Comments Concerning Nondiscrimination Standards for Governmental Plans

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

These comments were prepared by individual members of the Committee on Employee Benefits of the Section of Taxation. Principal responsibility was exercised by Kyle N. Brown and W. Scott Magargee, III. Substantive contributions were made by Kyle N. Brown, W. Scott Magargee, III, Marian Campbell and Judith Mazo. The Comments were reviewed by David L. Raish of the Section's Committee on Government Submissions and by Elaine Church, the Council Director for the Committee on Employee Benefits.

Although many of the members of the Section of Taxation who participated in the preparation of these Comments necessarily have clients affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Executive Summary

The Taxpayer Relief Act of 1997 \(^1\) enacted a permanent moratorium from the nondiscrimination rules for governmental plans, as defined in §414(d) of the Code, \(^2\) along with retroactive deemed compliance for such plans. Accordingly, the determination of whether a qualified retirement plan is a governmental plan is a matter of tremendous significance for the plan sponsor, eliminating substantial compliance burdens and reducing the expenses of administering the plan.

Because of the significance of the governmental plan determination, it is recommended that the IRS issue guidance clarifying the scope of the governmental plan definition for Internal Revenue Code purposes. Guidance on the criteria for being a governmental plan exists, but there are several areas where it is unclear whether a plan is a governmental plan for purposes of the Code. This comment addresses some of those areas, particularly the scope of the "established and maintained" standard, and the application of governmental plan status to plans not maintained by governmental employers or plans benefiting both governmental and private employees. Additionally, the comment addresses the need for guidance on the definition of controlled group for governmental employers and the scope of the nondiscrimination moratorium with regard to testing matching and employee contributions.

Scope of Established and Maintained Standard

Issue

Section 414(d) defines a governmental plan as a plan "established and maintained" by the government of the United States, by the government of any state or political subdivision thereof, or by any agency or instrumentality of any of the foregoing (hereinafter, a "governmental employer").

The application of this standard is unclear when the status of the plan sponsor changes, either from private employer to governmental employer or from governmental employer to private employer. A private employer is most likely to convert to a governmental employer upon the acquisition of the private employer by a government agency or instrumentality. A governmental employer is most likely to convert to a private employer upon the privatization of a function or service or disposition of an operating unit to a private employer.

When a private employer converts to a governmental employer, governmental plan status may turn on whether the plan, which may have been initiated by the private employer, meets the "established" prong of the test. When a governmental employer converts to a private employer, governmental plan status may turn on whether the plan is "maintained" by a governmental employer.

Analysis

The definition of governmental plan in the Code is slightly different from the definition in Title I of ERISA, which uses the words "established or maintained" by a governmental employer. \(^3\) Title IV of ERISA uses the "established and maintained" standard for determining whether a plan is exempt from Pension Benefit Guaranty Corporation (PBGC) coverage. \(^4\)

The governmental plan standard for Title I is obviously more amenable to a determination that a plan established by a private employer is a governmental plan upon the purchase of the employer by a governmental employer, and the Department of Labor has given an advisory opinion to that effect. \(^5\) That advisory opinion was based on the determination that, at all times since the
enactment of ERISA, a governmental employer maintained the plan, with no discussion at all of the "established" prong of the governmental plan standard.

Applying the same language as appears in the Code, the PBGC has opined that strict construction of the terms of the statute would frustrate Congressional intent concerning plans sponsored by governmental employers, so that pension plans taken over from a private business by a governmental employer are governmental plans excluded from the provisions of Title IV of ERISA. 

The IRS’ interpretation of the established or maintained language remains largely a mystery. In the only ruling to date concerning the acquisition of a private employer and its plan by a governmental employer, the IRS ruled without discussion that such a plan is a governmental plan.

The status of a plan established by a government entity and subsequently privatized and taken over by a private employer has not been ruled on. The legislative history of the governmental plan provision indicates that such a plan should not be considered a governmental plan, since a significant reason for exempting governmental plans from ERISA was "the ability of the governmental entities to fulfill their obligations to employees through their taxing powers." If the plan is no longer sponsored and maintained by a governmental employer, the security provided by the government’s taxing authority is no longer available to the plan.

