STAFF’S ARGUMENT TO ADOPT THE PROPOSED DECISION

Golden Gate Regional Center, Inc. (GGRC) is a nonprofit corporation, established in 1977, that operates a regional center for the developmentally disabled in the counties of San Francisco, San Mateo and Marin. GGRC receives funding to provide these services through successive, 5-year cost-reimbursement contracts with the State of California, Department of Developmental Services (DDS), which can be terminated by DDS for cause.

Historically, GGRC has offered its approximately 230 employees a private, defined-contribution retirement plan. In August 2016, GGRC applied to contract with CalPERS and provide GGRC employees with CalPERS’ public, defined-benefit plan.

CalPERS reviews pension contract applications to ensure compliance with the California Public Employees’ Retirement Law (PERL), Government Code section 20000 et seq., and to ensure that allowing an entity to contract with CalPERS would not pose unnecessary risk to CalPERS’ “governmental plan” status under federal tax law. (26 U.S.C. § 414(d).) CalPERS reviewed GGRC’s application, founding documents, contract with DDS and other records, and determined that GGRC was not eligible to contract with CalPERS.

GGRC appealed this determination and exercised its right to a hearing before an Administrative Law Judge (ALJ) with the Office of Administrative Hearings. A hearing was held on January 29, 2019. GGRC was represented by counsel at the hearing.

Records provided by GGRC in support of its application and submitted at the hearing demonstrated that GGRC was formed for the purpose of obtaining a contract with DDS to fund the operation of a regional center for persons with developmental disabilities, pursuant to the terms and conditions set forth in the Lanterman Act. (Welf. & Inst. Code (WIC) § 4620 et seq.) The Lanterman Act gives DDS the authority to contract with nonprofit corporations to operate regional centers, which serve as “fixed points of contact in the community for persons with developmental disabilities.” (WIC § 4620(a).) Such contracts shall be with “appropriate agencies” that meet Lanterman Act requirements. (Id.) Contracts are awarded for 5-year periods and are subject to termination or renewal. (WIC §§ 4630-36.) DDS shall only contract with nonprofit corporations that comply with the Lanterman Act requirements. (WIC § 4622.)

Pursuant to a 5-year, $200 million contract with DDS for the period of 2017 through 2021, GGRC and its employees operate in an “independent capacity and not as officers or employees or agents of the State of California.” The DDS/GGRC agreement is a cost-reimbursement contract that DDS “may terminate … and be relieved of any payments … should [GGRC] fail to perform the covenants.” In the event of termination, the State may proceed with the work “in any manner deemed proper by the State.” The State is a signatory on bank accounts holding contract funds used for GGRC.
operations, but not on accounts holding funds used to administer “standard employee benefits.” In the event employee benefits exceed expectations, GGRC cannot use more than 15 percent of DDS funding on administrative costs.

A Board of Directors controls and oversees GGRC. Directors shall live or work in the counties GGRC serves, be at least 18 years of age, and possess an interest in or have knowledge of developmental disabilities. The Board solicits nominees through community outreach and appoints Directors to a 3-year term by majority vote of the Board. Directors can be removed if they fail to attend three consecutive meetings, fail to serve on a committee, or engage in gross misconduct. The Board replaces removed Directors the same way it appoints new Directors.

At the hearing, a CalPERS witness testified that CalPERS follows a two-step process for evaluating contract applications. First, CalPERS looks at state law, which provides that CalPERS “may” contract with a “public agency,” but is not required to do so. (Gov. Code §§ 20460-61.) The PERL defines “public agency” as “any city, county, district, other local authority or public body.” (Gov. Code § 20056.) GGRC does not meet this definition, the CalPERS witness explained at hearing, because it is a non-profit corporation that contracts with the State, and is not an arm of the State.

Over time, the California Legislature amended the PERL’s definition of “public agency” to include entities that could apply to contract with CalPERS even though they are not cities, counties, districts, or other public bodies. These amendments to the definition of “public agency,” as used in the PERL, include nonprofit corporations that contract with the State to operate regional centers, such as GGRC. At the hearing, however, the CalPERS witness explained that effective January 1, 2002, such entities are not considered to be “public agencies” under the PERL unless they obtain an advisory opinion from the U.S. Department of Labor (DOL) stating the entity is an “agency or instrumentality of the state or a political subdivision thereof.” (Gov. Code §§ 20057-20057.1.) As explained at the hearing, GGRC did not possess the required DOL advisory opinion, and therefore did not qualify as a “public agency” under State law.

