving LEOFF 1:

1. 2011 LEOFF Merger Study by the OSA.

2. Letter from Mr. Robert Klausner to Mr. Steven Nelsen dated April 26, 2011.

3. Memorandum from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) dated May 2, 2011.

4. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) and Mr. Jerry Taylor (President of Retired Seattle Police Officers' Association) dated June 21, 2011.

5. Ice Miller letter to David Nelson at the Washington State Department of Retirement Systems ("DRS"), Anne Hall at the Washington State Attorney General's Office and Aaron Gutierrez at the OSA dated October 5, 2011.

6. Letter from Mr. J.E. Fischnaller to Mr. Matthew M. Smith dated October 22, 2011.

7. Letter from Mr. J.E. Fischnaller to the LEOFF 1 Coalition Board dated January 12, 2012.

8. Letter from Mr. J.E. Fischnaller to the LEOFF 1 Coalition Board dated January 30, 2012.

9. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck and Mr. Jerry Taylor dated January 31, 2012.

10. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) and Mr. Jerry Taylor (President of Retired Seattle Police Officers' Association) dated February 1, 2012.

11. Letter from Ice Miller LLP to Mr. Aaron Gutierrez (OSA) dated June 13, 2013.

12. Letter from Ice Miller LLP to Mr. Aaron Gutierrez (OSA) dated April 23, 2015.

13. Memorandum from Mr. Phil Talmadge to Mr. Dick Warbrouck dated February 29, 2016.

14. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck dated February 29, 2016.

15. Letter from Mr. Robert D. Klausner to Mr. Dennis Lawson (President, Washington State Counsel of Firefighters) dated March 4, 2016.

16. The Actuary's Fiscal Note for SB 6668 dated October 27, 2016.

Also, for purposes of our consideration, please know that we have considered DRS's Comprehensive Annual Financial Report ("CAFR") for the year ended June 30, 2015 (this is the most recent CAFR available). In particular, we have considered:

- LEOFF Plan 1 had an actuarial value of assets in the approximate amount of $5.5 billion, it is stated to have a funding surplus of $1.1 billion and a funded ratio of 127%; and

- LEOFF Plan 2 had an actuarial value of assets in the approximate amount of $8.64 billion and a funded ratio of 107%[1].

Finally, this will confirm our understanding that the SCPP has been asked to perform an updated study of a potential merger of LEOFF Plan 1. In this regard, we understand that the possible scenarios for a merger with LEOFF Plan 1 involve either TRS Plan 1 or LEOFF Plan 2. However, based upon SB 6668, the contemplated merger is between LEOFF Plan 1 and TRS Plan 1. Notwithstanding, we also understand that LEOFF Plan 2 is updating the 2011 LEOFF Merger Study for consideration by the SCPP. Finally, we understand that SCPP, OSA, the AG's Office, DRS, each of the Plans and the members of each of the Plans collectively want to understand the requirements and/or restrictions for a potential merger for purposes of federal tax law.

[1] The data regarding the funding and funded status of each plan was as of June 30, 2014, the most recent actuarial valuation date contained in the CAFR (pg. 160). We also understand that the Actuary's Fiscal Note for SB 6668 has not updated either the surplus analysis for LEOFF Plan 1 or the funded status of LEOFF Plan 1 from the analysis in the 2015 CAFR.

III. BACKGROUND

Before responding to the questions submitted to the SCPP, we want to consider the possible meanings of the word "merger." As discussed below, under the Code "merger" has a very distinct meaning – it is the actual merger of assets and liabilities into a single plan, where the assets and the liabilities are "useable" across the spectrum of merged plans. This concept is to be distinguished from a number of other transactions. For example, policy makers may wish to consider forms of joint administration of plans, which we have referred to as "consolidation." We are aware that substantial consolidation already exists – for example, DRS administers LEOFF Plan 1, PERS and TRS (among a number of other plans) and the Washington State Investment Board handles the investments for each of the Plans. In this regard, each Plan's assets are strictly assets of each individual Plan – they are not "useable" across the spectrum of consolidated plans. For example:

- LEOFF Plan 1 is a cost-sharing multiple-employer defined benefit plan which was established by the Washington State Legislature during the 1969 session. It covers all full-time, fully compensated, local law enforcement and firefighters who established membership on or before September 30, 1977. The Plan is closed to new members. Based on membership data from the CAFR, there were 120 active members as of June 30, 2014 and 7,607 retired or inactive members. Based upon information from the OSA's 2015 Actuarial Valuation Report, there were 82 active members and 7,507 annuitants as of June 30, 2015. Based upon information provided to us, we understand there currently are 54 active members and 6,752 retired or inactive members in LEOFF Plan 1. LEOFF Plan 1 members are eligible for retirement at the age of 50 with five years of service. RCW 41.26.090. Also, members are vested after the completion of 5 years of eligible service. RCW 41.26.170. Based upon information in the CAFR (page 190), for the fiscal year ended June 30, 2015, LEOFF Plan 1 included 19 county and/or municipality employers and 4 other political subdivisions. Finally, LEOFF Plan 1 has certain local disability boards to adjudicate disability claims.

- LEOFF Plan 2 is a cost-sharing multiple-employer defined benefit plan which was established by the Washington State Legislature during the 1977 session and became effective October 1, 1977. LEOFF Plan 2 covers persons who first became members of the System on and after October 1, 1977. LEOFF Plan 2 is governed by the LEOFF Plan 2 Retirement Board, which is the policy-making board that studies pension issues, acts as fiduciary for LEOFF Plan 2, sets contribution rates and recommends pension policy to the legislature for LEOFF Plan 2 members. (RCW 41.26.705-735). Based upon the CAFR, as of June 30, 2014, LEOFF Plan 2 had 16,773 active members and 3,984 retired or inactive members. Members of LEOFF Plan 2 are all full-time, fully compensated, local law enforcement commissioned officers, firefighters, and, as of July 24, 2005, emergency medical technicians. Members are vested after the completion of 5 years of eligible service. RCW 41.26.530. Additionally, members are eligible for retirement at the age of 53 with 5 years of service. RCW 41.26.430. Based upon information in the CAFR, for the fiscal year ended June 30, 2015, LEOFF Plan 2 covered the State of Washington, 195 county and/or municipality employers and 157 other political subdivisions.

Under SB 6668, the assets and liabilities of TRS Plan 1 and LEOFF Plan 1 are proposed to be merged specifically to "improve the actuarial soundness of the teachers' retirement system plan 1 . . ." SB 6668 also stated that the Legislature intends that the merger of assets, liabilities and membership will be accomplished in a way which does not impact benefits provided to members of either plan. Indeed, under Section 2 of SB 6668, the assets, liabilities and membership of LEOFF Plan 1 are proposed to be merged into TRS Plan 1. As a result, the current assets and liabilities of LEOFF Plan 1 are proposed to become the assets and liabilities of TRS Plan 1. Importantly, Section 3 of SB 6668 states that "each member of each of these plans is entitled to receive benefits immediately after the merger on the effective date of this section that are equal to the benefits the member would have been entitled to receive immediately before the merger in accordance with plan terms." Further, the merger is proposed to not impact the disability board established in RCW 41.26.110 for LEOFF Plan 1. In order to entice LEOFF Plan 1 members, Section 6 of SB 6668 establishes that LEOFF Plan 1 members, including inactive vested members, retirees and survivors, shall be eligible to receive a $5,000 lump sum payable on either January 3, 2017 or on the member's retirement date, whichever is later (if there are multiple survivor beneficiaries for a single member, the lump sum shall be divided equally between those survivor beneficiaries).

Finally, the Actuary's Fiscal Note evaluates that the proposed merger under SB 6668 potentially results in an expected long-term total employer savings of about $2.1 billion through reduced contribution requirements over the next 25 years for employers of TRS Plan 1 (there are not currently any member or employer contributions required for LEOFF Plan 1 unless the most recent actuarial evaluation report shows the plan has unfunded liabilities). For purposes of the Actuary's Fiscal Note, the Actuary assumed that the LEOFF Plan 1 funding policy would remain in effect. However, the Actuary also discussed the possibility that, under pessimistic projections, remaining LEOFF Plan 1 members and their local employers would be required to contribute 6% of LEOFF Plan 1 salaries if LEOFF Plan 1 drops below its fully-funded status. Importantly, we understand that LEOFF Plan 2 is having the OSA conduct an updated fiscal analysis of the 2011 LEOFF Merger Study in order to report to the SCPP the potential savings from a LEOFF Plan 1 and LEOFF Plan 2 merger.

IV. OVERVIEW OF FEDERAL LAW - MERGER

In this section, we consider the federal tax law requirements for a plan merger – the rules that would apply to any merger of assets and liabilities of two or more governmental defined benefit plans. (We will not cover the situation where a governmental plan and a nongovernmental plan would merge, as we do not believe that would be pertinent or helpful in the current discussion.)

A. Source of Guidance

Governmental pension plans are subject to certain specific provisions of the Code and related Treasury Regulations. In general, governmental pension plans are not subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). In lieu of ERISA provisions, governmental plans are often subject to pre-ERISA guidance from the Internal Revenue Service ("IRS") on a particular subject (*e.g.*, vesting at normal retirement age). Governmental plans may also follow ERISA provisions by analogy or as a "best practice."

B. Exclusive Benefit Rule

One of the threshold rules in the qualified plan world is the "exclusive benefit" rule. This rule dictates that plan assets cannot be used other than to pay benefits to members and beneficiaries and to pay reasonable administrative expenses. In this regard, Code § 401(a)(2) requires that for a plan to be qualified, it must be "impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be . . . used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries . . ." *See also* Treas. Reg. § 1.401-2(a). Accordingly, the IRS has held that "funds accumulated under a qualified plan in trust are intended primarily for distribution to employee participants." Rev. Rul. 72-240, 1972-1 C.B. 108. This exclusive benefit requirement applies to all qualified pension plans, including governmental plans, and, therefore, must be considered in any plan merger. It is important to note that the exclusive benefit rule is incorporated into each of the Plans at WAC 415-02-756.

C. Qualified Plan Status

Pre-ERISA guidance provides that only qualified plans under Code Section 401(a) may be merged. Revenue Ruling 67-213. In a merger of governmental plans, it is important to ascertain or confirm the qualified status of each plan prior to the merger, as well as the qualified status of the "surviving" plan.

D. Consideration of Termination Issues

Pre-ERISA guidance also provides that, if the merger results in the termination of one plan, then all accrued benefits under the terminating plan must be 100% vested to the extent that benefits are funded. Code § 401(a)(7)(1974). Whether a plan is terminated is generally a question to be determined with regard to all the facts and circumstances in a particular case. A plan is not considered to be terminated merely because an employer consolidates or replaces that plan with a comparable plan. Treas. Reg. § 1.401-6(b)(1); Rev. Rul. 67-213, 1967-2 C.B. 149. A comparable plan is not necessarily one of the same type, but it is one of the same category (*e.g.*, defined benefit vs. profit-sharing). Rev. Rul. 67-213 (citing Treas. Reg. § 1.381(c)(11)-1(d)(4)). Therefore, in a merger of qualified defined benefit plans, the IRS could find that one (or all) of the merged plans had not terminated, but that determination is based on all the facts and circumstances involved in the merger.

E. Participant Elections

In some cases, policy makers may ask if they could give plan participants the option of whether or not to be part of a merger. Pre-ERISA, it was permissible to give participants the option of moving from one plan to another, so long as there was no option to receive a distribution. Rev. Rul. 67-213. However, at the current time, and as to a governmental plan, giving existing employees a choice among plans currently will not be approved by the IRS if the choice impacts the employees' pre-tax contributions and, as a result, creates a cash or deferred arrangement ("CODA"). Revenue Ruling 2006-43, 2006-35 I.R.B. 329; *see also* PLR 201532036.[2] While we recognize there are very few active employees (54) in LEOFF Plan 1, any active employees still would cause problems in terms of the IRS' prohibition on impermissible CODAs. Given the current prohibition in the IRS' position, we have set this potential approach aside, both because it would not seem to be a useful design in the circumstance and because it would raise issues that would likely significantly impede any resolution.

F. Assets/Liabilities

Pre-ERISA guidance applicable to governmental plans does not provide any specific guidance with respect to the treatment of the merger of assets and liabilities/benefits. Code §§ 401(a)(12) and 414(l) establish merger requirements for private sector plans, which requirements are intended to demonstrate compliance with the exclusive benefit rule. Government plans, such as LEOFF Plan 1 and LEOFF Plan 2, are not required to follow these merger rules. Treas. Reg. § 1.414(l)-1(a)(1). However, we believe that certain essential elements of these federal laws provide a good road map for a merger of plans and would demonstrate to the IRS the intent of the Legislature to comply with the exclusive benefit rule. We believe it would be difficult for the IRS to make an adverse decision on a merger that satisfied these essential IRS rules.

In this respect, the Code takes a broader position than might be expected. Code § 401(a)(12) provides that, in the case of **a merger, consolidation or a transfer of assets or liabilities, each participant must receive benefits on a termination basis from the plan immediately after the merger or transfer which are equal to or greater than the benefits the participant would receive on a termination basis immediately before the merger, consolidation or transfer**. *See also* Treas. Reg. § 1.414(l)-1(a)(2) (Emphasis added). This treatment is not limited solely to a merger, but also includes consolidation where the assets may be used for the consolidating plans. A "merger" or "consolidation" means the combining of two or more plans into a single plan…. [A] merger or consolidation will not occur if two plans are not combined into a single plan, such as by using one trust which limits the availability of assets of one plan to provide benefits to participants and beneficiaries of only that plan." Treas. Reg. § 1.414(l)-1(b)(2).

A "transfer of assets or liabilities" occurs when there is a diminution of assets or liabilities with respect to one plan and the acquisition of these assets and/or the assumption of

[2] While Private Letter Rulings ("PLRs") are only binding on the taxpayer to whom they are issued, they are instructive on the IRS' views regarding the issues covered in them.

these liabilities by another plan. For example, the shifting of assets or liabilities pursuant to a reciprocity agreement between two plans in which one plan assumes liabilities of another plan is a transfer of assets or liabilities. However, the shifting of assets between several funding vehicles used for the assets of a single plan (such as between trusts, between annuity contracts, or between trusts and annuity contracts) is not a transfer of assets or liabilities. Treas. Reg. § 1.414(1)-1(b)(3).

In accordance with Treas. Reg. § 1.414(l)-1(b)(3), the term "benefits on a termination basis" means the benefits that would be provided exclusively by the plan assets pursuant to ERISA § 4044 and the regulations thereunder if the plan terminated. Treas. Reg. § 1.414(l)-1(b)(5). As noted above, for governmental plans, the pre-ERISA minimum vesting standards require 100% vesting of benefits accrued to: (i) the date of termination upon normal retirement, (ii) the date of plan termination, and (iii) the date or discontinuance of employer contributions to the plan.

Importantly, based upon WAC 415-02-753(3) “[t]he Plan may only be terminated by action of the legislature and employer contributions must be paid in accordance with state law. In the event the legislature took action to terminate a plan, in whole or in part, or discontinue employer contributions to the plan, any applicable state law and constitutional protections would apply to accrued benefits. In such event, pursuant to the state and federal rules, a plan member’s accrued benefit under the plan is nonforfeitable to the extent funded.”

G. Benefit Changes

To the extent that a merger results in benefit changes post-merger, there would have to be a state law analysis with respect to pension protections under state law; this would include an analysis of federal and state constitutional protections. From a federal tax law perspective, the accrued benefit of a plan member (at the time of the merger) under the plan must be protected to the extent funded.

H. Plan Terms

A qualified plan must always follow its written terms and conditions, so long as those terms do not violate relevant federal and state law. Thus, any transaction, such as a merger, must be reflected in each involved plan's terms via an amendment. This must be done before the merger occurs. The terms of the merger could be that one plan merges into the other. Alternatively, the terms could be that a new plan is created and both existing plans would merge into the new plan. Separately, the amendment may state whether one or both of the plans are being terminated. Of course, a final analysis of the potential legal issues will depend on the structure of the merger as determined by the Legislature.

I. Taxation

To confirm that the merger of one plan into another does not have a taxation impact on the members, and considering the possibility that the merger could include one overfunded plan with an underfunded plan, we strongly recommend that a PLR be sought from the IRS. The purpose of the PLR would be to confirm that the merger complies with the exclusive benefit rule and the pre-ERISA vesting requirements, and does not result in any adverse tax consequences to the members.

J. On-going Compliance Post Merger

After the merger, the merged plans must be maintained in compliance with Code § 401(a).

K. Consolidation

In the case of consolidation, the exclusive benefit rule must be applied – in that the plan assets of one plan could only be used for the benefit and expenses attributable to that plan.

In a consolidation, the above described issues of maintenance of qualified status, participant elections, and plan terms would still need to be considered. However, consolidation is not necessarily treated the same as a merger - the treatment depends on whether the plan assets of a consolidating plan are available to fund benefits for any other consolidating plan or not, and, therefore does or does not raise issues with regard to vesting and valuation of benefits on a termination basis. *See* Treas. Reg. § 1.414(l)-1(b)(1)(v).

L. Reversion of Excess Assets

Under ERISA, for an employer to accept a reversion of excess assets, the plan must have always provided for such reversion or have been amended more than five plan years before the termination to permit a reversion. ERISA § 4044(d)(2). As a result, under ERISA, an employer is prohibited from amending a plan in conjunction with a plan termination to give excess assets back to the employer if the plan previously provided for a different allocation of excess assets. Even if an excess asset reversion to the employer is permitted, Code § 4980 imposes a tax of 20% of the amount of any employer reversion from a qualified plan. The 20% excise tax may be increased to 50% of the reversion from a qualified plan if the employer does not establish or maintain a qualified replacement plan or the employer does not provide a pro rata increase in the accrued benefits of all qualified participants. Code § 4980(d). However, the ERISA requirements related to plan amendments and the excise tax on a reversion of qualified plan assets to the employer specifically <u>**do not apply to a governmental plan**</u>. Code § 4980(c)(1)(B). As a matter of interest, the Treasury Regulations specifically recognize that a merger likely would involve a "lower funded plan." Treas. Reg. § 1.414(l)-1(b)(6). These rules are all part of the federal plan insurance provisions of ERISA and the Pension Benefit Guarantee Corporation, and consequently, the parallels and basics are quite different between governmental plans (not covered by the federal plan insurance program) and nonqualified governmental plans. Therefore, we would not anticipate using these provisions in the governmental settings.

Based upon WAC 415-02-753, without further amendment to the Plans by the Legislature, the Legislature could discontinue or modify employer contributions to the remaining/resulting plan as part of the merger. Based upon certain questions raised during the SCPP hearing on November 15, 2016, it is important to note that if a merger involving LEOFF

Plan 1 included a reduction in employer contributions in the merged plan, such a reduction in employer contributions would not constitute a reversion of excess assets for purposes of either ERISA § 4044 or Code § 4980.

V. CONSIDERATION OF SPECIFIC MERGER POSSIBILITIES

Based upon our discussions with you, we understand that the possible merger transaction for purposes of the update to the 2011 LEOFF Merger Study would include one of the following scenarios (we have shown what we assume are the most likely scenarios):

1. Merger of LEOFF Plan 1 and LEOFF Plan 2:

LEOFF 1 → LEOFF 2 (merger of assets and liabilities; no change in benefits)

LEOFF 2 → LEOFF 1 (merger of assets and liabilities; no change in benefits)

LEOFF 1 → LEOFF 2 (new tier with new benefits formula and/or benefit provisions and all assets and liabilities merged)

Under the Pre-ERISA rules, the merger of one plan into another plan would not be considered a termination if a qualified plan is replaced by a comparable plan (a plan of the same type) and so long as the plan assets are not distributed to the members. Therefore, from a termination perspective, it will not matter if LEOFF Plan 1 is merged into LEOFF Plan 2 (or vice versa), because two conditions are met:

1. Both LEOFF Plan 1 and LEOFF Plan 2 are the same type of plan – qualified defined benefit plans under IRC Section 401(a); and

2. No distribution will be made of plan assets to current active members.

Using Code § 414(l) as a guide, and in accordance with WAC 415-02-753, members must be entitled to receive the same benefit after a merger or transfer of assets as they would have received before the merger. The calculation of those benefits is done on a termination basis. This would be true under the 414(*l*) model, where the benefits have to be tested as though there had been a plan termination, even though there is not necessarily a plan termination. This testing of benefits would apply if LEOFF Plan 1 is merged into LEOFF Plan 2 (or vice versa).

