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No Determination Letters on Coverage and Nondiscrimination Compliance—Now What?

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Last December, the Internal Review Service (IRS) announced that beginning in 2012,[1] it would no longer consider a plan's compliance with the coverage and nondiscrimination rules as part of the IRS determination letter program. This change marks the end of an important feature of the determination letter program that plan sponsors have relied on for many years. Although the IRS has legitimate reasons for eliminating this aspect of its determination letter program, the unfortunate result for plan sponsors is less certainty and potentially greater costs. This article describes recent changes narrowing the determination letter program, and examines the implications of this change for plan sponsors and their advisors. It also discusses the need for some form of replacement in the form of individual private letter rulings or guidance of general applicability and what the absence of an effective replacement may mean for plan sponsors.

BACKGROUND

From its inception, the IRS determination letter program has provided peace of mind to plan sponsors who want assurance that the form of their plan (*i.e.*, plan language required by the IRS) is qualified under Internal Revenue Code (Code) Section 401(a) and will receive favorable tax treatment. In 1993, following the issuance of final nondiscrimination regulations under Code Section 401(a)(4), the IRS expanded the scope of its determination letter program to include, at the plan sponsor's election, certain non-form requirements (*e.g.*, compliance with the minimum coverage requirements under Code Section 410(b) and the nondiscrimination requirements under Code Section 401(a)(4)).[2]

An IRS determination letter provides protection that as long as a plan sponsor timely amends the plan's terms to satisfy applicable qualification requirements, the IRS generally will not disqualify the plan for a form error in the event the plan is audited. As long as a plan is properly amended by the end of its remedial amendment period under Code Section 401(b), it will be deemed to be in compliance with the qualification rules. In contrast, a determination letter does not cover operation or demographic failures—a plan must still operate in accordance with its terms as well as satisfy various coverage and nondiscrimination tests. But if a plan received a determination letter with respect to the plan's satisfaction of coverage or nondiscrimination requirements, the plan sponsor generally could continue to rely on the same testing methodology that was utilized in the determination letter application.

Recent Changes Limiting Access to Determination Letter Program

In previous years, after the passage of major legislation, the IRS experienced significant inventory spikes in the number of plans requesting review, as most retirement plan sponsors would submit their amended plans for determination letters just as the remedial amendment period deadline approached. This massive increase in determination letter requests imposed a huge administrative burden on the IRS that required the reallocation of agents away from examination to handle the overflow. In order to lessen this burden, the IRS implemented two new staggered remedial amendment periods, described in Revenue Procedure 2005-66, intending to more evenly spread the flow of determination letter requests over several years. Instead of all plans having the same due date, both for retroactive amendments tied to the effective date of certain laws and for the submission of the related determination letter request for such plans to the IRS, the new procedure assigned staggered deadlines to plan sponsors under which they could, subject to an important exception referred to below, wait to adopt all the necessary amendments at one time and then submit their amended plans for IRS determination.[3]

The remedial amendment periods introduced in Revenue Procedure 2005-66 are: (1) a five-year staggered period for individually designed plans divided into five cycles based on the plan sponsor's EIN; and (2) a six-year staggered period for pre-approved plans. However, the new staggered periods also required the timely adoption of good faith interim amendments; that is, a sponsor must expend a good faith effort to amend its plan to satisfy all necessary qualification requirements by the end of the normal Code Section 401(b) remedial amendment period, not the staggered cycle.

As it turned out, the IRS experienced some unexpected consequences of the interim amendment rule, particularly a significant increase in the number of plans requiring "non-amender" corrections through its Employee Plans Compliance Resolution System (EPCRS).[4] More generally, practitioner responses to the staggered remedial amendment period and interim amendment requirement largely were negative, especially regarding the complexity of the system, confusion over deadlines, and the length of time it took to receive a determination letter.

Recent Changes Limiting Scope of Determination Letter Program

On December 16, 2011, the IRS issued Announcement 2011-82, setting forth changes to the scope of the determination letter program, which are designed to address issues with the prior process.[5] Specifically, the changes eliminate certain features of the determination letter program that, in the view of the IRS, are overly cumbersome and of limited utility compared to the burdens on plan sponsors and examination personnel. The primary change is the elimination of the elective determinations (*i.e.*, Schedule Q) covering a plan's compliance with coverage and nondiscrimination requirements.[6] The IRS hopes these changes will help simplify the application process as well as improve internal efficiency by reducing the time it takes to process determination letter requests.

