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IRS Nondiscrimination Proposal Limits QSERPs, Adds Cross-Testing Option and New Closed Plan Relief

Proposed IRS regulations would tighten some of the nondiscrimination options that had allowed for flexible designs for select highly paid employees while providing relaxed nondiscrimination testing options for certain closed defined benefit pension plans. The package does not include any relief for closed defined benefit plans from the minimum participation rule that requires coverage of no fewer than 50 employees (or 40% of employees, if less). A new cross-testing option for combinations of defined benefit and defined contribution plans would allow the combined plan to be tested on a benefits basis as long as testing can be satisfied using a 6% interest rate (rather than the 7½ to 8½% rate allowed under the current rules).

Background

With the current trend of employers gravitating to the certainty of defined contribution (DC) plans and away from the perceived volatility of defined benefit (DB) pension plans, many employers that closed their DB plan to new hires continued the DB plan accruals for those who entered the plan before the freeze to meet the expectations of employees who did not have sufficient time to save under the new DC plan. However, those plan sponsors were projecting that they soon would no longer meet certain nondiscrimination requirements. Seeing a complete freeze of their DB plans as the only option for the future, these employers appealed to IRS and Treasury for a change in the rules. Similarly, other employers added sweeteners to their DC plans for those affected by a DB plan freeze, but they also were encountering problems with the nondiscrimination tests.

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 participants are currently accruing benefits under aggregated plans that include a mix of DB and DC benefits, the regulations require that the combined DB/DC plan can either be tested on a contributions (DC) basis or a benefits (DB) basis.

However, to test the combined DB/DC plan on a "benefits basis" (which is generally more favorable), the combined plan must 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 a combined normal allocation rate of 7½% of Section 415 compensation for each non-highly compensated employee (NHCE) as a safe harbor

Similar requirements apply to DC-only plans that need the option of converting to equivalent DB accruals to show that the plan benefits are not discriminatory. In Notice 2014-05, the IRS provided temporary relief to some employers using DB/DC testing in an effort to avoid disappointing reasonable expectations of covered participants. For plans that were closed to new entrants before December 13, 2013, DB/DC testing could be used for 2014 and 2015 provided certain conditions were satisfied. This relief was extended to 2016 in Notice 2015-28. Our *FYI Alert* publications from March 20, 2015 and December 13, 2013 provide additional information on this interim relief.

Although the plight of participants in closed plans drew sympathy, the IRS is not as sympathetic to HCEs who benefit from flexible plan designs that had developed under the regulations in general. Revisiting the regulations for closed plans opened the door to reconsideration of designs that allowed employers to move benefits that otherwise would have been provided under nonqualified plans into their qualified plans (commonly referred to as QSERPs). Also under consideration would be flexible benefits allowed using "groups" that were often defined to cover just a single employee.

Changes for Everyone

The proposed changes to the nondiscrimination regulations include modifications that apply much more broadly than to just closed plans.

Restrictions for QSERPs and Groups

The first key provision in the proposed regulations would add a reasonable business classification requirement for each DB or DC plan formula as a gateway to using lower ratio targets for general "rate-group" testing. If the classification test is not met, each rate group must show that it meets a 70% ratio rather than the lower nondiscriminatory classification threshold. *To meet the reasonable classification requirement, the classification itself does not have to be nondiscriminatory,* but there need to be objective business criteria for identifying the employees who benefit — the class can't be just someone identified by name (or by other provisions having a similar effect).

For example, if a plan provides a formula of $20,000 for a single individual and 10% of pay for everyone else, there are two

What is a "rate group"?

In nondiscrimination testing, various tests are performed that compare the ratio of NHCEs covered to the ratio of HCEs covered. For example, if a plan covers all NHCEs and only 50% of HCEs, the coverage ratio is 200% – which is a good result. If a plan covers all HCEs and only half of NHCEs, the coverage ratio is 50% – which is bad. A rate group is composed of an HCE and all the HCEs and NHCEs who have benefit accrual rates equal to or greater than that HCE. If the coverage ratio for that rate group is 70% or more, the group passes the test. The rate group can also pass with a ratio that is less than 70% but only if the overall average benefits under the plan pass a 70% test and certain other criteria are met.

formulas and each rate group is held to the 70% ratio standard. On the other hand, if the formula is 10% of pay plus an additional 10% of pay in excess of $100,000 for everyone to a maximum of $20,000, the formula presumably meets the test even though all the NHCEs earn less than $100,000.

