NAPEO Legal Insights™

Volume 5, Number 2 February 2012

NAPEO POWERING PEO SUCCESS

IRS Approval for Your PEO Retirement Plan

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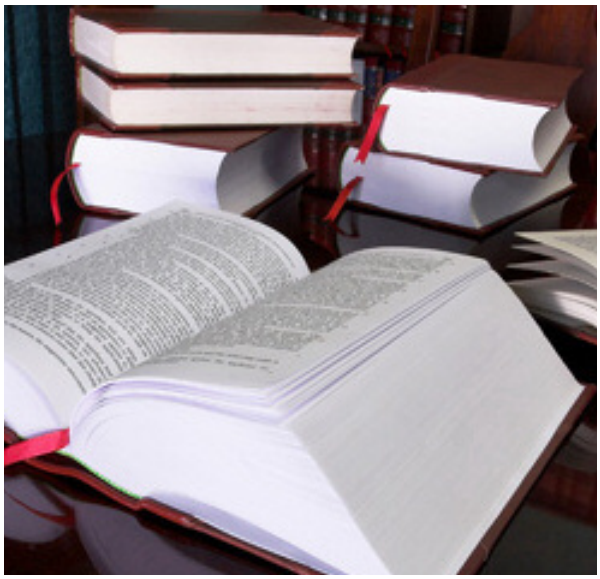

An important component of the PEO value proposition is the PEO's ability to provide competitive and efficient retirement benefits to worksite employees. Most (if not almost all) PEOs sponsor a multiple-employer 401(k) plan for adoption by PEO clients for the benefit of worksite employees.

Employees like 401(k) plans because they don't pay taxes now on the money set aside on their behalf. However, to achieve this tax deferral, the plan must meet certain legal requirements. As indicated in the February 2012 issue of *PEO Insider*,®[1] this is an important year for individually designed multiple-employer 401(k) plans, as they must be filed with the Internal Revenue Service (IRS) for a determination letter sometime between February 1, 2012, and January 31, 2013. Due to the complexity of preparing IRS filings for multiple-employer plans, you should have started the process, and if you haven't, you should start as soon as possible. This article explores the benefits of and the process involved in obtaining an IRS determination letter.

Benefits of a Determination Letter

A qualified retirement plan provides several tax benefits to the plan's sponsor and its participants:

- An employer can deduct, for federal income tax purposes, its contributions to the plan subject to certain limits;

1 "Time to Restate Section 401(k) Retirement Plan Documents," by Dale Vlasek, available to NAPEO members at http://bit.ly/ydSa6C.

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- Participants are not taxed on contributions made to the plan until they receive distributions;
- Earnings accumulated in the plan's related trust are not taxable until distributed; and
- Distributions may be eligible for special tax treatment.

These benefits, however, are only available if the plan meets the qualification requirements of the Internal Revenue Code of 1986, as amended (Code).

Some prospective clients will want to see that your 401(k) plan has an IRS determination letter before they agree to come on board.

To satisfy the qualification requirements, there are generally two broad hurdles that must be overcome. First, there must be a written plan document that satisfies the Code's qualification requirements. Second, the plan must be operated in accordance with its terms and the IRS rules. The IRS maintains a determination letter program to help employers make sure their retirement plans satisfy the written plan document requirement. Through the determination letter program, the IRS will provide a formal determination that the plan, in form, complies with the Code's qualification requirements, thereby retaining the positive tax aspects of plan qualification.

While not mandatory, a favorable determination letter provides assurances to the plan's sponsor that the plan satisfies the Code's qualification requirements in form. Because of this benefit, the vast majority of plan sponsors elect to seek favorable determination letters from the IRS. Because determination letters are standard for most plan sponsors, new clients of a PEO may require a copy of the determination letter prior to adopting the plan. In addition, some participants may have a difficult time completing a rollover from the plan to another qualified plan or an individual retirement account if a determination letter cannot be provided to the sponsor of the other qualified plan or IRA.

