Dealing with New IRS Qualification Requirements for Pension, Profit Sharing and 401(k) Plans, Effective January 1, 2017

What to do (*and rely on*) when the IRS no longer gives determination letters for amended plans.

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January 27, 2017

The procedures for qualification of an employer sponsored individually designed pension, profit sharing or 401(k) plan for favorable tax deferred treatment under the Internal Revenue Code ("Code") changed significantly effective on January 1, 2017.

The result is the IRS will no longer give a determination letter to assure a plan sponsor an amended plan is qualified.

Employers sponsoring an individually designed plan now need an alternative way to provide reliance the plan is amended as required by the Code and qualified for favorable tax deferred treatment and tax exemption.

For an employer that sponsors an individually designed qualified plan this change seems to make it advisable, and perhaps *essential*, to adopt a specific internal policy and *plan qualification review and amendment procedure* to follow in order to comply with the new IRS guidance and requirements for maintaining a plan's qualification under the Code. This can assure the plan complies with the new IRS guidelines, continues to be both operated and amended to meet all plan qualification requirements that apply to the plan, and the plan sponsor and plan will have an effective method and records to confirm it.

IRS Revenue Procedure 2016-37; Rules Changed on Plan Qualification

Internal Revenue Service ("IRS") Rev. Proc. 2016–37, 2016-29 Internal Revenue Bulletin, ("IRB") published in June 2016, generally *effective January 1, 2017*, makes changes to the:

(1) IRS determination letter program for tax-qualified individually designed plans; and

(2) Requirements for adoption of qualified plan document amendments and the remedial amendment period within which the amendments must be made.

Rev. Proc. 2016–37 includes important changes related to when an individually designed qualified plan must be amended for law and other guidance changes, and when the plan sponsor may request an IRS determination letter that the plan meets qualification requirements under the Code. *See also*, Rev. Proc. 2017-4, 2017-1 IRB 146.

Qualification of a Plan under the Code

As background, the Code provides that a qualified pension, profit sharing plan or 401(k) plan must satisfy numerous specific requirements as to *both the written form and terms of the plan document and in the operation of the plan*. That means the provisions in the plan document must satisfy the requirements of the Code and that those plan provisions must be followed.

Plan *qualification* generally allows substantial tax favored treatment and deferral of compensation, including that (i) amounts contributed to the plan are not includible in gross income of the Plan participants for federal income tax purposes until distributed from the plan at retirement or upon termination of employment, (ii) income of plan investments held for the benefit of participants in the trust of the plan is exempt from federal income tax, and (iii) contributions to the plan are deductible by the employer sponsoring the plan.

In reverse, the *disqualification* of a plan that has been qualified under Code has adverse federal income and employment tax consequences. The plan's trust loses its tax-exempt status and becomes a nonexempt trust. Plan disqualification affects three groups which are employees, the employer and the plan's trust. Generally, an employee would include in income any employer contributions made to the trust for his or her benefit in the calendar years the plan is disqualified to the extent the employee is vested in those contributions. In general terms an employee who is a participant in a disqualified plan must in include in income employer contributions to the plan that are vested. Also, a distribution from a plan that has been disqualified is not an eligible rollover distribution and cannot be rolled over to either another eligible retirement plan or to an IRA rollover account; and when a disqualified plan distributes benefits, they are subject to taxation. For an employer the tax deduction of contributions it makes to the plan can be denied or delayed. The trust of the plan loses its tax-exempt status and must file a federal income tax return and pay income tax on trust earnings. For contributions to a nonexempt employees' trust the FICA and other employment taxes can be required to the reported and paid by the employer or the plan trust.

The disqualification of a plan and its adverse effects can be addressed and avoided in part by using procedures established and published for the IRS Employee Plans Compliance Resolution System (EPCRS). It is provided for in Rev. Proc. 2016-51. It generally provides for a Self-Correction Program (SCP) that permits a plan sponsor to correct certain plan failures without contacting the IRS or paying any fee, a Voluntary Correction Program (VCP) that permits a plan sponsor to, any time before audit, pay a fee and receive IRS approval for correction of plan failures, and an Audit Closing Agreement Program (Audit CAP) that permits a plan sponsor to pay a "sanction" and correct a plan failure while the plan is under audit. The amount of the sanction under Audit CAP is a negotiated amount that is determined based on the facts and circumstances, including the relevant factors described in Rev. Proc. 2016-51. Those factors include the extent to which the plan sponsor had otherwise adopted applicable amendments

identified on the *Required Amendments List* described Rev. Proc. 2016–37 and published annually by the IRS, discussed below; and the extent to which the plan sponsor had reasonably determined that a provision on the *Required Amendments List* was not applicable to the plan.

