A number of health care entities in California have traditionally considered themselves to be governmental entities and any benefit plans they sponsor to be governmental retirement plans. Governmental retirement plans are exempt from various requirements for employee benefit plans (pertaining to areas such as vesting, non-discrimination, participation, and funding) that otherwise apply to retirement plans under the Internal Revenue Code (the “Code”) and the Employee Retirement Income Security Act of 1974 (“ERISA”).

However, this area of the law is currently under active consideration by the agencies charged with the administration of the Employee Retirement Income Security Act of 1974 (“ERISA”) (the Internal Revenue Service (“IRS”), the Department of Labor (“DOL”), and the Pension Benefit Guaranty Corporation (“PBGC”)). It is possible that the status of some entities such as governmental entities would change if reviewed under new guidance that may be issued soon by the IRS.

Under an advance notice of proposed rulemaking issued in late 2011 (the “ANPR”), the IRS gave an indication that new factors may be considered in making the determination as to governmental status. In late November 2014, the Treasury Department and the IRS issued their fall regulatory agenda, which indicated that the IRS intended to issue in December 2014 the long-awaited proposed regulations that will provide further rules for the issues first addressed in the ANPR. The IRS is not bound to issue the proposed regulations based on the dates shown on their regulatory agenda—sometimes these dates slip, as has obviously already happened in this case. However, this does indicate that the IRS has put a high priority on moving this issue forward—and we likely can expect something soon.

In the ANPR, the IRS indicated that the effective date for any changes would be for plan years beginning after final regulations are published in the Federal Register. Additionally, the ANPR made several requests for comments about transition rules. When there are major changes in the tax law, the effective date, grandfathering and transition are always key issues. The ANPR did not mention grandfathering, but there was some hint of this. Hanson Bridgett attorneys submitted comments to the IRS and testified in Washington, D.C. at the IRS hearings on this issue, urging the IRS to include grandfathering, both for governmental plan status and for governmental agency status. We are hopeful that the proposed regulations about to be issued will address some of these issues.
Overview of ANPR Description of Possible New Rules

There are two basic issues that are involved in determining if a plan is a governmental plan that the IRS attempted to confront in the ANPR: (i) what is a governmental agency, and (ii) what is a governmental retirement plan. The answers are based on the facts and circumstances of each situation.

A. IRS ANPR Rules Regarding a Governmental Retirement Plan

The rules in the ANPR for what is a governmental plan are simple. A plan is a governmental plan if it is:

1. Established and maintained for the employees of a governmental entity;
2. The employer is a governmental entity; and
3. The “only participants covered by the plan” are employees of that governmental entity.

Given these rules, the real focus in the anticipated new regulations will be on what is a governmental agency, discussed below.

B. IRS ANPR Rules Regarding a Governmental Entity - A State or Local Subdivision

There are two basic categories of governmental agencies under the ANPR: (i) States and political subdivisions, and (ii) agencies and instrumentalities of a state or political subdivision.

We know what a “state” is – there are 50. A political subdivision is defined as a “regional, territorial, or local authority” like a county or city “that is created or recognized by State statute to exercise sovereign powers” like taxation, power of eminent domain, and the police power. Additionally, the governing officers are either appointed by State officials or publicly elected. These entities should be relatively easy to define and determine.

C. IRS ANPR Rules Regarding a Governmental Entity - An Agency or Instrumentality of a State or Local Subdivision

This is the heart of the ANPR and probably will create most of the issues under the new proposed regulations which should be issued soon. For entities like many health care entities in California, the answer to the question of whether they will continue to be considered governmental entities—and thus have their retirement plans remain governmental plans—likely will be determined by application of their particular facts and circumstances to some set of criteria like that proposed in the ANPR. We are hopeful that the criteria will be clarified and simplified in the upcoming IRS guidance. As you will see from reviewing the information below, currently the answer may not always be clear.

1. The “main factors” in determining governmental agency status

The main factors to consider in determining an agency’s governmental status under the ANPR include the following:

(a) The entity’s governing board is controlled by a state or political subdivision. “For example”, state or political subdivision officials have the power, without restriction, to appoint, remove, and replace a majority of the governing board. (The IRS cautions that if there are “so many governing entities that none of them can be said to be responsible” that the control factor may not be met.)

(b) The members of the governing board are publicly nominated and elected. (This appears to be an alternative to the “control” factor above. This may be important for some entities that exercise independent authority.)

(c) A State or political subdivision “has fiscal responsibility for the general debts and other liabilities of the entity” including paying for its benefit plans.

(d) The entity’s employees are treated in the “same manner” as employees of the State or political subdivision. “For example” they are “granted civil service

2 It appears that the IRS is willing to treat some government plans that have a few non-governmental employees as still being governmental plans, but only under stringent conditions that the IRS is still considering. The correct answer, we suspect, should be something like this: any plan with a de minimus number of non-governmental employees should be grandfathered—the current employees and contributing employer should be grandfathered. But it is not certain how the IRS will ultimately decide this issue.
protection.” (The meaning of “civil service protection” is not clear, particularly in the way that many California agencies operate.)

(e) The entity is delegated sovereign powers such as taxation, eminent domain and police powers.

It is clear from the ANPR that an entity need not meet every one of the factors to be a governmental entity. The ANPR is remarkably silent on how to work with them, however. For example, if the control factor (item (a)) exists, is the fiscal responsibility factor (item (c)) needed? Our best guess of how the IRS will look at this is that if at least one of the main factors above exists, then the “other factors” discussed below come into play. And if two of the main factors exist, then the “other factors” would be of lesser weight. How this all works, including any weighting of the factors, is still a mystery that hopefully will be answered soon.

2. The “other factors” under the ANPR

The “other” factors to consider in determining an agency’s governmental status include the following:

(a) The entity’s operations are controlled by the State or political subdivision. (Exactly how this is different from the main control factor, item 1.(a) above, is unclear.)

(b) The entity is “directly funded through tax revenues or other public sources.” However this is not met if the funding is from a contract to provide government services or from government grants. There are questions regarding how this criterion will affect, for example, a separately organized county hospital that provides services to the general public, to employees of the county under the county’s health plan and to the indigent, meeting the county’s obligations under Welfare & Institutions Code 17000. Would this type of arrangement meet this funding requirement?

(c) The entity is created by a State government or political subdivision pursuant to “a specific enabling statute that prescribes the purposes, powers and manners in which the entity is to be established and operated.”

This does not include a nonprofit organized under the general corporation laws. Of course, the question for this criterion is how specific must an enabling statute be and can specificity be remedied retroactively? It is also not clear if the fact that an entity is also organized as a not-for-profit will somehow cause it not to meet this criteria even if it were organized under an enabling statute.

(d) The entity is treated as a governmental entity for federal employment tax or income tax purposes or under other federal laws. (Apparently, this means that the entity will be considered a governmental entity if the IRS has already said it is in some other context.)

(e) The entity is an agency for purposes of State law, such as open meeting laws, public records laws, and being represented by the State’s Attorney General in court.

(f) A State or federal court determines that the entity is an agency or instrumentality of a State or political subdivision.

(g) A State or political subdivision “has the ownership interest in the entity” and “no private interests are involved.”

(h) The entity serves a governmental purpose. (This appears to be a catch-all that the IRS could use to override the other criteria. But how it will be applied seems extremely uncertain until it is clarified in new proposed regulations.)

There are still many questions to be answered by the IRS on these issues. We look forward to seeing how the IRS proposes to deal with this complex subject that may have far-reaching effects on many agencies in California that currently consider themselves governmental entities.

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