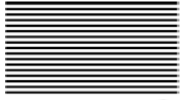

The ERISA Industry Committee

Driven By and For Large Employers

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Will Hansen, Senior Vice President of Retirement Policy

December 15, 2016

CC:PA:LPD:PR
Announcement 2015-19
Room 5203
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, DC 20044

RE: Announcement 2016-32 – Facilitating Compliance with Qualified Plan Document Requirements

Ladies and Gentlemen:

The ERISA Industry Committee ("ERIC") is pleased to respond to the request of the U.S. Treasury Department and the Internal Revenue Service (collectively, the "Agencies") for comments regarding Announcement 2016-32, relating to "Facilitating Compliance with Qualified Plan Document Requirements" (the "Announcement").

I. ERIC'S INTEREST IN THE ANNOUNCEMENT

ERIC is the only national association that advocates exclusively for large employers on health, retirement, and compensation public policies at the federal, state, and local levels. ERIC's members provide comprehensive retirement benefits to tens of millions of active and retired workers and their families. ERIC has a strong interest in proposals that would impact its members' ability to provide secure retirement programs, such as this Announcement.

Announcement 2016-32 requests comments on ways in which the Department of the Treasury and Internal Revenue Service can improve compliance with the requirement of federal pension law that qualified plans be maintained under, and governed by, a written plan document. In particular, the Announcement requests comments on ways in which documentary compliance can be enhanced in light of the changes to the determination letter program described in Revenue Procedure 2016-37.

The overwhelming majority of tax-qualified retirement plans sponsored by ERIC's members - - - large employers – are individually designed plans with complex plan designs that contain unique provisions reflective of individual company benefit priorities and culture. In addition, many large company plans have been in existence for many decades and include merged plans that often must operate independently. Large employers historically have offered, and many still have, ongoing and/or legacy defined benefit plans. As a result, ERIC member company retirement plans generally cannot use pre-approved documents due to the inherent limitations of that format, and similarly cannot use Internal Revenue Service ("IRS") model amendments without substantial revision. In particular, the design features of defined benefit plans raise particular challenges with respect to the use of pre-approved plans.

Accordingly, ERIC appreciates the opportunity extended by the Agencies in the Announcement to provide comments on ways in which documentary compliance can be enhanced. In particular, ERIC appreciates the opportunity to comment on (i) the expanded use of incorporation by reference, (ii) the permissibility of omitting plan provisions and amendments that are inherently inapplicable to a given plan, and (iii) additional ways to facilitate compliance. We have no suggestions on facilitating conversion to pre-approved plans since, as noted, most ERIC members cannot effectively use a pre-approved format.

II. SUMMARY OF COMMENTS

The following is a summary of ERIC's comments, which are set forth in greater detail below:

- Plan sponsors should be allowed to incorporate by reference statutory and regulatory provisions that have few, or no, optional features, such that the incorporation would be readily administrable by reference to those provisions. In order to ensure compliance with the definitely determinable benefit requirement, sponsors would be required to explicitly describe in the plan document any optional features that they select.

- Plan sponsors should be permitted to omit from their governing documents, in the interests of simplicity and clear documentation, provisions that do not apply to their plans due to the status of the plan sponsor or the design of the plan.

- The IRS should adopt a flexible approach to the existence of form defects discovered on audit, to the extent that (i) the plan sponsor had in place an administrative practice to regularly review its plan document for form compliance, and (ii) no participants or beneficiaries were harmed by the defect.

III. RECOMMENDATIONS

A. ***Incorporation by Reference.*** Section 404(a)(1)(D) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), requires that a qualified plan fiduciary discharge his or her duties "in accordance with the documents and instruments governing the plan." Similarly, the IRS has held that a "plan must be operated in compliance with its plan terms in order to be a qualified plan under section 401(a) of the Code. This requirement flows from the definitely determinable requirement and insures that employees covered by the plan receive their promised benefits."[1] In both instances, the basis for the requirement is the status of the plan document as a quasi-contractual agreement between the employer and its employees, and an attempt to enforce a statute of frauds provision that ensures employees get the benefit of their bargain. This conceptual approach, however, readily allows for incorporation by reference to the Internal Revenue Code of 1986, as amended (the "Code"), ERISA and the related regulatory guidance.

