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THE MYSTERY OF THE CRUMBLING “CHURCH PLAN” EXCEPTION

WILLIAM P. HURLEY NEW YORK, NEW YORK

I plan to summarize briefly for you the advantages of the traditional church plan exemption from ERISA. Then, I am going to discuss a more limited church plan exemption, what Joan Brophy and I call the FICA church plan exemption. Finally, I will discuss the Church Alliance proposed bill on pension and welfare benefit plans.

A church plan is permitted to satisfy flexible rules in order to be a qualified pension plan under section 401(a) of the Code. For example, a church plan can require a longer waiting period than ERISA pension plans—up to five years of service. In contrast, an ERISA plan must permit employees to be eligible for the plan after age twenty-one or one year of service.

The church plan in essence need cover only fifty-six percent of the employees. A church plan need not meet the ERISA requirements for vesting. A church may have a very flexibly designed plan under the exemption for church plans. Under ERISA, a plan participant must vest after five years of service or must vest gradually over three to seven years of service. The vesting rules under the old rules that church plans are working under are far more liberal.

A church plan need not meet the funding requirements of an ERISA pension plan nor the fiduciary responsibility rules imposed on such plans. The reason I feel that the church plan exemption is extremely important is because church plans are not subject to the jurisdiction of the Pension Benefit Guaranty Corporation. Why is that so? Why is this a very critical consideration? Well, what has been happening is that there has been a gradual increase in the premium charged to employers for plans subject to jurisdiction of the Pension Benefit Guarantee Corporation. Right now the annual premium is \$16 per participant and that could increase depending on what has been happening with the funding of your plan—up to \$50 per participant. So, if you have a large church plan with, *e.g.*, 10,000 participants, you are talking about an annual PBGC premium of \$160,000 to operate the plan. Not having to pay that premium represents

a substantial savings in the cost of administration of the plan.

A church plan is not subject to the ERISA reporting and disclosure requirements, which again represents a substantial savings in cost and in time in the administration of the plan. The point to bear in mind here is that we are assuming that church plans are operated in an ethical and responsible manner, and that they are well funded, because the plans that I represent are well funded. If so, these types of considerations regarding the Pension Benefit Guaranty Corporation, or not having to comply with the ERISA reporting and disclosure requirements, are very important from the viewpoint of cost savings in the operation of the plan for the employers involved.

Now, for a church plan to obtain those advantages, it must be a church plan, as defined in section 414(e) of the Code. Once you find that the plan fits within that definition, then it must be a plan that has not elected to be subject to ERISA, what Joan Brophy and I call a non-electing church plan. So the first point is to see whether or not the plan fits within the section 414(e) definition of a church plan. That means simply, and I will try to summarize it somewhat, a plan that is established by a church or a plan maintained by the pension board of a church. It includes pension plans of institutions owned and operated by a religious order, if it can be demonstrated that the plan's Administrative Committee is controlled by or associated with the church, which in short usually means the religious order has some representation or control over that committee. That plan will then be within the church plan definition.

Not only the church or parishes may participate in the plan, but also any employer exempt from income taxes under section 501 of the Code, meaning tax-exempt organizations that share common religious bonds or convictions with the church. Thus, for example, schools, hospitals, nursing homes, social service agencies associated with the church, may participate in the plan. The typical church plan is a diocesan plan. A diocese may establish a plan, and cover employees of parishes, schools, hospitals, child care and social services agencies. Such a plan enjoys the exemption provided to non-electing church plans under ERISA.

Recently, with the enactment of the Tax Reform Act of 1986, a new church plan exemption was introduced into the employee benefits area. Joan Brophy and I call it the FICA church plan exemption, because it is derived from FICA Code section 3121(w) definition of church. This definition now appears in section 403(b)(12) to provide an exemption from nondiscrimination requirements that are imposed on the use of section 403(b) annuities or tax-deferred annuities by tax-exempt organizations.

As for qualified church-controlled organizations, they are organizations that are associated with a church, that is, they share common religious bonds and convictions with that church. But the definition of qualified church-controlled organizations excludes organizations which are

church-associated but which sell goods and services to the general public at more than a nominal charge and normally receive more than twenty-five percent of their support from receipts derived from any combination of governmental services or from sales to the general public. So, if a church-associated organization derives more than twenty-five percent of its support from governmental sources or from services or sales to the general public then that type of a church-associated organization is not a qualified church-controlled organization.

