Preapproved Plan Pros and Cons

by **Daniel Schwallie, Ph.D.** | *Aon*

There are a number of good reasons employers that sponsor 401(k), 403(b) and even defined benefit plans would be interested in Internal Revenue Service (IRS) preapproved plan documents.[1] *Preapproved plan documents* are generally plan documents with fixed provisions and an adoption agreement from which an employer may select plan features. Employers should be aware of the reduced flexibility of a preapproved document compared with an individually drafted document. Employers must take the time to ensure that any particular preapproved document satisfies their design and administrative needs and that the adoption agreement or other plan document elections are completed properly. The employer is ultimately responsible for ensuring that the plan satisfies the requirements of the Internal Revenue Code (the Code) and the Employee Retirement Income Security Act (ERISA) in both form and operation.

Advantages of Preapproved Plan Documents

Preapproved plan documents can be a cost-effective document solution for employers looking to offer a retirement plan without having to perform a lot of ongoing document maintenance. Many preapproved documents consist of a base plan document with fixed provisions and an adoption agreement from which an employer may select plan features by checking boxes. IRS refers to these as *adoption agreement plans* (formerly known as *prototype documents*). Some preapproved plans are *single document plans* consisting of a single document that may contain alternate paragraphs and options to be selected by an adopting employer, which may include blanks to be completed within preapproved parameters. Among IRS preapproved documents, single document plans tend to offer somewhat more flexibility than adoption agreement plans.

Reliance on IRS Opinion Letters

Providers of preapproved plan documents submit an application to receive an opinion letter, which is a written statement from IRS to the provider that the plan document is qualified in its form under the Code (i.e., preapproved). Because IRS has eliminated the determination letter program for individually drafted plan[2] documents (i.e., those plan documents not preapproved by the IRS), other than for new or terminating individually drafted plans, employ-

AT A GLANCE

- Preapproved plan documents, formerly known as prototype documents, can be a cost-effective document solution for employers looking to offer a retirement plan without having to perform a lot of ongoing document maintenance.
- Advantages of preapproved plan documents include the ability to rely on IRS opinion letters of the plan's qualified status under the Internal Revenue Code. Some recordkeepers offer preapproved plan documents as part of their service packages at no additional charge to the employer.
- Disadvantages include limited flexibility to amend the plan while retaining preapproved status. Preapproved plans also are not available for all plan types.

ers that currently use individually drafted documents may now be more interested in preapproved documents. There never has been a determination letter process for individually drafted 403(b) plans, but IRS has recently begun to preapprove 403(b) plan documents of recordkeepers and other providers.[3] Preapproved documents can provide employers with ongoing IRS approval of their plan documents, which can permit reliance on the qualified status of the plan document for various purposes, such as participant rollovers and employer representations relating to mergers, acquisitions and spinoff transactions. Preapproved plans have a regular, six-year remedial amendment cycle, and providers may apply for new opinion letter once every six years.

Inclusion of Ancillary Services

Providers of preapproved plans include law firms, consulting firms, investment firms and insurance companies. Many recordkeepers offer adoption agreement plan documents as part of their service packages at no additional charge to the employer, although the fees may be built into the recordkeeping and investment fees paid by participants. Providers of preapproved plan documents, whether purchased separately by the employer or included in recordkeeping fees, typically include updates to the plan document for changes in applicable law. The provider also may provide certain related document services, such as providing summary plan descriptions, summaries of material modifications, and participant notices and election forms. Since the preapproved documents of recordkeepers will generally align with their own recordkeeping abilities, the result can be more standardized plan administration for employers.

