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CC:PA:LPD:PR (REG-157714-06)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington DC, 20044

Re: REG-157714-06
Proposed Rulemaking Under Section 414(d) of the Internal Revenue Code

This letter is being submitted on behalf of the California Public Employees' Retirement System ("CalPERS" or the "System"), the largest State pension system in the nation. CalPERS provides retirement and health benefit services to over 1.6 million public employees, retirees and their families. As of January 31, 2012, CalPERS' investment portfolio had a market value of approximately \$231.9 billion. The System includes four tax-qualified defined benefit pension funds and two tax-qualified defined contribution retirement funds. The Public Employees' Retirement Fund ("PERF") is the largest of the tax-qualified plan funds administered by CalPERS.

We commend the Internal Revenue Service (the "Service") for the thoughtful process it has implemented in considering the need for additional guidance under Section 414(d) of the Internal Revenue Code of 1986, as amended (the "Code"). We appreciate the Service's understanding that it will be an enormous undertaking for the Service to issue regulations relating to the types of entities that may establish and maintain plans intended to be recognized as "governmental plans." We have confidence based on the Service's unprecedented approach of using an advance notice of proposed rulemaking ("ANPRM") with detailed potential regulation language to begin a dialogue with the governmental plans community, supplemented by Town Hall meetings and other outreach efforts, that the Service will ensure that any new rules it issues will not jeopardize qualified retirement plan coverage for millions of State and local government employees, retirees and beneficiaries.

In our role as the administrator of a State-sponsored, multiple-employer defined benefit plan, CalPERS stands ready to work with the Service to develop a reliable, streamlined system for ensuring that any new regulations issued by the Service will be used to

accurately determine whether employers may join our plan in the future. However, with more than 3,000 employers currently participating in our plan, CalPERS is concerned with how the existing status of multiple-employer governmental plans may be affected by the proposed rulemaking discussed in the ANPRM. As the ANPRM points out, but for a single revenue ruling (which did not address multiple-employer governmental plans), the Service has issued no guidance of general applicability relating to Section 414(d) since the passage of that Section as part of the Employee Retirement Income Security Act of 1974 ("ERISA") nearly 40 years ago. Governmental plans like ours existed long before ERISA, and have operated since that time based on a reasonable, good faith interpretation of Section 414(d).

As the Service points out in the ANPRM, Section 414(d) of the Code and Section 3(32) of ERISA, and the related exceptions from the requirements of ERISA and certain provisions of the Code, came into being based on the concept of federalism, which minimizes the Federal government's interference in the relationship between State governments and their employees.¹ Pension plans provided by State and local governments are part of the government's basic employment and compensation functions and the State and local government sponsors are in the best position to determine the factors and conditions that must be addressed by such plans. In addition, State and local governments bear responsibility for meeting the pension obligations imposed by such plans.²

Governmental plans, particularly defined benefit plans, are long-term vehicles for providing promised government retirement benefits. Funding needs for plans like ours are projected based on long-term assumptions, including those relating to each participating employer's eligible workforce. Governmental plan participants in California and most other states have vested legal rights to receive promised benefits under an actuarially sound plan. Accordingly, multiple-employer governmental plans like ours have very little flexibility in making changes that will affect current participating employers, employees or retirees.

Fortunately, the Service has acknowledged in the ANPRM, in Town Hall meetings, and elsewhere that there is a separate set of issues that will need to be addressed in the context of how any new rules would apply to existing, multiple-employer plans. We appreciate the opportunity to provide written comments with regard to these issues in advance of the Service's issuance of proposed regulations under Section 414(d) of the Code.

¹ See, e.g., H.R. Rep. No. 533, 93d Cong., 1st Sess. (1973).

² We also note that, based on the legislative history of ERISA, the Pension Benefit Guaranty Corporation (the "PBGC") has determined that pension plans maintained by a public agency or political subdivision that have been taken over from a private business are exempt from the provisions of Title IV of ERISA as governmental plans. The PBGC's determination and the legislative history it was based on manifest the intent that the Federal government would not assume the obligations of an underfunded governmental plan. See PBGC Opinion Letter 75-4 4.

System for Determining Initial and Ongoing Governmental Entity Status of Prospective Participating Employers

Like other administrators of multiple-employer governmental plans, CalPERS historically has reviewed the eligibility of entities that request to begin participating in the plans it administers. This review has been based on State law and has taken into account a reasonable, good faith interpretation of the application of Section 414(d) and Section 3(32) of ERISA. Much of the Service's focus in the ANPRM is on the parameters of a detailed facts and circumstances analysis that would need to be used in determining whether a particular entity is a governmental entity. We encourage the Service to take a flexible approach in this regard, recognizing that there are a wide variety of potential structures for governmental entities. We note, however, that the very nature of a facts and circumstances analysis is such that reasonable minds may differ in considering the importance of various factors and are very likely to draw different conclusions based on the same set of facts and circumstances. Unless the Service wants to defer entirely to the decisions of plan administrators in making these determinations in the future, the Service will need to establish its own process.

