



## District Business & Advisory Services

Nimrat Johal: Director- DBAS: 408-453-6599

Cathy McKim, Manager-DBAS: 408-453-6588

Bulletin: 12-131

Date: May 16, 2012

To: District Fiscal Directors  
Charter School Administrators

From: Cathy McKim

Re: IRS Considers Clarifying Definition of Governmental Plans

---

The Internal Revenue Code treats governmental pension plans differently from private sector pension plans. In some cases, governmental plans have been exempted from federal tax rules applicable to private sector plans, and in other cases special rules specific to governmental plans have been established, reflecting the unique circumstances of the state or local government sector the plan serves.

In an effort to help clarify which governmental plans are eligible for the special tax rules, the Internal Revenue Service is in the process of developing proposed regulations to define the term "governmental plan" under Internal Revenue Code Section 414(d) and has issued an advance notice of the proposed rulemaking to solicit feedback. It is expected that the proposed regulations are likely to list multiple facts and circumstances tests as the means to determine whether an entity is an agency or an instrumentality of a state or political subdivision and thus eligible to have its employees participate in a governmental plan.

Both CalSTRS and CalPERS have been monitoring the development of the IRS proposal and recently became aware that public charter schools in California operating as nonprofit organizations under 501(c)(3) would probably not be considered agencies or instrumentalities of the state or a political subdivision. Ultimately, this would compel both CalSTRS and CalPERS to prohibit the participation of those charter schools in its benefit programs so that the programs do not lose their governmental plan status.

On April 12, 2012, CalPERS, in order to protect CalPERS tax qualified status indicated it would not allow any charter schools to come into CalPERS membership until further notice. Since the IRS has initiated hearings as to whether or not charter schools meet the test to be members of STRS and PERS; CalPERS is indicating that they are not accepting any more charter schools until the IRS rules. This may not occur until at least July; however, CalPERS has clarified their position on Charter Schools at this point.

### **CalPERS Position**

There is not a moratorium on letting charter schools into CalPERS. Rather, they are reviewing each application, including the school's charter, on a case-by-case basis to determine if the charter school qualifies to participate in the CalPERS plan. This analysis must be completed before they can add a charter school to their new My CalPERS system. CalPERS requests the charter schools submit their entire charter school agreement, school district board meeting minutes approving the charter school and charter school contact information (administrator, address, etc.).

County Board of Education: Leon F. Beauchman, Michael Chang, Joseph Di Salvo, Julia Hover-Smoot, Grace H. Mah, Craig Mann, Anna Song  
1290 Ridder Park Drive, San Jose, CA 95131-2304 (408) 453-6500 [www.sccoe.org](http://www.sccoe.org)

Re: IRS Considers Clarifying Definition of Governmental Plans

It appears that charter schools that are currently being reported will not be affected at this time. It is likely that charter employees in district/COE operated charters would not be affected since they are processed on regular payroll and reported as employees of the COE/district without a distinction as to the program in which they work.

CalPERS has issued Circular Letter No: 200-013-12 dated April 20, 2012 (attached) intended to provide a brief summary of the notice, its potential impacts on CalPERS and the next steps in the rulemaking process. This Circular Letter is not intended to be an analysis of the anticipated proposed regulations contained in the Notice or a definitive statement of the impact on CalPERS, its existing defined benefit plans, or its members and employers, nor should it be relied upon as such.

CalSTRS has issued a Fact Sheet regarding the advance notice of proposed regulations (see attached).

We will keep everyone apprised of any new developments as they occur.

*Please share this information as deemed appropriate.*



California Public Employees' Retirement System  
P.O. Box 942709  
Sacramento, CA 94229-2709  
**(888) CalPERS** (or **888-225-7377**)  
TTY: (877) 249-7442  
[www.calpers.ca.gov](http://www.calpers.ca.gov)

Reference No.:  
Circular Letter No.: 200-013-12  
Distribution: IV, V, VI, X, XII, XVI  
Special:

## Circular Letter

April 20, 2012

TO: **ALL CALPERS EMPLOYERS**

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

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

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

### **Background**

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

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

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

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

### **The Notice**

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

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

- The entity’s governing board or body is controlled by a State or political subdivision thereof;
- The members of the governing board or body are publicly nominated and elected;
- A State (or political subdivision thereof) has fiscal responsibility for the general debts and other liabilities of the entity (including funding responsibility for the employee benefits under the entity’s plan);
- The entity’s employees are treated in the same manner as employees of the State (or political subdivision thereof) for purposes other than providing employee benefits (for example, the entity’s employees are granted civil service protection); and
- In the case of an entity that is not a political subdivision, the entity is delegated, pursuant to a statute of a State or political subdivision, the authority to exercise sovereign powers of the State or political subdivision (such as, the power of taxation, the power of eminent domain, and the police power).

