Employee Benefits Corner

The IRS Provides Helpful Guidance Through Chief Counsel Advice and IRS Website

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Following the latest restructuring of the TE/GE division of the IRS, the IRS has found a way to provide nonbinding guidance through the issuance of Chief Counsel Advice (CCA) and use of its website and EP News. We look at the latest developments below, which focus on the following three areas:

- Age discrimination relief for cash balance plans with "whipsaw" feature
- Testing of "otherwise excludable employees"
- Voluntary Closing Agreement Program extended to cover late pre-approved PPA plan adopters

A. Cash Balance Plans with "Whipsaw" Feature

A recently released CCA memorandum, CCA 201617006,[1] provides helpful guidance for cash balance plans that have retained a "whipsaw" feature. In summary, although a cash balance plan with a "whipsaw" feature would not satisfy the age discrimination safe harbor for lump-sum-based plans, the plan can meet the age discrimination safe harbor rule for plans with indexed benefits. This is welcomed relief for plans that have retained this once mandated feature.

1. Background

The final hybrid plan regulations, which become fully effective as of January 1, 2017, provide several different safe harbor rules under which a cash balance or other hybrid plan benefit formula can be deemed to satisfy the anti-age discrimination requirements applicable to tax-qualified retirement plans. These rules are a condition for the continued tax-favored status of the affected qualified retirement plans. The general requirement in this area is contained in section 411(b)(1)(H)(i) of the Internal Revenue Code of 1986, as amended (the "Code"), and the special safe harbor rules for cash balance plans (and other "hybrid" plans) are contained in Code Sec. 411(b)(5). These rules are also a part of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and the Age Discrimination in Employment Act of 1967, as amended ("ADEA"), which, if violated, could give rise to a cause of action against the plan and/or plan sponsor by participants.

The hybrid plan regulations provide a safe harbor for plans with a lump-sum-based benefit formula, but this safe harbor is only available to a plan under which the lump-sum benefit payable to a participant is always equal to the current hypothetical account balance under the plan at the time of distribution. As explained in the CCA, a cash balance plan with a "whipsaw" feature, *i.e.,* where the plan provides that the lump-sum benefit payable to a participant is equal to the account balance projected with interest to normal retirement age and then discounted back to current age, will not meet this safe harbor because

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the actual lump-sum distribution amount could be greater than the account balance. This can occur where the interest rate used to project the account to normal retirement age is higher than the rate used to discount the projected account to the participant's current age. This requirement of the final hybrid plan regulations was made clear by final regulations issued in 2014, when plan sponsors and practitioners became concerned that plans with whipsaw may not qualify for any of the safe harbor rules implemented as part of the Pension Protection Act of 2006 ("PPA").

Notably, while PPA expressly made clear that a cash balance plan was not required to provide a whipsaw feature, it did not prohibit the use of whipsaw. After the passage of PPA, many plans that had a whipsaw feature eliminated it as permitted by the PPA. Plan sponsors were generally permitted to eliminate whipsaw, without violating the anti-cutback rules, provided they did so by the end of the 2009 plan year. However, a number of plan sponsors chose to retain the whipsaw feature for a variety of reasons, one of which, of course, is that the feature can add valuable benefits for participants. As PPA had not prohibited the whipsaw feature, there was some concern when the final Treasury regulations appeared to call into question whether a plan with whipsaw could meet the age discrimination safe harbor rules for cash balance plans. If a cash balance plan cannot meet any of the safe harbors, it could still satisfy the age discrimination rules by satisfying the general, nonsafe harbor standards of Code Sec. 411(b)(1)(H). However, these general standards are not well defined by existing regulations or case law.

2. New Guidance

The CCA confirms that, as of the effective date of the 2014 revisions to Reg. §1.411(b)(5)-1[2] (which generally apply for plan years beginning on or after January 1, 2017), a plan with whipsaw will not qualify for the safe harbor that applies to lump-sum-based plans. However, it explains that such a plan can qualify for the safe harbor available to plans with "indexed benefits." Under Code Sec. 411(b)(5)(E), this safe harbor rule provides that a plan will not be treated as age discriminatory solely because it provides for a "periodic adjustment of the accrued benefit by means of the application of a recognized investment index or methodology."

The CCA explains that a cash balance plan with whipsaw will satisfy this "indexed benefits" safe harbor provided that:

(1) the plan's cash balance account interest crediting rate does not exceed a market rate of return and is the same for participants of all ages, and
(2) the lump-sum payable from the plan is determined as the present value of the participant's accrued benefit using the actuarial assumptions specified in Code Sec. 417(e)(3) (these are the assumptions required to ensure a plan's lump-sum distribution meets minimum requirements).