Therefore, certain church-associated organizations (*e.g.*, Catholic Charities, child care agencies, social service agencies, “church-run universities and hospitals”) may not qualify for the exemption from the nondiscrimination requirements imposed on 403(b) plans. If Congress had used the section 414(e) definition of church plan in providing an exemption from the nondiscrimination requirements of section 403(b)(12), all of these organizations would be exempt from these requirements.

Since it seems that Congress likes the FICA church plan definition very much, it has now spread into other provisions of the Internal Revenue Code that affect church-associated organizations. The FICA definition is now in section 401(a)(9) of the Internal Revenue Code. This section provides that distribution of benefits from a pension plan must begin by April 1 of the calendar year following the year in which a participant reaches seventy and one-half years of age. Congress used the FICA definition to provide an exemption from that requirement.

Also, Congress used the FICA definition to provide an exemption from section 89 requirements for group health and group life insurance plans and other statutory employee benefit plans. Our Pension Committee would like to know if you have had any problems with the fact that Congress has been using the FICA definition, not only in connection with the 403(b) plans, but also in connection with the age seventy and one-half distribution requirement and the section 89 rules on group life insurance and group health plans. We would like to find out what has been happening in your dioceses regarding these matters.

Now, what I would like to do is move on to the Church Alliance legislative proposal. The Church Alliance has developed a proposal concerning church pension and welfare benefit plans. Certain members of our Pension Committee met with Church Alliance representatives. On behalf of our Committee, Deirdre Halloran wrote an April 7th letter commenting on that proposal. She also sent a copy of that letter to all the diocesan attorneys under a Memorandum of April 14th in which she solicited the views of the diocesan attorneys on that proposal. What I would like to do is review briefly and at least apprise you of one very important part of the proposal.

The Church Alliance wants to establish a whole new section, 401(A) of the Code. Section 401(A) would create two new kinds of Church plans:

(1) an A plan; and (2) a B plan.

The "A plan" would be a plan which would cover the FICA church plan organizations, *i.e.*, churches, elementary and secondary schools that are controlled, operated *or* supported by a church, and qualified church-controlled organizations. "A" plans would have to meet very minimal requirements and would have no discrimination requirements applying to them. It is my understanding from the Church Alliance representatives that their rationale for introducing this special type A plan is that Congress did exempt FICA church plans entirely from the nondiscrimination requirements of section 403(b). Since Congress exempted FICA church plans from such 403(b) requirements, the Church Alliance is trying to get Congress to provide type A plans with a similar exemption from the non-discrimination requirements for pension plans.

Type B plans would cover the other kinds of organizations which are church associated, but which do not fit the FICA church plan definition. There are certain problems that we see as a Committee, but before we go on to make further comments about the proposal, we would like to get some input from you regarding what problems you have with the proposal.

DEIRDRE HALLORAN: I would like to say a few words before we open up to questions. This is, I know, a very arcane area of the law. I thank you, Bill, for trying to keep everybody interested. First, could I see by a show of hands, how many of you work with your diocesan pension plans? That is about half. Does anybody have any comments about the material that we sent out under our memorandum of the 14th? I would like to start discussing it now or answer any questions about what we said.

BILL HURLEY: The immediate problem is that the bill that the Church Alliance proposes does not take into account the typical diocesan plan. The diocesan plan typically includes the churches and parishes, and also other institutions, including child care agencies. So the proposal right now is defective from our viewpoint. What they are doing is splitting it up as two plans. One plan is for churches and qualified church-controlled organizations that are not dealing with the general public. That would be one kind of plan. The important factor is that the Church Alliance people are saying that this is desirable because this kind of plan does not have to meet any kind of requirements.

To summarize, the problem that was seen for us is that diocesan plans are not covered by this proposal. You would have to amend the proposal and put in a provision that would cover our situation—maybe a type C plan, which covers not only the parishes but also hospitals, etc. That's the main problem I saw with the proposal. Of course, there are other things. It is a very long proposal that goes on and on about a lot of different issues. The only way that we can approach it is to see if anybody has had a chance to look at the proposal and can give us some feedback

about it.

