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VIA ELECTRONIC MAIL

www.regulations.gov
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Internal Revenue Service
1111 Constitution Ave NW
Washington, DC

Re: Advance Notice of Proposed Rulemaking
Determination of Governmental Plan Status

Dear Sir and/or Madam:

This letter provides comments on the above advance notice of proposed rule making (the "notice").

A. INTRODUCTION

Thank you for providing this advance notice of proposed rule making. We appreciate that the Service is using this procedure to establish wide-ranging rules that will affect millions of plan participants and retirees, their government retirement plans and the plan sponsors.

We understand that a key goal of the notice is to develop regulations that will result in certainty with respect to what constitutes a government plan under Code section 414(d). 76 Fed. Reg. 69178. The key goals of the government retirement systems that we represent are to provide and protect the retirement benefits of their members. This requires that systems are able to operate in accordance with clear rules that can be efficiently administered and that do not divert resources from providing sound retirement benefits. These goals should mesh well with those of the Service.

We appreciate the work of the Service in drafting the notice but we respectfully submit that substantial change is needed to achieve its goals. We believe that the Service understands this need to change because of the specific requests for comment set out in the notice. Below we comment on the questions asked and propose changes to the draft regulations in the notice. We look forward to a dialog with the Service to assist you in resolving your concerns in a manner that also meets the needs of government systems and participating government agencies and that protects the retirement benefits of their participants and beneficiaries.

B. BACKGROUND FACTS

In California most public sector employees receive their retirement benefits from multiple employer retirement systems. There are three multiple employer systems established by State statute: systems governed by the County Employee Retirement Law (the "CERL"), the California Public Employee Retirement System ("CalPERS") and the California State Teachers' Retirement System ("CalSTRS"). We represent systems governed by the CERL[1] (called "37 Act" systems), most of which are multiple employer systems. We also represent a number of single employer systems. These facts in this section focus on 37 Act systems; our comments below on the notice however apply to many single employer systems as well.

Under the CERL, any California county may establish a 37 Act retirement system governed by that statute.[2] (A county may instead participate in CalPERS or may establish its own, stand alone, system.) Once a county establishes a 37 Act system, the CERL determines what other government agencies may participate in that system.[3]

When an eligible agency (called a "district") wants its employees to participate in a 37 Act system, the district may do so at the decision of its governing board.[4] Additionally, while the board of administration ("BOR") of each system has "plenary authority" to administer the system, the BOR (or any other agency) seems to have no authority to prevent a district from joining a system though it can require additional contributions from a district in some circumstances.[5] A district can decide to withdraw from a system but there seems to be no statutory ability of the BOR (or any other agency) to require a district to terminate its participation in a 37 Act system.[6]

Every government employer that participates in a 37 Act system provides to the BOR the data required for it to administer retirement benefits for the agency's employees. This is done on a payroll-by-payroll basis. In general, the agency provides the names, employee identification numbers, compensation and service information for the particular period, amount of member contributions made to the system,[7] and other information needed for administration. The key point is that, by necessity, the BOR must rely on the information provided by the agency. Many systems provide benefits to thousands of employees – both active, terminated vested and retired – and their beneficiaries. Systems are not equipped to determine, e.g., whether any

[1] Gov. Code sec 31450 et seq. (All references to the Gov. Code are to California statutes)

[2] Gov. Code sec. 31500

[3] Gov. Code sec 31468

[4] Gov. Code sec. 31557

[5] Gov. Code sec 31564.5

[6] Gov. Code sec 315464

[7] 37 Act systems are funded by employer and employee contributions.

individual who is treated as a government employee by a contributing agency actually is an employee or has another relationship with the reporting employer.[8]

In these circumstances, 37 Act systems follow state law – as they must -- in accepting districts as participating employers, and they must trust the reporting of contributing employers with respect to the status of any individual system member.

With respect to whether a district is a government agency, 37 Act systems have operated in the spirit of good faith federalism. Among the powers reserved to the States under the federal Constitution, certainly one must be power to determine what institutions the voters of the State will create to govern themselves. Therefore, if the State has determined that an agency created for governance is a "governmental agency" then from the viewpoint of a 37 Act retirement system it is one. There may be situations where this conclusion does not fit with the Internal Revenue Code. However, unless there is material evidence of a lack of good faith in the State's actions, federalism requires both deference to State decisions on what is a government agency as well as a workable process for good faith correction under the tax laws.

The notice asks for comments on the clarity of the draft regulations and how they can be made easier to understand.[9] Below we comment on these issues.

C. SCOPE OF REGULATIONS

The notice states that "These proposed regulations are only applicable for purposes of section 414(d), and not for any other purpose under the Code."[10] Additionally, the notice refers to many other sections of the Code that use section 414(d). It also states that the same principles that are in these regulations would apply for purposes of sections 403(b) and 457.

