

If you have questions, please contact your regular Groom attorney or one of the attorneys listed below:

Elizabeth T. Dold
edold@groom.com
(202) 861-5406

Dan Hogans
dhogans@groom.com
(202) 861-5414

Jeffrey W. Kroh
jkroh@groom.com
(202) 861-5428

David N. Levine
dlevine@groom.com
(202) 861-5436

Mark L. Lofgren
mlofgren@groom.com
(202) 861-6614

Louis T. Mazawey
lmazawey@groom.com
(202) 861-6608

John F. McGuinness
jm McGuinness@groom.com
(202) 861-6625

David W. Powell
dpowell@groom.com
(202) 861-6600

Allison Ullman
aullman@groom.com
(202) 861-6336

Brigen L. Winters
bwinters@groom.com
(202) 861-6618

Jeff Witt
jwitt@groom.com
(202) 861-6651

J. Rose Zaklad
rzaklad@groom.com
(202) 861-6626

IRS Withdraws Proposed Regulations that Could Have Limited QSERPs

The IRS recently released Announcement 2016-16, which withdraws certain provisions from the IRS proposed regulations issued on January 29, 2016 (“Proposed Regulations”) that would have placed new limits on the ability to provide special benefit formulas to a limited number of highly compensated employees. As a result, the current nondiscrimination testing rules allowing the use of certain special benefit formulas (e.g., qualified supplemental employee retirement plans or “QSERPs”) continue to be available for use by qualified retirement plan sponsors.

As discussed in a prior Benefits Brief, the preamble to the Proposed Regulations indicated that certain changes were made to limit the ability of plan sponsors to use special benefit formulas under the existing nondiscrimination rules to provide disproportionately greater benefits to highly compensated employees. Specifically, the Proposed Regulations would have limited the use of these special benefit formulas by requiring such benefit formula to meet one of two requirements – (1) the benefit formula applies to a rate group used for nondiscrimination testing that is a “reasonable classification” of employees, or (2) the benefit formula must apply to enough non-highly compensated employees to meet the ratio percentage coverage threshold (generally 70%). One example where this change would have typically created a testing issue would be a plan that provides an enhanced benefit formula for participants identified by name or position, as QSERPs typically do.

We understand that after the Proposed Regulations were issued, certain trade organizations for small businesses provided significant feedback to the IRS regarding how these changes would adversely impact the continued maintenance of existing defined benefit programs and likely discourage the adoption of new defined benefit programs by small businesses. The input apparently made a big difference as the IRS reconsidered its position and withdrew this portion of the Proposed Regulations nearly two weeks before the comment period was scheduled to end.

Even with the changes to the Proposed Regulations, the IRS still remains concerned about qualified retirement plan benefit formula designs that attempt to circumvent the nondiscrimination testing rules. In the April 4, 2016 Employee Plans News (Issue No. 2016-05), the IRS highlighted concerns about discriminatory plan designs. Specifically, the IRS mentioned that plan designs that pass the numerical tests under the existing nondiscrimination rules may still run afoul of the rules if the designs are structured in manner that provides little or no benefits to nonhighly compensated employees. The IRS highlighted its position that plan designs that satisfy the required numerical tests by accruing benefits for nonhighly compensated employees with little compensation or service may still not satisfy the requirement in Treasury Regulation Section 1.401(a)(4)-1(c)(2) that the

nondiscrimination regulations be interpreted in a reasonable manner that prevents discrimination in favor of highly compensated employees.

We expect that the IRS will continue to review and monitor plan designs that appear to provide greater benefits to highly compensated employees. While such designs may be permissible, qualified retirement plan sponsors should review the terms and operations of such designs to ensure appropriate compliance.

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