DEIRDRE HALLORAN: Let me ask some more questions. We have met with the Church Alliance, a group of various pension plans operated by other denominations. There is one Catholic representative, the Catholic Mutual Insurance Company. However, that insurance company does not necessarily represent the majority of our diocesan plans. We got involved in this rather late in the game. The other groups have spent a lot of money to develop this legislative proposal. Now we are getting lots of pressure because they want to move the proposal forward. Yet, they know that they can not move it forward if the Catholics oppose it. I think the sense of our Pension Committee is, “What does this bill do for us?” Because our plans are hybrid plans, we have some “FICA” church organizations that will not be covered, just as they are not covered under the exemptions from section 89 and section 403(b). So the proposal is not necessarily going to help us a great deal. How many of you who work with diocesan pension plans are having problems living with the system as it exists now? Could you raise your hand?

BERNIE HUGER: I think that the point that Bill brought up is the big point, and that is that those places in the Code where they use the FICA definition are now set up in such a way that the common diocesan plan does not fit. So everywhere they use that, it is as though you don’t have a church plan. That is a major problem. Under section 89, they put the 89(i)(4) definition in there for what is not considered covered employment. We looked at how that fit in with the diocesan plan. When you have any employees that are working in classes that do not fit those two definitions, it seems the plan itself does not fit, and so we have got a problem. Now, how do we deal with that. I think we just cross our fingers and hope that section 89 goes away. The real problem is we start moving this beyond section 89, to 403(b), 401(a)(9)—all those different sections where you have got that FICA thing built in. I think, I am not sure why, but it seems the Church Alliance has been more interested in it than we have, and they have got a different concept of church than we have, and we haven’t been in there pushing to keep our concept of church before the Congress. So when they do pension legislation that exempts church plans, they don’t have a true understanding of what one big segment of “church” is all about. I think that is where I see the problem. I don’t know what we would do about that. I think it is too late, but I would encourage your committee to go ahead.

DEIRDRE HALLORAN: Bernie, the bottom-line issue in making a decision about what to do about this legislation is do we want to leave things the way they are? In other words, do we say to the Church Alliance that in the 401(a) qualified plan area, things are fine for us? Or do we want to say that we will go along with your proposal, but it is going to introduce the FICA distinction into the 401(a) area?

BERNIE HUGER: It would seem, and this is what your memo said and your comments, that sooner or later we are going to have the church plans and the church-related plans, and the church-related plans may get thrown out someday. Or at least they are not going to get the favorable treatment because people are sympathetic to "Church." The more we do it, the worse it is. First of all, the church plan exemption itself does not even fit what we are doing. Let's forget the hospitals and nursing homes for the moment. The diocesan plans with their Catholic charities don't fit within the definition of church plan. So we are not even dealing with the basic diocesan plan, not even thinking about the Catholic universities and Catholic hospitals, which now fit under section 414(e).

JIM SERRITELLA: I think that the level of complexity that Bernie identified exists, and then there is another level of complexity, at least in some of the dioceses, like Chicago, where different plans are administered by different bodies. Some of the dioceses are administered directly and some of them are administered by insurance companies, and the lawyer visits the insurance company's plan once every twenty or thirty years, it seems, and they have no idea that any of this is going on and that would really throw the whole thing into a mess. My question is have the Mormons been involved in the Church Alliance, and if they have not, they are probably a good group to contact because the complexity of their organization is somewhat similar to ours and they were a natural ally when we were arguing the 990 requirements and integrated auxiliary of a church definition and so forth, which kind of echo these problems. Deirdre do you know the answer to that question?

DEIRDRE HALLORAN: I don't have the Church Alliance stationery here. There are twenty-eight denominational groups, so I can't answer the first question that you raised, but there has been no Mormon representative active in the cadre that has been working with us. I will certainly follow through on your suggestion.

DAN WINTZ: Isn't the problem really with the definition of church-controlled organization within section 3121(w)? If you look at the legislative history, it was clear that what Congress intended was to exclude hospitals and universities from the provision. Now, if it was made clear that the definition in 3121(w) applies to all church-controlled or church-related organizations to the exclusion of the colleges and the hospitals, if that was part of the Church Alliance proposal to amend that definition, would it not be possible to support the Church Alliance proposal?

