

Benefits, Rights and Features Nondiscrimination Testing and Phased Retirement Programs

Introduction

Various studies indicate that formal phased retirement programs within defined benefit plans are wanted and needed by both employers and employees.¹ Phased retirement programs may be useful for employees who want to reduce their hours during later stages of their careers, but who wish to remain in the workforce. For employers, a phased retirement program may be a useful tool to retain talented employees who may otherwise fully retire.

In designing phased retirement programs, It is not surprising that many employers wish to have significant discretion in deciding which employees they will seek to retain through a phased retirement program. Indeed, the employer may view such discretion as vital to its business needs and interests. Under current law, however, such discretion would generally run contrary to the nondiscrimination requirements under the Internal Revenue Code (Code), which prohibits more favorable treatment of highly compensated employees.

This memo explores the history of the Code's nondiscrimination rules, with a particular focus on the benefits, rights and features test. The memo also considers whether such rules remain appropriate for bona fide phased retirement programs within qualified pension or retirement plans or whether alternative approaches to achieve the social goals of the nondiscrimination rules are possible.

A Brief History of the Code's Nondiscrimination Rules

Nothing in current law requires an employer to provide a pension or retirement plan to any of its employees. However, as a way of encouraging the establishment of such plans, if an employer chooses to provide a pension or retirement plan, both the employee and the employer receive significant tax benefits.²

To receive these tax benefits, an employer's plan must satisfy various rules under the Code. One of these rules is the nondiscrimination rule, which, on the

¹ See generally, AARP and Society for Human Resource Management (2006). "Phased Retirement and Flexible Retirement Arrangements: Strategies for Retaining Skilled Workers" available at http://www.aarp.org/money/careers/employerresourcecenter/trends/erc_order_form.html and Brown, S.K. (2005). "Attitudes of individuals 50 and older toward phased retirement." Available at http://www.aarp.org/research/reference/publicopinions/attitudes_of_individuals_50_and_older_to_ward_phase.html.

² See EBRI (2004). "Tax Expenditures and Employee Benefits: An Update From the FY 2005 Budget," available at <http://www.ebri.org/pdf/publications/facts/0204fact.pdf>.

most simplistic level, prevents a plan from discriminating with respect to coverage or contribution and benefits in favor of highly compensated employees.³

1942 Amendments to the Code

The origins of the Code's nondiscrimination rules go back to 1942. Before 1942, a pension or retirement plan simply needed to cover "some or all employees" in order to receive favorable tax treatment. The purpose of the 1942 nondiscrimination amendments was two-fold: 1) eliminate pension plan tax avoidance schemes, and 2) increase pension and retirement coverage of rank and file workers.

The 1942 amendments added two new provisions to the Code – the coverage test and the contributions and benefits test.⁴ The *coverage* test required that a plan benefit 70% or more of all employees, or 80% or more of all the employees who were eligible to benefit under the plan, if 70% or more of all the employees were eligible to benefit under the plan.⁵ Alternatively, the test required that a plan benefit "such employees as qualify under a classification set up by the employer and found by the commissioner not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees."

The *contributions and benefits test* provided that a plan would meet the Code's qualification requirements only if "the contributions or benefits provided under the plan [did] not discriminate in favor of employees who [were] officers, shareholders, persons whose principal duties consist[ed] in supervising the work of other employees, or highly compensated employees."⁶

³ See Code Sections 401(a)(3) and (4).

⁴ The 1942 Amendments originally were codified at Code Section 165(3) (coverage) and (4) (contributions and benefits). In 1954, the Code was restated. These sections were moved from Code Section 165(3) and (4) to Code Section 401(a)(3) and (4), where they remain, in modified form, today.

⁵ In each case employees who had been employed less than a minimum period prescribed by the plan (not exceeding five years), employees whose customary employment was not for more than 20 hours in any one week, and employees whose customary employment was not more than five months in any calendar year could be excluded from the coverage test.

⁶ The Tax Reform Act of 1986 changed the nondiscrimination rules to provide that a plan could not discriminate in favor of highly compensated employees and it defined the term "highly compensated employee." The current Code Section 414(q) generally defines a highly compensated employee as any employee who:

(A) was a 5-percent owner at any time during the year or the preceding year, or

(B) for the preceding year -

(i) had compensation from the employer in excess of \$80,000, and

(ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year.

