

### **Internal Revenue Service’s Proposed Regulation to Define “Governmental Plans”**

On November 7, 2011 the Internal Revenue Service (IRS or Agency) released its ‘advance notice of proposed rulemaking’ to define the term ‘Governmental Plan’ under section 414(d) of the Internal Revenue Code of 1986 (IRC).<sup>1</sup> Unlike IRS’s usual rulemaking process, the agency has added another initial step in the process by providing an ‘advance notice of proposed rulemaking’ to receive public comments. Following the completion of this process, the IRS has indicated that it may use public input to develop the ‘notice of proposed rulemaking’ for another round of comments.<sup>2</sup>

At this time, IRS is soliciting written or electronic comments to be submitted by June 18, 2012.<sup>3</sup>

Governmental pension plans are exempt from ERISA requirements and therefore subject to different rules than nongovernmental retirement plans. Hence, a plan’s status determination as a governmental or nongovernmental plan becomes crucial in order to outline the obligations of the plan sponsor and the rights of participants and beneficiaries.

IRS in its draft regulation has indicated the reason for its proposed regulation. The notice states that the Agency has become concerned due to the growing number of requests for governmental plan determinations from plan sponsors whose relationship to states or political subdivisions are increasingly remote and whose arguments to be determined as governmental plans raise novel issues.

In order to understand the potential issues raised by the proposed regulation, it is important to first visit the existing governmental plan definition under the IRC section 414(d).

#### **Current Statutory Definition**

Section 414(d) of the IRC generally defines the term “governmental plan” as 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

Currently there are no regulations defining or interpreting the key terms relating to governmental plan definition, including the terms “political subdivision,” “agency or instrumentality,” and “established and maintained.”

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<sup>1</sup> See IRS Regulation Number 157714-06 (Nov. 7, 2011); available at [http://www.irs.gov/pub/irs-tege/reg\\_157714\\_06.pdf](http://www.irs.gov/pub/irs-tege/reg_157714_06.pdf)

<sup>2</sup> Available at <http://www.irs.gov/retirement/article/0,,id=249178,00.html>

<sup>3</sup> Electronic comments can be submitted at <http://www.regulations.gov/#!searchResults:rpp=25;po=0;s=157714-06>. For information to mail your comments please refer the ‘advanced Notice of proposed rulemaking’

## **Key Provisions of the Proposed Regulations**

IRS in its advanced notice has proposed to amend the current definition of the term “governmental plan” by defining the related key terms.

### **Definitions of key terms under section 414(d).**

- defines the term “United States”
- defines the terms “State” and “political subdivision of the State”
- defines whether an entity is an agency or instrumentality of the United States or an agency or instrumentality of a State or political subdivision by providing a facts and circumstances test, and
- defines the term “established and maintained” and rules that would apply when a plan sponsor changes its status from a governmental entity to a private entity or from a private entity to a governmental entity

**Request for comments.** The IRS is requesting comments on

- all aspects of the guidance under consideration
- whether there should be distinctions between major and other factors relating to the determination of an agency or instrumentality of a State or political subdivision of a State
- the ordering and application of main and other factors, and
- whether an exception should be provided in cases where a small number of private employees participate in a governmental plan

**Effective date.** The IRS anticipates that

- the guidance resulting from this process will not be effective any earlier than plan years beginning after publication of final regulations
- the time required to complete the State legislative process for amending a State or local retirement plan will be taken into consideration when determining an effective date, and
- transition relief may apply for entities that previously operated as if they were governmental entities eligible to participate or sponsor governmental plans but later were determined to be private entities under the guidance under consideration

In the interest of reviewing the potential impact of the proposed rules on various States, including Texas, the following discussion will only define the State-related key terms of the current governmental plan definition.

### **Definition of a “State” or “Political Subdivision of a State”**

The term “State” is defined as any State of the United States and the District of Columbia. The term “political subdivision” is defined as a regional, territorial, or local authority, such as a county or municipality that is created or recognized by State statute to exercise sovereign powers like the power of

taxation, the power of eminent domain, and the police power and the governing officers either are appointed by State officials or publicly elected.