The IRS will continue to review whether a plan's benefit or contribution formula satisfies a nondiscriminatory design-based safe harbor under Treasury Regulations Sections 1.401(a)(4)-2(b) and 1.401(a)(4)-3(b), and whether the plan's terms satisfy Code Sections 401(k) and 401(m). It also has been reported that the IRS is considering establishing a private ruling program for plan sponsors to demonstrate compliance with the coverage and nondiscrimination requirements, although it is possible that if such a program is established, it would be limited to cases of "business necessity."[7]

IMPLICATIONS OF EXCLUDING COVERAGE AND NONDISCRIMINATION REVIEW FROM DETERMINATION LETTER PROCESS

As mentioned already, the IRS has instituted these changes with the hope that they will reduce the strain on the determination letter process, presumably without affecting compliance by plan sponsors. It seems fairly clear that the changes will lessen the burden on IRS reviewers of determination letters, but it is unclear whether the changes will end up increasing the burdens on other IRS operations such as its private ruling program or its plan audit function.

Even if, on a net basis, the burden on IRS resources is reduced by the narrowing of the scope of the determination letter program, it remains to be seen whether the burden will be effectively transferred to plan sponsors who will end up having to shoulder increased costs to achieve a reasonable level of comfort with respect to compliance with the coverage and nondiscrimination requirements. Compliance with these requirements is essential to a plan's qualified status, and the consequences of noncompliance can be substantial.[8] As discussed below, plan sponsors may now have to confront questions, which previously could be resolved through the determination letter program, involving the availability and application of particular testing methodologies or whether a plan satisfies the available "facts and circumstances" criteria.

Methodology Questions

In justifying the change to the determination letter program, the IRS explains in Announcement 2011-82 that an elective determination does not obviate the need for subsequent testing because reliance on the determination is limited to the facts presented in the demonstration. This justification implies that elective determinations were of limited value because their results could be affected by future changes in the sponsor's demographics. While this is true, it overlooks the fact that plan sponsors in many instances sought elective determinations to resolve uncertainty about the availability of, or application of, a particular testing methodology. This elective determination feature of the determination letter program certainly had value to plan sponsors.

As most practitioners can attest, the regulations under Code Sections 401(a)(4) and 410(b) are extremely complex and technical. The regulations allow for restructuring, under which one plan may be tested as if it were multiple plans, and aggregation, under which multiple plans may be tested as if they were one plan; they allow a defined benefit plan to be tested as if it was a defined contribution plan and a defined contribution plan to be tested as if it was a defined benefit plan; and they allow a "mixing and matching" of a broad array of testing alternatives. Given the complexity and the technicalities involved, and the consequences of making a mistake, it is understandable that plan sponsors and their advisors would want assurances that the IRS agrees that testing was performed correctly.

Even testing requirements that on their face appear to be straightforward sometimes raise questions of applicability, and plan sponsors frequently sought elective determinations to resolve this uncertainty. For example, the cross-testing regulations under Regulation Section 1.401(a)(4)-8 include a safe-harbor testing method for floor-offset arrangements involving a defined benefit plan "floor" benefit and a defined contribution plan "offset." The safe harbor, set forth in Regulation Section 1.401(a)(4)-8(d), generally allows the plan sponsor to test the benefit under the defined benefit plan, without regard to the offset, if certain conditions are satisfied. Absent this safe harbor, it appears that the defined benefit plan must be tested on the basis of the "net" benefit (*i.e.*, the benefit determined after the defined contribution plan offset), which may make for extremely volatile testing results. Thus, the safe harbor is very attractive.

But certain seemingly simple requirements of the floor-offset safe harbor are open to interpretation. For example, one requirement of the safe harbor is that the defined benefit plan and the defined contribution plan must benefit the same employees. Presumably, the IRS does not want the plan sponsor's highly compensated employees to escape the offset, while the non-highly compensated employees are subject to it. But what happens if the defined benefit plan is closed to new entrants—should this cause the plan sponsor to lose its ability to rely on the safe harbor? Another requirement of the safe harbor is that the offset under the defined benefit plan apply to all employees on the same terms. Does any difference in the benefit available to participants under either the defined benefit or defined contribution plan preclude use of the safe harbor because of the latter requirement? In the past, the plan sponsor could seek an elective determination to resolve these questions.

