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# New IRS Regulation Project Tackles Definition of 'Governmental Plan'

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The Internal Revenue Service in November officially kicked off its initiative to fill a long-standing gap in the vast regulatory scheme that the Employee Retirement Income Security Act has produced—the definition of ''governmental plan.''[1]

Governmental pension plans are exempt from the reporting, participation, vesting, and fiduciary standards of ERISA, and similarly governmental welfare plans are generally exempt from the ERISA rules that privately sponsored welfare plans must satisfy. Thus, a plan's status as ''governmental'' is critically important to defining the obligations of the plan sponsor, and the rights of participants and beneficiaries.

In broad terms, the ERISA exemption for such plans primarily reflects congressional policy that the federal government should not dictate the rules for the benefit programs of state and local governments.

The recent advance notice of proposed rulemaking (REG-157714-06[1]) has been in the works for at least five years. Although the statutory provisions have existed without regulations for 37 years, concern about the growing number of requests from plan sponsors whose relationships to states or political subdivisions are increasingly remote—and plan sponsors who raise novel issues in arguing that their plans are governmental plans—led to this push for more definitive regulatory criteria.

**Although the statutory provisions have existed without regulations for 37 years, the growing number of requests from plan sponsors whose relationships to states or political subdivisions are increasingly remote has raised concerns.**

By issuing an advance notice, IRS is demonstrating that it has heard the concerns expressed by the governmental plan community that any new guidance provide ample lead time for comments and transition before it is finalized. As a result, governmental entities have time to review, evaluate, and comment on the proposed guidance—and the governmental plans community will have another bite at the apple when the Section 414(d) governmental plan regulations are formally proposed.

Though the advance notice was issued by IRS, the preamble states that the Department of Labor and Pension Benefit Guaranty Corporation were consulted, and comments on the advance notice will be shared with the other agencies. We understand that the close coordination by the agencies was one of the reasons that this advance notice has taken several years to be issued.

Below, we discuss several key features of the advance notice.

[1] Section 414(d) of the Internal Revenue Code of 1986, as amended, provides ''the term 'governmental plan' means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.'' Sections 3(32) and 4021(b) of ERISA contain substantially identical definitions.

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[1] 76 *Fed. Reg.* 69172 (Nov. 8, 2011).

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## Attempt to Harmonize New Guidance With Existing Authority

IRS's approach in the advance notice is generally based upon existing case law and assorted agency guidance in the area, which the notice discusses, as opposed to creating a new line of analysis. In that vein, the proposed regulations contemplate a facts and circumstances analysis that would draw from factors historically used in governmental plan determinations.

We would assume that this reliance on historical precedent implies that IRS does not intend to force governmental plans maintained by ''core'' governmental entities, such as states, counties, cities, and towns, to conduct a complex re-evaluation of their governmental plan status.

## Definition of 'Agency or Instrumentality'

The most difficult part of the definition of governmental plan is probably what constitutes an ''agency or instrumentality'' of a state or political subdivision of a state. For example, this issue has commonly been a challenge when a plan is designed to cover employers one or more steps removed from a state, county, city, or town, such as a water district or sanitation authority.

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Here, the proposed regulation would set out a number of major and minor factors, as briefly described below, for a facts and circumstances determination, accompanied by examples. Notably, IRS has expressly asked for comments on whether these factors should be modified, combined, or expanded.

The factors currently proposed as ''major'' factors are as follows:

■ **Control of Governing Board or Body.** The entity's governing board or body is controlled by a state or political subdivision of a state.

■ **Membership of Governing Board or Body.** The members of the governing board or body are publicly nominated and elected.

■ **State or Political Subdivision Responsibility for Debts and Liabilities.** A state (or political subdivision of the state) has fiscal responsibility for the general debts and other liabilities of the entity (including funding responsibility for the employee benefits under the entity's plans).

■ **Treatment of Employees.** The entity's employees are treated in the same manner as employees of the state (or a political subdivision of the state) for purposes other than providing employee benefits (e.g., the entity's employees are granted civil service protection).

■ **Delegation of Sovereign Powers.** In the case of an entity that is not a political subdivision, the entity is delegated, pursuant to a statute of a state or political subdivision, the authority to exercise sovereign powers of the state or political subdivision (e.g., the power of taxation, the power of eminent domain, and the police power).

The factors currently proposed as ''minor'' factors are as follows:

■ **Control of Operations.** The entity's operations are controlled by a state (or political subdivision of the state).

