Plan Reflection

Satisfying nondiscrimination testing at closed DB plans

While there are certainly strategies for reducing the costs or managing the liabilities of an ongoing defined benefit (DB) plan, some employers—particularly those with final average pay plans—have felt uncomfortable with the adverse effect that a hard freeze would have upon long-service employees nearing retirement age.

Those employers have adopted one of two general strategies—either significantly changing the type of benefit formula under the plan, such as in the case of a conversion to a cash balance plan, or prohibiting new employees and rehires from entering the plan, in an action referred to as a plan closure or a "soft freeze." However, in the case of a cash balance plan, certain participating employees may be entitled to a "greater of" benefit, taking into account the old and new formulas. Additionally, in a traditional defined benefit plan closed to new hires and rehires, participants may continue to accrue benefits—such employees often being referred to as "grandfathered employees."

The legal difficulty with these well-intentioned actions is that, over time, they may lead to difficulties satisfying the applicable nondiscrimination tests for defined benefit plans under the Internal Revenue Code (IRC).

Q: What nondiscrimination provisions under the IRC may become difficult to satisfy over time in closed defined benefit plans?

A: There are three sections of the code that need to be taken into account by a closed defined benefit plan:

Under IRC Section 401(a)(26), in one plan year, at most 50 employees may benefit under the plan or, instead, 40% of the business's employees—whichever number is smaller; permissible exclusions and the possibility of testing on a qualified separate line of business basis are available. This section primarily affects smaller employers.

IRC Section 410(b) provides that a plan is qualified only if the classification of employees who benefit under it does not discriminate in favor of highly compensated employees. Section 410(b)(6)(B) provides that two or more plans may be aggregated for purposes of Section 410(b), but only if the plans can be aggregated for purposes of Section 401(a)(4). Section 401(a)(4) also requires that benefits, rights and features, such as early retirement subsidies, be available on a nondiscriminatory basis.

According to Section 401(a)(4), a plan is qualified only if the contributions or benefits provided under it do not discriminate in favor of highly compensated

 Illustration by Adam McCauley

employees and compliance can be demonstrated on the basis of contributions or benefits. The regulations under code Section 401(a)(4)9 permit a defined benefit plan and a defined contribution (DC) plan to be aggregated for testing purposes and tested on the basis of equivalent benefits if one of three alternative conditions is satisfied, although those conditions reflect in part the Internal Revenue Service (IRS) response to the totally unrelated issue of "new comparability" plans. Such plans are referred to under the IRS regulations as DB/DC plans.

The IRS has observed that, in the early years after a defined benefit plan is closed, one of those conditions will generally be satisfied; however, over time, for the same demographic reasons that it becomes difficult to satisfy Section 410(b), it will become difficult to satisfy one of the three conditions permitting aggregation of the closed plan and the defined contribution plan on an equivalent benefit basis.

Q: Under current IRS regulations, what options are available to a plan sponsor whose plan cannot satisfy the applicable regulations?

A: The plan sponsor has four options available, if it is unwilling or would find it too expensive to close down the plan via a standard termination.

First, it can reduce the number of highly compensated employees participating in the closed defined benefit plan by ceasing benefit accruals for them. In situations where the plan sponsor may establish a nonqualified deferred compensation (NQDC) plan—sometimes referred to as a "top hat" plan—those employees could be provided benefits there, but only certain highly compensated employees, under the IRC, would be eligible.

Second, more non-highly compensated employees could be added to the plan, although the plan was frozen to preclude this additional expense from occurring. These first two options may be combined, i.e., some highly compensated employees could be removed from the plan, and some non-highly compensated employees added.

Third, contributions on behalf of the ineligible employees could be reconfigured so they can be taken into account for purposes of satisfying one of the three conditions required for aggregating defined benefit and defined contribution plans for testing on an equivalent benefit basis; matching contributions are not taken into account.

And fourth, if an employer does not wish to reconfigure its defined contribution plan allocation for employees ineligible for the defined benefit plan, and it finds the other two options unacceptable, the fourth option—and the one the IRS would like to avoid—is the cessation of benefit accruals for all participants in the plan.

Q: What actions has the IRS taken to address these potential nondiscrimination testing issues?

A: In Notice 2014-5, the IRS issued temporary relief, through the 2015 plan year, to address this issue. It permitted defined benefit plans and defined contribution plans to be aggregated and tested on an equivalent benefit basis if the former was soft frozen prior to December 13, 2013, and if it fell into one of two categories: 1) for the plan year beginning in 2013, the defined benefit plan satisfied one of two conditions permitting aggregation of DB and DC plans for nondiscrimination testing—it was part of a DB/DC plan that either was primarily defined benefit in character or it was part of a DB/DC plan that consisted of broadly available separate plans; or 2) it was not part of a DB/DC plan for the plan year beginning in 2013 because it satisfied nondiscrimination testing without aggregation.

Notice 2015-28 extended this transitional relief through the 2016 plan year, and the recently issued Notice 2016-57 extended it through 2017. However, neither extension modified the requirement that the plan provide ongoing accruals and that it was soft-frozen with an amendment it had adopted before December 13, 2013. Nondiscrimination testing of benefits, rights and features was not addressed in these notices.

In January of this year, the IRS sought again to address the matter, looking toward a permanent solution by issuing proposed regulations under IRC Section 401(a)(4). The best case scenario for sponsors of soft-frozen defined benefit plans would be a general exemption from nondiscrimination testing, but the proposed regulations, structured to avoid abusive practices, are highly technical in nature and, while expanding the relief available, contain some important limitations.

The proposed regulations would be applicable for plan years beginning after the date of publication in the Federal Register, so, for calendar year plans, the expected effective date is January 1, 2018. Taxpayers are generally permitted to rely upon these proposed regulations for plan years beginning on or after January 1, 2014. If final regulations are more restrictive than the proposed regulations, taxpayers will not be required to apply the final ones prior to their effective date.

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