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CC:PA:LPD:PR (REG-157714-06)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Dear Sir or Madam:

We write on behalf of a group of governmental state-level tax-qualified defined benefit plans in response to the request for comments on the Advance Notice of Proposed Rulemaking ("Notice") which discusses the rules for determining whether a plan is a governmental plan within the meaning of section 414(d) of the Internal Revenue Code of 1986 (the "Code"). 76 Fed. Reg. 69175 (Nov. 8, 2011). We appreciate the effort to solicit input from the governmental plans community through the issuance of Notice, and make the recommendations contained in this letter for your consideration.

I. Overview of Comments

We have separated our comments into two parts –issues relating to certain groups of employees and issues relating to general implementation – as follows:

- *Comments Specific to Certain Groups of Employees*
    - *Privatized Employers*. Over the past several decades, a number of governmental employers have ceased to be governmental entities through privatization activities. In some of these situations, privatized employees have remained as active participants in a state-level governmental plan. The Notice helpfully sets forth some guidance on the transition of entities from governmental to non-governmental status, and vice versa. However, in that many privatizations have previously occurred based on a contractual basis or other agreement that some or all of the privatized employees will continue to be eligible to participate in the state-level governmental plan (*e.g.*, on reliance on there only being a de minimis number of such private sector employees, as noted below), the Code section 414(d) regulations should recognize these prior privatizations (*i.e.*, privatizations commenced prior to a certain date) as not requiring the removal of privatized

employees from a governmental plan and not adversely affecting a plan's governmental plan status.

- *De Minimis Rule*. The Notice does not currently provide a de minimis rule permitting the participation of a small number of non-governmental employees in a governmental plan, with the exception of certain employees of a labor union or a plan under Code section 413(b)(8). In that many state-level defined benefit plans can have hundreds or thousands of participating employers, it is very difficult and costly from a resource perspective for a state-level defined benefit plan to ensure 100% compliance with the rigid rule reflected in the Notice. Moreover, due to the facts and circumstances nature of the definition of agency or instrumentality of a state or political subdivision of a state, it may not be possible to know with certainty if the test is met by every single employer or employee absent obtaining a private letter ruling or opinion with respect to those as to which there may be some question – a process which can take years, if it can be done at all. In the past, a reasonable belief that there was a "de minimis" rule served as something of a safety valve that – even if the inclusion of a particular set of privatized employees or an association of governmental entities which the system reasonably believed to be permitted to participate in the plan might later be found not to meet the governmental plan criteria – the inclusion would still be permissible due to their being de minimis in number. Accordingly, a general de minimis rule, such as allowing up to 3% of total plan participants to be non-governmental without affecting a plan's Code section 414(d) status, is necessary in order to not overly burden systems that will make good-faith efforts to comply, as well as to not burden the Service, Department of Labor and Pension Benefit Guaranty Corporation with a large number of governmental plan ruling or opinion requests concerning particular entities.

- *Agency or Instrumentality of a State or Political Subdivision*. Many entities participating in governmental plans have made a determination that they fit the definition of an "agency or instrumentality" of a State or political subdivision under prior Service guidance under a number of Code sections, especially in lieu of detailed Code section 414(d) guidance. In that these entities have reasonably relied on these determinations, the Code section 414(d) regulations should recognize being classified as a governmental entity or instrumentality under Code section 115 or because of coverage under a FICA replacement plan described in Treasury Regulation section 31.3121(b)(7)-2 also results in the entity being eligible to participate in a Code section 414(d) governmental plan. To require these entities to conduct a reevaluation based on the factors listed in the Notice would require many to undertake another, potentially costly and burdensome, review of their status as a governmental plan. Further, this approach would

eliminate the need for additional ruling requests and ensure consistency in treatment across multiple Code sections.