The Secretary of the Treasury is required to adjust the \$80,000 each year. For 2007, the amount was adjusted to \$100,000.

Thus, although the 1942 amendments did not mandate that an employer provide pension or retirement plans, the nondiscrimination rules effectively operated as a mandate to expand coverage to a greater number of employees once an employer chose to offer a plan. These nondiscrimination provisions became “the pillar in the government’s campaign against discrimination and tax avoidance.”⁷ The 1942 amendments are the basis for the current Code’s nondiscrimination provisions, which have remained virtually unchanged since that time.⁸

Revenue Rulings 71-296 and 71-540

Following the 1942 amendments and the 1954 Code restatement, the Internal Revenue Service (IRS) did not offer significant regulatory guidance on the nondiscrimination rules. In 1971, however, the IRS issued two Revenue Rulings, 71-296 and 71-540, that provided guidance in the area for pension and profit-sharing plans respectively. Both Revenue Rulings provided guidance on whether the nondiscrimination rules would be violated if a pension or profit sharing plan allowed plan trustees discretion in deciding the form of a participant’s final benefit. In both instances, the IRS found that the nondiscrimination rules would not be violated “merely because [the plan] grants discretion to the trustee to determine the option under which distributions will be made.”

Revenue Ruling 85-59

In 1985, the IRS reduced the scope of permissible employer discretion with regard to optional forms of benefits through Revenue Ruling 85-59. This Ruling addressed a series of plan designs in which the plan allowed a participant to elect – as an alternative to the normal form of benefit provided under the plan – to receive an actuarially equivalent benefit in a single sum, subject to specific eligibility conditions.

In its discussion, the IRS first noted that neither the Code nor the regulations expressly preclude subjecting optional forms of benefits to certain restrictions. However, the IRS noted: “when these restrictions may operate to provide the

⁷ Sass, Steven A., The Promise of Private Pensions, The First Hundred Years, p. 118. Harvard University Press, 1997.

⁸ In 1974, under the Employee Retirement Income Security Act (ERISA), a new Code Section 410(b) was created, and the coverage test was moved to that section. Code Section 401(a)(3) was changed to provide that the coverage requirements of Code Section 410 must be met in order for the plan to be qualified. Specifically, Code Section 401(a)(3) now reads that a plan is qualified under Code Section 401(a) if it “satisfies the requirements of section 410 (relating to minimum participation standards).” ERISA did not significantly change the contribution and benefit language in Code Section 401(a)(4), which now provides that a plan is qualified “if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of section 41(q)). For purposes of this paragraph, there shall be excluded from consideration employees described in section 410(b)(3)(A),” which includes employees covered by a collective bargaining agreement and non-resident aliens who receive no income within the United States.

restated option primarily to the prohibited group, such restriction causes the plan to become discriminatory within the meaning of section 401(a)(4) of the Code.”⁹

The IRS acknowledged that, under Revenue Rulings 71-296 and 71-540, it had concluded that pension and profit-sharing plans (respectively) would not fail to satisfy the requirements of section 401(a) of the Code (particularly section 401(a)(4)) merely because such plans granted discretion to the trustee to choose between actuarially equivalent benefit payment options for each participant. However, the IRS then restricted the discretion it had authorized under those rulings by noting: “[a]lthough these revenue rulings indicate that trustee discretion in those circumstances is not necessarily discriminatory, this does not mean that the use of the discretion might not result in discrimination in operation.”¹⁰

To provide some guidance on how such discretion might result in a violation of the non-discrimination rules, Revenue Ruling 85-89 provided the following examples:

- A plan that provides a single sum that is available only to employees earning \$50,000 or more in the final year of employment violates the nondiscrimination rules, where, based on the facts and circumstances of the employer, employees earning \$50,000 per year are highly compensated employees and those earning less than \$50,000 per year are nonhighly compensated employees.
- A plan that provides that a single sum is available only to employees who either a) furnish evidence that they have a net worth above a specified amount, or b) present a letter from their accountant or attorney declaring that it is in the employee’s best interest to receive a lump sum is not necessarily discriminatory. If, however, in operation, the provisions cause the plan to discriminate in favor of highly compensated employees, the plan will violate the nondiscrimination rules.
- Similarly, plans that provide that the trustees will determine whether any participant may receive a single sum distribution, without specifying the selection criteria to be used by the trustees, are not per se discriminatory. However, if the trustees uniformly and consistently apply the standards set out in the above examples, the plans will violate the nondiscrimination rules if, “in operation, administrative practices cause the Plans to discriminate in favor of the prohibited group.”

