

## **Retirement Security Preservation Act of 2017**

### **Summary**

#### ***The problem: protecting retirement security for older workers***

Many companies are transitioning away from a traditional defined benefit (“DB”) plan benefit formula in various ways. This can arise, for example, by reason of (1) closing the plan to new hires (“closed plan” issue), or (2) closing a plan feature to new hires, such as closing an early retirement subsidy to new hires in the context of a conversion of a traditional formula to a hybrid formula for new hires (“closed feature” issue).

In the context of such transitions, it is not unusual for companies to grandfather some or all of the existing employees under the benefit formula or feature in effect. A prime example of the closed plan issue is closing a traditional DB plan to new hires (who often receive an additional contribution under the company’s defined contribution (“DC”) plan), but allowing existing employees to continue to participate in the DB plan.

These “grandfathering” arrangements are very helpful to the older longer service employees who (1) often have made retirement plans based on the benefits previously in effect, and (2) may lose the higher benefits provided by DB plans at the end of a career, without having benefited from higher DC plan contributions in earlier years.

However, these grandfather arrangements can, over time, cause nondiscrimination testing problems. These nondiscrimination testing problems have caused many plans to have to freeze completely, eliminating future benefit accruals for thousands of employees. Far more plans will have to freeze in the future unless these issues are effectively addressed.

On January 28, 2016, Treasury issued proposed regulations to address nondiscrimination testing problems related to closed plans and closed features. The proposed regulations provide an improved framework for addressing these issues, but only for a certain subset of affected plans. According to recent surveys, a significant majority of closed or frozen DB plans, representing hundreds of thousands of participants, will not be able to take advantage of the proposed regulations. In addition, Treasury does not have the regulatory authority to address common testing issues arising from the “minimum participation rule”; instead, legislation is required.

#### ***The solution: addressing inadvertent nondiscrimination testing problems***

The Retirement Security Preservation Act (“RSPA”) addresses four nondiscrimination testing issues. The RSPA incorporates several elements of the proposed Treasury regulations, but also provides targeted relief to the many plans that are not able to take advantage of the regulations.

*Closed plan issue.* This issue arises when, for example, a DB plan is closed to new hires, but existing employees are grandfathered and allowed to continue earning pension benefits. Over time, the participants in the DB plan can become disproportionately highly compensated. This happens not by design, but simply by reason of the fact that (1) turnover among nonhighly compensated employees (“NHCEs”) tends to be higher than among highly compensated employees (“HCEs”), and (2) many grandfathered NHCEs become HCEs by reason of gaining experience and seniority. This causes nondiscrimination testing problems. Generally, under recent IRS guidance, many plans have a pass on this problem, but only through the end of 2016.

- *Proposed solution.* Very generally, if (1) the defined benefit plan passes the nondiscrimination testing rules for the year in which the plan is closed and for two subsequent plan years, and (2) the plan is not amended in a discriminatory manner after the plan is closed, the nondiscrimination problem would not apply.

*Closed feature issue.* Certain plan features, such as an early retirement subsidy or a certain method of calculating a lump sum benefit, may be removed from the plan for future accruals, but some or all existing participants may be grandfathered from such removal. This often comes up in the context of a conversion of a traditional defined benefit plan formula to a cash balance plan formula, where some employees are permitted to remain in the traditional formula (which may have an early retirement subsidy) for future accruals. It could also come up if participants were grandfathered from the Pension Protection Act change in how lump sums are calculated. Over time, the group of grandfathered employees generally becomes too highly compensated, so that the grandfathered group fails the nondiscrimination rules.

- *Proposed solution.* Very generally, if (1) the grandfathered group satisfies the nondiscrimination tests as of the for the year in which the group is closed and for two subsequent plan years, and (2) the plan is not amended in a discriminatory manner after the group is closed, the nondiscrimination problem would not apply.

*DB replacement plan issue.* A defined benefit plan is completely frozen and some or all of the existing employees receive “make-whole” contributions or replacement benefits (either through non-elective allocations, matching contributions, or replacement benefits, rights, and features) under the defined contribution plan. The make-whole contributions are designed to make the existing employees whole, in sum or in part, for the loss of the future pension benefits. These make-whole contributions or replacement benefits cause nondiscrimination testing problems over time, because over time the grandfathered group receiving such contributions or benefits generally becomes too highly compensated for the reasons described above.

- *Proposed solution.* Very generally, if (1) the group receiving the make-whole contributions or replacement benefits satisfies the nondiscrimination rules as of the year in which the group is closed and for two subsequent plan years, and (2) the plan is not amended in a discriminatory manner after the group is closed, the nondiscrimination problem would not apply.

*Minimum participation issues.* A DB plan is closed to new hires, but existing participants are grandfathered. Over time, the plan will fail the minimum participation rule of section 401(a)(26), which generally requires that a plan cover at least the lesser of (a) 50 employees, or (b) 40% of the workforce. This issue can also arise when a plan is completely frozen, since the “50/40” rule applies to former employees in some cases.

- *Proposed solutions.* If no employee benefits (i.e., currently earns accruals) under a plan, the plan satisfies the minimum participation test. Also, very generally, if (1) a DB plan satisfies the minimum participation test as of the year in which the plan closes, and (2) the plan is not amended in a discriminatory manner after the plan is closed, the minimum participation problem would not apply.

## ***Preventing abuses***

Taking into account concerns raised in the Treasury regulations, the RSPA contains anti-abuse parameters for plans that close after the date of introduction of the bill. These anti-abuse parameters are meant to prevent incentivizing plan closures or the creation and immediate closing or freezing of a plan or plan features.

Plans that have *already* closed prior to the introduction of the bill could not be encouraged by the bill's relief to close (since closure has already occurred) and could not create or close a DB plan solely to take advantage of that relief (since the closed plan has already been created).

However, plans that close after the date of introduction are on notice regarding the relief the bill provides and could, in theory, opportunistically be created, and then immediately freeze or close. For example, a small business owner could adopt a DB plan today, and then tomorrow (or very soon thereafter) close the plan to new hires, enabling the plan to take advantage of the relief provided in the legislation. Or similarly, an employer could significantly increase benefits, especially for higher paid employees, shortly before closing the plan.

- *Proposed solutions.* With these concerns in mind, the bill states that no relief would be provided with respect to any plan closed after introduction of the legislation unless the plan has been in existence for five years. In addition, the plan size and the average benefits for HCEs may not be increased by more than 50% over the five year period before the class is closed, except by reason of a business acquisition or merger.