- *Comments Relating to Implementation and Transition Issues*

  - *Grandfathering Relating to Stringent State and Local Law Protections and Other Difficulties in Making Plan Changes*. The Notice recognizes that changes to a state or local governmental retirement plan, particularly as to entities eligible to participate, generally require amendment of the state legislation governing the plan. In many states, however, state contractual or constitutional protections may serve to restrict a state's ability to amend its plan to bring it into compliance with any final Code section 414(d) regulations, and even in states where such protections are uncertain under the law, such changes will often be problematic for legislative or administrative reasons. Accordingly, the Code section 414(d) regulations should specifically recognize and provide specific grandfathering relief for the existing terms of state and local governmental plans because the legislative process will often not practically allow such changes or be able to override state contractual and constitutional requirements.

  - *Transition Rules*. Because the implementation, to the extent possible, of many of the changes reflected in the Notice may take several legislative sessions, significant transition rules should be included in the Code section 414(d) rules. These transition rules should include both delayed effective dates (*i.e.*, several plan years after final regulations are issued) and transition rules allowing ineligible groups to transition out of coverage on a going-forward only basis (*e.g.*, employees of a privatized employer hired after a specific post-final regulations date might be excluded from the governmental plan but employees already participating could remain in the plan).

  - *Reasonable and Good Faith Application of Rules with a Low-Cost and Simple Correction Program*. Along with the grandfathering and transition period requested above, a correction program should be available which would allow governmental plans that made a good faith effort, but failed to comply with the requirements of the final regulations, to make the required corrections for compliance at minimal or no cost. An analogy here would be the remedial correction period for governmental Code section 457(b) plans.

II. Detailed Comments

A. Certain Groups of Employees

1. Privatized Employers

The Notice currently generally provides that employees of a privatized employer may continue to keep their benefits under a plan if (1) a governmental entity continues to be the plan sponsor after the change in status of the privatized entity and (2) future benefits accrual credits under the plan are frozen. Advanced Proposed Regulation ("APR") § 1.414(d)-1(k)(2)(ii)(B).

Over the past several decades, a number of governmental entities have privatized portions of their activities. These privatization activities have taken a number of forms – ranging from the establishment of tax-exempt organizations, to the hiring of independent non-governmental entities, to the merging of certain governmental entities into non-governmental entities. This privatization process and practice can vary from state to state and entity to entity.

As part of the privatization process, agreements have regularly been reached between employees, governmental entities, and privatized employers providing that some or all privatized employees will continue to participate in a governmental plan. For example, employees in the governmental plan on the date of privatization may continue to participate in that plan. Or governmental employees on the date of privatization may continue to be employees of a governmental entity but be leased to the now-privatized employer. Under some agreements, private sector employers may be liable for a portion of the underfunding of the prior governmental defined benefit plan and may have an obligation to make contributions. Depending on the jurisdiction, these agreements can have the force of law or even protection under specific state constitutional provisions or contract law requirements. Were a governmental or privatized entity to attempt to modify these terms, they could be exposed to potentially significant litigation costs and legal exposure.

Accordingly, while we appreciate the Notice's efforts to provide flexibility in providing benefits in connection with privatized employers, we suggest that the following additional rules also be included:

- *Employers Privatized Prior to the Issuance of Final Code Section 414(d) Regulations*. Governmental entities have been operating without Code section 414(d) guidance for a long period of time.[1] As noted in the Notice, between agency interpretations, various Code provisions, and court decisions, there have been many interpretations of what constitutes a "governmental plan." To the extent than an entity has been privatized prior to the effective date of final Code section 414(d) regulations, it should not be forced to attempt to breach the terms of a prior agreement, made in good faith, providing for coverage in a governmental plan for privatized employees. Further, the inclusion of these employees in the governmental plan should not affect its governmental plan status under Code section 414(d). Such a prospective-only approach would be consistent with the Service's position in many other situations,

[1] Revenue Ruling 89-49 provides very limited guidance and is silent on the issue of privatization.

such as grandfathered Code section 415(b) limits for both governmental and private plans, the grandfathered Code section 401(a)(17) limits for governmental plans, and the Service's position on pick-ups in Revenue Ruling 2006-43. In addition, such an approach would provide for efficient tax administration because the group of participants covered by this relief would be a closed group that would diminish over time. Lastly, under this approach, these employees could be deemed to be governmental employees, thus avoiding the significant complexities and potentially impractical requirement that a governmental plan apply ERISA requirements to a small subset of its population.

