SECURE Act Testing Relief for Closed/Frozen Defined Benefit Plans

PUBLISHED: January 10, 2020
AUTHORS: Kimberly Boberg, Mark Carolan, Mark Lofgren, Joshua Shapiro

In recent years, many defined benefit ("DB") pension plan sponsors have taken action to limit ongoing coverage and benefit accruals of their DB plans. Over time these plans may have difficulty continuing to satisfy the nondiscrimination or minimum participation requirements applicable to tax-qualified pension plans. Employers that continue to maintain DB plans, as well as their recordkeepers and consultants, may find that the SECURE Act's new rules in this area will provide helpful flexibility.

Below we provide more background on the critical compliance issues facing these plans and explain how the SECURE Act may provide helpful relief. At the end, we lay out some basic next steps to consider in this area for all those who work with DB pension plans.

Background

It is well documented that over time US employers have largely moved towards providing tax-qualified retirement benefits to their employees through 401(k) and other defined contribution ("DC") retirement plans. During this time, many of those employers that already maintained DB pension plans have taken steps, short of plan termination, to limit the ongoing pension benefit accruals either through freezing the benefit formula or by limiting the group of employees who would remain eligible to earn those benefits. Generally, these sponsors either:

- Close the DB Plan: Amend the DB plan to no longer allow any new entrants, but allow the existing participants continue to earn a benefit. This is sometimes called a "soft freeze", and plans that have adopted a "soft freeze" are generally referred to as "closed" plans (they are no longer open to new participants).
- Freeze the DB Plan: Amend the DB plan to no longer provide any new benefit accruals. This is sometimes called a "hard freeze", and plans that have adopted this are generally called "frozen" plans.

A DB plan can also have both frozen and closed subgroups within a larger plan.

Both these plans—closed plans and frozen plans— have had a growing problem with compliance testing. As their participant populations have dwindled or grown older, these plans may have trouble passing the coverage, participation, and/or nondiscrimination testing requirements under the Code. Plans that cannot pass these tests are required to take substantial corrective actions. In some cases, a plan sponsor of a closed plan may decide to prematurely freeze the plan entirely to avoid compliance testing issues.

Taking note of this issue, on December 13, 2013 IRS issued limited relief for closed plans to satisfy the nondiscrimination rules. That relief would only apply for plans that were closed by an amendment adopted before December 13, 2013. This relief has been reissued each succeeding year, currently extending through 2020. In addition, proposed Treasury Regulations have been issued to update these nondiscrimination rules as applicable to closed DB plans. However, while both of these updates provide welcome relief to these closed DB plans, they do not offer a comprehensive solution for closed and frozen plans.

The SECURE Act provides expanded relief from nondiscrimination, minimum coverage, and minimum participation testing, but only in specific circumstances and subject to detailed requirements (described below). Generally, these provisions give new tools for closed and frozen DB plan sponsors to pass these tests (as applicable), thus allowing the plan to continue coverage and benefits for the closed or frozen plan participants. An overview of the specific relief is provided below.

DB Plans: "BRF" Testing Relief

The nondiscrimination rules for qualified plans require that any benefit, right, or feature ("BRF") provided by a plan cannot discriminate in favor of highly compensated employees ("HCEs"). However, when a plan covers a closed group of employees, participants in that group generally receive a BRF that does not extend beyond the closed group. The BRF may pass testing initially, but as the closed group's demographics change over time (i.e., career advancements and attrition), the plan may start to fail BRF testing even though there has not been any substantive change to the plan provisions.

To address this issue, the SECURE Act provides that closed DB plans will be deemed to pass BRF testing if the following requirements are met:

1. 3-Year BRF Testing Post-Closure: The plan must pass BRF nondiscrimination testing during the plan year in which the closure occurs, and the two following plan years.
2. No Subsequent Discriminatory Amendments: After the closure, the plan cannot be amended to significantly favor highly compensated employees by (1) modifying the closed class, or (2) changing the BRFs provided to the closed class.
3. No Increase in Coverage or Value of BRF for Past Five Years (Unless Grandfathered): The DB plan cannot have any substantial increase in the coverage or value of the BRF for the 5-year period preceding the date the class is closed. A "substantial" increase in coverage is generally a more than 50% increase in the number of participants covered from the start of the 5-year

period, compared against the number of participants on the closure date. A substantial increase in value occurs if amendments during the 5-year period causes the value of the BRFs to the closed group as a whole to be "substantially greater" than the value as of the beginning of the 5-year period. However, if the closure occurred before April 5, 2017, these requirements are deemed to be satisfied. For this purpose, the closure occurred before April 5, 2017 if the plan sponsor's intention to create the closed group is reflected in formal written documents *and* communicated to participants before that date.