There are a number of other provisions in the Code that apply special rules to government employees and employers. For example, section 3121(u) that applies special rules for Social Security coverage to these employees and employers. That section, in turn, relies on section 218 of the Social Security Act for the applicable definitions.

In accordance with the notice, we would appreciate it if the Service made clear that any regulations under section 414(d) do not apply for any other purpose including but not limited to the definition of government employer and government employee for Social Security tax and coverage purposes.

[8] In fact, as you know, the reporting employer may not understand whether an individual is an employee or an independent contractor. Status is determined under the common law "20 factor" test which is often uncertain.

[9] 76 Fed. Reg. 69183.

[10] 76 Fed. Reg. 69175

Additionally, the regulations do not deal with what constitutes an "integral part" of a state.[11] However, an entity that is an integral part of a state surely must be a governmental entity under section 414(d). We would appreciate it if the Service made this clear as well.

D. UNCERTAINTIES CAUSED BY THE DRAFT REGULATION – POLITICAL SUBDIVISIONS

It appears that there are only two criteria for determining whether an entity is a "political subdivision", whether the governing officers are appointed by State officials or are publicly elected and whether it may exercise sovereign powers such as the power of taxation, of eminent domain, and the police power.[12]

Key questions for this definition are as follows:

1. Appointment

Does appointment by "State" officials actually mean appointment by officials at the State level or does it also include appointment by local officials (such as a county board of supervisors)? The question arises because under the "control" factor for agency or instrumentality, the draft regulation is different and says that the entity's governing board is controlled by "a State or political subdivision".

If the goal is to ensure public control and accountability, appointment by local officials should be sufficient. If that is not the goal, then we would appreciate additional explanation from the Service on its goal and why there would be a difference between appointment at the State or local level.

2. Publicly Elected

In California, there are over 3,000 special purpose agencies, which are generally established for special purposes and are called "districts".[13] To distinguish our discussion of these districts from the term used in the CERL, above, we call them SPDs, for "special purpose districts".

For the most part, we understand that the governing boards of SPDs are elected by a community's registered voters.[14] However, in some water districts the governing boards are elected by "landowner-voting" under which voting rights are restricted to landowners. In addition, this voting may be proportional to the assessed value of the land. The United States Supreme Court has held that this type of voting is allowed under the Constitution.[15]

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[11] 76 Fed. Reg. 69179

[12] Draft regulation (D. Reg.) 1.414(d)-1(e).

[13] Senate Local Government Committee, "What's So Special About Special Districts?", A Citizen's Guide to Special Districts in California, (Fourth Edition, October, 2010).

[14] Id., page 7.

[15] Salyer Land Company v Tulare Lake Basin Water Storage District, 410 U.S. 719 (1973).

It is not clear whether landowner voting creates a "publicly elected" board under the draft regulations. However, since the United States Supreme Court has held this voting to be valid, the Service should not take a different position.

3. Sovereign Powers

The draft regulation says that the agency must have sovereign powers. Agencies may have one or more but not all of the sovereign powers that are listed. For example, a water agency may have the power of eminent domain and the power of taxation but not the police power.

It is not clear from the draft regulation that having fewer than all of the listed powers is sufficient for an agency to be a political subdivision. However, having fewer than all should be sufficient. Otherwise, the Service would effectively be overriding the State's decision on the most appropriate way to conduct its business. A State could easily decide that it is most effective to concentrate the police power (or the taxing power or the eminent domain power) in a limited number of agencies with highly trained personnel. The Service should not interfere with such a decision and require that sovereign power be dispersed among many agencies in order for them to be treated as political subdivisions.

E. AGENCY OR INSTRUMENTALITY – MAIN FACTORS

The draft regulations have many more factors for determining whether an entity is a governmental "agency or instrumentality" than for determining whether it is a "political subdivision". The agency or instrumentality factors are discussed below.

1. Control

The first factor listed is that the entity's governing board is controlled by a State or political subdivision. The draft regulation gives as an example the ability of a State or subdivision" to appoint, and to remove and replace", a "majority" of the entity's governing board. It also says that this criterion is not met if the power to control is "materially restricted". There are substantial uncertainties in the draft definition of control that should be clarified. In each of the situations described below, the Service should make clear that they do not adversely affect "control", as there is clearly public control of the governing board.

In some circumstances, a county's board can appoint an agency's board members for a specified term of office, without the ability to remove them prior to the end of the term.

In some circumstances, a county's board can appoint 50% of an agency's board members and the person who makes up the remaining vote needed for a majority is an official who is elected by the registered voters.

In some circumstances, the appointed members of the board of an agency must act without regard to the wishes of the appointing board because they have a fiduciary responsibility to act solely for the benefit of stated parties and not for the benefit of the appointing board.

We do not know how all 3,000+ SPDs are governed nor how their boards are chosen. Based on public information, we suspect that most of them come within the control definition in the draft regulation. However, we also know that the issues above apply to some SPDs and given the diversity of California government, it is probable that there will be other issues as well. Local

government is created by the voters and their representatives, and they do not all fit into any particular pattern.