Other factors include whether:

- The entity’s operations are controlled by a State (or political subdivision thereof);
- The entity is directly funded through tax revenues or other public sources. However, this factor is not satisfied if an entity that is not otherwise an agency or instrumentality is paid from public funds under a contract to provide a

governmental service or is funded through grants by the State or Federal government;

- The entity is created by a State government or political subdivision of a State pursuant to a specific enabling statute that prescribes the purposes, powers, and manners in which the entity is to be established and operated. However, a nonprofit corporation that is incorporated under a State's general corporation law is not created under a specific enabling statute;
- The entity is treated as a governmental entity for Federal employment tax or income tax purposes (such as, the authority to issue tax-exempt bonds under section 103(a)) or under other Federal laws;
- The entity is determined to be an agency or instrumentality of a State (or political subdivision thereof) for purposes of State laws. For example, the entity is subject to open meetings laws or the requirement to maintain public records that apply only to governmental entities, or the State attorney general represents the entity in court under a state statute that only permits representation of State entities;
- The entity is determined to be an agency or instrumentality of a State (or political subdivision thereof) by a State or Federal court;
- A State (or political subdivision thereof) has the ownership interest in the entity and no private interests are involved; and
- The entity serves a governmental purpose.

### **Next Steps**

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

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

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

ANN BOYNTON, Deputy Executive Officer  
Benefit Programs Policy and Planning

## Information for...

- Members
- Employers

## Learn about...

- CalSTRS
- Offices
- Multimedia
- Legislation
- Newsroom
- Investments
- Corporate Governance
- Pension2
- Career Opportunities
- 403bComply
- 403(b) + 457(b) Information Portal

## Tools...

- Calculators
- Counseling/Workshops
- Publications
- Forms
- Home Loan Program
- myCalSTRS
- Quick Topics
- Retirement Planning
- 403bCompare.com

## Potential IRS Regulations May Affect Public Charter Schools

The Internal Revenue Code treats governmental pension plans differently from private sector pension plans. In some cases, governmental plans are carved out altogether from federal tax rules applicable to private sector plans; in other cases, such rules are tailored to reflect the unique circumstances of governmental plans and the state or local government sector they serve.

To help clarify which governmental plans are eligible for the special tax rules, the Internal Revenue Service has issued an advance notice of proposed rulemaking to solicit feedback as it develops proposed regulations to define the term "governmental plan" under Internal Revenue Code section 414(d). The forthcoming proposed regulations are likely to list multiple facts and circumstances tests—categorized as *main* factors and *other* factors—as the means to determine whether an entity is an agency or an instrumentality of a state or political subdivision and thus eligible to have its employees participate in a governmental plan.

At this point, the IRS has yet to officially propose these regulations. An official proposal constitutes one of the first steps in a multi-step federal process that includes a public comment period; further review, analysis and incorporation of the comments; and publication of the final regulations in the Federal Register. The official process can span the course of a year or longer.

### California Public Charter Schools

CalSTRS has been monitoring the development of the IRS proposal and recently became aware that public charter schools in California operated by nonprofit organizations probably would not be considered agencies or instrumentalities of the state or a political subdivision. Ultimately, this would compel CalSTRS to prohibit the participation of charter schools in its benefit programs so that the CalSTRS programs do not lose their governmental plan status.

Below is a brief summary of the main and other factors the IRS is considering to determine whether employees of an entity are eligible to participate in a governmental plan, and how California public charter school employees might fare when tested against them.

### Main Factors

The IRS is considering the following main facts and circumstances to determine whether an entity's employees are eligible to participate in a governmental plan:

- A. The entity's governing board or body is controlled by a state or political subdivision.
- B. The members of the entity's governing board or body are publicly nominated or elected.
- C. A state or political subdivision has fiscal responsibility for the general debts and other liabilities of the entity, including the responsibility for the funding of benefits under the entity's employee benefits plans.
- D. The entity's employees are treated in the same manner as employees of the state or political subdivision for purposes other than providing employee benefits.
- E. The entity is designated the authority to exercise sovereign powers, which generally means the power of taxation, eminent domain or police power.

- **Do California public charter schools pass the main facts and circumstances tests?**

Most California public charter schools likely would not pass these main tests, primarily because the presence of a nonprofit operator introduces a layer of oversight and management separate from that of the school district which eventually leads to ineligibility under these tests.

For example, a nonprofit corporation typically has and selects its own board and members without public nomination or election, thus disqualifying the school under tests A and B above. Also, nonprofit-run charter schools tend to operate outside the fiscal responsibility of the school district and are solely liable for their debts, so these schools fail test C. These governance and fiscal responsibility tests are likely to be viewed as key by the IRS when it issues the proposed regulations.

