

Relief for Certain Participants in § 414(d) Governmental Plans

Notice 2015-07

I. PURPOSE

The IRS and the Treasury Department anticipate issuing proposed regulations under § 414(d) of the Internal Revenue Code (Code) to define the term “governmental plan.” This document describes specific rules that the IRS and Treasury Department are considering proposing that relate to whether a State or local retirement system that covers employees of a charter school is a governmental plan within the meaning of § 414(d). Section III of this notice describes the guidance under consideration, which would provide that employees of a public charter school may participate in a State or local retirement system if certain conditions are satisfied. Section IV of this notice discusses the potential for broader transition relief for governmental plans once final regulations under § 414(d) are issued. Section V of this notice requests comments on the guidance under consideration described in section III of this notice.

II. BACKGROUND

Section 414(d) of the Code provides that the term governmental plan generally means “a plan established and maintained for its employees 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.” See sections 3(32) and 4021(b)(2) of

the Employee Retirement Income Security Act of 1974 (ERISA) for definitions of the term “governmental plan,” which govern for purposes of title I and title IV of ERISA, respectively.¹

Currently, there are no regulations interpreting § 414(d) of the Code. Neither § 414(d) of the Code nor ERISA define key terms relating to governmental plans, including the terms “established and maintained,” “political subdivision,” “agency,” and “instrumentality.” Revenue Ruling 89-49, 1989-1 C.B. 117, provides guidance for determining whether a retirement plan maintained by an organization is a governmental plan within the meaning of § 414(d). The revenue ruling lists several factors for determining whether a sponsoring organization or participating employer is an agency or instrumentality of the United States or any State or political subdivision of a State. The factors in Rev. Rul. 89-49 are similar to the factors listed in Rev. Rul. 57-128, 1957-1 CB 31, which provides guidance on whether an entity is an instrumentality that is wholly-owned by one or more States or political subdivisions of a State for purposes of the exemption from employment taxes under §§ 3121(b)(7) and 3306(c)(7) of the Code.

Rev. Rul. 57-128 lists the following factors to be considered in determining whether an organization is an instrumentality of one or more States or political subdivisions thereof: (1) whether the organization is used for a governmental purpose

¹ The definition of the term “governmental plan” also includes special rules relating to (a) plans to which the Railroad Retirement Act of 1935 or 1937 (49 Stat. 967, as amended by 50 Stat. 307) applies, (b) plans of an international organization that is exempt from taxation by reason of the International Organizations Immunities Act (59 Stat. 669), and (c) certain plans that are established and maintained by an Indian tribal government (as defined in § 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with § 7871(d)), or an agency or instrumentality of either.

and performs a governmental function; (2) whether performance of its function is on behalf of one or more States or political subdivisions; (3) whether there are any private interests involved, or whether the States or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) whether express or implied statutory authority or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of the organization's financial autonomy and the source of its operating expenses.

Rev. Rul. 89-49 focuses more on the degree of control that the Federal or State government has over the organization's everyday operations than Rev. Rul. 57-128. Other factors considered in Rev. Rul. 89-49 include: whether there is specific legislation creating the organization; the source of funds for the organization; the manner in which the organization's trustees or operating board are selected; and whether the applicable government unit considers the employees of the organization to be employees of the applicable government unit. Rev. Rul. 89-49 provides that satisfaction of one or all of the factors is not necessarily determinative of whether an organization is a governmental entity.

On November 8, 2011, the IRS and Treasury Department published an Advance Notice of Proposed Rulemaking (ANPRM) (REG-157714-06), relating to the definition of a governmental plan under § 414(d) of the Code, in the **Federal Register** (76 FR 69172) (§ 414(d) ANPRM). The § 414(d) ANPRM describes guidance under consideration that would set forth rules relating to the determination of whether a

retirement plan is a governmental plan within the meaning of § 414(d).² The guidance under consideration would define key terms relating to governmental plans, including “established and maintained,” “political subdivision,” and “agency or instrumentality.”

