Flashpoint: IRS Determination Letter Program Expanded… To a Limited Extent

The IRS has expanded the availability of determination letters on individually designed plans in two circumstances: temporarily for "statutory hybrid plans" and permanently for merged plans. The availability of IRS approval of plan documents should give sponsors in these situations an opportunity to be reassured that their plan documents are "up to snuff."

The Determination Letter Program: Limited Availability to Individually Designed Plans

Retirement plans are written using two types of documents. First, there are "preapproved plan documents." These are mass-produced documents with check-the-box optional provisions used by practitioners for myriad adopting employers. The IRS grants approval to these documents and their optional choices, and that approval extends to the adopting employers, unless they improperly modify the preapproved language or make option selections that are internally inconsistent. So, unless the preapproved document is used incorrectly (e.g., the drafter "colors outside the lines"), the adopting employer can rely on the fact that the language in the document contains what the IRS requires, and does not contain provisions that the IRS prohibits; the IRS cannot challenge the document's adequacy on audit.

The second type of document is an "individually designed plan" or "IDP." These documents are commonly prepared by attorneys and are custom documents for a given client. As these documents are not preapproved by the IRS, there is no "reliance" available that the plan document meets all IRS requirements. Under current rules, however, the plan sponsor may submit the plan to the IRS **once** for an individual review of the plan language and confirmation that it is adequate for tax qualification. If the IRS approves the plan language, it issues something called a "favorable determination letter" or "FDL," confirming that the plan language meets all qualification requirements.

Before 2016, an employer could apply for an FDL for an IDP any time the plan was amended. Now, after the plan has its initial FDL, the employer cannot apply again until the plan terminates. The IRS calls this limitation "one and done."

Unfortunately, that one-time FDL does not extend to amendments adopted later, whether they are due to the employer's desire to change something about the plan or a modification that is mandated by the IRS due to a legal or regulatory change. Nor does the FDL protect a plan sponsor that is obligated to amend the plan due to a change in the law or regulations but fails to do so.

The IRS's newly issued Revenue Procedure 2019-20 provides for two situations in which a new FDL can be requested for an eligible IDP that has already received its "one-time" FDL.

Situation #1: Cash Balance and Other "Hybrid" Plans

Cash balance plans are types of defined benefit plans that base a participant's benefit on the accumulation of amounts allocated to a hypothetical account. These are commonly called "hybrid" plans, because they contain features that mirror those of a profit sharing or other defined contribution plan, while guaranteeing benefits and requiring funding under the defined benefit plan rules. The IRS finalized regulations in relation to these plans in 2010, 2014, and 2015, that required that the interest credited to the hypothetical account for a participant not exceed the market rate of return (which was also defined in the regulations). The regulations mandated that affected plans be updated to comply with the market rate of return rules by the first day of the first plan year that began on or after January 1, 2017. However, notwithstanding the complicated nature of these regulations, the "one and done" rules prevent a plan sponsor from requesting IRS review of the new language to be sure that it meets the requirements of the regulations.

Rev. Proc. 2019-20 provides a special 12-month period—from September 1, 2019, through August 31, 2020—during which a plan sponsor that amended its cash balance or other hybrid plan for the market-rate-of-return regulations may submit the plan to the IRS for a new FDL. This FDL will be based on the plan documentation requirements, as outlined on the IRS's Required Amendments List for 2017 (i.e., pursuant to IRS Notice 2017-72).

Situation #2: Plan Mergers

It is common that, when two companies become related through a purchase or merger transaction, the retirement plans of those companies will also be merged into one. If the merged plan is an IDP, it is likely that the plan will need to be amended significantly to accommodate the details of the plan merger.

The IRS is opening up the FDL process to allow the plan sponsor of the merged plan to get new document approval. Under Rev. Proc. 2019-20, the merged plan may be submitted for an FDL if (a) the plans are merged not later than the end of the plan year following the year in which the business transaction occurred; and (b) the FDL application is submitted by the end of the last day of the first plan year that begins after the plan year in which the merger occurred.

Example: ABC Company buys XYZ Company, which becomes a wholly owned subsidiary, on May 15, 2019. Both ABC and XYZ sponsor calendar year 401(k) plans that have previously received FDLs. The XYZ Plan is merged into the ABC Plan effective April 30, 2020. Because the merger happened before December 31, 2020 (the last day of the plan year following the year in which the business transaction occurred), if the FDL application is submitted before December 31, 2021 (the last day of the plan year following the year in which the plan merger occurred), ABC may file for a new FDL with the IRS.

Unlike the hybrid plan rules, the FDL process for merged plans will not sunset in 2020; this is a permanent change to the IRS's procedures.

Problems Found in the FDL Process

If the IRS finds a problem with the plan document during the FDL process that is related to the reason why the plan is eligible for a new FDL (i.e., the final hybrid plan regulations for cash balance plans or in relation to effectuating the merger for merged plans), the IRS will permit the remedial amendment of that problem without the application of any kind of sanction.

Suppose instead that the plan sponsor timely and in good faith adopted an amendment to its plan to comply with a different change in the law that occurred since the last FDL was issued, and the IRS finds that the amendment was not sufficient to meet its requirements. In such a case, the IRS will permit the plan sponsor to adopt a remedial amendment, but will charge a sanction equal to the fee the plan sponsor would have had to pay under the IRS's Voluntary Compliance Program (VCP)—either $500, $3,000, or $3,500, depending on plan assets. This rule would similarly apply if the IRS determines that an amendment was needed to conform the plan to a change in the law, but the plan sponsor did not timely adopt the amendment because it determined reasonably and in good faith that no amendment was required.

Finally, if the IRS finds another problem with the plan document that does not fit into the limitations discussed above, it will permit the plan sponsor to correct that issue, but will charge a sanction that is equal to either 150% or 250% of the VCP user fee, depending on how long the problem has been outstanding. Under this schedule and the current VCP fees, the maximum sanction would be $8,750 (250% of $3,500).

Conclusion

Most small to medium-sized companies use preapproved plan documents for their retirement plans. Nonetheless, there are times (particularly in relation to hybrid plans or the merger of plans) when the document must be more flexible than a preapproved document will permit. In that situation, the ability to obtain a new FDL in limited circumstances is a very welcome change. Furthermore, the fact that Rev. Proc. 2019-20 has been issued means that the IRS is listening to the concerns of practitioners, which is always a welcome development. Therefore, even if your situation does not require the use of the Rev. Proc., it is good to know that this type of change has occurred.

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