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Church Plans Update

The Consolidated Appropriations Act, 2016 was signed by the president on December 18 and contains several church plan provisions. Specifically, the legislation allows church plans to include auto-enrollment features, changes the controlled group rules for churches, releases grandfathered defined benefit 403(b) plans from having to meet the defined contribution 415(c) limits, allows church investments in retirement plan collective trusts, and permits plan mergers and transfers between qualified plans and 403(b) plans sponsored by the same church (or the same convention or association of churches). In general, these provisions are effective immediately.

In the courts, new decisions from two circuits fall on opposite sides on the definition of church plan and who can establish a church plan.

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Background

Churches and church-related organizations that are employers face a number of unique issues that private enterprise employers do not. Conversely, they escape many issues faced by private enterprises thanks to ERISA exemptions.

Past legislative efforts strove to address some of the most nettlesome issues such as lack of clarity about controlled group rules, state law payroll hurdles for implementing auto-enrollment, and portability issues. The challenges to the ERISA exemption for plans handled by a separate church-controlled organization has not drawn legislative attention yet, but remains a key issue for courts in several jurisdictions.

Church Plan Clarification

The Consolidated Appropriations Act, 2016 addresses the following compliance issues for church plans.

Automatic Enrollment

Many non-electing church plans have avoided automatic enrollment features because of state payroll deduction laws that are designed to protect employee wages from unauthorized employer deductions and/or access by creditors. The Pension Protection Act of 2006 confirmed that state payroll deduction laws are preempted by the federal ERISA statute as long as the retirement plan implementing automatic enrollment meets certain annual notice requirements, subjects a uniform percentage of pay to the automatic contribution arrangement, and gives the participant a reasonable period to opt out before the automatic deductions are put into effect. However, church plans that did not elect to be subject to ERISA ("non-electing church plans") could not use preemption to avert conflicts with state payroll laws. This prevented sponsors of non-electing church plans from implementing an automatic contribution arrangement in certain states. Though not all states prohibit involuntary deductions, compliance with state payroll deduction laws was a significant obstacle to implementing automatic enrollment for church plan sponsors with participants in multiple jurisdictions.

The Consolidated Appropriations Act, 2016 exempts church pension plans from state laws that prohibit or restrict the ability to include an automatic contribution arrangement if they meet the same conditions required of ERISA plans. However, since non-electing church plans are not subject to ERISA's fiduciary provisions, instead of providing that the default investment under the automatic enrollment arrangement will be invested in accordance with the DOL's default investment regulations under ERISA, the legislation provides that the default investment will be selected "with the care, skill, prudence and diligence that a prudent person selecting an investment option would use."

> **Comment.** The automatic enrollment provision furthers recent efforts to expand retirement coverage to American workers, including President Obama's directive to the Department of Treasury to create myRA and the DOL's recent guidance for state-run retirement savings programs. (See our January 31, 2014 *Legislate* for more information on myRA and see our December 4, 2015 *For Your Information* on the DOL guidance.) However, this legislation does not bring church pension plans under the ambit of ERISA or preempt state and local laws related to church pension plans, other than those state and local laws that would interfere with inclusion of an automatic enrollment feature.
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> Church plan sponsors who were previously hesitant to implement automatic enrollment or automatic escalation provisions in their 403(b) or 401(k) plans due to state payroll deduction restrictions may now consider amending their plans to take advantage of automatic enrollment. However, non-electing church plans that implement automatic enrollment must select default investments based on ERISA-like prudence requirements. Fiduciaries of non-electing church plans may need to be more careful than ERISA fiduciaries in selecting default investments, since non-electing church plan fiduciaries cannot rely on the fiduciary relief provided for ERISA plans under the DOL's Qualified Default Investment Alternative (QDIA) regulations. However, these plans should see no different treatment when it comes to the ability to allow withdrawals during the initial 90-day period under the tax rules for automatic contribution arrangements.

Controlled Group Status

Organizations under common control are considered a single employer for purposes of certain plan qualification requirements under the Code, including minimum coverage and nondiscrimination, Section 415 limits, and the top-heavy plan provisions.

