North Carolina
Total Retirement Plans

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State Treasurer of North Carolina

TO: Employers in the Local Governmental Employees' Retirement System (LGERS)

FROM: N.C. Department of State Treasurer, Retirement Systems Division (RSD)

DATE: November 23, 2022

RE: "Leased Employee" Agreements with Nonprofit Incorporated Fire/Rescue Departments

Background

During 2022, RSD has become aware of instances where a municipality considers a "leased employee" arrangement with a nonprofit incorporated fire/rescue department ("department") providing services to the municipality. The details may differ by case, but the basic arrangement is typically as follows. The "leased employee" will be officially employed by the municipality, eligible for pay and benefits as a municipality employee. The department will reimburse the municipality for salary and benefit costs. The department hires the employee and directs their work.

Guidance

RSD urges municipalities who participate in LGERS, before entering into this type of "leased employee" arrangement, to review the attached legal analysis provided to RSD for its own purposes carefully. Municipalities must independently determine whether the "leased employees" will be eligible for membership in LGERS, and if so, whether as general employees, as opposed to firefighters or rescue squad workers.[1] In making this evaluation, RSD urges municipalities to bear in mind the following:

- It is each employer's responsibility to report its eligible employees to LGERS, and the regular reporting of that information "constitutes a certification of its accuracy." G.S. 128-30(g)(4).
- The attached legal memorandum outlines a history of federal and common law guidance on this topic that has sometimes varied and is not tailored to any municipality's specific facts and circumstances.
- In case of doubt, employers should understand the critical importance of protecting the "governmental" status of LGERS. While the municipality "leasing" the employee will make the decision as to whether the employee qualifies for LGERS membership, the consequences of an erroneous determination could affect all members and employing entities under LGERS.

[1] RSD does not provide legal advice to municipalities. Municipalities may not rely on the analysis of RSD's counsel and should conduct their own analysis and look to advice of their own counsel.

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Further Discussion

If the municipality is a participating employer in LGERS, this type of arrangement raises potential concerns about the administration of retirement benefits.

- On the one hand, the municipality is required to report its eligible employees for participation in LGERS. On the surface, this would seem to include the "leased employees" who are in positions requiring LGERS participation.
- On the other hand, LGERS is a governmental plan under the meaning of Section 414(d) of the Internal Revenue Code. All members of LGERS enjoy tax treatment based on this "governmental" status. One, but not the only, example is that in general, the contributions employees make to LGERS (6% of their pay) are not immediately subject to income tax. LGERS has always opposed policy recommendations, and avoided administrative decisions, that could jeopardize the system's tax status for the hundreds of thousands of individuals, and approximately 900 employing units, who participate. There is reasonable concern that accepting members who may be found to be "non-governmental" could jeopardize the tax status of LGERS. In fact, LGERS has in the past received at least one Private Letter Ruling from the Internal Revenue Service (in 2001) indicating that "deeming employees of a fire department which is not a department of a municipal government, a county government, or a sanitary district maintained by such government entity but which is incorporated as a nonprofit corporation under the law of [North Carolina] and is certified by the Commissioner of Insurance to be employees of the local county, incorporated city, or town unit for purposes of [LGERS]... will adversely affect the status of [LGERS] as a governmental plan under section 414(d) of the Code."

Because of the importance of this question, RSD recently requested a legal memorandum on the topic from its tax counsel, Groom Law Group. A copy of the memorandum follows this memo. The memorandum states that subject to certain assumptions and limitations, there is a reasonable basis to conclude that the participation of these "leased employees" would not jeopardize the tax status of LGERS. Importantly, those assumptions and limitations depend on a case-by-case analysis of various issues. One issue is whether the department may be governmental in nature; another is whether the "leased employees" are common law employees of the municipality. The final portion of the memo points out that even if "leased employees" may be eligible for membership, their eligibility may be as general employees, rather than as firefighters or rescue squad workers.

Each municipality should conduct its own analysis and obtain advice of its own counsel in making a determination.

