Client Advisory
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CHEIRON

PROPOSED NONDISCRIMINATION RELIEF FOR CLOSED DEFINED BENEFIT PLANS

The Internal Revenue Service (IRS) issued proposed regulations that would modify the nondiscrimination requirements applicable for qualified plans. In particular, the proposed regulations would provide relief with respect to a "closed defined benefit pension plan" (a closed plan). This Advisory describes the proposed changes.

A copy of the proposed regulations can be found at https://www.gpo.gov/fdsys/pkg/FR-2016-01-29/pdf/2016-01675.pdf

Action Needed Now: Plan sponsors with closed plans should review the proposed regulations and determine the impact upon their plans. Plan sponsors may also want to submit comments on the proposed rules. Comments are due by April 28, 2016.

Specific Comments Requested: The IRS is requesting comments on all aspects of the proposed regulations, including the proposed applicability date. In addition, comments are requested on the following specific issues:

- Whether guidance needs to be developed for a plan that has more than one closure or closure amendment?
- Whether the rules regarding transition allocations and successor employers are still needed in light of the modifications to the DBRA rules?

Public Hearing on May 19, 2016: The IRS has already scheduled a public hearing on May 19. Individuals who submit comments by April 28 may make oral statements at the public hearing, which will begin at 10 a.m. in the Auditorium, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Contact Oluwafunmilayo (Funmi) Taylor at (202) 317-6901 for more information.

BACKGROUND

Internal Revenue Code (Code) section 401(a)(4) provides that a plan, including a closed plan,[1] is a qualified plan only if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees. In addition, qualified plans must satisfy the coverage requirements under Code section 410(b), which generally requires that a sufficient percentage of non-highly compensated employees benefit under the plans.

[1]The proposed regulations define a "closed defined benefit plan" as a defined benefit plan that has been amended to (i) cease accruals under a benefit formula provided by the defined benefit plan for some or all employees whose benefits were previously determined under that benefit formula; or (ii) limit participation in the defined benefit plan to a group of employees that consists of some or all of the plan participants who participated in the plan as of the closure date.

The existing IRS regulations provide a complex set of rules that include various alternative methods for testing compliance with Code sections 401(a)(4) and 410(b). The regulations provide a number of safe harbors and a general testing methodology, including the following:

- Defined contribution plans can be tested on the basis of benefits by converting the amounts allocated to employees to equivalent benefits.
- A defined benefit plan can be aggregated with the employer's defined contribution plan and the combined plans are then treated as a single plan (a "DB/DC plan"). In order for a DB/DC plan to demonstrate compliance with the nondiscrimination requirements on the basis of equivalent benefits, it must satisfy a minimum aggregate allocation gateway (unless the DB/DC plan either fits within the definition of "primarily defined benefit in character" or consists of "broadly available separate plans"). The minimum aggregate allocation gateway requires a minimum allocation rate (or equivalent allocation rate) for each non-highly compensated employee of up to 7.5% of compensation.
- Defined benefit replacement allocations ("DBRAs"), i.e., allocations under a defined contribution plan that are provided only to a grandfathered group of employees[2] with respect to a closed plan, can be disregarded when determining whether a defined contribution plan has broadly available allocation rates.

In recent years, many large companies have closed their defined benefit plans to new entrants, with the result that over time the employees benefiting under the plans will be a proportionately greater percentage of highly compensated employees. In some cases this occurs because covered employees receive promotions and pay raises so that they become highly compensated employees after the plan has been closed to new entrants. Accordingly, because of the demographic changes that occur over time, closed plans may well fail to satisfy the existing nondiscrimination requirements. While the closed plans could be aggregated with the companies' defined contribution plans, companies have been concerned about the level of contributions that would be required to satisfy the DB/DC plan rules. Therefore, companies have asked the IRS for relief with respect to closed plans.