Strict construction of §414(d) would require that a plan be both established by a governmental employer and maintained by a governmental employer in order to enjoy governmental plan status. However, strict construction is not only unnecessary in this instance, but contrary to Congressional intent. A recognized treatise on statutory construction indicates the significance of Congressional intent in interpreting such provisions:

Where two or more requirements are provided in a section and it is the legislative intent that all of the requirements must be fulfilled in order to comply with the statute, the conjunctive "and" should be used. Where a failure to comply with any requirement imposes liability, the disjunctive "or" should be used. There has been, however, so great laxity in the use of these terms that courts have generally said that the words are interchangeable and that one may substituted for the other, if consistent with the legislative intent. 

A significant body of case law illustrates and confirms this principle. Thus, the use of the "established and maintained" phrase in §414(d) does not necessarily mandate that a plan meet both criteria in order to be considered a governmental plan subject to the nondiscrimination moratorium. Both the legislative history of the definition of governmental plan and the actual text of the moratorium provisions indicate that current sponsorship of a plan by a governmental employer is the single criterion for determining governmental plan treatment.

The legislative history of ERISA indicates that the special rules concerning vesting, participation and funding are for "plans sponsored by State and local governments." Additionally, the new sections of the Code exempt "a governmental plan (within the meaning of section 414(d)) maintained by a State or local government or political subdivision thereof (or agency or instrumentality thereof)" from various nondiscrimination requirements. So the ERISA legislative history focuses on the current sponsorship of the plan, and the Code’s
nondiscrimination provisions use a maintenance requirement for determining whether a plan falls under the moratorium.

**Recommendation**
The IRS should issue guidance consistent with the clear Congressional intent that plans currently maintained by governmental employers are considered governmental plans and exempt from the nondiscrimination requirements. Accordingly, plans initiated by private employers but currently sponsored by governmental employers should be considered governmental plans exempt from the nondiscrimination requirements, and plans initiated by governmental employers but currently sponsored by private employers are not governmental plans and are not exempt from the nondiscrimination requirements. Such a position would not only follow the congressional intent, but also provide a unified policy and definition of governmental plan for all purposes of ERISA and the Code.

**Plans Not Sponsored by Governmental Employers**

**Issue**
The treatment of plans not sponsored by governmental employers but covering governmental employees, or employees providing services to a governmental employer, is unclear. Such plans can be sponsored either (1) by a joint board of trustees as a result of collective bargaining between a union representing governmental employees and a governmental employer or (2) by a private employer under a mandate by a governmental employer as a result of government contracting.

**Analysis**
Plans maintained pursuant to collective bargaining are often maintained not by either the employer or the union representing the employees, but by a joint board of trustees comprised of representatives of both the employer and the union in equal number. Special rules exempt plans maintained pursuant to a collective bargaining agreement (even where the employer is a private employer) from many of the nondiscrimination rules. However, plans maintained pursuant to a collective bargaining agreement between a private employer and a union representing employees are not exempt from the Average Deferral Percentage (ADP) test (if the plan contains a cash or deferred arrangement under §401(k)) or the minimum participation standards of §410(a). Under the terms of the nondiscrimination moratorium, governmental plans are exempt from both requirements.

The DOL has opined that a governmental plan is not limited to plans established solely by governmental employers, but includes collectively bargained plans and plans jointly administered by trustees appointed by governmental entities and by labor unions if these plans were funded by the employer and covered only employees of governmental entities. The DOL has stated that governmental plan status is not "so narrow as to include only plans established by the unilateral action of employers which are governmental entities and plans which are ultimately within the exclusive control of governmental entities." 13

At least one court has held that plans established pursuant to collective bargaining between a governmental employer and a union representing governmental employees are established and maintained by a governmental employer and therefore exempt from Title I of ERISA. 14 The basis of the holding was, *inter alia*, the court’s belief that the legislative history of ERISA and the governmental plan exemption indicated Congressional focus on the governmental nature of
public employees and public employers rather than the details of how a plan was established or maintained.

Having the same number of plan trustees represent the governmental entity as represent the union apparently is not a prerequisite for governmental plan status in the DOL’s view. The key to governmental plan status appears to be whether the plan is funded by and covers only employees of governmental entities.

A plan can also be considered "maintained" by a governmental employer when a private employer under a mandate from a governmental employer sponsors the plan. The limited PBGC guidance on the governmental plan treatment of a plan maintained at the direction of a governmental entity, but not actually sponsored by the governmental entity, focuses on whether the governmental entity is contractually required to pay benefits under the plan, including benefits that would be insured by the PBGC in the event of plan termination. Maintenance of the plan under the direction of the governmental entity or the allowance of plan funding costs as a reimbursable expense under the terms of the contract is apparently not sufficient to consider a plan maintained by a private employer as a governmental plan.

