Well, They've Done It:
The IRS Jettisons the FDL Program

As we warned in our FlashPoint, "Is this the End of Rico … er, FDLs?" (4/1/15), the IRS just released Announcement 2015-19, confirming the end of the favorable determination letter (FDL) program for individually designed retirement plans, effective January 1, 2017, except for when a plan is first adopted and when it is terminated. (The IRS notes in the Announcement that there may be other "limited circumstances" when an FDL is available, but does not expound on what those circumstances might be.)

> An *individually designed plan* is one that is drafted particularly for a given plan, customarily by attorneys.
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> A *preapproved plan* is one that has been drafted using a pre-designed document with some standard language and some flexible language that permits the plan to be customized to accommodate the sponsor's and participants' needs. These types of documents, generally called prototype plans or volume submitter plans, are reviewed and approved by the IRS in advance of their use by plan sponsors, and are commonly provided to plan sponsors by various service providers, including third party administrators, financial institutions, and attorneys.

The FDL program, which is usually unavailable to prototypes and volume submitter plans (which are preapproved through another process), confirms that the language of a retirement plan document meets the IRS's requirements. IRS rules mandate that a plan document include certain language and not contain other language. If the IRS audits a plan and finds the document does not comply with these rules, the plan may lose its tax-favored status, resulting in significant taxation to the plan sponsor, the trust holding the plan funds, and the participants (a process called "disqualification").

As we discussed in our earlier FlashPoint, the IRS's views on the required and prohibited language of plan documents change, sometimes unpredictably, making it challenging to know that a plan will meet with IRS approval. Historically, the FDL program reassured a plan sponsor that the document was fine, while giving sponsors of noncompliant documents an opportunity to fix any issues without negative ramifications. Therefore, disqualification due to document problems has not been common. However, if the IRS's stringent approach to plan documentation on audit remains while the availability of the FDL program disappears, the potential for disqualification increases exponentially. (Another reason why disqualification is rare is the existence of the IRS's compliance resolution program, under which such a problem discovered on audit can be corrected. However, this process requires the plan sponsor to pay a penalty or sanction to the IRS, commonly $10,000 or more—hardly an attractive proposition, particularly for smaller employers.)

There are attorneys who strongly prefer their own individually designed plans over preapproved plans. However, in many, many situations, there may be little technical reason for this preference. Commonly, plan designs are fairly run-of-the-mill, and most of the operable provisions can be found easily in a preapproved plan.

However, some plans do not lend themselves to preapproved documents. These include:

• *ESOPs and Cash Balance Plans.*
Historically, neither employee stock ownership plans (ESOPs) nor cash balance plans were permitted to be documented using a preapproved plan. The IRS formally announced earlier this month in Revenue Procedure 2015-36 that these two types of plans are now permitted to use a prototype or volume submitter document, and also released sample language for drafters of these preapproved plans to use. There will be some delay while this preapproval process is underway, but these documents will ultimately be available.

Even after the IRS preapproval process is in full swing for these plans, there will still be types of ESOPs and cash balance plans that may not use preapproved documents. These include:

♣ Cash balance plans that:
- Are conversions from a customary defined benefit plan but do not define the participant's benefit to equal the sum of the present value of accrued benefit as of the date of conversion and the post-conversion cash balance plan additions, i.e., the so-called "A+B" formula;
- Are pension equity plans, or are other types of hybrid plans that do not use cash balance formulas;
- Permit participants to select the investments on which the interest accumulation rate is based;
- Tie the interest accumulation rate to actual plan investments;
- Use the 3% accrual or fractional accrual rules of Code Section 411; or
- Offset benefits by those earned in another plan, except under certain limited circumstances.

♣ ESOPS that:
- Are combinations of stock bonus plans and money purchase pension plans; or
- Hold preferred employer stock.

• *Other Plans Excluded by the IRS from the Preapproved Plan Program.*
Rev. Proc. 2015-36 notes that these other plan types also remain ineligible for preapproval:
- Stock bonus plans that are not ESOPs;
- Union plans and multiemployer (Taft-Hartley) plans;
- Plans that contain Section 414(k) features;
- Target benefit plans;
- So-called "nonelecting" church plans;
- Fully insured pension plans under Code Section 412(e)(3);
- Plans that contain fail-safe provisions for average benefits coverage or nondiscrimination testing;
- Plans that incorporate either the 401(k) deferral or matching contribution testing or the contribution/benefits limits of Code Section 415 by reference;
- Plans that contain Section 401(h) post-retirement medical accounts;
- So-called DB(k) plans;
- Plans that are designed to satisfy the provisions of Code Section 105 (i.e., contain accident or health plans);
- Variable annuity plans; or
- Defined benefit plans that base accrual of benefits on the value or rate of return of identified assets.

• *Plans With Complex Formulas that Accommodate Specific Needs of the Plan Sponsor or Participants.*
These types of situations may be more common in defined benefit plans than in profit sharing and 401(k) plans, and are often the result of plan changes that are effective prospectively only. These plans often base benefits on different formulas for service provided at different times, such as one benefit rate for years between 2000 and 2003, a second formula for the service between 2004 and 2006, a third formula for 2006 through 2009, and so on.

Company acquisitions, particularly those involving plan mergers, also create complications. There may

be a desire or need to protect participants' service, benefits, or vesting earned prior to an acquisition of a company by the current plan sponsor. In those cases, formulas may provide that people who previously worked for XYZ company have a certain minimum benefit (or vesting percentage), while a different minimum is provided to those who previously worked for ABC company.

Even if efforts are made to simplify these formulas going forward, the need to "spell out" the protected benefits from prior documents may make a preapproved plan impractical.

Finally, a plan sponsor may have internal reasons to want a complex plan design that does not fit well into a preapproved document. In that case, the plan sponsor may find that it must choose between having the flexibility it needs and using a more simplified document.

What Do We Suggest? If you are affected by these changes to plan document rules, here are some things you can do:

1. Interested persons should make their views known to the IRS through written comments on or before October 1, 2015.
2. All sponsors of individually designed plans should discuss with their legal counsel whether the plan may be converted to a preapproved plan on or before January 1, 2017. If so, this may reduce costs for plan documentation going forward, while better protecting the plan from IRS challenges to the plan document if it is chosen for audit.
3. If the plan is not amenable to conversion to a preapproved document, the plan sponsor will need to determine whether the provision that prevents such conversion is worth maintaining in light of concerns regarding the documentation process.
4. Practitioners who favor their own individually designed plans may decide to choose between using an available preapproved document that represents the "lesser of evils" or preparing and filing their own document for preapproval to preserve their favorite special provisions for their clients.

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