In fact, all of the issues raised above exist with regard to the boards of retirement of 37 Act systems in the situations where, by statute, those boards are separate SPDs. Each BOR has 9 members, 4 of whom are appointed by the county board of supervisors, one of whom is the county treasurer who often is elected by the registered voters[16], and 4 of whom are elected by members or retirees of the 37 Act system.[17] Each has stated terms of office. Each must act solely for the benefit of the system members and beneficiaries.

There should be no question that these retirement systems are government agencies and that their employees can participate in their retirement systems. It would be quite ironic if the personnel who are responsible for administering public retirement systems cannot participate in those systems (unless, of course, they are employed by a commercial administrator).[18] Other factors, such as open meeting laws, public records acts, treatment in the same manner as other government employees, etc. all weigh toward their being employed by a government agency. However, the examples in the draft regulations make clear that the "control" criterion is first among all.

Separately, the notice says that the control factor will not be met where "the legal power to control is shared among so many governing entities that none of them can be said to be responsible in the event of a failure to exercise control"[19]. In California a number of government services are provided through joint powers authorities, authorized by State statute. These are effectively partnerships of government entities and are often controlled by governing boards composed of representatives of the partnering agencies. In some cases, there are many partners and the governing boards are large. It is not clear whether this statement in the notice would apply to these joint powers authorities. If it is intended to apply then we respectfully request that it be eliminated. The governance of these entities is fully public.

2. Public Nomination and Election

a. In General

With respect to election, please see the discussion above concerning landowner – voting.

With respect to nomination, please note that the nomination process varies substantially among entities. This criterion should be explained. We suspect that the goal is to ensure that the nomination process is not limited to nomination by a small group such as a self perpetuating

[16] If not elected, the Treasurer is appointed by the board of supervisors.

[17] There are separate elections by safety members, "general" members and retirees for their BOR representatives.

[18] Most of the 37 Act systems are still under the umbrella of county government and all of their employees are designated as county employees. It would also be quite ironic if the employees of those systems that were made SPDs by State legislation in order to create more independence of the system were then prevented from participating in their own systems.

[19] 76 Fed. Reg. 69180

board. Nevertheless, there are many ways to nominate and the Service should not prevent them from operating.

b. Stakeholder Boards

Some SPDs provide government services to a focused segment of the community; that, in fact, is the essence of SPDs. Some SPDs have boards that must include representatives of multiple community stakeholders, with the stakeholders specified to obtain broad representation from the affected community. Stakeholder nominees are selected by publicly elected boards and there may be limits on the ability of those boards to reject a nominee. These SPD boards are in fact chosen by the public, but not in the broad-based traditional electoral sense. In fact the nomination process is designed to ensure that the SPD board is representative of the members of the affected community. These SPD boards should be considered publicly nominated and elected.

3. Fiscal Responsibility

The reality of local government is that in some circumstances a political subdivision cannot take the risk that the liabilities of a potential high-liability but very important-to-the-community enterprise will adversely affect its other services. Therefore, in accordance with governing law, the local government (political subdivision) will establish a separate agency to provide those services and the subdivision will not take on that agency's liabilities. The establishing subdivision may provide financial support, but may do so in a limited way, or it may not provide any support.

Where support is limited, it is unclear from the notice what extent of support is needed to meet this criterion. Where support is not provided, this fact should not be the sole factor that prevents an entity from being a governmental agency.[20]

The Service should take account of this fiscal reality -- particularly in this economy when public agency resources are being unusually squeezed -- and not appear to try to force local government into unwanted or irresponsible fiscal situations. At a minimum, where a political subdivision provides material support, this should be sufficient to meet this criterion. Additionally, where no support is given, the Service should make clear that this does not mean that the entity is not governmental.

4. Employees

Under this criterion, the agency's employees are treated in the same manner as those of the State or political subdivision, and the draft regulations give as an example civil service protection. Please note that many jurisdictions in California do not have a civil service system. Nevertheless, governmental employees are treated differently than private sector employees with respect to, e.g., the rules governing union bargaining, and "vested rights" in retirement benefits. Therefore, the example should be expanded.

[20] That has been the case in prior dealings with the Service.

5. Sovereign Powers

Please see the discussion above in section C concerning political subdivisions with respect to sovereign powers.

6. Political Subdivision *or* Agency or Instrumentality?

To be a political subdivision, only two criteria must be met: having sovereign powers and having an elected or publicly appointed board, perhaps appointed by the State and not by a local agency.