Specifically, the evidentiary function of the plan document requirement is not weakened if sponsors are allowed to incorporate by reference clear statutory and regulatory provisions that are invariable, or that only allow for a limited number of optional selections. In such a case, both the plan sponsor and the IRS can clearly determine by reference the plan's terms for purposes of administration and enforcement, respectively, while at the same time the incorporation significantly reduces the size and complexity of the plan's governing document. Although the IRS had initially (after enactment of ERISA) held that "[a]s under prior law, incorporation by reference of Code

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[1] IRS Employee Plans Division, "The Remedial Amendment Period Under Internal Revenue Code ('Code') Section 401(b)" (Dec. 14, 1994), reprinted in 4 *RIA Pension & Profit Sharing 2nd* ¶ 64,320.

section is not permitted," it later adopted a more flexible approach in the limited number of circumstances described in its "EP Determinations Quality Assurance Bulletin No. FY-2010 No. 2."[2]

In addition, incorporation by reference greatly reduces the risk of a disqualifying defect that results when sponsors unknowingly misstate a statutory or regulatory provision, since the incorporation necessarily constitutes a faithful rendition of it. This is crucial in the wake of the discontinuance of the ongoing determination letter program - - - sponsors will no longer be alerted to the defect by an IRS determination letter reviewer, and will likely not realize the failure until well after the Code Section 401(b) remedial amendment period has lapsed. To the extent that the statutory or regulatory provision is subsequently revised (by Congress or the applicable regulator), the changes will automatically be picked up by the incorporated reference, thereby diminishing the risk of a late amendment, and the resulting disqualifying defect. This sort of plan sponsor-friendly approach to plan drafting may encourage sponsors to adopt or continue to maintain a qualified plan.

Given the foregoing observations, we suggest that the following provisions also be eligible for incorporation by reference, for the following reasons. Note that the list of provisions discussed below is not necessarily exhaustive, but rather is intended to highlight the more prominent candidates. In addition, the justifications for incorporation by reference discussed below would apply equally, as appropriate in the circumstances, to any future statutory or regulatory provisions.

1. *Code Section 401(a)(4).* Treasury Regulation Section 1.401(a)(4)-5(b)(3) establishes restrictions on the distribution of benefits in any form other than a straight life annuity to the top twenty-five highly compensated employees under a defined benefit plan if the value of plan assets or the value of benefits do not meet certain requirements. Defined benefit plans - - - including the IRS's "listing of required modifications" - - - typically restate the full text of the regulation in such a way that is functionally equivalent to its incorporation by reference. Given this fact, it makes sense to allow plan sponsors simply to incorporate the rule by reference, thereby enhancing their plan document's readability and reducing its volume.

2. *Code Sections 401(a)(11) and 417.* The requirements regarding qualified joint and survivor annuities ("QSJA"), qualified optional survivor annuities, and pre-retirement survivor annuities are extensive, formulaic, and admit of only a few optional provisions. For example, a sponsor can opt to allow participants fewer than the full 180-day period to review the QJSA notice, can select the actuarial factors to convert the benchmark single life annuity form of benefit into a joint and survivor form, and can generally use a percentage greater than 50% as the default survivor portion of the accrued benefit. Beyond these choices, however, the statute and regulations impose a uniform set of baseline requirements. Thus, we believe that sponsors that do not deviate from the default provisions of the Code and regulations should be entitled to incorporate them by reference. To the extent their plan's design moves beyond these four corners, sponsors would be required to spell out their choices. In either event, the plan document will be more readable (with respect to core design provisions), without any sacrifice of legal compliance (with respect to boilerplate provisions that are highly familiar to administrators and record-keepers).

3. *Code Section 401(a)(17).* The compensation limits of Code Section 401(a)(17), as interpreted by the underlying regulations, are complex and extensive (reflecting the initial establishment of the limit by the Tax Reform Act of 1986, its later reduction by the Omnibus Budget Reconciliation Act of 1993, and the subsequent reinstatement of a higher limit by the Economic Growth and Tax Relief Reconciliation Act of 2001). In-house administrators typically are not familiar with the nuances of the regulation, its grandfathering provisions, and its prorated application to less than full plan years. Instead, record-keepers and actuaries are equipped to implement those rules on behalf of the plan sponsor. Accordingly, it would be reasonable to allow the document to incorporate the limitation by reference.

[2] *See* Announcement 75-110.

4. *Code Section 401(a)(35).* The company stock diversification requirements of Code Section 401(a)(35) are extensive, complicated, and actually impose a lower bar than was already common prior to the Pension Protection Act of 2006. For example, both the statutory and regulatory provisions only apply to employer contributions if the affected participant has at least three years of service, and only require a minimum of three investment options (other than company stock). In the experience of ERIC members, these are somewhat unusual limitations: plans often allow participants to divest out of company stock without regard to a minimum period of service, and allow (by virtue of a robust ERISA Section 404(c) provision) divestment into a wider range of other options. Given this background, it seems reasonable to us to allow sponsors to incorporate Code Section 401(a)(35) by reference, as a minimum requirement. Note that the regulations underlying Code Section 401(a)(35) themselves use incorporation by reference; for example, they refer to restrictions designed to ensure compliance with "applicable securities laws."

