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IRS provides temporary nondiscrimination testing relief for closed defined benefit plans

IRS will allow plan sponsors of certain defined benefit plans that are closed to new participants to use the defined benefit cross testing rules to show that their combined retirement plans — defined benefit and defined contribution together — are not discriminatory without having to satisfy the normally applicable regulatory conditions for such tests. Relief is limited to 2014 and 2015 plan years. Future regulatory changes will be considered.

Background

Current nondiscrimination testing regulations allow plan sponsors to aggregate plans to demonstrate that their plans do not impermissibly discriminate in favor of highly compensated employees (HCEs). When the aggregated plans include a mix of defined benefit and defined contribution plans, the regulations require that the combined DB/DC plan satisfy one of three alternative conditions:

- The benefits under the DB/DC plan must be primarily defined benefit in character.
- The DB/DC plan must consist of broadly available separate plans.
- In combination, the DB/DC plan must meet the minimum aggregate allocation gateway, which is set at 7.5% of compensation as a safe harbor.

With the trend to move new employees to defined contribution plans, many plan sponsors who had retained their DB plans for employees who had entered prior to the date they initiated the change (“soft-frozen” plans) are finding that they can no longer meet any of the three alternatives within their intended budget. Seeing a complete freeze of their DB plans as the only option for the future, these employers had appealed to IRS and Treasury for a change in the rules.

IRS announces temporary relief

In Notice 2014-05, the IRS adds a temporary additional eligibility criterion to the three listed above. Under this alternative, the DB/DC plan may use the DB cross-testing option for a plan year that begins before January 1, 2016, if it includes a DB plan providing ongoing accruals that was soft frozen with an amendment adopted before December 13, 2013 (*today*). In addition, each of the DB plans in the DB/DC plan must satisfy one of the following conditions:

- For the plan year beginning in 2013, the DB plan was part of a DB/DC plan that either was primarily defined benefit in character or consisted of broadly available separate plans.
- In the case of a DB plan that was soft frozen before December 13, 2013, the DB plan was not part of a DB/DC plan for the plan year beginning in 2013 because the DB plan satisfied the coverage and nondiscrimination requirements without aggregation with any DC plan.

IRS notes that this relief does not change the other requirements of the nondiscrimination regulations such as the requirement that the timing of an amendment be nondiscriminatory.

Request for comments

IRS and Treasury will consider making permanent changes to the regulations. Notice 2014-05 presents some possible alternatives that are under consideration and invites public comment. The alternatives include various averaging options, including an option to reflect average matching contributions for the contribution gateway, an option to use a lower interest rate for converting contributions to benefits, and access to the nondiscrimination safety valve that allows testing to disregard up to 5% of the plan's HCEs. IRS and Treasury will also consider additional modifications to the nondiscrimination rules for benefits, rights, and features, and permitting matching contributions to be included in testing whether other plan contributions and benefits are nondiscriminatory in amount. Future changes will be evaluated in the context of concerns that a lower testing standard for closed plans will encourage sponsors to close their open DB plans or create an opportunity to increase the disparity in benefits for HCEs and those for the non-highly compensated.

In closing

With a comment deadline of February 28, 2014 and an expectation that this topic will continue to attract high-level attention in light of the serious threat to ongoing plan retention for many employer plans, plan sponsors should be hopeful that a reasonable permanent solution is in sight.

Authors
Marjorie Martin, EA, MAAA, MSPA
Jay P. Rosenberg, EA, FSA, MAAA, FCA

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