

Temporary Nondiscrimination Relief for Closed Defined Benefit Plans and Request for Comments

I. PURPOSE

This notice provides temporary nondiscrimination relief for certain “closed” defined benefit pension plans (i.e., defined benefit plans that provide ongoing accruals but that have been amended to limit those accruals to some or all of the employees who participated in the plan on a specified date). Closing a defined benefit (DB) plan often occurs in conjunction with an amendment that provides new or greater contributions under a defined contribution (DC) plan intended to replace accruals under the DB plan for new hires or other employees to whom the DB plan is closed.

This notice permits certain employers that sponsor a closed DB plan and a DC plan to demonstrate that the aggregated plans comply with the nondiscrimination requirements of § 401(a)(4) on the basis of equivalent benefits, even if the aggregated plans do not satisfy the current conditions for testing on that basis. In addition, this notice requests comments on possible permanent changes to the nondiscrimination rules under § 401(a)(4).

II. BACKGROUND

A. Law and Regulations

Section 410(b) provides in general that a plan is a qualified plan only if the classification of employees who benefit under the plan does not discriminate in favor of highly compensated employees (HCEs). Section 410(b)(6)(B) provides that two or more plans can be aggregated for purposes of satisfying § 410(b), but only if those plans are also aggregated for purposes of § 401(a)(4).

Section 401(a)(4) provides in general that a plan is a qualified plan only if the contributions or the benefits provided under the plan do not discriminate in favor of HCEs. Compliance with § 401(a)(4) can generally be demonstrated on the basis of either contributions or benefits (including equivalent benefits). Section 1.401(a)(4)-9(b) of the Treasury regulations contains special rules that apply for purposes of determining whether an aggregation of plans that includes one or more DB plans and one or more DC plans (referred to as a DB/DC plan) satisfies the requirements of § 401(a)(4). See § 1.401(a)(4)-9(a). A DB/DC plan can demonstrate compliance with § 401(a)(4) on the basis of equivalent benefits only if the DB/DC plan satisfies one of three alternative conditions, specifically that it

- be primarily defined benefit in character,
- consist of broadly available separate plans, or

- meet the minimum aggregate allocation gateway.

See § 1.401(a)(4)-9(b)(2)(v).

A DB/DC plan is primarily defined benefit in character within the meaning of § 1.401(a)(4)-9(b)(2)(v)(B) “if, for more than 50% of the non-highly compensated employees (NHCEs) benefitting under the plan, the normal accrual rate for the NHCE attributable to benefits provided under DB plans that are part of the DB/DC plan exceeds the equivalent accrual rate for the NHCE attributable to contributions under DC plans that are part of the DB/DC plan.”

A DB/DC plan consists of broadly available separate plans within the meaning of § 1.401(a)(4)-9(b)(2)(v)(C) if the DC plan and the DB plan that are part of the DB/DC plan each would satisfy the requirements of § 410(b) and the nondiscrimination in amount requirement of § 1.401(a)(4)-1(b)(2) if each plan were tested separately (assuming that the average benefit percentage test of § 1.410(b)-5 were satisfied).

The minimum aggregate allocation gateway under § 1.401(a)(4)-9(b)(2)(v)(D) requires that each NHCE in the DB/DC plan have a minimum aggregate normal allocation rate that is a function of the aggregate normal allocation rate of the HCE in the aggregated plans who has the highest aggregate normal allocation rate. If this highest aggregate normal allocation rate is less than 15%, the minimum aggregate normal allocation rate is one third of the highest rate. If the highest aggregate normal allocation rate for any HCE is greater than 15% but not greater than 25%, the minimum aggregate normal allocation rate is equal to 5%. If the highest aggregate normal allocation rate for any HCE is greater than 25%, the minimum aggregate normal allocation rate increases on a sliding scale up to 7.5% (which applies if the highest aggregate normal allocation rate exceeds 35%).