To be an agency or instrumentality, it appears that more than these two criteria must be met. Respectfully, that difference does not seem appropriate. In both cases, the same basic criteria would be satisfied; in both cases that should be all that is required. This apparent conflict should be resolved.[21]

F. AGENCY OR INSTRUMENTALITY - OTHER FACTORS

1. Control

The draft's "other " control factor is that the entity's "operations" are controlled by the State or a political subdivision. The difference – if any – between this control factor and the "main" control factor is uncertain. If the entity's operations are controlled by a subdivision, then the governing board for the entity must be that of the subdivision. Therefore, it appears that this control factor is the same as that of D, 1. If this is not the case, the draft needs clarification.

2. Funding

The draft's "other" financial factor is that the entity is "directly" funded by tax revenues or "other public sources". This raises a number of questions that should be clarified.

Are user fees "other public sources"? User fees are now increasing in California because of the difficulty of raising taxes. Water and other public utilities are funded by user fees. Roads and bridges are funded by user fees. Parks and recreation facilities are funded by user fees. The list is long. These fees are set publicly and are paid by the public for public services so they should be "other public sources".[22]

What is "directly" funded compared to "indirectly funded"? Is "directly" only if the agency collects tax revenues itself (or by the county on its behalf) but "indirectly" is where, e.g., the county contributes tax revenues to the agency? If that is the difference, then it should be eliminated from the criteria. Certainly an agency that receives a share of tax revenue by county contribution is publicly funded.

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[21] Below, we propose additional changes in regard to meeting either of these criteria.

[22] Additionally, the Service charges user fees for a number of services including EPCRS, determination letters, PLRs, etc. .E.g., Rev. Proc 2012-8, sec. 6. User fees are part and parcel of government agency revenue at all levels of government.

What if the entity is funded both by tax revenues and by other sources? For example, some SPDs may be funded by taxes and user fees. This situation also should meet the criterion. We would be surprised if the Service were to establish a rule that penalizes shared revenue sources.

3. Creation Pursuant to Statute

The creation criterion is that the entity is created pursuant to a "specific" enabling statute that prescribes the purposes, powers, and manners in which the entity is to be established and operated.

Many SPDs are created in accordance with detailed California statutes. But the enabling statutes for others are not anywhere near as detailed. For those agencies, this criterion appears to create an opportunity for a substantial dispute with a Service reviewer or auditing agent.[23]

Presumably the goal of this criterion is to rule out establishment pursuant to general laws providing the basis for incorporation of not-for-profit entities. If that is the case the regulation should make this criterion only that the agency is not created under such laws.

4. Employment and Income Taxes

This criterion is that the entity is treated as a governmental entity for federal employment or income tax purposes. We appreciate this criterion, however it is not wholly clear. Certainly if the Service has determined, in written form, that for federal employment or income taxes the entity is a government entity, then it meets this criterion. However it is not clear whether a writing from the Service is required. For example, an entity may have filed and paid withholding taxes for decades and also not have entered into a section 218 agreement (and otherwise not be required to pay OASDI taxes) so never has filed and paid Social Security taxes, with no question raised by the Service. For employees hired on and after April 1, 1986, though, it will have paid Medicare (HI) taxes. It is unclear whether this situation also meets this criterion. It should meet it, of course, because the Service has been on full notice that the entity has claimed government status and has not raised any question.

Additionally, in a situation where the agency has received a written determination, as a private letter ruling, we do not understand why this is an "other" criterion. Instead, if the Service has decided that the entity is governmental, that should be the end of the inquiry.

5. Other State Laws

This criterion is that the entity is a governmental agency for purposes of State laws such as open meetings laws and public records. Again, we appreciate this criterion. It is clear and easy to apply. However, we do not understand why this is an "other" criterion. If State or local law requires open meetings, open and public records and other laws that apply only to public

[23] The drafting of State statutes is as complex a process as that of federal legislation and many factors go into the determination of the detail – or lack thereof – in a State statute. Evaluating the level of statutory detail should not be the province of the Service.

entities (such as labor laws), that also should be the end of the inquiry. As noted, under federalism it is the responsibility of the States, and their instrumentalities and agencies, to decide how to conduct the public's business.

6. Court Determination

This criterion is that a court has determined that the entity is a government agency. Again, this criterion is clear and an easy to apply; and once again, if a court has made this determination, this should be the end of the inquiry.

7. Governmental Purpose

We respectfully suggest that this criterion be eliminated.

What is a "governmental purpose" is entirely subjective and does not create certainty.

How is the Service to decide what is a governmental purpose? Take a simple example: football stadiums. Is it a public purpose if a stadium is built, financed, and operated by an entity with power of eminent domain, a publicly elected governing board, and financed with public revenues but used only by a professional football team? We respectfully suggest that the Service is not in a position to make that decision. In this example, the community clearly has decided that the stadium fulfills a public purpose and that should be sufficient.[24]

G. SHOULD THERE BE "MAIN" AND "OTHER" FACTORS?

The short answer is "No, there should not be main and other factors".