Disadvantages of Preapproved Plan Documents

Preapproved plan documents are less flexible in plan design and administration, although many employers may be satisfied with the design offered by a preapproved plan. A preapproved plan may have limited features to choose from, and the fixed provisions of the document may limit certain design alternatives, either of which may require adjustments to an employer's intended plan design and administration. Unfortunately, it is not uncommon for plan sponsors to unknowingly check the incorrect boxes when choosing plan features, check those boxes inconsistently, or incorrectly fill in blanks due to inadequate communication and lack of understanding between the employer and the provider of the preapproved document.[4] Such errors may result in incorrect plan administration and, possibly, noncompliance with the Code or ERISA.[5]

Limited Flexibility to Amend

An employer generally can rely on an IRS opinion letter with respect to a preapproved plan only if the employer's document is identical to the preapproved plan. Except for certain limited amendments, an employer that amends any provision of a preapproved plan, including its adoption agreement, will lose the ability to rely upon the IRS opinion letter regarding the qualified status of the document.[6] Exceptions include amendments to the plan to add or change a provision (including choosing among options in the plan), provided that the employer is permitted to make the modification or amendment under the terms of the preapproved plan as well as under the Code and that the provision is identical to a provision in the preapproved plan. Also, amendments to the administrative provisions in the plan (such as provisions relating to investments, plan claims procedures and employer contact information) are permitted, provided the amended provisions are not in conflict with any other provision of the plan and do not cause the plan to fail to qualify under the Code.[7]

Not Available for All Plan Designs

Preapproved documents are not available for certain plans,[8] such as multiemployer plans,[9] certain employee stock ownership plans (ESOPs), statutory hybrid defined benefit plans with a benefit formula other than cash balance, as well as certain cash balance plan designs.[10] Preapproval is also not available for plans that include blanks or fill-in provisions for the employer to complete, unless the provisions have specified parameters that preclude the employer from completing the provisions in a manner that could violate requirements under the Code.[11]

Potential to Lose Preapproved Status

Under the following circumstances, IRS will treat a preapproved plan adopted by an employer as an individually

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drafted plan that is not eligible to rely upon an IRS opinion letter for the preapproved plan.

- An employer amends the preapproved plan, except as otherwise permitted by IRS rules for preapproved plans.
- An employer amends a preapproved plan (including its adoption agreement if applicable) to incorporate a type of plan not allowed in the opinion letter program.
- IRS, in its discretion, determines that a plan is an individually drafted plan due to the nature and extent of amendments made.
- An employer chooses to discontinue participation in a preapproved plan that has been amended by the preapproved plan provider without substituting another preapproved plan.

Independent Review May Be Prudent

Once a preapproved plan is signed and adopted, the plan must be administered in accordance with its terms, including those defined by checked boxes and blanks the employers fill in. Employers are ultimately responsible for ensuring that their retirement plans comply with document and operational requirements of the Code and ERISA. Therefore, it is crucial that the features selected reflect the intended plan design and that an employer fully understands any limitations imposed by the preapproved document that could affect plan features or operation. Preapproved documents are often completed in short order during, or after, a high-level discussion of the employer's plan design, with little or no review of how base plan document language may affect the selections. Given the importance of properly completing the preapproved documents, both to match the employer's intent and to ensure compliance, it may be prudent to involve a third party to participate in an independent review of the preapproved document before it is adopted.[12]

The preapproved plan provisions, boxes to be checked, and blanks to be filled should be carefully reviewed to be consistent with the employer's intent for the plan and how the plan is, or will be, administered.[13] The "check the box" nature of an adoption agreement plan, coupled with lengthy and detailed base plan provisions covering the various features,[14] can result in costly mistakes or lead to future noncompliance and IRS penalties. Filling out an adoption agreement without simultaneously reviewing the base plan document language can be confusing and lead to erroneous elections in the adoption agreement.[15]

Some preapproved plan options may not be advisable for some employers due to the administrative implications. For example, some plans may permit elective deferrals to be excluded from the definition of safe harbor compensation in a 401(k) plan using matching contributions to satisfy the actual deferral percentage (ADP) and actual contribution percentage (ACP) testing safe harbors. The result can be that the safe harbor compensation used to determine the amount of safe harbor matching contributions becomes smaller as a participant elects larger percentage elective deferrals.[16]

In Summary

The importance of understanding and carefully completing preapproved documents to align with an employer's plan design and administration cannot be overstated. Employers should allow adequate time to review, understand and complete the documents prior to implementation. Employers should also ensure that knowledgeable individuals from both the provider and the employer (including human resources, payroll and plan administrators) are involved in reviewing and completing the documents. Finally, employers should consider involving a knowledgeable and independent third party who can both help explain details and implications of

the documents and choices and also better ensure mutual understanding between the employer and provider as to the expected outcome. BQ

