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BENEFITS BRIEF

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IRS Plans to Severely Curtail Determination Letter Program

Around two months ago, Sunita B. Lough, Commissioner of the IRS's Tax-Exempt and Government Entities Division, announced informally, in speeches to various professional groups, that the IRS determination letter system for qualified plans is expected to change as of 2017. While Ms. Lough made it sound like there would be ample time for public input, the IRS position seems to have hardened in recent weeks. Thus, it now appears that, after the current Cycle E filing season, the 2016-17 Cycle A slot may be the last one to follow the pattern set in the mid-2000's.

We provide below a high level review of events leading to this major development and expected IRS follow up.

A. Background

The IRS Determination Letter ("DL") program was developed many decades ago to meet the needs of employers and others in the benefits community for a process that provides relative certainty that the form of a plan satisfies the applicable requirements for tax qualification under section 401(a) of the Code.

A DL provides invaluable assurance that the substantial tax advantages of maintaining a tax-qualified plan will be available, including –

- current deductibility of employer contributions (subject to IRS limits),
- tax-free growth of plan investments held in trust or through an annuity contract,
- tax deferral of contributions to employees until amounts are actually received, including the ability to make tax-free rollovers to other plans or IRAs.

Under Code section 7805(b), plan sponsors are generally entitled to rely on a favorable DL for prior periods, subject to certain conditions, even if the IRS made an error in reviewing the plan document. Of course, plan sponsors are also required to operate their plans in accordance with their terms and applicable law.

Historically, it was common to request a DL when a plan was first established, and otherwise at the discretion of the plan sponsor and its legal counsel, including upon plan termination. After ERISA was enacted – adding an immense number of new rules and making other complex changes in the system – it became customary to request updated DLs whenever a group of laws created a need for a new review. These filings generally became known by the

following acronyms, based on the series of laws that made the changes:

- TEFRA, DEFRA and REA – 1982-1984,
- TRA 86 and various omnibus budget acts from 1987-90, and
- GUST – 1994-2000.

Typically, the IRS fixed one date for all plans to be amended (i.e., the remedial amendment period) and filed to meet the above deadlines (which it often extended, for various reasons). Thus, the vast majority of plans would file around the same time – imposing major burdens on IRS review personnel.

In response to these periodic filing onslaughts, the IRS developed in the mid-2000's the "staggered" five-year filing system, which established a plan's required filing deadline based on the EIN of its plan sponsor (e.g., Cycle E for sponsors whose EIN ends in "5" or "0"). The IRS also developed complex guidelines that forced employers to adopt "interim amendments," before guidance was issued, and restricted the retroactivity of discretionary plan changes. The IRS also steadily expanded programs for pre-approved plans to reduce the volume of individual plan filings.

B. Why IRS is Revamping the DL Program

The IRS' budget has shrunk steadily over the past five years – largely due to anti-IRS forces in Congress. Indeed, the IRS' budget is reportedly less today than it was 20 years ago – and Congress has piled on massive new programs including the Affordable Care Act and "FATCA" for IRS to run. The reduced budget has frozen IRS hiring and promotions, increased staff workloads, and encouraged the retirements of experienced managers and technical staffs.

A lean "Six Sigma" assessment conducted last summer reportedly sealed the fate of the DL program. IRS management became concerned that the lack of time and attention on the part of the IRS staff – devoting essentially three review hours per plan – produced questionable legal results, and could no longer be sustained as an economic matter in any event.

C. What's to Come?

Changes in the program for individual DLs are expected to be announced this summer with some opportunity for public comment. As of now, we expect that the IRS is likely to allow individual DLs for newly established plans and terminating plans, and for compliance with new laws (as specifically identified by IRS guidance). Also, there may be some mechanism for plans with unusual designs – or impacted by major business events – to be reviewed. The IRS expects to continue its pre-approved plan programs and expand them to include plans with cash balance and ESOP features.

The IRS may hope that these changes will force more plan sponsors to adopt pre-approved plans, but we know from experience that such plans are unlikely to meet the needs of large corporate employers and multiemployer plans for highly individualized benefit programs. It is for this reason that while the vast majority of plan documents are pre-approved plans, the vast majority of participants remain covered by individually designed plans.

D. What Does It All Mean?

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We expect that a greatly pared-down DL program is likely to increase the risks employers face if their plans are found to be non-compliant. Further, employers may be forced to seek other assurances that their plans remain compliant and may be subject to changes in other IRS programs. As examples –

- The IRS is still expected to audit plans – requiring document production and review and likely leading to more errors and additional costly sanctions.

- Company and plan auditors – as well as investment managers who rely on SEC exemptions for "section 401(a) plans" – are likely to require opinions from management, and possibly counsel, that their plans are up to date and in compliance.

- Companies will be required to do more due diligence and may be at greater risk for violating "reps and warranties" that their plans are in compliance when they are involved in M&A transactions.

- Participants in bankruptcy may have difficulty establishing that their plan benefits are held in IRS-qualified plans legally protected from creditors under federal law.

- Congruent changes may also be coming to the IRS private letter ruling process, the "EPCRS" correction program, and audit procedures.

Whether these and other concerns will persuade the IRS to some type of middle ground remains to be seen. Based on recent IRS informal comments, however, it is difficult to be optimistic.

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