5. *Code Sections 401(k)(8) and 401(m)(6).* The provisions of the Code addressing the correction by plan sponsors of a failure of the "ADP" and "ACP" tests are extensive and complicated; accordingly, their description in a plan document adds considerable bulk, without demonstrably enhancing compliance with those tests. For that reason, we believe that sponsors should be permitted to incorporate the two statutory provisions (and underlying regulations) by reference. Because the applicable corrective methodologies include choices - - - specifically, a sponsor can either contribute a "QNEC," or can make corrective distributions - - - we suggest that sponsors be required only to definitely state their plan's corrective approach as between the two options, without being required to add all of the related formulaic language.

6. *Code Section 401(k)(12) (Safe Harbor Notice).* Members of ERIC report that determination letter reviewers have begun to request plan language reflecting the notice requirements of Treasury Regulation Section 1.401(k)-3(d). Because both the Code and the regulation explicitly spell out the required contents of a safe harbor 401(k) plan notice, we believe that a related plan provision is completely unnecessary.

7. *Eligible Rollover Distributions.* The eligible rollover distribution provisions of a plan (*i.e.*, the type of distributions that can be rolled over from the plan, and the vehicles to which they can be rolled over) are completely formulaic and set by law. Despite that fact, a recitation of all of the facets of the provisions as currently required adds considerable verbiage to a plan document, with no apparent gain to compliant administration. Accordingly, we suggest that sponsors be permitted to incorporate these provisions by reference.

8. *Code Section 414(n).* The definition of "leased employee" in Code Section 414(n) is an ideal candidate for incorporation by reference, since there are no related regulations, and the definition has no optional subparts (other than the definition of "compensation" to be used with the money purchase pension plan safe harbor). Despite this fact, several ERIC members report that in recent years, determination letter agents have routinely required that the definition be fully spelled out in the plan document. We believe this is a lost opportunity for stream-lining the plan document without sacrificing clarity.

9. *Code Section 414(q).* The definition of "highly compensated employee" is fairly rigid, with only a few optional provisions. Specifically, an employer can make a "calendar year election" and a "top paid group election"; otherwise, the definition is invariable, and thus is ideal for incorporation by reference with no loss of clarity in any meaningful sense.

10. *Code Section 416.* The top heavy rules are complex and extensive, but are typically inapplicable to most large plan sponsors since the high number of non-key employee participants in their plans prevents application of the rule. Accordingly, we believe that non-optional top heavy provisions should be eligible for incorporation by reference, while optional provisions such as the top-heavy vesting schedule should be made explicit in the document if, and to the extent that, the plan's non-top heavy schedule is less favorable.

11. *Code Section 436.* The provisions of Code Section 436 are extremely complicated and long, and admit of only a few optional provisions. In the interests of a more readable document, we suggest that sponsors who have not already adopted the model amendment provided by the IRS in Notice 2011-96 be permitted to incorporate the non-optional provisions of that statute and regulation by reference. This will likely be helpful to only the (relatively) small number of sponsors who adopt a new defined benefit plan in the future, but eliminating these sorts of hyper-technical provisions from plan documents would be a welcome development, and may encourage the adoption of cash balance plans (which appear to still be attractive to a subset of potential plan sponsors, as distinct from "traditional" defined benefit plans). We note, in passing, that the inherently complex subject matter underlying Code Section 436, and the density of its regulatory provisions, make it unlikely that in-house administrators actually read or understand them. Rather, actuaries already understand the rules, and merely look for the optional provisions in a plan document, which could be easily "called out" in an incorporation-by-reference approach.

B. *Superfluous Provisions.* Although few in number, there are certain statutory provisions that do not apply to a given plan due to the nature of its sponsor, or the design of the plan. We believe that it is reasonable to allow these provisions to be omitted from a plan document in the same interests of conciseness and readability noted above, in the discussion of incorporation by reference.

1. *Code Section 401(a)(35).* The diversification requirements of Code Section 401(a)(35) apply to plans holding "publicly traded employer securities." Accordingly, they do not apply to the large number of plans sponsored by privately-owned companies and are, to that extent, completely inapplicable to them. We believe it is reasonable to omit the detailed requirements of Code Section 401(a)(35) (and the related regulation) from those plans, with the understanding that the sponsor will be required to add them if it becomes publicly owned, within the period for adopting discretionary amendments described in Revenue Procedure 2016-37. This requirement of delayed adoption could be easily and readily satisfied if the IRS were to allow for the incorporation by reference of Code Section 401(a)(35), as suggested above.