For purposes of determining whether an entity is an agency or instrumentality of the United States or an agency or instrumentality of a State or political subdivision of a State, the guidance under consideration described in the § 414(d) ANPRM would provide a facts and circumstances analysis. The factors used in this analysis are drawn from the factors historically used in governmental plan determinations, including the factors set forth in Rev. Ruls. 57-128 and 89-49, as well as court decisions.³ The factors described in the anticipated guidance described in the § 414(d) ANPRM include whether the entity’s governing board or body is controlled by a State or political subdivision; whether the members of the entity’s governing board or body are publicly nominated and elected; the extent to which a State has financial responsibility for the general debts and other liabilities of entity; and the extent to which the entity is delegated, pursuant to statute, the authority to exercise sovereign powers. For a complete discussion of each of the factors in the guidance under consideration described in the § 414(d) ANPRM, see the discussion under the heading “Definition of agency or instrumentality of a State or a political subdivision of a State” in the

² The IRS and Treasury Department also issued an ANPRM (REG-133223-08) relating to special rules for ITGs on November 8, 2011 in the **Federal Register** (76 FR 69188).

³ For a discussion of court cases analyzing governmental entity status, see the discussion under the heading, “Judicial Determinations of Governmental Entity Status” in the Appendix to the § 414(d) ANPRM.

“Explanation of Provisions” section of the Appendix to the § 414(d) ANPRM.

The § 414(d) ANPRM requested comments from the public on the guidance under consideration. With respect to this request, members of the public charter school community submitted over 2,000 comments, which, together with all of the other comment letters received, the IRS and Treasury Department continue to review. Although the § 414(d) ANPRM does not change the law regarding or directly address whether a charter school is a governmental entity or whether employees of charter schools are permitted to participate in a governmental plan (such as a State or local retirement system), comments from members of the charter school community raised several concerns with the guidance under consideration. Mainly, the commenters expressed concern that if the guidance described in the § 414(d) ANPRM were published in its current form as a final regulation, the guidance would deter State or local retirement systems from permitting charter school employee participation in their retirement systems in order to retain their governmental plan status. Commenters indicated that this, in turn, would jeopardize the retirement security of charter school employees and adversely affect charter schools’ ability to attract and retain teachers.

Forty-two States and the District of Columbia have laws authorizing the chartering of independent public schools of choice. These schools, often referred to as public charter schools, are generally funded with public revenue on a per-pupil basis. Public charter schools do not charge tuition, are open to all students within a specified geographic boundary, and are viewed by States as part of the public school system. However, public charter schools typically operate independently of the governance

structures that generally are in place for other public schools, such as a district board of education.

In general, States that authorize public charter schools either require or permit public charter school employees to participate in their State retirement systems. In response to the § 414(d) ANPRM, commenters from the public charter school community expressed concern that the autonomy granted to public charter schools would mean that charter school employees would not be able to continue participation in State or local retirement systems. Commenters argued that Congress intended charter schools to be treated as public schools, but recognized that charter schools were not subject to governmental control in the same manner as traditional public schools.⁴ Commenters requested that, when the guidance under consideration described in the § 414(d) ANPRM is ultimately issued, the guidance permit participation of public charter school employees in governmental plans. One request was that the proposed regulations provide the use of a safe harbor to permit public charter school employees to participate in State or local retirement systems. Other requests included that the proposed regulations provide a revised set of factors, without distinction between main factors and other factors, that a typical public charter school would more clearly satisfy; that the proposed regulations include an example under the facts and circumstances test showing that a typical public charter school is an agency or

⁴ See Part B of the Individuals with Disabilities Act, 20 U.S.C. § 1400 *et. seq.*, under which charter schools are treated as public schools for purposes of eligibility for federal funding and 20 U.S.C. §7221i(1)(A), under which a charter school is defined as a public school that “is exempt from significant State or local rules that inhibit the flexible operation and management of public schools, . . .”

instrumentality of a State or political subdivision of a State; and that the proposed regulations provide a grandfathering rule permitting current and future public charter school employees to participate in a State or local retirement system.