Attachment: Memorandum from Groom Law Group

GROOM LAW GROUP

MEMORANDUM

August 17, 2022

TO: Department of State Treasurer

FROM: David N. Levine
Kimberly M. Boberg

RE: Fire Department – Leased Employees

This memorandum addresses the extent to which there is a potential plan qualification risk to the Local Governmental Employees' Retirement System ("LGERS") if certain employees are leased to nonprofit fire departments by LGERS participating employers.

Summary Conclusion

Subject to the assumptions and limitations set forth in this letter, pending future guidance, it is reasonable to permit the Leased Employees (defined below) to participate in LGERS without jeopardizing LGERS' qualification as a "governmental plan" as provided in section 414(d) of the Internal Revenue Code of 1986, as amended (the "Code") and section 3(32) of the Employee Retirement Income Security Act of 1974 ("ERISA").

Background

Municipalities will sometimes provide fire prevention and suppression services through an exclusive contract with a local nonprofit fire department. The nonprofit fire department will enter into an employee leasing agreement with the municipality where the services are provided. Under the agreement, individuals will be hired by the municipality and leased to the nonprofit fire department to provide services ("Leased Employees"). The Leased Employees will be employees of the municipality, will be paid by the municipality, and will receive the same benefits as other full-time employees of the municipality. Participation in LGERS will be mandatory for the Leased Employees, consistent with participation by other full-time municipality employees.[1] However, the Leased Employees will fall under the direct command of the fire chief, an employee of the nonprofit fire department, and the nonprofit fire department will make hiring decisions (for implementation by the municipality) and will reimburse the municipality for all payroll expenses, including benefits.

Legal Background

[1] If the Leased Employees are given the choice whether to participate in LGERS, that would raise cash or deferred arrangement concerns that would require further analysis.

A. Current Governmental Plan Federal Authority

1. Internal Revenue Code

Code section 414(d) defines "governmental plan" to mean "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 . . . ."

2. ERISA

ERISA section 3(32) defines "governmental plan" to mean "a plan established or 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. . . ."

3. Treasury and DOL Regulations

At this time, there are no adopted regulations interpreting Code section 414(d) or ERISA section 3(32).

4. IRS Revenue Rulings

IRS Revenue Ruling 89-49 (Jan. 1, 1989) outlines factors to consider in determining whether an organization is an agency or instrumentality of the United States or any state or political subdivision so that the employees of the organization can be covered by a governmental plan. Specifically, the IRS identified the following factors: (i) the degree of control that the federal or state government has over the organization's everyday operations, (ii) whether there is specific legislation creating the organization, (iii) the source of funds for the organization, (iv) the manner in which the organization's trustees or operating board are selected, and (v) whether the applicable governmental unit considers the employees of the organization to be employees of the applicable governmental unit.

5. Prior IRS Private Letter Rulings

The IRS currently includes the issue of whether a plan is a governmental plan on their "no ruling" list. Therefore, while they have addressed this question in the past, until further notice, they will no longer issue a private letter ruling or determination letter regarding a Plan's governmental status under Code section 414(d). *See* Rev. Proc. 2022-3, § 3.01(70).

Prior to the above limitation, the IRS did issue private letter rulings regarding a plan's governmental status. In one such ruling, the IRS generally applied the factors from Revenue Ruling 89-49 for determining whether a sponsoring organization is an agency or instrumentality of a state. The IRS held that certain plans in which the organization's employees participated were governmental plans based on facts including that a local county and the board of a public university had the power to appoint and remove the organization's board of trustees, exercised considerable control over the day to day operations of the organization, and monitored the organization's financial affairs, and that a public medical school, through its faculty members,

directly supervised the operation of the organization's clinical departments that were chaired by such faculty members. *See* Private Letter Ruling 199947039 (Sept. 1, 1999).[2]

6. Prior DOL Advisory Opinions

a. Agency or Instrumentality

The DOL has consistently noted that the terms "agency" and "instrumentality" are not defined in ERISA, and that there are no current regulations that interpret those terms. The DOL has specifically noted that the definition of governmental plan should be broadly construed - "not so narrow as to include only plans which are ultimately within the exclusive control of governmental entities." DOL Adv. Op. 79-36A (Jun. 11, 1979). The DOL noted that Congress was reluctant to extend the requirements under ERISA to plans covering governmental entities before analyzing the issue further. *Id.* In accordance with that Congressional intent, the DOL has previously taken an expansive approach as to whether a plan was "established or maintained" by a governmental entity, so those plans remain exempt from ERISA. *Id.*