The IRS position is that governmental plan status depends on whether the private employer is an agency of the government, and that the degree of control that the government has over the organization’s everyday operation is crucial in that regard. Other factors include: (1) whether there is specific legislation creating the organization; (2) the source of funds for the organization; (3) the manner in which the organization’s trustees or operating board are selected; and (4) whether the applicable governmental unit considers the employees of the organization to be employees of the applicable governmental unit. Although all of the above factors are considered in determining whether an organization is an agency of a government, the satisfaction of one or all of the factors is not necessarily determinative.

Using these standards, a plan sponsored by a §501(c)(3) tax-exempt organization that was responsible for the daily operation of a municipal transit system was held to be a governmental plan. The municipal government controlled the organization’s funding and exercised substantial control over the transit operations carried out by the organization. Conversely, a plan sponsored by a government contractor was determined not to be a governmental plan where the financial relationship between the private employer and the contracting governments was not significant enough for the contractor to be considered the "alter ego" of the governments.

This analysis is in accord with the legislative history of the governmental plan exemption from ERISA, which considers whether benefits under the plan are protected by the taxing power of a government. If the government and its taxing authority are ultimately responsible for the payment of benefits, there is no need for the protection of the plan or participants by ERISA.

**Recommendation**

The IRS should modify its existing guidance concerning when a plan sponsored by a non-governmental employer will be considered a governmental plan to consider whether the governmental employer has ultimate liability for the payment of benefits from the plan. A plan maintained under the direction of a governmental employer, such as through a collective bargaining agreement, should be considered a governmental plan as long as the governmental employer is responsible for the funding of the plan. A plan sponsored and maintained by a private employer or a tax-exempt organization should be considered a governmental plan if the
government has responsibility for the payment of benefits in the event such benefits could not be paid from the plan funds.

Plans Benefiting Governmental and Private-Sector Employees

Issue

Under existing guidance concerning Title IV, a plan that includes both government and non-government employers and employees cannot be a governmental plan, while such a plan may be a governmental plan for purposes of Title I of ERISA. It is not clear whether governmental plan status will extend to such plans for purposes of the nondiscrimination moratorium under the Code.

Analysis

As a general matter, it is desirable to have rules that are consistent for all purposes of ERISA and the Code. A plan that is a governmental plan for purposes of Title I of ERISA should be considered a governmental plan for purposes of the Code and Title IV of ERISA. So far, all of the recommendations of this comment follow that precept. However, that may not be possible with respect to plans covering both governmental and non-governmental employees.

The PBGC has opined that a plan covering both government employers and private employers is not a governmental plan and, therefore, is covered by Title IV of ERISA. While the ruling was clear that section 4044 would apply to the entire plan upon plan termination, it was not clear, because key portions of the ruling are redacted, whether PBGC premiums were due for the government employees.

The position of the DOL is even less clear. While the DOL has indicated that allowing employees or former employees of a non-governmental entity to participate in a plan could jeopardize governmental plan status, the Department has opined that a plan would maintain its governmental plan status even though it provided benefits to a few non-governmental employees. Whether this latter opinion can be read expansively is unclear, since the only non-governmental employees provided benefits under the plan were former employees of a private employer taken over by the governmental employer.

Given that a position consistent with Titles I and IV of ERISA may not be possible, the IRS should apply the governmental plan nondiscrimination exemption in a manner consistent with the Congressional intent supporting the provision. According to the legislative history, the moratorium was extended to governmental plans because of "the unique circumstances applicable to governmental plans and the complexity of compliance." This indicates the moratorium should not be interpreted or applied in a narrow manner.

The inclusion of some non-governmental employees should not preclude governmental plan status for this purpose. The unique circumstances applicable to governmental plans may include allowing the participation in a governmental plan of some non-governmental employees, and the complexity of compliance for such plans is clearly not diminished by the inclusion of such participants.

A governmental employer may, for example, include in its plan employees working for a public service agency that is later determined not to be a governmental agency. Given the myriad forms of organization used by governmental and non-governmental organizations, the misclassification of an organization as a governmental agency is a potentially real scenario. The accidental
inclusion of such employees should not result in the loss of governmental plan status or the application of the nondiscrimination rules to the plan.

