



AMERICAN BENEFITS COUNCIL

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SURVEY SHOWS: HUNDREDS OF THOUSANDS OF PARTICIPANTS COULD LOSE BENEFITS IF TESTING ISSUE NOT FIXED

A nondiscrimination testing rule contained in U.S. Treasury Department regulations will effectively compel many defined benefit plans across the country to completely freeze all benefits in the next few years. Based on a national survey, far more than 600,000 participants could lose benefits by reason of this rule.

[Internal Revenue Service \(IRS\) Notice 2014-5](#), issued on December 13, 2013, would address this problem very effectively for 2014 and 2015. However, based on the discussion in the IRS Notice regarding future guidance, it appears likely that the problem will return in 2016. This would cause hundreds of thousands of participants to lose benefits.

We look forward to further constructive discussions with Treasury and the IRS regarding the additional guidance referenced in the IRS Notice. But in light of the critical nature of this issue, we believe that it is also important to work on a legislative solution that would protect participants' benefits more broadly. A comprehensive solution to this issue was contained in Section 406 of the [Retirement Plan Simplification and Enhancement Act of 2013 \(H.R. 2117\)](#), introduced by Representative Richard Neal (D-MA). We urge Congress to move forward with this legislative solution to prevent widespread benefit losses.

BACKGROUND

Many companies across the country feel compelled by economic and regulatory pressures to either freeze or close their defined benefit pension plan. When a plan closes, existing participants (or a subset of existing participants) continue to earn benefits under the plan. New hires, on the other hand, do not earn benefits under the plan. Under a plan freeze, no participants earn any additional benefits under the plan.

For many companies, maintaining an open plan — with all employees earning benefits — has become too expensive and too volatile, so that closing and freezing are the only viable options. Thousands of other companies have already confronted this issue, having already decided to either close or freeze their pension plans.

From a participant's perspective, a plan closing is generally far better than a complete freeze, especially for older, long-service participants. Late-career accruals under a traditional defined benefit plan are very valuable, so losing those accruals can have adverse effects on participants.

LEGAL FRAMEWORK

IRS nondiscrimination testing rules exist to ensure that retirement plans do not favor high-paid employees but rather provide benefits to rank-and-file employees that are comparable to the benefits provided to high-paid employees. Unfortunately, in some contexts, the mechanical nature of the rules creates some very counterintuitive results, which can produce great harm for participants. Plan closings are an acute example of this.

When a plan is closed, some or all of the existing plan participants are "grandfathered" and thus continue to earn benefits. The problem arises because, over time, the group of grandfathered participants becomes disproportionately high-paid. This occurs not because of any action by the employer, but rather for two reasons: (1) turnover is generally more frequent among less well-paid employees, thus depleting the grandfathered group of lower paid employees, and (2) over time, many lower paid employees in the grandfathered group become higher paid.

Because the grandfathered group generally becomes more highly compensated, closed plans almost always end up violating the IRS nondiscrimination testing rules. This "violation" is, however, hyper-technical. If the defined benefit plan can be tested together on a benefits basis with the employer's defined contribution plan (generally, a 401(k) plan), the nondiscrimination tests would be satisfied. But the rules generally prohibit such combined testing when the grandfathered group becomes too disproportionately high paid.

POSSIBLE RESULTS OF TESTING VIOLATION

In general, when a closed plan fails the nondiscrimination tests, employers have four ways to cure the failure, only one of which is realistic in most cases:

- First, the employer could "un-close" the plan by bringing the new hires into the plan. This is very uncommon.

- Second, the employer could remove some older long-service employees from the plan because they are higher paid. This can work for a few years, but it is hard to communicate to affected employees and eventually will not work anymore.
- Third, the employer could provide benefit increases in the defined contribution plan that are generally prohibitively expensive. This rarely occurs.
- Fourth, and by far the most frequently used approach, the employer can freeze the entire plan, so no one earns any new benefits.

SOLUTION

The American Benefits Council has for several years been proposing a very simple solution. If the grandfathered group is a nondiscriminatory group when the plan is first closed (or at a later date), then the plan is permitted to be tested with the employer's defined contribution plan on a benefits basis. This rule would apply indefinitely as long as the employer does not amend the plan in discriminatory ways.

This proposal was included in Section 406 of H.R. 2117, as introduced by Congressman Neal. We urge Congress to move forward with that legislative proposal to prevent hundreds of thousands of participants from losing benefits.

IRS NOTICE 2014-5

The issue technically could be addressed without legislation by simply amending the IRS rules at issue, which are not based on any specific statutory provision. The American Benefits Council has in that regard had several very constructive meetings with Treasury and the IRS. We were very appreciative of Treasury and the IRS adding this issue to their priority guidance plan last year. Pursuant to that priority guidance plan, late last year, the IRS issued Notice 2014-5 addressing this issue, which provides very effective transition relief for 2014 and 2015. The IRS Notice also asks for comments on how to solve the issue for 2016 and later years, and specifically identifies four possible solutions.

The Council worked closely with major consulting firms on a national survey to determine the extent to which any of the four possible solutions identified by the IRS Notice would solve the problem. Here is what we found:

- The survey indicated that far more than 600,000 participants are potentially affected by the nondiscrimination testing issue and the total is

likely in the millions. In other words, if this issue is not resolved in a workable way, far more than 600,000 participants who are currently accruing benefits in a defined benefit plan potentially could have those benefits completely frozen.

- While a small minority of plans would be helped by the possible long-term solutions described in the IRS Notice, we would not expect any of those solutions to prevent hundreds of thousands of participants from losing benefits by reason of the nondiscrimination rules.

The Council's proposal, on the other hand, (1) would prevent substantially all participants from having their benefits frozen by reason of the nondiscrimination rules, and (2) is more restrictive than the approach used in the IRS Notice for the temporary relief. The IRS Notice cites two concerns with respect to the Council's approach:

- In the Notice, Treasury and the IRS expressed concern that the Council's approach could provide an incentive for plans to close. In fact:
 - Current law creates an extremely powerful incentive to freeze completely which is generally much less favorable for participants.
 - Based on information from the consulting firms, the most common debate within companies is whether to freeze or close. It is very uncommon for employers to only consider closing or maintaining an open plan, and not consider freezing. Accordingly, since the discussions within companies are mainly about whether to freeze or close, the IRS should be concerned about the current strong incentives to freeze, not an incentive to close that is largely theoretical.
- The IRS Notice states that the Council's approach would require the development of anti-abuse rules. In fact:
 - The IRS Notice's own temporary relief relies on existing anti-abuse rules.
 - The nondiscrimination rules already contain numerous anti-abuse rules that would prevent abuses.
 - The Council's approach contains a requirement that the grandfathered group be nondiscriminatory when it is formed (or at an even later date), so this eliminates much opportunity for abuse. The small other opportunities for abuse are covered by the existing anti-abuse rules, as demonstrated by the reliance of the IRS Notice on such rules for purposes of the temporary relief.

In short, the IRS Notice suggests that an administrative solution may not be comprehensive enough to fully protect participants. In this context, it is important to address this issue legislatively, while continuing to work with Treasury and the IRS on

broader administrative rules. Thus, we urge Congress to move forward with the proposal set forth in the Neal bill.