Notice 2014-5: The IRS provided temporary nondiscrimination relief under Notice 2014-5 if certain requirements were met. Under Notice 2014-5, a plan sponsor is permitted to test a DB/DC plan that includes a closed plan that was closed before December 13, 2013, on a benefits basis for plan years beginning before January 1, 2016, without complying with the minimum aggregate allocation gateway, even if that would otherwise be required under the current regulations. Notice 2014-5 also requested comments on whether the regulations should be amended to provide additional alternatives. In Notice 2015-28, the IRS extended this relief for an additional year by applying it to plan years beginning before 2017.

[2]A "grandfathered group of employees" means the group of employees who, after the closure date, either continue accruals under the closed defined benefit plan's benefit formula or are entitled to an allocation formula under a defined contribution plan because those employees previously participated in the closed defined benefit plan.

SUMMARY OF THE PROPOSED REGULATIONS

The proposed regulations, reflecting certain comments received by the IRS in response to Notice 2014-5, would make permanent changes to the nondiscrimination rules to help sponsors of eligible closed plans comply with the nondiscrimination requirements. These changes are applicable to situations where the proportion of the grandfathered group of employees who are highly compensated employees compared to the employer's total workforce increase due to ordinary demographic changes.

I. Rules related to closed plans and similar arrangements

A. Modifications to the DBRA rules. The proposed regulations would:

- Modify the rules applicable to DBRAs to allow more allocations to fit within the DBRA rules, thereby making it easier for employers to replace defined benefit plan retirement benefits without having to satisfy the minimum aggregate allocation gateway.

  For example, whereas under existing regulations a DBRA must be reasonably designed to replace the benefits that would have been provided under the closed benefit plan, the proposed regulations allow the allocations to be reasonably designed to replace some or all of the benefits that would have been provided under the closed plan, so long as the allocations are provided in a consistent manner to all similarly situated employees.
- Ease the restriction on the types of defined benefit plans with respect to which a DBRA can be provided.

  For example, a DBRA is allowed to replace the benefit provided under a defined benefit plan with a benefit formula that generates equivalent normal allocation rates that increase from year-to-year as employees are credited with additional years of service (previously permitted only as the employees attained higher ages).
- Limit application of the existing rule that requires the group of employees who receive a DBRA to be a nondiscriminatory group of employees that satisfies the minimum coverage requirements of section 410(b) (determined without regard to the average benefit percentage test) to only the first 5 years after the closure date.[3]
- Incorporate the existing rule in Revenue Ruling 2001-30[4] regarding whether a defined benefit plan was an established nondiscriminatory defined benefit plan by requiring the closed plan to have been in effect 5 years prior to the closure date (with one year substituted for 5 years in the case of a defined benefit plan maintained by a former employer[5]), provided there was no substantial change to the closed plan during that time. The following types of amendments will not constitute a substantial change for this purpose:
  - Amendments that do not (i) increase the accrued benefit or future accruals for any employee, (ii) expand coverage (except as permitted below), or (iii) reduce the ratio-percentage under any applicable nondiscrimination test.

[3]The closure date is the last day before accruals cease or participation is limited pursuant to the closure amendment.

[4]Revenue Ruling 2001-30, 2001-2 C.B. 46.

[5]If the employees of a former employer become employees of the new employer as a result of a transaction that is a merger, acquisition, or similar event, then the transaction is treated as a closure amendment with respect to the former employer's plan as of the effective date of the transaction.

- An amendment that extends coverages to an acquired group of employees, provided that all similarly situated employees within that group are treated in a consistent manner.
- An amendment that makes de minimis changes in the calculation of a DBRA.
- An amendment that adds or removes a "greater-of" plan provision (under which a participant receives the greater of the otherwise applicable allocation and the DBRA).
- Any plan amendment modifying a DBRA that does not reduce the ratio percentage under any applicable nondiscrimination test.