In addition to the State law requirements, CalPERS must also comply with certain requirements under federal tax law, including the requirements of Section 414(d) of the Internal Revenue Code (IRC). IRC section 414(d) generally defines the term “governmental plan” as a plan established and maintained by the government of the United States, a state or a political subdivision thereof, or by any agency or instrumentality of any of the foregoing. (Id.) Hence, to participate in a governmental plan like CalPERS, an employer must qualify as an eligible entity within the meaning of IRC section 414(d). Failure to comply with these federal tax law requirements could adversely affect the current and future governmental plan and tax-qualified status of the CalPERS plan. If CalPERS were to lose its governmental plan status within the meaning of IRC section 414(d) by contracting with ineligible entities, it risks losing its tax-qualified status. This would have serious adverse impacts on plan participants and

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their employers, including loss of the members’ ability to defer taxation on employer and member contributions until retirement.

For this reason, it is critical that CalPERS maintain its governmental plan status under federal tax law and exercise its authority to refuse to contract with any public agency where the Board determines such contract would “adversely affect the administration of the system.” (Gov. Code § 20461.)

In the past, CalPERS has exercised its right to refuse to contract with public agencies where doing so would violate the IRS’ “exclusive benefit rule” and therefore place CalPERS’ tax-qualified status at risk. (See In the Matter of the Application to Contract with CalPERS by Galt Services Authority (2008), Precedential Decision No. 08-01.)

In 2011, through an Advance Notice of Proposed Rulemaking (ANPRM), the IRS announced its intent to adopt regulations defining “key terms” relating to “governmental plan” status under the IRC. The ANPRM recognized that the IRS had issued prior guidance related to governmental plan eligibility through Revenue Rulings and Private Letter Rulings. Instead of affirming the standards contained therein, the IRS proposed a comprehensive “Facts and Circumstances” analysis to make clear the IRS’ present view of what it meant to be an “agency or instrumentality” of the State or political subdivision thereof for purposes of IRC section 414(d).

The IRS’ “Facts and Circumstances” analysis contains five “Main Factors” (Main Factors) and eight “Other Factors” (Other Factors). The Main Factors are (A) the entity’s governing body is controlled by a state (or political subdivision thereof); (B) public election of the governing body; (C) the state (or political subdivision thereof) has fiscal responsibility for the entity’s general debts and other liabilities; (D) the entity’s employees are treated in the same manner as employees of the state (or political subdivision thereof) for purposes other than employee benefits, such as civil service status for entity employees; and (D) the entity’s possession of sovereign powers is delegated by statute. The Other Factors are (A) state control of entity operations; (B) tax funding; (C) created by a state statute; (D) governmental status under employment/income tax law; (E) state law treatment as an agency/instrumentality; (F) deemed an agency/instrumentality by a court of law; (G) state owned; and (H) serving a governmental purpose.

The “Facts and Circumstances” test arose from shared concerns between the IRS and DOL with the “growing number of requests for governmental plan determinations from plan sponsors whose relationships to governmental entities are increasingly remote.”

In April 2012, as explained at the hearing, CalPERS advised its contracting agencies that, as a governmental plan, CalPERS would be subject to any final regulations that the IRS adopts interpreting IRC Section 414(d), and that CalPERS would refuse to contract with agencies on a going forward basis that did not satisfy the IRS guidance set

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2 The ANPRM technically contains four Main Factors. Satisfaction of either Main Factor (A) or (B) above is sufficient to satisfy the “Control” factor.
forth in the ANPRM. Though the Facts and Circumstances listed in the ANPRM are not final, CalPERS advised its contracting agencies that they are “drawn on past IRS guidance, and related statements by IRS officials strongly suggest that they reflect current tax law in this area. Moreover, the IRS has made clear that the inclusion of even a single non-governmental entity could jeopardize the governmental plan status of CalPERS.”