Plan sponsors who had provided some executive benefits within qualified plans with individualized lists of supplemental benefits (QSERPs) or that otherwise defined each HCE as a member of his or her own "group" under the plan formula may need to make adjustments if the rules are finalized as proposed.

New Cross-Testing Options for All DB/DC Plans

Employers with DB plans and DC plans that provide nonelective contributions can combine those plans to assess whether the benefits and allocations are nondiscriminatory on a DB basis, assuming one of the threshold tests can be met. Conversions of DC allocations to a DB basis are made using a standard interest rate of between 7½ and 8½%. Many years of deferral at these rates produces high DB accrual rates for young DC NHCE participants, thus favorable testing results. The proposed change to the DB/DC cross-testing regulation would allow DB testing without the bother and cost of meeting the threshold tests in the current regulation, as long as the numbers are crunched using a 6% interest rate.

> **Comment.** Plans that met the gateway by providing NHCEs a 7½% aggregate normal allocation rate may have had very favorable test results that could easily survive being tested at the lower interest rate. However, if the design of the plan is changed to reduce contributions or benefits once the 7½% gateway requirement no longer applies, passage at any interest rate could become out of reach. Sponsors who are considering reducing the rate of future benefit accruals or contributions if this option does become available in final regulations will need to consider this interplay.

As in the current regulation, plans can also use the average equivalent benefit accrual rate under the DB plan to satisfy the minimum allocation gateway for NHCEs under the DC plan. The proposed changes would make it easier to satisfy the DB/DC gateway contribution requirement by generally allowing the use of average allocation rates for NHCEs in the employer's DC plan and allowing up to 3% of compensation in matching contributions to be counted towards the gateway. Currently, matching contributions are not considered at all.

The proposal would, however, limit both the DB and DC averaging options by capping individual NHCE rates at 15% (or 25% if older or longer-service employees have higher equivalent allocation rates due to a function of age or service in the plan design) to prevent outliers from skewing the testing results.

> **Comment.** Although the proposal would allow certain matching contributions to count toward the DB/DC testing gateway, that doesn't mean those matching contributions find their way into actual testing of the DB/DC arrangement (other than the average benefits percentage test as is the case currently). Instead, they would continue to be assessed under the usual tests for matching contributions (e.g., the ACP test).

The proposed relief can make it easier to obtain permission to cross test, but it does not change the actual test.

Changes Aimed at Closed Plans and Formulas

The proposed rules include several changes that are aimed at allowing plans closed to new participants, and plans that have modified their formulas such as from a traditional pension formula to a hybrid formula, to meet participant

expectations. The proposals would somewhat relax tests used to show benefits, rights and features (BRFs) are nondiscriminatory and would add some adjustments for transition benefits in evaluating threshold tests for access to cross-testing on a benefits basis.

> **Comment.** Absent from the proposals is relief from the minimum participation rule that requires meaningful coverage of no fewer than 50 employees (or 40% of employees, if less). It remains to be seen whether additional guidance will provide options for addressing this issue short of having to fully freeze accruals for the last handful of participants.

Benefits, Rights and Features

In addition to showing that benefit accruals and allocations under a plan are nondiscriminatory, each BRF must pass nondiscrimination tests as well. This includes the rate of matching contributions in a DC plan as well as early retirement and option factors in a DB plan.

Current exceptions in existing regulations address situations where BRFs are eliminated for future accruals and where ongoing accruals are frozen. For a closed DB plan, typically the early retirement and option factors are retained for ongoing accruals of the closed population. Over time, it becomes difficult to show that the remaining eligible population represents a nondiscriminatory classification of employees and the existing exceptions are of no use.

Other employers who attempt to soften the blow of cutting back future DB accruals have provided enhanced matching contribution opportunities in their DC plans. There are no current exceptions to help these employers once the protected closed group falls short on meeting the nondiscriminatory classification test.