Even though a CCA may not be used or cited as precedent, this analysis should be helpful for many plans that have retained the whipsaw feature. But it will be important for these plans to ensure that their interest crediting rate meets the final regulation standards to not exceed a market rate of return, and to review the actuarial assumptions being used to calculate the lump-sum distribution amount to make sure they meet these requirements.

B. Testing Treatment of "Otherwise Excludable Employees"

A retirement plan is permitted to exclude from eligibility employees who have not reached age 21 or been credited with one year of service ("otherwise excludable employees").[3] If a plan does not cover otherwise excludable employees, they may be excluded in performing coverage and nondiscrimination testing.[4] However, if a plan covers them, special rules permit them to be tested separately from other employees—as if they were employed by a separate unrelated employer.[5]

A longstanding issue has been whether employees lose their status as otherwise excludable employees immediately upon reaching age 21 and being credited with one year of service or whether they may continue to be treated as otherwise excludable employees until either (1) the plan's entry date or (2) the statutory entry date. The statutory entry date (*i.e.,* the maximum date by which an otherwise eligible employee must be covered by the plan) is the date no later than the earlier of the first day of the plan year or the date that is six months after the date the employee reaches age 21 and has been credited with one year of service.[6] The reason for the confusion is that the Code provision describing otherwise excludable employees only references the minimum age and service requirements—not the entry date rules.

In a CCA dated January 8, 2016, the IRS analyzed the regulations and legislative history and concluded that it would be permissible to interpret the Code and relevant regulations to treat the population of otherwise excludable employees for purposes of Code Sec. 410(b) coverage testing and ADP testing as including employees participating in the plan who have not satisfied the Code Sec. 410(a)(4) entry date period applicable to them (meaning through the earlier of the date six months after the participant attains age 21 and completes one year of service or the first day of the first plan year after the participant attains age 21 and completes one year of service). The CCA also provides that there are other readings that may also be acceptable applications of the statutes and regulations. For example, one could take the position that (1) a covered employee is an otherwise excludable employee only until the date on which he or she attains age 21 and completes one year of service (*i.e.,* no period is tacked on to the maximum age and service conditions), or (2) a covered employee is an otherwise excludable employee for the period through the date on which he or she attains age 21 and completes one year of service and any additional waiting period specified in the plan before an employee who has satisfied the plan's minimum age and service requirements actually enters the plan (*i.e.,* the plan's waiting period, if any (and only the plan's waiting period, if any), is tracked on to the maximum age and service conditions).

C. IRS Extends Voluntary Closing Agreement Program to Cover Late Pre-Approved PPA Plan Adopters

The April 30, 2016, deadline for pre-approved plan adopters to sign a restated plan that complies with the Pension Protection Act of 2006 has past. (Individually designed plans that convert to pre-approved plans still have another year.) Plan sponsors that fail to adopt the documents timely can correct the problem through filing a Voluntary Correction Program (VCP) submission with the IRS under Rev. Proc. 2013-12,[7] as amended.[8] But, in anticipation of numerous VCP submissions by plan sponsors, the IRS has also extended its voluntary closing agreement program to permit a group submission by the financial institution/service provider that sponsors the pre-approved plan to address this issue.

The new program largely mirrors a group VCP filing, which presumably is not available as this failure is generally not a "systemic failure by the provider." Notably, the program is purely voluntary. The parameters of this new program are briefly summarized below:

- Minimum of 20 plans
- $5,000 fee for the first 20 plans ($10,000 after April 30, 2017) plus $250 for each additional plan, with a maximum fee of $50,000
- Eligible employers include those that: (1) provided an affirmative agreement to participate in the closing agreement program, (2) timely adopted the prior EGTRRA restatement (or obtained a compliance statement, if signed late) and (3) executed the PPA restatement using the service provider's pre-approved document
- List the employers covered and provide full payment of any additional filing fees by the later of May 1, 2017, or 120 days from the closing agreement execution date[9]

ENDNTOES

1 CCA 201617006 (Mar. 28, 2016).
2 Reg. §1.411(b)(5)-1.
3 Code Sec. 410(a)(1)(A).
4 Code Sec. 410(b)(4)(A).
5 *See, e.g.,* Code Secs. 410(b)(4)(B) and 401(k)(3)(F) and Reg. §1.401(k)-2(a)(1)(iii).
6 Code Sec. 410(a)(4).
7 Rev. Proc. 2013-12, IRB 2013-4, 313.
8 *See www.irs.gov/Retirement-Plans/VCP-Submission-Kit-Failure-to-adopt-a-new-Pre-Approved-Defined-Contribution-Plan-by-the-April-30-2016-Deadline.*
9 *See www.irs.gov/Retirement-Plans/New-Program-Allows-Providers-of-Pre-Approved-Plan-to-Correct-Missed-Deadlines (posted April 4, 2016).*