403(b) PLANS

403(b) Plan Documents: A Step Toward Compliance

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For nonprofit organizations, documentation of their 403(b) retirement plans is a smart way to ensure continued tax deferral. PLRs from the IRS give additional security, but the authors suggest several ways to significantly improve the entire process.

An anomaly of 403(b) programs (also called tax sheltered annuities or TSAs) is the fact that they are sometimes subject to the same rules as qualified plans, and are sometimes subject to an entirely different set of laws. This mixed treatment is troubling for both plan design and administration. After all, TSAs are retirement savings plans with features remarkably similar to plans of for-profit organizations, although they may benefit only employees of public school systems and 501(c)(3) tax exempt organizations. But, despite the fact that TSAs "look like a duck, talk like a duck, and walk like a duck," they are not ducks—that is, they are not qualified plans. The nonqualified status of TSAs affects their operation in many different ways. One such effect relates to document issues.

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TO DOCUMENT OR NOT TO DOCUMENT? THAT IS THE QUESTION

Unlike qualified plans, which are required by Treasury Regulations Section 1.401-1(a)(2) to have a written plan, nothing in the Internal Revenue Code or Treasury Regulations requires TSAs to have plan documents. Title I of ERISA [§ 402(a)(1)] requires covered plans to have written documents, but they do not have to be fully integrated into one "contract," as do qualified plans. Therefore, it is common for TSAs to have no single plan document, but an amalgamation of items that together approximate a document. For example, a TSA may consist of an annuity contract, a summary plan description, salary deferral elections, notices from the employer to the employee, and employment contracts. However, in many (if not most) cases, important plan terms are not written down anywhere, but are procedural in nature, with these procedures existing only in institutional memory.

Although this limited freedom from the requirements of documenting a plan in a single writing may seem attractive at first blush, it is also a source of substantial administrative difficulties. TSAs that do not have consolidated documentation generally have a much harder time complying with legal requirements, because there is no single authority for how the program operates. Decisions about plan operations are often made on an ad hoc basis, changing willy-nilly depending on which authority figure at the employer's office happens to be available when an issue is raised. We have also seen several cases of conflicts between the provisions of the various documents. For example, the employment contract for a hospital executive promised immediate eligibility for a 6 percent employer contribution to the 403(b) program. However, the summary plan description required one year of service for eligibility for a 2 percent employer contribution. Needless to say, such a situation substantially increases the chances of violating one of Section 403(b)'s requirements.

There are also employee relations issues to be considered. When there is no controlling document, impromptu policies may create unfair results for some groups of employees. The uncertainty of these situations can make a 403(b) program unpopular and unwieldy.

Having an integrated plan document serves several purposes, not the least of which is to solve the problems mentioned above. In addition, the document will generally outline the responsibilities of the various parties to the TSA, which often leads to more successful plan operations. Also, the plan document should

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contractually provide (1) who is responsible for correcting defects in the program if they are discovered on audit or otherwise, and (2) mandate cooperation on the part of the custodian or insurer for those corrections (assuming they are parties to the document). The employer may find that the custodian or the insurer will refuse to approve such a provision. In that event, the employer may delete this clause or may search for an investment vendor that will be more cooperative.

The recently released IRS Proposed Examination Guidelines for 403(b) Programs (see "The 403(b) Examination Guidelines: A Road Map" on page 3 of this journal) discuss several situations in which the program documentation either must specify something "by its terms" or should be examined to ensure that a provision exists. [Ann 95-33, 1995-19 IRB] For example, Guidelines Section V.A.2.a. states that, "a 403(b) plan by its terms must preclude the making of excess deferrals to plans of the employer." Similarly, the Examination Steps to section V.C. note, "Check plan documents, including the basic plan document and SPDs, as well as the funding vehicles, to determine whether contributions are properly limited by Section 415."

The Guidelines raise the specter that, where TSAs have little or no real documentation, what they do have will be insufficient if an IRS audit occurs.

Clearly, we favor the view that TSAs should always (with very rare exceptions) have comprehensive plan documents. The next question is: how do we know the document is sufficient?

Unlike qualified plans, TSA documents cannot be submitted to the IRS district offices for advance determination letters. TSA documents cannot be pre-approved for use by a group of employers through a master, prototype, or volume submitter program. TSA sponsors are subjected to the archaic requirement that, if a ruling is desired, each plan must be individually submitted to the Washington, D.C. Headquarters (formerly National Office) of the IRS for a private letter ruling (PLR).