Under 2007 IRS regulations, tax-exempt organizations are generally considered to be under common control with another organization if 80% or more of the directors or trustees of one organization either are representatives of, or are directly or indirectly controlled by, the other organization. The common control regulations generally *do not* apply to churches and QCCOs but they apply to Non-QCCOs (see sidebar for definitions). Older guidance in IRS Notice 89-23 applied to determine the controlled group for churches and QCCOs.

IRS Notice 89-23 provides that *in addition to* the 80% directorship control test described above, an entity is included in the same controlled group as the contributing employer if it provides (directly or indirectly) at least 80% of the contributing employer's operating funds, and there is a degree of common management or supervision between the entities. A degree of common management or supervision exists if the entity providing the funds has the power to appoint or nominate officers, senior management or members of the board of directors (or other governing board) of the entity receiving the funds. A degree of common management or supervision also exists if the entity providing the funds is involved in the day-to-day operations of the entity.

The Consolidated Appropriations Act, 2016 provides that only the second part of Notice 89-23 applies to churches and QCCOs: there is no aggregation required unless one organization is directly involved in the day-to-day operations of the other organization and provided 80% or more of its operating funds in the prior year. On the other hand, a Non-QCCO must still be aggregated with other Non-QCCOs and organizations not exempt from tax if at least 80% of the directors or trustees of the other organization are representatives of, or directly or indirectly controlled by, the Non-QCCO.

What's a Church?

Organizations that may use the church plan rules include tax-exempt organizations that are controlled by or associated with a church or a convention or association of churches. Tax rules define subsets of organizations, and those subsets are subject to different requirements:

- Churches and qualified church-controlled organizations (QCCOs) include steeple churches, conventions or associations of churches, elementary or secondary schools controlled by, operated by, or principally supported by a church, and other tax-exempt entities that meet certain requirements. A key requirement for these other entities is that they not receive more than 25% of support from government sources or for providing goods, services or facilities. Nursing homes, hospitals, and universities, for example, will generally fail this requirement.
- Non-qualified church-controlled organizations (Non-QCCOs) are entities that fall short of being QCCOs — such as nursing homes, hospitals and universities.

Either type of "church" can elect into ERISA.

Permissive Aggregation. The 2007 regulations permit Non-QCCOs to treat themselves as under common control with another exempt organization if they share the same plan, have a common exempt purpose and coordinate their day-to-day activities (even though the 80% directorship control test isn't met). No similar rule was available for churches and QCCOs. Under the Consolidated Appropriations Act, 2016, a church or convention or association of churches can elect to be aggregated with other church-related organizations with which they have common religious bonds and convictions, but only if they agree to be aggregated with that organization in all subsequent plan years (unless or until they revoke their election in the manner specified by the Secretary of Treasury).

Permissive Disaggregation. The 2007 regulations permit disaggregation of Non-QCCO entities from churches and QCCOs. The Consolidated Appropriations Act, 2016 provides that an employer may elect to disaggregate Non-QCCOs as a group from churches and QCCOs as a group if the election is applied to all subsequent plan years unless (or until) the election is revoked in the manner specified by the Secretary of Treasury. Previously, permissive disaggregation was available only to the extent that more than one entity was participating in the plan; the rule is now available regardless of whether the entities participate in the same plan.

Anti-Abuse Rule. The new law clarifies that the permissive aggregation and disaggregation elections are subject to an anti-abuse rule in the 2007 regulations, whereby the IRS can nullify an organization's election if it determines it was made to evade tax requirements.

Transfer of Assets among 403(b) and Qualified Plans of Churches and Related Entities

Currently, churches may sponsor both qualified plans [including 401(k) plans] and 403(b) plans. However, plan sponsors are generally prohibited from merging qualified plans into 403(b) plans, or initiating transfers of assets from qualified plans to 403(b) plans (and vice versa). Although since 2002 there has been no prohibition on employee initiated rollovers between qualified plans and 403(b) plans for participants who are entitled to elect an eligible rollover distribution; the wall between the Code sections prevented plan sponsor initiated mergers and transfers if the employer identified advantages to consolidating plans, such as a decrease in administrative costs.