Individually Designed Versus Volume Submitter

Qualified plans maintained by PEOs are required to be established and maintained as "multiple-employer" plans as described in Code Section 413(c). For determination letter purposes, multiple-employer plans are classified as individually designed or volume submitter. It is important to understand the difference between an individually designed multiple-employer plan and a volume-submitter multiple-employer plan because the determination letter process is different for each kind.

An individually designed plan is a plan document drafted specifically for the plan sponsor. The individual design gives the plan sponsor complete customization of the structure and design of the retirement plan, as long as it does not violate the Code's qualification requirements. A volume-submitter plan, on the other hand, is a plan document that has been "pre-approved" by the IRS for use by any PEO client that wishes to adopt the volume-submitter plan. Volume-submitter plans are often "sponsored" by a financial institutional, which receives an "advisory letter" from the IRS that the plan, if adopted word for word by a client, will satisfy the Code's qualification requirements, in form. The client is permitted to rely on this advisory letter if it so wishes, or can seek its own individual determination letter using a short-form determination letter application. Although volume-submitter plans may be cheaper to maintain, the major disadvantage of the volume-submitter document is that the plan does not permit as much individual customization or choices as does an individually designed plan. In fact, IRS rules provide that if a volume-submitter document is modified too much from the pre-approved form, the plan is considered individually designed and the client that adopts the plan is no longer permitted to rely

on the IRS advisory letter. Recent guidance from the IRS indicates that it is further limiting the flexibility available under volume-submitter documents. For this reason, many PEOs elect to adopt individually designed plans rather than work within the structure of the volume-submitter paradigm.

Compliance with Interim Amendment Requirements

As part of the determination letter review process, the IRS will verify that the plan was timely amended for all interim law changes. If the IRS determines that a required amendment was not timely adopted, it will require the plan sponsor to pay a sanction and enter into a closing agreement to retain the plan's qualification. The sanctions imposed under this program depend upon the number of participants in the plan and which amendment was not timely adopted, but these sanction amounts can be significant. For example, the sanction for a plan with between 501 and 1,000 participants that failed to adopt an amendment subsequent to the Economic Growth and Tax Relief Reconciliation Act of 2001 will face a sanction of $17,500, and that sanction increases to $25,000 if the plan has between 1,001 and 5,000 participants. Due to the significance of such sanctions, it is extremely important to determine, prior to submitting the determination letter application, whether all interim amendments were timely adopted. If an interim amendment was not timely adopted, it is possible to submit a relatively short voluntary compliance program (VCP) filing with the IRS prior to submitting the determination letter application and pay a reduced sanction of $375, but competent counsel must complete this prior to submitting the determination letter application. A plan sponsor may be required to file a joint VCP submission/determination letter application in certain instances.

Make sure all necessary amendments have been adopted prior to submitting the plan to the IRS.

It is relatively easy to fix late amendments, if this is done prior to submission to the IRS. Failure to do so can be very costly.

Determination Letters for Adopting Employers

Generally, if an employer adopts a standardized multiple-employer plan that has a favorable determination letter (i.e., there is no deviation from the pre-approved plan document and approved adoption agreement), the adopting employer can rely on the favorable determination letter issued by the IRS. If, however, an adopting employer's plan language deviates from the approved plan document or approved adoption agreement (for example, through the use of an addendum), the adopting employer cannot rely upon the plan's favorable determination letter that its plan is qualified under Code Section 401(a). Therefore, it is usually recommended, that if there is any deviation at all from the standard approved plan document, an individual determination letter is sought for each adopting employer. If a determination letter is sought for an adopting employer, a separate Form 5300, Form 2848, and pertinent plan documentation must be submitted along with the main determination letter application (and additional fees apply).

Some clients will want to see a letter from the IRS with their own name on it. Others will be comfortable relying on the determination letter issued to the plan sponsor.