- *Employers Privatized On and After the Effective Date of the Final Code Section 414(d) Regulations*. Employers privatized on and after the effective date of the final Code section 414(d) regulations would be subject to the final Code section 414(d) regulations. Assuming a delayed effective date, as suggested below, is included in the final Code section 414(d) regulations, governmental entities going through the privatization process would have sufficient advance notice to ensure that new privatization agreements comply with the new requirements.

- *Continued Contributions by Privatized Employers*. In any event, we believe that the final regulations should permit continued contributions by privatized employers to governmental defined benefit plans to the extent necessary to fund benefits which may be provided by such plans under the regulations, whether as frozen plans or pursuant to other transition relief.

2. Plans and Employers who have Received Prior Private Letter Rulings or Opinions.

There are also numerous private letter rulings and advisory opinions applying Code section 414(d) and its counterparts in ERISA which, while they cannot be relied upon other than by the entity to which they were issued, in the absence of actual guidance, were generally considered indicative of the Service's, Department of Labor's and Pension Benefit Guaranty Corporation's views on the definition. Those employers whose participation in a governmental plan has already been approved in a ruling or opinion issued to that employer or that governmental plan should be able to continue to rely on their ruling or opinion. In addition, as noted above, such participation now may be subject to state constitutional or contract law protection. We note that this approach also is not without precedent. *See* Treasury Regulation § 1.403(b)-8(c)(3) (addressing certain self-insured annuity plans).

3. De Minimis Rule

The Notice does not currently contain a de minimis rule permitting a small number of non-governmental employees to participate in a governmental plan without adversely affecting

its status under Code section 414(d). *See* APR § 1.414(d)-1(k)(4), Example 5 (participation of candy and soft drink vendor's 10 employees in a plan results in loss of governmental plan status). However, for the reasons set forth below, we believe a de minimis rule with a bright line standard, such as up to 3% of plan participants being non-governmental employees, should be adopted instead.[2]

State-level or state-wide governmental plans, while often having sophisticated staff and experienced in-house counsel, often face the following limitations in validating the governmental status of their participating employers:

- *Statutory Authority*. State-level governmental plans may be statutorily bound to include any entity described as an eligible entity under state law. The plans themselves do not have the ability to unilaterally change these requirements, thus leading to significant burdens, even if the plans are permitted by state law to and do make good faith efforts to do so.

- *Audit Authority*. Although state-level governmental plans are compliance-focused entities, their ability to audit and evaluate their participating employers is often limited to certain operational duties, such as the remittance of contributions.

- *Resource Limitations*. Many state-level plans have hundreds of participating employers. Even if the plans were to have the authority to review every participating entity for compliance with Code section 414(d)'s requirements, few, if any, would have the resources to comprehensively audit their employer population and, below that, the employee population as well. To require such an action would further detract from the resources available in these plans to pay for plan benefits.

- *Inherent Uncertainty*. As the notice of proposed rulemaking indicates, whether a particular entity is eligible to participate in a governmental plan is inherently a facts and circumstances determination. Equally, whether a particular individual performing some services for a government-related entity (for example, an association of counties, an economic development corporation, a public utility, a public health board, or a local museum) who is treated as a eligible to participate in a larger governmental plan, either by virtue of the nature of the entity or being treated as an employee of a participating governmental entity on whose payroll they appear,

[2] Privatized employees would remain subject to the special "deemed governmental employee" status described above.