THE PRIVATE LETTER PROGRAM

Revenue Procedure 95-4 [1995-1 IRB 97, § 6.02(1)] specifies that PLRs are the proper means for obtaining rulings relating to TSAs. A review of the section of this revenue procedure dealing with determination letters issued by local key district offices reveals that such letters are not authorized to encompass Code Section 403(b) issues. Therefore, the IRS Headquarters has exclusive jurisdiction to rule on whether TSA documents meet the requirements of Code Section 403(b) and the key districts may not rule on these plans.

How does a PLR differ from a determination letter? The main difference between a letter ruling and a determination letter is procedural. One (the PLR) comes from the IRS headquarters; the other is issued by the local key district office based on guidance previously provided by the IRS Headquarters. Both PLRs and determination letters are issued only to the taxpayer and have no precedential value to other taxpayers. Both are modifiable or revocable for future tax years, and can also be revoked for past years if the application is found to contain misstatements or omissions of material facts. In fact, Revenue Procedure 95-4, Section 12.01 states, "A determination letter issued by a Key District Director has the same effect as a letter ruling issued to a taxpayer under section 12 of this revenue procedure [relating to PLRs]." Therefore, despite the fact that it is issued by the IRS headquarters, a PLR is not more binding or "better" than a determination letter.

How does applying for a PLR differ from requesting a determination letter from the local key district office? In general, the procedure for applying for a PLR is much less structured than the procedure for obtaining a favorable determination letter. Revenue Procedure 95-4 outlines several requirements for the PLR request that must be followed. However, there is no specific IRS form (such as the Form 5300 or 5307) that must be completed in applying for a PLR. There are no set "demonstrations and certifications" to be used by the TSA sponsor in making a PLR application. There is a checklist found in the Appendix to Revenue Procedure 95-4 that must be completed and signed by the taxpayer or his or her representative as part of the PLR application. This checklist is procedurally oriented, general in nature, and of little assistance in helping the applicant to identify issues peculiar to TSA programs.

Generally, only attorneys, accountants, and enrolled actuaries may act as authorized representatives of an employer in procuring a PLR. It is important to remember that there is no "remedial amendment period" under

Code Section 403(b). Therefore, it may be difficult to correct documentation defects retroactively for a TSA.

PLR application contents. In addition to completing the checklist in Revenue Procedure 95-4, a PLR application must contain the following:

1. Statement of Facts. Revenue Procedure 95-4, Section 9.02 notes that the PLR application must contain a complete statement of all relevant facts. The IRS generally looks for at least the following:

1. The names, addresses, telephone numbers, and taxpayer identification numbers of all "interested parties." The revenue procedure notes that "interested parties" does not mean all the employees involved, if there are many. It is not clear whether this employee information is ever required.
2. The IRS key district office with jurisdiction over the tax return that would be examined in relation to the TSA. Again, it is unlikely that a large tax-exempt entity would have to put down each key district covering the personal tax returns of the various employees. The key district at issue is the one with jurisdiction over the employer.

A TSA employer should also discuss in the application the basic elements of the TSA program, including such things as:

- The type of the employer (*i.e.*, a public school or a 501(c)(3) organization)
- When the program was adopted for the employees
- The investment media to be used in the program
- Whether the program will have contributions by the employer, or only salary-reduction contributions by the employees.

Since there are no pre-established "demonstrations and certifications" for TSAs (as there are for qualified plans), it is unclear whether the sponsor should submit sample nondiscrimination testing for review by the IRS. (Naturally, this testing is not required if there are no employer contributions or if the TSA is a church plan.) When such testing is submitted by a qualified plan sponsor as part of the demonstrations under Revenue Procedure 93-39, the IRS's favorable determination letter is considered to be an approval of the testing methodology. It appears possible that a similar ruling on nondiscrimination testing is possible within the PLR program for a TSA; however, nothing in Revenue Procedure 95-4 identifies this as a specifically approved ruling area.

2. A copy of the program documentation. The revenue procedure requires that copies of all relevant documents be provided. Therefore, in addition to the TSA document, a practitioner should enclose the annuity contracts and custodial agreements, summary plan description, sample deferral elections, and any other documents that are part of the program. If the TSA sponsor is a 501(c)(3) organization, it is also advisable to include a copy of the IRS determination of the organization's tax-exempt status.