We note that the IRS already applies this flexible approach to other tax regimes that have an analogous contractual and "definitely determinable" basis. Specifically, Code Section 409A requires that a nonqualified deferred compensation plan be maintained pursuant to a written agreement, and that the plan document explicitly set forth its main design elements.[3] Despite this requirement, the provisions of Code Section 409A that only apply to publicly-owned companies - - - that is, the "specified employee" provisions of Code Section 409A(a)(2)(B) - - - are not required to be included in the underlying document until the company becomes publicly owned.[4] In the preamble to the related regulation, the IRS notes that "the plan must contain the [specified employee] provision by the time at which the employee becomes a specified employee (*either because the stock of a component of the service recipient becomes publicly traded*, or because the specified employee effective date has been reached for a list of specified employees that includes the employee)" [emphasis added].[5] We see no reason why the same flexible approach would not apply to qualified plans, since the same "statute of frauds" role of the written document requirement underlies both regimes.

As a more general observation, a large number of plans already have diversification provisions that go well beyond the threshold requirements of Code Section 401(a)(35), as noted above in our discussion of incorporation by reference. We do not believe such plans should need to include a formulaic recitation of the statute and regulation, other than as an aid to the policing of the diversification requirement.

2. *Code Section 416.* As previously noted, the top heavy requirements typically do not apply to the plans of large employers; rather, they apply (and are intended to capture) only the plans of small employers that

[3] *See* Treasury Regulation Section 1.409A-1(c)(3).
[4] *See* Treasury Regulation Section 1.409A-1(c)(3)(v).
[5] 72 Fed. Reg. 19,250 (Apr. 17, 2007).

have a disproportionate number of key employees. Given this purpose, we believe that large employers who establish a plan should be eligible to forego including top heavy provisions unless and until their plan actually becomes top heavy. At that time, the plan could be amended to include the necessary provisions - - - including by incorporation, if allowed by the IRS as suggested above - - - by the deadline for the adoption of discretionary amendments described in Revenue Procedure 2016-37.

C. *Additional Ways to Facilitate Compliance.*

1. *Application of Less Onerous Sanctions for Form Defects Discovered on Audit.* In the past, form defects discovered on audit were subject to the fairly significantly penalties described in Revenue Procedure 2013-12 pursuant to the IRS's "Audit CAP" program. Arguably, these penalties bear only a tenuous relationship to the harm created by the defect, and are (to that extent) merely punitive. By way of example, the requirements of Code Section 401(a)(35) - - - even in the case of a publicly-held plan sponsor - - - are often less favorable than the diversification provisions already set forth in plans, but sponsors who overlooked adopting a related "interim amendment" within their remedial amendment period were nonetheless at risk of significant economic sanctions. This sort of disproportionate response to arguably immaterial errors greatly discourages the adoption by sponsors of qualified plans, since employers are put in the position of diverting time and resources from their core business to dealing with hyper-technical form defects by which no participant is harmed. Revenue Procedure 2016-51 improves this situation to some extent by providing that Audit CAP sanctions will no longer be automatically based on a negotiated percentage of the "Maximum Payment Amount," but instead will be based on all of the facts and circumstances. However, the new approach still puts the plan sponsor at the mercy of the IRS agent.

Instead, we endorse the proposal put forth by the Advisory Committee on Tax Exempt and Government Entities (ACT) in its 2016 Report of Recommendations. Specifically, the ACT Report notes:

> The EP Subcommittee recommends that instructions be given to IRS plan auditors on a nationwide level to not apply retroactive penalties for 'immaterial' flaws in plan document language. The EP Subcommittee also recommends that the IRS provide remedial-amendment like protection for any plan amendments that were made in "good faith."

This approach, in turn, reflects the common-sense approach taken by the United States Tax Court in an early pension case. Specifically, in the facts underlying that decision, a plan sponsor failed to adopt certain required provisions within its remedial amendment period under Code Section 401(b). It did so, however, before the date that any of the omitted provisions would have affected any plan participants. The court held that the Code Section 401(b) remedial amendment period is merely a "safe harbor," and that no participants were unfairly benefited or harmed by the omitted provisions. Importantly, the court stated:

> An adverse holding would primarily penalize the employees. To deny plan qualification under these circumstances would frustrate the purposes of section 401, and accordingly, we hold that under such circumstances, the plan did qualify for the years 1969 and 1970.[6]

Similarly, we believe that "immaterial" form defects should not result in sanctions if the plan sponsor was diligent in maintaining its document and merely overlooked the defect in good faith. Although this standard necessarily requires a certain amount of judgment on the part of the IRS agent, the immateriality of the defect can readily be determined by the amount of harm it caused. We believe this flexible approach will encourage the establishment by employers of qualified plans, and will act to some extent as a counterbalance to the uncertainty and disincentive created by the suspension of the determination letter program.

[6] *Aero Rental v. Comm'r*, 64 T.C. 331, 342 (1975).

ERIC appreciates the opportunity to provide comments on the Announcement. If you have any questions concerning our comments, or if we can be of further assistance, please contact us at (202) 789-1400 or whansen@eric.org.

Sincerely,

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