In previous rulings, the DOL, like the IRS, has reviewed the individual facts and circumstances of each case to evaluate whether a plan is a governmental plan. While there is no established list of factors published by the DOL, the important factors for an entity in determining whether the entity's employees are eligible to participate in a governmental plan have been the following:

- Governmental Functions: Whether the entity performs public and essential government functions. *See* DOL Adv. Op. 2003-18A (Dec. 23, 2003).
- Public Funding: The extent to which the plan is funded by a governmental entity. *See* DOL Adv. Op. 2004-01A (Jan. 27, 2004).
- Government Administration: The extent to which the governmental entity is involved in the discretionary administration of the plan. *Id.*

These factors are not as comprehensive as the currently applicable IRS factors, but they are generally consistent with the ANPRM (as defined below).

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[2] Code section 6110(k)(3) provides that a private letter ruling (a "PLR") "may not be used or cited as precedent." Thus, in any dispute between the Service and a taxpayer other than a taxpayer that receives a PLR, the PLR may not be cited as valid authority. However, although a PLR is not formal precedent that may be cited, it is authority that a taxpayer may consider to establish the tax consequences of a potential transaction or situation. *See Hanover Bank v. Comm'r*, 369 U.S. 672, 686-687 (1962) ("although the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them, such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws."); *Ogiony v. Comm'r*, 617 F.2d 14, 17 (2d Cir. 1980) (concurring opinion).

With regard to the third factor in the previous paragraph—that the governmental entity be involved in the discretionary administration of the plan—the DOL's prior opinions have varied on the extent of the involvement required. In one ruling, a plan was governed by seven trustees, with only one appointed by the governmental entity. Even though a majority vote was required for action, the DOL held that this was sufficient governmental involvement in the plan's administration. *See* DOL Adv. Op. 79-83A (Nov. 20, 1979); *see also* DOL Adv. Op. 2000-11A (Sept. 22, 2000) (three out of five trustees being governmental representatives was sufficient); DOL Adv. Op. 2000-07A (May 17, 2000) (one out of twelve trustees appointed by state was sufficient). However, the past DOL rulings have provided conflicting conclusions: in one instance the DOL ruled that a plan was a governmental plan even though the governmental entity had no trustees in the plan and did not otherwise participate in the operations of the plan, but in another ruling the DOL took the opposite position. *Compare* DOL Adv. Op. 86-23A (Sept. 9, 1986) *with* DOL Adv. Op. 83-36A (Jul. 5, 1983).

Regardless of the governmental employer's involvement, under existing guidance, the DOL has consistently required that a governmental plan be funded by a governmental employer and that the employer perform a governmental function.[3]

b. De Minimis Exception

Even where a particular employer is not governmental, the DOL has reviewed individual cases to determine whether the participation by that employer's non-governmental employees in a governmental plan is de minimis. In multiple cases, the DOL has found non-governmental employee participation in a governmental plan of approximately 2% or less qualifies as de minimis, but there is no defined percentage at which the level of non-governmental employee participation becomes no longer de minimis. *See* DOL Adv. Op. 2005-17A (Jun. 22, 2005) (5 out of 33,600 participants); DOL Adv. Op. 2005-07A (May 3, 2005) (1,500 out of 315,000 participants); DOL Adv. Op. 2000-08A (Jun. 12, 2000) (no more than 540 of 158,000 participants); DOL Adv. Op. 2000-04A (Mar. 30, 2000) (3 out of 838 participants); DOL Adv. Op. 2000-01A (Feb. 18, 2000) (11 out of 1488 participants); DOL Adv. Op. 99-15A (Nov. 19, 1999) (236 out of 10,987 participants); DOL Adv. Op. 99-10A (Jul. 26, 1999) (inclusion of 28 nongovernmental employees of an educational accrediting agency in CalPERS did not cause CalPERS to fail to be a governmental plan); DOL Adv. Op. 99-07A (May 19, 1999) (300 out of 25,221 participants); DOL Adv. Op. 95-27A (Nov. 8, 1995) (270 out of 3,700 participants); DOL Adv. Op. 95-15A (Jun. 26, 1995) (12 out of 10,987 participants); and DOL Adv. Op. 95-14A (Jun. 26, 1995) (253 out of 183,000 participants). *See also* DOL Adv. Op. 2012-01A (Apr. 27, 2012) (participation not de minimis where there are 175,000 non-governmental employees eligible to enroll, but only 100,000 current participants).