⁹ In 1971, Code Section 401(a)(4) provided that a plan will be qualified if the “contributions and benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees or highly compensated employees.”

¹⁰ Revenue Ruling 85-59 superceded Revenue Rulings 71-296 and 71-540.

Treasury Regulation §1.401(a)-4

Based on its opinion in Revenue Ruling 85-59, the IRS issued proposed regulation section 1.401(a)-4 in 1986.¹¹ The regulation has come to be known as the benefits, rights and features (BRF) test. It provides that, under a plan, all benefits, rights and features (*i.e.*, all optional forms of benefits, ancillary benefits and other rights and features available to any employee under the plan) must be currently and effectively available to all plan participants.

Generally, BRF will satisfy the *current availability* requirement only if the group of employees to whom a BRF is currently available during the plan year satisfies the ratio percentage test of Section 410(b) of the Treasury Regulations.¹² Treas. Reg. §1.401(a)(4)-4(b)(1). The ratio percentage test under Code section 410(b) is satisfied if the BRF benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees who benefit under the plan. Code §410(b)(1)(B); Treas. Reg. §1.410(b)-2(b).

Generally, whether a BRF that is subject to specified eligibility conditions is currently available to an employee is determined based on the current facts and circumstances with respect to the employee. Treas. Reg. §1.401(a)(4)-4(b)(2). The regulations list some conditions that are disregarded, such as being disabled, having executed a covenant not to compete, or having executed a waiver under the Age Discrimination in Employment Act, in determining the employees to whom the BRF is currently available. Treas. Reg. §1.401(a)(4)-4(b)(2)(ii)(B). The regulations also provide that any age or service condition with respect to an optional form of benefit is disregarded in determining whether the optional form of benefit is currently available, except if the condition (*i.e.* age or service) must be satisfied within a limited time period. Treas. Reg. §1.401(a)(4)-4(b)(2)(ii).

A BRF will satisfy the *effective availability* requirement only if, based on all the facts and circumstances, the group of employees to whom the BRF is effectively available does not substantially favor highly compensated employees. Treas. Reg. §1.401(a)(4)-4(c)(1). If, in practice, only highly compensated employees take advantage of a BRF, the plan will not pass the effective availability test.

To explain how the test would work in practice, the regulations provide three examples of plans that would pass the current availability test but not the effective availability test:

¹¹ These regulations were not fully finalized until 1993, and they became effective for plan years on and after January 1, 1994.

¹² If the plan does not satisfy the ratio percentage test, the plan may, instead, satisfy the nondiscriminatory classification test (without regard to the average benefit percentage test) of Section 410(b) of the Treasury Regulations. Treas. Reg. §1.401(a)(4)-4(b)(1).

- In the first example, the plan covers both highly compensated and nonhighly compensated employees, pays normal retirement benefits as an annuity beginning at age 65, and an early retirement benefit payable upon termination of employment on or after age 55 with 30 or more years of service. However, all but two of the nonhighly compensated employees were hired after age 35 and, therefore, they will never qualify for the benefits. The regulations provide that this example violates the effective availability test. Treas. Reg. §1.401(a)(4)-4(c)(2)(Example 1).
- In the second example, the plan was amended to provide an early retirement benefit for individuals who are age 55 with 10 years of service and who elect the early retirement option during a 15-day period after the amendment. The employer did not take any steps to inform employees of this new option after the plan amendment and only two highly compensated employees actually retired under the early retirement option. Again, the regulations found that this plan amendment violated the effective availability test. Treas. Reg. §1.401(a)(4)-4(c)(2)(Example 2).
- In the final example, the plan was amended to provide for a single lump sum distribution to any employee who terminated employment within six months of the plan amendment. The availability of the benefit was conditioned on an employee having a particular disability at the time of termination. The only individual who met the disability requirement at the time of the amendment was a highly compensated employee and no other employee became disabled in the six-month period. This amendment also violated the effective availability test. Treas. Reg. §1.401(a)(4)-4(c)(2)(Example 3).