B. Special testing rule for the nondiscriminatory availability of a benefit, right, or feature provided to a grandfathered group of employees:

- Benefit, Right, or Feature. The proposed regulations would establish a special nondiscrimination testing rule under §1.401(a)(4)-4 that applies if a benefit, right, or feature is made available only to a grandfathered group of employees with respect to a closed plan. To be eligible for this special rule:
  - the benefit, right, or feature must have been in effect without being amended for a 5-year period before the closure date (subject to a limited exception for acquired employees),
  - the amendment restricting the availability of the benefit, right, or feature must also effect a significant change in the type of the defined benefit plan's formula (such as a change from a benefit formula that is not a statutory hybrid formula to a lump sum-based benefit formula),
  - the benefit, right, or feature must be currently available to a group of employees that satisfies the minimum coverage requirements of section 410(b) for the plan years that begin within 5 years after the closure date, and
  - no substantial amendments to the availability of or eligibility for the benefit can be made after the closure date.

  If these eligibility conditions are satisfied, the special testing rule treats a benefit, right, or feature that is provided only to a grandfathered group of employees as satisfying the current and effective availability tests of §1.401(a)(4)-4(b) and (c).

  The special testing rule would apply to plan years beginning on or after the fifth anniversary of the closure date and applies on a plan-year by plan-year basis. Once the special testing rule applies to a benefit, right, or feature, the special testing rule continues to apply for purposes of that benefit, right, or feature indefinitely (unless a later amendment (that's not a permissible amendment) changes the eligibility for the benefit, right, or feature, in which case, the special testing rule will cease to apply).

  Examples:
  A conversion from a final average pay formula to a cash balance formula would be a significant change in the type of benefit formula, so that the special testing rule would apply to facilitate preservation of any subsidized early retirement factors for the employees who continue to benefit under the prior benefit formula.

In contrast, in the case of a benefit formula that determines benefits as a percentage of compensation, a change in that formula to reduce that percentage would not be considered a significant change in the type of benefit formula, even if the reduction is large.

- Rate of Matching Contributions. The special testing rule would also apply to a rate of matching contributions under a defined contribution plan meeting the following requirements:
  - The rate of matching contributions must be reasonably designed so that the matching contributions will replace some or all of the value of the benefit accruals that each employee in the grandfathered group of employees would have been provided under the closed plan in the absence of a closure amendment.
  - The rate of matching contributions for the grandfathered group of employees must be provided in a consistent manner to all similarly situated employees.

II. Modification of testing options for DB/DC plans, including DB/DC plans that do not include a closed plan

The proposed regulations would:

A. Ease the rules under which any DB/DC plan can satisfy the nondiscrimination in amount requirement on the basis of benefits, by permitting satisfaction on the basis of benefits through satisfaction of the closed plan rule or the lower interest rate rule (described below).

B. Expand the ability to use the average of the equivalent allocation rates under the defined benefit plan for purposes of satisfying the minimum aggregate allocation gateway by permitting the averaging of allocation rates for non-highly compensated employees under the defined contribution plan for this purpose. This modification is intended to better accommodate plan sponsors that have a defined contribution plan with service or age-based allocation formulas. The IRS determined that it is appropriate, in this context, to allow shorter-service non-highly compensated employees to be provided less than the minimum aggregate allocation gateway rate, as long as longer-service non-highly compensated employees are provided allocation rates that are sufficiently higher than the minimum aggregate allocation gateway rate.

The IRS is considering whether any restrictions on this rule are appropriate so that the rule serves its intended purpose of facilitating formulas that provide higher allocation rates to longer-service non-highly compensated employees, and invite comments on ways to permit appropriate flexibility while ensuring the provision is not used to circumvent the purpose of the nondiscrimination rules.

C. Include a limitation on the averaging of rates that applies to both defined contribution and defined benefit plans in order to minimize the impact of outliers. This special rule applies a cap under which any equivalent normal allocation rate or allocation rate in excess of 15% is treated as equal to 15%. The cap is raised to 25% for any allocation rate or equivalent normal allocation rate that results solely from a plan design providing allocation rates or generating equivalent normal allocation rates that are a function of age or service under which higher rates are provided to older or longer-service employees.

D. Provide that the average of the matching contributions actually made for non-highly compensated employees may be used to a limited extent (up to 3 percent of compensation) for purposes of determining whether each non-highly compensated employee satisfies the minimum aggregate allocation gateway test. The average matching contributions, rather than matching contributions allocated for each employee, is used in order to avoid diluting the incentive effect of an employer match.