In an analogous area, the IRS has held that a de minimis number of non-church employees may be covered by a church plan (subject to Code and ERISA exemptions similar to governmental plans) without adversely affecting the status of the plan as a church plan under

[3] The IRS, DOL and PBGC intend to apply consistent rules to determine whether a plan is a governmental plan under both the Code and ERISA. *See* Preamble to the ANPRM discussed *infra*.

Code section 414(e). *See* IRS Priv. Ltr. Rul. 9810034 (Dec. 11, 1997) (130 out of 5,218 participants); IRS Priv. Ltr. Rul. 9441040 (Jul. 18, 1994) (less than 7.5% non-church employee participants); IRS Priv. Ltr. Rul. 9204034 (Oct. 29, 1991) (less than 5% non-church employee participants); and IRS Priv. Ltr. Rul. 8734045 (May 28, 1987) (6 out of 2200 participants). However, unlike the DOL, the IRS has never ruled on de minimis participation in the governmental plan context.

B. ANPRM Factors

In an Advanced Notice of Proposed Rulemaking ("ANPRM")[4] issued in 2011, the IRS identified the following factors to be considered when determining the governmental status of a plan as a plan established and maintained for the employees of an entity which is an agency or instrumentality of a state or a political subdivision of a state:

- Major Factors
    - Control of Governing Board or Body. The entity's governing board or body is controlled by a state or political subdivision of a state.
    - Membership of Governing Board or Body. The members of the governing board or body are publicly nominated and elected.
    - State or Political Subdivision Responsibility for Debts and Liabilities. A state (or political subdivision of the state) has fiscal responsibility for the general debts and other liabilities of the entity (including funding responsibility for the employee benefits under the entity's plans).
    - Treatment of Employees. The entity's employees are treated in the same manner as employees of the state (or a political subdivision of the state) for purposes other than providing employee benefits (e.g., the entity's employees are granted civil service protection).
    - Delegation of Sovereign Powers. 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 (e.g., the power of taxation, the power of eminent domain, and the police power).
- Minor Factors
    - Control of Operations. The entity's operations are controlled by a state (or political subdivision of the state).

[4] 76 Fed. Reg. 69172 (November 8, 2011).

- Source of Funding. The entity is directly funded through tax revenues or other public sources.

- Enabling Legislation. 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.[5]

- Federal Income Taxation of the Entity. The entity is treated as a governmental entity for federal employment tax or income tax purposes or under other federal laws.

- Applicability of State Laws for State Governmental Entities. The entity is determined to be an agency or instrumentality of a state (or political subdivision thereof) for purposes of state laws.

- Judicial Determination of Agency or Instrumentality Status. The entity is determined to be an agency or instrumentality of a state (or political subdivision of the state) by a state or federal court.

- Ownership Interest. A state (or political subdivision of the state) has the ownership interest in the entity and no private interests are involved.

- Governmental Purpose. The entity serves a governmental purpose.

C. Common Law Employee Guidance

The IRS and courts have identified a number of factors for determining an individual's status as an independent contractor versus an employee of an employer. Such determination requires a facts and circumstances analysis, based largely on the degree of control exercised by the party for whom the individual is performing services – generally, an individual is an employee when the person for whom the services are performed has the right to control and direct the individual. This control reaches not only the result to be accomplished, but also the details and means by which that result is to be accomplished. Note that the right to control must be present, but need not actually be exercised. However, there is no one determining factor or magic number of relevant factors that would require a particular conclusion.

