



## IRS proposes new nondiscrimination rules

The Internal Revenue Code (IRC) generally provides that a plan is qualified only if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees. A plan is permitted to demonstrate that either the contributions or the benefits provided under the plan are nondiscriminatory in amount, regardless of whether the plan is a defined benefit plan or defined contribution plan. In addition, for purposes of nondiscrimination testing, a defined benefit plan and defined contribution plan are permitted to be aggregated and treated as a single plan, which is referred to as a DB/DC plan.

On January 29, 2016, the IRS published proposed rules to provide additional nondiscrimination testing relief to both closed plans and ongoing plans that provide grandfathered benefits to closed groups of employees. The intent of these rules is to enable plan designs to continue to meet nondiscrimination requirements, even though the covered populations may become more discriminatory over time. In general, the greatest impact will be on closed defined benefit plans and defined benefit plans that have converted from a traditional plan design to a cash balance plan design.

After the publication of the proposed rules, the IRS responded to comments from plan sponsors and trade associations by publishing Announcement 2016-16, which withdrew certain provisions contained in the proposed rules.

The following discussion focuses on the aspects of the regulations that may be helpful for closed defined benefit plans and plans containing grandfathered benefits.

### Definitions

To understand the significance of these rules, it is necessary to understand the underlying concepts, including some special terminology.

A plan is a “frozen plan” or “closed plan” when either:

- No new participants are allowed into the plan and existing participants stop earning or accruing benefits as of a specified date (this is typically referred to as a “hard freeze”); or
- No new participants are allowed into the plan but existing participants continue to earn or accrue benefits or receive contributions based on their ongoing compensation and often take into account their additional years of service (this is typically referred to as a “soft freeze” or a “closed plan.”)

Participants who continue to earn or accrue benefits or receive contributions under a closed plan are typically referred to as “grandfathered employees”. The benefit or contribution formula that applies to grandfathered employees is referred to as a “grandfathered benefit” or “closed formula”. Benefits, rights or features that are available only to grandfathered employees are also considered to be grandfathered benefits.

An ongoing plan may also contain a closed group of employees who are eligible to receive specified benefits that other participants are not eligible to receive. This could be the result of a plan merger or a plan design change (for example, a change from a traditional defined benefit plan design to a cash balance plan design). These would be considered grandfathered benefits.

## Basic nondiscrimination testing rules

Both defined benefit (DB) plans and defined contribution (DC) plans must satisfy nondiscrimination rules. In general each plan must stand on its own for nondiscrimination testing. However, special rules require certain employee groups to be disaggregated for testing and tested separately. Other rules allow separate plans to be aggregated and tested together as one plan.

The “nondiscrimination in amounts” rules are designed to ensure that the plan does not provide benefits or contributions to highly compensated employees (HCEs) that are disproportionate to benefits or contributions provided to nonhighly compensated employees (NHCEs). In general, DB plans are tested for nondiscrimination in amounts with respect to benefits provided and DC plans are tested with respect to contributions provided. The regulations specify certain plan formula designs that are deemed to comply with these rules and do not require actual testing.

The Internal Revenue Code and related regulations also permit cross-testing. “Cross-testing” allows benefits to be converted to contributions or contributions to be converted to benefits for testing purposes. When a DB plan is combined with a DC plan to prove nondiscrimination, cross-testing must be used.

The “nondiscrimination availability” rules are designed to ensure that benefits, rights and features (BRFs) offered under a plan are not offered in a manner that discriminates in favor of HCEs. BRFs include different forms of distribution (e.g., lump sum payments, annuities, installments), certain types of disability benefits, investment options, and rates of matching contributions under DC plans. When plans are aggregated for purposes of nondiscrimination testing, they must also be aggregated for nondiscriminatory availability testing.

## Closed plan testing issues

The IRS considers closed plans to be ongoing plans that must continue to satisfy the nondiscrimination in amount and nondiscriminatory availability rules. Grandfathered benefits in ongoing plans must also continue to meet all nondiscrimination rules.

While closed plans typically satisfy the nondiscrimination requirements at the time they are closed, closed plans suffer most from demographic changes that occur over time. For example, many employees in the closed plan who are originally NHCEs may become HCEs due to seniority and promotions that increase their compensation. In addition, newly hired employees who tend to be NHCEs do not participate in the closed plan and NHCEs have higher rates of turnover than HCEs. To maintain compliance with the nondiscrimination rules, plan sponsors could find that they have to provide increased benefits to NHCEs who are not part of the grandfathered group, which would defeat the purpose of closing the original plan or group to limit increased plan liabilities and related expenses.

Since late 2013, sponsors of closed DB plans have been able to satisfy the nondiscrimination requirement under special temporary rules that allow them to combine the closed plan with an ongoing DC plan, and test the aggregated plan on a cross-tested benefits basis. However, in order to use the special rules, the closure amendment to the DB plan had to be in effect by December 13, 2013. As a result, the special rules did not provide relief to those plans that were closed after that date or plans that simply grandfathered specified benefits under an ongoing plan.

