

IRS Proposes Testing Changes

Proposed Changes for DB & DC Plans

The IRS has proposed nondiscrimination testing changes that would impact some defined benefit (DB) and defined contribution (DC) plans. Since these rules are in proposed form, they generally would not become effective until after publication of the final regulations.

Background

Over the past decade, many plan sponsors have decided to close their defined benefit plans to new entrants, which is referred to as a “soft freeze”, as compared to a “hard freeze” where accrued benefits are frozen for all participants. Under a soft freeze, current participants and beneficiaries are grandfathered into the defined benefit plan, and a defined contribution plan is typically offered for new hires. Over time, as grandfathered employees gain seniority and become more highly compensated than newer employees, the defined benefit plan may fail to satisfy the nondiscrimination tests of the Internal Revenue Code, which requires that a qualified plan does not discriminate in favor of highly-compensated employees (HCEs) in providing contributions and benefits. The proposed changes provide testing relief for frozen plans.

In addition, the proposed changes may allow some sponsors who rely on testing their DB and DC plans together to lower DC plan contributions to non-highly compensated employees (NHCEs). Lastly, while current regulations allow providing higher benefits to HCEs if certain nondiscrimination tests are met, the proposed changes may limit this ability in some circumstances.

Testing Relief for Closed Defined Benefit Plans

If a DB plan, closed to new entrants, passes certain tests for the first five years subsequent to closure and no changes have been made to the plan (i.e. amendments), the nondiscrimination testing rules after the fifth year are relaxed, which means it will be easier to demonstrate that the plan is nondiscriminatory.

For DB plans that are completely frozen and provide “defined benefit replacement allocations” (DBRAs) for affected participants through a DC plan, the proposal gives more flexibility in allowing allocations to fit within the existing DBRA rules, subject to a requirement that the allocations be provided in a consistent manner to all similarly situated employees.

Relief for Defined Benefit/Defined Contribution “Cross Testing”

Some employers that sponsor DB and non-elective DC plans rely on aggregating their plans in order to pass the nondiscrimination tests, which is referred to as “cross testing”. This can allow DB plans, including cash balance plans, to provide higher benefits to some HCEs. This type of arrangement has become popular with small professional service organizations. The proposed regulations may ease the nondiscrimination testing rules for some DB/DC cross-tested plans, depending on the DB plan design and demographics. This may provide an opportunity to lower non-elective DC contributions to NHCEs.

Employee Classification based on Reasonable Business Purpose

The proposal addresses special benefit formulas for individual employees or employee groups that are not based on reasonable business purposes. The proposed regulation adds a reasonable business class requirement which necessitates that a class be based on objective business criteria for identifying those who benefit under a particular benefit structure. If the classification requirement is not satisfied, the nondiscrimination testing rules become more stringent, which means it may be more difficult to pass the tests.

Plan Sponsors with qualified supplemental executive retirement plan arrangements, known as QSERPs, or those with individual HCE members defined as a “group” under the plan formula, may need to make adjustments if the proposal is finalized.

Next Steps

It is likely that the regulations will be finalized sometime during 2016. Some of these proposed changes could be retroactive to 2014, while others would be prospective only. Employers who sponsor DB plans, whether ongoing, closed to new entrants, or totally frozen, and who must rely on nondiscrimination testing, should review the impact these changes may have on their plans and begin to consider whether plan design changes would be either desired or necessary.

The 90-day comment period for the proposed rulemaking, entitled “Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan Nondiscrimination Requirements”, concludes on April 28, 2016 and will be followed by a public hearing on May 19, 2016. Please refer to the [Federal Register Vol. 81, No. 19](#) for instructions to submit a comment.