Perhaps more widespread are questions about application of the general nondiscrimination test to cash balance plans, which in the past could be resolved by a determination letter, but now potentially are open issues. For example, if a cash balance plan credits interest based on an external (variable) index, such as the 10-year Treasury rate, certain assumptions about future interest rates must be made in order to determine the benefit payable at normal retirement age. Uncertainty arises over whether, for testing purposes, one is required to assume that the current rate remains in effect for all future years, or whether one may make assumptions about rates that may be in effect over the long term. Each approach may lead to very different testing results.

Facts and Circumstances Questions

Aside from questions about testing methodologies, uncertainty with respect to the application of the coverage and nondiscrimination rules can arise because, in certain instances, the rules specify that whether a plan satisfies the applicable coverage or nondiscrimination requirements is determined by the surrounding facts and circumstances.

One facts and circumstances test arises out of the minimum coverage requirements and is of particular importance to a plan that is closed to new entrants, something that is now fairly common in the world of defined benefit plans. Such a plan may rely on the average benefit percentage test to satisfy the minimum coverage requirements of Code Section 410(b). One element of the average benefit percentage test, the nondiscriminatory classification test, is a numerical test based on the plan's ratio percentage and the "safe harbor" and "unsafe harbor" percentages identified in the regulation. If the plan's ratio percentage is greater than or equal to a "safe harbor percentage" listed in the regulation, the plan satisfies the nondiscriminatory classification test by a safe harbor. If the plan's ratio percentage falls between the safe harbor and unsafe harbor percentages, the plan must satisfy a facts and circumstances test.

A plan satisfies the facts and circumstances test "if and only if, based on the relevant facts and circumstances, the Commissioner finds that the classification is nondiscriminatory."[9] The regulation goes on to identify relevant facts and circumstances as including:

- The underlying business reason for the classification,
- The percentage of employees benefiting under the plan,
- Whether the number of employees benefiting in each salary range is representative of the number of employees in each salary range of the employee's workforce,
- The difference between the plan's ratio percentage and the employer's safe harbor percentage, and
- The extent to which the plan's average benefit percentage under Regulation Section 1.410(b)-5 exceeds 70 percent.

If a plan's ratio percentage is very close to the safe harbor percentage, the employer may be comfortable. But when the plan's ratio percentage gets close to the unsafe harbor, the question becomes more unsettled. In the case of a plan closed to new entrants, a decline in the relevant ratio percentage into the facts and circumstances zone raises the critical issue of when the plan sponsor needs to implement changes to its retirement programs.

A similar issue arises in connection with benefits, rights, and features (BRF) testing. Generally, a BRF must satisfy the nondiscriminatory classification test described above. If the BRF does not satisfy this test, it must be offered to an expanded group of employees for a limited period of time.[10] For plans closed to new entrants or legacy plans in which the covered participants continue to accrue benefits, BRF compliance can be problematic. BRF testing results can fluctuate from year-to-year, particularly when attributable to legacy plan benefits provided by a plan sponsor that encounters substantial demographic changes (*e.g.*, due to acquisitions or dispositions). Thus, whether or not the BRF satisfies the facts and circumstances test in any one particular year may present crucial decisions about whether to expand the availability of the BRF.

Another facts and circumstances test arises when testing a plan's definition of compensation. Plans that test contributions or benefit accruals on a definition of compensation that does not satisfy one of the safe harbors under Regulation Section 1.414(s)-1(c) must use a definition of compensation that: (a) does not by design favor highly compensated employees, (b) is reasonable (within the meaning of Regulation Section 1.414(s)-1(d)(2)), and (c) satisfies the nondiscrimination requirement under Regulation Section 1.414(s)-1(d)(3). The standard for the latter nondiscrimination requirement is that generally, the average percentage of total compensation taken into account for the plan sponsor's highly compensated employees may not exceed, by more than a *de minimis* amount, the average percentage of total compensation taken into account for the employer's non-highly compensated employees. The determination of what constitutes a *de minimis* amount is based on all of the relevant facts and circumstances.[11]

Although some practitioners believe that the IRS views a differential of less than 3 percent as *de minimis*, there is no formal guidance on this point. To avoid these questions, plan sponsors could perform nondiscrimination testing by using a safe harbor definition of compensation, but this would likely require additional data collection and verification, thus increasing their costs.