Accordingly, we recommend that a streamlined approval process be developed by the Service under which an entity may obtain a determination directly from the Service with regard to whether the entity is a governmental entity for purposes of Section 414(d). We anticipate that determinations usually will be unnecessary in the case of political subdivisions. However, agencies and instrumentalities often will present close cases and it is imperative that such entities seeking to participate in a multiple-employer governmental plan like ours be able to present the determinations they have obtained from the Service to the administrator of the plan, and that the administrator of the plan be able to rely on those determinations in permitting the entities to participate in the plan. A governmental entity participating in a plan, and not the plan administrator, should be responsible for making sure that any material changes to the governmental entity's organizational structure or activities are reported to the Service.

The Service also correctly observed in the ANPRM that entities change over time and may cease to be governmental entities. Because changes may occur, and because entities may not always adequately report these changes on a timely basis, new rules issued by the Service should consider some sort of a "de minimis" rule that permits continued participation by these types of entities in a multiple-employer governmental plan, at least for some period of time. We also recommend that any "change in status" rules also make clear that continued funding by a former governmental entity of pension benefits previously accrued by employees will be permitted without limitation, as the rules set forth in the ANPRM would not seem to permit this.

Effect on Governmental Plan Status for Multiple-Employer Plans

The Service has obviously devoted a great deal of time and effort to developing a framework for determining whether an entity should be considered a governmental entity, and we applaud the Service for the thoughtful approach it is taking. Upon finalization of these rules, it follows that an entity that is a governmental entity within the parameters established by the Service would be able to establish and maintain a single-employer governmental plan that covers its employees. Conversely, an entity that is not a governmental entity under the new rules would not be able to establish and maintain a single-employer governmental plan. We understand that the Service may also want to limit the ability of a non-governmental entity (as defined under new regulations) to avoid the restrictions on establishing and maintaining a governmental plan by instead joining a multiple-employer governmental plan. Implemented properly, the streamlined determination process discussed above should go a long way toward preventing that from happening.

We strongly disagree, however, with any notion that an employing entity's failure to satisfy new rules promulgated by the Service should jeopardize the governmental plan status of an existing, State- or local-government sponsored, multiple-employer governmental plan in which the entity participates, particularly in situations where reasonable, good faith interpretations of Section 414(d) led to the initial participation of the entity in the multiple-employer governmental plan. This potential misunderstanding should be cleared up from the outset of this process. Saying that a non-governmental entity should not be permitted to participate in a multiple-employer governmental plan is a far different matter than saying that a multiple-employer governmental plan will somehow lose its governmental plan status if a non-governmental entity participates in the plan. This is particularly important where a currently participating entity loses its "governmental entity" status due to new rules issued by the Service. Multiple-employer governmental plans do not want to be miscast as somehow failing to be governmental plans and needing relief under the Service's qualified plan correction programs because of a change in the rules by the Service. Such an approach would not be productive for the Service, for governmental plans, or for retirement security.

In CalPERS' case, for example, the PERF administered by CalPERS is clearly "a plan established and maintained for its employees . . . by the government of" the State of California. CalPERS and the PERF were established by the California Legislature in 1931, for the purpose of providing secure retirement to State employees. CalPERS administers the PERF and is itself an agency of the State of California, governed by the California Constitution, California Public Employees' Retirement Law, and California Code of Regulations. Thus, there should be no doubt that the PERF is both established

and maintained by the State for the benefit of State employees.³ The fact that local agencies may also participate in the PERF pursuant to State law does not change that.

In this same regard, we have concerns with the current language of Example 5 of Section 1.414(d)-1(k)(4) of the ANPRM. The facts of that Example are extreme, involving an existing governmental plan with 7 participants that is amended to include 10 additional participants employed by what appeared to be a for-profit vendor of candy and soft drinks. Thus, after the amendment, the majority of participants appear to be employees of a for-profit entity. Although we would agree that a reasonable, good faith interpretation of Section 414(d) generally would not support a finding of governmental plan status where a majority of plan participants are employed by a for-profit entity, this example is then used to draw a stark conclusion: the hypothetical governmental plan “is no longer a governmental plan within the meaning of section 414(d) because it provides benefits to employees of a non-governmental employer.” The conclusion itself does not say that it is based on the fact that a majority of participants were non-governmental employees, or on the fact that the employer of a majority of participants apparently was a for-profit entity. Some have said that the point of the Example is to highlight a potential “one employee” rule under which the inclusion of even a single employee of a non-governmental employer in a multiple-employer governmental plan would cause that plan to lose its governmental plan status. We hope that was not the intent, and ask that the conclusion in the Example be clarified.