The reason is practical. Our experience with the Service is that if there are main factors, the "other" factors will be largely ignored.[25] In fact, this process has begun in the examples in the draft regulations, which are almost all oriented to emphasize the "control" factor and relegate any other factors to second class status, if that high. [26] Therefore, the practical result of "main" and "other" likely will be for Service reviewers and auditing agents to read out "other" in many circumstances. That should not be the result of the Service's efforts.

[24] To take other examples -- water, power and waste disposal all are provided in California by agencies that are clearly governmental under the Service's criteria. However, each of these services are also provided by private entities in this State. Does the fact that private entities provide services detract from the fact that the agencies are governmental when they have elected boards, taxing power, are subject to open meeting laws, but charge user fees for services? Certainly not.

[25] Our previous experience with the Service is that reviewers have applied a rigid perspective. In one case "fiscal responsibility" was the only criterion of interest to the Service in determining whether an agency was governmental.

[26] We read examples 1, 2, 3, 4, 5, 6,,8 as primarily focused on the control criterion. While there is mention of other criteria, control seems to be the key in each of these.

Additionally, as discussed above a number of "other" factors should not be "other" but should be conclusive. Furthermore, some of the "other" factors seem to be the same as or encompassed by some "main" factors. This is another reason to eliminate the distinction.

Instead of main and other factors, as explained below we respectfully suggest that the draft regulations be reoriented to take account of key issues such as federalism, clarity, and ability of systems to administer the rules.

H. THE "ONE EMPLOYEE" RULE

The notice provides that if even one employee who participates in the system is not a government employee, the system is not a government system.[27] This creates a high risk that the system will then lose its tax qualified status because government systems do not operate as do private sector systems, as detailed by the discussion in the notice.[28] Disqualification will severely penalize employees, retirees, systems and contributing agencies.

Please note, as discussed above, that it is common for many thousands of active employees, terminated vested employees and retirees to participate in the 37 Act multiple employer systems.[29] And please note that these systems are not equipped to evaluate the status of each and every employee who participates. The systems must rely on the participating employers for information on the status of members.

Systems can try to educate their participating employers regularly about how to determine the status of employees. Systems can regularly remind employers about the risks and penalties of error. But errors will occur. Hiring in large counties is often decentralized. The terms and conditions of "employees" may vary by division within a county. The ability of a county's HR department to police hiring and terms and conditions will also vary. There will be errors in putting individuals on payroll systems. Moreover, there can be substantial difficulties in applying the common law test of who is an employee.[30] Furthermore, small employers who participate in 37 Act systems may well not have the sophistication or the bandwidth to apply the common law employee rules. A mosquito abatement district will put all of its resources on the mosquitos, not on the fine points of who is and who is not an employee. The opportunities for error are many.

In this setting, to propose that severe penalties be applied to employees, retirees, systems and contributing employers through the one employee rule is astonishing.

Moreover, the one employee rule is not applied uniformly. The draft regulation provides that employees of unions – which are private sector entities -- that represent government

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[27] 76 Fed. Reg. 69174, 69181.

[28] Many of these differences have been discussed previously with the Service in connection with determination letter applications for a number of government retirement systems.

[29] CalPERS and CalSTRS have hundreds of thousands of active participants.

[30] The draft regulations apply the common law test. D. Reg. 1.414(d)-1(l). The Service has recently established a new voluntary compliance program to assist employers who have had difficulty in applying the common law test and determining who is and employee or independent contractor. Announcement 2011-64, Voluntary Classification Settlement Program.

employees are treated as employees of the plan sponsor.[31] Presumably the policy is that the union employees serve a public function by assisting public employees. If that is the policy, then we recommend that the same policy of serving a public function should be applied uniformly and not just to employees of unions.

The notice asks whether the regulations should allow a "small number" of private sector employees to participate in a governmental plan, and asks for criteria such as prior government agency employment, de minimis (and what this means), etc. (Please note that the union-employee rule is not limited by such criteria.)

We recommend that separate good faith and de minimis rules apply. If the participation of private sector employees is due to good faith error (such as a misunderstanding of the employees' status or a misunderstanding of the mission, governance, financing of an agency or the mis-reporting of an individual's status to a 37 Act system), then this should not be cause for loss of government plan status. Additionally, if the number of affected members is less than 2% of all active, terminated and retired members of the system, this should be a de minimis error that does not cause loss of government system status.

I. THE FACTORS AND SYSTEM ADMINISTRATION

We have discussed the difficulties with the draft regulations from a lawyer's viewpoint. We are accustomed to working with uncertainties in the tax law. However, these rules must be administered on a day to day basis by system staff who are not lawyers and who are focused on providing and protecting retirement benefits under State law. The Internal Revenue Code is foreign territory for them.

Below we turn the discussion to the administrator's viewpoint.

1. Necessary System Actions

Administration of the draft regulations will be extremely difficult and uncertain. To properly administer the draft regulations, system staff must regularly do the following:

- Assess the status of each participating district in light of its current situation.