III. GUIDANCE UNDER CONSIDERATION

After review and consideration of comments received with respect to the § 414(d) ANPRM, the IRS and Treasury Department are considering issuing the guidance described in section III.A of this notice relating to whether a State or local retirement system that covers employees of a public charter school is a governmental plan within the meaning of § 414(d). The guidance under consideration would take into account the special and unique nature of public charter schools, the governance structure associated with these schools, the structure of many public school systems that permit or encourage public school teachers to move between public charter and traditional public schools, and the relationship between public charter schools and the agencies authorized by the State or political subdivision of the State (such as an authorized public chartering agency as defined in 20 U.S.C. § 7721i(4)) that hold these schools accountable for academic results. It is expected that the principles described in section III.A of this notice would apply regardless of whether the retirement plan is a defined benefit, defined contribution, § 403(b), or § 457(b) governmental plan. The IRS and Treasury Department intend the guidance described in section III.A of this notice to cover only employees of public charter schools and anticipate that the effect of participation of employees of entities other than public charter schools in a State or local retirement system on the system's status as a governmental plan under § 414(d) of the

Code would be determined in accordance with the general rules set forth in the regulations after final regulations under § 414(d) are issued.

A. Participation of a public charter school in a State or local retirement system

The IRS and Treasury Department are considering proposing regulations under § 414(d) specifying that a State or local retirement system that covers employees of a public charter school will not fail to be a governmental plan within the meaning of § 414(d) if certain conditions are satisfied. Specifically, the guidance under consideration would specify that a State or local retirement system will not fail to be a governmental plan within the meaning of § 414(d) merely because the system permits employees of an entity that satisfies the requirements listed in paragraphs (a) through (e) below to participate in the system:

(a) The entity is a nonsectarian independent public school that serves a governmental purpose by providing tuition-free elementary or secondary education, or both.

(b) The entity is established and operated in accordance with a specific State statute authorizing the granting of charters to create independent public schools or authorizing the establishment of independent public schools.

(c) Participation in the State or local retirement system by the entity's employees is expressly required or permitted under applicable law.

(d) The entity satisfies either paragraph (d)(1) or (d)(2) below.

(1) The entity's governing board or body is controlled by a State, political subdivision of a State, or agency or instrumentality of a State or of a political subdivision

of a State. For this purpose, either (i) a State, political subdivision of a State, or an agency or instrumentality of a State or political subdivision of a State must have the power to nominate, appoint, remove, and replace a majority of the members of the entity's governing board or body, or (ii) a majority of the members of the entity's governing board or body must be publicly nominated and elected.

(2) In lieu of satisfying the requirements in paragraph (d)(1), the entity satisfies the requirements in paragraphs (d)(2)(i) through (d)(2)(iii) below.

(i) The primary source of the entity's funding is from a State, political subdivision of a State, or agency or instrumentality of a State or political subdivision of a State.

(ii) The rights of the entity's employees to their accrued benefits under the State or local retirement system are not dependent on whether the entity continues to participate in the system and, in the event the entity ceases participation, a governmental entity has responsibility for the accrued benefits of the entity's employees, including the continued funding of the accrued benefits, to no lesser extent than a governmental entity has responsibility for the continued funding of the accrued benefits of the employees of any other participating employer in the system in the event that other employer were to cease to be a participating employer.

(iii) The entity is part of a local educational agency, as defined in 20 U.S.C. 7801(26) (or is its own local educational agency), and is subject to the significant regulatory control and oversight by a State, political subdivision of a State, or agency or instrumentality of a State or political subdivision of a State, as described in paragraphs (d)(2)(iii)(1) and (d)(2)(iii)(2) below.