**Definition of “Agency or Instrumentality of a State or Political Subdivision of a State”**

Under the proposed regulation, the term “agency or instrumentality of a State or political subdivision of a State” means an entity that satisfies the facts and circumstances test. The proposed regulation is based on numerous factors historically applied in case laws by the courts and in determination rulings by the Agency to determine whether an entity is an agency or instrumentality of a State or a political subdivision of a State. Satisfaction of one or more of the factors is not necessarily determinative of whether an organization is a governmental entity. The notice provides both main factors and other factors.

**Major factors for determining whether an entity is an agency or instrumentality of a State or political subdivision of a State are whether:**

1. The entity’s governing board or body is controlled by a State (or political subdivision thereof).
2. The members of the governing board or body are publicly nominated and elected.
3. A State (or political subdivision thereof) has fiscal responsibility for the general debts and other liabilities of the entity, including responsibility for the funding of benefits under the entity’s employee benefit plans.
4. The entity’s employees are treated in the same manner as employees of the State (or political subdivision thereof) for purposes other than providing employee benefits (for example, the entity’s employees are granted civil service protection).
5. In the case of an entity that is not a political subdivision, the entity is delegated the authority to exercise sovereign powers (which generally means the power of taxation, the power of eminent domain, and police powers).

**Other factors to be considered are whether:**

1. The entity’s operations are controlled by a State (or political subdivision thereof).
2. The entity is directly funded through tax revenues or other public sources. However, this factor is not satisfied if an entity that is not otherwise an agency or instrumentality is paid from public funds under a contract to provide a governmental service or is funded through grants by the State or Federal government.
3. 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.
4. The entity is treated as a governmental entity for Federal employment tax or income tax purposes (such as, the authority to issue tax-exempt bonds under section 103(a)) or under other Federal laws.
5. The entity is determined to be an agency or instrumentality of a State (or political subdivision thereof) for purposes of State laws. For example, 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.

6. The entity is determined to be an agency or instrumentality of a State (or political subdivision thereof) by a State or Federal court.
7. A State (or political subdivision thereof) has the ownership interest in the entity and no private interests are involved.
8. The entity serves a governmental purpose.

The proposed regulations include a variety of examples to illustrate whether an entity is an agency or instrumentality of a State or political subdivision thereof. Many of these examples are drawn from prior judicial opinions, as well as the Agencies' determinations.<sup>4</sup>

### **Definition of "Established and Maintained"**

The notice also discusses that a plan is "established and maintained" for the employees of a governmental entity if:

1. The plan is established and maintained for employees by an employer, within the meaning of §1.401-1(a)(2) of the Treasury Regulations<sup>5</sup>
2. The employer is a governmental entity, and
3. The participants covered by the plan are employees of that governmental entity

Furthermore, the notice provides rules for **change in plan status from a private entity to a governmental entity and vice versa (for example, as a result of stock acquisition or asset transfer)**. A change in status could raise potential compliance concerns because under the notice, if a governmental employer ceases to be a governmental entity, the plan will be treated as being established by a private employer on the date of the change.

### **Potential impact on public retirement systems**

IRS's proposed facts and circumstances test to determine whether an entity is an agency or instrumentality of a State or political subdivision of a State could potentially create issues relating to state public retirement systems. The potential issues can be broadly categorized into three areas:

- a. **Uncertainty:** In the proposed notice, IRS states that one or more factors will not be determinative of an entity's status. Hence, any determination of governmental status will depend upon how the IRS weighs the different factors, which could create uncertainty amongst the existing and new entities seeking governmental status determination. IRS has provided examples in the notice in order to illustrate the application of the facts and circumstances test, including the following example:

**Example.** *A county contracts with a non-profit corporation to operate a zoo in the county. The Non-profit entity is organized under the laws of the State. Although the entity was not created by State law, the legislature of the State authorized the State's forest districts to contract with zoological societies for the*

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<sup>4</sup> [http://www.irs.gov/pub/irs-tege/reg\\_157714\\_06.pdf](http://www.irs.gov/pub/irs-tege/reg_157714_06.pdf)

<sup>5</sup> 26 C.F.R., Section 1.401-1(a)(2) generally provides that a qualified pension, profit-sharing, or stock bonus plan is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer.