If the merger of the two plans results in a lower cost and thus a lower required contribution rate, federal law would not dictate whether the employers' or the employees' (mandatory) contributions were adjusted. That would be a matter of state law and plan design.

2. Merger of LEOFF Plan 1 and LEOFF Plan 2 into a New LEOFF:

LEOFF 1 and LEOFF 2 → New LEOFF (new tier(s) with new benefits formula and/or provisions; assets and liabilities merged)

If the two plans were to merge into a single new LEOFF Plan 3, policy makers could choose that the benefits could stay exactly the same (two tiers incorporating current provisions), or there could be a new structure with new benefits (for example, all LEOFF Plan 3 members have the same retirement eligibility, *etc*.)

We understand the LEOFF Plan 2 separately is considering whether benefits can be changed as part of the merger from a state law perspective, including an analysis of vested rights.

From a federal tax law perspective, a plan member who has reached normal retirement age or reached other vested status under the plan must be vested in his accrued benefit as of that date. It is our understanding that every participant in LEOFF Plan 1 has reached normal retirement age under the terms of the plan and has met all requirements for vesting. If our understanding is correct, then all benefits accrued to date for participants in LEOFF Plan 1 cannot be changed as part of a proposed merger. To the extent that participants in LEOFF Plan 2 have reached normal retirement age and met the requirements for vesting, those benefits accrued to date also cannot be changed. Therefore, any benefit change that is adopted as part of a merger could only affect new members (of which there would be none), non-vested members (of which there are very few) and/or vested members (which constitutes virtually all of the members) prospectively with regard to future accruals.

If this approach is taken, we believe there is a good chance the new plan could secure a determination letter, even under the IRS' new restricted determination letter program.

3. Consolidation:

LEOFF 1 and LEOFF 2 → New LEOFF consolidation of administration of benefit plans; no change in benefits; with on-going segregation of assets and liabilities.

From a federal tax law perspective, there would be fewer issues to address – primarily the exclusive benefit rule.

VI. IRS APPROVAL

Finally, if some type of merged or consolidated plan is passed by the Legislature, then we strongly recommend that the Plans and/or DRS seek a new determination letter on the new structure in order to ensure the qualified status of the new structure under the Code. Of course, this would be dependent on whether a new plan is being created or any plan(s) is/are being terminated as part of the merger. Also, whether a determination letter can be requested will have to be determined in accordance with the IRS' new procedures for determination letters for individually designed plans (*see* Revenue Procedure 2016-37).

If some type of asset transfer is passed by the Legislature, then we also recommend that the Plans and/or DRS seek a PLR to confirm that the transfer does not result in any tax consequences to any affected members. This is not affected by the new determination letter changes, and should be done regardless of whether the determination letter process is available or not.

VII. LEGAL QUESTIONS RAISED BY STAKEHOLDERS OF THE POTENTIAL MERGERS

Considering the background information contained in this Memorandum, we have answered certain questions which were raised and submitted to the SCPP by stakeholders of the Plans being considered for a potential merger (at least LEOFF Plan 1 and TRS Plan 1, if not also stakeholders from LEOFF Plan 2). Those stakeholder questions and answers are being attached to this Memorandum as Appendix A.

VIII. CONSIDERATIONS RELATED TO SB 6668

We certainly understand that SB 6668 proposes a merger between LEOFF Plan 1 and TRS Plan 1. Additionally, we understand that there currently is not a legislative proposal for the merger of LEOFF Plan 1 with LEOFF Plan 2. However, if a proposed merger of LEOFF Plan 1 and LEOFF Plan 2 contains certain features which are included in SB 6668, then we believe the proposed merger would be intended to comply with the Code's requirements for merger. In particular, Section 2 of SB 6668 states that the Legislature intends that the merger of assets, liabilities and membership will be accomplished in a way which does not impact benefits provided to members of either plan. Further, Section 3 states that "each member of each of these plans is entitled to receive benefits immediately after the merger on the effective date of this section that are equal to the benefits the member would have been entitled to receive immediately before the merger in accordance with plan terms." In this regard, we note that the merger proposes to retain the disability board for LEOFF Plan 1, including any official action of those boards. Therefore, to the extent that the LEOFF Plan 1 disability board structure is a vested right in accordance with state law, the vested benefit appears to be preserved as part of the proposed merger. Similarly, we note that SB 6668 does not contemplate a distribution of surplus assets from LEOFF Plan 1 (to the state and/or LEOFF Plan 1 participating employers) as part of the merger. Accordingly, in its current form, SB 6668 does not contain a reversion of excess assets. Finally, we note that under Section 15 of SB 6668, the proposed merger is intended to comply with the Code, including Code § 401(a) (which contains the exclusive benefit rule at Code § 401(a)(2)).

Based upon the analysis of the federal tax considerations related to a merger which we are providing in this Memorandum, if a merger of LEOFF Plan 1 and LEOFF Plan 2 contained the same requirements as contained in SB 6668, then we believe the merger would be intended to comply with the Code requirements for a valid merger, including Code §§ 401(a)(2), 401(a)(12) and 414(l).

IX. CONCLUSION

We hope that this Memorandum provides LEOFF Plan 2 with pertinent information regarding the federal tax considerations for its update of the 2011 LEOFF Merger Study. Of course, if you have any questions or comments regarding our analysis, or if there is any additional information (or proposed legislation) you would like us to consider, please do not hesitate to let us know.

APPENDIX A

A. Goals

Question No. 1: What is the purpose of a merger?

Answer No. 1: As discussed in Section IV (especially Section IV.F.), under the Code, the purpose of a merger generally is to merge the assets and liabilities of two or more plans into a single plan. As a result, the assets and liabilities become useable across the spectrum of the merged plan.

Question No. 2: Why merge two different entities?

Answer No. 2: The question is somewhat confusing to us because of the use of the word "entities." Assuming that "entities" means plans, we believe the reason a Legislature could be considering a merger would be to consolidate the assets and liabilities of the Plans. Presumably, the fact that LEOFF Plan 1 is a better-funded plan (based on the most recent actuarial analysis) is a factor in the Legislature's consideration.

Question No. 3: Why not merge other plans instead? For example:

(a) All state plans into one with the same benefits?

(b) Legislator's pension plan with the Teachers' Retirement System 1 (TRS 1)?

(c) Public Employees' Retirement System (PERS 1), TRS 1, and the Law Enforcement Officers' and Fire Fighters' Plan 1 (LEOFF 1) into one big plan?

(d) Washington State Patrol Retirement System with TRS 1?

(e) Public Safety Employees' Retirement System with LEOFF 2?

(f) LEOFF 2 with TRS 1?

(g) TRS 1 with TRS 2?

Answer No. 3: These questions are better directed to the Legislature as they involve policy decisions.

Question No. 4: How would a merger benefit:

(a) LEOFF 1 members?

(b) Employers?

Answer No. 4: As discussed in Section IV.F. and G., the merger does not automatically result in enhanced benefits for LEOFF Plan 1 members. Whether enhanced benefits will be provided is a determination for the Legislature. As it relates to participating employers, depending on the actuarial analysis of the merger, the merger could result in a long-term cost savings for the employers.

Question No. 5: Why not wait until all benefits are paid out?

(a) What would happen to the surplus after all remaining members have died?

Answer No. 5: Why not wait until all benefits are paid out raises a policy decision for the Legislature. However, if the Legislature waited until all remaining members of LEOFF Plan 1 have passed away and all liabilities under the Plan have been satisfied, in accordance with Code § 401(a)(2) and Treas. Reg. § 1.401-2(a), and WAC 415-02-753 and 756, the remaining assets would be returned to the employers involved in LEOFF Plan 1.

Question No. 6: Will the merger be temporary?

(a) *i.e.*, once TRS 1 is fully funded, will they be unmerged?

(b) Would it be like a loan of funds, with interest?

Answer No. 6: As discussed in Section IV.F., a merger is not temporary nor is it like a loan of funds (with or without interest). Instead, the merger results in combining two (or more) Plans into a single Plan. Whether there would be any future separation of the merged plans would be a future decision for the Legislature.

Question No. 7: Benefit improvements.

(a) Can LEOFF 1 and LEOFF 2 be merged to allow enhanced LEOFF 2 benefits like medical benefits, a higher multiplier, or earlier retirement?

(b) Can any excess funding in LEOFF 1 be used to increase benefits for LEOFF 1 members instead?

Answer No. 7: As discussed in Section IV.G., a merger does not automatically result in enhanced benefits for the members of either plan (the plans) being merged. Whether enhanced benefits will be provided is a determination for the Legislature. As discussed in Section IV.F., as a matter of federal tax law, members in a merged plan must be vested and entitled to benefits calculated on a termination basis from the Plan immediately after the merger which are equal to or greater than the benefits the members would have been entitled to on a termination basis immediately before the merger, consolidation or transfer. *See also* Treas. Reg. § 1.414(l)-1(a)(2).

For purposes of federal tax law, assuming compliance with the exclusive benefit rule, members must be vested in their benefits, (not in an allocated account balance based on an actuarial equivalent of their benefits). Finally, as discussed in Section IV.H., the Legislature would have to pass specific amendments to modify the Plans being merged.

B. Legal

Question No. 8: Is a merger legal?

(a) What legal entities control (*e.g.*, Internal Revenue Service (IRS), State Supreme Court)?

(i) What are their respective roles and jurisdictions?

(b) What case law is relevant, and what does it tell us?

(i) Does it prevent/prohibit a merger?

(ii) Will the *Bakenhus* case apply to the new plan?

(c) What are the terms of the contract that exists between LEOFF 1 members and the state?

(i) *i.e.*, what do members have a right to?

(ii) Benefits?

(iii) Funding plan?

(iv) Cash in the trust fund?

(1) Are LEOFF 1 members vested in the money itself?

(2) *i.e.*, is the money being "stolen" from the trust fund?

(d) What laws need to be changed to complete a merger?

(e) What protections exist for vested rights and financial interests of plan participants?

Answer No. 8: Federal law controls the continuation of the qualified status of the plans involved in a merger. The federal law on mergers focuses on the protection of each member's/survivor's benefit payable from the separate plans and from the merged plan. As a matter of federal tax law, and as discussed in Section IV.F., a merger is a combination of the assets and liabilities of two or more qualified defined benefit plans. Accordingly, based upon the IRS' rules, a merger is legal provided that there is compliance with the exclusive benefit rule and, in accordance with Code § 414(l), the members of the merged plans receive the same benefits after a merger or transfer of assets as they would have received before the merger. This rule must be met in order to retain the qualified status of the funds involved. Consequently, federal law covers the vested rights of the members' and individuals' benefits pre and post-merger.

Whether members have a vested right to certain features or assets (the "contract" between LEOFF/members and the state) under each of the Plans, (as opposed to their individual benefits) would require an analysis of Washington State law which is not being provided as part of this Memorandum. As to the questions about case law, based upon our review of the prior legal opinions from other attorneys which we listed in Section II, we anticipate that the State law analysis would include an analysis of the case *Bakenhus v. City of Seattle*, 48 Wn.2d, 695, 296 P.2d 536 (1956) and its progeny.

Question No. 9: Who are the fiduciaries for each plan?

(a) Is the Legislature a fiduciary to both the plan and the general state?

Answer No. 9: Determining who are the fiduciaries of a qualified plan generally is based upon an analysis of common law trust principles and state law requirements. This primarily is because in accordance with Treas. Reg. § 1.401-1(a)(3)(i), one of the requirements for a qualified plan is that the plan assets must be held in trust. We note that RCW 43.33A.030 vests trusteeship of the Plans' assets in the voting members of the State Investment Board. Also, under RCW 41.50.060 the Director of DRS is responsible for the Plans and, under RCW 41.50.077, the State Treasurer is the custodian of funds of the Plans. ERISA § 3(21) defines a "fiduciary" with respect to a plan as a person to the extent (i) the person exercises any discretionary authority or discretionary control respecting management or dispositions of its assets, (ii) the person renders investment advice for a fee or other compensation or has authority of responsibility to do so, or (iii) the person has any discretionary authority or discretionary responsibility in the administration of the plan. Code § 4975(e)(3) defines "fiduciary" (for purposes of prohibited transactions) in essentially the same manner:

> (3) Fiduciary.
>
> For purposes of this section, the term "fiduciary" means any person who –
>
> (A) exercises any discretionary authority or discretionary control

respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,

(B) lends investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan, or has any authority or responsibility to do so, or

(C) has any discretionary authority or discretionary responsibility in the administration of such plan.

Based upon these federal definitions, we believe that the IRS would consider DRS, the Washington State Investment Board ("WSIB"), the individual WSIB Board members, the LEOFF 2 Retirement Board, and the individual LEOFF 2 Board members, as fiduciaries. In addition, there would be a number of financial and investment related fiduciaries (*e.g.*, registered investment advisors to DRS and WSIB), custodial bank(s), *etc.*) likely are considered fiduciaries of the Plans for purposes of state law.

Question No. 10: Who owns the surplus?

(a) Does case law from Alaska on excess funding show that any surplus belongs to the members?

Answer No. 10: As a matter of federal tax law, unless the plan terms specify otherwise, the employer (or employers) sponsoring the plan generally owns any surplus but only once there has been a complete satisfaction of all liabilities with respect to employees and their beneficiaries under the trust. *See* Treas. Reg. § 1.401-2(b). Plan terms can establish a different structure.

We defer to the Washington state law analysis on whether the Alaska case law would be persuasive to Washington.

Question No. 11: Will there be any direct tax impact on the members?

(a) *e.g.*, will a medically disabled member lose their individual tax exempt status?

Answer No. 11: A merger would not change the tax treatment of any benefits to members of LEOFF Plan 1 (or to the members of another plan with which LEOFF Plan 1 might be merged). So, a LEOFF Plan 1 member who is receiving a service-connected disability benefit which is exempt from federal taxation (whether in whole or in part) would continue to receive the same tax treatment of his/her disability benefit after a merger.

Question No. 12: Are there any other IRS issues?

(a) What would be the impact of an unfavorable opinion by the IRS?

(i) What are the range of outcomes?

(ii) Would the plan members be made whole/held harmless under those scenarios?

(1) If so, how?

(iii) Would the merger be undone?

(1) If so, how?

(b) Does each plan's funded status impact the ability to merge?

Answer No. 12: If the IRS did not approve the merger, the results could range from i) the IRS requiring the Legislature to cease the merger, ii) the IRS requiring the Legislature to make necessary amendments to the merger to address the concern(s) raised by the IRS, to iii) the ultimate penalty by the IRS is disqualification of the underlying plans and/or the merged plan. Disqualification of the underlying plans would be an extreme result, which typically would only be considered if the merger disregarded the exclusive benefit rule or did not provide benefits to participants in the merged plans which were at least equal to or greater than the benefits the members would have received on a termination basis immediately before the merger.

To the extent that any of the involved plans were disqualified by the IRS that would raise an individual taxation issue for the involved members. Whether the affected plan, DRS or the state would reimburse the members or hold them harmless from the potential taxes would depend on legislative action.

Finally, as discussed in Section IV.L., each plan's funded status does not affect the ability to merge. *See also* Treas. Reg. § 1.414(l)-1(b)(6).

Question No. 13: How will the state pay if it needs to defend a merger in court?

Answer No. 13: Whether or not legal expenses incurred to defend a merger in court are appropriate plan expenses or whether they are settlor expenses which should be paid by the State are questions of both federal law and state law. From the federal law perspective, protection of a plan's qualified status could be argued to be a reasonable and necessary expenditure of the affected plan.

We leave the state law analysis to others. We note that RCW 41.50.255 authorizes the director of DRS to pay from the interest earnings of the trust funds of the Plans lawful obligations of the appropriate [retirement] system for legal expenses which are incurred for the purpose of protecting the appropriate trust fund or are incurred in compliance with statutes governing such funds.

Question No. 14: Can you charge separate rates for the different tiers of benefits within a merged plan?

Answer No. 14: Governmental plans, whether or not merged, are able to have different employee and/or employer contribution rates between tiers in the plan.

Question No. 15: Is a plan trust more like an escrow account to pay benefits or a savings/investment account to accumulate funds?

Answer No. 15: A plan trust is neither an escrow account nor a savings/investment account. Rather, it is a trust under Washington State law, governed in part by federal law, in which employee and employer contributions are held and co-invested for the payment of benefits under the terms of the plan.

Question No. 16: Is there a process for appealing or opposing a merger?

Answer No. 16: This is a question of state law.

Question No. 17: Would employers receive refunds for contributions used for members of another system?

Answer No. 17: As discussed in Section IV.L., the Legislature can decide how to handle any excess assets. *See also* Answer Nos. 10 and 34.

Question No. 18: Are plan members trustees or fiduciaries of their plans?

Answer No. 18: In general, no. However, a plan member may be a trustee or a fiduciary in his/her individual capacity. *See* Answer No. 9.

C. Fiscal/Actuarial

Question No. 19: Historical.

(a) How did gainsharing impact TRS 1?

(i) Is that partly why LEOFF 1 is in such good shape and TRS 1 is not?

(b) What is the funding history for each plan?

(i) Who paid what?

(c) Is LEOFF 1 cost sharing the same as other plans?

(i) *i.e.*, did the state only put in 20 percent of contributions?

(d) What would have happened if there had been no general fund contributions to LEOFF 1?

(i) Or the Prior Act systems (*e.g.*, City of Seattle)?

Answer No. 19: These are historical and actuarial questions which are not being addressed by this Memorandum.

Question No. 20(a): Related to a merger.

(a) What is the financial situation before and after?

(i) What does the "surplus" represent?

(1) Is it the excess of funds needed to pay benefits this month? This year?

(ii) Is the surplus "real" or just projected?

(1) How reasonable is the investment return assumption?

(2) What would it look like under alternate scenarios (*e.g.*, 7 percent or 6 percent)?

(iii) If the surplus disappears, would it be too late to insure the LEOFF 1 benefits?

(1) *e.g.*, ensuring payment under a pay-go scenario versus insuring through plan immunization.

(iv) Would a merger be revenue neutral?

Answer No. 20(a): *See* Answer No. 10. Also, the current funding level of each Plan, and whether each Plan has a funding surplus or funding deficit of plan assets necessary to satisfy the benefits obligations under each Plan, is a matter of actuarial analysis. The actuarial analysis will state the assumptions used as part of the analysis. To the extent that a merged plan would have a deficit of total plan assets, *see* Answer No. 20.c. Finally, we do not understand the question as to whether a merger would be revenue neutral. Rather, whether something is "revenue neutral" to a plan typically means that an increased benefit is offset by an increase in contributions (whether employer or employee). In other words, the increased benefit is considered to be revenue neutral because the plan's net revenues remain unchanged (*i.e.* the cost is offset by the increased contributions).

Question No. 20(b):

(b) How might the funds be used?

(i) Clarify: Usable across the merged plan vs. usable outside either of the retirement plans (other obligations).

(ii) Should it be treated like a reserve for LEOFF 1 only?