Availability of Testing Method Contingent on IRS Approval

Finally, a number of coverage and nondiscrimination rules that were intended to provide plan sponsors with relief specifically require IRS approval. While most plan sponsors tend to avoid these rules because of the specific approval requirement, some plan sponsors may feel the need to resort to them, and in the absence of a private ruling program, it is unclear whether they are now accessible at all. For example, the so-called safety valve exception in the general testing rules for defined benefit plans provides that a plan is deemed to satisfy the general rate group test if the plan would satisfy the requirement by treating as not benefiting no more than 5 percent of the highly compensated employees in the plan and the IRS determines that on the basis of all of the relevant facts and circumstances, the plan does not discriminate with respect to the amount of employer provided benefits.[12]

Another example of such a rule is the relief provision in the QSLOB gateway testing rules. These rules generally provide that a plan is not permitted to be tested separately with respect to the employees of a QSLOB unless the plan satisfies a gateway test, that is, it benefits a classification of employees that is nondiscriminatory, determined by applying the ratio percentage test or nondiscriminatory classification test of Code Section 410(b) on an employer-wide basis. As a relief measure, the QSLOB rules further provide that if a plan benefits a group of employees for the year that would satisfy the ratio percentage test on a separate line of business basis using 90 percent instead of 70 percent, the unsafe harbor percentage that is used for the gateway test may be reduced. The regulations go on to state that if, in these circumstances, the plan has a ratio percentage less than the adjusted unsafe harbor percentage, the plan may still be treated as satisfying the gateway test if the IRS determines that, on the basis of the relevant facts and circumstances, the plan benefits such employees that qualify under a nondiscriminatory classification.[13]

WHAT NOW?

For many years, plan sponsors have been relying on the ability to obtain assurances through the determination letter program that their plans satisfy coverage and nondiscrimination requirements. These assurances are useful not only in the event of an IRS audit, but also when making representations as to a plan's qualified status to the plan's independent auditors. Given the issues described above, it seems certain that there will be a continued desire for such assurances and the IRS may respond in limited ways to this desire. The question for plan sponsors, however, is what avenue best suits their needs? The two possibilities discussed below each have different pros and cons.

One possible solution is use of the IRS letter ruling program to seek assurances on coverage and nondiscrimination requirements. The IRS has indicated that it is exploring the possibility of using the letter ruling program where, for "business necessity" reasons, plan sponsors may need certain assurances.[14] One would assume that letter rulings would be available where the availability of a particular testing methodology is contingent on IRS approval, and the individual ruling process would allow a plan sponsor to obtain a "determination" based on its unique set of facts. But there are timing considerations—plan sponsors only have nine and a half months after the end of a plan year to correct coverage and nondiscrimination testing failures.[15] This deadline is extended automatically if the plan sponsor requests a determination letter, but it is not clear whether a request for a letter ruling would have the same effect (the currently applicable remedial amendment period regulations suggest that it would not).[16] There also are costs and administrative burdens associated with the preparation of a ruling request, and a user fee that generally is more than the standard determination letter application fee.

Another possibility is that the IRS would issue general guidance addressing common areas of uncertainty.[17] Ideally, this would involve interaction between the benefits community and the IRS, but it could require a commitment of resources the IRS National Office may not have. And while any general guidance would likely be helpful in resolving some areas of uncertainty, because the guidance would, by its nature, have general applicability, it is unlikely to be flexible enough to address many plan sponsors' unique set of facts. Moreover, it is likely that generally applicable guidance would reflect a more conservative view, one that not all plan sponsors may agree with. Although the guidance may not have the force and effect of law, it could be an additional hurdle for those plan sponsors to contend with.

To the extent the IRS does not act to establish a private ruling program or address methodology issues in general guidance, the absence of an effective substitute for resolution of these issues may lead to increased costs. Issues may arise, for example, when a plan sponsor replaces the firm that was performing the coverage and nondiscrimination testing and there is a difference of opinion between the new firm and the old firm as to the validity of the testing methodologies being used. In such instances, the plan sponsor may feel the need to have a third party—another actuarial, accounting, or law firm—to act as a tie-breaker or umpire to resolve the matter.