BILL HURLEY: Well, that is up to the hospitals. We have these Catholic hospitals that are involved in 403(b) annuity plans, but it comes down to what horsetrading you can do, how much of an expansion of that definition you can obtain from the Congress. Congress apparently was very upset with doctors obtaining 403(b) annuities, contributed to by the employer. Also targeted, except for some reason baffling to me, are college

professors. I never thought college professors made that much money, and because of that, it is very interesting that the House Committee Report states that church-run universities and hospitals won't qualify for the church exemption. Therefore, they will have to comply with these nondiscrimination requirements. It is very unfortunate.

There is one other point here: whether or not, on section 403(b), Congress is truly of the attitude that the FICA church plan definition is the best you are going to get. I was wondering whether maybe a cap could be imposed. You know, put a cap on employer contributions, top 403(b) plans, but please leave us alone so we can go on trying to run these hospitals and other institutions. I am thinking about the hospitals because so many Catholic hospitals located in our cities are dealing with people who don't have that much money and are really there for charitable purposes. What they don't realize is that by cutting out so many other institutions, even in the hospital, they are cutting out other personnel from getting this type of a benefit. Are there any other questions?

DEIRDRE HALLORAN: Let's assume we are willing to consider some sort of a compromise on this FICA definition, which was used because Congress wanted to cut out the hospitals and the universities. Where would you draw the line? What kinds of organizations should be covered under the definition of church plan?

DAN WINTZ: Since Bill brought it up, it was the doctors in particular that the Congress was looking at. How about a provision that would not allow us to cover highly compensated employees of organizations under 3121(w) provision or that they would have limited benefits? That would focus specifically on the problem group.

BROTHER PETER CAMPBELL: One of the concerns that I have listening to this conversation, and I have been participating in several others similar to it relative to section 89, is a concern about what is the ministry of the Church in relationship to our efforts in the United States. I think any type of definition should identify education and health care. I am curious as to taking a direction that undercuts the broader concepts of what we are doing as a Church, by singling out some of the efforts that we make in health care as if they were businesses and really not related. I think there is some danger of sort of lopping off a major ministry within the Church. Even though with respect to that ministry lots of arguments can be made relative to compensation practices and problems relative to doctors and the like, we can't pursue Catholic health care without the doctors, so I think we have to be cautious there.

DEIRDRE HALLORAN: Thank you, Peter. I think that is a very important point. Speaking of section 89, would anybody care to let us know what you have been doing at the diocesan level to deal with section 89, where we do have this FICA definition of church plan in the current law?

BERNIE HUGER: I'll tell you what we have done with respect to the

diocesan agencies. We have given them advice to just wait and see what happens with section 89, since it doesn't look like it is going to be around next year in the same form. We have done that, and with some of the Catholic high schools that are religious-sponsored, we have the question of whether they fit within 3121(w)(3). We looked at that, and came to the conclusion that they were in fact church-controlled. So we have advised them that they are church-controlled and therefore they are probably not covered in section 89. That is how we have been dealing with it.

DEIRDRE HALLORAN: Thank you. After you called and we talked about that issue, Bernie, we did mention it to the Church Alliance. They have attempted to graft onto section 3121(w) some language including religious orders in the definition of church that would clarify the question that you had, so that a school operated by a religious order would clearly come within that definition. Whether that is enough to make us support the bill is another question.

BERNIE FRIGON: We are from a very small diocese and I am sure that there are others. We find that our plans are sponsored by a Church organization. One of the things I would like to hear about are costs. We are a small diocese. Does this proposal in any way help us to stop paying large premiums? Cost-wise does that enter in?

DEIRDRE HALLORAN: I don't think that it would have very much cost implication. If it did, it would be very very minimal in terms of funding, because that is essentially what you are talking about. I don't think it would change that very much at all.

BILL HURLEY: You would have to go and start shopping around to see what could be done with your plan. Maybe a bank might do a better job rather than an insurance company. We have to look at other plans of other institutions. You are using just an insurance company, correct?

BERNIE FRIGON: The only cost implication I know about which we are talking is the Rider Corporation in Miami; it recently spent around \$100-150,000 in order to test for section 89, only to find out that they are now about to amend the bill again to who knows what. So why spend the money to test, when we don't even know what we are testing for yet.