■ **Source of Funding.** The entity is directly funded through tax revenues or other public sources, but not including services provided by contracts or grants.

■ **Enabling Legislation.** The entity is created by a state government or political subdivision of a state pursuant to a specific enabling statute that prescribes the purposes, powers, and manners in which the entity is to be established and operated. Notably, the advance notice does not consider a nonprofit corporation that incorporated under a state's corporate laws as satisfying this factor.

■ **Federal Income Taxation of the Entity.** The entity is treated as a governmental entity for federal employment tax or income tax purposes (e.g., the entity has authority to issue tax-exempt bonds under Section 103(a)) or under other federal laws.

■ **Applicability of State Laws for State Governmental Entities.** The entity is determined to be an agency or instrumentality of a state (or political subdivision thereof) for purposes of state laws (e.g., the entity is subject to open meetings laws or the requirement to maintain public records that apply only to governmental entities, or the state attorney general represents the entity in court under a state statute that only permits representation of state entities).

■ **Judicial Determination of Agency or Instrumentality Status.** The entity is determined to be an agency or instrumentality of a state (or political subdivision of the state) by a state or federal court.

■ **Ownership Interest.** A state (or political subdivision of the state) has the ownership interest in the entity and no private interests are involved.

■ **Governmental Purpose.** The entity serves a governmental purpose.

Although satisfaction of a particular factor would not be conclusive, the preamble to the advance notice particularly seems to emphasize the element of control of the governing body of the entity by the state or political subdivision, such as control of a majority of the board of directors. Interestingly, the preamble indicates that where there are a number of tiers of intervening corporations between the entity and the state, and in cases in which control is shared among so many governing entities that none can be said to be responsible, there may be a lack of control by the state or political subdivision. Any ownership interest by a private entity would also indicate that the entity is not an agency or instrumentality of a state or political subdivision.

The preamble also discusses and requests comments on a potential safe harbor standard where, if certain

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factors are met, an entity would be treated as an agency or instrumentality of a state or political subdivision. Multiple safe harbors would help to reduce the burdensome and costly process of evaluating each entity's facts and circumstances—and for requesting DOL advisory opinions and IRS private letter rulings (which may not even be available until after final regulations are issued).

## De Minimis Participation By Nongovernmental Employees

For classification as a governmental plan, the proposed regulations generally would not permit participation by any nongovernmental employees (i.e., they do not propose to adopt the ''de minimis'' rule in certain Department of Labor advisory opinions), except for employee labor union employees described in Section 413(b)(8) (e.g., a teacher who has shifted from active teaching to working for the teachers' union) and plan employees (i.e., system staff).

While the positive guidance with respect to these two groups is very helpful, other arrangements—such as employees who were ''privatized'' pursuant to contractual arrangements providing for continued participation in a governmental plan—might be suggested to IRS in comments. Specifically, the preamble to the advance notice asks for comments on cases where a small number of private employees participate in what would otherwise be a governmental plan. Some considerations suggested in the preamble include:

■ **Privatized Employees.** Whether the private employees were previously employees of the sponsoring governmental entity (e.g., a mental health or hospital system where a private employer has taken over a former governmental institution) and whether the private employees were previously participants in the governmental plan.

■ **Limitation on Number.** Whether the number or percentage of such former employees who participate in the governmental plan is de minimis (and, if so, what constitutes a de minimis number or percentage). This item has been the subject of conflicting authority from IRS, DOL, and PBGC.

■ **Existing Plan Rules.** Whether the coverage is pursuant to pre-existing plan provisions. Some existing privatization agreements require the continuation of coverage and some plans already provide such coverage.

■ **Function of the Private Employer.** Whether the private employer performs a governmental function and has been officially designated as a state entity for plan participation purposes.

■ **Types of Plans That Can Be Sponsored by Private Employer.** Whether the employer is ineligible to sponsor the particular type of governmental plan (e.g., whether a private employer is a tax-exempt organization under Section 501(c)(3) that can sponsor a Section 403(b) plan), and whether the private employer sponsors or has sponsored plans that cannot be sponsored by a state governmental entity (e.g., a cash or deferred arrangement under Section 401(k) or an unfunded Section 457(b) plan of a tax-exempt entity).

