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subject: Application of sections 401(a)(4) and 401(a)(26) to a cash balance plan that offsets benefits with benefits under a defined contribution plan

This Chief Counsel Advice responds to your request for assistance dated February 1, 2018. This advice may not be used or cited as precedent.

ISSUES

You have asked the following questions regarding a floor-offset arrangement under which benefits under a defined benefit plan are offset by benefits under a defined contribution plan only for nonhighly compensated employees (NHCEs), so that for NHCEs who participate in both plans, but not for highly compensated employees (HCEs) who participate in both plans, benefits are eliminated under the defined benefit plan:

(1) How may this combination of plans satisfy the conditions for combined testing on the basis of equivalent benefits under § 1.401(a)(4)-9(b)(2)(v)?

(2) Are the NHCEs whose benefit under the defined benefit plan is entirely offset considered to be benefitting under the defined benefit plan, and to have a meaningful benefit under the defined benefit plan, for purposes of determining whether the plan satisfies the minimum participation requirement of § 401(a)(26)?

CONCLUSIONS

(1) The special rule of § 1.401(a)(4)-3(f)(9) (under which an employee's accrued benefit under a plan includes that portion of the benefit that is offset by benefits under another plan) applies only to the extent that the benefit is attributable to pre-participation service or past service. Therefore, the offset is taken into account in determining whether the DB/DC plan is primarily defined benefit in character within the meaning of § 1.401(a)(4)-9(b)(2)(v)(B) or consists of broadly available separate plans within the meaning of § 401(a)(4)-9(b)(2)(v)(C). Because, after the offset, NHCEs receive no benefit under the defined benefit plan, the DB/DC plan is not primarily defined benefit in character. Similarly, the DB/DC plan does not consist of broadly available separate plans because the defined benefit plan does not satisfy the applicable conditions set forth in § 1.401(a)(4)-9(b)(2)(v)(C). Accordingly, the DB/DC plan must satisfy the minimum aggregate allocation gateway of § 1.401(a)(4)-9(b)(2)(v)(D) to be eligible for testing for nondiscrimination on the basis of equivalent benefits.

(2) The special rule of § 1.401(a)(26)-5(a)(2)(iii) (under which an offset of benefits under a defined benefit plan by benefits under another plan is disregarded) does not apply to an offset that applies only to a subset of participants in the defined benefit plan. Because the offset must be taken into account and reduces the benefits of NHCEs under the defined benefit plan to zero, the NHCEs do not benefit under the defined benefit plan within the meaning of § 401(a)(26)(A) and § 1.401(a)(26)-2(a) and do not have a meaningful benefit under the plan's prior benefit structure as specified in § 1.401(a)(26)-3(c). Accordingly, the NHCEs are not taken into account for purposes of satisfying the requirements of § 401(a)(26).

FACTS

The employer maintains a cash balance plan and a defined contribution plan for the benefit of its employees. The defined contribution plan is a profit sharing plan to which the employer makes an annual contribution that is allocated ratably to all participants based on compensation. All employees of the employer are eligible to participate in the defined contribution plan.

The cash balance plan covers two groups of participants. The first group of participants (all of whom are HCEs) consists of the owner-employees of the employer. This group of participants receives the lesser of (1) the maximum pay credit so that the resulting annual benefit will not exceed the limitations of § 415(b), and (2) the maximum pay credit that enables the plan to comply with § 401(a)(4) (determined using a method specified in the plan). The second group of participants (all of whom are NHCEs) consists of the lowest-paid group of employees who are not owner-employees and who perform at least one hour of service during the plan year. The lowest-paid group is limited to the number of employees necessary so that the plan covers the lesser of 40%

of the total number of employees for the plan year or 50 employees. This second group of participants receives an annual pay credit of 1% of compensation.