  Districts may change in mission, organization, financing, legal status, governing boards and the way in which they are chosen, etc. Furthermore, because of the nature of the criteria, system staff too often will not be able to make a clear assessment. The criteria are uncertain, the priority of the criteria is unclear, the number of criteria that must be satisfied is unclear, the weighting of the criteria is unclear, and each agency will be different. In these circumstances, too often staff will have to conclude that : "X criteria argue for government agency status; Y criteria argue for not; we cannot make a clear recommendation." This will especially be the case since the notice says that

[31] D. Reg. 1.414(d)-1(k)(3).

"Satisfaction of one or more of the factors is not necessarily determinative of whether an organization is a government entity".[32]

If certainty is a key goal of the draft regulations for determining whether an entity is a governmental agency and therefore whether a plan is a governmental plan, we have to conclude that this goal is not met.

- Assess the status of all participating members.

  To meet the one employee rule, systems should audit the employee records of all members, especially those who are currently employed, and assess whether they are "employees" or not, applying the common law 20 factor test. The difficulty of applying this test is well known. Certainty is not a part of the common law test. That issue is separate and apart from the fact that systems are not equipped to audit these records and must rely on the participating employers.

- Recommend specific changes to their boards of retirement (BORs) and/or recommend changes to the governing bodies of the participating employers. (Of course, unless change can be retroactive, government plan status may already be at risk.)

- The BORs could then take action with respect to individual members and/or participating agencies. Similarly the board of the identified employer could take action. In this case, however, it is likely that the employer would want its own assessment of the need to take action, which could differ from that of the system.

- Prior to any recommendation for change, California law (e.g., the CERL) would have to be changed to allow the BORs to take action, which ultimately might require segregation or termination of an agency employer's participation in the system.

2. Practical Effects

- The criteria are uncertain. The facts will most always be messy. System staff will be uncomfortable with making recommendations. Necessarily, given the problems in the draft regulations, at best their conclusions often will be inconclusive. The responsibility for recommendation will devolve to the lawyers.

- The lawyers will not be able to give clear answers in many situations. They can provide opinions, but the risks are very high if they are wrong. The risks are high on either side.

  If the lawyers advise that there is no problem (and rarely would advice be that clear) and the Service disagrees, then there is a risk of loss of government plan status and disqualification.

  If the lawyers advise that there is a problem (with all of the caveats expected) then this may well be challenged by members, unions, and/or employers. Challenge could be

[32] 76 Fed. Reg. 69180.

brought in State court (there does not seem to be jurisdiction in federal court), but State courts have no jurisdiction over the Service.[33]

Additionally, there are State constitutional vested rights issues involved in any unwanted termination of participation by any member of a system of any contributing employer). Any litigation will certainly have this as a main issue. It could take many years to resolve, and might have to go to on appeal for decision.

- The BOR may be reluctant to take adverse action because its mandate is to provide and protect retirement benefits for all members and action could adversely affect particular individuals. Of course the BOR must act on behalf of all members. This could put the BOR in a very difficult position.

- All of this will take time. So even if the system acts with certainty and alacrity it still may be in jeopardy of losing its governmental status because problems may continue during the assessment period (as well as before assessment begins).

- Please note that these issues concern not just district employers that participate in 37 Act systems but also counties, because of the one employee rule. There is no way under the CERL that a county's participation in a 37 Act system can be terminated.

- Of course, these issues concern every member of the system, every retiree, and every participating employer – almost all of whom will be innocent bystanders with no ability whatsoever to protect their retirement benefits and retirement plan which are harmed by the actions of another wholly separate agency. This truly is the one bad apple can spoil the whole barrel case.

We respectfully submit that all of this will be very unfortunate, and is not necessary. Below we suggest changes to the draft regulations.

J. PROPOSALS FOR CHANGE TO THE DRAFT REGULATIONS

Our proposals are based on two goals:

- Achieve certainty for the Service and retirement systems, and

- Respect the basic principal of federalism, applied in good faith.

1. Federalism

Federalism, applied in good faith by all parties, is the keystone.

The notice recognizes that the special rules for government plans were enacted by the Congress at least in part because of the principles of federalism.[34] One basic principle of

[33] We note that one of the "other" criteria is the decision of a court on the status of the agency. But we also note that this is not a conclusive criterion under the draft regulations.

[34] 76 Fed. Reg. 69178.

federalism must be that the States and local government are able to decide the manner in which public services are provided and the way in which their communities organize to provide such services.

The draft regulations should be changed to recognize this fundamental principle. Of course, the Service cannot blindly accept any statement that an entity is a government entity. However, if that statement is supported by sound State and/or local government rules it should be respected.

2. Certainty – Governmental Entity

Following the federalism principle, the draft regulations should be revised to provide that if an entity meets any one of the following criteria, it is a government entity.[35] Each of these criteria is, by itself, sufficient evidence that the State or local community has determined to provide its public services through a governmental agency.