Additionally, a governmental unit may find it necessary in order to provide needed services to constituents to include certain non-government employees in the governmental plan. In order to provide health care services to the indigent, for example, a governmental employer may have to contract with a private health care provider. Part of that contract could be the participation in the governmental plan of some of the health care provider’s employees. While the IRS might consider such a situation potentially abusive, there are legitimate reasons why a governmental employer might determine that such an arrangement is necessary to provide needed services. Even if some non-governmental employees participate in the plan, the operation and administration of the plan is still subject to all the unique circumstances and the complexity of compliance applicable to governmental plans. Such a plan should still be exempt from the nondiscrimination requirements as a governmental plan.

Fortunately, the IRS has already established a position that protects governmental plans and plan sponsors in such a situation. The IRS has taken the position that up to fifty percent of a plan’s population may be non-governmental employees without affecting the plan’s status as a governmental plan for purposes of the Tax Reform Act of 1986 effective dates and remedial amendment period. This fifty percent rule is a simple rule that governmental plan sponsors could follow.

**Recommendation**

The IRS should issue guidance stating that if at least fifty percent of the participants in a plan are employees of a governmental employer, then the plan is exempt from the Code’s nondiscrimination requirements. If the IRS is unwilling to extend the fifty percent standard it has already established to the nondiscrimination moratorium, it should at least provide guidance stating that the inclusion of a *de minimis* number of non-governmental employees does not preclude governmental plan status. While the fifty percent standard is clearly preferable, a *de minimis* standard would at least provide some assurance to governmental employers that the nondiscrimination requirements will not be applied to the plan upon the inclusion of a small number of private sector employees.

**Definition of Controlled Group**

**Issue**

Section 414 contains several provisions for determining the "controlled group of employers," the related businesses that are considered the employer for most employee benefit plan purposes. While the statutory rules are effective for determining the controlled group for private employers, they are not effective for determining the controlled group among governmental employers.

**Analysis**

The controlled group rules generally determine the scope of the employer based on some determination of ownership, such as stock ownership of a corporate employer, a standard that is ineffective for determining relationships between governmental entities. In fact, the controlled group rules generally take separate employers and treat them as a combined employer. In the employee benefit plan context, there is no guidance concerning which governmental employers are considered separate, much less those that would then be combined.
The nondiscrimination moratorium for governmental plans significantly reduces the importance of the controlled group rules for governmental employers. However, the controlled group rules are still important for governmental plans for purposes of applying the §415 limits on contributions and benefits and the §401(a)(17) limit on compensation. Benefits and contributions from different plans sponsored by different employers that are part of the same controlled group are aggregated in applying the limits of §415. Likewise, compensation paid by different employers that are part of the same controlled group is combined in applying the limits of §401(a)(17).

In the only known guidance on the application of the controlled group rules to governmental employers for these purposes, a general information letter states the following:

Where separate governmental plans are maintained by different governmental units, the governmental units are treated as a single employer for purposes of the aggregation requirement under section 415(f) pursuant to a reasonable and good faith interpretation of the rules and definitions under sections 414(b), (c), (m), and (o) of the Code. The controlled group definition under Notice 89-23, 1989-1 C.B. 654 (the 80 percent control or funding test), is considered a reasonable (but not exclusive) interpretation of these definitions consistent with the unique nature of governmental entities.

**Recommendation**

Given the limited use of the controlled group rules for governmental employers and the complex issues to be resolved in establishing definitive controlled group rules for governmental employers, expending critical IRS resources in establishing more complete guidance does not appear to be warranted. The reasonable, good faith standard established in the general information letter should be sufficient for governmental employers and their advisors to determine the appropriate application of the §415 limits on contributions and benefits and the §401(a)(17) compensation limit. However, providing the only statement of the controlled group rules for governmental employers in a general information letter is generally insufficient to apprise such employers of this standard.

The reasonable, good faith standard for the application of the controlled group rules for governmental employers should be announced in IRS guidance of general application. The guidance concerning the definition of governmental plans discussed above could serve as a suitable vehicle. If the IRS has internally developed other reasonable interpretations concerning the application of the controlled group rules to governmental employers, those should be included as well.

**Clarification of §401(k) and §401(m) Treatment**

**Issue**

One change made to the moratorium during the conference deserves a minor clarification. Sec. 912(b) of the House bill (H.R. 2014) and sec. 1308(b)(2) of the Senate bill (S. 949) contained provisions treating governmental plans as satisfying the requirements of §401(m)(2) of the Code. This provision was omitted in conference and is not contained in the legislation enacted on August 6, 1997. Additionally, the text of the legislative provisions does not discuss the application of the requirements of §401(k)(3) of the Code to "grandfathered" §401(k) plans sponsored by governmental employers.