The Consolidated Appropriations Act, 2016 gives church plan sponsors the ability to initiate a merger from a qualified plan to a 403(b) plan and the ability to transfers assets between qualified plans and 403(b) plans. As is the case with similar qualified plan transactions, the participant's total accrued benefit under the plan immediately after the merger or transfer must be at least equal to the participant's total accrued benefit before the merger. Unlike mergers and transfers between qualified plans, for these transactions, the total accrued benefit after the merger or transfer must be fully vested.

> **Comment:** This rule gives church plan sponsors an opportunity to initiate mergers or transfers between qualified plans and 403(b) plans that are not available to other plan sponsors. 403(b) plans are subject to different rules than qualified plans, so some IRS guidance on the rules that must be followed by a plan after a merger or transfer takes place may be needed. For example, transfers from one 403(b) plan to another 403(b) plan are generally not permitted unless the receiving plan agrees to maintain any distribution restrictions imposed under the transferring plan. It is not known whether these requirements would also apply to a qualified plan receiving assets transferred from a 403(b) plan.

Investment in Collective Trusts

Investing in a collective trust is generally thought to benefit the retirement plan and its participants by facilitating economies of scale in both investment and plan operations.

Prior to the Consolidated Appropriations Act, 2016, church plan assets could be commingled in a group trust with the assets of other tax-favored retirement plans [including qualified plans, IRAs, Roth IRAs, deemed IRAs, governmental 457(b) plans, 403(b)(7) custodial accounts, and 403(b)(9) church retirement income account plans] pursuant to IRS Revenue Rulings 81-100 and 2004-67. In addition, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) provided that the assets of a church plan may be commingled in a common fund with other amounts devoted exclusively to church purposes if the assets that belong to the church and the church retirement plan are separately accounted for and cannot be diverted to purposes other than for the exclusive benefit of employees and beneficiaries, or to defray reasonable administrative expenses. Accordingly, the IRS Section 403(b) regulations also allowed church plans to be commingled with other amounts devoted exclusively to church purposes (such as assets used to fund nonqualified plan distributions to former employees of a church). It was not clear if those nonqualified amounts were allowed to be commingled in a group trust under the existing IRS Revenue Rulings.

The Consolidated Appropriations Act, 2016 codifies the ability of church plans to participate in a group trust if the requirements of existing IRS Revenue Rulings (and any successor guidance) are met. It also clarifies that even non-plan assets of a church that are allowed to be commingled with church retirement plan assets can be held in a group trust without adversely affecting the tax-exempt status of the group trust or the underlying tax-favored plans — provided that the non-plan assets belong to an organization whose primary purpose is to handle the funding and administration of a church retirement plan. The effective date of this change is the date of enactment, December 18, 2015.

Changes to the Section 415 Limits Applicable to Grandfathered 403(b) Defined Benefit Plans

The 2007 IRS Section 403(b) final regulations provide that generally a 403(b) plan must be maintained pursuant to a written defined contribution plan. Defined benefit 403(b) plans are not permitted except for certain grandfathered defined benefit arrangements in effect on September 3, 1982 that were sponsored by churches (including conventions or associations of churches, or tax-exempt employers that are controlled by, or associated with, a church or a convention or association of churches).

The 415 regulations provide that the defined contribution limitations under Section 415(c) apply to any Section 403(b) annuity contract, regardless of whether the contract satisfies the requirements to be a defined contribution plan. For the grandfathered 403(b) defined benefit plans, the final 403(b) regulations required the annual increase in the participant's accrued benefit to be converted into an "annual addition" and then counted toward the Code Section 415(c) limit for defined contribution plans. In addition, the final Section 415 regulations clarified that these grandfathered 403(b) defined benefit plans were *also* subject to the usual Section 415(b) limit for defined benefit plans.

The Consolidated Appropriations Act, 2016 modifies TEFRA so that 415(b), and not 415(c), applies to church defined benefit plans in existence on September 3, 1982. The change is effective for all years — both before, and on or after enactment.

