

One Minute Memo®



IRS Provides Temporary Nondiscrimination Relief for Certain “Closed” Defined Benefit Plans

By Jon Karelitz

On December 13, 2013, the IRS issued Notice 2014-5, which provides temporary relief from the Internal Revenue Code’s nondiscrimination rules for certain defined benefit pension plans that are “closed” (*i.e.*, frozen) to new participants. Sometimes this approach is referred to as a “soft freeze,” as opposed to a “hard freeze” where the plan is closed to new participants *and* all benefit accruals are frozen.

As a general matter, qualified retirement plans cannot cover a disproportionate number of highly compensated employees (HCEs) (determined through coverage testing), or discriminate in favor of HCEs with respect to the benefits provided. Plans must satisfy annual testing for both of these requirements. Treasury regulations permit two or more plans to be aggregated (*i.e.*, tested as a single plan) for coverage testing purposes if the plans are also aggregated for testing benefits for nondiscrimination. A defined benefit plan may be aggregated with a defined contribution plan, such as a 401(k) plan, and tested on the basis of “equivalent benefits,” if the aggregated plans:

- are primarily defined benefit in character (*i.e.*, for at least half of the non-HCE participants in the aggregated plans, the normal accrual rate under the defined benefit plan exceeds the equivalent normal accrual rate under the defined contribution plan);
- consist of broadly available separate plans; or
- meet a “minimum aggregate allocation gateway” described in the regulations.

The permissive aggregation rules described above can be useful for closed defined benefit plans, since employers will frequently provide “make up” contributions to a defined contribution plan for participants frozen out of the defined benefit plan.

Under the existing regulations, it is difficult to satisfy the nondiscrimination test on an aggregated basis if the defined benefit plan is closed to new participants. This is because the ratio of HCEs to non-HCEs in the closed plan tends to increase over time as employees’ compensation increases and due to the natural attrition of lower-paid employees. As a result, the plan may only be able pass coverage testing if aggregated with the sponsoring company’s defined contribution plan covering new hires. If the plan fails to pass coverage testing on its own, the plan sponsor would have to (i) reopen the closed defined benefit plan to non-HCEs, (ii) freeze defined benefit plan accruals for some or all HCEs, or (iii) reconfigure the defined contribution plan to meet the minimum aggregate allocation gateway in order to permit aggregation. None of these options is consistent with the goal of preserving defined benefit plan accruals for existing participants and covering new employees under the defined contribution plan.

In Notice 2014-5, the IRS recognizes that nondiscrimination testing poses a significant obstacle for defined benefit plans with a soft freeze and, without relief, could lead to a complete or hard freeze of the plan. The Notice provides temporary relief that allows aggregated defined benefit and defined contribution plans to demonstrate compliance with the Code's nondiscrimination rules on the basis of "equivalent benefits," despite not meeting the bulleted requirements above (*i.e.*, being primarily defined benefit in character, consisting of broadly available separate plans, or meeting the minimum allocation gateway). The new Notice 2014-5 relief is available for plan years beginning before January 1, 2016 if the soft freeze happened before December 13, 2013, and the defined benefit plan satisfies one of the following conditions:

- For the 2013 plan year, the defined benefit plan was aggregated with a defined contribution plan for testing purposes and was either (i) defined benefit in character or (ii) consisted of broadly available separate plans – both of which are more likely in the case of a recent soft freeze, as the number of active participants in the frozen defined benefit plan will decrease over time; or
- The defined benefit plan was not aggregated with a defined contribution plan for the 2013 plan year because it independently satisfied the Code's coverage and nondiscrimination requirements.

This temporary relief provides sponsors of closed defined benefit plans with a three-year period to either freeze accruals or implement an alternative retirement plan strategy that satisfies both business objectives and the testing rules.

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Seyfarth Shaw LLP One Minute Memo® | January 27, 2014

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