(iii) Can money be "skimmed out" of the fund during transfer from LEOFF 1 to TRS 1?

Answer No. 20(b): As discussed in Section IV.F., under a merger, a transfer of assets and liabilities occurs when there is a diminution of assets or liabilities with respect to one plan and the acquisition of these assets or the assumptions of these liabilities by another plan. *See* Treas. Reg. § 1.414(l)-1(b)(3). Further, based upon the pre-ERISA minimum vesting standards, if qualified governmental defined benefit plans are merged, they are required, to the extent funded, to have 100% vesting of benefits accrued to the date of merger. Accordingly, if a merger combined LEOFF Plan 1 and another Plan, but the Plan assets of LEOFF Plan 1 were not available to pay for benefits other than for the original members (and beneficiaries) of LEOFF Plan 1, then a merger will not have occurred, and assets of one plan could not be used for payments to members of another plan. *See* Treas. Reg. §§ 1.414(l)-1(b)(1)(v) and 1.414(l)-1(b)(2). If the assets were combined to pay benefits for both plans, there would be a merger, and the federal laws explained above would apply.

In this regard, the assets of LEOFF Plan 1 are not considered "skimmed out" of the LEOFF Plan 1 trust fund. Rather, the assets of LEOFF Plan 1, TRS Plan 1 and/or LEOFF Plan 2 remain in the merged plan and are combined into a single trust to pay benefits to all members and beneficiaries of both plans. Treas. Reg. §1.414(l)-1(b)(2).

Question No. 20(c):

(c) What happens in the event of a deficit?

(i) If the funded status were 87 percent, would that mean I only get 87 percent of my current check amount?

(ii) Before merger?

(iii) After?

(iv) Who pays what?

(v) Who will be paid first? (Overlap with legal/admin analysis)

(vi) Could the state default on the pensions?

Answer No. 20(c): As discussed in Section IV.F., as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. It is important to note that we are not aware that the merger concept to be used would provide an immediate liquidation of the trusts, which would raise, at least in part, the concept of a reduced benefit. Instead, we anticipate that the members in pay status would continue to receive their full monthly benefits, unless otherwise legally altered by the legislature. These benefits would be paid by the merged plan. Of course, the ultimate funding level of the merged plan and cost of benefits from the merged plan depends on plan earnings, market value of investments and the actuarial experience of the merged plan, including mortality experience. Finally, this answer is ultimately dependent on the analysis of state law issues regarding vested rights.

Question No. 20(d):

(d) Would there be other costs (*e.g.,* admin)?

Answer No. 20(d): Certainly, it should be anticipated that a merger would have an increase in administrative costs in the short term. However, it also should be anticipated that there may be savings in administrative costs over a longer term because there could be some cost savings in only administering one plan as opposed to administering two separate plans.

Question No. 20(e):

(e) How would a merger impact financial reporting (GASB) for state and local governments?

Answer No. 20(e): Based on the actuarial analysis of the merged plan, we would expect that the required financial reporting under GASB 67 (for the merged plan) and the required financial reporting under GASB 68 (for the participating employers in the merged plan) would be different than the financial reporting would have been if the merger did not occur.

Question No. 20(f):

(f) Who is constitutionally liable for future benefit payments?

Answer No. 20(f): The constitutional obligation for future benefit payments under the merged plan is not a matter of federal tax law. Notwithstanding, *see* Answer No. 20.c.

Question No. 20(g):

(g) Are there other options to address TRS 1 underfunding?

Answer No. 20(g): Whether there are other options to address underfunding in TRS Plan 1 is not a matter of federal tax law. Rather, it is a policy determination to be made by the Legislature.

D. Benefits

Question No. 21: Will benefits be impacted?

(a) *i.e.*, can they be reduced?

(b) Will benefits be increased in exchange for the merger?

(i) Would LEOFF 1 benefits be given to teachers?

(1) *e.g.*, will TRS 1 members receive health benefits similar to LEOFF 1?

(c) Would LEOFF 1 be paying for TRS 1 benefits?

(d) Will it impact rights for Prior Act City of Seattle or Seattle Police Pension Board (which "interprets the rights" for members)?

(e) Will this include survivor benefits?

(f) Will benefits be interrupted (*e.g.*, are there any administrative issues that might delay issuing checks)?

Answer No. 21: *See* Answer Nos. 20.b. and 20.c.

Question No. 22: Will COLAs be impacted?

(a) Can TRS 1 COLA be reinstated without negative impact to LEOFF 1?

(b) Can LEOFF 1 COLAs be modified so as to not be dependent on date of retirement?

Answer No. 22: As discussed in Answer Nos. 8 and 20.c, as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. Whether COLAs under LEOFF Plan 1 and LEOFF Plan 2 (or TRS Plan 1) are vested rights requires an analysis under Washington State law which is not being provided as part of this Memorandum.

Question No. 23: Will medical coverage be impacted?

(a) LEOFF 1

(i) Source of medical benefit payments?

(ii) Disability boards.

(iii) Can it be provided to spouses?

(b) TRS 1 PEBB subsidy?

Answer No. 23: As discussed in Answer Nos. 8 and 20.c., as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. Whether medical benefits under LEOFF Plan 1 and LEOFF Plan 2 (or TRS Plan 1) are vested rights requires an analysis under Washington State law which is not being provided as part of this Memorandum.

Question No. 24: Will survivor benefits be impacted?

(a) Are reductions for survivor benefits considered contributions to the plan?

Answer No. 24: *See* Answer Nos. 22 and 23.

Question No. 25: Will LEOFF 1 have priority in benefit payments over TRS 1?

Answer No. 25: As discussed in Section IV.F. and Answer No. 8, based upon the IRS' rules, the members of a merged plan receive the same benefits after a merger or transfer of assets as they would have received before the merger. Each member's/survivor's benefits payable from the separate plans are protected and become payable by the merged plan. Therefore, it would not be appropriate for one of the merged Plan's members to have priority in the payment of benefits after a merger.

Question No. 26: Will I still be considered a "retired police officer" as opposed to a general state retiree?

(a) Does this definition have legal implications (*e.g.*, qualifying for certain benefits) or just personal ones?

Answer No. 26: For the reasons discussed in Answer No. 11, and for purposes of federal tax law, whether a member qualifies as a "qualified public safety employee" under the Code will not be affected by a merger.

Question No. 27: Under SB 6668, could members individually refuse the $5,000 lump sum?

Answer No. 27: Based upon our understanding of SB 6668, there is not a provision to specifically allow LEOFF Plan 1 members to individually refuse the lump sum defined benefit which was contemplated under Section 6. If they have an unrestricted right to the benefit, it does present a question of whether federal constructive receipt concepts would apply. We think the better answer would be that the federal constructive receipt concept would not apply and, instead, benefits would only be taxed when received under Code Section 402. Whether LEOFF Plan 1 members would be eligible to disclaim the lump sum defined benefit would be a State law consideration.

E. Governance

Question No. 28: Will governance be impacted?

(a) Will there be equal representation on the LEOFF 2 Board?

(b) Will LEOFF 1 oversee TRS 1 benefits?

(c) Will LEOFF 2 Board control LEOFF 1 benefits?

Answer No. 28: Certainly, governance of the merged plan is something which should be addressed by the Legislature. Notwithstanding, to the extent that either LEOFF Plan 2 or TRS Plan 1 is not part of the merger, then, presumably, there would not be any change to the governance and/or administration of LEOFF Plan 2 or TRS Plan 1.

F. Other General Questions

Question No. 29: Is this a redistribution of the member's income?

Answer No. 29: For the reasons discussed in Answer No. 20.b., no.

Question No. 30: Would a LEOFF1/TRS 1 merger impact LEOFF 2?

Answer No. 30: For the reasons discussed in Answer No. 28, no.

Question No. 31: Would a LEOFF 3 be created for new hires?

Answer No. 31: This question is better directed to the Legislature as it involves a policy issue.

Question No. 32: Can LEOFF 1 members opt out and "take their money out" entirely?

Answer No. 32: Unless the Legislature decided to change the distribution rights of LEOFF Plan 1 members as part of the merger, the members of LEOFF Plan 1 would be limited to the Plan's current provisions related to the distribution of benefits.

Question No. 33: Is lump sum still on the table? If so:

(a) Some feel it should be higher than $5,000.

(b) Why not pay it now, regardless of a merger?

(c) Employers would like a share.

Answer No. 33: These questions are better directed to the Legislature as they involve policy decisions.

Question No. 34: Can any excess be distributed every few years: one-third state, one-third employer, one-third member?

Answer No. 34: As discussed in Section IV.L., generally the Legislature can decide how to handle any excess assets. However, the IRS likely would not approve a reversion of plan assets before all obligations were liquidated. For example, if commercial annuities were purchased for all members/survivors pursuant to the respective plan terms, the IRS likely would determine that after the annuities were purchased, then (and only then) could the Legislature provide for a distribution of excess assets. We do note that SB 6668 does not currently contemplate a distribution of excess assets.

Question No. 35: Even if the overall idea is sound, could a mistake in administration jeopardize benefits?

Answer No. 35: As a matter of federal tax law, mistakes in administration are considered operational failures which can be corrected in accordance with Revenue Procedure 2013-12 (which recently was amended by Revenue Procedure 2016-51 effective January 1, 2017). The IRS' correction procedures are intended to help qualified plans correct their failures and preserve their qualified status.

Question No. 36: Why not just increase the contribution rates for new members of these plans?

Answer No. 36: This question is better directed to the Legislature as it involves a policy issue.

Question No. 37: Will the state be able to make further changes after a merger (*i.e.* slippery slope)?

Answer No. 37: This question is better directed to the Legislature as it involves a policy issue. Notwithstanding, it should be noted that a merger of the Plans does not necessarily preclude the Legislature from making other plan changes. However, all the federal restrictions would still apply. In other words, the exclusive benefit rule must be followed and the members of the merged plans must receive the same benefits after a merger or transfer of assets as they would have received before the merger. *See* Answer No. 8.

Question No. 38: Could recruitment be impacted by a merger?

Answer No. 38: This is not a question of federal tax law.

Question No. 39: How does a merger benefit taxpayers?

Answer No. 39: This question is better directed to the Legislature as it involves a policy issue.

Question No. 40: Will plan members retain their voting rights in plan governance?

Answer No. 40: *See* Answer Nos. 28 and 57.

Question No. 41: Are pension plans governed by local oversight boards, and will those boards be allowed to vote on a proposal?

Answer No. 41: *See* Answer Nos. 28 and 57.

Question No. 42: Can LEOFF 1 members cash out of the retirement system entirely?

Answer No. 42: *See* Answer No. 32.

G. Concerns

Question No. 43: Benefits should be fully funded.

Question No. 44: Funds should be kept separate – TRS with TRS, *etc.* – and never go back to the general fund.

Question No. 45: A plan should not be merged with a "lesser" plan.

__Question No. 46:__ LEOFF 1 should be administered locally, and not be "some unknown voice in Olympia."

__Question No. 47:__ LEOFF 1 funding was frozen in 2000 without consent of members.

(a) Some members feel employer contributions should have continued up until now.

(b) Some members feel the remaining active members should have been paying over the last 16 years.

__Question No. 48:__ LEOFF 1 system was forced on city and county plan members.

__Question No. 49:__ LEOFF 2 benefits are already substantially higher than LEOFF 1.

__Question No. 50:__ The LEOFF 1 funded status should never drop below 125 percent.

__Question No. 51:__ Transparency in process.

(a) All stakeholders need sufficient notification of any potential changes or discussions.

(b) Members of the plan should be able to vote since it is their plan and not the Legislature's.

__Question No. 52:__ Dual member provisions for members who leave LEOFF 2 should be reviewed.

__Question No. 53:__ There is no guarantee the state will make required contributions.

__Question No. 54:__ Employers have expressed concerns about medical benefits being expanded.

__Question No. 55:__ Local governments are facing high costs for LEOFF 1 medical.

__Answer Nos. 43-55__: To the extent that Question Nos. 43-55 are questions, they should be directed to the Legislature as they involve individual policy issues/considerations.

__Question No. 56:__ Any payout must be conditional on IRS approval.

__Answer No. 56:__ For the reasons discussed in Section VI, we agree that approval of a merger should be obtained from the IRS before a merger is finalized.

H. Additional Questions

__Question No. 57:__ Will it require a vote of all members and beneficiaries to agree to the merger before a merger can occur.

<u>Answer No. 57:</u> As a matter of federal tax law, unless the respective Plans' terms specifically require it (which we do not see that they do), a vote of all members and beneficiaries is not necessary to agree to a merger before it may occur.

<u>Question No. 58:</u> Has the Legislature reserved its right to change the pension system?

<u>Answer No. 58:</u> Ultimately, this is a question of state law, and, therefore, is not being addressed by this Memorandum.

<u>Question No. 59:</u> Is the LEOFF 2 Board a vested right to which members are constitutionally entitled?

<u>Answer No. 59:</u> Whether or not the establishment of the LEOFF Plan 2 Board is a vested right is not a matter of federal tax law. Rather, it is a matter of state law.

<u>Question No. 60:</u> Is a merger of the two plans, where the merger reduces assets, a violation of members' and retirees' constitutional rights?

<u>Answer No. 60:</u> This is a question which is being analyzed separately by the AG's Office. However, it should be noted that a merger itself cannot inherently reduce plan assets.

<u>Question No. 61:</u> Is there a history of mergers in Washington and have there been any legal challenges to mergers in LEOFF 1? How about in 1970 when LEOFF 1 began?

<u>Answer No. 61:</u> This is not a question which is being addressed by this Memorandum.

<u>Question No. 62:</u> Are one or the other of the plans terminated?

<u>Answer No. 62:</u> Whether one of the Plans is being terminated as part of a merger is a determination to be made by the Legislature as a part of the design of the merger. For purposes of federal tax law, and as discussed in Section IV.D., a merger does not require the termination of one of the Plans being consolidated.

<u>Question No. 63:</u> Do the plan terms prevent a merger?

<u>Answer No. 63:</u> As a matter of federal tax law, we do not believe that the Plans' terms prevent a merger.

<u>Question No. 64:</u> If merger is found to be illegal, how do we un-merge? How do you separate the funds? What will happen to the $xxxx that is given to each LEOFF 1 member/retiree/beneficiary – how are you going to get that back?

Answer No. 64: Because we strongly recommend that both a PLR and an updated determination letter (if a new plan is being created or if one or both of the merged plans are being terminated) be obtained from the IRS as part of the merger, the merger would be contingent on receiving these favorable rulings from the IRS. If this is done, there would not be any concern about having to "unwind" a merger based upon an unfavorable ruling by the IRS.

Question No. 65: Can we get the process underway for IRS review of the merger?

Answer No. 65: It is important to note that the IRS will not issue a PLR on a "hypothetical" situation. Accordingly, a piece of "draft" legislation likely would not be considered by the IRS for purposes of a PLR. Similarly, the IRS will not issue a determination letter on a "hypothetical" basis. Rather, the IRS will only consider a determination letter request based upon an action which has been authorized and/or is in process.

K&L GATES

Appendix B

December 5, 2016

Peter Mixon
peter.mixon@klgates.com

T +206 370 7802

Steve Nelson
Executive Director
Law Enforcement Officer and Firefighters Plan
2100 Evergreen Park Dr. SW
Suite 180
Olympia, WA 98502

Tor Jernudd
Assistant Attorney General
Washington State Attorney General's Office
7141 Cleanwater Dr. SW
Olympia, WA 98501-6503

Re: Proposed Merger

Dear Mr. Nelson and Mr. Jernudd:

The Law Enforcement Officers and Firefighters Retirement System Plan 1 ("LEOFF 1") and the Law Enforcement Officers and Firefighters Retirement System Plan 2 ("LEOFF 2") are defined benefit pension plans. LEOFF 2 is governed by a Board of Trustees ("LEOFF 2 Board"). It is our understanding that the LEOFF 2 Board has been asked to review the legal issues raised by a merger of LEOFF 1 and LEOFF 2. Our firm has been asked to provide analysis and advice on a proposed merger of LEOFF 1 and 2.

This memorandum will address whether the Contracts Clause of the Washington Constitution would limit, preclude or affect the merger of these two public pension plans in Washington. As part of this analysis, we will address the following:

- Whether the funded status of the plans, both before and after merger, would impact these issues;
- Whether the open or closed status of the plans, both before and after merger, would impact these issues;
- Whether a reduction in the aggregate amount of State contributions after merger would impact these issues;

- Whether a change in the character of employer sponsors for the merged plan would impact these issues;
- Whether a change in plan governance for the merging plans would impact these issues;
- Whether the legislature may repeal or reduce the current LEOFF 1 Cost Of Living Adjustment;
- Whether the legislature may impose employee contributions on active LEOFF 1 members; and
- Whether there are Washington state law fiduciary issues when the legislature approves the merger of two public pension plans

We understand that there is no bill language covering or describing the proposal. For purposes of our analysis, therefore, we make several assumptions. First, we assume that the proposed merger will combine the assets and liabilities of LEOFF 1 and LEOFF 2 into a single pension plan. Thus, all assets of the new plan will be available to pay all liabilities of the same plan. Second, we assume that the combined assets of the new plan will continue to be invested by the Washington State Investment Board on a commingled basis consistent with current law. Third, we assume that the existing benefit levels and formulas for all LEOFF 1 and LEOFF 2 members will remain the same after the merger. Fourth, we assume that merger legislation will authorize the State of Washington to make a reduced contribution to LEOFF 2 for two years after the merger. Fifth, we assume that the new plan will satisfy the requirements of the Internal Revenue Code for tax-qualified employee benefit plans. Finally, we assume that there are no collective bargaining agreements or memoranda of understanding that bear on the issues analyzed here.

I. Background

In 1969, the Washington Legislature enacted a comprehensive benefits plan for police officers and firefighters in the state. Laws of 1969, 1st Ex. Sess., ch. 209. The "Washington Law Enforcement Officers' and Fire Fighters' Retirement System Act" created this new plan, known as LEOFF, which was administered by the state Department of Retirement Systems. *McAllister* v. *City of Bellevue Firemen's Pension Bd.*, 166 Wn.2d 623, 627 (2009). In 1977, the Legislature amended LEOFF to create two classes of members. Laws of 1977, 1st Ex. Sess., ch. 294, §§ 1-2. Police officers and fire fighters employed on or before September 30, 1977 constituted one class and those employed after that date constituted another. In a subsequent amendment, the Legislature designated the former class as LEOFF 1 and the latter class as LEOFF 2. RCW 41.26.030(21), (22); see *Adams* v. *City of Seattle*, 173 Wn. App. 398, 400 fn. 4. LEOFF 2 is a "less generous retirement system" than LEOFF 1. *City of Pasco* v. *Dep't of Ret. Systems*, 110 Wn. App. 582, 587 fn. 6.

In 2002, the citizens of Washington passed Initiative Measure 790, making substantial changes in the governance of LEOFF 2. The express intent of the measure was to establish a board of trustees endowed with fiduciary duties and responsible for administration of specified pension management functions. Laws of 2003, ch. 2, § 2, codified at RCW 41.26.705. Among other duties, the LEOFF 2 Board is responsible for the actuarial functions of the plan and establishes employee, employer and State of Washington contributions to the plan consistent with the statutory ratio. RCW 41.26.725(1) ("The board of trustees shall establish contributions as set forth in this section.") and RCW 41.26.720 (board shall "adopt actuarial tables, assumptions, and cost methodologies"; provide for design and implementation of increased benefits; recommend changes in benefits to legislature; and retain professional advisors).