The procedure requires that each document be titled, and that the documents be provided in alphabetical order. Originals should not be used in the application, since they will not be returned to the sponsor.

3. Analysis of Material Facts. This is the portion of the ruling request where the practitioner explains to the IRS why the facts presented above mean that the TSA program should be approved.

For example, the ruling request should note what type of entity the employer is (as specified in the statement of facts above), and the subsection of Code Section 403(b) which allows that type of entity to sponsor a 403(b) arrangement. Similarly, the request should note the type of investment medium and which clause in Code Section 403(b) authorizes these investments.

It is important to remember in this ruling request that the PLR is only as good as the application. If the practitioner fails to disclose key issues relating to the TSA, the IRS's ruling will not take those issues into account. If one of those issues would destroy the TSA's tax-sheltered status, the PLR will offer no protection from this occurring retroactively. Therefore, the PLR application must be carefully crafted to ensure that it covers all important elements of the program.

4. Required Statements. The application must contain a statement of whether, to the best of the employer's knowledge (or the knowledge of the practitioner making the submission), the same issue was in an earlier return of the employer or a related taxpayer. If it is (for example, the

plan has been sponsored for several years—affecting several years' returns), the applicant must note whether the issue has been audited, or is currently under audit, or in Appeals at the IRS, or in litigation, or is currently being reviewed by the Department of Labor (DOL) or the Pension Benefit Guaranty Corporation.

The application must also state whether the subject of the ruling request has ever been ruled on or submitted previously for a ruling.

Finally, the application must contain a statement of:

- Authorities supporting the approval of the application
- Authorities supporting disapproval
- Pending legislation

One might think that the IRS is in a better position to know this information than the taxpayer and that the taxpayer is being asked to do the IRS' work for them. However, Revenue Procedure 95-4 specifies that failure to provide this information will require the IRS representatives to research the legal issues involved in the application, and will delay its approval. This is particularly important if the employer is requesting that the IRS rule on a particular feature of its 403(b) program. For example, the plan document may allow participants to invest in a certain vehicle which may (or may not) meet the requirements of an "annuity contract" under Code Section 403(b)(1). As part of its ruling request, the employer wants the IRS to rule on whether this investment vehicle is acceptable under Code Section 403(b). The employer should outline why it believes the vehicle to be acceptable, but what authorities would support the argument that it is not. This statement of authorities should be persuasively written to explain why the "pro" authorities are more compelling than those who are contrary to the taxpayer's position.

The last statement required is the "deletions statement." The PLR will generally be available to the public (in fact, many are published by various tax services). Therefore, to the extent that the taxpayer wants things deleted from the version made available to public (such as its name and other identifying information), it must be noted in the deletions statement. The deletions statement must be provided even if no deletions are requested, and is considered to be a document separate from the PLR request. It must be signed by the applicant or its authorized representative. [Rev Proc 95-4, § 9.02(9)]

5. Signature. The PLR application must be signed by the applicant or its authorized representative. A Power of Attorney must also be provided if the application is made by a representative.

6. Perjury Statement. The application must be accompanied by the following statement, signed by the taxpayer (and not its representative):

> Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the requested letter ruling or determination letter are true, correct, and complete.

7. User Fee. Under Revenue Procedure 95-8, the user fee for a PLR request is $1,775.

HEY, GUYS, DOES ANYBODY REALLY DO THIS?

The IRS reports that they receive approximately 75 applications per year for PLRs on TSA programs, and have issued approximately 1,000 PLRs since the 1960s. Roughly half of these situations involve investment vendors who are marketing some feature in a TSA program, who want to ensure that the feature will not violate the tax sheltered status of the TSA. Since the PLR program accepts applications only from real taxpayers with bona fide tax issues, the vendors convince a client to act as the guinea pig, and apply for a ruling on the document prepared for that client. Often, the vendors ask for a specific ruling on the issue they most care about, in addition to a ruling that the plan constitutes a valid TSA.

Although PLRs cannot be relied on by anyone but the applying taxpayer, the successful vendor will use the PLR as evidence to future clients that their idea (whatever it is) works.

The other half of the PLR applications are made by employers wishing to ensure that their document meets all legal requirements. Such employers are similar to companies that sponsor qualified plans. They want to ensure that all required language is in the document, and that there is no defective language in the plan that could cause a problem under Code Section 403(b), so that all interested parties can have some level of confidence that the program's tax-sheltered status is protected.

