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IRS Expected to Slash Part of Retirement Plan Determination Letter Process Due to Budget Constraints and Limited Resources



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The Internal Revenue Service (“IRS”) has announced a dramatic change to its long-standing system of reviewing individually designed plans for periodic compliance reviews. Sunita B. Lough, Commissioner of the IRS’s Tax Exempt and Government Entities Division, has informed various professional groups, including the American Bar Association Joint Committee on Employee Benefits and the American Society of Pension Professionals & Actuaries’ Philadelphia Regional Conference, that the determination letter system is expected to change as of 2017 (84 PBD, 5/1/15).

Employers have historically submitted their qualified employee benefit plans, such as pension plans and 401(k) plans, to the IRS for a review as to whether plan documents have been properly updated. After its review, the IRS generally issues a favorable determination letter that the plan, as updated, conforms to the requirements for favorable tax treatment, which serves as an invaluable resource for employers.

According to the IRS Advisory Committee on Tax Exempt and Government Entities (ACT)’s 2010 Report,

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the IRS has received more than one million determination letter applications since the enactment of ERISA (110 PBD, 6/10/10). To address the significant backlog of submissions, the IRS moved to a five-year staggered system in 2007 under which: (i) single employer individually designed plans submit during one of the five-year cycles that correspond with the last digit of their employer identification number (“EIN”); (ii) multiple employer plans submit during Cycle B; and (iii) multi-employer plans submit during Cycle D. Cycle D was the last cycle to be completed, on Feb. 2, 2015, and Cycle E is currently open through Jan. 31, 2016, which will complete the 10th cycle of the staggered system for individually designed plans.

Last Digit of Plan Sponsor’s EIN	Plan’s Cycle	First Five-Year Determination Letter Cycle	Second Five-Year Determination Letter Cycle
1 or 6	A	Jan. 31, 2007 – Jan. 31, 2012	Jan. 31, 2012 – Jan. 31, 2017
2 or 7	B	Jan. 31, 2008 – Jan. 31, 2013	Jan. 31, 2013 – Jan. 31, 2018
3 or 8	C	Jan. 31, 2009 – Jan. 31, 2014	Jan. 31, 2014 – Jan. 31, 2018
4 or 9	D	Jan. 31, 2010 – Jan. 31, 2015	Jan. 31, 2015 – Jan. 31, 2020
5 or 0	E	Jan. 31, 2011 – Jan. 31, 2016	Jan. 31, 2015 – Jan. 31, 2021

Even with the staggered system in place, the IRS has continued to struggle with a backlog of applications and limited resources. Below are figures reported by the ACT on the number of determination letter applications submitted to the IRS for review by employers during the first four cycles of the staggered system:

Cycle A (2007)	Cycle B (2008)	Cycle C (2009)	Cycle D (2010)
17,681 Plans	18,171 Plans	13,432 Plans	23,383 Plans

Given the current volume, the ACT Report indicated that the IRS takes on average six months to complete its review and issue a determination letter. Employers, however, can experience delays of more than one year.

Due to budget constraints, the IRS is preparing to cease its review of individually designed plans during the life of the plan. Instead, it is expected that the IRS will only review a plan at the beginning of its existence and then again at termination. This is a drastic shift for plan sponsors, who will no longer have a system in place to receive a periodic letter confirming that the plan is being maintained properly for compliance purposes. When a plan is reviewed by the IRS, there is an opportunity to make corrections to ensure compliance.

Without this system in place, employers will lose the assurances that were historically given to plan sponsors that their plan documents were written according to the legal requirements. More employers may face adverse tax consequences on audit because the failure to satisfy a plan document requirement can lead to the disqualification of the plan. Disqualification of the plan causes numerous adverse consequences to employees and employers.

Risks of Plan Disqualification	
Employers	Employees
Employers would not be able to deduct contributions made into the Plan.	Employees would become subject to income tax on the value of their vested benefits.
Employers would be penalized for failing to withhold payroll and income taxes in a timely	Employees would be taxed on future amounts as they become vested, rather than being

Risks of Plan Disqualification	
manner.	able to defer income tax until the amounts are ultimately distributed from the plan.
Employers would need to issue amended Form W-2s to employees.	Employees in certain states would lose the ability to roll over their plan distributions to an IRA or another employer plan.
Employers would be subject to income tax on the earnings of the trust, which would lose its tax-exempt status and would be required to file Form 1041.	Employees would lose the protection of PBGC insurance for their benefits under a pension plan.

As a result of the anticipated changes to the plan determination letter system, it will become even more important for employers sponsoring individually designed plans to maintain internal systems and controls for maintaining plan document compliance. The IRS will continue to audit plans, and the sanctions imposed for a failure that is discovered on audit can be costly.

Accordingly, employers and other plan sponsors should consider implementing their own periodic internal review process so that if a plan sponsor discovers a document compliance problem, it can take advantage of the IRS voluntary correction program called the Employee Plans Compliance Resolution System (EPCRS), which was recently updated by the IRS in Revenue Rulings 2015-27 and 2015-28 (67 PBD, 4/8/15). The voluntary correction program allows a plan sponsor to fix a plan document failure at a lower cost than if the error was found on audit. Plan document failures are not permitted to be corrected through self-correction; they must be submitted to the IRS for approval through the EPCRS program.

The IRS has always encouraged good internal controls, which can be a key factor in limiting problems during an employee plan audit. Employers and other plan sponsors will now need to expand their internal controls to include more attention to plan document compliance and should avoid putting the need to continue to update and monitor plan document compliance on the back burner.