B. Closed Defined Benefit Plans

A number of DB plans have been closed to new entrants. The plan sponsor of a closed DB plan typically provides a DC plan for its new hires. Under these arrangements, in the early years after the DB plan has been closed to new entrants, the plan may be able to satisfy the coverage requirement of § 410(b) without being aggregated with the DC plan. However, the § 410(b) minimum coverage test typically becomes more difficult for the closed DB plan to satisfy over time, as the proportion of plan participants who are HCEs increases. This might occur for several reasons, including the tendency of NHCEs to have higher rates of turnover than HCEs, as well as the potential for some of the NHCEs in the closed plan to become HCEs as they continue employment and their pay increases.

If the closed DB plan cannot satisfy the coverage requirement of § 410(b) on its own, it will need to be aggregated with another plan in order to satisfy that coverage requirement. If the DB plan is aggregated with a DC plan that covers the employer’s

new hires to satisfy the coverage requirement, then it is also required to be aggregated with the DC plan for purposes of satisfying the nondiscrimination requirements of § 401(a)(4). In the typical case, the aggregated plans will fail the requirements of § 401(a)(4) unless they are permitted to demonstrate compliance with the nondiscrimination requirements on the basis of equivalent benefits. The aggregated plans usually will be permitted to demonstrate nondiscrimination on the basis of equivalent benefits in the initial years of aggregation, because the aggregated plans will either be primarily defined benefit in character or consist of broadly available separate plans. However, the same demographic forces that drive the increase in the proportion of HCEs in the closed plan might also over time lead to the aggregated plans being neither primarily defined benefit in character nor consisting of broadly available separate plans. When this occurs, the aggregated plans will be permitted to demonstrate nondiscrimination on the basis of equivalent benefits only if the plans satisfy the minimum aggregate allocation gateway.

In many cases, the DC plan provides sufficient allocations to enable the DB/DC plan to satisfy the nondiscrimination requirements on the basis of equivalent benefits if the DB/DC plan were permitted to demonstrate satisfaction of the nondiscrimination requirements on that basis. However, the DC plan may not provide for allocations that satisfy the minimum aggregate allocation gateway. If the DB/DC plan does not meet any of the three alternative conditions for testing on the basis of equivalent benefits, then the DB/DC plan is not permitted to demonstrate satisfaction of the nondiscrimination requirements on that basis. As a result, the aggregated plans will fail to satisfy § 401(a)(4) unless one or both of the plans are changed. In circumstances such as these, a plan sponsor generally has three choices: (1) reduce the proportion of HCEs in the closed DB plan (by either opening it to some new NHCEs or by stopping participation by some HCEs); (2) reconfigure the contributions under the DC plan so that it meets the minimum aggregate allocation gateway; or (3) cease accruals in the DB plan entirely.

Some plan sponsors have chosen to reduce the proportion of HCEs by stopping participation in the DB plan for some of the HCEs; however, this approach might not be consistent with a plan sponsor's goal of preserving the retirement expectations of some or all of the current participants in the DB plan while covering others, such as new hires, in a DC plan. A number of plan sponsors are making substantial contributions to a DC plan, but those contributions are not always structured as nonelective contributions at a level that is sufficient to meet the minimum aggregate allocation gateway. For example, a portion of the contributions under the DC plan for new hires might be matching contributions that are not taken into account under the minimum aggregate allocation gateway. Some plan sponsors have indicated that they are sufficiently committed to the specific design of their DC plan that they are considering ceasing accruals in the DB plan rather than restructuring the DC plan.

The nondiscrimination regulations under § 401(a)(4) provide that the Commissioner may, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, provide any additional guidance that may be necessary or

appropriate in applying the nondiscrimination requirements of § 401(a)(4), including additional safe harbors and alternative methods and procedures for satisfying those requirements. See § 1.401(a)(4)-1(d).