For an owner-employee, the accrued benefit under the cash balance plan is the single life annuity payable at age 65 that is the actuarial equivalent of the current balance of the cash balance account. For a participant who is not an owner-employee, the accrued benefit under the cash balance plan is the single life annuity payable at age 65 that is the actuarial equivalent of the current balance of the cash balance account, offset by the single life annuity payable at age 65 that is the actuarial equivalent of the participant's vested account balance attributable to employer contributions under the profit-sharing plan. Because the benefits for this second group of participants attributable to employer contributions under the profit-sharing plan is larger than the benefits payable under the cash balance plan absent the offset, the offset for this second group of employees reduces the benefit under the cash balance plan to zero.

LAW AND ANALYSIS

Issue 1

Section 401(a)(4) provides that a plan is a qualified plan only if the contributions or the benefits provided under the plan do not discriminate in favor of highly-compensated employees (HCEs).

Section 1.401(a)(4)-1(b)(2) requires that either the contributions or the benefits provided under the plan must be nondiscriminatory in amount. To be nondiscriminatory in amount, either the contributions alone or the benefits alone must be nondiscriminatory in amount; it is not required that both the contributions and the benefits be nondiscriminatory in amount.

Section 1.401(a)(4)-3 describes the rules for determining nondiscrimination in amount of employer provided benefits under a defined benefit plan. Section 1.401(a)(4)-3(b) provides a number of safe harbors that apply to a plan that provides for uniform benefits, and § 1.401(a)(4)-3(c) provides a general test that applies to a plan that does not provide for uniform benefits.

Section 1.401(a)(4)-3(c) provides that the employer-provided benefits under a defined benefit plan are nondiscriminatory in amount for a plan year if each rate group under the plan satisfies section 410(b). For purposes of §1.401(a)(4)-3(c)(1), a rate group generally consists of an HCE and all other employees with a normal accrual rate greater than or equal to the HCE's normal accrual rate and who also have a most valuable accrual rate greater than or equal to the HCE's most valuable accrual rate.

Section 1.401(a)(4)-3(f) provides special rules of application. Section 1.401(a)(4)-3(f)(9) provides that an employee's accrued benefit under a plan includes that portion of the benefit that is offset under an offset described in § 1.401(a)(4)-11(d)(3)(i)(D) (pertaining

to offsets for pre-participation service). The rule applies only to the extent that the benefit is attributable to periods for which the plan being tested credits pre-participation service or past service. Section 1.401(a)(4)-3(f)(9)(ii), Example 1 illustrates that the rule applies to an offset for pre-participation service but not to an offset for concurrently earned benefits.

Section 1.401(a)(4)-9 provides the requirements for testing situations in which plan aggregation or restructuring is used to satisfy nondiscrimination.

Section 1.401(a)(4)-9(b)(2)(v)(A) addresses a plan that consists of one or more defined contribution plans and one or more defined benefit plans (a DB/DC plan). Specifically, it provides that unless the DB/DC plan is primarily defined benefit in character or consists of broadly available separate plans, the DB/DC plan must satisfy the minimum aggregate allocation gateway of § 1.401(a)(4)-9(b)(2)(v)(D) for the plan year in order to be permitted to demonstrate satisfaction of the nondiscrimination in amount requirement of § 1.401(a)(4)-1(b)(2) on the basis of equivalent benefits.[1]

Section 1.401(a)(4)-9(b)(2)(v)(B) provides that a DB/DC plan is primarily defined benefit in character if, for more than 50% of the non-highly compensated employees (NHCEs) benefitting under the plan, the normal accrual rate for the NHCE attributable to benefits provided under defined benefit plans that are part of the DB/DC plan exceeds the equivalent accrual rate for the NHCE attributable to contributions under the defined contribution plans that are part of the DB/DC plan.

Section 1.401(a)(4)-9(b)(2)(v)(C) provides that a DB/DC plan consists of broadly available separate plans if the defined contribution plan and the defined benefit plan that are part of the DB/DC plan each would satisfy the requirements of section 410(b) and the nondiscrimination in amount requirement of § 1.401(a)(4)-1(b)(2) if each plan were tested separately and assuming that the average benefit percentage test of § 1.410(b)-5 were satisfied. For this purpose, all defined contribution plans that are part of the DB/DC plan are treated as a single defined contribution plan and all defined benefit plans that are part of the DB/DC plan are treated as a single defined benefit plan.