*creation, operation, and maintenance of zoological parks. The County entered into a contract with the entity, giving the entity exclusive control and management authority over the zoo in the County. The entity, through government contracts, receives over half of its revenues from County taxes. The remaining revenue is generated from the zoo. The County maintains a significant amount of control over the budget of the non-profit entity. The zoo is located on county-owned land, and vehicles used at the zoo are also owned by the County. Only one of 35 members of the governing board is a public official. Only 4 of 240 members who elect the board are public officials. In addition, the county has no direct role in the non-profit entity's operation and maintenance of the zoo. Employees of the entity are not treated in the same manner as public employees. **Based on the facts and circumstances, the entity is not an agency or instrumentality of the county or the State.** The non-profit entity receives the public funds under a contract and very few members of both the board of trustees and the governing members of the entity are public officials.*

- b. **Conflict with state laws:** While an organization, like a river authority or a water district or other special purpose district may be treated as government agencies under the state and/or local laws, under the proposed IRS rules they might be considered a nongovernmental entity without the authority to offer or participate in a governmental plan. This could create confusion and conflict between the proposed federal and existing state laws.
- c. **Transition issues for the existing governmental plans:** Generally, under the proposed rules, for a plan to be classified as a governmental plan, nongovernmental employees' participation would not be allowed. However, the notice does not provide exceptions or safe harbor provisions for existing State practices under which, special purpose districts or certain entities are considered government agencies per the State and/or local laws and are allowed to offer or participate in governmental plans. Under the proposed rules, if these types of entities do not pass the facts and circumstances test, they would be considered private entities and would not be allowed to offer a governmental plan or their participation in a governmental plan may jeopardize the plan's status. In that regard, the notice requests comments whether an exception should be provided in cases where a small number of private employees participate in a governmental plan, based on the following parameters:
  - whether the private employees were previously employees of the sponsoring governmental entity;
  - whether the private employees were previously participants in the governmental plan;
  - 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);
  - whether the coverage is pursuant to pre-existing plan provisions;
  - whether the private employer performs a governmental function and has been officially designated as a State entity for plan participation purposes; and
  - whether the private employer sponsors or has sponsored plans that cannot be sponsored by a State governmental entity

Additionally, the proposed notice does not provide rules for transition, if indeed such entities would be required to discontinue their participation in governmental plans or change their plan status. Instead, the IRS requests comments addressing transition relief issues and related correction methods.

### **Potential conflict with PRB's governing statute**

The Pension Review Board (PRB) is mandated to oversee public retirement systems in Texas. In that regard, the Government Code, section 802.001 defines a 'public retirement system' as a continuing, organized program of service retirement, disability retirement or death benefits for officers or employees of the state or political subdivision, or agency or instrumentality of the state or a political subdivision. In interpreting the definition, the agency includes governmental plans offered by special purpose districts or other entities of the State that could potentially be categorized as a nongovernmental plan under the proposed definition of the IRS. This could potentially create a conflict between the proposed IRS rules and the PRB's statutory provisions and raise statutory questions because a plan might be considered a governmental plan under the PRB statute but not under the IRS proposal. This could in turn become a cost and filing burden on such a plan.

Due to the rudimentary nature of the proposed rules, it will be premature to definitively comment on the impact of the rules. Nonetheless, the PRB will be closely monitoring the development of the proposed rules.

### **Instructions for submitting comments to the IRS**

Click the link to view [IRS Proposed Regulation No. 157714-06](#)

**Electronic comments** can be submitted via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS-REG-157714-06)

**Written Comments** can be mailed to: CC: PA: LPD: PR (REG-157714-06), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington DC, 20044.

**Submissions may be hand delivered** Monday through Friday, between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-157714-06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC.

IRS has scheduled a **public hearing on July 9, 2012**, at 10 a.m. on the advance notice of proposed rulemaking to be held at IRS building, 1111 Constitution Avenue NW, Washington, DC.

Additionally, IRS has organized **two town hall meetings and a phone forum** to discuss the proposed draft and obtain comments from the public.<sup>6</sup> Information on the town hall meeting registrations and the phone forum can be found at <http://www.irs.gov/retirement/article/0,,id=254265,00.html> and <http://www.irs.gov/retirement/article/0,,id=254265,00.html> .

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<sup>6</sup> <http://www.irs.gov/retirement/article/0,,id=254265,00.html> & <http://www.irs.gov/retirement/article/0,,id=218995,00.html>