

What Advisors Need to Know about Plan Documents

By Timothy M. McCutcheon

There are two principal types of retirement plan documents recognized by the IRS: individually designed plans and pre-approved plans. The classification has nothing to do with the format or appearance of the plan document but rather the type of plan. Each type of plan is subject to a different restatement cycle.

All documents need to be restated every five to six years.

Individually designed plans must be restated every six years based on the employer's ID number (EIN). The most common individually designed plans aren't eligible for the pre-approval program and include employee stock ownership plans (ESOPs), cash balance plans, multiemployer plans, and 403(b) plans (The IRS is working on a pre-approval program for 403(b) plans). Individually designed plans also include custom documents for plans sponsored by larger adopting employers that may not be able to fit on preapproved documents.

Pre-approved plans must be restated every six years on a schedule determined by the IRS. The current six-year cycle for pre-approved defined benefit plan ends April 30, 2012. The next six-year cycle for pre-approved defined contribution plans opens in early 2014. Pre-approved plans limit plan options to those that have been pre-approved by the IRS.

Two common formats for pre-approved plans are the prototype (adoption agreement and basic plan document) format and the "long" format, which resembles a custom drafted document. Each pre-approved plan will have a pre-approval letter from the IRS issued to either the TPA or the document vendor.

As was mentioned above, you cannot distinguish an individually designed plan from a pre-approved plan just by looking at the format. Many individually designed plans will use the adoption agreement and basic plan document format and some pre-approved plans will use the "long" format.

All plans may need interim amendments.

The IRS procedures require that all plans—both individually designed and pre-approved—be amended for changes in law or regulation. Since the new IRS procedures went into effect in 2006, each plan sponsor has had to execute an amendment nearly every year.

Individually designed plans vs. pre-approved plans

As mentioned above ESOPs, cash balance plans, multiemployer plans, and 403(b) plans (for now) must be individually designed. In addition, a larger adopting employer with the resources to retain outside counsel to draft custom documents will often use an individually designed plan. Larger employers often need multiple benefit/allocation formulas and special provisions applying to acquired groups of employees. All individually designed plans must be restated and submitted to IRS on a Form 5300 every six years at a minimum IRS filing fee of \$2,500.

It's generally most cost effective to use a pre-approved plan where possible, both from a drafting and IRS filing fee perspective. A pre-approved plan can be prepared much more quickly and cheaply. In addition, filing with IRS for a favorable determination is optional and those employers who do file only incur a \$250 IRS filing fee. Recent 5500 filing data indicates that at least 80 percent of all retirement plans use preapproved plan documents.

Pre-approved plan choices

Which pre-approved plan type to use (prototype or volume submitter) for a given plan is largely a matter of practitioner choice, although IRS procedures currently provide for two major differences:

- Employers may currently make minor, post-approval modifications to a volume submitter document and file for a determination letter using Form 5307. Minor changes to a prototype document require a submission for determination letter using Form 5300 at a much higher fee.
- Volume submitter plans offer more flexibility for cross-tested plan designs.

When to file for a favorable determination letter for a pre-approved plan.

While it's generally not necessary to file for a favorable determination letter for a pre-approved plan, it may be advisable. When performing an audit or processing a determination letter request, the IRS will often request all copies of required and optional plan amendments and restatements that were executed after the plan's last individual favorable determination letter. Submitting a "protective" favorable determination letter filing largely precludes a request to produce documents that predate the date of the latest favorable determination letter.

General drafting tips

Most pre-approved plan documents provide a wide array of options for various plan provisions, and individually drafted documents provide nearly unlimited flexibility in drafting documents. Because many options are offered doesn't mean they should be chosen in all situations. The following options, while offering potential cost savings to adopting employers, will often result in operational failures where the selected feature is difficult or impossible to follow in practice:

- *Break-in-service rules.* The eligibility and vesting rules permit a plan to forfeit or delay recognition of service after a predetermined break in service and have the potential to save adopting employers money. If such rules are actually written into the plan, however, they must be followed and if they're not, the plan will suffer an operational failure that needs to be corrected.
- *Use of elapsed time instead of hours of service.* On the surface, the elapsed-time method of calculating service is quite straightforward. In actual practice, however, it can get quite complicated, particularly when a break in service occurs, situations requiring less than a year of service, and when trying to calculate benefits service in a defined contribution plan. Nearly the same effect as elapsed time can be accomplished by using the 190 hours equivalency for each hour worked in a month.

- *Use W-2 based definition of compensation.* There are several safe harbor definitions of compensation that automatically satisfy the nondiscrimination rules for compensation. By far, “Box 1 (gross wages) on form W-2” is the easiest to administer.
- *Cross-tested plan design.* To provide maximum flexibility and ease of use, a volume submitter document in prototype format should be used as well as the option of placing each participant in his or her own allocation group.

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