Section 1.401(a)(4)-9(b)(2)(v)(D)(1) provides that a DB/DC plan satisfies the minimum aggregate allocation gateway if each NHCE has an aggregate normal allocation rate that is at least one third of the aggregate normal allocation rate of the HCE with the highest such rate (HCE rate) or, if less, 5% of the NHCE's compensation, provided that the HCE rate does not exceed 25% of compensation. If the HCE rate exceeds 25% of compensation, then the aggregate normal allocation rate for each NHCE must be at

[1] An additional exception from the minimum aggregate allocation gateway applies under some circumstances to a DB/DC plan that contains a defined benefit plan that is closed to new entrants. See Notice 2014-5, 2014-2 I.R.B. 276, and successor notices extending the relief in Notice 2014-5; see also proposed amendments to § 1.401(a)(4)-9 in REG-125761-14, 81 FR 4976 (January 29, 2016). This exception does not apply under these facts, and is not discussed further in this memorandum.

least 5% increased by one percentage point for each 5-percentage-point increment (or portion thereof) by which the HCE rate exceeds 25%.

The employer intends to aggregate the cash balance plan and the profit-sharing plan for purposes of nondiscrimination testing. Accordingly, in order to demonstrate satisfaction of the nondiscrimination requirements on the basis of equivalent benefits without satisfying the minimum aggregate gateway allocation, the aggregated plan must either be primarily defined benefit in character or consist of broadly available separate plans.

The DB/DC plan resulting from aggregating the cash balance plan and the profit-sharing plan is not primarily defined benefit in character within the meaning of § 1.401(a)(4)-9(b)(2)(v)(B). That is because, for the NHCEs accruing pay credits under the plan, the normal accrual rate attributable to benefits provided under the cash balance plan is zero as a result of the offset by the larger benefit attributable to the defined contribution plan. The offset may not be disregarded because it is an offset for concurrently earned benefits and only an offset for pre-participation service may be disregarded. Therefore the benefit for each NHCE does not exceed the equivalent accrual rate for the NHCE attributable to contributions under the defined contribution plan.

The DB/DC plan resulting from aggregating the cash balance plan and the profit-sharing plan does not consist of broadly available separate plans. Section 1.401(a)(4)-9(b)(2)(v)(C) requires that to be considered broadly available separate plans, each plan separately must satisfy the requirements of section 410(b) and the nondiscrimination in amount requirement of § 1.401(a)(4)-1(b)(2) if each plan were tested separately and assuming that the average benefit percentage test of § 1.410(b)-5 were satisfied. The cash balance plan does not separately meet the coverage requirements, taking the offset into account, because the benefits under the cash balance plan for participants who are NHCEs are reduced to zero under the offset. As discussed above, this offset may not be disregarded in testing the cash balance plan, because it is not an offset attributable to pre-participation service and, under § 1.401(a)(4)-3(f)(9), the only offsets that may be disregarded are offsets attributable to pre-participation service. After applying the offset to determine the accrued benefit, the cash balance plan does not satisfy the requirements of section 410(b) when tested separately, because an insufficient number of employees have normal and most valuable accrual rates greater than or equal to the rates of the HCEs.

Since the aggregated plan is not primarily defined benefit in character and does not consist of broadly available separate plans, in order for the DB/DC plan to be permitted to demonstrate satisfaction of the nondiscrimination requirements on the basis of equivalent benefits, NHCEs must receive sufficient allocations under the profit-sharing plan to satisfy the minimum aggregate allocation gateway of § 1.401(a)(4)-9(b)(2)(v)(D).

Issue 2

Section 401(a)(26) provides that a trust that is part of defined benefit plan is a qualified trust only if it benefits at least the lesser of (i) 50 employees of the employer, or (ii) the greater of (I) 40 percent of all employees of the employer, or (II) 2 employees (or if there is only 1 employee, such employee).