The relief can apply in a spun-off plan, as long as the plan continues to satisfy the three requirements above following the spinoff. Further, if a plan was amended to eliminate a BRF before the SECURE Act was enacted, and is later amended to restore that BRF to the closed group, it will not violate the requirements for this relief.

DB Plans: Aggregate with a Defined Contribution Plan and Test on a Benefits Basis

When a sponsor offers both DB and DC plans, it can be beneficial to aggregate the plans when performing nondiscrimination testing and coverage testing. Further, the aggregated DB/DC plan may have more favorable testing results if the testing is performed as if the combined plan were a DB plan (i.e. on a "benefits" basis). However, the Treasury Regulations require that the combined plan meet specific requirements to use this approach.

The SECURE Act provides a new alternative for closed DB plans. The new law provides that a closed DB plan may be aggregated with the plan sponsor's DC plan(s) for compliance testing purposes, and the aggregated DB/DC plan may be tested on a benefits basis, if the following requirements are met:

1. DB Plan: Closed Group: The DB plan must provide benefits to a closed class of participants.
2. DB Plan: 3-Year BRF Testing Post-Closure: The plan must pass nondiscrimination testing and coverage testing during the plan year in which the closure occurs, and the two following plan years.
3. DB Plan: No Subsequent Discriminatory Amendments: After the closure, the plan cannot be amended to significantly favor highly compensated employees by either (1) modifying the closed class or (2) changing the benefits provided to the closed class.
4. DB Plan: No Increase in Coverage or Value of Benefits for Past Five Years (Unless Grandfathered): The DB plan cannot have any substantial increase in the coverage, or the value of benefits provided, for the 5-year period preceding the date the class is closed. A "substantial" increase in coverage is generally a more than 50% increase in the number of participants covered from the start of the 5-year period, compared against the number of participants on the closure date. A substantial increase in benefits is generally a 50% increase in the average benefit provided *due to the changes to the plan* (not due to additional accruals). However, if the closure occurred before April 5, 2017, these requirements are deemed to be

satisfied. For this purpose, the closure occurred before April 5, 2017 if the plan sponsor's intention to create the closed group is reflected in formal written documents *and* communicated to participants before that date.

5. DC Plan – Specific Benefits Required: The DC plan must either:
   - Provide matching contributions,
   - Provide annuity contracts described in Code section 403(b) that are funded by either matching contributions or nonelective contributions, or
   - Be an ESOP (or tax-credit ESOP).

If all the above requirements are met, the DB/DC plans can be aggregated and tested on a benefits basis. However, if the DC plan offers matching contributions, it must also be aggregated with any portion of the DC plan which provides elective deferrals (i.e. 401(k) contributions), and the matching contributions must be treated as nonelective contributions for purposes of performing the coverage and nondiscrimination tests.

DC Plans: Expanded Availability to Test on a "Benefits" Basis

As noted earlier, many plans can have more favorable results if they perform nondiscrimination testing on a benefits basis. The current Treasury Regulations require standalone DC plans to meet specific requirements to be tested this way. Many plan sponsors provide additional DC plan benefits when they freeze DB plan benefits, a sweetener that can help make up for the lost future DB accruals. However, these additional DC plan benefits can be limited by the current nondiscrimination rules.