**Analysis**

Section 401(m)(2) provides a nondiscrimination test for matching and employee contributions to
a qualified plan, referred to as the Average Contribution Percentage test (ACP test). The ACP test is a subset of the general nondiscrimination test set forth in §401(a)(4). For example, plans that are the subject of collective bargaining are generally exempt from the nondiscrimination standards of §401(a)(4) and specifically exempt from the ACP test. More broadly, §401(m) is by its terms merely a prerequisite for satisfying §401(a)(4) with regard to matching and employee contributions. Accordingly, the permanent moratorium for government plans from the nondiscrimination standard under §401(a)(4) presumably covers the ACP test as well. The legislative history of the moratorium in its early stages confirms this, indicating that "the exemption from the nondiscrimination and participation rules includes exemption from the ACP and ADP tests." 

Though governmental employers are generally precluded from sponsoring §401(k) plans, certain "grandfathered" governmental §401(k) plans are allowed. Section §401(k)(3) provides a nondiscrimination standard for elective deferrals into a qualified cash or deferred arrangement, referred to as the Average Deferral Percentage test (ADP test). It is our understanding that the IRS views the ADP test as both a nondiscrimination standard and a qualification requirement for a qualified cash or deferred arrangement, thereby making the ADP test a prerequisite for the pre-tax treatment of elective deferrals and potentially outside the scope of the nondiscrimination moratorium. The legislative history of the moratorium (referenced above), however, indicates congressional intent that governmental §401(k) plans be exempt from the ADP test.

**Recommendation**

The IRS should clarify that the reason for the removal from the legislation of the specific exemption from the ACP test was that a specific exemption was unnecessary, not that the ACP test continues to apply to government plans. Otherwise, some plans might not be aware of the exemption and continue to perform compliance testing. Additionally, the IRS should clarify the application of the ADP test to §401(k) plans maintained by governmental employers. The IRS should issue guidance indicating that the moratorium on the nondiscrimination standards includes both the ADP test for elective deferrals and the ACP test for matching and employee contributions.

**End Notes**

1 Pub. L. 105-34.
2 Unless otherwise noted, all references are to the Internal Revenue Code of 1986.
3 ERISA §3(32), 29 U.S.C. 1002(32).
6 PBGC Opinion Letter 75-44. The PBGC has similarly ruled that the exemption for plans established and maintained by substantial owners should be construed so that plans currently maintained by substantial owners are exempt from Title IV of ERISA, regardless of the status of the plan upon establishment. See PBGC Opinion Letter 90-6.


10 See, for example, United States v. Fisk, 70 U.S. 445 (1865); Bruce v. First Federal Savings and Loan Association, 837 F.2d 712 (5th Cir. 1988); United States v. Moore, 613 F.2d 1029 (D.C. Cir. 1979), cert. denied, 446 U.S. 954 (1980); Peacock v. Lubbock Compress Co., 252 F.2d 892 (5th Cir. 1958); United States v. Tot, 131 F.2d 261 (3rd Cir. 1942), rev’d on other grounds, 319 U.S. 463 (1943); and Union Central Life Insurance Co. v. Skipper, 115 F.2d 69 (8th Cir. 1902).


12 §§401(a)(5)(G), 401(a)(26)(H), 401(k)(3)(G), and 403(b)(12)(C).


16 ERISA Op. Ltr. 79-36A.

17 However, a mere "affiliation" with a governmental employer or the possession of some quasi-governmental power is insufficient to justify governmental plan status for a plan maintained by a private employer. PLR 8045106.

18 PBGC Opinion Letter 77-126.


21 Id.

22 PLR 9710029.

23 PLR 8045106.

24 PBGC Opinion Letter 77-169.


26 ERISA Op. Ltr. 80-50A.

The IRS has taken similar positions regarding plans sponsored by tax-exempt employers for purposes of the TRA 1986 effective date and remedial amendment period in Notice 92-36 and Rev. Proc. 94-13, 1994-1 C. B. 566.


Reg. §1.401(a)(4)-1(c)(5).

Reg. §1.401(m)-1(a)(3).

Reg. §1.401(a)(4)-1(b)(2)(ii)(B), Reg. §1.401(m)-1(a)(1).

Statement of Managers, House Rept. 105-220.

§401(k)(4)(B)(ii).

IRS Reg. 1.401(k)-1(e)(4).

See IRS Reg. 1.401(k)-1(a)(7).