Section 1.401(a)(26)-1(a) provides that a plan is a qualified plan for a plan year only if the plan satisfies section 401(a)(26) for the plan year. A plan that satisfies any of the exceptions described in § 1.401(a)(26)-1(b) passes section 401(a)(26) automatically for the plan year. A plan that does not satisfy one of those exceptions must satisfy § 1.401(a)(26)-2(a). In addition, a defined benefit plan must satisfy § 1.401(a)(26)-3 with respect to its prior benefit structure. Finally, a defined benefit plan that benefits former employees must separately satisfy § 1.401(a)(26)-4 with respect to its former employees.

Section 1.401(a)(26)-1(b) provides exceptions for plans that do not benefit any highly compensated employees, multiemployer plans, certain underfunded defined benefit plans, and certain plans involved in acquisition or disposition transactions of the employer.

Section 1.401(a)(26)-2(a) provides that a defined benefit plan that does not meet an applicable exception must benefit at least the lesser of 50 employees or 40 percent of the employer's employees.

Section 1.401(a)(26)-3(a) provides that a defined benefit plan that does not meet one of the exceptions in § 1.401(a)(26)-1(b) must satisfy § 1.401(a)(26)-3(c) with respect to its prior benefit structure.

Section 1.401(a)(26)-3(c)(1) provides that a plan's prior benefit structure satisfies § 1.401(a)(26)-3(c) if the plan provides meaningful benefits to a group of employees that includes the lesser of 50 employees or 40 percent of the employer's employees.

Section 1.401(a)(26)-3(c)(2) provides that whether a plan is providing meaningful benefits, or whether individuals have meaningful accrued benefits under a plan, is determined on the basis of all the facts and circumstances. The relevant factors in making this determination include, but are not limited to: the level of current benefit accruals; the comparative rate of accruals under the current benefit formula compared to prior rates of accrual under the plan; the projected accrued benefits under the current benefit formula compared to accrued benefits as of the close of the immediately preceding plan year; the length of time the current benefit formula has been in effect; the number of employees with accrued benefits under the plan; and the length of time the plan has been in effect. A plan does not satisfy § 1.401(a)(26)-3(c) if it exists primarily to preserve accrued benefits for a small group of employees and thereby functions more as an individual plan for the small group of employees or for the employer.

Section 1.401(a)(26)-5(a)(2) provides a rule for determining whether an offset plan provides meaningful benefits. Section 1.401(a)(26)-5(a)(2)(i) provides that generally an employee is treated as accruing a benefit under a plan that includes an offset or reduction of benefits that satisfies § 1.401(a)(26)-5(a)(2)(ii) or (iii) if either the employee accrues a benefit under the plan for the year or the employee would have accrued a benefit under the plan if the offset or reduction of the benefit were disregarded.

Section 1.401(a)(26)-5(a)(2)(iii) states:

> An offset or reduction of benefits under a defined benefit plan satisfies the requirements of this paragraph (a)(2)(iii) if the benefit formula provides a benefit that is offset or reduced by contributions or benefits under another plan that is maintained by the same employer and the following additional requirements are met:
>
> > (1) The contributions or benefits under a plan that are used to offset or reduce the benefits under the positive portion of the formula being tested accrued under such other plan;
> >
> > (2) The employees who benefit under the formula being tested also benefit under the other plan on a reasonable and uniform basis; and
> >
> > (3) The contributions or benefits under the plan that are used to offset or reduce the benefits under the formula being tested are not used to offset or reduce that employee's benefits under any other plan or any other formula.

In the present case, the cash balance plan does not meet any of the exceptions listed in § 1.401(a)(26)-1(b). Therefore it must satisfy § 1.401(a)(26)-2(a) by benefitting a group of employees that includes the lesser of 50 employees or 40 percent of the employer's employees. Furthermore, the cash balance plan must satisfy § 1.401(a)(26)-3 with respect to its prior benefit structure by providing meaningful benefits to a group of employees that includes the lesser of 50 employees or 40 percent of the employer's employees.