Under the SECURE Act, testing on a benefits basis is available to plan sponsors that have frozen (or limited) DB plan benefits for a group of participants, and provided additional DC plan benefits to those participants. Under these new rules, a DC plan can be tested on a benefits basis if the following requirements are satisfied:

1. DB Replacement Contributions for Closed Class: The DC plan must provide make-whole contributions to a closed class of participants whose accruals under a DB plan have been reduced or eliminated. This can be through matching contributions, nonelective contributions, or a combination of the two. A contribution can be considered "make-whole" as long as it is intended to replace some or all of the frozen DB plan benefit accruals.
2. Pass Classification Test for 3-Year Period After Closure: The DC plan must pass the nondiscriminatory classification test under the Code section 410(b) regulations (*see* Treas. Reg. section 1.410(b)-4) for the plan year of the closure, and the two following plan years.
3. No Subsequent Discriminatory Amendments: After the closure, the DC plan cannot be amended to significantly favor highly compensated employees by (1) modifying the closed class or (2) changing the allocations or BRFs provided to the closed class.
4. No Increase in Coverage or Value of Benefits for Past Five Years (Unless Grandfathered): The DB plan cannot have any substantial increase in the coverage, or the value of benefits provided, for the 5-year period preceding the date the class is closed. A "substantial" increase in coverage

is generally a more than 50% increase in the number of participants covered from the start of the 5-year period, compared against the number of participants on the closure date. A substantial increase in benefits is generally a 50% increase in the average benefit provided *due to the changes to the plan* (not due to additional accruals). However, if the closure occurred before April 5, 2017, these requirements are deemed to be satisfied. For this purpose, the closure occurred before April 5, 2017 if the plan sponsor's intention to create the closed group is reflected in formal written documents *and* communicated to participants before that date.

If the DC and DB plans meet the above requirements, the DC plan can be tested on a benefits basis to satisfy nondiscrimination testing. In addition, such a plan can be aggregated with other DC plans, but those additional DC plans must meet the same requirements as applied for aggregating with a DB plan—(1) provide matching contributions, (2) provide annuity contracts described in Code section 403(b) that are funded by either matching contributions or nonelective contributions, or (3) be an ESOP (or tax-credit ESOP). Finally, this treatment shall apply even after a portion of the plan is spun off, as long as the plan continues to meet the requirements specified above following the spinoff.

Minimum Participation Testing Relief

Generally, a closed DB plan's benefit structure (or prior benefit structure, if the plan is frozen) must provide meaningful benefits to at least the lesser of (1) 50 employees, or (2) 40% of all employees. As a closed or frozen plan's population dwindles, it may no longer satisfy this requirement without substantial remedial actions.

The SECURE Act amends this rule to provide relief for certain frozen plans, or plans with a closed group of participants. Under the new law, the minimum participation testing is deemed to be satisfied if the following are met:

1. Frozen / Closed: The plan must either be amended to (1) cease all benefit accruals, or (2) to provide future benefit accruals only to a closed class of participants.
2. Passed Participation Testing on Close/Freeze Date: The plan must have satisfied the minimum participation test as of the effective date of the closure or benefit freeze date.
3. No Increase in Coverage or Value of Benefits for Past Five Years (Unless Grandfathered): The plan cannot have any substantial increase in the coverage, or the value of benefits provided, for the 5-year period preceding the date the class is closed. A "substantial" increase in coverage is generally a more than 50% increase in the number of participants covered from the start of the 5-year period, compared against the number of participants on the closure date. A substantial increase in benefits is generally a 50% increase in the average benefit provided *due to the changes to the plan* (not due to additional accruals). However, if the closure or freeze amendment was adopted before April 5, 2017, this requirement is deemed to be satisfied.

Next Steps

These provisions of the SECURE Act are already effective, and an employer may elect to apply them as early as 2014 plan years. For any plan sponsor of a DB pension plan, and for those who advise these plan sponsors, we recommend the following:

- Determine if the DB plan already has closed groups or frozen benefits, or if the plan sponsor may be interested in closing or freezing benefits in the future.
- For any DB plan identified, review if and how the plan has satisfied the nondiscrimination and minimum participation requirements in recent years.
- If the DB plan has passed these tests, review whether the projected change in demographics in the plan and at the employer could lead to a difficulty in continuing to satisfy these tests in the coming years.
- Review the specific testing issues that may apply in light of the plan sponsor's DB and DC plans and begin to consider if aspects of the new SECURE Act provisions may be helpful.
- Stay alert for subsequent guidance from IRS on implementation of these SECURE Act provisions.

Understanding the potential impact and flexibility of these rules may provide new options for DB plan sponsors and their advisors to craft ways to continue to offer DB plan benefits on a limited basis beyond what may have otherwise been permitted under the existing IRS regulations.