> **Comment.** Given that the change is retroactive, church plan sponsors that counted the defined benefit plan accruals under the Section 415 annual additions limit for defined contribution plans (capping defined contribution plan contributions, or issuing excess annual addition refunds to participants) may need further guidance or relief from the IRS to address their plan operations in prior years. For example, if a plan sponsor counted 403(b) defined benefit accruals toward the defined contribution Section 415 limit in prior years, guidance may or may not require corrective defined contribution plan allocations for participants who were provided smaller contributions than they would have been entitled to receive if the defined contribution limit had not been in effect during those years. Also, if the aggregation of the defined benefit plan annual additions resulted in excess annual refunds of excess annual additions in prior years [from 403(b) plan deferrals or after-tax accounts under a defined contribution 403(b) arrangement], it is not clear whether such refunds need to be returned to the plan.

Church Plan Litigation Update

As noted in our May 4, 2015 *For Your Information*, a number of district courts ruled on class actions filed against, or motions related to, church controlled or associated entities that established employee benefit plans and claimed church plan status. The participants in these cases alleged that such plans are not church plans exempt from ERISA despite having received IRS private letter rulings to the contrary. They sought to force the plan sponsor or plan fiduciaries to remedy violations of the ERISA rules and obtain PBGC coverage. Since then, the first appeals court has weighed in on one case and a district court decided on another.

St. Peter's Healthcare's Plan not a Church Plan

The U.S. Court of Appeals for the 3rd Circuit in *Kaplan v. Saint Peter's Healthcare System* upheld the district court's denial of St. Peter's Healthcare System's motion to dismiss the class action on the ground that its plan qualifies as a church plan. The court held that, based on a strict reading and history of the definition of a church plan in ERISA, only a church may establish a church plan, and since St. Peter's Healthcare System is not a church, it could not *establish* a church plan.

As an aside, the court expressed its reservations that St. Peter's could even maintain a church plan since its principal purpose or function was the provision of health care services and not "the administration or funding of a plan or program for the provision of retirement benefits or welfare benefits, or both, for the employees of a church or a convention or association of churches." Furthermore, it was not sufficient that St. Peter's Retirement Plan Committee's principal purpose is to maintain the plan; it must be the sponsoring organization itself. Since St. Peter's did not meet the principal purpose test, the court did not look at whether St. Peter's met the requirement that the organization be "controlled by or associated with a church or a convention or association of churches" — another requirement to maintain a church plan.

The 3rd Circuit rejected the IRS private letter ruling St. Peter's received because the IRS' position is based on an IRS General Counsel Memorandum and not on a formal adjudication or notice-and-comment rulemaking.

> **Comment:** This case suggests that an IRS private letter ruling in this area is of little value to plan sponsors.

Catholic Health Initiatives is a Church Plan

Earlier in the month, a federal judge in the 10th Circuit granted summary judgment to the defendants in *Medina v. Catholic Health Initiatives*, ruling that the defined benefit pension plan sponsored by Catholic Health Initiatives was a church plan. In this case, the court found that to qualify as a church plan, a plan could be either established by a church or maintained by an organization controlled by or associated with a church whose principal purpose or function is the administration or funding of a benefits plan. The court interpreted this to apply to plans sponsored by church-affiliated organizations and administered by such an organization's plan committee if the principal purpose or function of the committee is administering the plan, and the committee is controlled by or associated with a church. The court analyzed the history and structure of Catholic Health Initiatives and, relying on the same IRS General Counsel Memorandum (GCM 39007) that was rejected by the Third Circuit's decision in *Kaplan*, determined that "[a]ny organization listed in [The Official Catholic Directory] is considered associated with the Roman Catholic Church in the United States," and an employee of any such organization "is considered as an employee of the Roman Catholic Church of the United States for purposes of the church plan rules." Thus, by virtue of its listing in The Official Catholic Directory, Catholic Health Initiatives could claim church plan status.

In Closing

The Consolidated Appropriations Act, 2016 addresses a number of problematic church plan compliance issues, but does nothing to address the elephant in the room: whether ERISA's church plan exemption can be extended to

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plans established by church-related organizations. The issue of church plan status for church-related organizations will likely not be resolved unless and until heard by the Supreme Court.

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