To achieve and maintain plan qualification and tax favored treatment there are *many* specific and detailed Code plan qualification requirements that *must be satisfied by the written terms and provisions of the plan document and in actual operation of the plan,* which include a minimum participation requirement, a requirement that the plan must be operated in accordance with its terms, a requirement that there can be no cutback of vested plan benefits by a plan amendment, 401(k) plan deferral percentage and distribution requirements, matching contribution tests, an elective deferral test, maximum contribution limits, a maximum compensation limit, minimum vesting requirements, minimum distribution requirements, a consent to distribution requirement, joint and survivor annuity requirements, direct rollover requirements, prohibited assignment and alienation requirements, nondiscrimination requirements, coverage requirements, employer funding requirements, an exclusive benefit requirement, and reporting and disclosure requirements.

IRS guidance states that employers should establish practices and procedures to ensure the plan is operated in accordance with the plan document so participants and beneficiaries receive their proper retirement benefits.

This guidance also notes and emphasizes that employers should be aware that the law and regulations with respect to qualified retirement plans *frequently changes*.

IRS Determination Letter Program Then and Now

The IRS has previously administered a determination letter program for qualified individually designed plans to enable plan sponsors to get written assurance from the IRS as to the form of their retirement plan document and that it meets qualification requirements. This IRS determination letter program will continue to be administered under Rev. Proc. 2016-37, but in revised form.

The IRS published guidance states a favorable determination letter is issued by the IRS in response to a request by a plan sponsor as to the qualified status of its retirement plan under Code section 401(a). An IRS determination letter expresses the IRS's opinion regarding the form of the plan and it is issued based on the applicable Cumulative List or Required Amendments List published by the IRS for the submission period in which the plan sponsor applies for it.

This guidance indicates benefits of a favorable determination letter issued by the IRS to a plan sponsor are that having a favorable determination letter provides the employer and plan sponsor with reliance that the plan is qualified under Code section 401(a), and the plan's trust is exempt under Code section 501(a). Also, it is generally recognized that if the employer operates the plan according to the terms of a plan document for which the plan sponsor has received a favorable IRS determination letter, the plan will satisfy the law in operation.

Pursuant to Rev. Proc. 2016-37, beginning January 1, 2017, the IRS determination letter program is now significantly changed and reduced in scope and availability to employers that sponsor individually designed qualified plans.

Under previous IRS guidelines and procedures, primarily under Rev. Proc. 2007-44, the IRS provided a 5-year remedial amendment cycle system. It provided for individually designed plans to request an IRS determination letter on a plan's qualification generally every 5 years. Under that system, plans also had to timely adopt interim amendments for items on a Cumulative List of required plan changes published annually by the IRS. If the interim amendments were timely adopted they would have an extended *remedial amendment period* to the end of the 5-year period to correct any qualification failures.

Under the new rules in Rev. Proc. 2016-37, a plan sponsor can request a determination letter only if:

> (1) The plan has never received a favorable determination letter, such as when a plan is first established and adopted by an employer;
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> (2) The plan is terminating; or
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> (3) The IRS makes a *special exception*, taking into account and considering additional circumstances, such as the nature of the change in qualification requirements, new approaches to plan design, or inability of a plan to convert to a pre-approved plan document, as well as the IRS "program capacity" (IRS current case load and resources available to process determination letter applications) and other factors.

For an employer that sponsors an individually designed plan that is already established and in operation, and has previously received an IRS determination letter for the plan, Rev. Proc. 2016-37 generally means the plan sponsor will no longer be required or allowed to periodically apply for and receive an updated IRS favorable determination letter that the plan is qualified under the Code after being amended.

In other words, the IRS will now generally issue a determination letter only upon the start and end of the life of an individually designed plan, being when the plan is initially established, and in the event the plan is terminated by the plan sponsor. Of course for many plans, including those presently in existence the interval between these two events can be an extended period of time, in some cases forty or fifty years, or longer, during which the requirements for qualification of the plan under the Code will likely change many times.