(1) The entity is held accountable by an authorized public chartering agency as defined in 20 U.S.C. § 7221i(4), which has the power to approve, renew, and revoke the charter of the entity. For this purpose, the authorized public chartering agency must be authorized under State law to approve charters for the creation of independent public schools and to hold the entity accountable for results.

(2) The entity is required to comply with health and safety standards, as well as academic and financial accountability standards, that are similar to those that are generally applicable to other public schools in the State.

(e) All financial interests of ownership in the entity are held by a State, political subdivision of a State, or agency or instrumentality of a State or of a political subdivision of a State. A State, political subdivision of a State, or agency or instrumentality of a State or political subdivision of a State is not treated as holding all financial ownership interests in an entity unless, upon dissolution or final liquidation of the entity, the entity's governing documents require the entity's net assets to be distributed to another public school that meets the requirements in (a) through (e) of this section III.A or to a State, political subdivision of a State, or agency or instrumentality thereof.

B. Example

For purposes of illustrating the guidance under consideration described in section III.A of this notice, the following example is provided.

1. Facts. Charter School A is an independent public school of choice (that is, a public school in which parents have a choice in determining the school their children will attend) established and operated in accordance with the laws of State X as a nonprofit

corporation under § 501(c)(3) of the Code. Charter School A is a nonsectarian elementary school that provides tuition-free education.

Under the laws of State X, Charter School A has elected to be a participating employer in State X's Retirement System P, which is a defined benefit governmental plan as described in § 414(d). Under the laws of State X, Charter School A is responsible for making any employer contribution that otherwise would be the legal responsibility of the school district, and the State X will be responsible for making employer contributions to the same extent it would be legally responsible if the employees of Charter School A were school district employees.

Charter School A is funded through appropriations of State X based on the school's average daily attendance. This funding mechanism is similar to the funding mechanism for traditional public schools. Charter School A is controlled by an independent board of directors elected by parents of children who are enrolled in the charter school. Although subject to certain State X laws relating to education, Charter School A is exempt from other State X laws that apply to traditional public schools, such as laws relating to student transportation and purchasing and contracting. Charter School A, like all public charter schools in State X, is overseen by the State X Board of Education (which is the sole authorized public chartering agency in State X). For example, Charter School A is subject to audit by the State X Board of Education, which has the power to place the charter school on probation, not renew the charter contract, or revoke the charter contract. Charter School A is also subject to the same health and safety standards and state-level educational assessments used for accountability

purposes as traditional public schools in State X. In addition, Charter School A must participate in the statewide testing programs of State X.

The board of directors for Charter School A is responsible for budgeting, staffing, and other management of the school, but State X requires that Charter School A must satisfy generally accepted accounting standards of fiscal management. Charter School A's charter provides that it will engage in an annual independent, outside audit by a certified public accountant of its financial and administrative operations and will provide a copy of the audit to the State X Board of Education. Charter School A must comply with rules and implementing statutes that prescribe how appropriations of State X may be spent.

Charter School A's governing documents require that, upon closure, dissolution, or final liquidation of the entity, Charter School A's net assets would be distributed to another public school that meets the requirements in (a) through (e) of section III.A of this notice or to an agency or instrumentality of State X, such as a traditional public school or the State X Board of Education.

2. Conclusion.

Based on the facts described in section III.B.1 of this notice, Charter School A meets the requirements of the guidance under consideration described in section III.A of this notice. Therefore, State X's Retirement System P will not fail to be a governmental plan within the meaning of § 414(d) merely because the system permits Charter School A to participate in the system as a participating employer.

C. Coordination with other agencies

The IRS and Treasury Department, in developing the guidance under consideration described in section III.A of this notice, consulted with the Department of Labor (DOL) and Pension Benefit Guaranty Corporation (PBGC) (the “Agencies”). As was the case with the § 414(d) ANPRM, staff from the DOL and PBGC agreed that it would be advantageous for the Agencies and the regulated community for there to be coordinated criteria for determining whether a plan is a governmental plan within the meaning of § 414(d) of the Code, section 3(32) of ERISA, and section 4021(b)(2) of ERISA. With respect to this notice, the IRS and Treasury Department also consulted with the Department of Education.