IRS Revenue Ruling 87-41 cites 20 factors for consideration in determining whether an individual is an employee or independent contractor.

- Many relate to the business entity – an individual is likely an employee if the entity has: the right to require compliance with instructions; the right to require training; the right to integrate the individual's services into business operations; the right to require that services be rendered personally; the right to hire, supervise and pay assistants; a

[5] The advance notice does not consider mere incorporation under a state's general corporate laws as being created under a specific enabling statute.

continuing relationship with the individual; the right to establish set hours of work; the right to require full-time employment; the right to set the location where the work is to be done; the right to set the order the work is done; the right to require submission of reports; an hourly/weekly/monthly payment process; an expense payment process; tools and materials which are supplied to the individual; not invested in separate facilities where the individual performs services; and the right to discharge the individual.

- Others look more directly to the individual – an individual is likely an employee if the individual is not: able to realize a profit or suffer a loss as a result of his services; working for multiple unrelated parties at the same time; making his services available to the general public; or prevented from terminating his services for the entity.

Nationwide Mut. Ins. Co. v. Darden, 503 U.S. 318 (1992), is the seminal case holding that "employee," for purposes of the employee benefit plan rules, is determined under traditional agency law principles, and cites the 20 factor test for employee status under IRS Rev. Rul. 87-41.

In *Community for Creative Non-Violence v. Reid*, 490 U.S. 730 (1989), the court set out 12 factors to determine a hiring party's right to "control the manner and means by which the product is accomplished." The twelve factors are: the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party.

D. Plan Language

N.C. Gen. Stat. section 128-21(10) defines "Employee" to include "all full-time, paid firemen who are employed by any fire department that serves a city or county or any part of a city or county and that is supported in whole or in part by municipal or county funds."

N.C. Gen. State. Section 128-21(11b) defines "Firefighter" as "a person (i) who is a full-time paid employee of an employer that participates in the Local Governmental Employees' Retirement System and maintains a fire department certified by the North Carolina Department of Insurance and (ii) who is actively serving in a position with assigned primary duties and responsibilities for the prevention, detection, and suppression of fire."

Analysis

In determining the eligibility of the Leased Employees to participate in LGERS, there are several potential levels of analysis that could support the conclusion that Leased Employees may participate in LGERS.

A. Governmental "Status" of the Nonprofit Fire Department

When determining whether the nonprofit fire department itself could be considered governmental, and thus the Leased Employees, even if common law employees of the nonprofit fire department, could participate in LGERS, the factors in Revenue Ruling 89-49 and the ANPRM guide the review.

The municipality will treat the Leased Employees as employees of the municipality and will pay the Leased Employees and fund their participation under LGERS. While the nonprofit fire department will contract to reimburse the municipality for these costs, ultimate financial responsibility will remain with the municipality. The Leased Employees will be treated as municipality employees in all respects, beyond eligibility for benefits, consistent with other municipality employees. In addition, the nonprofit fire department will serve a governmental purpose in providing fire prevention and suppression services, albeit subject to some degree of control by a private entity. On the other hand, the nonprofit fire department will not be subject to the control of the municipality in its provision of services, is likely to be (at least partially) funded by non-public sources, and is not created pursuant to a specific enabling statute. While no single factor is determinative, pending future guidance, certain Revenue Ruling 89-49 and ANPRM factors could be read to support the treatment of the fire department as a governmental agency or instrumentality of the municipality. Under that conclusion, it would be reasonable to conclude that LGERS would continue to qualify as a governmental plan even if the nonprofit fire department is the common law employer of the Leased Employees.

B. Leased Employees as Common Law Employees of Municipality

A second approach would be to conclude that the Leased Employees are common law employees of the municipality.

With respect to the status of the Leased Employees, the applicable guidance is in the context of independent contractor versus employee, but does advise a determination of the proper employer of an employee. Common law employee status is a facts and circumstances determination, looking to the factors delineated by the IRS and the courts, with the right to control and direct the employee an important consideration. If too much control is exercised by the nonprofit fire department, the Leased Employees may be determined to be employees of the fire department rather than the municipality. In that case, the nonprofit fire department's status as an agency or instrumentality of the municipality becomes important. If, however, the Leased Employees are found, based on the facts and circumstances, to be common law employees of the municipality, there is little, if any, risk to LGERS continued treatment as a governmental plan.