Under the new rules in Rev. Proc. 2016-37, beginning January 1, 2017, maintaining the qualification of a plan (after it is established, and prior to its termination) in accordance with the numerous requirements specified in the Code mentioned above, must now be accomplished without the ability to periodically get an IRS favorable determination letter giving written assurance from the IRS that the plan is qualified.

Thus, the continuing qualification of an existing plan on an ongoing basis during its life span will now need to be basically *self-determined* by the employer as plan sponsor, or determined by the employer along with obtaining some alternative form of written assurance (hopefully equivalent in effect to an IRS favorable determination letter) that the plan has been timely and

correctly amended so as to be in a written form that meets all applicable qualification requirements.

Reliance on Previously Issued IRS Determination Letters

Rev. Proc. 2016-6, published last year, provides that, effective as of January 4, 2016, determination letters issued to individually designed plans will no longer contain an expiration date. Also, under Rev. Proc. 2016-37, expiration dates included in determination letters issued prior to January 4, 2016, are no longer operative.

Under Rev. Proc. 2016-37, in general, a plan sponsor that maintains a qualified plan for which a favorable determination letter has been issued and that is otherwise entitled to rely on the determination letter may not continue to rely on the determination letter with respect to a plan provision that is subsequently amended or that is subsequently affected by a change in law. However, a plan sponsor may continue to rely on a determination letter with respect to plan provisions that are not amended or affected by a change in law.

Rev Proc. 2016-37 Remedial Amendment Period; Required Amendments Deadline

An individually designed qualified plan must have a written plan document that contains terms and provisions that meet the qualification requirements stated in the Code. When those requirements are changed by enactment of amendments of the Code or by new or changed regulations, a qualified plan will likely not meet the new or changed qualification requirements under the Code until it is amended.

To deal with this timing issue and to in effect allow retroactive plan amendments the Code also contains provisions for a "remedial amendment period" during which amendments of the plan document can be made by the plan sponsor which will be effective and recognized retroactively. This is provided for in Code section 401(b) and the regulations under that section. Those allow retroactive amendments to a qualified plan for "disqualifying provisions," which means and can include a plan provision which results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in those requirements or a plan provision designated by the IRS as a disqualifying provision, or the absence from a plan of provisions required by a change to the qualification requirements of the Code, if the plan was in effect on the date the change became effective with respect to the plan.

Rev. Proc. 2016-37 establishes a new remedial amendment period and date by which a qualified plan must be amended for changes in qualification requirements, based upon the particular time when qualification needs to be addressed and acted upon, and provides for IRS annual publication and application of a *Required Amendments List*.

For a *new* individually designed plan the remedial amendment period ends the later of (1) the 15th day of the 10th calendar month after the end of the plan's initial plan year; or (2) the

modified Code Section 401(b) expiration date. The "modified Code Section 401(b) expiration date" is generally the due date for the employer's income tax return, determined as if the employer has an extension to file its return.

For *existing* plans the remedial amendment period for a disqualifying provision (other than those in the *Required Amendments List*) is the end of the second calendar year after the amendment is adopted or effective, whichever is later.

For *existing* plans the remedial amendment period for a disqualifying provision that relates to a change in Code qualification requirements is the end of the second calendar year that begins after the issuance of the *Required Amendment List* on which the change in qualification requirements appears.

IRS Required Amendments List

Under Rev. Proc. 2016-37, beginning January 1, 2017, the IRS will annually publish a *Required Amendments List*.

The Code Section 401(b) remedial amendment period for amendments that become required to be made by changes in the law and regulations will now be tied to the *Required Amendment List* published by the IRS, unless legislation or other guidance states otherwise. The *Required Amendments List* is to be an annual list of all the amendments for which an individually designed plan must be amended to retain its qualified plan status. IRS guidance indicates it will publish the *Required Amendments List* after October 1 of each year. Generally, plan sponsors must adopt any item placed on Required Amendments List by the end of the second calendar year following the year the *Required Amendments List* is published. For example, plan amendments for items on the *2016 Required Amendments List* generally must be adopted by December 31, 2018. This is indicated in IRS Notice 2016-80, Dec. 27, 2016, containing the 2016 IRS *Required Amendments List*.

The new plan qualification rules indicate that an item will be included on a *Required Amendments List* after guidance with respect to such item (including any model amendment) has been provided in regulations or in other guidance published by the IRS in the Internal Revenue Bulletin. However, an item may be included by the IRS in a *Required Amendments List* in other circumstances, such as when a statutory change of the Code is enacted and it is anticipated that no IRS guidance will be issued.