The proposed regulation would provide that such provisions for a grandfathered group would be treated as satisfying the nondiscriminatory classification tests *beginning five years after the closure date* if certain conditions are met. The BRF needs to have been in effect for at least five years prior to the closure, not be amended from that date through the end of the plan year the special rule is being used (with limited exceptions), and for a DB plan, apply to a plan that undergoes a significant change in the type of benefit formula under the plan (such as from a traditional formula to a cash balance formula). Similar rules apply to a DC plan, with the excepted BRF being available to a grandfathered group from the DB plan.

> **Comment.** As noted above for matching contributions in the DB/DC test, although the proposal would allow this BRF exception for matching contributions, that doesn't mean those matching contributions would escape the ACP test. Indeed, if the exception is needed — meaning the group getting enhanced matching contributions is weighted in favor of HCEs — the additional matching contributions may cause an ACP test failure.

For plans that are not able to show satisfaction of the nondiscriminatory classification test for the full five year period after the closure, options to consider may include fully freezing DB accruals, modifying BRFs such as matching contributions to increase coverage of NHCEs, or reducing coverage of HCEs where doing so is not prohibited under the anti-cutback rules.

Relief for DB/DC Cross-Tests

To use the DB/DC cross-testing rules (see previous section), plans are required to pass one of the threshold tests described above in the Background. In addition to the rule for applying matching contributions toward the

contribution gateway and the ability to test using a 6% interest rate as an alternative threshold, the proposed regulation would add another threshold test for closed plans that, like the BRF rules, would not be available until five years after the closure date. To be eligible to use this rule, during the five-year waiting period, the plan would need to do one of the following:

- Pass on a benefits basis without aggregation with a DC plan
- Aggregate with a DC plan and test on the basis of contributions
- Aggregate and satisfy the "primarily DB in character" or the "broadly available separate plans" criteria

  Comment. Passing during the waiting period by providing the 7½% gateway is not one of the options. Presumably, the IRS is loath to allow retrenchment in the level of benefits provided after the five-year waiting period expires if the plan had to meet the contribution gateway in the intervening period.

As with the option proposed for BRF testing, certain limited amendments would be permitted without losing access to this option.

Relief for DC Plans

For employers who opt to fully freeze DB accruals, but seek to provide some form of replacement benefits in DC form, it is often easier to show that allocations are nondiscriminatory using cross-testing. As with DB/DC cross-testing, there are some threshold tests for gaining access to this option. In the DC-only model, the three tests include:

- Broadly available allocation rates, disregarding certain DB replacement allocations
- Gradual age or service schedule allocations
- A minimum allocation gateway, which is set at 5% of compensation as a safe harbor

The proposed regulation would somewhat modify rules for DB replacement allocations. The key change is the group receiving DB replacement allocations need only pass the nondiscriminatory classification test for five years after the closing of the DB plan to be able to ignore the replacement allocations in assessing compliance with the broadly available allocation rates threshold. Under the proposed changes, the exception for replacement allocations would be available to plans that meet certain closed plan rules limiting amendments before and after closure, that met coverage and nondiscrimination for the year preceding closure without using the merger and acquisition transition rule or aggregating with another plan, and that would have generated equivalent normal allocation rates that grew with increasing age *or* service.

The proposed regulation would also allow DB replacement allocations to be ignored when using the gradual age or service allocation option. The options of counting matching contributions toward the contribution gateway and the ability to test using a 6% interest rate as an alternative threshold are not available for cross-testing that only involves DC plans.

> **Comment.** Passing a threshold only means that the plan is permitted to cross-test. It does not remove the need to do the test.

Effective Dates and Comments

It is proposed that the revised rules will become applicable to plan years beginning after the publication of the final rule. However, employers may use some of the rules for plan years beginning on or after January 1, 2014. These include the BRF and cross-testing exceptions — other than the 6% interest option and the use of average contributions to meet the 7½% DB/DC gateway.

IRS invites comments on the proposed regulations that are timely submitted by April 28, 2016.

In Closing

Although the changes adding a reasonable classification requirement for formulas is sure to draw criticism, some employers of closed, soft-frozen, plans may find the proposals provide welcome relief. With a number of the options available for use right away, plan sponsors may wish to evaluate their own situation and become aware of what they can and cannot do to make sure not to inadvertently make changes that preclude ongoing access.

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