Endnotes

1. Note that Revenue Procedure 2017-41 eliminated the prior terminology of *master, prototype* and *volume submitter* plans and replaced them with the single term of *preapproved plan,* which can be either an adoption agreement plan or a single document plan. A preapproved plan can be either a standardized plan or a nonstandardized plan as long as specified requirements are met. A nonstandardized plan may be adopted with minor modifications, which must be minor changes to an otherwise word-for-word identical preapproved plan of a mass submitter that the Internal Revenue Service (IRS) determines does not require an in-depth IRS technical review. An *adoption agreement plan* consists of a basic plan document and an adoption agreement. The basic plan document contains all of the nonelective provisions applicable to all adopting employers, and the adoption agreement contains the options that may be selected by each adopting employer. No options (including blanks to be completed) may be provided in the basic plan document portion of the adoption agreement plan (except as provided in Revenue Procedure 2017-41 for "flexible plans"). A *single document plan* consists of a single plan document without an adoption agreement. A single document plan may contain alternate paragraphs and options (including blanks to be completed by the adopting employer in accordance with specified parameters) that may be selected by an adopting employer.

2. IRS uses the term *individually designed plan* rather than the term *individually drafted plan* used by the author in this article.

3. See this link to "403(b) Preapproved Plans" at the IRS website: www.irs.gov/retirement-plans/403b-pre-approved-plans.

4. It is the author's experience that well over half of all preapproved documents reviewed are not fully completed with all required boxes checked and blanks filled, are completed inconsistent with plan operations or are completed with internally inconsistent provisions. An example of inconsistent completion of an adoption agreement occurred when an employer selected actual contribution percentage (ACP) safe harbor provisions in a 403(b) plan adoption agreement and also selected a box to write in other excluded employees. Although the adoption agreement warned about exclusions that would violate the 403(b) plan universal availability requirement for elective deferrals, the employer wrote in that certain specified categories of employees were not eligible for matching contributions. Since the safe harbor matching contributions were the only matching contributions under the plan and the specified employee exclusions included non-highly compensated employees who were otherwise eligible to make elective deferrals under the plan, these exclusions were not permissible under an ACP safe harbor plan. No one pointed out this inconsistency prior to the adoption agreement being signed and the exclusions implemented, so the employer is left to consider possible corrections under the IRS Employee Plans Compliance Resolution System (EPCRS).

5. For example, a provider told an employer with an individually drafted defined contribution plan document that its preapproved plan could not handle the employer's definition of *normal retirement date* as the first day of the month coincident with or immediately following the date a participant attains the age of 65. Because the employer's plan also required benefits to commence on the normal retirement date, changing the plan's normal retirement date to be the actual date a participant attains the age of 65 might possibly be a cutback under Code Section 411(d)(6).

6. See Section 8.03 of Revenue Procedure 2017-41.

7. See Section 8 of Revenue Procedure 2017-41 regarding amendments to a preapproved plan.

8. See Section 6.03 of Revenue Procedure 2017-41 and Revenue Procedure 2018-21.

9. See Code §414(f), which defines a *multiemployer plan* as a plan maintained pursuant to one or more collective bargaining agreements and to which more than one employer is required to contribute. Note that an employer adopting a preapproved plan is not precluded from covering employees of the employer that are included in a unit covered by a collective bargaining agreement, if it is adopting a preapproved plan for its nonbargaining employees, or from adopting a preapproved plan pursuant to such agreement as a single employer plan that covers only bargaining employees of the employer. See Section 6.03(2) of Revenue Procedure 2017-41.