The IRS guidance states that the fact that a change in a plan qualification requirement is included on the *Required Amendments List* does not mean that a plan must be amended as a result of that change; and that *each plan sponsor must determine whether a particular change in a qualification requirement requires an amendment to its plan.*

Rev. Proc. 2016-37 provides that plan amendments that are "discretionary," meaning that they are not required by reason of a change in the law or regulations but are made at the discretion of and by choice of the employer and still within the Code requirements for qualification after being made, will be required to be made by the end of the plan year in which the plan amendment is operationally put into effect.

Plan Operation; IRS Operational Compliance List

The remedial amendment period provided for under the Code and regulations permits a qualified plan to be amended retroactively to comply with a change in plan qualification requirements. However, a plan must still be *operated* in compliance with a change in qualification requirements under the Code from the effective date of the change.

Revenue Procedure 2016-37 does not change a plan's operational compliance standards. Employers still need to operate their plans in compliance with any change in qualification requirements from the effective date of the change, regardless of the plan's 401(b) period for adopting plan document amendments.

Rev. Proc. 2016-37 provides for the IRS to also publish an *Operational Compliance List* to give guidance on maintaining qualification of a plan in accordance with changes in the Code prior to an employer making the formal written amendment of the plan to conform it to changes listed and described in the *Required Amendments List.*

To assist plan sponsors in achieving operational compliance, the IRS will annually publish the *Operational Compliance List*. It will identify changes in qualification requirements under the Code that are effective during a calendar year.

The IRS guidance states also that in order to be qualified a plan must comply operationally with each relevant qualification requirement, even if the requirement is not included on an *Operational Compliance List*.

Plan Qualification Planning and Compliance under Rev. Proc. 2016-37

The new rules and requirements under Rev. Proc. 2016-37 suggest an employer that sponsors an individually designed qualified plan should adopt, maintain and follow a policy and specific *plan qualification review and amendment procedure* as a "to do list" for meeting plan qualification requirements, such as:

(1) Adopt *plan qualification review and amendment procedure* of the plan sponsor taking into account and consistent with the IRS rules, procedures and guidance provided for and described in Rev. Proc. 2016-37.

(2) Determine if there is a previously issued IRS favorable determination letter with respect to the plan that was applied for and obtained in accordance with procedures in effect under Rev. Proc. 2007-44. Keep that determination letter, and identify and retain the form of the plan document and terms of the provisions of the plan at the time of, and for which the favorable IRS determination letter found the plan to meet qualification requirements. (Note: the determination letter cannot be relied upon as to subsequent plan amendments or disqualifying provisions).

(3) Annually review of the plan document and identify how it is written to meet plan qualification requirements in the Code.

(4) Review IRS published guidance, rulings and regulations on plan qualification requirements.

(5) Annually review the published IRS *Required Amendments List* for that year.

(6) Determine if any "*special exception*" may apply to the plan and its amendments that would enable the plan sponsor to request and receive an IRS determination letter under Rev Proc. 2016-37, or other related guidance published by the IRS.

(7) The plan sponsor should adopt written amendments to the plan necessary to comply with the IRS *Required Amendments List* before the end of the remedial amendment period stated in the IRS *Required Amendments List*.

(8) Annually determine and have the plan sponsor take action to assure that *discretionary* plan amendments made by the plan sponsor are adopted and made by the end of the plan year in which the plan amendment is operationally put into effect.

(9) Complete and retain a *pro forma* IRS Form 5300, Application for Determination for Employee Benefit Plan, or a written instrument having essentially the same form and content, to serve as kind of internal record and checklist which includes information that would be required to be filed with the IRS for the plan, and would support its qualification, if a favorable IRS determination letter could be requested for the plan as it is amended.

(10) Annually review the published IRS *Operational Compliance List*.

(11) Apply the IRS *Operational Compliance List* to the facts and circumstances and records of administration and operation of the plan to assure the plan is being operated in accordance with all plan qualification requirements.

(12) Prepare, complete, date and retain the plan document, in the form it is amended and restated in each instance, to comply with all then applicable plan qualification requirements.

(13) Amend and/or update all other documents, including the summary plan description of the plan, to conform to the plan document as amended and restated, and assure administration and operation of the plan is in accordance with the terms and provisions of the plan as amended and restated to meet plan qualification requirements.