> is actually so eligible can be a difficult facts and circumstances determination.[3] Without a de minimis rule, the task of ensuring that there are absolutely no nongovernmental employees will encourage systems to file for rulings or determination on any entities and relationships as to which there may be a question. In addition to being expensive for the systems, this also seems likely to burden the Service, Department of Labor and Pension Benefit Guaranty Corporation with a large number of governmental plan ruling and opinion requests.

Further, as noted in the Notice, the Department of Labor, has previously provided rulings concluding that a plan remains a governmental plan under ERISA section 3(32) even with a de minimis number of non-public employees participating. *See*, *e.g.*, DOL Adv. Ops. 95-14A, 95-15A, 95-27A, 2000-1A, 2000-04A, 2005-7A, 2005-17A and 2005-21A. Although the Service is not bound by these rulings, to adopt a position inconsistent with these related positions of other agencies will only increase the regulatory burden on governmental plans that often rely by analogy on other governmental plans' agency determinations.

Accordingly, we suggest that the Service adopt a bright line standard, potentially up to as many as 3% of participants, for a de minimis amount of non-governmental employees may participate in a plan without adversely affecting a plan's governmental status under Code section 414(d).

4. Agency or Instrumentality of a State or Political Subdivision

The Service and Department of Labor have historically followed certain factors in determining whether an entity is an agency or instrumentality of a state or political subdivision. *See* Rev. Rul. 57-128; Rev. Rul. 89-49; and DOL Adv. Op. 2003-18A. The factors considered in this prior guidance are included in the list of factors in the proposed regulations. However, the proposed regulations contain further factors that could be more restrictive than the historical guidance.

Although the new factors under the proposed regulations contain more specific requirements for being an agency or instrumentality of a state or political subdivision of a state, they do not appear to contradict the factors which were previously looked to in determining such status. Further, many governmental entities, in the absence of definitive guidance, have relied on their status under other Code provisions, such as being a political subdivision under Code section 115, or under other legal requirements, such as whether they are treated as exempt from participating in the FICA portion of Social Security FICA coverage. Requiring entities to undertake a repeat review of their status as an agency or instrumentality of a state or political

[3] We note that the same facts and circumstances issues was often involved in governmental plan participants providing services to related unions, for which the Notice provides a de minimis exception.

subdivision is a burden that may require entities to shift resources that could otherwise be used more effectively elsewhere or that simply may not be available under the tight budget constraints so prevalent today.

Therefore, we recommend that entities that were previously determined by a state in good faith, or determined by the Service, Department of Labor, or Pension Benefit Guaranty Corporation, to be an agency or instrumentality of a state or political subdivision of a state for these similar purposes, be permitted to continue be treated as a governmental employer. Entities not determined in good faith to be agencies or instrumentalities of a state or political subdivision as of the effective date of the final Code section 414(d) regulations could be required to meet the more specific requirements outlined in the Notice.

B. Comments Relating to Implementation and Transition Issues

1. Grandfathering Relating to Stringent State and Local Law Protections and Other Difficulties in Making Plan Changes

The Notice recognizes that changes to a state or local governmental retirement plan, particularly those governing eligibility, generally require the amendment of the state legislation governing the plan. In some states, state-level plans have been historically designed with flexibility allowing significant changes in the plans' eligibility and other plan provisions such that it would likely be possible to amend a plan to bring it into compliance with any final Code section 414(d) regulations. However, in other states, state contractual or constitutional protections may serve to restrict a state's ability to amend its plan to bring it into compliance with any final Code section 414(d) regulations, even if the Service were to adopt a significantly delayed effective date. In other states, such contractual or constitutional protections might be unclear or not exist, but in all cases there are significant burdens to making any changes, whether legislative, administrative, or otherwise. Where a governmental plan currently includes an employer that may no longer satisfy the requirements for participation if the standards proposed in the Notice are adopted in final Code section 414(d) regulations, a state may be restricted from implementing that change for existing participants without the threat of significant lawsuits and related costs and burdens. This potential for litigation is not theoretical as the recent litigation in a number of states regarding plan design changes has proven to be both a costly and burdensome experience for many state-level systems. Thus, the Code section 414(d) regulations should specifically recognize and provide for specific grandfathering for relief for the current terms of state and local governmental plans, because the legal ability of the legislature to make changes may not be clear, and the legislative process may not be reasonably able to make such changes or be able to override state contractual and constitutional requirements.