The Washington Legislature enacted a statute that suspends employer and employee contributions to LEOFF 1 unless "the most recent valuation study for [LEOFF 1] indicates the plan has unfunded liabilities." RCW 41.26.080(2). We understand that LEOFF 1 has not received any employer or employee contributions since 2000. See Comprehensive Annual Financial Report, Funds for the State of Washington for Year Ended June 30, 2016 ("CAFR") at 77. As of June 30, 2016, the actuarial value of assets in LEOFF 1 exceeded estimated pension liabilities by approximately $1 billion and the plan is approximately 123.7% funded on an actuarial basis. Id. at p. 64. As of the same date, LEOFF 2 is approximately 106% funded on an actuarial basis. Id. at p. 67.

Washington courts will generally defer to the legislative branch on plan design issues: "[w]e will not substitute our judgment for the Legislature's with respect to the structure of public retirement plans." *Washington Federation of State Emps.* v. *State*, 107 Wn.App. 241, 246 (2001). Nevertheless, the Contracts Clause of the Washington State Constitution restricts the power of the legislature to make changes in pension funding and benefits.

II. Overview of the Contracts Clause

Article I, section 23 of the Washington Constitution provides that "no … law impairing the obligations of contracts shall ever be passed." The Washington Supreme Court has repeatedly held that this protection "echoes" the parallel federal Contracts Clause of the United States Constitution. *Washington Educ. Ass'n* v. *Dep't. of Retirement Systems*, 181 Wn.2d 233, 242 (2014). Thus, the state and federal Contracts Clauses are given the same effect. *Ibid.* Under these provisions, the State's attempts to impair its own contracts are given a more "stringent" review by the courts in Washington. *Ibid.*

The Washington Supreme Court has long recognized that state pension statutes can create enforceable contract rights. *Washington Educ. Ass'n*, 181 Wn.2d at 242. In *Bakenhus* v. *City of Seattle*, 48 Wn.2d 695 (1956), the Court reviewed the contract rights of a police officer whose monthly pension benefit was reduced by a city ordinance enacted after he first became employed and prior to his retirement. The court ruled that the ordinance violated the officer's contract rights to a higher pension, reasoning that "pensions are 'deferred compensation for services rendered' and therefore create a contract that can be modified only to ensure the continued flexibility and integrity of the system." *Washington Educ. Ass'n.*, 181 Wn.2d at 243, quoting *Bakenhus*, 48 Wn.2d at 698. Changes in the pension plan must be for the purpose of ensuring "continued flexibility and integrity" of the plan. *Lenander* v. *Dep't of Ret. Systems*, -- Wn.2d -- [2016 Wash. LEXIS 903, *1, *26] (2016) And "[m]odifications that have an adverse effect on employees must be accompanied by 'comparable new advantages.'" *Washington Educ. Ass'n.*, 181 Wn.2d at 243, quoting *Bakenhus*, 48 Wn.2d at 702. These principles have historically formed the Contracts Clause analysis for public pension rights in Washington.

In 2014, the Washington Supreme Court reviewed these principles in *Washington Education Association* v. *Washington Department of Retirement Systems.* Noting that the *Bakenhus* test is a part of an "overarching" framework applied to all public contracts, the Court held that these contracts are analyzed using a three-part test: "(1) whether a contractual relationship exists, (2) whether the legislation substantially impairs the contractual relationship, and (3) if there is substantial impairment, whether the impairment is reasonable and necessary to serve a legitimate public purpose." *Washington Educ. Ass'n.*, 181 Wn.2d at 243-244; accord, *Lenander,* 2016 Wash. LEXIS at *25-26; see also *Retired Pub. Emps. Council of Wash.* v. *Charles*, 148 Wn.2d 602, 624 (2003). The *Bakenhus* requirements of "flexibility, integrity, and comparable new advantages" remain important, "focus[ing]" the analysis in the specific context of pension contract rights. *Washington Educ. Ass'n.*, 181 Wn.2d at p. 244; see also, *Lenander*, 2016 Wash. LEXIS at *26-27 ("While the three-prong contract impairment test forms the backbone of the analysis in pension cases, the analysis of substantial impairment is guided by the principles set forth in *Bakenhus* and its progeny.") (internal quotations omitted).

III. Contracts Clause Issues When Two Plans Merge

The "merger" of two public pension plans raises substantial Contracts Clause issues. Combining assets and liabilities of two separate plans will change the funded status of the plans unless the two plans have exactly the same funded status and the same benefit/ liability structures and durations prior to the merger. This change could also affect the method and security of funding for future benefits, the level of employee contributions, and the governance of the plans.

A. Funding Rights

Under Washington law, the terms and limitations of pension contract rights "are defined by the language of the statutes creating those rights." *Lenander*, 2016 Wash. LEXIS at *27. In *Weaver* v. *Evans*, 80 Wn.2d 461 (1972), the Washington Supreme Court applied the vested contract rights analysis to actions affecting the funding of a public pension plan.

The *Weaver* Court reviewed the constitutionality of the Governor's action "curtailing" a substantial portion of the State's contributions to Washington State Teachers' Retirement System (TRS). The Court first examined the origins and evolution of the TRS plan. The Court found that the legislature had through the years "evinced a growing concern with maintaining the actuarial soundness of the retirement system … and determined upon a systematic amortization of the unfunded liabilities … and a systematic computation and funding of current and future liabilities …." *Id.* at 472. The *Weaver* court held:

> [W]here, as here, the legislature has over a span of years indicated a deep concern with the actuarial soundness of the retirement system, and that concern has culminated in the express adoption of a systematic method of funding to ultimately attain the desired soundness, *then the principle of systematic funding so adopted becomes one of the vested contractual pension rights flowing to members of the system.* This being so, it follows under *Bakenhus* that such a vested contractual right cannot be unilaterally modified except for the purpose of keeping the retirement system flexible and maintaining its integrity, which modification must in turn be reasonable and bear some material relation to the theory of a pension system and its successful operation, *else the vested contractual right becomes unconstitutionally impaired.*

Weaver, 80 Wn.2d at 478 (emphasis added). The Court concluded that the actions taken by the Governor violated the "vested contractual rights to a retirement system actuarially designed through systematic funding to meet present and future pension liabilities." *Ibid.*; followed by *Charles*, 148 Wn.2d at 625 (members of two state pension plans have "vested contractual rights to the systematic funding of the retirement system to maintain actuarial soundness").

When the Legislature established the original LEOFF plan in 1969, its purpose was "to provide for an *actuarial reserve system* for the payment of death, disability, and retirement benefits to law enforcement officers and firefighters …." RCW 41.26.020 (emphasis added); see *Pasco*, 110 Wn. App. At 587 fn. 5. The legislation defined "actuarial reserve" as follows:

> a method of financing a pension or retirement plan wherein *reserves are accumulated* as the liabilities for benefit payments are incurred *in order that sufficient funds will be available on the date of retirement of each member to pay the member's future benefits* during the period of retirement.

RCW 41.26.030 (emphasis added). When the Legislature created LEOFF 2 in 1977, these provisions were made expressly applicable to the old LEOFF plan (now LEOFF 1) as well as the new LEOFF 2. RCW 41.26.005.

In 1989, the Legislature expressed its intent "to provide a dependable and systematic process for funding the benefits provided to members and retirees of … the law enforcement officers' and firefighters' retirement systems …." RCW 41.45.010; see Laws of 1989, ch. 273, § 1 (adding actuarial funding provisions). The legislature established goals of fully funding LEOFF 2 and fully amortizing the total costs of LEOFF 1 not later than June 30, 2024. RCW 41.45.010(1) and (2).

Consistent with *Weaver*, these provisions establish the legislature's intent to create actuarially sound plans. Like members of TRS, the members of LEOFF 1 and LEOFF 2 have a contractual right to a retirement plan that is systematically funded on the basis of sound actuarial principles.

B. Substantial Impairment

Substantial impairment is measured by the implied consent and comparable new advantages analysis established by the *Bakenhus* decision. *Lenander*, 2016 Wash. LEXIS at *33. "A contract is impaired by a statute which alters its terms, imposes new conditions or lessens its value." *Ibid.* (internal quotations and citations omitted). Changes in pension contract terms must be for "the sole purpose of ensuring the continued flexibility and integrity of the pension system[] [and] … [a]ny modifications that have the effect of reducing a pension benefit or have an adverse effect on members must be counterbalanced by a corresponding increase or additional benefit." *Id.* at *26. A modification of a pension contract will not result in substantial impairment "if the overall result of the change is favorable to employees." *Washington Educ. Ass'n.*, 181 Wn.2d at 250. And whether a modification is favorable "is a fact-specific question that must be measured by the totality of the circumstances." *Ibid.*

LEOFF 1 members have a contract right to a retirement plan that is systematically funded on an actuarially sound basis. After merger, the general system of funding the retirement benefits of these members will not be affected. The new plan will, however, have a funded status that is lower than the current funded status of LEOFF 1. As a result, there will be fewer assets available to pay the future benefits of LEOFF 1 members. Compare CAFR at 64 (LEOFF 1 is 123.7% funded) with *id.* at 67 (LEOFF 2 is 106% funded). There is a risk that a court could consider this action a reduction in the value of the LEOFF 1 contract.

In addition, we assume that legislation authorizing the merger will allow the State of Washington to avoid making an actuarially determined contribution to fund LEOFF 2 benefits for at least two years after the merger. Even though the funded status and therefore security of these benefits will likely increase as a result of the merger through the transfer of "suplus" assets[1] from LEOFF 1, there is a risk that a court could consider this action a reduction in the value of the LEOFF 2 contract.

We believe that analysis of these risks is impacted by several factors.

C. Funded Status of the Plans

Consistent with actuarial standards of practice, the goal of a sound plan is 100% funded status. See., e.g., American Academy of Actuaries Issue Brief (July 2012) at 1, available at https://www.actuary.org/files/80_Percent_Funding_IB_071912.pdf ("Pension plans should have a strategy in place to attain or maintain a funded status of 100% or greater over a reasonable

[1] Surplus assets are the assets excess in value of the actuarial liabilities of the plan.

period of time."). Based on information set forth in CAFR, the new plan will remain over 100% funded.

The merger will reduce the amount of assets available to pay the future benefits of the former LEOFF 1 members. We have found no case from Washington that directly addresses whether a change in funded status through a merger of two separate plans is a "substantial impairment" of vested contractual pension rights to an "actuarially sound" plan. We have also found no Washington cases that directly considered the use of "surplus" plan assets. Cases from other jurisdictions which have considered similar changes in plan design nevertheless shed some light on these issues.

In *Koster* v. *City of Davenport*, 183 F.3d 762 (8th Cir. 1999), the Court of Appeals for the Eighth Circuit considered a constitutional challenge to a merger of local public pensions in Iowa into the statewide plan. At the time the plans were merged, each of the cities' plans was overfunded. The merger law included a provision allowing each city to use "excess" funds in the city plan to offset the city's future contributions to the statewide plan. *Id.* at 765. Reviewing the challenge under the federal Contracts Clause, the *Koster* court held that there was no substantial impairment of any contract right to an actuarially sound pension plan. Central to the court's reasoning was the funded status of the plans.

> The [challenged] statute required the plan's actuary to first determine that the assets transferred from each separate plan to the statewide plan *were more than adequate to meet the plan's accrued liabilities* before allowing the city to offset its future contributions. [Citation omitted.] Thus, the statute does not infringe on the members' rights to receive predefined benefits upon retirement and provides measures to ensure that the statewide fund remains sound.

Id. at 768 (emphasis added) (internal citation omitted). The court concluded that any impairment was not substantial because it does not "compromise the soundness of the plan." *Ibid.*

State courts in West Virginia, North Dakota, and California have reached similar conclusions.

In *Dadisman* v. *Caperton*, 186 W.Va. 627 (1991), the West Virginia Supreme Court of Appeals rejected a constitutional challenge to a statute that merged two pension "divisions." From an actuarial standpoint, the "state" division had an unfunded liability while the "non-state" division had a large surplus "which more than offset[] the state unfunded amount." *Id.* at 633. In a prior proceeding, the court had ordered the state pension plan trustees to engage an independent actuary to determine whether underfunding had rendered the plan "actuarially unsound." Two actuaries were consulted and, ultimately, both opined that the system was actuarially sound at the time of the merger, "whether the System is viewed as a whole or the former state division of the System is viewed separately." *Id.* at 632. Plaintiffs nevertheless claimed unconstitutional impairment because members of the non-state plan were "deprived" of the surplus held for the benefit of the members of that plan. The *Dadisman* court rejected these claims and ruled that the legislation was valid because (1) the assets of both divisions were "owned" by the retirement system as a whole, and (2) the system as a whole, or each division separately, has "at all times … continued to be actuarially sound." *Ibid.*

Similarly, the North Dakota Supreme Court determined that a merger of underfunded and overfunded pension plans did not violate rights of overfunded plan members because the members were not entitled to "surplus" assets and the employer was not required to continue funding to preserve a surplus. *Klug* v. *City of Minot*, 795 NW2d 906, 912 (North Dakota 2011); see also *Claypool* v. *Wilson*, 4 Cal.App.4th 646 (1992) (no substantial impairment when funds in special account were used to offset employer contributions but plan actuary had determined these funds were not necessary to the actuarial soundness of the plan).

Under the reasoning of these cases, plan assets in excess of actuarial liabilities may not be essential to the actuarial soundness of the plan. Each of the courts in these cases evaluated the consequences of the merger and, relying on the opinions of actuaries, concluded that the change in funded status did not jeopardize the actuarial soundness of the combined plan after the merger, provided that, in the opinion of responsible actuaries, the funding of benefits provided by the new plan remained sound.

The opinions in these cases supports the view that a reduction in the amount of funds available to pay the benefits of LEOFF 1 members would not substantially impair their vested contract rights, provided that new plan remained actuarially sound. The *Koster* and *Claypool* decisions also support the view that "surplus" assets in an over-funded plan may be used to offset contributions otherwise required to maintain the soundness of the plan, again provided that the plan remains actuarially sound. It appears that the funded status of the newly merged plan, post merger, would be well over 100%, which would seem to support a finding of actuarial soundness. However, a case from Alaska might cast some doubt on these conclusions.

In *Municipality of Anchorage* v. *Gallion*, 944 P.2d 436 (Alaska 1997), the court reviewed the constitutionality of an ordinance permitting the city to use surplus assets in two plans to fund the liabilities of a third plan. Each plan had a different funded level prior to this consolidation of assets and liabilities: the first two plans were funded at levels of 135% and 112%, while the third plan was funded at 89%. *Id.* at 438-439. Even though the three plans were approximately 100% funded in the aggregate after the consolidation,[2] the *Gallion* court held that the ordinance impaired the pension rights of members of the better funded pension plans.

The Alaska Constitution "protects 'accrued benefits' of public employee retirement systems from diminution or impairment." *Id.* at 440, quoting Alaska Const., art. XII, § 7. The *Gallion*

[2] The actuarial calculations revealed that the funding for the new plan was either 102% or 99%, depending upon the assumptions used. *Id.* at 444.

court first noted that the separate treatment of each plan's funding was an essential part of the funding scheme of the plans. Members in the first two plans "reasonably could have expected that the product of their contributions would be used for their ultimate benefit[] [and] [c]ertainly they could not have expected that any surplus would be used for the benefit of non-plan members." *Id.* at 443. Because the funding level of the new plan was reduced from the pre-consolidation levels of Plans I and II, the court held that the ordinance "clearly impaired the inherent integrity of Plans I and II." *Id.* at 444. The court held:

> We conclude that [the ordinance] unconstitutionally impairs the vested right of members of Plans I and II to have the actuarial soundness of those plans *evaluated and maintained separately without being affected by the soundness of the other plans*. That failure impairs the ability of Plans I and II to withstand future contingencies, such as increases in plan obligations, declines in investment revenue and inability by [the city of Anchorage] to fund any shortfall. It is therefore unconstitutional.

Id. at 444 (emphasis added); compare *McDermott* v. *Regan*, 191 A.D.2d 47 (N.Y. App. Div. 1993) (legislative change in actuarial valuation method which created an actuarial "surplus" and allowed employers to "offset" contributions was unconstitutional impairment of right to independent trustee's exercise of discretion over setting contribution rates).

It is not clear whether Washington courts would adopt the *Gallion* analysis. Unlike the Washington Constitution, the Alaska Constitution contains a specific provision protecting pension rights. In a line of pension cases involving the alleged impairment of pension contract rights, the Alaska courts have rejected the reasoning of one Washington court. See *Sheffield* v. *Alaska Pub. Employees' Ass'n.*, 732 P.2d 1083, 1086-1087 (Alaska 1987) (rejecting reasoning of *King County Employees' Ass'n* v. *State Employees' Retirement Bd.*, 54 Wn.2d 1 (1959). And, in a recent case, the Washington Supreme Court acknowledged the difference in case law between the two jurisdictions. *Lenander*, 2016 Wash. LEXIS at *31-*32 fn. 9 (rationale in *Sheffield* is "incompatible" with precedent in *King County Employees' Ass'n* and is rejected).

In contrast, at least one Washington court has cited the *Koster* decision with approval in the context of a challenge to the standing of retirement plan members to file suit. See *Charles*, 148 Wn.2d at 478-479, citing *Koster*, *supra*, 183 F.3d at 767 (defined benefit plan does not entitle its members "to any use of the contributions other than to ensure the … entitlements [to a predetermined pension and an actuarially sound plan] are met").

If the Washington courts nevertheless applied the reasoning of the *Gallion* case, there is a substantial risk that the LEOFF 1 and 2 merger would be held unconstitutional. The Alaska Supreme Court was concerned with the structure of the plans and pre-ordinance authorization for consolidation of the assets and liabilities of the plans. We have found no Washington statute that specifically authorizes a merger or consolidation of the LEOFF 1 and 2 plans. Similarly, we have not found any statute or plan materials that notify LEOFF 1 members of such a merger. It is also clear that the separate structure of LEOFF 1 and 2 would not be maintained and the percentage of assets to liabilities for the LEOFF 1 benefits would be lowered. For the same reasons, the *Gallion* court held that the consolidation ordinance under its consideration was invalid.

Finally, Washington courts may look to federal law in evaluating whether a merger of LEOFF 1 and LEOFF 2 retirement plans would impair the vested rights of plan participants. Private pension plans are governed by the Employee Retirement Income Security Act, 29 U.S.C. §§ 1001 *et seq.* ("ERISA"). Section 1058 of ERISA and Internal Revenue Code section 414(l) each provide essentially similar rules concerning the merger of pension plans and requires that in the case of a merger, each participant in the newly formed plan "would (if the plan then terminated) receive a benefit immediately after the merger, consolidation, or transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger, consolidation, or transfer (if the plan had then terminated)." 29 U.S.C. § 1058. The Internal Revenue Service has issued regulatory guidance under section 414(l), which we understand will be addressed in a different memorandum.[3] The Code of Federal Regulations, 26 CFR 1.414(l)-1 provides that, for defined benefit plans, "if the sum of the assets of all plans is not less than the sum of the present values of the accrued benefit (whether or not vested) of all plans, the requirements of section 414(l) will be satisfied merely by combining the assets and preserving each participants accrued benefits." 26 CFR 1.414(l)-1(e). Both the ERISA statute and regulation governing plan mergers focus on the preservation of accrued benefits, and do not speak to a plan participant's entitlement to plan surplus that exists prior to merger. Since the LEOFF 1 and LEOFF 2 plans are both overfunded, it appears that the application of this law, by analogy, would not support an argument that the merger of LEOFF 1 and 2 pensions is impermissible.

Nevertheless, private plan participants have challenged plan mergers and amendments on the basis that they are entitled to the surplus assets of the over-funded pension plan in which they were a participant, or the basis that the merger or amendment impermissibly reduces the funded status of their pension plan. The federal courts, however, have generally rejected such challenges.