C. De Minimis Rule

If the nonprofit fire department is both found to be the common law employer of the Leased Employees and to not be governmental under the Rev. Rul. 89-49 and ANPRM-based facts and circumstances tests, it would then be necessary to fall back on the possible application of a de minimis rule. Unfortunately, there is no "explicit and unambiguous" guidance regarding de minimis non-governmental participation. That said, as discussed above, the DOL and IRS have issued a number of advisory opinions and private letter rulings addressing permissible de minimis participation of certain employees in specific plans, without providing hard and fast rules. However, as noted previously, IRS private letter rulings issued to other parties may

generally not be relied upon or cited as precedent, and DOL Advisory Opinions are treated similarly. Therefore, there is risk in relying on opinions not issued to the parties involved herein, though such guidance does provide helpful parameters.

The ANPRM also includes de minimis language, but it currently addresses only plan coverage for employees of a labor union or plan under Code section 413(b)(8). Otherwise, the current draft proposed regulations do not include special rules addressing existing practices under which a small number of employees of a nongovernmental entity participate in a plan that would otherwise constitute a governmental plan under Code section 414(d). That said, the ANPRM does request comments on whether a de minimis exception should be provided:

> Parameters that could be taken into account for such a special rule include the following: (1) whether the private employees were previously employees of the sponsoring governmental entity; (2) whether the private employees were previously participants in the governmental plan; (3) whether the number or percentage of such former employees who participate in the governmental plan is de minimis (and, if so, what constitutes a de minimis number or percentage); (4) whether the coverage is pursuant to pre-existing plan provisions; (5) whether the private employer performs a governmental function and has been officially designated as a State entity for plan participation purposes; and (6) whether the employer is ineligible to sponsor the particular type of governmental plan ....

Therefore, while an applicable de minimis rule is not included in current draft proposed regulations under the ANPRM, the IRS request for comments on such rule does indicate that it will be considered for inclusion in the eventual proposed and final regulations. While the number of Leased Employees will depend on the number of jurisdictions that follow this leasing approach, there are about 295,000 current members in LGERS, which provides some room before reaching the de minimis levels approved in prior DOL advisory opinions and analogous IRS rulings. It is unlikely the level of participation by the Leased Employees would rise to the level so as not to be considered de minimis under current guidance and, if a de minimis rule is included in future guidance, that future guidance as well. As such, the facts of this arrangement support a conclusion that LGERS will likely retain its governmental status even if the Leased Employees were considered employees of the nonprofit fire department, due to the anticipated inclusion of a de minimis rule under eventual proposed and final regulations. That said, there is currently no defined standard and the final rules addressed in the ANPRM could contain stricter rules (or no de minimis rule).[6]

D. Firefighter versus Employee

In addition to the above considerations regarding the Leased Employees' general eligibility for LGERS is the necessary determination of whether they would qualify as a

[6] In addition, we believe it is likely, based on informal comments by senior IRS national office representatives over the years, that some form of transition relief will be provided for existing participants or participating employers in governmental plans, particularly in view of constraints on making changes to public plans under many state laws.

"Firefighter" or an "Employee" under LGERS.[7] The definition of Firefighter is more limiting, requiring that a governmental employer participating in LGERS maintain the North Carolina Department of Insurance-certified fire department. Qualification of the nonprofit fire department as an agency or instrumentality of the municipality would not only support the Leased Employees participation in LGERS, but would arguably also support classification of the Leased Employees as "Firefighters" under LGERS. However, a determination that the nonprofit fire department is not an agency or instrumentality of the municipality would require a member-level eligibility determination under the common law or de minimis rules discussed above, and would lead to a classification of "Employee" under LGERS (if eligible).

[7] A determination of whether the Leased Employees meet the definition of Firefighter under LGERS is not conclusive for other State benefits that rely on a different definition.