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CLIENT ALERT

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On December 18, 2015, President Obama signed the *Protecting Americans from Tax Hikes Act of 2015* ("PATH Act") into law. Section 336 of the PATH Act contains important provisions applicable to church retirement and welfare benefit plans. The language in section 336 is identical to that of the Church Plan Clarification Act of 2015 introduced in the United States Senate (S. 2308) and House of Representatives (H.R. 4085) in November of 2015. The following provides background information on and summarizes section 336 of the PATH Act.

Controlled Group Rules

Background. Section 414(c) of the Internal Revenue Code ("Code") states that employees of employers that are members of a group under common control are treated as all being employed by a single employer (sometimes referred to as the "controlled group" or "aggregation" rule). This rule is used in applying various requirements applicable to retirement and health care plans (for example, when determining if benefits provided under certain employers' retirement plans are nondiscriminatory). It is also used for various other purposes (for example, when determining if an employer is an "applicable large employer" for purposes of Affordable Care Act).

For taxable entities, common control is based on equity ownership, with a threshold of 80% ownership being necessary to constitute control. In 2007, the Internal Revenue Service ("IRS") issued final regulations under Code section 414(c) establishing controlled group rules for tax-exempt entities, effective for plan years beginning on and after January 1, 2009 (the "2009 Regulations"). These rules apply to qualified 401(a) plans, 403(b) plans, and various welfare benefit plans.

Controlled Group Rules Prior to Passage of the PATH Act. The 2009 Regulations generally provide that, if one organization has the ability to remove and appoint 80% or more of the trustees or directors of another organization, the two organizations are in a controlled group. Two or more organizations are also in a controlled group under the 2009 Regulations if 80% or more of the same individuals serve on the respective boards of all the organizations.

The 2009 Regulations did not apply to churches and qualified church-controlled organizations ("QCCOs") but did, however, apply to non-QCCOs.[1] However, churches and QCCOs were still subject to controlled group rules – the preamble to the final 2009 Regulations (and other IRS

[1] A non-QCCO is generally a church-controlled organization that (1) offers goods, services, or facilities for sale to the general public, other than those sold at a nominal charge, and (2) normally receives more than 25 percent of its support from either governmental sources or receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities. Examples of non-QCCOs are church-related universities, colleges, hospitals and nursing homes open to the general public.

guidance) made it clear that churches and QCCOs had to apply a reasonable, good faith interpretation of the controlled group rules set out in IRS Notice 89-23 in the instances where the employee benefit provisions of the Code required the use of such rules.[2]

IRS Notice 89-23 contains two controlled group rules: (1) a "governance control" test (almost identical to the test used in the 2009 Regulations and described above), and (2) a "financial control" test which provides that a nonprofit organization is in a controlled group with another nonprofit organization if the first organization provides 80% or more of the operating budget of the second organization and there is a degree of common management or supervision between the entities.

Problems Created by the 2009 Regulations. The controlled group rules of both the 2009 Regulations and IRS Notice 89-23 created a great deal of confusion as different church denominations or associations tried to apply the rules to the governance structure created by their various polities. For example, if a bishop has canon law control over the appointment and removal of an organization's board, is the bishop considered to be an organization for purposes of the rules, or is control only present in a civil law context? If an unincorporated general assembly or similar governing body which meets every 3 to 4 years must ratify appointments to an organization's board, does this required ratification create control under the 2009 Regulations and IRS Notice 89-23? The 2009 Regulations and IRS Notice 89-23 did not provide clear answers to these questions.

The 2009 Regulations also suggested, in an example, that if a church state convention or similar organization had the right to remove the directors or trustees of church-controlled organizations within its jurisdiction (e.g., colleges and universities, retirement homes and children's homes), the organizations would be in a controlled group – even though the state convention only maintained control for purposes of theological oversight of the organizations and was not otherwise involved in their day-to-day operations. The PATH Act legislation was designed to fix these and other controlled group problems.

The New Statutory Language. Section 336(a) of the PATH Act clarifies the application of controlled group rules to church plans. The new controlled group rules are effective for all years beginning before, on or after the date of enactment of the PATH Act, so the legislation retroactively corrects any problems caused by the 2009 Regulations.