In *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999), the Supreme Court considered changes in the design of a defined benefit plan holding assets whose value substantially exceeded the actuarial value of the accrued liabilities. Under the plan amendments, early retirees were provided significant additional benefits while new employees were placed in a new "non-contributory" benefit structure. *Id.* at 435-436. Existing members were allowed to choose between the original benefit structure or the new one. Certain members filed suit claiming inter alia that the plan's surplus assets could not be used to fund the new non-contributory benefit

[3] The United States Department of Labor has not issued any regulations under ERISA section 1058.

structure. The Supreme Court rejected this claim, reasoning that "[t]he structure of a defined benefit plan reflects the risk borne by the employer. Given the employer's obligation to make up any shortfall, no plan member has claim to any particular asset that composes a part of the plan's general asset pool." *Id.* at 440. Thus, the Court concluded, the employer "could not have violated ERISA's vesting requirements by using assets from the surplus attributable to the employees' contributions to fund the noncontributory structure." *Id.* at 441. Similar conclusions have been reached by other federal courts. See *Systems Council EM-3 v. AT&T Corp.*, 159 F.3d 1376 (D.C.Cir. 1998) (participant in spun-off plan not entitled to residual assets that would be available upon termination of plan); *Brillinger v. General Elec. Co.*, 130 F.3d 61 (2d Cir. 1997) ("We therefore hold that the participants in the RCA plan were not entitled to have their benefits increased at the time of the merger with the GE plan, to take into account the existence of the RCA plan's residual assets.").

Governmental plans, like LEOFF 1 and 2, are of course exempt from ERISA. Nevertheless, the *Jacobson* case has been followed in two public pension cases in Washington. In *Johnson* v. *City of Tacoma*, 2016 Wash. App. Lexis 1326, *1 (June 6, 2016),[4] the Washington Court of Appeals considered a claim on employee contributions credited to the account of a member. Citing *Jacobson* with approval, the court observed that "[e]mployees who participate in a defined-benefit plan do not share in any decrease or surplus in the value of plan assets." *Id.* at *9; see *Washington Federation of State Emps.* v. *State*, 107 Wn. App. 241, 245 fn.5 (2001) (citing *Jacobson* with approval).[5]

Under this reasoning, LEOFF 1 plan members have no vested or contractual rights to the actuarial surplus of the LEOFF 1 plan and this surplus could be used to fund the benefits of LEOFF 2 plan members post merger without impairing the vested rights of LEOFF 1 members. It remains unclear whether another Washington court would apply this reasoning to the proposed merger.

We recommend that the Board consult with OAS and request the State Actuary to conduct an appropriate study to measure the actuarial impacts of a merger (including authorization for the State to skip its contributions for one or two years after the merger) and issue an opinion on the soundness of the new plan after merger. The results of this study will be critical to evaluating the impacts of the merger on the contract rights of LEOFF 1 and 2 members.

---

[4] The opinion in *Johnson* is not published in the official Washington Appellate Reports. Under Washington law, it may be cited as non-binding authority and may be given such persuasive authority as a court deems appropriate. Wash. State Court Rules, GR 14-1.

[5] This reading is reinforced by statute as well. See RCW 41.26.080(d) (Payment of salary and compensation to LEOFF 1 members less contributions "shall be a complete discharge of all claims and demands whatsoever for the services rendered ..., except his or her claim to the benefits" provided to these members).

D. Open and Closed Status

We understand that LEOFF 1 is a closed plan and therefore not accepting any new entrants. In addition, it is a very mature plan. As of June 2016, there were 62 active members and 7,431 retired members and beneficiaries receiving benefits.[6] CAFR at 46.

In contrast, LEOFF 2 is an open plan still accepting new entrants. It is also a younger plan, with 17,321 active members (both vested and non-vested) and 4,508 retired members and beneficiaries receiving benefits.[7]

Pursuant to statute, the assets of both plans are currently managed and invested by the Washington State Investment Board ("WSIB"). RCW 43.33A.10; RCW 41.26.735 (LEOFF 2). Along with the assets of other Washington pension funds, the assets of LEOFF 1 and LEOFF 2 are commingled for investment purposes in the Commingled Trust Fund ("CTF"). CAFR at 64, 66; see RCW 43.33A.170 (WSIB may establish commingled trust funds for any combination of funds under its jurisdiction). Assets in the CTF are currently allocated to different classes pursuant to the Retirement CTF Asset Allocation policy. WSIB Policy No. 2.10-050 (Feb. 18, 2016). The WSIB believes that "[t]he selection of asset classes, the amount invested in each, and the correlation of those asset classes are the greatest source of return and risk to the CTF[,]" and therefore to LEOFF 1 and LEOFF 2. *Ibid.* The WSIB aggregates the liabilities of all the pension funds in the CTF as part of its evaluation of the appropriate asset mix. *Ibid.* The current target allocations for each class of assets are as follows:

- 20% Fixed Income
- 5% Tangible Assets
- 15% Real Estate
- 37% Public Equity
- 23% Private Equity
- 0% Innovation Portfolio
- 0% Cash

Ibid.[8] The Washington Legislature set the target rate of investment return at 7.70% per year, beginning July 1, 2017, for all assets in the CTF, except for those of LEOFF 2. RCW 41.45.035(3)(c).

[6] There was also one terminated member not yet receiving benefits.
[7] In addition, there were 839 terminated members not yet receiving benefits.

[8] These are target allocations. Under the policy, the actual allocation of each class of the CTF may fluctuate between 2 and 5 %, plus or minus, of the target.

This target allocation might not be ideal for a closed, mature plan. It is designed to generate relatively higher investment returns but with higher risk and therefore more volatility. As the Washington Office of the State Actuary ("OSA") explains:

> In deciding the trade-off between risk and return, WSIB can take advantage of the long time horizon of the pension financing plan. [¶] The long time horizon for investing means that as a general matter, WSIB does not need to match pension liabilities with the short term ups and downs in the market. Instead, *WSIB can take more investment risk and seek higher expected returns* over the long term.

Office of the State Actuary's 2010 Risk Assessment (August 31, 2010) at 10 (emphasis added). Because LEOFF 1 is a closed plan and relatively mature, the duration of its liabilities is shorter than, and its cash flow needs are greater than, most of the other plans whose assets are managed by WSIB. Declines in asset values through investment losses will not be immediately replaced by incoming contributions of active members. Large investment losses could also cause the sale or liquidation of assets because of the need for cash to pay out benefits. The ability of plans like LEOFF 1 to absorb large investment losses is likely to be lower than that of an open and less mature plan. Thus, the current funding structure and target investment allocation may increase the risk of underfunding and, possibly, insolvency. (See, e.g., Office of the State Actuary 2011 LEOFF Merger Study at 20-22 (lack of ongoing funding policy requires new unfunded liabilities to be paid on a non prefunded or "pay as you go" basis and LEOFF 1 has "nearly a one in three chance of going into pay-go status at some point in the plan's life cycle.").

If LEOFF 1 is merged with LEOFF 2, the resulting new plan will be an open plan with approximately 17,383 active members and 11,939 retired members and beneficiaries. It will also be less mature and will likely have, in the aggregate, longer duration liabilities. For these reasons, the asset allocation adopted by the WSIB might be better suited to reducing the long-term risks of under funding or insolvency. Under the Contracts Clause analysis, public pension contract modifications "must be made for the sole purpose of ensuring the continued flexibility and integrity of the pension system." *Lenander*, 2016 Wash. LEXIS at *26-27, citing *Bakenhus*, 48 Wn.2d at 701. Mitigating these risks to ensure the integrity of the system likely satisfies this requirement. It is also possible that a reduction in funding risk could be considered a "comparable new advantage" to LEOFF 1 members. See *Bakenhus*, 48 Wn.2d at 702.

We recommend that OSA review the change in funding and analyze the "pay-go" risks for LEOFF 1 benefits as part of its actuarial study. This review should include an analysis of these risks both pre and post merger of the two plans.

E. Reduction In Aggregate State Contributions

Under current law, funding of LEOFF 1 is based upon statute. RCW 41.26.080 provides that every member shall make an employee contribution of 6% of the member's basic salary and every employer shall make a similar 6% employer contribution for every employee in the plan. However, no employer or member contribution is required "unless the most recent valuation study for [LEOFF 1] indicates the plan has unfunded liabilities." RCW 41.26.80(2).

Remaining liabilities of LEOFF 1 are funded by the State of Washington ("State"). RCW 41.26.80(1)(c); and RCW 41.45.010, et seq. The OSA provides preliminary actuarial valuation results to the Pension Funding Council, which in turn adopts a LEOFF 1 contribution rate for the State. This rate is recommended to the Legislature for final approval. RCW 41.45.060(1)-(3). Because LEOFF 1 has been overfunded, we understand the State has not made a contribution to LEOFF 1 for many years.

The funding of LEOFF 2 is also set forth in statute. RCW 41.26.725(1) provides that the LEOFF 2 Board has the duty to establish the rates of contribution for employers and employees according to the funding ratio set by statute. For the year 2015, the State contributed 3.15% of payroll, employers contributed 4.73% of payroll and employees contributed 7.88% of pay. Law Enforcement Officers' and Firefighters' Plan 2 Actuarial Valuation Report 2015 ("Valuation Report") at 5. Collectively, the State and participating employers contributed $147 million to LEOFF 2 in 2015. Valuation Report at 17.

After a merger of LEOFF 1 and 2, it is likely that aggregate contributions by employees, employers and the State will be reduced from their prior levels. The assets and liabilities of both plans will be combined and the funded status of the new plan will be higher than the funded status of the former LEOFF 2. As a general matter, a higher funded status will reduce the amount of contributions needed to fund current and future pension liabilities. Provided that future rate-setting for the new plan follows the existing rules for LEOFF 2, and members, employers, and the State continue to make required contributions, a change in the aggregate amount of State and employer contributions should be consistent with the "actuarial soundness" requirements of the Contracts Clause. See *Washington Federation of State Emps*. v. *State*, 107 Wn.App. at 245 fn. 5 (sponsor of overfunded pension plan may reduce or suspend its contributions) (dicta).

However, if the State enacts a statute allowing it to reduce or avoid making otherwise required contributions after a merger, this action would raise an additional risk of a Contracts Clause violation. The Washington Supreme Court in *Weaver* declared the Governor's action "curtailing" a substantial portion of the State's contributions to the Teachers' Retirement System an unconstitutional impairment of contract. The court concluded that this diversion of contributions violated the vested contractual rights to an actuarially sound retirement system. Under the *Koster* and *Jacobson* decisions as explained above, a Washington court could adopt the view that LEOFF 1 members do not have an interest in the surplus assets of their plan. The legislature would therefore remain free to use these assets to help fund LEOFF 2 benefits, provided that the soundness of the plan is not jeopardized. A contrary view was expressed in the *Gallion* case and a Washington court following it could conclude that these assets are not a State contribution and their use to pay an otherwise required contribution impairs the contract rights of LEOFF members.

F. Character of Employer Plan Sponsors

The members of both LEOFF plans have a vested contract right to an actuarially sound pension plan. For these defined benefit plans, "[t]he employer bears the risk of investment and guarantees the distribution of the fixed benefit even if the value of plan's investments decline." *Johnson*, 2016 Wash. App. LEXIS at *8-9. Thus, the employers in the LEOFF plans are ultimately responsible for the payment of benefits to the LEOFF members. Post merger, there will be a difference in the employer sponsors responsible for the actuarial soundness of the benefits provided by the LEOFF 1 and 2 plans. It does not appear that this difference will materially affect the soundness of the new plan.

LEOFF 1 currently has 64 active employee members employed by 29 different employer sponsors. CAFR at p. 194. The City of Seattle is the primary sponsor, accounting for 37.5% of all member participants. The remaining active members are employed by a variety of cities, counties, and special districts including the City of Bellevue, King County, and the City of Pasco. Other than Seattle, no single employer accounts for more than 5% of the active membership. *Ibid.*

LEOFF 2 currently has 17,470 active members employed by 369 different employers. CAFR at 195. As with LEOFF 1, Seattle has the largest number of active employees but the percentage is much lower -- 13.4%. The remainder of employers includes cities, counties, and special districts in Washington.[9] *Ibid.*

Based upon this composition of employers, there does not seem to be a substantial change in the risk of plan funding. From the standpoint of LEOFF 1 members, the addition of more than 200 employers with active members responsible for maintaining the actuarial soundness of the new plan seems to be a favorable change. And in any event, unless this change at least "likely" harms the actuarial soundness of the system, there can be no showing that the vested contract rights of the members have been impaired. *Charles*, 148 Wn.2d at 627.

G. Change in Plan Governance

Under Washington law, the LEOFF 2 Board is clearly a fiduciary to the members of the LEOFF 2 plan, responsible for adopting actuarial standards and setting contribution rates that "will

[9] The State of Washington is also a sponsor, accounting for about 1.4% of active employees.

guaranty the viability of the plan." RCW 41.26.705. Under current law, the State "shall make" contributions to LEOFF 2 based on rates established by statute, "regardless of the level of appropriation provided in the biennial budget." RCW 41.45.050(2) and (3). Because the legislature of course may generally amend statutes, it is possible that it could modify these rules and alter contribution rates set by the Board. We understand, however, that the legislature has not exercised this authority since the creation of the LEOFF 2 Board.

The Contracts Clause may limit the legislature's authority in this area. In *McDermott* v. *Regan*, 191 A.D.2d 47 (N.Y. App. Div. 1991), the court considered a challenge to a new statute compelling the trustee of the New York State Employees' Retirement System and the New York State and Local Police and Fire System to use certain actuarial methods of calculating pension liabilities and calculating employer contribution rates. Using the new method, the funds had an actuarial surplus of about $9 billion. The legislation further authorized the contributing employers to offset their contributions against a share of this "surplus." The end result of these changes was a reduction in employer contributions and a faster depletion of the surplus. This change "essentially shift[ed] the burden of funding the retirement systems from the present to the future [and] was admittedly imposed upon the [trustee] in an attempt to ease the State's budgetary problems." *Id.* at 49. The court held the legislation an unconstitutional impairment of the members' contract rights.

> The imposition of a particular funding method, as opposed to the mere setting of guidelines for selection of a method, vitiates the members' right to have the benefit of the [trustee's] discretion in fixing the amount of contributions needed for the continued stability and security of the systems.

Id. at 51. The court further reasoned that the legislation not only imposed a dramatically different funding method on the trustee, it dictated the depletion of surplus funds, "a further usurpation of the [trustee's] authority to manage the accounts of the fund." *Ibid.* The *McDermott* court concluded that the additional changes in the actuarial valuations "strip[ped] the systems' members of their right to the [trustee's] independent judgment, and therefore they too are unconstitutional." *Ibid.*

It is unclear whether a Washington court would follow *McDermott* and hold unconstitutional a legislatively imposed reduction in the contribution rates set by the LEOFF 2 Board. Nevertheless, the fiduciary authority and responsibility of the LEOFF 2 Board to make actuarial valuations and set contribution rates independent of the State legislature or any State agencies is likely considered a valuable aspect of LEOFF 2 plan governance.

As Initiative 790 noted, the then existing LEOFF 2 plan was "subject to policymaking by the legislature's joint committee on pension policy with ratification by the members of the legislature ...." Laws of 2003, ch. 2, § 1 (codified at RCW 41.26.700). The initiative created a new plan governance that was intended, in the words of the initiative, "to give management of the retirement program to the people whose lives are directly affected by it ...." *Ibid.* The initiative created a new board -- the LEOFF 2 Board -- with authority to manage certain aspects of the system. The 11 member board is composed of three fire fighters, three police officers, three employer representatives and two legislators. At least one Board member must be a retired participant of LEOFF 2. RCW 41.26.715. Although members are appointed by the Governor, the Board has independent pension management authority. This includes authority over actuarial standards, providing for additional benefits under certain conditions, providing effective monitoring of the plan, establishing contribution rates, and authority to retain professional and technical advisors. RCW 41.26.705. The LEOFF 2 Board must "[e]xercise fiduciary responsibility in the oversight of those pension management functions" assigned to it and thus owes duties of loyalty and prudence solely to the plan members and their beneficiaries. RCW 41.26.705(3).

Unlike LEOFF 2, there is no board or other body or official that has fiduciary oversight for LEOFF 1. OSA performs an advisory role. See RCW 44.44.040. The Washington Department of Retirement Services ("DRS") is only responsible for administering the system. RCW 41.50. Neither the Washington Legislature, OSA, nor DRS is expressly a fiduciary. In *Retired Public Employees Council of Washington* v. *Charles*, the Washington Supreme Court considered whether the Public Employees Retirement System I and the Teacher's System I are considered trust funds and whether the DRS Director is a trustee or other fiduciary of the two plans. *Charles*, 148 Wn.2d at 612. Relying on a number of prior decisions, the court held that "this State's case law, recent case law in particular, has refused to characterize the retirement funds as trusts." *Id.* at 622. The court concluded that if the retirement funds are not trusts, then the DRS Director may not be considered a trustee. *Ibid.* Thus, there is no fiduciary responsibility for administration of LEOFF 1.

If the newly merged plan were governed by the current LEOFF 2 Board having the same fiduciary responsibilities and the same composition, this change in governance could well be considered a change enhancing the integrity of the system. As explained above, under Washington law public pension contract modifications "must be made for the sole purpose of ensuring the continued flexibility and integrity of the pension system." *Lenander*, 2016 Wash. LEXIS at 26-27. Merging LEOFF 1 into LEOFF 2 and placing the new system under the governance regime of LEOFF 2 would seem to clearly enhance the system's integrity. As with the change in the maturity and closed status of LEOFF 1, this modification likely satisfies the requirement that pension plan modifications must be for the purpose of ensuring the continued flexibility and integrity of the system. In addition, it might well be considered an additional benefit for LEOFF 1 members which was conferred on them by the merger of LEOFF 1 and 2.

H. LEOFF 1 Cost Of Living Adjustments

A mandatory cost of living adjustment ("COLA") to a public pension benefit can be part of the vested contractual rights of the member. Effective April 1, 1971, the Washington Legislature granted LEOFF members an annual COLA based upon percentage increases in the consumer price index. See Laws of 1970, 1st Ex. Sess., ch. 6, §16, codified at RCW 41.26.240. In 1974, the legislature made slight changes to the calculation of the allowance based, LAWS 1974, 1st Ex. Sess., ch. 120, § 13. Since then, this statutory COLA has consistently been paid each year to LEOFF 1 members.

A legislative reduction or elimination of the current COLA provided to LEOFF 1 members would likely impair their contractual pension rights.

In *Washington Education Association,* the Washington Supreme Court considered several legislative changes to COLAs provided to the PERS and TRS Plan 1 members. *Wash. Educ. Ass'n.*, 181 Wn.2d at 236. In 1972, the legislature enacted a statute providing for a COLA, "'provided that the [DRS] finds, in its sole discretion,'" that system assets were sufficient to fund the COLA. *Id.* at 236, quoting former RCW 41.32.499 and former RCW 41.40.195. Under this statutory scheme, COLAs were never granted to TRS 1 members and were granted only through 1980 to PERS 1 members. Thus, for 15 years prior to the adoption of a new COLA scheme, DRS never exercised its discretion to grant a COLA under the 1973 enactment. *Id.* at 238. In 1995, the legislature adopted a new uniform cost of living adjustments ("UCOLA") for these members (and others). Under this new scheme, the legislature repealed the 1973 COLA and replaced it with a different benefit. "To prevent a perpetual obligation to increase the COLA amount each year, the legislature included a clause that reserved its right to modify or repeal the UCOLA scheme in the future and specified that it was not creating any contract rights." *Id.* at 239, citing former RCW 41.32.489(6) and former RCW 41.40.197(6). In 2011, the legislature repealed the UCOLA statutes, eliminating a COLA for TRS and PERS 1 members who had not yet retired at the time of the repeal. These members filed suit, bringing unconstitutional impairment claims. Id. at 240-241.