Accordingly, CalPERS decided to align its eligibility review process for contract applicants to incorporate the “Facts and Circumstances” test set forth in the ANPRM, in addition to the PERL requirements, “in order to mitigate potential risks to the System.” CalPERS adopted a new Public Agency Applicant Questionnaire, which explains that the applicant is subject to review under the ANPRM. This review under the ANPRM forms the second part of CalPERS’ evaluation of new contract applications, as explained by CalPERS’ witness at the hearing.

At the hearing, CalPERS explained that it determined that GGRC did not meet any of the Main Factors of the ANPRM, and only two or three of the Other Factors. For these reasons, CalPERS determined that it could not accept the GGRC application, due to the fact that GGRC had not demonstrated it was an “agency or instrumentality” of the State and thus, eligible to participate in CalPERS’ “governmental plan” under the IRS guidance set forth in the ANPRM.

GGRC submitted various documents at hearing, including corporate formation records, bylaws, a recent financial audit, its contract with DDS, and various correspondence with the IRS affirming GGRC’s exemption from certain federal employment taxes. GGRC’s Chief Executive Officer and Chief Financial Officer testified at the hearing and explained DDS’ oversight over GGRC operations, but admitted that in the event GGRC was allowed to contract with CalPERS, neither could guarantee that DDS would pay any of GGRC’s unfunded pension obligations, to the extent any arose, under any potential GGRC contract with CalPERS.

After considering all the evidence introduced, as well as arguments by the parties, the ALJ denied GGRC’s appeal. The ALJ found that GGRC met the definition of “public agency” found in the PERL at Government Code section 20057, subdivision (k)(1), because GGRC is a nonprofit corporation that operates a regional center. However, the ALJ found that because GGRC did not possess an advisory opinion from DOL, as required by Government Code section 20057.1, GGRC was not eligible, under State law, to contract with CalPERS.

The ALJ also held that CalPERS’ decision to align its contract review process with the ANPRM to include the Main Factors and Other Factors “was a proper exercise of [CalPERS’] fiduciary obligations” to “safeguard the tax-exempt status of the CalPERS plan in order to protect its members.”

Applying the ANPRM analysis to GGRC, the ALJ agreed that GGRC did not satisfy any of the Main Factors. The ALJ held that the State did not control GGRC’s governing board because the State did not have the power to remove and replace a majority of the
Board. The ALJ agreed that GGRC’s board members are not publicly elected or nominated. Even though the State/DDS funds GGRC operations, the ALJ found the State was not ultimately liable for the nonprofit’s general debts and liabilities. The ALJ also found that GGRC employees do not possess civil service status, and that GGRC does not possess sovereign powers. The ALJ found that GGRC met only four of the eight Other Factors.

Because GGRC did not meet any of the Main Factors, and only four of the eight Other Factors, the ALJ concluded that CalPERS correctly determined that GGRC does not qualify as an agency or instrumentality under the ANPRM. The ALJ also found that tax correspondence from the IRS that GGRC obtained affirming its exemption from certain employer taxes did not demonstrate GGRC was an agency or instrumentality of the State for purposes of CalPERS governmental plan status under IRC section 414(d). For all the reasons stated above, the ALJ upheld CalPERS’ determination, and denied GGRC’s appeal.

Staff argues that the Proposed Decision be adopted by the Board. The Decision applies the plain language of Government Code section 20057.1 and enforces the DOL advisory opinion requirement upon applicants, like GGRC, that seek “public agency” status under one of the amendments set forth in Government Code section 20057.1. The Decision affirms CalPERS’ authority, pursuant to the PERL, to refuse to contract with an entity, where doing so would pose unnecessary risk to the rights and benefits of existing members.

The Decision also affirms that CalPERS properly exercised its fiduciary duty to preserve CalPERS’ governmental plan and tax-qualified status by applying the Main Factors and Other Factors of the ANPRM to contract applicants, including GGRC. The Decision properly applies the ANPRM factors to GGRC, finding the entity does not qualify under the ANPRM guidance as an “agency or instrumentality” eligible to participate in a governmental plan within the meaning of IRC Section 414(d). For all the above reasons, staff argues that the Proposed Decision be adopted by the Board.

June 19, 2019

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KEVIN KREUTZ
Senior Attorney