> Controlled group rules for churches and QCCOs**.** The new Code section 414(c) statutory language provides that churches and QCCOs are only subject to the "financial control" test of IRS Notice 89-23 – the "governance control" test of that Notice no longer applies. If either the requisite financial control or common management or supervision is not present, there is no controlled group. Code section 414(c) now states that a church or QCCO that is otherwise eligible to participate in a church plan will only be aggregated with another church, QCCO or non-QCCO and treated as a single employer with such other organizations for a plan year beginning in a taxable year if:

[2] The following guidance also supports application of the controlled group rules of Notice 89-23 to churches and QCCOs: Revenue Ruling 2009-18, Revenue Procedure 2007-71, 2007-51 I.R.B. 1184, and the 403(b) Plan Listing of Required Modifications ("LRMs") promulgated by the IRS in March of 2015 in connection with the opening of the 403(b) pre-approved plan program.

(1) such organization provides (directly or indirectly) at least 80% of the operating funds for the other organization during the preceding taxable year of the recipient organization, and

(2) there is a degree of common management or supervision between the organizations so that the organization providing the operating funds is directly involved in the day-to-day operations of the other organization.

Controlled group rules for non-QCCOs. The new language in Code section 414(c) also provides that a non-QCCO will be aggregated with 1 or more other non-QCCOs, or with an organization not exempt from tax under Code section 501, and treated as a single employer with such organization, if at least 80% of the directors or trustees of such other organization are either representatives of, or indirectly or directly controlled by, such non-QCCO.[3] This means that non-QCCOs only are aggregated with other non-QCCOs under the "governance control" test – control of a non-QCCO by a church or QCCO will not result in a controlled group unless financial control and common management or supervision are also present.[4]

Permissive Aggregation and Disaggregation**.** Consistent with the 2009 Regulations, the PATH Act allows a church or a convention or association of churches to elect to treat its church-related organizations as a single employer for a plan year. Such election, once made, will apply to all succeeding plan years unless revoked with notice provided to the Secretary in such manner as the Secretary prescribes.

An employer may also elect to "permissively disaggregate" and treat churches and QCCOs separately from non-QCCOs without regard to whether such entities maintain separate church plans. Such election, once made, shall apply to all succeeding plan years unless revoked with notice provided to the Secretary in such manner as the Secretary prescribes.[5]

Anti-Abuse Provision. The PATH Act contains a statement that the anti-abuse provision of Code section 414(c) continues to apply to these church plan controlled group rules. This means the IRS can treat an entity as under common control with an exempt organization in certain cases, including any case in which the IRS determines the structure of one or more exempt organizations (which may include an exempt organization and a taxable entity) or the positions taken by the organizations have the

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[3] This is the same rule that is applicable to other nonprofit employers under the 2009 Regulations.

[4] However, if a non-QCCO financially controls a QCCO, and there is common management or supervision between them, the non-QCCO and the QCCO will be in a controlled group under the "financial control" test.

[5] It appears there will be few instances where permissive disaggregation is needed under the new controlled group rules. Permissive disaggregation is only needed if a church or QCCO and a non-QCCO are in the same controlled group, and that can only happen if the church provides 80% or more of the organization's operating support – and if the organization is in fact a non-QCCO, the church will not be providing that level of support. Permissive disaggregation may also be useful in the situation where a non-QCCO financially controls and manages or supervises a QCCO.

effect of avoiding or evading any requirements for tax-favored retirement plans (or any other employee benefit requirements to which the common control rules apply).[6]

Automatic Enrollment

Background. Most qualified defined contribution and 403(b) plans include a salary reduction feature under which an employee may elect between the receipt of cash compensation or making elective deferral contributions into the employer's defined contribution retirement plan. Some plans also provide for automatic enrollment, a plan design feature under which elective deferrals are made at a specified rate for employees, unless employees elect not to make deferrals, or to make deferrals at a different rate. In ERISA-covered defined contribution plans, ERISA generally preempts state laws relating to employee benefit plans, including state wage withholding laws that could prevent plans from providing an automatic contribution arrangement. ERISA preemption of course does not apply to non-electing church plans, so church defined contribution plans cannot provide for automatic enrollment in any states that require an employee's written consent before deducting amounts from pay.

The New Statutory Language. Section 336(c) of the PATH Act preempts any state law directly or indirectly prohibiting or restricting the inclusion of an automatic contribution arrangement in any church plan, effective as of the date of enactment of the PATH Act.