The *Washington Education Association* court first considered the 2011 repeal of the UCOLA statutes. Assuming that COLAs could be considered a part of the members' contract rights, the court rejected this claim because there was no substantial impairment. The authority to repeal the UCOLA was expressly reserved in the original legislation and "the legislature could not have been more explicit in reserving the power to amend the UCOLA statute and disclaiming any grant of contractual rights." *Wash. Educ. Ass'n.*, 181 Wn.2d at at 247. Thus, the court held, no vested contractual rights were violated.

The court also considered the claim that the 1995 legislation establishing UCOLA and repealing the 1973 COLA was an unconstitutional impairment. This claim was rejected as well. The court noted that even when modifications are detrimental to plan members there is no contract impairment "so long as those disadvantageous modifications were accompanied by comparable new advantages." *Id.* at 249, citing *Bakenhus*, 48 Wn.2d at 701-703. Whether an alteration is favorable to the members "is a fact-specific question that must be measured by the totality of the circumstances." *Id.* at 250. Turning to the repeal of the 1973 COLA in 1995, the court held that the affected members received comparable new advantages through enactment of the UCOLA benefit. Because the 1973 COLA was discretionary and contingent upon adequate funding, the UCOLA system represented a "substantial improvement" over the former COLA provisions.

> Notwithstanding the reservation clause, UCOLA provided a guaranteed right to an annual COLA of increasing amounts for as long as the program remained in effect. In contrast, the 1973 COLA ... merely assured employees that the DRS would *consider* whether a COLA was practicable based on current funding levels. ... Although the UCOLA statute reserved the legislature's right to change or terminate the program, such reservation clauses are enforceable and even the creation of an undefined automated COLA system constitutes an added favorable benefit ....

Id. at 250 (italics in original). Thus, the court held, replacement of the 1973 COLA by the UCOLA did not impair any existing contract rights.

We have found no legislative reservation of rights to modify or eliminate the LEOFF 1 COLA. Since 1971, the LEOFF COLA statute has provided that every eligible retirement allowance "shall be adjusted" to reflect changes in the consumer price index. Further, we understand that each LEOFF 1 member has received this annual adjustment since enactment of the statute. Unlike the 1973 COLA and the UCOLA considered in *Washington Education Association*, the legislature did not make the award of a COLA in any year discretionary and did not expressly reserve the right to modify or repeal the LEOFF COLA. Thus, this benefit would likely be considered a vested contractual right by Washington courts subject to impairment if the legislature reduced or eliminated it.

Under the reasoning of this case, however, it is possible that a court could consider the governance and demographic changes addressed in sections D. and G., supra, as an added favorable benefit and thus find no impairment. New benefits typically must be "comparable" to the detriment suffered to avoid a finding of impairment. See *id.* at 447; see also, e.g., *Bowles*, 121 Wn.2d at 65 ("modifications *reducing pension levels* must be counterbalanced with *increases in pension levels*") (emphasis added); *Wash. Fed'n of State Employees Council 28* v. *State*, 98 Wn.2d 677, 689 (1983) (legislative change eliminating a pension benefit "without giving ... employees a *comparable benefit substitute*" held unconstitutional) (italics added); *Vallet* v. *Seattle*, 77 Wn.2d 12, 21-22 (1969) (sliding scale escalator clause for pension allowance over a period of years "outweighed" a higher but fixed pension benefit). In *Washington Education Association*, the Washington Supreme Court explained this analysis further:

> [M]odification of a pension contract will not substantially impair an existing contract if the *overall result of the change is favorable to employees*. Whether an alteration is favorable to employees is a fact-specific question that must be measured by the totality of the circumstances.

Wash. Educ. Ass'n., 181 Wn.2d at 250 (emphasis added).

It is difficult to compare the loss of an annual COLA with the benefit of added fiduciary oversight, better governance, and a possible increase in the benefit security of the new plan. The former entails a direct reduction in the dollar amount of each member's benefit while the latter enhances the future security of benefit payments. Despite these differences, a Washington court might view the totality of these changes as an added benefit that outweighs the loss of a COLA. Nevertheless, elimination or reduction of the LEOFF 1 COLA remains a substantial risk under *Bakenhus* and its progeny.

I. LEOFF 1 Member Contributions

LEOFF 1 members are not obligated to pay any employee contributions, "unless the most recent valuation study for [LEOFF 1] indicates the plan has unfunded liabilities." RCW 41.26.080(2). We understand that LEOFF 1 members have not paid any employee contributions to the plan since at least 2000.

Under *Bakenhus* and its progeny, "modifications reducing pension levels must be counterbalanced with increases in pension levels." *Bowles* v. *Wash. Dept. of Ret. Sys.*, 121 Wn.2d 52, 65 (1993), following *Bakenhus*, 48 Wn.2d at 701. In *Allen* v. *City of Long Beach*, 45 Cal.2d 128, 131-133 (1955), the California Supreme Court held that an increase in the amount of an employee's contribution without a corresponding increase in benefit payments was an unconstitutional impairment of the employee's contract rights. In its opinion, the *Bakenhus* court noted this result and relied on the *Allen* decision for its conclusion that a decrease in a pensioner's benefit made without a corresponding benefit was also unconstitutional. *Bakenhus*, 48 Wn.2d at 701-702. If any existing active member of LEOFF 1 is required to pay employee contributions after the merger, it is likely this change would be held unconstitutional, unless this change were accompanied by a corresponding benefit to these members. Even a higher likelihood of payment could be grounds for a constitutional challenge. See *Charles*, 148 Wn.2d at 627 (impairment claim must at least demonstrate "likely" harm to member). Under more recent case law, a Washington court might possibly be inclined to find the "overall result" of the merger favorable to members. See section H., *supra*. However, changes that impose employee contributions on LEOFF 1 active members retain a substantial risk of contract impairment.

IV. Fiduciary Issues In Plan Mergers

The proposed merger would be effected through statutory changes enacted by the Washington Legislature. A pension plan merger is a change in plan design. In Washington, "the legislature has the authority under its police power to establish a retirement system for public employees …." *Wash. Fed. Of State Emps.* v. *State*, 107 Wn.App. at 247 (internal quotations and citation omitted). Retirement plan design issues, such as a "lack of an independent trustee," a need for a "review and clarification" of fiduciary duties, and a need for a retirement trust "are matters for legislative, not judicial, action[.]" Id. at 246-247. Thus, "[t]he courts have repeatedly said we will not substitute our judgment for the Legislature's with respect to the structure of public retirement plans." Id. at 247. Legislative exercise of the police power is not a fiduciary function and it is unlikely that a Washington court would require to act as a fiduciary in enacting pension plan merger legislation.

This conclusion is consistent with federal law governing non-governmental plans. Under ERISA, an employer's decision to change the plan design generally does not implicate fiduciary duties. *Jacobson*, 525 U.S. at 444-445. Plan design changes are typically "trustor" or employer functions and plan sponsors who alter plan terms "do not fall into the category of fiduciaries." Id. at 445 (internal quotations omitted).[10] Under this reasoning, the Washington Legislature's actions in re-designing the LEOFF 1 and 2 plans should not be subject to fiduciary principles. As explained above, Washington courts have cited the *Jacobson* case with approval, albeit in different contexts.[11]

V. Conclusion

The Contracts Clause in the Washington Constitution provides members of LEOFF 1 and 2 with vested contract rights to an actuarially sound plan for providing their retirement benefits. Legislation merging these plans will make changes that could affect these rights. Washington courts may review changes in plan funding, plan status, contributions, plan governance, and benefits in addressing any constitutional challenge to a merger. Evaluation of these factors will shape a judicial decision whether the legislation unconstitutionally impairs the members' contract rights.

Peter Mixon

Brian Peterson

cc: David Morse

[10] The Supreme Court recognized a potential exception for "sham transactions" -- a transaction "meant to disguise an otherwise unlawful transfer of assets to a party in interest[.] Id. at 445 (internal quotations omitted). Unless the merger legislation violated the vested contract or other constitutional rights of plan members, it is difficult to envision the merger plan being categorized as a sham under the circumstances presented here.

[11] See text accompanying footnotes 4 through 5, supra.

Office of the State Actuary

"Supporting financial security for generations."

November 30, 2016

Mr. Steve Nelsen
Executive Director
LEOFF 2 Retirement Board
PO Box 40918
Olympia, Washington 98504-0918

SUBJECT: LEOFF 2 BOARD REQUEST FOR ANALYSIS OF LEOFF 1 RISKS

Dear Steve:

At your request, we have performed analysis on the risks inherent in the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 1 (LEOFF 1). Specifically, you asked us to analyze the following:

- Impact to LEOFF 1 under varying investment return scenarios.
- Impact of LEOFF 1 annuitants receiving a one-time $5,000 bonus.
- Plan merger of LEOFF Plans 1 and 2.

The key results from our analysis are presented in the body of this communication along with our written responses to other questions you asked. We document the data, assumptions, and methods we used to perform this analysis in **Appendix A**. **Appendices B-D** provide additional information for the requested scenarios including tables and graphs of the projected surplus and funded status. **Appendix E** contains plan merger analysis and **Appendix F** contains projected benefit payments.

Summary of Analysis

Impact to LEOFF 1 Under Varying Investment Return Scenarios

We calculated the projected funded status and surplus for LEOFF 1 assuming: (i) the long-term Rate of Return (ROR) assumption is reduced from 7.7 percent to 7.5 percent; (ii) the fund earns actual investment returns of 5 percent (and 10 percent) for 10 years followed by 7.7 percent; and (iii) the fund earns average actual investment returns of 7.7 percent that follow two different paths – low/high returns for the first ten years, followed by high/low returns for the next ten years.

PO Box 40914 | Olympia, Washington 98504-0914 | state.actuary@leg.wa.gov | osa.leg.wa.gov
Phone: 360.786.6140 | Fax: 360.586.8135 | TDD: 711

The funded status measure compares actuarial assets to the present value of accrued (earned) benefits. With each of these scenarios, neither the current assets nor the stream of future benefit payments are changing. What changes is the amount of future earnings we expect on the assets. When the amount of earnings changes, it means more (or less) money is needed today to pay for the same stream of benefits in the future.

Under each scenario described above, the projected funded status of LEOFF 1 remains above 100 percent. Please see **Appendices B and D** for additional information.

The requested analysis did not include any impact from the inflation assumption. We believe that it would be reasonable to assume inflation is correlated with investment returns. As an example, a period of higher than expected investment returns could be the result of higher than expected inflation. Inflation that is lower (or higher) than expected would improve (or worsen) the funded status of the plan. To show the impact inflation can have on the results, we added two scenarios to the third graph in **Appendix B** where actual inflation is correlated to the investment return.

Based on our analysis, it would take a larger investment shock or a much longer low investment return environment to take LEOFF 1 out of a fully funded position. For example, if the commingled trust fund experienced an immediate shock of -6 percent for two years, followed by 7.7 percent thereafter, the funded status for LEOFF 1 would drop below 100 percent. Alternatively, if the long-term ROR assumption was lowered to 5 percent instead of the assumed 7.7 percent, or the assets earned an average of 4 percent for the next ten years followed by 7.7 percent thereafter, LEOFF 1 would fall below 100 percent funded. In addition, the plan merger analysis will include investment shocks since we analyze 2,000 simulations of different economic environments (stochastic analysis), among other assumptions. Please see those results in **Appendix E**.

Impact of LEOFF 1 Annuitants Receiving a One-Time $5,000 Bonus

We estimate this bonus would add approximately $36.5 million to the expected liabilities in Fiscal Year (FY) 2018. This bonus would lower the funded status in FY 2018 by approximately 1 percent. Please see **Appendix C and D** for additional information.

Plan Merger of LEOFF Plans 1 and 2

We analyzed the impact to LEOFF when we merge LEOFF plans 1 and 2 based on the merger definition you provided. The defined merger includes a long-term ROR assumption of 7.5 percent and a two-biennia state contribution rate holiday. We also considered two different merged plan scenarios; (i) updating the merged plan based on our *2011 LEOFF Merger Study*; and (ii) the merged plans with a 7.5 percent ROR assumption and no state contribution rate holiday. Ultimately, we did not observe a significant change in the LEOFF 2 risk measures under any of the merged plan scenarios.

The four-year state contribution rate holiday provides a savings for the state of approximately $300 million but did not materially impact the results. We compared the expected funded status when we merged LEOFF plans 1 and 2 with (and without) the contribution rate holiday. The funded status decreased from 112.8 percent to 110.9 percent in the year following the four-year state contribution rate holiday (FY 2022).

Please see **Appendix E** for additional information.

Miscellaneous Questions

In your letter dated September 9, 2016, there were several questions that require a written answer versus actuarial analysis. These questions and our answers follow.

What are the greatest risks of a LEOFF 1 Unfunded Actuarial Accrued Liability (UAAL) emerging, and what are the budgetary impacts if that occurs?

As of June 30, 2015, LEOFF 1 has a funded status of 125 percent; however, a LEOFF 1 UAAL could emerge in the future. The financial measures of a retirement plan rely on assumptions about unknown future events so many risks exist. Some of these risks include members outliving their expected benefit payments, benefit improvements occur without sufficient funding, investments earn less than expected, and inflation is higher than expected. Since the Legislature has adopted mortality improvement assumptions and has authority to manage benefit improvements, we believe the greatest risks LEOFF 1 faces are economic in nature. For example, significant negative investment earnings, long periods of lower than expected investment earnings, or long periods of high inflation would negatively impact the assets and future obligations of the plan. In addition, the combination of low investment returns and a high inflation environment would also put the plan's funded status at risk of dropping below 100 percent. Since LEOFF 1 annuitants receive fully indexed Cost-of-Living Adjustments (COLAs), high inflation or long periods of inflation that exceed the 3 percent assumed rate, will increase the future benefit payment streams above our current projections.

If a UAAL emerged, RCW 41.26.080 states that employees (and their employers) would contribute 6 percent of their salary annually until the plan no longer has unfunded liabilities. In addition, the funding goal in statute states that any LEOFF 1 UAAL be amortized by June 30, 2024, over all plan payroll. LEOFF 1 members (and their employers) are not currently required to contribute to LEOFF 1 while the plan remains in surplus.

Do LEOFF 1 liabilities reflect the Office of the State Actuary's (OSA's) recommended mortality assumption?

Yes, the liabilities calculated in the most recent Actuarial Valuation Report (AVR) and the analysis contained in this communication reflect an assumption for mortality improvement based on 100 percent of Scale BB.

What are the LEOFF 1 projected benefit payments?

Please see **Appendix F** for the expected benefit payments for LEOFF 1, by year. The expected benefit payments assume an annual 3 percent COLA.

Does OSA use the most-up-to-date data to perform analysis?

OSA uses data consistent with the most recent AVR. The data is prepared by the plan administrator, the Department of Retirement Systems, and reviewed by OSA for reasonableness for the purpose of performing an annual actuarial valuation. Our most recent AVR measurement date is June 30, 2015. All data and assets are based on that measurement date, however, our projections model includes the most recent investment returns as of June 30, 2016.

Can OSA provide monthly changes to the LEOFF 1 surplus?

Plan surplus or funded status is calculated at a measurement date using both the actuarial assets and plan liabilities valued at that same date. While the assets may be reported monthly by the Washington State Investment Board (WSIB), plan liabilities are not calculated that frequently. In addition, the assets used to determine the plan's surplus or funded status are not market value assets, as reported by WSIB, but rather actuarial assets. Actuarial assets are determined using an asset smoothing method that defers recognition of the annual investment gain or loss over a defined period of time. This asset smoothing method is defined in statute.

This analysis, like most actuarial analysis, will quickly become outdated. Some examples of why this analysis can become outdated include the following: material changes to benefit provisions, changes to actuarial assumptions or methods, and the inclusion of more recent participant or asset data. We recommend updating this analysis after the 2017 Legislative Session.

We prepared this analysis for the LEOFF 2 Board to understand the risks inherent in LEOFF 1. We advise readers of this analysis to seek professional guidance as to its content and interpretation and not rely upon the communication without such guidance. Please read the analysis shown in the letter and attached appendices as a whole. Distribution of, or reliance on, only parts of this analysis could result in misuse and may mislead others.

The undersigned, with actuarial credentials, meets the Qualification Standards of the American Academy of Actuaries to render the actuarial opinions contained herein. Matt Smith was the supervising actuary for the actuarial analysis contained in this communication. We are both available to answer any additional questions that arise.

Sincerely,

Lisa Won, ASA, FCA, MAAA
Deputy State Actuary

cc: Kelly Fox, Chair
LEOFF Plan 2 Retirement Board
Matthew M. Smith, FCA, EA, MAAA
State Actuary
Mitch DeCamp
Actuarial Analyst

O:\LEOFF 2 Board\2016\12-7\LEOFF1.Risks.docx

APPENDIX A – DATA, ASSUMPTIONS, AND METHODS WE USED

Data We Used

This analysis is based on the data as disclosed in the *June 30, 2015, AVR* along with future new member data as disclosed in our New Entrant profiles on our projections webpage.

Assumptions We Used

Demographic Assumptions: All current members are expected to decrement (or leave) the retirement systems via termination, disability, retirement, or mortality. As members leave the retirement systems, they are replaced by new entrants. Demographic assumptions for our projections model are needed to develop new entrants into LEOFF 2 over the next 50 years.

Economic Assumptions: For purposes of determining the present value of future salaries and benefits when determining projected contribution requirements, we assumed a 7.7 percent ROR for LEOFF 1 (7.5 percent for LEOFF 2) for all future years beginning July 1, 2016. For purposes of projecting the growth of invested assets, we used actual asset returns through June 30, 2016 (2.65 percent for FY 2016).

Unless noted otherwise, all analysis was developed using deterministic projections. Deterministic projection assumptions will match our long-term expectations for each assumption and assume full funding with no benefit improvements.

Please see the AVR and our projections webpage for additional detail on assumptions used to develop the analysis in this communication.

Methods We Used

With the data and assumptions noted above as inputs, we used our valuation software to project the outputs (i.e., projected salaries, benefit payments, etc.) necessary to project the next 50 AVRs. We then applied the current funding and asset smoothing methods set in statute to these outputs to determine projected asset values, contribution rates, and the associated contribution requirements.

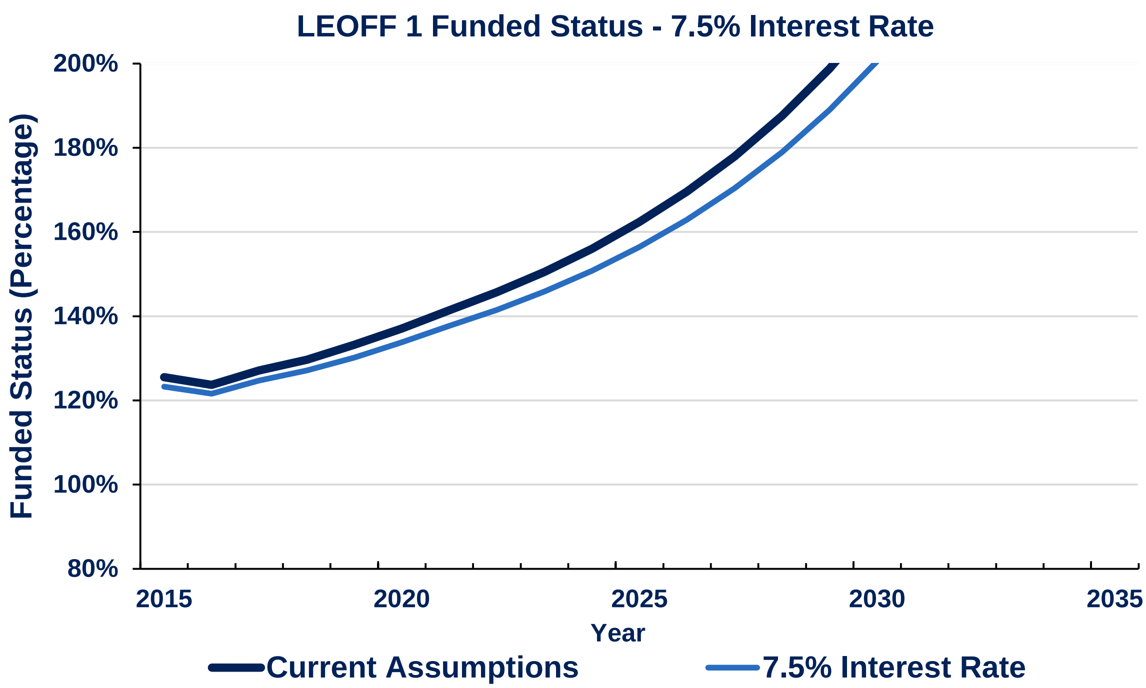
APPENDIX B - IMPACT TO LEOFF 1 UNDER VARYING INVESTMENT RETURN SCENARIOS

Unless noted otherwise, all data, assumptions, and methods are consistent with **Appendix A**.