Notices to Interested Parties

Plan participants (and others) must be notified that the plan is being submitted to the IRS. Before a plan sponsor submits a determination letter application, it must issue a notice to interested parties at least 10, but not more than 24, days prior to the date the determination letter application is submitted.

The notice to interested parties may be distributed in one of several different ways, but it must be delivered in a way that reasonably ensures that all interested parties receive the notice. Some of the most common methods of delivery include first class mail, hand delivery, and posting the notice where other employee notices are typically posted. Electronic delivery of the notice is also permissible and becoming more common, but a few requirements must be met to use electronic delivery. Due to the complexity of these requirements, it is recommended that a plan sponsor work with its ERISA counsel to make sure the requirements for electronic delivery are satisfied.

Because the notice to interested parties is distributed to employees of the many employers who participate in a multiple-employer plan, it might be necessary to coordinate distribution of the notice with the various adopting employers, depending on the method of delivery selected.

Determination Letter Application

Timing. Sponsors of individually designed plans are required to submit applications for determination letters once every five years, under a staggered system of five-year cycles. Under this system, individually designed multiple-employer plans are assigned to Cycle B. The current Cycle B opened February 1, 2012 and runs through January 31, 2013.

Application Preparation. Preparing the determination letter application involves gathering and submitting various IRS forms, attachments, plan documents, amendments, and additional data. Make sure you allocate sufficient time and funds to this process, as the requirements are significant and detailed.

Filing Fee. The base determination letter filing fee for an individually designed multiple-employer plan is $2,500. In addition to receiving a determination letter for the sponsoring employer, the filing can also request that additional adopting employers each receive a determination letter, in which case the IRS filing fee increases. If a determination letter is sought for two to 99 additional adopting employers, the filing fee is $3,000, and if a determination letter is sought for 100 or more additional adopting employers, the filing fee is $15,000.

IRS Review Process

The IRS is currently running behind schedule in reviewing determination letter filings and it may take 18 to 24 months from the time the application is submitted to receive an initial response, although practitioners have been pleasantly surprised to have random applications processed quickly. To give you a sense of how far behind the IRS is in processing determination letter applications, the IRS website indicates that it is currently processing determination letter applications that were postmarked in April 2009.

The IRS's first response to a plan sponsor will be an acknowledgment letter that it has received the application and it has been assigned to a reviewer. The IRS will

next contact the plan sponsor when it either issues a favorable determination letter or, more typically, makes an information request. If the IRS issues an information request, the plan sponsor generally will have two to three weeks to respond to the request. The request may ask for additional documents or information and often requires a plan sponsor to amend its plan to comply with certain laws or regulations or for specific language required by the IRS. The IRS generally will then issue a favorable determination letter within two to three weeks of receiving the plan sponsor's response to the information request, unless additional information is requested.

Once the plan has received its favorable determination letter from the IRS, this letter can be shared with clients and prospective clients to assure them that the PEO's plan document meets current legal requirements.

About the Authors

James B. Longacre, Esq. and Edward C. Renenger, Esq. are shareholders in the Reading, Pennsylvania, office of Stevens & Lee.

Longacre concentrates his practice on employee benefits and compensation matters. He advises clients on the structure and administration of pension, 401(k), and nonqualified deferred compensation plans. He also assists clients with welfare benefits, Consolidated Omnibus Budget Reconciliation Act (COBRA), and Health Insurance Portability and Accountability Act (HIPAA) concerns.

Longacre is an active member of the National Association of Professional Employer Organizations (NAPEO) and is a member of NAPEO's Legal Advisory Council. He regularly handles matters before the Internal Revenue Service, the Department of Labor, and the Pension Benefit Guaranty Corporation.

Renenger is an employee benefits attorney who concentrates his practice on qualified retirement plans. He also advises clients on the structure and administration of defined benefit pension plans and defined contribution plans, including 401(k) plans. In addition, he guides clients through retirement plan correction programs and, in this capacity, regularly acts as legal counsel before the Internal Revenue Service and Department of Labor.

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