Definition of Automatic Contribution Arrangement. An automatic contribution arrangement is defined under Section 336(c) as an arrangement:

(1) under which a participant may elect to have the plan sponsor or employer make payments as contributions under the plan on behalf of the participant, or to the participant directly in cash;

(2) under which a participant is treated as having elected to have the plan sponsor or employer make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects to have such contributions made at a different percentage or stopped; and

(3) under which certain notice, election and investment requirements are satisfied.

Notice Requirements. The plan sponsor of (or plan administrator or employer maintaining) an automatic contribution arrangement must, within a reasonable period of time before the first day of each plan year, provide a notice of a participant's rights and obligations under the arrangement to each participant to whom the arrangement applies.[7] The notice must be sufficiently accurate and comprehensive to apprise the participant of such rights and obligations,

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[6] The anti-abuse rule in the 2009 Regulations appears to apply even if there is a demonstrable business purpose for the structure of a group of organizations if the IRS finds the structure has the effect of evading or avoiding any of the employee benefit provisions to which Code section 414(c) applies.

[7] The annual notice requirement will not prevent an employer from adopting, for the first time, an automatic contribution arrangement mid-year. This conclusion is supported by IRS FAQs regarding automatic contribution arrangements (*see* FAQ #4 – "Can an employer add an automatic contribution arrangement to its existing retirement plan?" https://www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-Regarding-Automatic-Contribution-Arrangements-Automatic-Enrollment-Arrangements).

and must be written in a manner calculated to be understood by the average participant to whom the arrangement applies. The notice must:

(1) include an explanation of the participant's right under the arrangement <u>not</u> to have elective contributions made on the participant's behalf (or to elect to have such contributions made at a different percentage);

(2) ensure that the participant has a reasonable period of time, after receipt of such explanation and before the first elective contribution is made, to make such election; and

(3) explain how contributions made under the arrangement will be invested in the absence of any investment election by the participant.

Default Investment. If no affirmative investment election has been made by a participant with respect to an automatic contribution arrangement, contributions to such arrangement must be invested in a default investment option selected with the care, skill, prudence and diligence that a prudent person selecting an investment option would use. Information describing the default investment fund must be included in the notice.

Auto Enrollment Guidance. There is of course no current regulatory or other agency guidance addressing the new church plan automatic enrollment provisions. However, the IRS has issued guidance governing automatic contribution arrangements, including regulations describing the requirements for "eligible automatic contribution arrangements," or "EACAs," and "qualified automatic contribution arrangements," or "QACAs." If a church plan's automatic contribution arrangement is an EACA or QACA, the rules that apply to it are clear – including provisions requiring an initial notice to plan participants who become eligible to participate in an EACA or QACA, annual EACA and QACA participant notice requirements, and rules governing a participant's ability to withdraw contributions made under an EACA (or a QACA qualifying as an EACA.) These rules will presumably only continue to apply to a church plan automatic contribution arrangement that is intended to qualify as an EACA or QACA, but that remains to be seen.[8]

Church Plan Transfers and Mergers

Background. It is common for local churches in some denominations to have established their own retirement plans. Churches sometime establish 401(k) plans through a fund advisor who is a member of the church congregation but is not familiar with 403(b) plans. It is not unusual for a church that has established a 401(k) plan to later determine it would prefer (for various reasons) to participate in its denominational 403(b)(9) plan. Until the passage of the PATH Act, trustee-to-trustee transfers or mergers between church qualified 401(a) retirement plans and 403(b) plans

[8] The new church plan automatic contribution arrangement rules contain a "uniformity" requirement. EACAs and QACAs are also subject to a uniformity requirement, and the EACA and QACA regulations clearly spell out the uniformity rules that apply to such arrangements. However, these regulations do not apply to automatic contribution arrangements that are not EACAs or QACAs, and they probably will also not apply to a church automatic contribution arrangement that is not an EACA or QACA.

were not permitted.[9] Plan assets could only move from a church 401(a) retirement plan to a church 403(b) plan (or vice versa) by a distribution to and rollover by a plan participant.

The New Statutory Language. Section 336(d) of the PATH Act adds a new Code section 414(z), effective for transfers or mergers occurring after the date of enactment of the PATH Act, which provides that the following transactions will not be treated as distributions includable in gross income:

(1) a transfer of all or a portion of the accrued benefit of a participant or beneficiary (whether or not vested) from a church 401(a) plan or 403(b) annuity contract[10] to a 403(b) annuity contract;

(2) a transfer of all or a portion of the accrued benefit of a participant or beneficiary (whether or not vested) from a 403(b) annuity contract to a church 401(a) plan; or

(3) a merger of a church 401(a) plan or 403(b) annuity contract with a 403(b) annuity contract.