An approach that would characterize multiple-employer governmental plans as failing to satisfy Section 414(d) due to the coverage of participants who are employees of non-governmental employers (as defined under new rules) would not seem appropriate either in light of the Service’s prior lack of guidance on multiple-employer plan issues or in light of the guidance actually provided by the United States Department of Labor (“DOL”). By way of background, the PERF has been in existence for over 80 years (and for almost 40 years since the passage of ERISA). Since the enactment of ERISA and Section 414(d) in 1974, the only Federal agency that has issued guidance on how multiple-employer governmental plans may be affected by the inclusion of potentially non-governmental employees has been the DOL. Over the years, and as recently as April 27, 2012, the DOL has consistently stated that a de minimis number of such participants would not affect a plan’s status as a “governmental plan” under ERISA. See DOL Advisory Opinion 2012-01A. The term “de minimis” was not defined, nor did it have to be. The Federal government was simply stating the obvious: governmental plan status is not defined by the few, but by the many. We all can agree, of course, that the Federal government should speak with one voice on these issues, particularly when it comes to decisions already made by multiple-employer plans decades ago.

³ As noted in the ANPRM, section 3(32) of ERISA refers to a “governmental plan” as a plan that is “established or maintained” by an eligible employer, rather than one that is “established and maintained” by such an employer under Section 414(d). Even if the PERF were not maintained by an agency of the State of California, the PERF should still satisfy ERISA’s definition of a governmental plan because the PERF was established by the California Legislature for employees of the State of California.

Grandfather Rule for Certain Entities Currently Participating in Multiple-Employer Governmental Plans

To address the issues discussed above, we recommend that a grandfather rule be adopted as part of any proposed guidance by the Service that would permit an entity that currently participates in a multiple-employer governmental plan to continue participating in that plan, both as to current and future employees, provided that the participation of the entity in the plan is consistent with a reasonable, good faith interpretation of Code Section 414(d) and ERISA Section 3(32) before the issuance of new regulations. Participation of an entity in a multiple-employer governmental plan should be deemed to be consistent with a reasonable, good faith interpretation of pre-regulation law where (1) either (a) a State statute specifically designates the entity as eligible to participate in the plan or (b) a State or local government agency responsible for making eligibility determinations has determined that the entity's participation in the plan is consistent with State law, and (2) the entity is not a for-profit entity.

Absent relief such as this, the Service would be forcing employers and participants out of multiple-employer governmental plans (as opposed to simply limiting access to such governmental plans in the future). Forcing employers and participants out of these plans will present a host of potential compliance, employment, and litigation issues for State and local governments, public plans, and employees affected by the proposed rulemaking. Participants have reasonably relied on their ability to receive benefits from the System in making employment and financial decisions. Their expectations (along with the vested rights they have) could be thwarted by the Service's actions in the absence of the type of grandfather provision described above.

Although we appreciate the Service's willingness to consider adopting a "participant level" grandfather rule to prevent a loss of coverage for existing employees and retirees of newly "non-governmental entities" out of a recognition of the vested rights employees have under State laws, a rule that applies solely to existing participants in a governmental plan, rather than to each participating employer, would offer little practical relief. It would still result in significantly increased compliance burdens for public retirement systems as they would have to reopen eligibility determinations for thousands of participating entities to determine whether new employees of those entities could continue to participate in the governmental plan. Moreover, this limited relief would require an affected employer to develop a separate plan to cover new employees hired on or after a specific date. Such an employer would be faced with the choice of maintaining more than one plan to provide benefits to different employee groups, or exiting the governmental plan altogether. As others have noted, such an approach would also jeopardize the funding of benefits for grandfathered participants. As a result, there would still be a significant risk that existing participants in the governmental plan would experience a reduction or loss in retirement benefits. In addition, this more limited grandfather relief would still impose potential litigation risks. For these reasons, we recommend an "entity level" grandfather rule along the lines

discussed above that would permit continued participation (both as to current and future employees) by those entities that have previously been identified in good faith as governmental entities eligible to participate in a multiple-employer governmental plan.

Extended Compliance Period

Finally, even if the Service adopts the type of relief described above, significant transition relief in the form of an extended compliance period will be needed by public retirement systems. For example, it will take a significant amount of time to amend State laws governing the types of entities that may prospectively participate in multiple-employer governmental plans. It will also take time to educate plan administrators and prospective employers regarding the new standards developed by the Service.

Conclusion

Again, CalPERS stands ready to work with the Service in its efforts to develop guidance relating to governmental plans. We commend the Service for the process it has used to date. We believe that a primary goal of the Service's guidance should be to support a streamlined approval process under which an employer that wants to begin participating in or sponsoring a governmental plan of its own may obtain a determination directly from the Service as to whether the employer is a governmental entity for purposes of Section 414(d). On the other hand, we feel strongly that an approach that would undermine existing employer participation in multiple-employer governmental plans would not end up advancing the goals of the Service or the interests of retirement security. Therefore, we recommend that any guidance include relief that would permit an entity that currently participates in a multiple-employer governmental plan to continue participating in that plan, provided its participation is consistent with a reasonable, good faith interpretation of the law prior to the issuance of new regulations.

Thank you for your consideration of these issues. We look forward to continuing to work with you. Please contact Don Wellington of Steptoe & Johnson LLP at (213) 439-9457 or me if you have any questions.

Very truly yours,



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