2. Transition Rules

Because the implementation, to the extent possible, of many of the changes reflected in the Notice may take several legislative sessions, significant transition rules should be included in the Code section 414(d) rules. These transition rules should both include delayed effective dates (*i.e.*, several years after final regulations are issued) in recognition of the complexities of the governmental plan legislative process. Specifically, in the privatization context, we suggest the potential approaches be made available on a going-forward basis after the application of the special privatization rules described above:

- *Freezing of Accruals*. The governmental plan could freeze accruals as of the date of privatization, but allow the frozen accruals to stay in the plan, treated as a governmental plan. Any future accruals would accrue under an ERISA plan of the private employer, and no new employees would be permitted to join the plan. There is analogous precedent for this approach under the Code section 457 rules. *See* Treasury Regulations § 1.457-10(a)(2).

- *Treatment of Retirees***.** Retirees in pay status with a governmental plan should be permitted to continue to receive their benefits from the plan and not be adversely affected because their former employer is privatized or subsequent to retirement determined not to have been eligible for a governmental plan.

- *Termination.* The portion of the governmental plan relating to active employees of the privatized employer could be terminated, with immediate vesting for participant accounts, and such amounts could be distributed to employees (in lump sums or annuities, as in a private entity defined benefit plan termination, with employees only getting to choose the form of distribution, and not whether to take a distribution). If this is completed as soon as practicable after the privatization, the plan should not cease to be a governmental plan prior to termination.

3. Reasonable and Good Faith Application of Rules with a Low-Cost and Simple Correction Program

As highlighted by our comments above, the Code section 414(d) regulations could present challenges to entities attempting (1) to determine whether they are a governmental plan, and (2) to ensure the plan meets the requirements of a governmental plan. Many of these employers have been operating under one set of governmental plan rules for an extended period of time. Even those employers who make a reasonable and good faith effort to comply with all applicable requirements have the potential to inadvertently violate some of the rules. Accordingly, we recommend that, in conjunction with final Code section 414(d) regulations, the Service establish a correction program under which states and employers could, via a no or low

Employee Plans Compliance Resolution System), bring their governmental plans into compliance with the final Code section 414(d) regulations. Such an approach could borrow from the "flush language" following Code section 457(b) that allows, without penalty, significant retroactive correction for governmental Code section 457(b) plans. See Treasury Regulation §1.457-9(a).

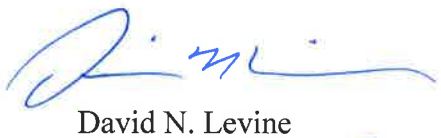
4. Relief While Private Letter Ruling or Similar Guidance is Pending.

As noted above, the Notice recognizes that the determination of whether an entity is eligible to participate in a governmental plan is a facts and circumstances determination, making a correct determination of critical importance. This use of a facts and circumstances standard is likely to lead to an increase in the submission of private letter rulings and opinions on the application of the law to specific sets of facts for particular entities. We request that the final Code section 414(d) regulations provide relief during any period that an employer is seeking a private letter ruling, DOL advisory opinion, or a judicial determination of its governmental status, and provide a reasonable transition period to apply the results once such a determination is handed down.

* * *

We appreciate the Service's effort to solicit comments on the issues surrounding guidance under Code section 414(d). We would be happy to discuss these proposals further, if desired, and can be reached at (202) 857-0620.

Very truly yours,



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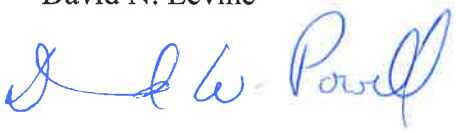

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