These transfers and mergers may occur only if the plan and annuity contracts are both maintained by the same church or convention or association of churches.[11] In addition, the participant's or beneficiary's total accrued benefit immediately after the transfer or merger must be equal to or greater than the participant's or beneficiary's total accrued benefit immediately before the transfer or merger, and such total accrued benefit must be nonforfeitable after the transfer or merger.

This ability to transfer and merge plans will provide church employers with a better alternative to terminating or having to maintain separate "legacy" plans, and should decrease complexity and administrative costs for church employers, as well as decreasing confusion for employees who are covered by more than one plan of the employer. This statutory language will also allow churches with frozen 401(a) plans to move the frozen assets into 403(b)(9) church retirement income account plans.

Investment In Group Trusts

Background. Generally, assets of a retirement plan must be held in a trust and used exclusively for providing benefits to plan participants and beneficiaries. In Revenue Ruling 2011-1, the IRS provided that qualified plan assets, including assets of church retirement plans and plans maintained by unrelated employers, could be pooled and held in a group trust, thus enabling participants in smaller plans to benefit from pricing economies of scale. Before Revenue Ruling 2011-1 was issued, church 403(b)(9) plan assets could not be combined with other types of retirement plan assets in a group trust. Church 403(b)(9) retirement income account assets can also be commingled in a common fund with other assets of the church

[9] This is true for all types of 403(b) plan assets – transfers from 403(b) plans to 401(a) plans, or vice versa, are not permitted.

[10] The term "annuity contract" also includes a Code section 403(b)(7) custodial account and a Code section 403(b)(9) church retirement income account.

[11] For this purpose, a "church or convention or association of churches" includes a church benefit board or an employer controlled by or associated with a church.

(church assets that are not retirement plan assets but are exclusively dedicated to church purposes, such as endowment fund assets).[12] However, unless permitted by the IRS, a Revenue Ruling 2011-1 group trust[13] cannot hold other non-retirement plan assets.

The New Statutory Language. Section 336(e) of the PATH Act provides that, for investments made after its date of enactment, the investment of assets of a: (1) church plan (as defined in Code section 414(e), including a 401(a) plan and a 403(b)(9) retirement income account, and (2) a Code section 414(e)(3(A) organization whose principal purpose or function is the administration of such plan or account (including any assets otherwise permitted to be commingled for investment purposes with the assets of such plan, account or organization) may be invested in a group trust described in Revenue Ruling 2011-1 without adversely affecting the tax status of the group trust, the plan, account or organization, or any other plan or trust that invests in the group trust. This new statutory language thus makes it clear that these amounts can be invested in 2011-1 group trusts, even though some of the assets being invested are from other church assets (such as church endowment funds) and not only church retirement plan assets.

Grandfathered Defined Benefit Plans

Background. Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), certain defined benefit arrangements established by churches and conventions or associations of churches that were in effect on September 3, 1982 (often referred to as "grandfathered defined benefit plans") are treated as 403(b) plans. These plans were intended to be treated, and continue to operate as, defined benefit plans. 403(b) defined contribution plans are subject to the Code section 415(c) limits on annual contributions, while tax-qualified defined benefit plans are subject to Code section 415(b) limits on benefits.

The current Code section 415 regulations issued in 2009 subject grandfathered 403(b) defined benefit plans to both the 415(b) accrued benefit and 415(c) annual addition limitations, and have resulted in clergy who are lower-paid and closest to retirement being harmed by having their benefits unnecessarily limited by the application of both limitations.

The New Statutory Language. Section 336(b) of the PATH Act amends section 251(e)(5) of TEFRA, for years beginning before, on or after the date of enactment of the PATH Act, to provide that any grandfathered defined benefit plan is subject only to the applicable limitations of Code section 415(b). These arrangements are thus no longer also subject to the limitations of Code section 415(c) applicable to defined contribution plans.

If you have questions about the information in this Client Alert, please contact Danny Miller at 202.887.4783, dmiller@cwlaw.com, or Jewelie Grape at 651.633.1717, jgrape@cwlaw.com.

[12] This commingling is permitted so churches and other church-affiliated organizations can benefit from a church benefit board's resources, investment skills, and economies of scale.

[13] These group trusts described in Rev. Rul. 2011-1 are often also referred to as "81-100 trusts."