IV. TRANSITION RELIEF

A. Periods prior to the effective date of final regulations under § 414(d) of the Code

The guidance under consideration in section III.A of this notice would first be issued as part of the proposed regulations under § 414(d). The IRS and Treasury Department anticipate that the proposed regulations will provide guidance under § 414(d), including the guidance under consideration described in section III.A of this notice and the subject matter of the guidance under consideration described in the § 414(d) ANPRM. The proposed regulations will reflect consideration of comments received in response to the comment requests in this notice and the § 414(d) ANPRM. Before the proposed regulations are ultimately adopted as final regulations, consideration will be given to any written or electronic comments that are submitted to the IRS in accordance with the comment request that will be included in the preamble to

the proposed regulations. The preamble to the proposed regulations will request comments on all aspects of the proposed rules.

The IRS and Treasury Department anticipate that the final regulations under § 414(d) will apply prospectively and will include a delayed effective date. The IRS and Treasury Department anticipate that the final regulations under § 414(d) will provide that a State or local retirement system that covers employees of a public charter school that meets the requirements of the guidance under consideration described in section III.A of this notice for periods starting on and after the effective date of the final regulations will not fail to be a governmental plan within the meaning of § 414(d), even if the plan covered those employees for periods before the effective date of the final regulations when the public charter school did not meet the requirements of the guidance under consideration described in section III.A of this notice.

The guidance under consideration described in section III.A of this notice should not be construed to create any inference concerning the proper interpretation of § 414(d) prior to the effective date of final regulations under § 414(d).

B. Broader transition relief

The § 414(d) ANPRM requested comments on whether safe harbors or transition relief, including grandfathering, should be provided in the proposed regulations. Some commenters suggested that the proposed regulations grandfather retirement plans that have received § 414(d) private letter rulings from the IRS, while other commenters advocated for full grandfathering for employees of any entity that has previously been a participating employer in a governmental plan. Comments were also received

requesting that future guidance provide a *de minimis* exception, create safe and unsafe harbors for governmental plan determinations, implement an extended period to come into compliance with the requirements after final regulations under § 414(d) are issued, and provide the ability to correct a § 414(d) governmental plan under the Employee Plans Compliance Resolution System, Rev. Proc. 2013-12 (2013-4 IRB 313), if the plan is not in compliance with final regulations under § 414(d). Commenters also pointed out that, in at least some cases, state contractual or constitutional protections may serve to restrict a state's ability to amend the plan provisions that apply to certain participants. The IRS and Treasury Department are in the process of reviewing each of these comments. It is expected that questions regarding broader transition relief will be addressed when proposed regulations are issued under § 414(d) of the Code.

V. COMMENTS REQUESTED

Comments are requested regarding the guidance under consideration that is described in III.A of this notice. Comments are also requested regarding whether the requirements of the guidance under consideration described in section III.A of this notice are sufficient to limit the guidance to participation of employees of public charter schools in a State or local retirement system and, for example, to not cover participation of employees of entities that provide management or other services to public charter schools. Written comments should be submitted by May 11, 2015. Send submissions to CC:PA:LPD:PR, (Notice 2015-07), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044. Comments may also be hand delivered Monday through Friday between the hours of 8 a.m. and 4:00 p.m. to: Internal

Revenue Service, CC:PA:LPD:PR, (Notice 2015-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington DC. Alternatively, comments may be submitted via the Internet at notice.comments@irs.counsel.treas.gov (Notice 2015-07). All comments will be available for public inspection.

DRAFTING INFORMATION

The principal author of this notice is Pamela R. Kinard of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Kinard or Sarah Bolen at (202) 317-6799 (not a toll-free number).