- Governance

  The entity is governed by a board, a majority of the members of which are (i) elected by registered voters (or by landowners in the case of that type of voting) in accordance with state or local law, or (ii) appointed by officials of a government instrumentality, or (iii) a combination of (i) and (ii).

- Sovereign Powers

  The entity has one or more sovereign powers of eminent domain, taxation, police power. Taxation may be subject to the approval of the registered voters. The police power is not limited to "safety" actions (fire, police, EMT, etc.) but includes all regulatory powers.

- Funding

  The entity is supported entirely or in material part, directly or indirectly, by tax revenue or other public funds.

- Employees

  Agency employees are governed by the same employment laws that apply to other, similar local government employees.

- State Laws

  The agency is governed by other state laws that determine the conduct of public agencies such as open meeting laws, public record laws, and labor laws.

[35] An alternative would be that the entity is presumed to be a governmental entity. The presumption would shift the burden of proof that the entity is not governmental to the Service and the Service would have to meet its burden by a preponderance of clear and convincing evidence.

- Prior IRS Determination

  The Service has previously determined, in a written form, that the entity is a government entity for another purpose under the Code, such as employment taxes.

- Private Interests

  No private interests are involved. However – as with the same criterion applied to federal agencies – an interest is not a private interest if it is not acquired for investment purposes or for purposes of control.[36]

- Court Determination

  A court of competent jurisdiction has determined that the entity is a governmental entity.

3. Certainty – Governmental Plan

   A system would be a governmental plan under section 414(d) if all of its participating employers are governmental entities and if all of its members are governmental employees, with the following exceptions. (Please note that we discuss transition rules and correction later in this letter.)

- Good Faith Error

  If the participation of private sector employees or of a non-governmental employer is on account of a good faith error (such as a misunderstanding of the employees' status or a misunderstanding of the mission, governance, financing of an agency, or the misreporting to a multiple employer system), then this would not be cause for loss of government plan status.

- De Minimis

  Additionally, if the number of affected members is less than 2% of all active, terminated and retired members of the system, this would be a de minimis error that does not cause loss of government system status.

K. CORRECTION

1. Practical Correction Mechanisms Are Needed

Even if the draft regulations are changed as proposed, there will be slip-ups. Administrative staff changes so the level of understanding will vary over time. And, of course, no one is perfect.

[36] D. Reg. 1.414(d)-1(c)(2)(ii).

2. The 180 Day Rule of Section 457

If there is a failure of a governmental 457 plan to comply with the rules of that section, the plan ceases to be an eligible 457 plan on the first day of the plan year beginning more than 180 days after the Service notifies the agency, in writing, that the plan is being administered in a non-compliant manner.[37] If the error is corrected before the first day of that plan year it will maintain its 457 eligibility status. This is a different rule than for private sector, tax exempt entities.

We recognize that this rule is based on Code section 457(b). However it demonstrates that the Congress wants the Service to give governmental retirement plans substantial leeway to correct errors. The same should be true under section 414(d). The Service should apply a rule similar to the 180 day rule of section 457 to allow correction of errors under section 414(d).[38]

3. EPCRS

There is no more value in the Service applying penalties to governmental systems where there are slip-ups than there is in applying penalties to private sector systems in similar circumstances. The Service has demonstrated the value of compliance, not penalties, with the EPCRS program.

EPCRS should be extended to governmental systems and it should be modified to take account of the unique issues that are faced by these systems, including the following:

- Governmental systems that are in non-compliance with section 414(d) should be able to correct the problem and retain their governmental status.

  Under EPCRS, private sector qualified plans that have erred in ways that would put their qualified plan status in question may apply to the Service for a retroactive correction, in accordance with established principles. In some cases, such as correction for a discriminatory benefit, right, or feature (BRF), correction must be prospective only.[39] We respectfully submit that the same principle should apply here. By its very nature, a BRF cannot be corrected retroactively, except perhaps in limited situations. For systems that do not fit with 414(d), the same may be the case.[40] EPCRS should allow correction for non-compliance with section 414(d) by prospective correction in the same way as for BRFs.

- Segregation from a system of a non-compliant agency and their employees should be one method of preserving the governmental status of the system as a whole.[41]

[37] Treas. Reg. 1.457-9.

[38] It may be appropriate to provide this rule in EPCRS.

[39] Treas. Reg. 1.401(a)(4)-11(g)(3)(vi).

[40] E.g., the governing board may not be fully "public". Or the de minims rule for non-governmental employees may have been missed for a limited time.

[41] Of course, the agency might be able to change and become governmental.

It is critical, of course, that the qualified status of the entire system be preserved and that one non-compliant agency not cause penalties for all of the innocent – and compliant-agencies and their employees. Some type of segregation of the non-compliant agency and its employees from the system seems to be one answer to this problem. Exactly how that will be done and what State law will allow are unanswered questions.