Impact to LEOFF 1 Assuming 7.5 Percent Long-Term ROR Assumption

To perform this analysis, we assumed all future benefit payments were discounted using a 7.5 percent interest rate assumption. We also assumed the future investment return will be 7.5 percent for all fiscal years following June 30, 2016.

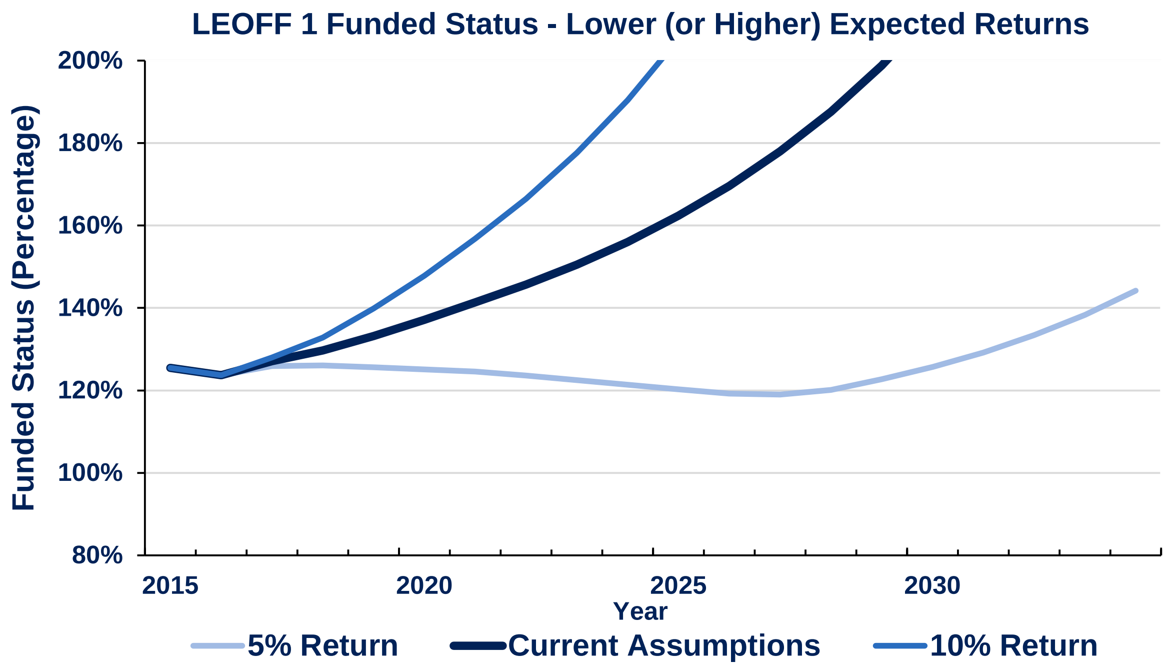
We observe a lower funded status under this scenario; however, LEOFF Plan 1 is more mature relative to other Washington State retirement plans and less impacted by a reduced interest rate assumption. The graph below summarizes the change in funded status under this scenario.



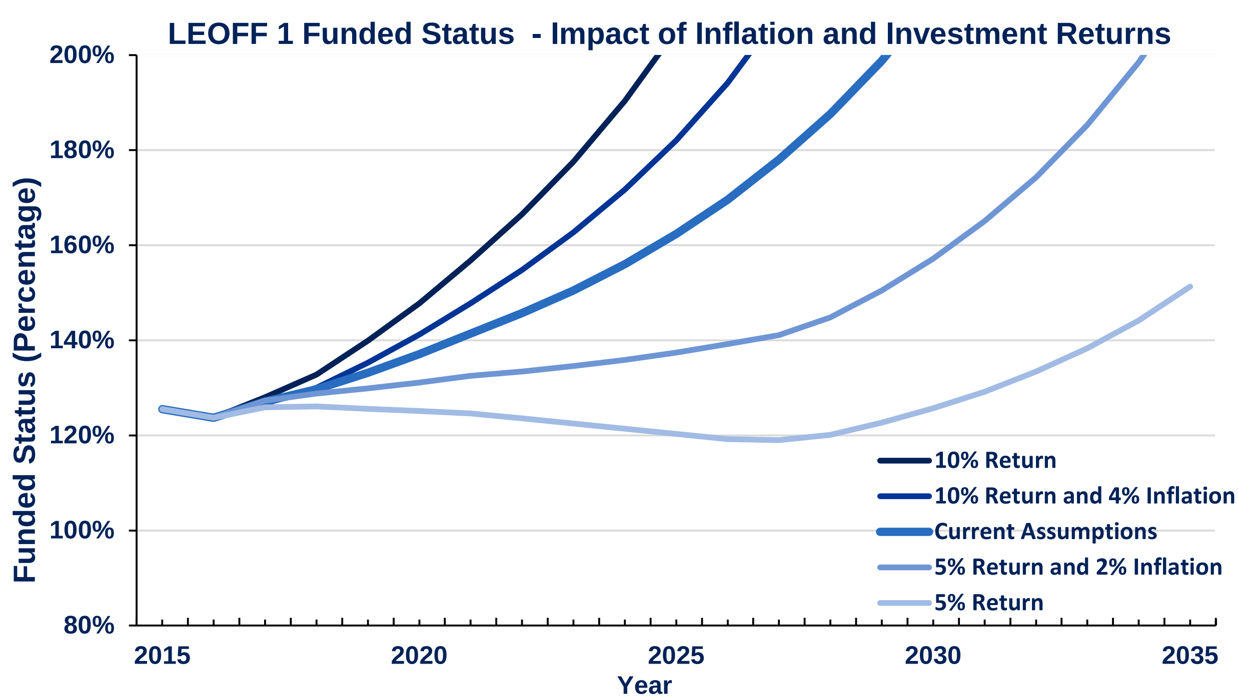
Impact to LEOFF 1 Assuming an Actual ROR Lower (or Higher) Than Expected Over the Next Ten Years

To perform this analysis, we assumed the actual future investment return will be 5 percent (or 10 percent) for the next ten years (FY 2017-2026). Following FY 2026, we assumed actual returns equal the assumed investment return of 7.7 percent.

Under both scenarios, we continue to observe a funded status above 100 percent. The graph on the next page summarizes the change in funded status under these two scenarios.



The analysis above did not consider the impact to inflation. We believe it would be reasonable to assume inflation is correlated with investment returns. The graph below models actual future inflation of 2 percent (or 4 percent) for FY 2017-2026. Following FY 2026, we assumed actual inflation equals the inflation assumption rate of 3 percent. In each scenario, the funded status for LEOFF 1 does not fall below 100 percent.



Impact to LEOFF 1 Under Low to High Returns and High to Low Returns

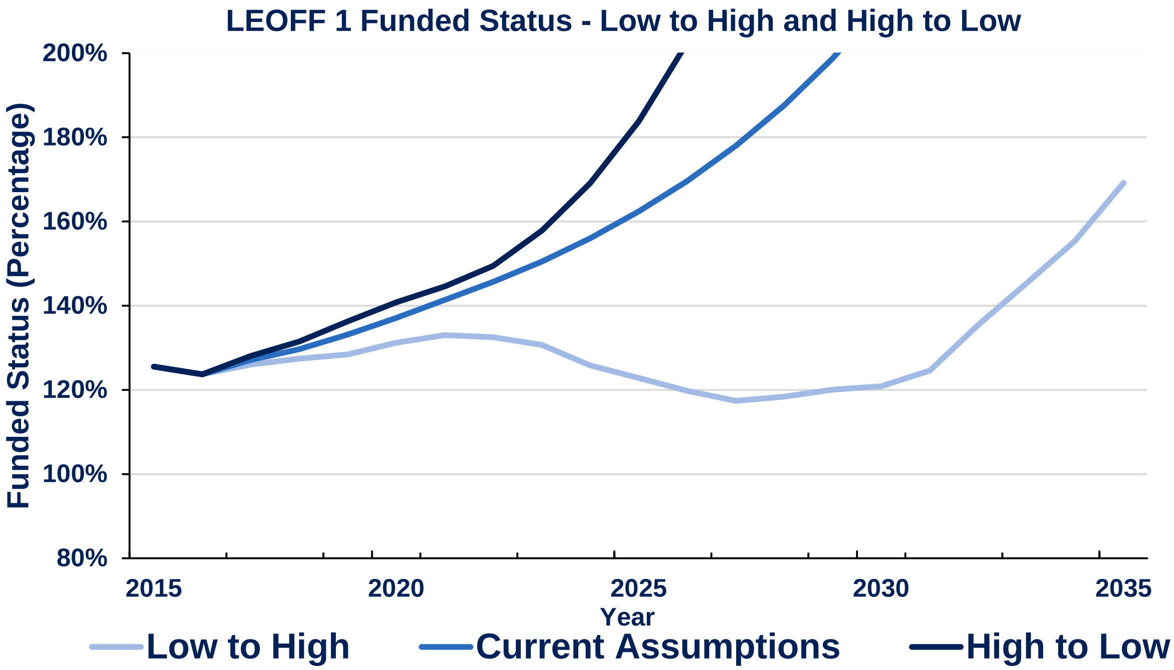
In these two scenarios, we assumed a "low to high" investment return scenario and a "high to low" investment return scenario. Each scenario randomly simulated returns over the next twenty years. In general, the "low" period of returns averaged an approximate 5 percent return and the "high" period of returns averaged an approximate 11 percent return.

The analysis of these scenarios does not consider any impact on inflation.

The investment returns, under each scenario, are displayed in the table below. Following FY 2036, we assumed actual investment returns equal the investment return assumption of 7.7 percent.

Low to High and High to Low Returns		
FY	Low to High	High to Low
2017	6.88%	9.32%
2018	0.93%	7.41%
2019	7.35%	9.47%
2020	11.37%	5.58%
2021	(2.68%)	7.82%
2022	2.49%	11.60%
2023	0.65%	12.16%
2024	(1.51%)	10.34%
2025	19.62%	13.28%
2026	6.12%	20.71%
2027	9.45%	(3.47%)
2028	12.62%	11.81%
2029	4.71%	23.88%
2030	5.49%	1.49%
2031	17.59%	3.50%
2032	20.48%	(7.61%)
2033	4.92%	1.49%
2034	6.29%	7.70%
2035	10.68%	3.00%
2036	14.35%	8.99%
First 10 Years	4.93%	10.70%
Next 10 Years	10.53%	4.76%
All 20 Years	7.70%	7.69%

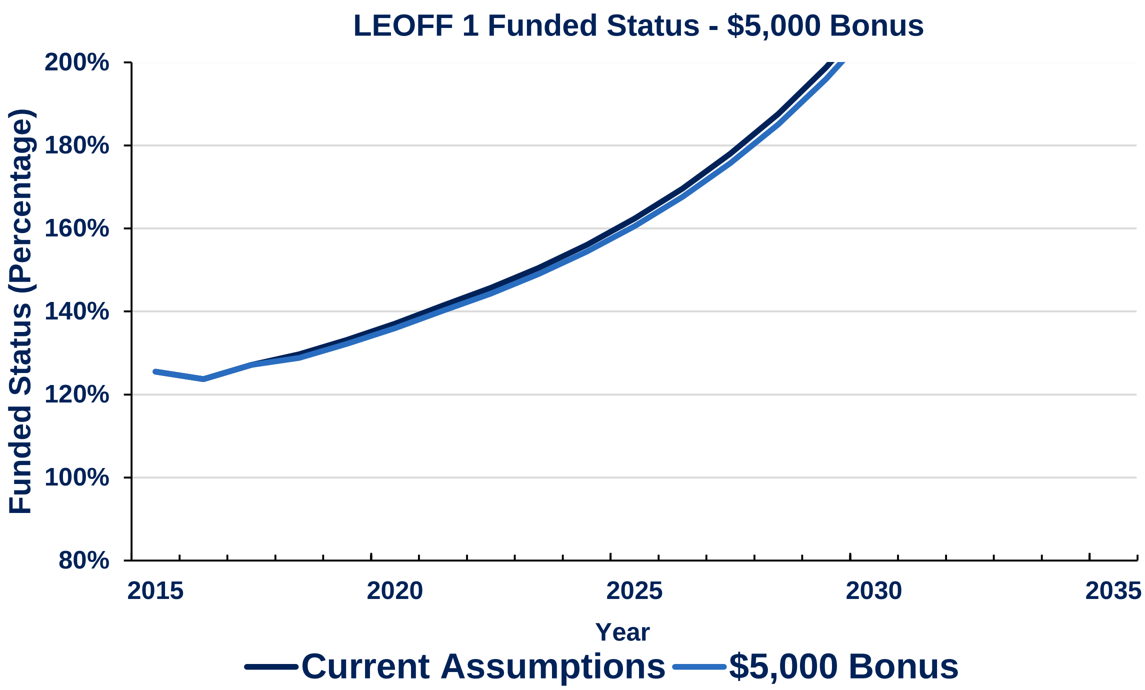
Under both scenarios, we continue to observe a funded status above 100 percent. The graph on the next page summarizes the change in funded status under these two scenarios.


LEOFF 1 Funded Status - Low to High and High to Low
Funded Status (Percentage)
200%
180%
160%
140%
120%
100%
80%
2015
2020
2025
2030
2035
Year
Low to High
Current Assumptions
High to Low

APPENDIX C – IMPACT OF LEOFF 1 ANNUITANTS RECEIVING A ONE-TIME $5,000 BONUS

To perform this analysis, we had to make an estimate of the number of annuitants who would receive a one-time $5,000 bonus as well as when the members would receive the bonus. We assumed 7,300 annuitants would receive this bonus based on the downward trend in number of annuitants in LEOFF 1. FY 2018 was determined to be appropriate since an annuitant bonus would occur after the 2017 Legislative session. Overall, the total expected benefit increase was $36.5 million ($5,000 * 7,300 = $36.5 million).

The graph below summarizes the change in funded status under this scenario.



Unless noted otherwise, all data, assumptions and methods are consistent with **Appendix A**.

APPENDIX D – SURPLUS UNDER VARYING SCENARIOS

Surplus is another way to look at the impact of various scenarios presented in this communication. The table below will display how the annual surplus will change under each scenario.

(Dollars in Millions)	LEOFF 1 Projected Surplus								
	Long-Term ROR Assumption		Actual Experience**						
Scenario	Current (7.7%)	New (7.5%)	5% ROR	10% ROR	5% ROR, 2% Inflation	10% ROR, 4% Inflation	High to Low ROR	Low to High ROR	$5,000 One-Time Payment
2015	$ (1,090)	$ (1,013)	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)
2016	$ (1,007)	$ (932)	$ (1,007)	$ (1,007)	$ (1,007)	$ (1,007)	$ (1,007)	$ (1,007)	$ (1,007)
2017	$ (1,138)	$ (1,055)	$ (1,091)	$ (1,180)	$ (1,135)	$ (1,133)	$ (1,180)	$ (1,095)	$ (1,138)
2018	$ (1,232)	$ (1,142)	$ (1,082)	$ (1,308)	$ (1,174)	$ (1,270)	$ (1,308)	$ (1,136)	$ (1,195)
2019	$ (1,355)	$ (1,255)	$ (1,044)	$ (1,484)	$ (1,186)	$ (1,483)	$ (1,484)	$ (1,161)	$ (1,314)
2020	$ (1,485)	$ (1,374)	$ (1,006)	$ (1,636)	$ (1,199)	$ (1,716)	$ (1,636)	$ (1,251)	$ (1,441)
2021	$ (1,623)	$ (1,502)	$ (966)	$ (1,748)	$ (1,214)	$ (1,969)	$ (1,748)	$ (1,295)	$ (1,576)
2022	$ (1,748)	$ (1,614)	$ (903)	$ (1,893)	$ (1,207)	*	$ (1,893)	$ (1,244)	$ (1,697)
2023	$ (1,882)	$ (1,735)	$ (840)	*	$ (1,203)	*	*	$ (1,143)	$ (1,828)
2024	*	$ (1,865)	$ (776)	*	$ (1,200)	*	*	$ (933)	$ (1,968)
2025	*	*	$ (711)	*	$ (1,200)	*	*	$ (799)	*
2026	*	*	$ (647)	*	$ (1,202)	*	*	$ (667)	*
2027	*	*	$ (617)	*	$ (1,210)	*	*	$ (565)	*
2028	*	*	$ (626)	*	$ (1,264)	*	*	$ (574)	*
2029	*	*	$ (674)	*	$ (1,361)	*	*	$ (596)	*
2030	*	*	$ (726)	*	$ (1,466)	*	*	$ (589)	*
2031	*	*	$ (782)	*	$ (1,578)	*	*	$ (658)	*
2032	*	*	$ (842)	*	$ (1,700)	*	*	$ (893)	*
2033	*	*	$ (907)	*	$ (1,831)	*	*	$ (1,071)	*
2034	*	*	$ (977)	*	$ (1,972)	*	*	$ (1,224)	*
2035	*	*	$ (1,052)	*	*	*	*	$ (1,418)	*
2036	*	*	$ (1,133)	*	*	*	*	$ (1,728)	*
2037	*	*	$ (1,221)	*	*	*	*	*	*
2038	*	*	$ (1,315)	*	*	*	*	*	*
2039	*	*	$ (1,416)	*	*	*	*	*	*
2040	*	-	$ (1,525)	*	*	*	*	*	*

Note: Negative values indicate a surplus. ROR = Rate of Return.
**Surplus in excess of $2 billion.*
***Actual experience equals the long-term assumptions from years eleven (or twenty-one) and beyond, depending on the scenario. Funding is based on the current ROR assumption of 7.7% for the entire period.*

Please see **Appendices A-C** for underlying assumptions.

APPENDIX E – ANALYZE THE MERGING OF LEOFF PLANS 1 AND 2

Unless noted otherwise, the analysis within this appendix will focus on the merger of LEOFF Plans 1 and 2 based on the parameters you provided to us. The defined "LEOFF 1/LEOFF 2 Merger" includes merging the assets and liabilities of both plans, using a long-term ROR assumption of 7.5 percent, and providing for a two-biennia state contribution rate holiday.

Assumptions

This merger analysis follows our "Past Practices" stochastic assumptions including future funding shortfalls and annual benefit improvements. Our stochastic analysis produces 2,000 randomly simulated future economic environments and we summarize the outcomes to quantify the 'likelihood' of a given risk. Please see our projections page of our website for additional information on our stochastic assumptions.

We assumed the benefit structure in each plan would remain unchanged and there would be no change to the current governance structure. We further assumed that future benefit improvements, for all LEOFF members, would occur at the same rate as those for LEOFF 2.

