



Is This the End of Rico ... er, FDLs?

Okay, I'm showing my age, but I started writing the real title of this Flashpoint, (i.e., "Is This the End of FDLs?") and I couldn't help but use this famous Edward G. Robinson quote from the movie, *Little Caesar*.

It is being reported by several friends of the Firm that Sunita Lough, head of the Tax Exempt/Government Entities Division of the IRS, is on the speaking circuit alerting the benefits community that the IRS is seriously considering whether to eliminate the favorable determination letter (FDL) program for all retirement plans. If the current thinking prevails, no FDLs will be available, except at the plan's inception and termination. This would mean that plans that are either individually designed (that is, not written in the form of a check-the-box plus boilerplate document that has been preapproved by the IRS) or for which the preapproved document has been significantly modified will have no means after the initial year, or before termination, to have the IRS confirm that the language of the plan is acceptable.

According to reports, Ms. Lough announced at meetings this week that the proposal would end "periodic" FDLs after the 2015-2016 submissions of Cycle E documents are approved. (Individually designed plans are currently submitted on a 5-year cycle, with approximately 20% of the plans going to the IRS each year. The submission order usually is based on the last digit of the plan sponsor's taxpayer I.D. number. Cycle E is the last of the current 5-year group.)

It is likely that this proposed change is motivated by the reduction in the IRS's budget in the past several years, which has resulted in a very real strain on the IRS's dwindling personnel resources. We understand that, on average, it takes more than a year to process current FDL requests. Certain IRS managers see the FDL program as something that can no longer be afforded, notwithstanding the fact that the IRS charges a user fee of \$2,500 to review an FDL request on an individually drafted plan document.

The proposal has not yet been implemented, although some indications are that "all systems are go." The IRS is expected to provide practitioners with an opportunity to comment on the proposal, although perhaps only with regard to the details of the revised procedures, rather than the change, itself.

Why Do We Care About This?

Let's put this into perspective.

First, how often are individually designed or modified preapproved plans used? The majority of plans—and the majority of plans with which we work—use preapproved documents, and we encourage this practice (although many other lawyers do not, for a variety of reasons). Using a preapproved plan keeps the costs down, and the standard language of these documents does not produce any kind of special challenge for the normal, run-of-the-mill plan.

However, there are times when the run-of-the-mill plan document just won't do the trick. Companies that commonly acquire other companies or have several business lines with different employee groups might find that a preapproved plan document does not have enough flexibility. Other examples of plans that might require special drafting are those that cover both union and nonunion employees or those conforming to special employment arrangements (such as Davis-Bacon rules). In addition, the IRS does not permit employee stock ownership plans (ESOPs) to use preapproved plan documents. Although the IRS historically did not permit the use of preapproved documents for cash balance plans, this policy is changing with the next wave of preapproved defined benefit plans.

The net result is that some plans *must* be drafted individually, and others require special language to accommodate complex plan designs or other special needs of the plan sponsor or participants.

Second, how important is it for the IRS to pre-review these plans? Under current IRS practices, it is **critical**. The Internal Revenue Code requires that all qualified retirement plans (as well as 403(b) and 457 plans) have written documents. The IRS interprets this rule not just to require that the plan be reduced to writing or that the plan be administered as drafted, but also to require that the plan recite certain mandatory provisions. When IRS reviewers look for these mandatory provisions, even very small variations in the wording can cause the reviewers to demand modifications to the plan. These variations may be due to real differences between what the law says and what the plan recites, or they can be the result of positions taken by the IRS that are not necessarily found in any guidance. For example, the IRS has taken the position for current plan documents that forfeitures may not be used to fund safe harbor contributions in a 401(k) plan. This principle is not clearly stated in either the law or Treasury regulations; it is the result of the IRS's interpretation of regulatory language that requires safe harbor contributions to be fully vested when contributed. The IRS's position is that forfeitures are considered to be "contributed," not when they are used to fund contributions, but when they were originally contributed to the plan (i.e., when they were placed in the account of the participant who ultimately left the company without full vesting). This position was certainly not anticipated by the practitioner community until the issue began to be raised by the IRS in relation to FDL submissions.

Even more importantly, the IRS's position with regard to specific plan language may change over time. As a result, a plan provision that was acceptable in one document on Monday may not be acceptable in another document on Tuesday, notwithstanding that both plans were drafted months or even years earlier. For example, preapproved plans for the previous cycle commonly permitted the use of forfeitures to fund safe harbor contributions. The prohibition currently being applied is the result of a change in view by the IRS and not any new guidance.