III. TEMPORARY PERMISSION TO TEST A CLOSED DB PLAN THAT IS AGGREGATED WITH A DC PLAN ON THE BASIS OF EQUIVALENT BENEFITS

A. Consideration of Requested Relief for Closed DB Plans

The Treasury Department and the IRS have received a number of requests that the nondiscrimination regulations under § 401(a)(4) be amended to provide additional alternative means of satisfying the nondiscrimination requirements in the case of a closed DB plan. Some have suggested that if a closed DB plan that is aggregated with a DC plan was eligible to demonstrate satisfaction of the nondiscrimination requirements on the basis of benefits (or equivalent benefits) at the time the plan was closed (or at a later time), then the aggregated plans should be permanently eligible, without further conditions, to be tested for nondiscrimination on that basis.

This suggestion raises a number of considerations and potential concerns. For example, it would apply a lower nondiscrimination standard with respect to closed DB plans than with respect to other DB plans that must be aggregated with DC plans to satisfy the requirements of § 410(b) as a result of changes in the composition of the employer's workforce (such as the acquisition of another entity with a significant number of NHCEs). Such a lower standard could provide an incentive for such an employer to close its DB plan. In addition, this approach would require the development of anti-abuse provisions to ensure that the closing of the DB plan was not motivated by the availability of the lower standard and that the new rule was not used inappropriately to increase benefits for HCEs or to reduce benefits for NHCEs.

The Treasury Department and the IRS believe that it is appropriate to consider modifying the nondiscrimination requirements under § 401(a)(4), while taking into account these considerations and potential concerns. This consideration and potential modification will be undertaken through the regulatory process in order to provide the opportunity for public comment on any proposed changes. Section III.B of this notice provides temporary relief to permit certain closed DB plans to continue accruals while possible regulatory changes to the nondiscrimination rules are being considered.

B. Temporary Eligibility Rule for Testing Certain DB/DC Plans on the Basis of Equivalent Benefits

Pursuant to the Commissioner's authority under § 1.401(a)(4)-1(d) to provide alternative methods for satisfying the nondiscrimination requirements, this section III.B provides a temporary additional eligibility criterion that permits a DB/DC plan to demonstrate satisfaction of the nondiscrimination in amount requirement of § 1.401(a)(4)-1(b)(2) on the basis of equivalent benefits even if the DB/DC plan does not meet any of the existing eligibility conditions for testing on that basis under

§ 1.401(a)(4)-9(b)(2)(v). Under this alternative, the DB/DC plan may nonetheless make that demonstration on the basis of equivalent benefits for a plan year that begins before January 1, 2016, if it includes a DB plan providing ongoing accruals that was amended, by an amendment adopted before December 13, 2013, to provide that only employees who participated in the DB plan on a specified date continue to accrue benefits under the plan, and if each of the DB plans in the DB/DC plan satisfies one of the following conditions:

1. 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 (within the meaning of § 1.401(a)(4)-9(b)(2)(v)(B)) or consisted of broadly available separate plans (within the meaning of § 1.401(a)(4)-9(b)(2)(v)(C)), or

2. In the case of a DB plan that was amended, by an amendment adopted before December 13, 2013, to provide that only employees who participated in the DB plan on a specified date continue to accrue benefits under the plan, 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.

During the period for which this temporary relief applies, the remaining provisions of the nondiscrimination regulations under § 401(a)(4) (including the rules relating to the timing of plan amendments under § 1.401(a)(4)-5) continue to apply. Thus, for example, a plan amendment made to add accruals to the closed DB plan during this temporary period must not discriminate significantly in favor of HCEs.

IV. Request for Comments

A. Comments Regarding the Ability of a DB/DC Plan to Satisfy Nondiscrimination Requirements on a Benefits Basis

The Treasury Department and the IRS are considering whether the regulations under § 401(a)(4) should be amended to provide additional alternatives that would allow a DB/DC plan to demonstrate satisfaction of the nondiscrimination in amount requirement of § 1.401(a)(4)-1(b)(2) on the basis of equivalent benefits. This section IV.A describes possible alternatives that would allow for such combined testing on the basis of equivalent benefits. Comments are requested on whether or not any of these additional alternatives should be made available, and whether there are any other alternatives that should be considered.