(14) Review and consider plan administration practices and procedures and the actual operation the plan with respect to contributions, allocations, distributions and other pertinent features in order to determine and assure that they are consistent with the plan as amended and restated to meet plan qualification requirements.

(15) Annually complete or obtain a form of internally or externally provided review and written plan qualification *determination*, or written tax *opinion*, to confirm that the plan document has been reviewed and determined to have been amended so as to meet all plan qualification requirements in effect at that particular time. This can include listing of the plan amendments made and the corresponding qualification requirements under the Code and regulations, and the IRS *Required Amendments List,* and a statement of why any provision in the *Required Amendments List* was not applicable to the plan.

(16) If the plan sponsor and its counsel and advisors determine it acceptable, a written form of protective reporting and disclosure statement could be voluntarily filed as an attachment to the federal income tax return of the plan sponsor, and/or the Form 5500 annual return/report for the plan, or by another means for each year in which the plan is amended to meet changes in plan qualification requirements and the IRS *Requirement Amendments List.* This could serve to regularly, periodically and contemporaneously provide a written communication by the plan sponsor to the IRS to substantiate the plan's qualification taking into account changes in qualification requirements during the life span of the plan (as previously provided by applications for and receiving IRS determination letters). It would confirm and also record in this way that the plan sponsor has considered and followed the provisions of Rev. Proc. 2016-37 and has timely amended the plan for changes in the Code and regulations, and the plan is being maintained in a form meeting applicable qualification requirements.

Related Implications of Rev. Proc. 2016-37; Without an IRS Determination Letter How Can a Plan Sponsor Confirm an Amended Plan is Still Qualified?

The new rules on IRS determination letters under Rev. Proc. 2016-37 have potentially important other implications in addition to direct effects of qualified status of an individually designed plan as between the plan sponsor, plan and trust, participants and the IRS.

The changes may have significance with respect to compliance with standards governing plan administration, and the relationship of a qualified plan to other disclosure and reporting involved in the business of the plan sponsor.

The fiduciary of an individually designed plan intended to be qualified under the Code may have a duty to assure that the plan is written and operated to meet applicable qualification requirements of the Code, at least to the extent such requirements parallel what is required to be in the plan under provisions in the Employee Retirement Income Security Act of 1974 (ERISA). The plan must also provide benefits to participants under a plan in accordance with its terms and provisions and stated purpose, and a plan fiduciary must provide and disclose material information to participants about the plan. A plan fiduciary could therefore arguably incur liability under ERISA for not maintaining the qualification of the plan, or for not disclosing to plan participants that the plan has not been amended to meet intended qualification under the Code. For a person or entity that is trustee of an individually designed qualified plan, treatment of the trust as exempt from federal income tax without reliance on periodic IRS determination letters will be less certain. This suggests that a plan fiduciary, as well as the plan sponsor, in the absence of IRS determination letters may be well advised to periodically request and obtain an alternative form of written determination or opinion that can be relied upon confirming the plan is still qualified under the Code and has been amended in accordance with Rev. Proc. 2016-37 and other IRS guidance.

A plan that offers employer stock as an investment option in which employees can participate and make voluntary 401(k) contributions may state and report the "tax status" of the plan under applicable securities law registration and reporting requirements. Prior to the new rules under Rev. Proc. 2016-37, disclosure and reporting about the tax status of a plan in this context may have included stating in filed and published documents (*e.g.* Securities and Exchange Commission, Form 11-K, Annual Report) that the plan was a qualified under Code section 401(a), the trust of the plan was exempt from federal income tax under Code section 501(a) of the Code, and that the plan sponsor had received and was relying upon a favorable determination letter from the IRS. Under Rev. Proc. 2016-37, reliance on an IRS determination letter and referring to it to describe or report the tax status of such a plan in these type of securities law filings will presumably also need to be changed and an appropriate alternative used.

In merger or acquisition transactions the qualification of individually designed plans of the parties under Code section 401(a) may need to be represented, warranted or documented as a condition of the transaction. The absence of periodic IRS determination letters now under Rev. Proc. 2016-37 also suggests a need for another form or type of written determination, or opinion, in this context to establish or evidence that the plan is qualified under the Code and has been amended in accordance with procedures stated Rev. Proc. 2016-37.

So there may be a variety of reasons for finding an effective alternative to provide the reliance that has previously come from receiving IRS determination letters in order to evidence continuing tax qualification of individually designed plans.

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