The IRS tells us that they have noticed no correlation between the number of employees and whether the PLR is sought for the plan—it's simply an individual decision on the part of employers.

Previously, getting a PLR on plan documentation may have seemed unnecessarily cautious; after all, 403(b) programs were rarely audited. However, in today's atmosphere, there is (and should be) a heightened concern that the plan document comply with the law. In recent speeches, IRS representatives have stated that *all* Exempt Organization Division audits of tax-exempt employers will include a review of their 403(b) programs. In addition, as mentioned earlier, there is substantial emphasis in the proposed Examination Guidelines on what the 403(b) documents say. Having a PLR approving the plan documentation could be a good way to get an audit started on the right foot.

IS THE PLR PROGRAM THE RIGHT PLACE FOR TSA APPLICATIONS?

It is clear from the above discussion that applying for a PLR is a more difficult process than filing for a determination letter for a qualified plan. A 403(b) program employer must retain counsel or other advisors to draft an individually designed document and submit it to the IRS headquarters. The employer must also pay a user fee that is considerably more than the user fee for qualified plans.

Perhaps this seems reasonable if the employer is a large public school system or a national tax-exempt entity. However, it is a mystery why such an entity should pay more than the analogous for-profit organization for the same service. On the other hand, if the employer is a local charity with relatively few employees, the cost of this process may be too high.

Whether a defective TSA document can cause substantial problems to the employer and the benefiting employees is answered clearly by sections of the Guidelines mentioned above. If there is a document and required provisions are omitted, the effect can be catastrophic—a plan defect can result in the loss of tax-sheltered status for the funds of all participating employees. The funds in the TSA would then become taxable to the employees—which is bad enough. However, annuity or custodial contracts often limit distribution events before retirement. This could leave the employees with taxes to pay and no access to the money with which to make payment.

In other words, an improper or nonexistent TSA document has the same (or worse) effect on the benefiting employees of a tax-exempt organization as a defective qualified plan document has on its participants. The negative effect on employee morale and loyalty is identical to that which one expects would occur at a for-profit organization if the qualified plan was disqualified.

NEW ENVIROMENT

Why does the IRS treat 403(b) programs differently from those of for-profit entities? Perhaps this dichotomy was historically based on the special consideration given to tax-exempt entities. Since these plans were not usually audited, there was no need to take special precautions to be sure that the documents were complete and proper. In addition, as most 403(b) plans have traditionally been considered to be sponsored by the employees, and not the employers, it was not seen as the obligation of the employer to secure approval of the plan documentation.

However, times have changed. The current environment for 403(b) programs is much more restrictive. The chance of the IRS auditing plans and finding defects is substantially increased. Tax-exempt and public school employers should be encouraged to ensure that the 403(b) program covering their employees conforms to the requirements of the Code so that the employees are protected from the potential adverse consequences of an IRS audit. We suggest that the IRS consider a change in its procedures relating to TSAs.

The review of 403(b) programs should be delegated to key district offices as part of the determination letter program. The user fee for reviewing a 403(b) plan should be reduced to conform to the fees for reviewing qualified plans. Finally, TSA vendors and advisors should be able to obtain master, prototype, and volume submitter approval of their documents, making the drafting of TSA plans easier and more reliable. IRS representatives indicate that there is no philosophical disagreement within the Service about these recommendations. The reason why these changes have not been made is because the key districts lack the financial and personnel resources to handle the additional responsibility. Perhaps the consolidation of the determination letter process in Cincinnati (which is slated for next year) will permit 403(b) plan review to be moved there.

We would suggest that the DOL issue guidance to provide that the employer's efforts to

document its 403(b) program and secure a PLR on that document do not constitute sufficient employer involvement to cause the plan to be automatically covered by Title I of ERISA.

The goal of the IRS's administration of TSAs should be to ensure that employees of eligible organizations are able to safely accumulate retirement benefits and savings. Employers are in the best position to make sure that these programs comply with the law. However, the current IRS procedures on plan documentation discourage employers from adopting adequate plan documentation, leaving their employees in substantial risk of taxation and penalties in the event of an IRS audit. The steps we have outlined will go a long way in achieving a level of parity and equal employee protection in the programs of tax-exempt and for-profit employers.

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