1. Alternative for DC plans with age- and/or service-graded contribution rates

Under this alternative, current rules that permit averaging of equivalent allocation rates for NHCEs in a DB plan could be extended to apply to NHCEs in an aggregated DC plan. For example, this alternative might allow a plan with an age- and/or service-

graded contribution rate that starts at 3% for newer or younger employees with higher rates for older or longer-service employees to satisfy the minimum aggregate allocation gateway if a sufficient number of NHCEs are actually receiving allocations at those higher rates.

2. Alternative for DC plans with combination of nonelective and matching contributions

Under this alternative, a portion of the minimum aggregate allocation gateway could be satisfied based on the average matching contribution rate for all NHCEs under the DC plan. For example, if under a DC plan the minimum aggregate allocation rate must be 6% in order to satisfy the minimum aggregate allocation gateway and the plan sponsor provides matching contributions to NHCEs that result in an average contribution of 2% of compensation, this alternative might allow the plan to satisfy this gateway by providing to each NHCE a nonelective contribution of 4% of compensation.

3. Alternative for DC plans that could satisfy nondiscrimination using a lower interest rate

Under this alternative, a DB/DC plan would be eligible for testing on the basis of equivalent benefits (without the need to satisfy the minimum aggregate allocation gateway or an alternative condition for eligibility) if the DB/DC plan could demonstrate satisfaction of the nondiscrimination in amount requirement of §1.401(a)(4)-1(b)(2) on the basis of equivalent benefits using an interest rate specified in the regulations that would be lower than the current standard interest rate for normalizing benefits of 7.5% to 8.5%.

4. Safety valve alternative under which plans can request permission to disregard outliers

Under this alternative, a DB/DC plan that does not satisfy the minimum aggregate allocation gateway because the aggregate normal allocation rate of the HCE with the highest rate is unusually large would be permitted to disregard that HCE under rules similar to the rules that permit the disregard of certain violations under § 1.401(a)(4)-3(c)(3). Under those rules, an employer can request that the Commissioner disregard the violation if the plan would satisfy the nondiscrimination rules by disregarding up to 5% of the plan's HCEs.

B. Other Possible Related Modifications to Other Nondiscrimination Requirements

The Treasury Department and the IRS are also considering whether other changes to the regulations under §§ 401(a)(4) and 401(a)(26) are appropriate to facilitate the continuation of accruals under the existing formulas of some or all employees in a DB plan when that plan is later amended. In many cases, employers would like to preserve retirement expectations of existing participants while offering a

new formula under a DC plan for new hires. This section IV.B describes two possible modifications to other nondiscrimination requirements that may be affected by such an arrangement. Comments are requested on whether or not either of the following possible modifications should be made available (and, if so, what conditions (if any) should apply) and whether there are any other modifications that should be considered.

1. Benefits, rights, and features under DB plans with grandfathered formulas

Under this proposed modification, if a DB plan has two or more benefit formulas, one or more of which are applicable to a closed group of participants, and one or more other formulas that are applicable to other participants, the benefits, rights, and features that apply only to the formula or formulas for the closed group would not prevent the plan from complying with the requirements of § 1.401(a)(4)-4 if appropriate conditions are satisfied.

2. Treatment of matching contributions

Under this proposed modification, matching contributions would be permitted to be used to enable a DB/DC plan to satisfy not only the minimum aggregate allocation gateway if modified as described in section IV.A.2 of this notice, but also the nondiscrimination in amount test.

C. Due Date and Contact Information

Written or electronic comments must be received by February 28, 2014. Send submissions to CC:PA:LPD:PR Notice 2014-5, Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR Notice 2014-5, Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, comments may be submitted via the Internet at notice.comments@irs.counsel.treas.gov. Please include "Notice 2014-5" in the subject line of any electronic communication. All materials submitted will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Adrien R. LaBombarde of the Employee Plans, Tax Exempt and Government Entities Division. Questions regarding this notice may be sent via e-mail to RetirementPlanQuestions@irs.gov.