10. See Revenue Procedure 2017-41 as modified by Revenue Procedure 2018-21.

11. The verbal gymnastics that sometimes accompany the "fill in" blanks can be mildly amusing, if not threatening of the preapproved status of a plan. For example, consider interpreting the double negative created in filling in the blank for the following adoption agreement item: "Compensation will be defined as W-2 wages exclusive of the following: Base salary excluding bonuses and incentive pay." Perhaps more importantly, it is not clear at what point filling in plan document blanks might be treated by IRS as amending the preapproved plan such that its IRS opinion letter no longer applies. Preapproved plan providers can become concerned about this. In another situation, the preapproved document defined *compensation* for purposes of determining contributions as defined by Treasury Regulation Section 1.415(c)-1(d)(3), which is a broad-based total compensation definition for purposes of limiting annual additions, although the adoption agreement permitted items of compensation to be named as excluded for purposes of contribution determination. The definition of *compensation* for purposes of contribution determination in the individually drafted plan document of an employer moving to the preapproved plan of this provider expressly included only base salary or wages, overtime, shift differentials and pretax amounts under Code Sections 125, 132(f) and 401(k). Rather than fill in the exclusion blank of the adoption agreement with language to the effect that compensation excludes everything except base salary or wages, overtime, shift differentials and pretax amounts under Code Sections 125, 132(f) and 401(k), the provider insisted that, instead, all of the nearly two dozen items of compensation described in Treasury Regulation Section 1.415(c)-1(d)(3) would need to be expressly listed as excluded to maintain the preapproved status of the document and looked to the employer's other advisors to determine the list of exclusions.

12. A compelling example involved an employer that redesigned its 403(b) plan to be an ACP safe harbor, with the requirement that participants complete one year of service (1,000 hours) before becoming eligible for the safe harbor matching contributions. As the implementation date was approaching, the employer wanted to review and complete the preapproved document adoption agreement in the near term. The vendor had submitted a prototype safe harbor 403(b) plan to IRS for preapproval but did not want to provide the submitted adoption agreement to the employer for review because it was not yet approved. Instead, the vendor provided an adoption agreement for an unapproved specimen safe harbor 403(b) plan, which included a box to check if eligibility for matching contributions required a year of service. The employer checked this box in completing the specimen plan adoption agreement and otherwise completed the agreement to indicate an ACP safe harbor plan. The employer sent the agreement to the vendor. When the safe harbor document adoption agreement was completed later, due to a lack of communication between the employer and vendor, it was not understood that the safe harbor adoption agreement included an additional, separate box to be checked to require one year of service to receive the safe harbor matching contributions. The previously checked box now applied only to matching contributions other than safe harbor matching contributions in the safe harbor adoption agreement. No third party reviewed the safe harbor adoption agreement or assisted with its completion. The adoption agreement was signed at the 11th hour. In the midst of the second plan year of the new design, the employer's auditors found and questioned the error, wondering why participants were not immediately eligible for the safe harbor contribution, despite the signed adoption agreement and the vendor generated summary plan description (SPD) indicating that eligibility for safe harbor matching contributions was immediate. The employer was left with the question of whether to correct the failure by providing the immediate safe harbor match retroactively with earnings or to submit an

application to the IRS Voluntary Correction Program (VCP) seeking to retroactively amend the plan to reflect what had been the documented intent up to the signing of the adoption agreement.

13. For example, an employer was surprised to find that the adoption agreement document from the recordkeeper that the employer chose did not even offer the "rule of parity" of Code Section 411(a)(6)(D) as an option for break in vesting service rules in its preapproved plan. In another instance, a preapproved plan document, along with the provider's administration system, could not limit installment payments to the life expectancy of the participant (or joint life expectancies of the participant and designated beneficiary) as had been the case under the employer's individually drafted plan document and prior recordkeeper.

14. The author has seen base plan documents that are anywhere from 60 to 120 or more pages in length, generally much longer than the typical individually drafted plan document for the same plan design of an employer.

15. Consider this explanation at the start of an adoption agreement section that defines compensation. "Compensation for ADP safe harbor contributions follows the definition of compensation chosen for elective deferrals. Compensation for ACP safe harbor contributions follows the definition of Compensation chosen for Matching Contributions." It is not clear how this language works in the case of a plan that uses matching contributions as the safe harbor contributions, because the same safe harbor matching contributions would be used to satisfy both the ADP safe harbor and the ACP safe harbor and, presumably, would need to use the same definition of compensation, even though the adoption agreement permits different definitions of compensation to be selected for purposes of elective deferrals and matching contributions.

16. See D. Schwallie, "ADP/ACP Safe Harbor Compensation Compliance Confusion," *Journal of Pension Planning & Compliance,* Volume 42, No. 1 (Spring 2016).

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