Furthermore, boards of retirement will be very reluctant to take any action that will adversely affect any members – that is contrary to their deep seated culture. So they will search for ways to protect members while protecting tax qualification.

In this environment, the Service should not try to establish uniform methods of segregation, but instead allow general rules to be established and practical approaches be worked out in each jurisdiction and with the Service under EPCRS.

- Segregation should not mean termination from the system.

  There are many difficult practical and legal issues (some are described below) with termination of the relation of an employer and its employees from a government system. Therefore, one solution may be for the non-compliant agency and its employees to be segregated for liabilities and assets, with the employees still earning benefits in accordance with the governmental system rules to the extent compliant with the qualification requirements, the system continuing to administer these benefits for a reasonable charge to the agency or charge to the assets that are segregated, and continuing to combine the segregated plan assets with the overall assets of the system for investments. Code section 401(a)(24) clearly allows this type of combination – including allowing for the combining of assets of a non-qualified government retirement system with those of a qualified system.

  EPCRS should allow this type of segregation.

- Loss of governmental status may require substantial changes in plan design, administration and compliance for those affected. This will take substantial time and cost and must be recognized in any correction program.

  Consider a multiple employer system with, e.g., 15,000 active employee participants, 20 of whom are employed by one small employer. On examination, and after careful consideration, the system determines that the employer is not governmental. If segregation as described above works, then many – though not all – practical problems will be resolved. But if the system must terminate the employer's relation with the system, the problems multiply substantially.

  First, in most states including California it is highly likely that vested rights will require that the current employees continue to earn benefits under the current formula; plan termination in the private sector sense is not available. The employer will not have the in-house capabilities to administer and invest the assets. There are few vendors that can administer systems with public sector type benefits. Moving benefits to a new administrative system, ensuring tax compliance, and doing this within a time and money budget will be difficult.

  EPCRS must recognize the practical and time consuming issues in any situation like this. Note also that all the while that a new arrangement is being developed, the employees will be earning benefits under the system in which they are participants and benefits will be

payable. We know of no way that a switch can be flicked to move these 20 employees to a new program.

- Termination or other segregation of a non-compliance agency and its employees could be very difficult, legally.

  The example above assumes that State law allows termination (or segregation) of a non-compliant agency and its employees. That does not exist in California law today, to our knowledge. The example also assumes that the 20 employees and their employer will acquiesce in termination or segregation. But this may be litigated by those adversely affected. Litigation is not fast, and a case could go on appeal. Any correction process must take into account the possibility of legal challenge.

L. TRANSITION

Substantial transition rules are necessary for any new section 414(d) regulations to work. Transition rules must take account of the existing situation on the ground. Otherwise, new regulations will cause major disruption to the retirement benefits for many employees, their plans and the plan sponsors.

The principles for establishing transition start with a recognition that the Service has effectively acquiesced in the current situation. For example, in some cases the Service has issued determination letters that state that a system is qualified. While the letter may have been issued some years ago, often the Service made no inquiry about the government status of the sponsor(s) so there was no reason for systems to think that this was an issue. In all cases, though, systems acted under good faith federalism and accepted that an agency (and its employees) were governmental if the State or local law so provided. This state of affairs has existed for many decades. As the Service has said, for many decades it did not provide to governmental plans the level of service that it provided to the private sector.

One of the gaps in this service was guidance – or even any demonstration of concern – about what is a "governmental plan" and what is a "governmental agency" for section 414(d).

In these circumstances, the appropriate action is to provide substantial transition by grandfathering all governmental plans and agencies under 414(d).

By grandfather, we mean that all governmental plans (and participating agencies) that acted in good faith compliance with section 414(d) will be treated as complying with section 414(d) as the systems exist on the date of publication of final regulations. Government systems and agencies have been left alone by the Service to follow State and local law on what is a government agency and therefore what is a government plan. They have complied with State and local law, as they must. To fault, for tax purposes, this compliance would raise serious questions of good faith federalism and the appropriate administration of the tax law.

Additionally, this type of grandfather rule fits with other rules that apply to government plans, such as under section 401(a)(17) and section 401(a)(9).

Additionally, systems will need time to adjust to any new rules including putting into place the administrative processes for compliance. States will need time to enact new laws allowing system governing boards to take action to comply with new tax rules. Any new rules must allow

for this transition, and must give realistic time for action. State legislation will be the most important hurdle. Legislators are overwhelmed with budget and other issues including "pension reform". Any pension legislation may raise significant political issues, and some legislatures will be skeptical of any statements that "the IRS requires this". Legislators also pay substantial attention to unions and unions will be skeptical about any change that suggests lessening of retirement security. We would like to discuss with you the time needed, but our experience is that at least 4 years from date of publication of final regulations should be provided to obtain needed legislation.

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Thank you for your consideration of our comments. We look forward to discussing them with you.

Very truly yours,

Robert A. Blum