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## Explanation of proposed rules

### Changes to cross-testing rules

The proposed rules modify the cross-testing rules applicable to defined benefit replacement ratios (DBRAs), which allow certain defined contribution plan allocations to be disregarded when determining whether a defined contribution plan has broadly available allocation rates. The rules applicable to DBRAs allow employers to provide, in a nondiscriminatory manner, certain allocations to replace defined benefit plan retirement benefits without having to satisfy the minimum allocation gateway. The changes are intended to allow more allocations under the DBRA rules, as long as the allocations are provided in a consistent manner to all similarly situated employees.

The proposed rules expand the list of permitted amendments to a closed plan that do not prevent allocations under a plan from being DBRAs. For example, the proposed rules permit an amendment to a closed plan during the 5-year period before it was closed, provided the amendment does not:

- Increase the accrued benefit or future accruals for any employee;
- Expand coverage; and
- Reduce the ratio-percentage under any applicable nondiscrimination test.

In addition, under the proposed rules, an amendment during this period could extend coverage to an acquired group of employees on condition that all similarly situated employees within that group are treated in a consistent manner.

### Guidance for closed defined benefit plans

The first new testing option offers a permanent exception to nondiscriminatory availability testing for any type of closed DB plan. This exception first becomes available five years after the closure date. It is available only if:

- There was a significant change in the plan's benefit formula in connection with the closure (for example, a change from a traditional DB plan formula to a cash balance plan formula);
- The affected BRF met the current availability requirement for the first five plan years beginning after the closure date; and
- The affected BRF was in place and generally was not amended for five years before the closure date.

This exception only applies to the nondiscriminatory availability requirement and does not apply to the nondiscrimination in amounts requirement.

If a closed DB plan must be aggregated with a DC plan to satisfy the nondiscrimination requirements, the aggregated plans must satisfy one of the following eligibility requirements in order to demonstrate compliance on the basis of equivalent benefits:

- The benefits must be primarily defined benefit in character;
- The plans consist of broadly available separate plans; or
- A minimum "aggregate allocation gateway" is satisfied.

The proposed rules provide a new exception to the gateway allocation requirement if:

- The closed plan was in effect for at least five years ending on the closure date;
- Neither the benefit formula nor plan coverage was significantly changed by an amendment made within the five years ending on the closure; and
- One of the three specific nondiscrimination in amounts options was met in each of the first five plan years following the closure date. These three options are:
  - Each DB plan must satisfy the requirements without being aggregated with a DC plan;

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- The DB/DC plan must satisfy the requirements on the basis of contributions (not equivalent benefits); or
- The DB/DC plan must satisfy the primarily DB in character requirement or the broadly available separate plans requirement.

If a combined plan does not qualify for an exception to the gateway allocation requirement, the proposed rules offer two new options for lowering the gateway allocation amount:

- If the DC plan that is aggregated with the closed DB plan includes matching contributions, the employer may use an average of matching contributions actually made to all NHCEs, up to 3% of compensation, towards satisfying the gateway requirement. For example, if the gateway allocation is 7%, and the average NHCE matching contribution amount is 3%, the employer would only have to make a gateway allocation contribution of 4%.
- The second option allows the employer to satisfy the gateway allocation requirement based on an average of the allocations provided to NHCEs. As a result, the longer-service NHCEs may receive more than the minimum required allocation and shorter-service NHCEs may receive less.

There is also a new exception to providing the gateway allocation for plans that satisfy the nondiscrimination requirements using an interest rate of 6.0%, instead of the current 7.5% to 8.5%.

However, the proposed rules do not provide relief from the minimum participation rules for frozen or closed defined benefit plans. Frozen or closed defined benefit plans must continue to satisfy the minimum participation rules, which require that that a plan must benefit at least the lesser of:

- 50 employees; or
- The greater of 40 percent of all employees, or two employees (unless there is only one employee, then such employee).

## Effective date

These regulations are only proposed. Plan sponsors are not required to comply with these rules. They are proposed to be effective for plan years beginning on or after the date the final regulations are published.

However, plan sponsors may choose to apply the rules relating to closed plans and grandfathered benefits to plan years beginning on and after January 1, 2014. If they do so, the IRS has indicated that any changes made by the final regulations would apply prospectively.

## Next steps

Plan sponsors should carefully read the information contained in this newsletter. Sponsors that maintain closed or frozen plans should discuss the impact of this guidance on their plans with their enrolled actuary and their plan counsel.

Since these regulations are only proposed and comments have been requested, plan sponsors can expect to see changes when final regulations are eventually published. It remains to be seen if plan sponsors will eventually see a general exemption from nondiscrimination testing for frozen plans.

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