In order for the offset to be disregarded in determining whether the cash balance plan satisfies §§ 1.401(a)(26)-2 and -3 (so that NHCEs, who benefit under the cash balance plan disregarding the offset but not if the offset is taken into account, are counted for purposes of satisfying these requirements), the offset must fall within the exception of § 1.401(a)(26)-5(a)(2)(iii). That exception applies to a defined benefit plan only if the benefit formula provides a "benefit that is offset or reduced by a contribution or benefit under another plan." In addition, the regulations provide that employees who benefit under the formula being tested must also benefit under the other plan on a reasonable and uniform basis. Since, as explained below, the benefit under the cash balance plan is not fully offset or reduced by the benefit under another plan under which the

employees who benefit under the cash balance plan benefit on a reasonable and uniform basis, the offset may not be disregarded in determining whether the cash balance plan satisfies the minimum participation requirements of § 401(a)(26).

An employer may argue that the reasonable and uniform basis requirement applies only to the coverage and benefits under the other plan, and that the exception for a "benefit that is offset or reduced by a contribution or benefit under another plan" is not restricted to full offsets that apply to all participants in the defined benefit plan. However, this is an unreasonable interpretation of § 1.401(a)(26)-5(a)(2)(iii), because the effect of an offset that does not apply fully to all participants is identical to the effect of an offset that applies uniformly to reduce benefits under the defined benefit plan by non-uniform benefits in the offsetting plan. For example, if each participant in an offsetting defined contribution plan receives an allocation of 6% of compensation (and therefore each participant has uniform benefits) and the benefit under the defined benefit plan is offset by 100% of the benefit under the defined contribution plan, the offset applies uniformly and may be disregarded under § 1.401(a)(26)-5(a)(2). But if the defined contribution plan provides for an allocation of 6% of compensation to one group of participants and 3% of compensation to another group of participants (so that the employees do not benefit under the defined contribution plan on a uniform basis), application of the 100% offset results in the group with the 6% allocation experiencing a larger benefit reduction as a result of the offset than the group with the 3% allocation. Under § 1.401(a)(26)-5(a)(2), this offset may not be disregarded, because employees who benefit under the defined benefit plan being tested do not also benefit under the offsetting defined contribution plan on a reasonable and uniform basis. If instead all allocations to participants under the defined contribution plan are 6% of compensation, but the offset under the defined benefit plan is 100% of the defined contribution plan benefits for one group of participants and 50% for another group, the reduction in the benefits in the defined benefit plan being tested is identical to the reduction in the prior alternative offset formulation, which does not satisfy the exception in § 1.401(a)(26)-5(a)(2).

The regulations under § 1.401(a)(26)-5 are intended to have a meaningful effect and prohibit certain arrangements. This goal would not be accomplished if the regulations could be applied to make the requirements so easily circumvented to achieve the prohibited result. Accordingly, the only reasonable reading of § 1.401(a)(26)-5(a)(2)(iii) is that "a benefit that is offset or reduced by a contribution or benefit under another plan" refers to a benefit to the extent it is offset or reduced by contributions or benefits under that other plan in the same manner for all participants. If the offset were not required to be applied in the same manner for all participants in the defined benefit plan, then, as demonstrated above, the uniformity provision with respect to the other plan would be rendered meaningless. In addition, the effect of such a non-uniform offset would be that the participants in the other plan do not, in effect, receive uniform benefits under that plan (because the use of the defined contribution plan benefit to offset the defined benefit plan benefit effectively diminishes the value of the defined contribution plan benefit for some participants but not for others).

Under the terms of the cash balance plan, the benefits for NHCE participants are reduced to zero by the offset of the profit-sharing plan benefit, while the benefits for owner-employee participants are not offset. Since the offset does not apply to all of the employees in the cash balance plan but only to NHCEs, it may not be disregarded. As a result of the offset, NHCE participants do not benefit under the cash balance plan and have not accrued a meaningful benefit under the cash balance plan. Moreover, the operation of the offset causes the cash balance plan to exist primarily to preserve accrued benefits for a small group of employees. Therefore, the NHCE participants in the cash balance plan are not taken into account for purposes of determining whether the cash balance plan satisfies the requirements of §§ 1.401(a)(26)-2 and -3.

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Please call Laura Warshawsky at (202)-317-6799 or Linda Marshall at (202) 317-6700 if you have any further questions.