We assumed a funding policy consistent with LEOFF 2 and contribution rates would be determined using the combined assets and liabilities but collected over LEOFF 2 payroll only.

We assumed pay-go has occurred when the amount of annual pay-go exceeds $50 million in present value dollars.

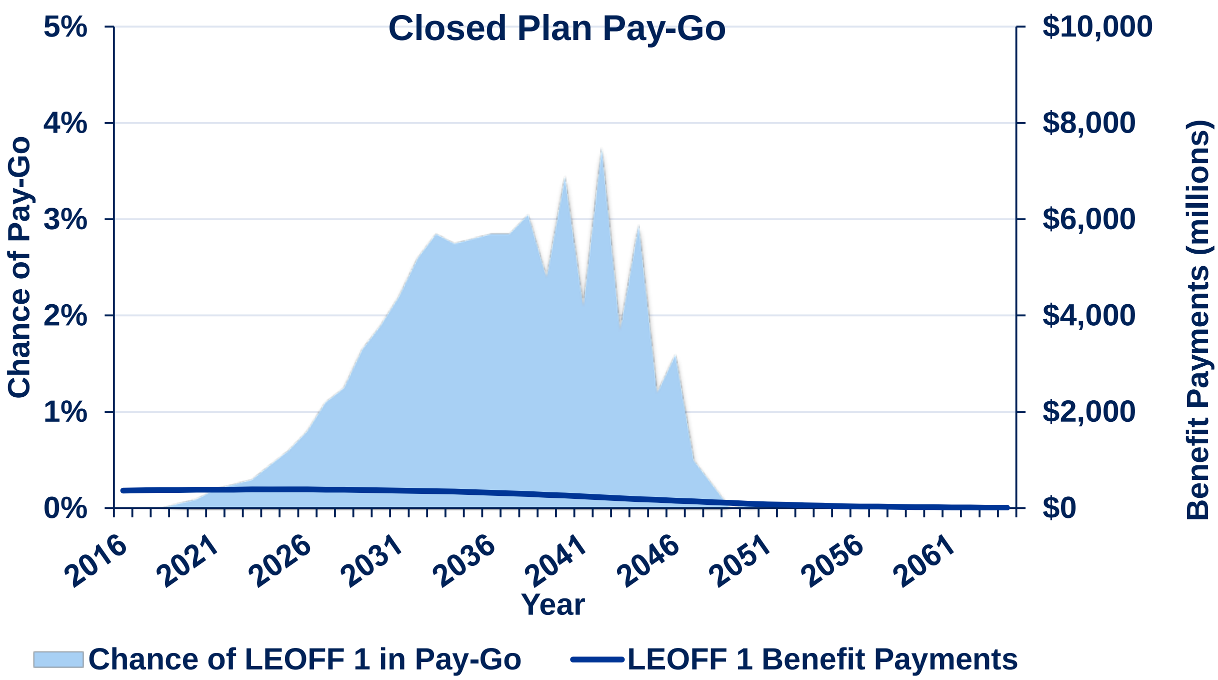
Lastly, we assumed no state contributions will be made for fiscal year 2018 through fiscal year 2021 (four-year state contribution rate holiday).

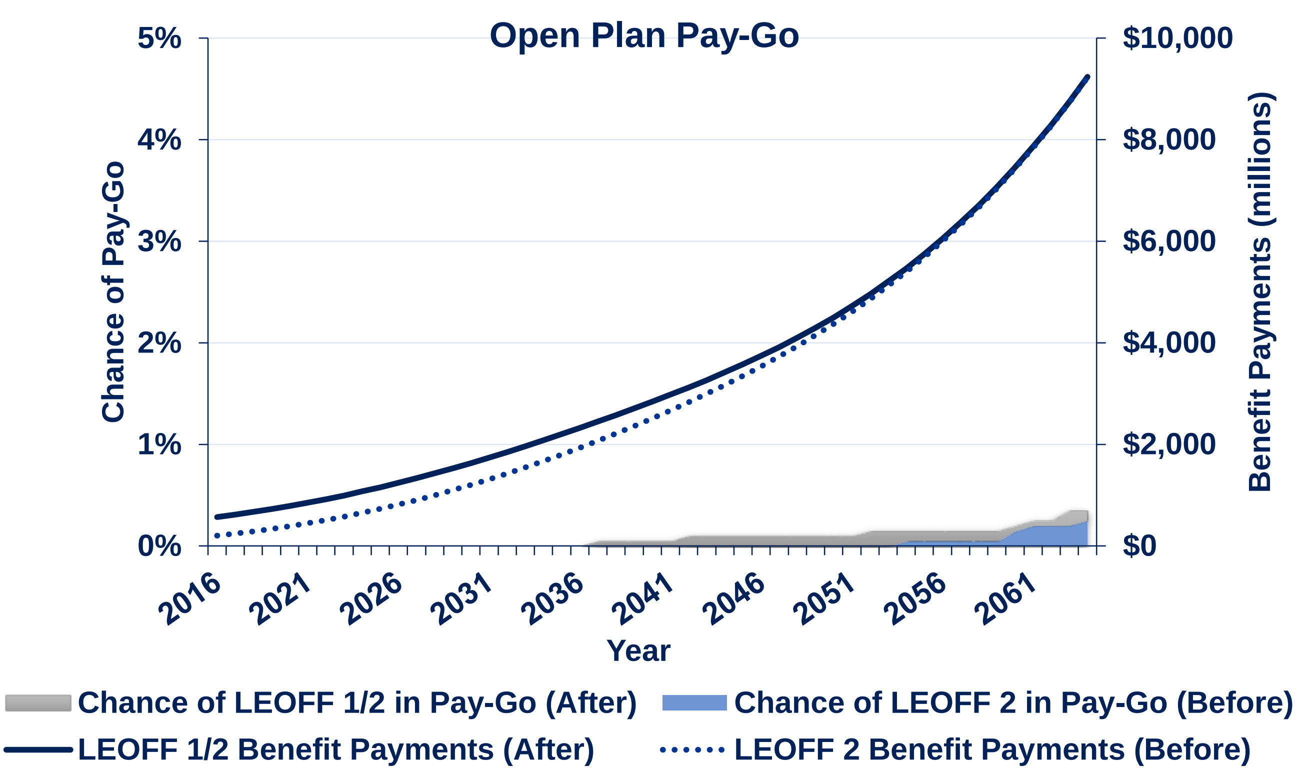
Analysis

Based on our stochastic analysis, the merger of LEOFF 1 and LEOFF 2 would remove the likelihood of pay-go occurrences prior to fiscal year 2037. Beginning in fiscal year 2037 we observe the likelihood of pay-go in the merged plan equal to or greater than our expectations for LEOFF 2 on its own. However, we do not expect the likelihood of pay-go in the merged plan to exceed 0.35 percent in any given year.

The two graphs on the next page display the likelihood of pay-go for LEOFF 1, LEOFF 2, and the merged plan (LEOFF 1/2). In addition to the likelihood of pay-go, we present the expected annual benefit payments to be paid from the plans.

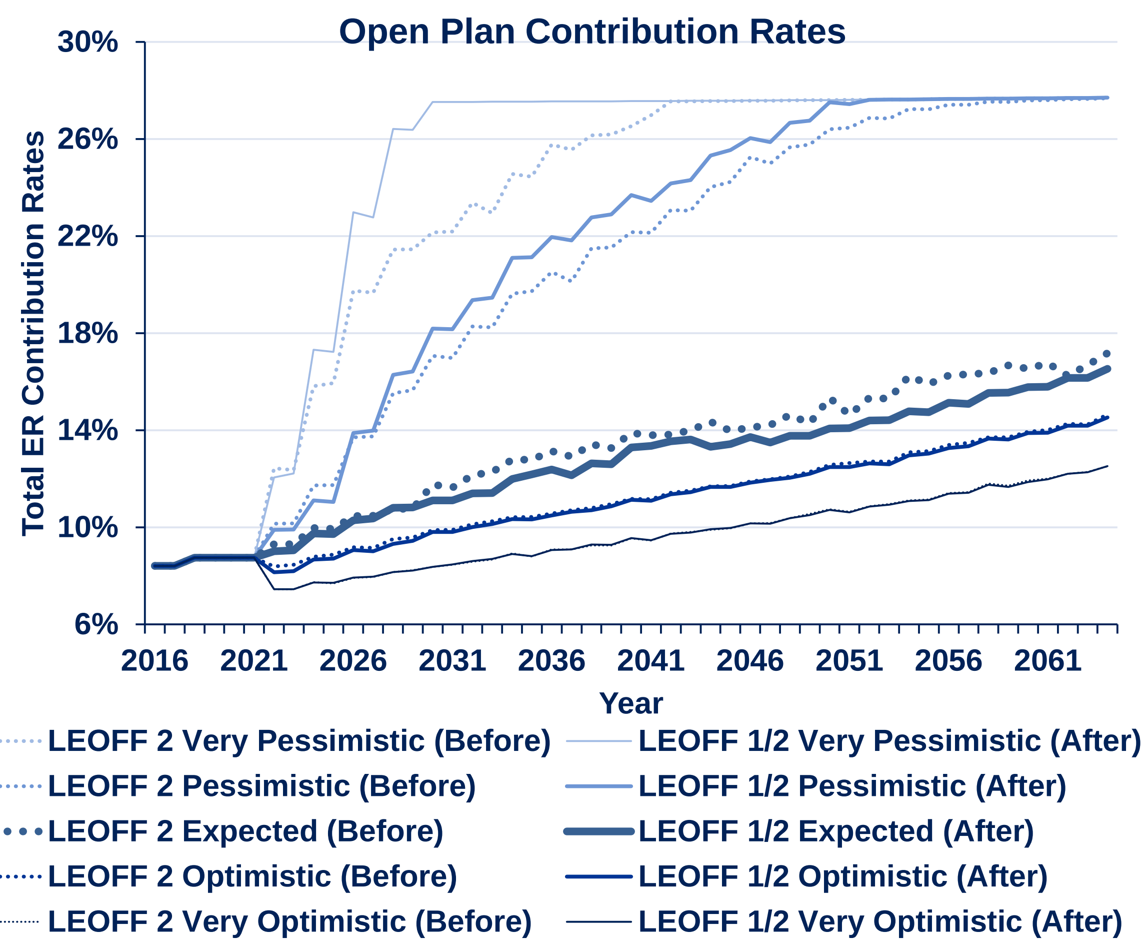
The results presented here could be different under a different set of assumptions. For instance, we would not expect pay-go to occur either for LEOFF 2 or the merged plans if we assumed "Current Law" projections. Under Current Law, we assume no future funding shortfalls or benefit improvements.


Closed Plan Pay-Go
5%
4%
3%
2%
1%
0%
Chance of Pay-Go
$10,000
$8,000
$6,000
$4,000
$2,000
$0
Benefit Payments (millions)
2016
2021
2026
2031
2036
2041
2046
2051
2056
2061
Year
Chance of LEOFF 1 in Pay-Go
LEOFF 1 Benefit Payments


Open Plan Pay-Go
5%
4%
3%
2%
1%
0%
Chance of Pay-Go
$10,000
$8,000
$6,000
$4,000
$2,000
$0
Benefit Payments (millions)
2016
2021
2026
2031
2036
2041
2046
2051
2056
2061
Year
Chance of LEOFF 1/2 in Pay-Go (After)
Chance of LEOFF 2 in Pay-Go (Before)
LEOFF 1/2 Benefit Payments (After)
LEOFF 2 Benefit Payments (Before)

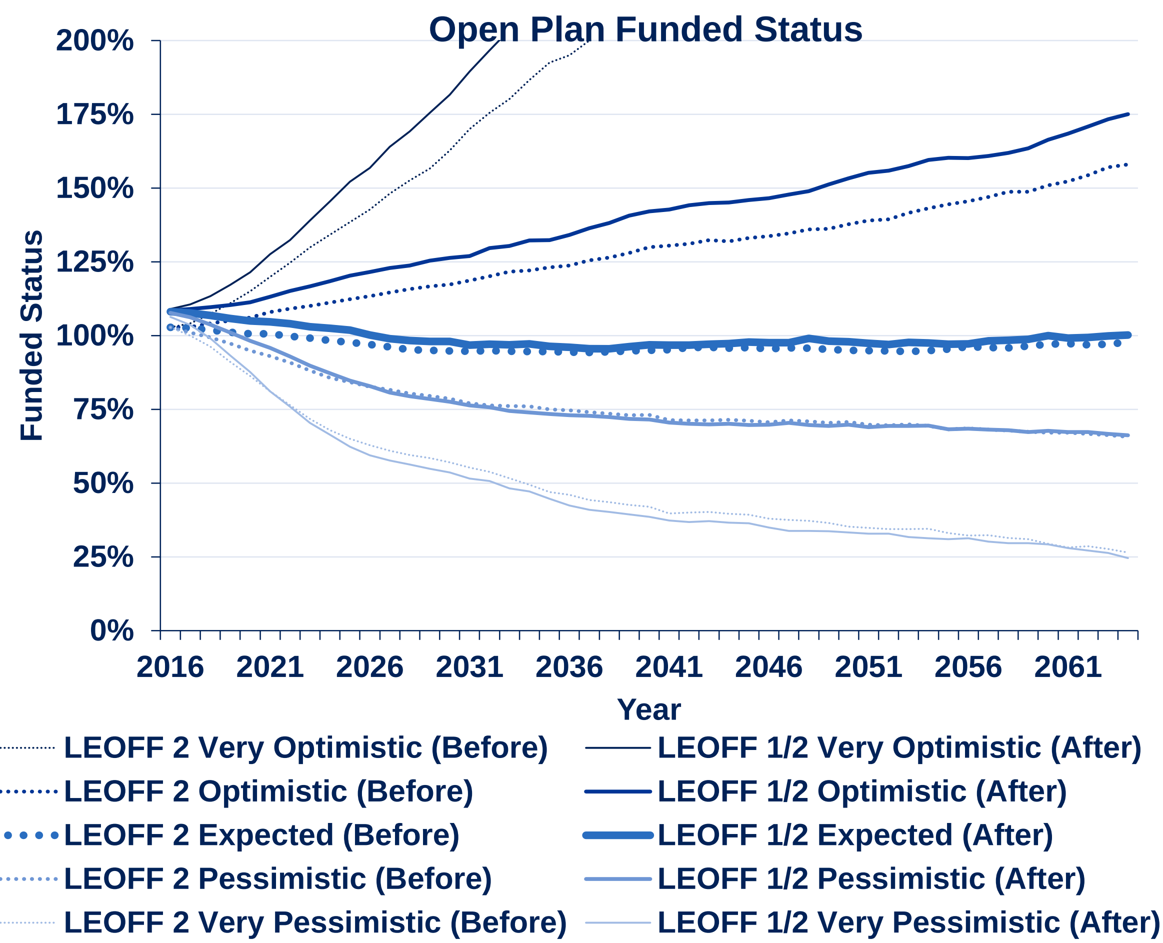
The graph below displays the projected contribution rates under varying percentiles including very optimistic (5th percentile), optimistic (25th percentile), expected (50th percentile), pessimistic (75th percentile), and very pessimistic (95th percentile). Please note that we expect contribution rates to increase under all scenarios as a result of the benefit improvement assumption used in our Past Practices stochastic analysis.

- Optimistic Scenarios: The contribution rates are similar between LEOFF 2 and the merged plan because they are at (or near) the rate floor under strong economic environments. The rate floor is calculated under the Entry Age Normal Cost method which is not impacted by LEOFF 1 assets added under the merger.
- Expected Scenario: The contribution rates improve (decrease) under the merged plan as a result of the addition of LEOFF 1 surplus assets.
- Pessimistic Scenarios: The contribution rates worsen (increase) under the merged plan when economic environments are poor due to the larger combined LEOFF 1 and LEOFF 2 liabilities impacted by poor conditions. The contribution rates ultimately hit the assumed system maximum rate under both pessimistic scenarios.



The graph below displays the projected funded status under varying percentiles including very pessimistic (5th percentile), pessimistic (25th percentile), expected (50th percentile), optimistic (75th percentile), and very optimistic (95th percentile).

- ❖ Optimistic Scenarios: Since the merged plan starts with additional surplus assets, the projected funded status grows larger in the merged plan than in LEOFF 2 under strong economic environments.
- ❖ Expected Scenario: The inclusion of LEOFF 1 surplus assets provide the merged plan with a higher funded status than LEOFF 2. Both LEOFF 2 and the merged plan are projected to fall below 100% funded status as a result of assumed future benefit improvements.
- ❖ Pessimistic Scenarios: Contribution rates reach the assumed system maximum faster under the merged plan so funding shortfalls occur more and the merged plan has a lower funded status than LEOFF 2.



We also considered the impact of the merged LEOFF plans under two other sets of assumptions and methods.

Updated 2011 Merger Study

The underlying assumptions and funding policy are consistent with our LEOFF 1/LEOFF 2 Merger scenario; however, we assumed an 80 percent Entry Age Normal Cost rate floor and contributions would be collected over LEOFF 1 and LEOFF 2 payroll. Additionally, we assumed no state contribution rate holiday.

Plan Merger under L2 Funding Policy without State Holiday

The underlying assumptions and funding policy are consistent with our LEOFF 1/LEOFF 2 Merger scenario; however, we assumed no state contribution rate holiday.

We did not observe a significant change in the chance of pay-go under either scenario from our LEOFF 1/LEOFF 2 Merger analysis. At most, we observed a 0.05 percent change in annual pay-go likelihood.

APPENDIX F – EXPECTED BENEFIT PAYMENTS

The projected annual benefit payments are summarized in the table below.

Fully Projected Benefit Payments											
(Dollars in Millions)					LEOFF - Plan 1						
Year	Future Value	Present Value	Year	Future Value	Present Value	Year	Future Value	Present Value	Year	Future Value	Present Value
2015	$362	$349	2040	$227	$34	2065	$4	$0	2090	$0	$0
2016	367	329	2041	210	29	2066	4	0	2091	0	0
2017	372	309	2042	192	25	2067	3	0	2092	0	0
2018	376	290	2043	175	21	2068	2	0	2093	0	0
2019	379	271	2044	158	18	2069	2	0	2094	0	0
2020	381	253	2045	141	15	2070	2	0	2095	0	0
2021	382	236	2046	126	12	2071	1	0	2096	0	0
2022	382	219	2047	111	10	2072	1	0	2097	0	0
2023	382	203	2048	97	8	2073	1	0	2098	0	0
2024	381	188	2049	84	6	2074	1	0	2099	0	0
2025	379	174	2050	72	5	2075	1	0	2100	0	0
2026	376	160	2051	62	4	2076	1	0	2101	0	0
2027	372	147	2052	52	3	2077	1	0	2102	0	0
2028	367	135	2053	44	3	2078	0	0	2103	0	0
2029	361	123	2054	37	2	2079	0	0	2104	0	0
2030	354	112	2055	31	2	2080	0	0	2105	0	0
2031	346	102	2056	26	1	2081	0	0	2106	0	0
2032	337	92	2057	21	1	2082	0	0	2107	0	0
2033	327	83	2058	17	1	2083	0	0	2108	0	0
2034	316	74	2059	14	1	2084	0	0	2109	0	0
2035	303	66	2060	12	0	2085	0	0	2110	0	0
2036	290	59	2061	10	0	2086	0	0	2111	0	0
2037	275	52	2062	8	0	2087	0	0	2112	0	0
2038	260	45	2063	7	0	2088	0	0	2113	0	0
2039	$244	$40	2064	$5	$0	2089	$0	$0	2114	$0	$0
									Total	**$10,633**	**$4,313**

Please see **Appendix A** for assumptions used to develop this table.