FDLs protect plans from disqualification when the IRS's language demands change, because FDLs have retroactive applicability. If the IRS objects to plan language during the FDL process, the procedures give the drafter an opportunity to cure the provision retroactively. If the IRS objects during an audit to plan language that was previously approved in an FDL process for that client, it can only insist that the provision be changed going forward. Without an FDL, however, the plan may be subject to *retroactive* disqualification to when the offending provision was first adopted. Needless to say, it is harder and usually more expensive to resolve problems "discovered" on audit than it is to work with a reviewer in the FDL program.

What is disqualification? *Disqualification* is the loss of tax benefits of a retirement plan. A qualified retirement plan has five advantages: (a) contributions to the plan are tax-deductible to the employer when made; (b) contributions to the plan are not taxed to the employee until the amounts are removed from the plan, thus creating a true deferral of tax from the year of contribution to the date of distribution; (c) the assets contributed to the plan's trust are invested and the investment returns are tax-exempt; (d) a participant who leaves the company has the option of rolling over his or her benefit to an IRA or another retirement plan so as to defer taxation until actual retirement; and (e) the retirement plan funds generally are not subject to claims of creditors of either the plan sponsor or the plan participant.

In short, disqualification may cause the revocation of all these advantages. Some or all of the tax deductions are lost to the employer. Funds that remain deductible to the employer are—at least partially—taxable to the employee. The tax exemption of the trust is lost, so that investment returns are taxed. Rollovers during the disqualified years are disallowed and distributions become fully taxable. In some circumstances, the full accounts of the highly compensated employees become taxable. The trust may lose its creditor protection.

In short, disqualification is the functional equivalent of a nuclear bomb to the plan.

Very few plans are disqualified in real life. This is because the IRS generally offers the plan sponsor a settlement of the matter, permitting retroactive correction in exchange for the payment of a sanction or penalty. That sanction, while significantly less expensive than plan disqualification, commonly falls within five figures for smaller employers who can ill-afford it. A very large part of our practice is representing clients in these kinds of negotiations.

If a plan sponsor or its service provider knows about a disqualification problem in advance of IRS audit, there are many cost-effective means by which the issue can be resolved. However, once an audit occurs and the defect is "found" by the IRS, settlement becomes much more expensive. This is intentional; it is the way that the IRS encourages plan sponsors to comply with the law. That makes enormous sense when it is within the plan sponsors' or practitioners' ability to be compliant. On the other hand, when the compliance "issue" is obscure or relates to a position being taken by the government that is a surprise to all, it is hard for even the most scrupulous and conscientious plan sponsor and practitioner to do what is needed.

Can't attorneys review their own plans for compliance with qualification rules? In short,

no. Attorneys and other plan drafters are able to review the documents they prepare to ensure that the provisions do what is intended. What attorneys and other drafters cannot do, however, is predict with any certainty the vagaries of the IRS's demands for what language must be in plans and what cannot be in plans, which change without notice and without an available cure period. If the IRS continues its policy of strict compliance with its views of what documents should and should not say, and as long as this policy is subject to change without notice, there is no way for any practitioner to ensure—other than to get an FDL for the plan—that an audit will not produce a threat of disqualification due to the plan language.

So What Should We Do?

At this point, the IRS has not definitively announced anything other than its intent. Nonetheless, you can do your part to prepare yourself and to help the benefits community:

- If you use a preapproved plan without modification, no action is needed. Your plan likely will not be affected by these changes.
- If you use an individually designed plan or if your preapproved plan document was modified by your service provider in such a way that IRS submission was recommended, you and your advisors should review the plan to determine whether you want to standardize the plan's provisions to avoid the need for this special language in the future (and how that change would affect your plan's operations).
- If you are active in ASPPA, the AICPA, the ABA, the Small Business Association, the Chamber of Commerce, or any other organization that engages in lobbying or makes comments on government releases, you should let your representatives know that you are concerned about this IRS proposal and its chilling effect on retirement plans. A call or note to your Congressperson or Senator couldn't hurt either.

Ferenczy Benefits Law Center LLP members are active in ASPPA, among other organizations, and we will be working on this issue with those organizations to represent the interests of plan sponsors, participants, and retirement plan service providers.

If you have any questions about the IRS proposal or your plan, please let us know.



Don't Forget the Pensions on Peachtree: April 16-17, 2015, in Atlanta, GA

We hope everyone is planning to join us for the Pensions on Peachtree - your Southern retirement plan conference. This year, we will be hosting the conference at the Century Center Marriott Hotel, in Atlanta, GA. This two-day conference is a great opportunity for you and members of your organization to catch up on what is latest on all retirement plan changes, get your ethics credits for your ASPPA, NIPA, or ERPA designations, and meet with colleagues from all over the South. Please join us for this annual event (the Thursday night barbecue at Ilene's house is not to be missed!). Come and see us, y'all hear?!

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