If a de minimis rule is adopted, the preamble notes that related issues could arise. For example, issues with respect to funding (i.e., applicability of the ERISA funding rules to part of a plan), multiple employer governmental plans (i.e., compliance with the multiple employer plan rules and the extent to which ''unaffiliated'' entities can participate in the governmental plan), and Section 414(h) governmental pickup plans.

Even if the final regulations do adopt a de minimis rule, it seems likely that a transition period will be provided for those plans unable to utilize any de minimis rule provided. The advance notice specifically requests comments on transitional relief that should be provided.

## 'Established and Maintained'

The proposed regulations would also address the critical issue of what it means for a plan to be ''established and maintained'' by a governmental entity, and what happens when a public entity becomes a private entity and vice versa.

The positions proposed in the advance notice are that a privatized employer's plan becomes a private plan at the time of the change and, where a private employer becomes a public employer, the plan becomes a public plan at that time. This approach would generally seem to follow what has been widely perceived to be the current rule, which is that a plan is either governmental or private depending on the facts at a given time, and can conceivably switch back and forth as facts change.

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Unfortunately, the preamble indicates that a public plan that becomes a private one may have immediate compliance concerns, and also contemplates that, after a privatization, sponsorship of a public plan may remain behind with another governmental employer under a ''soft freeze'' (i.e., currently covered employees can continue to receive service for vesting and eligibility for early retirement subsidies, and receive final pay adjustments, but apparently cannot earn further benefits attributable to future service with the private entity under the benefit formula) and remain a governmental plan, which is similar to a rule under the Section 457 regulations.

Recognizing the complexities raised by these proposed rules, the advance notice requests comments specifically addressing the following:

■ **Transition Relief.** What type of transition relief should be provided to governmental plans that cover privatized employees and that cover employees of a vendor to a governmental entity.

■ **Corrective Relief.** What relief should be made available when an entity, although it believed it was a governmental entity maintaining a governmental plan, is later determined to be a private entity.

## 'Integral Part'

The proposed regulations would not address what it means to be an ''integral part'' of a state or political subdivision. The preamble indicates this will be the subject of a separate guidance project that may include stricter criteria than this proposed regulation. Because the concept of ''integral part''—which generally has its source under the Section 115 rules—plays a significant role in many governmental plan investment and health care plan designs, significant attention should be given to any potential developments in this area.

## Federal Credit Union

The proposed regulations would address whether a federal credit union can have a tax-exempt employer Section 457(b) plan. The proposed answer is ''yes,'' and that federal credit unions will be nongovernmental tax-exempt organizations within the meaning of Section 457(e)(1)(B).

## Other Plan Types and Legal Requirements

Although the proposed regulations would be applicable only for purposes of Section 414(d) (i.e., Section 401(a) defined benefit and defined contribution plans), the advance notice indicates it is expected that the principles set forth will apply for parallel terms in Section 403(b) and 457 plans.

In addition, the advance notice specifically recognizes that any guidance under Section 414(d) will affect a number of other tax code requirements (e.g., the Section 503 prohibited transaction rules, the Section 4975 prohibited transaction rules, Section 4980B Consolidated Omnibus Budget Reconciliation Act requirements, and the exclusion of certain ''governmental plans'' from certain health care requirements under the Patient Protection and Affordable Care Act of 2010 (Pub. L. No. 111-148)), though it does not expressly mention whether it will apply for purposes of Section 218 agreements with the Social Security Administration for Federal Insurance Contributions Act replacement plans.

## Indian Tribal Governments

Concurrent with the issuance of the advance notice, a separate advance notice (REG-133223-08) addressing potential proposed regulations on the distinction between Indian tribal plans that are treated as governmental plans and those that are treated as nongovernmental plans due to the commercial activities underlying and performed by the plans' covered employees.

This guidance would follow-up on the interim ''reasonable and good faith standard'' set forth in Notices 2006-89 and 2007-67. As with the broader-focused advance notice, public hearings will be held on this potential tribal plan Section 414(d) guidance and listening meetings will be held to obtain input from tribal governments.

## Comments, Next Steps, and Effective Date

Comments are due to IRS by Feb. 6, 2012. The preamble indicates that IRS will also hold a number of hearings and ''town meetings'' to be scheduled in the future. These multiple avenues will expand the ability of governmental entities and their advisers to learn more about, and comment on, the proposals.

It is also expected that the effective date of any final regulations would provide sufficient time for any plan amendments to be made through the legislative process.

At this time, governmental entities and plans should review and potentially comment on the advance notice so that any concerns they have may be addressed early in the process.

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