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Circular Letter

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TO: **ALL CALPERS EMPLOYERS**

SUBJECT: **INTERNAL REVENUE SERVICE ADVANCE NOTICE OF PROPOSED RULEMAKING REGARDING DEFINITION OF A GOVERNMENTAL PLAN**

The purpose of this Circular Letter is to inform you that the Internal Revenue Service (IRS) and the Treasury Department recently issued an advance notice of proposed rulemaking (the Notice) regarding the definition of a "governmental plan" for purposes of section 414(d) of the Internal Revenue Code (IRC). A copy of the Notice, ["Determination of Governmental Plan Status"](#) is available on the IRS website.

This Circular Letter is intended to provide a brief summary of the Notice, its potential impacts on CalPERS, and the next steps in the rulemaking process. This Circular Letter is not intended to be an analysis of the anticipated proposed regulations contained in the Notice or a definitive statement of the impact on CalPERS, its existing defined benefit plans, or its members and employers, nor should it be relied upon as such.

Background

IRC section 414(d) generally defines the term "governmental plan" as a plan established and maintained for its employees by the government of the United States, the government of any State or political subdivision thereof, or by any of their agencies or instrumentalities. A pension plan that qualifies as a "governmental plan" under IRC section 414(d) is generally treated differently than a private sector pension plan under federal tax laws. For example, in some instances, the federal tax rules are tailored to reflect the unique circumstances of governmental plans, while in other instances, a governmental plan may be exempt altogether from certain federal rules applicable to private sector plans. To retain the benefits afforded governmental plans, such plans must comply with certain requirements under federal tax law, including the requirements of section 414(d).

The IRS and the Treasury Department have initiated this rulemaking process because of the current lack of comprehensive section 414(d) guidance, which they believe has made it difficult for government employers and their employees to have certainty regarding their status under section 414(d). The IRS has also indicated that it sees the Notice as a means to initiate a dialogue with the governmental plan community. Although it is difficult to anticipate what the final rules will look like, any regulations adopted by the IRS are

likely to provide greater clarity on whether the IRS would view an entity as “an agency or instrumentality of the State or a political subdivision of a State” that is eligible to participate in a governmental plan.

CalPERS is a governmental pension plan within the meaning of IRC section 414(d). Therefore, CalPERS will be subject to any regulations that the IRS adopts interpreting IRC section 414(d). Ultimately, what this means is that CalPERS will have to prohibit the participation of any entity in the CalPERS plan that is not “an agency or instrumentality of the State or a political subdivision of a State” as defined in the final regulations. It is not clear what impact this will have on employers currently participating in the CalPERS plan and the extent to which the final regulations will provide transition relief.

The Notice

The Notice includes an appendix setting forth a draft of anticipated proposed regulations. These draft regulations create a facts and circumstances test for determining whether an entity is an “agency or instrumentality of the state or political subdivision of a State.” They also include numerous examples to demonstrate how the facts and circumstances test might be applied. Below is a brief summary of the main and other factors that make up the facts and circumstances test in the Notice. It is important to note that these factors, and the weight that each factor plays in determining whether an entity is eligible to participate in a governmental plan, may change before the IRS adopts final regulations.

As proposed in the Notice, main factors for determining whether an entity is an agency of instrumentality of a State or political subdivision of a State include whether:

- The entity’s governing board or body is controlled by a State or political subdivision thereof;
- The members of the governing board or body are publicly nominated and elected;
- A State (or political subdivision thereof) has fiscal responsibility for the general debts and other liabilities of the entity (including funding responsibility for the employee benefits under the entity’s plan);
- 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); and
- 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 (such as, the power of taxation, the power of eminent domain, and the police power).

Other factors include whether:

- The entity’s operations are controlled by a State (or political subdivision thereof);
- 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;

- 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. However, a nonprofit corporation that is incorporated under a State's general corporation law is not created under a specific enabling statute;
- 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;
- 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;
- The entity is determined to be an agency or instrumentality of a State (or political subdivision thereof) by a State or Federal court;
- A State (or political subdivision thereof) has the ownership interest in the entity and no private interests are involved; and
- The entity serves a governmental purpose.

Next Steps

CalPERS expects that the Notice is the first step in what will likely be a lengthy rulemaking process. To help shape the development of the impending proposed regulations before they are finalized, **the IRS is accepting written comments from the public until June 18, 2012.** Oral comments from the public may also be made at a public hearing in Washington, D.C. on July 9, 2012. The IRS is also scheduling Town Hall meetings to gather public feedback. CalPERS recently participated in a Town Hall meeting held on March 15, 2012.

Because of the ongoing dialogue in this rulemaking process, it is possible that the facts and circumstances test contained in the Notice may be revised and that the factors and their relative importance may change. Therefore, it is not clear at this point what the impact will be if and when final regulations are issued by the IRS. CalPERS will continue to engage in the public comment process and to evaluate the potential impact on CalPERS of any proposed regulations as the rulemaking process moves forward.

CalPERS recommends that all contracting agencies consult with independent legal counsel if they have questions about whether they satisfy the definition of an "agency or instrumentality of a State or a political subdivision of a State," as set forth in the Notice.

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Benefit Programs Policy and Planning