E. Provide a new alternative to the minimum aggregate allocation gateway. Under this alternative, a DB/DC plan is not required to satisfy the minimum aggregate allocation gateway if it can satisfy the nondiscrimination in amount requirement on the basis of equivalent benefits using an interest rate of 6%, rather than the current standard interest rate of between 7.5% and 8.5%.

F. Add a "closed plan rule" to the plan aggregation and restructuring rules. This new alternative, which applies to a DB/DC plan that includes a closed plan, would provide a new exception to the minimum aggregate allocation gateway requirement that would otherwise apply, but only if the closed plan was in effect for 5 years before the closure date and no significant change was made to the closed plan during or since that time (except the permissible amendments listed under Section A above). The DB/DC plan may use this closed plan rule for a plan year that begins on or after the fifth anniversary of the closure date. To be eligible for the closed plan rule, during the 5-year period following the closure date, either the DB/DC plan must satisfy the nondiscrimination in amount requirement of section 401(a)(4) without using the minimum aggregate allocation gateway, or the closed plan must satisfy that requirement without aggregation with any defined contribution plan. The IRS considers this requirement as comparable to the requirement that the group of employees who receive DBRAs must be a group of employees who satisfy the minimum coverage requirements of section 410(b).

III. Benefit formulas for individual employees or groups without a reasonable business purpose; modifications to the amounts testing rules

The proposed regulations address certain arrangements that take advantage of the flexibility in the existing nondiscrimination rules, e.g., the use of rate groups in the general testing methodology, to provide a special benefit formula for selected employees without extending that formula to a classification of employees that is reasonable and established under objective business criteria. The proposed regulations would limit the existing rule under which a rate group with respect to a highly compensated employee is treated as satisfying the average benefit percentage test to those situations in which the allocation formula (or benefit formula) that applies to the highly compensated employee also applies to a reasonable business classification pursuant to §1.410(b)-4(b). For example, if a benefit formula applies solely to a highly compensated employee who is identified by name, it does not apply to a reasonable business classification and would have to satisfy the ratio percentage test.

PROPOSED APPLICABILITY DATE

Except for those items listed below, the regulations are proposed to be applicable to plan years beginning on or after the date of publication of the final regulations in the Federal Register.

Taxpayers can apply the following provisions of the proposed regulations for plan years beginning before the proposed applicability date, but not for plan years beginning before January 1, 2014.

- the disregard of certain defined benefit replacement allocations in cross-testing;
- the exception from the minimum aggregate allocation gateway with respect to certain closed plans;
- the special testing rule for benefits, rights, and features with respect to certain closed plans; and
- the rule applying the ratio percentage test to a rate group in the case of a benefit formula that does not apply to a reasonable business classification.

Where To Send Comments

Comments may be submitted via:

- **Mail:** Send submissions to CC:PA:LPD:PR (REG-125761-14), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.
- **Hand-delivery:** Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-125761-14), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or
- **Electronically:** Via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-125761-14).

All comments will be available for public inspection and copying at www.regulations.gov or upon request.

Cheiron Observation: The proposed regulations seek to balance competing policies of encouraging the continuation of traditional defined benefit plans on the one hand, but preventing discrimination in favor of highly compensated employees on the other hand. Accordingly, most of the proposed changes should be viewed in a favorable light. However, the proposed change to the general testing rules to require that a rate group satisfy a reasonable business classification adds a restriction that impacts all plans rather than merely closed plans. The proposed new restriction will be controversial and the focus of many of the comments.

Cheiron pension consultants can assist you in analyzing the impact of these proposed regulations and design changes for your defined benefit plans.

Cheiron is a full-service actuarial consulting firm assisting Taft-Hartley, public sector, and corporate plan sponsors with proactive management of benefit plans to achieve strategic objectives and satisfy the interests of plan participants and beneficiaries.

To discuss how Cheiron can help you meet your technical and strategic needs, please contact your Cheiron consultant, or request to speak to one by emailing your request to info@cheiron.us.

The issues presented in this Advisory do not constitute legal advice. Please consult with your own tax and legal counsel when evaluating their impact on your situation.