A nonprofit-run charter school *may* pass test D because its teachers are typically required to have a California teaching credential and are subject to California's education labor relations laws that govern unions and bargaining. However, charter school teachers are exempt from the laws that govern tenure, evaluation and dismissal, which reduces the likelihood that a charter school will pass test D.

Finally, charter schools lack the authority to exercise sovereign powers that are exclusively reserved for school districts, and therefore charter schools cannot satisfy test E.

### Other Factors

The IRS is considering a second tier of other facts and circumstances to determine whether an entity's employees are eligible to participate in a governmental plan:

- A. The entity's operations are controlled by a state or political subdivision.
- B. The entity is directly funded through tax revenues or other public sources.
- C. The entity is created by a state government or political subdivision pursuant to a specific enabling statute that prescribes the purposes, powers and manners in which the entity is to be established and operated.
- D. The entity is treated as a governmental entity for federal employment tax or income tax purposes, such as the authority to issue tax-exempt bonds.
- E. The entity is determined to be an agency or instrumentality of a state or political subdivision for purposes of state laws; for example, the entity is subject to open meetings laws or the requirement to maintain public records that apply only to governmental entities, or the state attorney general represents the entity in court under state statute that only permits representation of state entities.
- F. The entity is determined to be an agency or instrumentality of a state or political subdivision by a state or federal court.
- G. A state or political subdivision has the ownership interest in the entity and no private interests are involved.
- H. The entity serves a governmental purpose.

- **Do California public charter schools pass the other facts and circumstances tests?**

Generally, most California public charter schools may pass tests B, C and H. On the other hand, the presence of a nonprofit organization serving as the school operator may make tests A and G difficult to pass.

The ability of a charter school to pass test D is difficult to determine and will depend on how the IRS applies this test to a conduit financing arrangement. For example, a charter school may participate in a bond offering through a conduit issuer—such as the California School Finance Authority—and receive the proceeds of the bond offering, but not receive the federal tax exemption granted to the issuer.

With regard to test E, while school districts strongly encourage charter schools

to comply with open meetings laws and public records laws, these laws do not apply to nonprofit boards operating charter schools, therefore charter schools do not pass this test.

Finally, the ability to pass test F may or may not occur in isolated situations.

- **How does passing/not passing the other facts and circumstances tests rank against passing/not passing the main facts and circumstances tests?**

The answer is not entirely clear at this point. The IRS has not yet determined the ultimate weight and rank of main factors versus other facts and circumstances. However, if the bulk of the main factors are not met, it may be difficult to overcome that failure by successfully fulfilling the other facts and circumstances.

For example, the IRS is likely to view governance, control and fiscal responsibility factors as key. It is presumed the weight and ranking of the factors will be clarified when the proposed regulations are officially issued.

- **What happens if a charter school does not meet the test for its employees to participate in a governmental plan?**

Under current federal law, the inclusion of ineligible employees in a governmental plan could disqualify the plan from favorable tax treatment, subjecting CalSTRS and CalSTRS members to current taxation of plan earnings. The IRS does not indicate whether the remedy to correct any errors with respect to the participation of ineligible employees is to:

- Permit existing ineligible employees to continue to accrue benefits under the plan, but prohibit any such employees from becoming members in the future.
- Permit the ultimate payment of benefits already accrued by ineligible employees, but prohibit the accrual of future benefits for such existing or any subsequent ineligible employees.
- Prohibit the payment of any benefits for service performed as ineligible employees.

As a result, it is unclear at this time what the consequences would be if the regulations were implemented in their current form and charter school employees were determined to be ineligible to participate in CalSTRS benefit programs.

## What's Next

To help guide development of the impending proposed regulations, the IRS is accepting written comments from the public until June 18, 2012. Oral comments from the public can be made at a public hearing in Washington, D.C. on July 9, 2012. Town Hall meetings are also planned by the IRS to garner feedback, one of which will be in Oakland-the only session planned in California-on March 15, 2012, and will be attended by CalSTRS.

CalSTRS will communicate its concern about the charter school issue to the IRS through comments developed collaboratively with the National Association of State Retirement Administrators and the National Council on Teacher Retirement. The comments submitted by NASRA and NCTR will also include input from other state plans, many of which have identified similar issues with their public charter schools.

 [Print This Page](#)

ShareThis

Stay Connected:     

[CalSTRS Home](#) | [Contact Us](#) | [FAQ](#) | [Site Map](#) | [Related Sites](#) | [Glossary](#) | [Privacy](#)



Site Feedback