CONCLUSION

A plan sponsor's ability to demonstrate compliance with coverage and nondiscrimination requirements is fundamental to maintaining a qualified plan. The sponsor is in a sense accountable for such compliance not just to the IRS, in the event of an audit, but also to its plan's independent auditors and ultimately to its owners. Historically, plan sponsors were able to resolve questions about the methodology, meaning, and availability of certain coverage and nondiscrimination requirements through the determination letter program. Now that the elective determination feature of the determination letter program is unavailable, plan sponsors are faced with greater uncertainty and potentially greater costs to demonstrate compliance. The ability to obtain an IRS letter ruling and the issuance of general guidance from the IRS may help, but likely will not be a complete substitute for the assurances previously available through the determination letter program.

NOTES

1. This change became effective for determination letters filed after January 31, 2012, for individually-designed plans and May 1, 2012, for pre-approved prototype and volume submitter plans, and for terminating plans.

2. Rev. Proc. 93-39, 1993-2 C.B. 513. In 1996, the attachment required by Rev. Proc. 93-39 was replaced with the current Schedule Q (Elective Determination Requests). *See* Ann. 96-53, 1996-23 I.R.B. 12.
3. The IRS later allowed plan sponsors to submit terminating plans, certain new plans, and applications due to urgent business need "off cycle." *See* Rev. Proc. 2007-44, 2007-2 C.B. 54.
4. Rev. Proc. 2008-50, 2008-2 C.B. 464.
5. These changes also are reflected in Rev. Proc. 2012-6, 2012-1 I.R.B. 197.
6. This change is effective for determination letter applications filed on or after February 1, 2012, for plans with a five-year remedial amendment cycle and May 1, 2012, for terminating plans and plans with a six-year remedial amendment cycle. After these dates, a determination letter may no longer be relied on with respect to whether a plan satisfies the coverage and nondiscrimination requirements.
7. *See* Matthew Dalton, "Business Necessity Could Be Requirement for Private Employee Plan Rulings", *2012 TNT 37-2* (February 24, 2012) and Matthew Dalton, "Impact of Determination Letter Program Changes Not Expected Until Next Year", *2012 TNT 116-4* (June 15, 2012).
8. A plan that is found not to have satisfied coverage or nondiscrimination requirements for a particular year may find itself in the Audit Closing Agreement Progam (Audit CAP). In Audit CAP, the plan sponsor bears the cost of correcting the error (most likely by providing additional benefits to rank-and-file employees) and the cost of Audit CAP sanctions. Audit CAP sanctions are a negotiated percentage of the total taxes, interest, and penalties that the IRS could collect, for all open tax years, if the plan were disqualified. *See* Rev. Proc. 2008-50, § 5.01(5).
9. Treas. Reg. § 1.410(b)-4(c)(3)(ii).
10. Treas. Reg. § 1.401(a)(4)-11(g)(3)(vi).
11. Treas. Reg. § 1.414(s)-1(d)(3)(v). It is worth keeping in mind that while the IRS will continue to issue determinations as to whether a particular plan formula satisfies a safe harbor under § 1.401(a)(4)-2(b) and § 1.401(a)(4)-3(b), it now appears that employers will not be able to obtain a determination as to whether the plan's definition of compensation is nondiscriminatory. This may lead to sponsors of safe harbor plans to change their definition of plan-eligible compensation.
12. *See* Treas. Reg. § 1.401(a)(4)-3(c)(3). The factors to be considered in this determination are the extent to which the plan has failed the rate group test under the general rule, the extent to which the failure is for reasons other than the design of the plan, whether the highly compensated employees causing the failure are 5 percent owners or among the highest paid nonexcludable employees, whether the failure is attributable to an event that is not expected to recur, and the extent to which the failure is attributable to benefits accrued under a prior benefits structure or benefits accrued when the a participant was not a highly compensated employee.
13. Treas. Reg. § 1.414(r)-8(b)(2)(iii)(B).
14. *See* Dalton, *supra* n.7.
15. Treas. Reg. § 1.401(a)(4)-11(g)(3)(v).
16. *See* Treas. Reg. § 1.401(b)-1(e)(3).
17. Presumably, plan sponsors could continue to rely on a prior determination letter as to their testing methodology in accordance with the rules governing reliance on determination letters.