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ERISA Advisory

The Future of Qualified Plan Determination Letters: Glimpses From the IRS

July 24, 2015

IRS Announcement 2015-19 (July 21, 2015) confirms months of hints from IRS personnel: starting in 2017, the ability of pension, profit sharing, and stock bonus plans to obtain IRS review and approval of their plan documents will be severely curtailed. With limited – and as yet unspecified – exceptions, individually designed plans will be able to apply for determination letters only when they are established or terminated. During the intervening life of the plan, no way will exist to receive official confirmation that plan provisions continue to satisfy the requirements of section 401(a) of the Internal Revenue Code.

Contact Us

Questions and comments about the Steptoe ERISA Advisory are always welcome.

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Assuming that the IRS follows through with the proposals in the announcement, the current determination letter program for individually designed plans will come to an end on January 31, 2017, the deadline for the next round of "Cycle A" submissions. Beginning January 1, 2017, applications will be accepted only for:

- Cycle A plans that file in January 2017
- Plans that have never before received a determination letter
- Plans that are terminating through the distribution of all plan assets or the transfer of plan assets and liabilities to the Pension Benefit Guaranty Corporation
- Plans that meet other criteria that the Announcement does not describe (the IRS asks for comments on what should be included)

The IRS will leave intact the determination letter program for "pre-approved plans" (also known as "master," "prototype," and "volume submitter" plans). Dozens or hundreds of companies may adopt the same pre-approved plan document, so a single determination letter replaces the multitude that would be needed if each had an individually designed plan. (It is estimated that, while two-thirds of all plans use pre-approved documents, 90% of determination letter applications are for individually designed plans.)

The determination letter program has long been a central feature of the retirement plan universe. A qualified plan must comply with section 401(a) of the Internal Revenue Code in both form and operation. In principle, its form must be perfect; that is, the plan document must include every provision that the law requires and none that contravene it. Any mistake is disqualifying, even if it has no adverse impact on plan participants. Plans have, in fact, been disqualified for such obscure and inconsequential defects as failing to state that a "partial termination" will result in the full vesting of affected participants' benefits, even when no partial termination has actually occurred. In more recent years, drafting errors have typically led to monetary sanctions under the Employee Plans Compliance Resolution System (EPCRS), the IRS's de facto replacement for disqualification as a punitive measure.

ERISA Advisory – July 24, 2015

Determination letters originated as a device to make the demand for perfection bearable. They offer a kind of insurance policy: With rare exceptions, plan provisions that are the subject of a favorable determination cannot result in disqualification, even if they are later found to be defective. At worst, the IRS will require prospective corrective amendments. For this reason, although applying for a determination letter is not compulsory, no prudent plan sponsor operates without one.

This "insurance" is often valuable in corporate transactions. The determination letters received by an acquired company's plans give the buyer some assurance that the plans will not raise serious IRS compliance issues. In the absence of a reasonably current determination letter, a buyer or lender might demand such protective measures as burdensome representations and warranties, an opinion of counsel that plans satisfy all of the criteria for qualification, or even termination of the plans prior to the transaction, any of which could be severe impediments.

Until 2007, plans could seek determination letters at any time. Changes in the law would result in tidal waves of applications, bunched near the end of the time for adopting required amendments (known as the "remedial amendment period"). These influxes, while foreseeable, came at irregular intervals and strained IRS resources.

Revenue Procedure 2007-44 set up a new system designed to smooth the work flow. It divides individually designed plans into five "cycles." Each year (or, to be precise, from each February 1 through the following January 31), determination letter applications are, as a general rule, open to plans in just one cycle. (The current cycle, open from February 1, 2015, through January 31, 2016, is "E.") "Off-cycle" applications are not rejected outright. They are processed normally if they come from terminating plans or from new plans that would otherwise have to wait more than a year before becoming eligible to submit an on-cycle application. (Right now, for instance, a new plan that would ordinarily fall into Cycle B, C, or D could apply for a determination letter during the Cycle E window.) Until the issuance of the new Announcement, all other off-cycle applications, except those based on "a compelling business need," went to the back of the queue. The Announcement states that they will no longer be accepted at all.

The frequency with which qualification requirements mutate and the long space between determination letter windows led to a special rule for plan amendments intended to conform to changes in the law. Plan sponsors are allowed to adopt "interim" amendments within a short period after the change becomes effective. Interim amendments do not have to be perfect, so long as they are drafted in good faith. Any deficiencies can be corrected when the plan files for its next determination letter. This ability to "approximate" required amendments has proven useful both to plan draftsmen and to the IRS, which faces less pressure to produce guidance very quickly concerning new statutes.

The difficulties that the proposed new regime will raise for employers are obvious. Plans can change a great deal over the years, making a determination letter issued long ago essentially valueless. Perhaps the IRS will mitigate this problem through generous exceptions to the general rule, but too much generosity will undermine the goal of easing the agency's work load.

The preamble to the Announcement suggests another form of mitigation:

> In connection with the modifications to the determination letter program described in this announcement, the Department of the Treasury (Treasury) and the IRS are considering ways to make it easier for plan sponsors to comply with the qualified plan document requirements. This may include, in appropriate circumstances, providing model amendments, not requiring certain plan provisions or amendments to be adopted if and for so long as they are not relevant to a particular plan (for example, because of the type of plan, employer, or benefits offered), or expanding plan sponsors' options to document qualification requirements through incorporation by reference.

It is also possible that the IRS will from time to time open the determination letter process on a selective basis for discrete issues or law changes.

Steps like those would be somewhat useful but would not dissipate the cloud of uncertainty that would steadily gather over any long-lived plan.

One option for worried employers would be to switch from individually designed plans to pre-approved plans. Certainty about the form of the plan would thus be restored. The down side is that pre-approved plan documents are invariably extremely long and complex, as they offer numerous optional provisions and try to cover all contingencies, whether or not applicable to the provisions a particular employer actually selects. It is all but impossible for ordinary businessmen to find clear answers to questions by simply reading the document. Further, adopters may be lulled into a false sense of security that the pre-approved plan that they bought from a vendor requires no further understanding or action on their part. The result is an increased risk of operational mistakes.

Moreover, pre-approved plans are not available in all cases. There are no pre-approved multiemployer or governmental plans. The IRS recently began accepting applications for pre-approval of cash balance plans but has not yet approved any. It will not open the pre-approval program to employee stock ownership plans until 2017. And even when pre-approved plans exist, they often do not accommodate innovative plan designs or unusual circumstances.

Appeals to the IRS to retain the present system are virtually certain to get no hearing. IRS officials have declared that the agency simply lacks sufficient resources to continue to review and make determinations on all individually designed plans. Reducing the volume of determination letter applications by up to 80 or 90 percent is an attractive way to free personnel for higher priority tasks. It may be possible to reach a compromise, however. One option would be to let plans renew their determination letters following major events such as mergers, spinoffs, or significant changes in plan design, coupled with the less rigorous approach to minor or irrelevant defects suggested in the Announcement's preamble.

The Announcement asks for comments, with a due date of October 1, 2015. Aside from suggestions for circumstances in which ongoing plans might be allowed to obtain new determination letters, specific issues for comment include possible changes to the remedial amendment period, guidance on conversions from individually designed to pre-approved plans, and revisions to EPCRS to accommodate the reduced availability of determination letters.