Proposed Treasury Regulation §1.401(a)-3(e)(4)

In 2004, the IRS issued proposed regulations outlining the requirements of a bona fide phased retirement program within a defined benefit plan. In these proposed regulations, the IRS stated that phased retirement benefits would be considered a “benefit, right or feature” under Treasury Regulations Section 1.401(a)(4)-4. See Prop. Treas. Reg. §1.401(a)-3(e)(4). Under the proposed regulation, therefore, phased retirement benefits would need to be made currently and effectively available in a nondiscriminatory manner to both highly compensated employees and nonhighly compensated employees.

Some commentators to the proposed regulations sought clarification of the application of the BRF test to bona fide phased retirement programs. For example, the American Benefits Council (ABC) requested that the IRS provide “certain regulatory clarifications in order to facilitate trial basis phased retirement programs.” Furthermore, ABC indicated that it believed that “a facts and circumstances test under 401(a)(4) is appropriate for phased retirement programs in order to encourage their development. At the very least, the Council

believes that the age and service conditions should be disregarded for limited time programs (such as five years or less) in order to encourage employers to try out phased retirement programs on a trial basis without concern that the program will become a permanently protected benefit and/or that the feature will fail nondiscrimination testing.”

On the other hand, some commentators agreed with the IRS’ position. In AARP’s comments, AARP stated that [“e]nsuring that the nondiscrimination rules apply to phased retirement programs by treating them as a ‘benefit, right or feature’ of a pension plan is an appropriate way to protect nonhighly compensated employees and to help guarantee that a broad spectrum of an employer’s workers can participate in these plans.”

Phased Retirement and Treas. Reg. §1.401(a)(4)-4: An Analysis

If, as under the proposed regulations, a phased retirement program were required to satisfy both the current and effective availability tests, it appears that an employer would have only three options:

1. The employer could elect not to offer a bona fide phased retirement program within its defined benefit plan.
2. The employer could limit the number of highly compensated employees who would be allowed to participate in the bona fide phased retirement program.
3. The employer could increase the number of nonhighly compensated employees who participate in the bona fide phased retirement program by opening the option to all employees, by encouraging nonhighly compensated employees who might otherwise not participate to participate in such a program, or, at the most extreme level, by requiring all or many employees to participate in the bona fide phased retirement program.

From a public policy perspective, each of these options is somewhat problematic.

If the goal is to increase access to phased retirement programs, the first option in which employers elect not to offer a bona fide phased retirement program because of the nondiscrimination rules does nothing to further that goal. Instead, this option merely maintains the status quo, in which most employers who wish to offer phased retirement do so informally, generally by allowing retired employees to return as independent contractors. Such arrangements may not be in the best interests of employees, who lose all the protections and benefits of being an actual employee. Such arrangements are often not in the interest of the employer either, because the employer has no control over the former employee and may lose the individual to a competitor.

The second option might increase access to phased retirement programs to some degree. However, if an employer is required to limit the number of highly compensated employees who can participate in the program, the employer may not necessarily be able to use the phased retirement program to retain the critical talent that the employer would like to retain, especially because, in general, such “critical talent” most likely would be highly compensated employees under the Code.¹³ On the other hand, if not all highly compensated employees are eligible to participate in the program, some may fully retire, while hoping to secure a job elsewhere. But there is no guarantee that they will be able to obtain comparable employment.

The third option has the benefit of increasing access to a phased retirement program, but it might not serve the employer’s needs, and it might result in unintended consequences for certain employees. From a business perspective, an employer may not wish to retain all its employees who are approaching retirement age, nor may it be able to accommodate every employee who wishes to reduce his/her hours and enter into a phased retirement arrangement.

From an employee perspective, many nonhighly compensated employees may not want, or, more importantly, may not be able to afford to enter into a phased retirement program in which their current compensation is reduced and not necessarily fully replaced by in-service distributions from the pension plan. In addition, entering into a phased retirement program might jeopardize nonhighly compensated employees’ retirement security, because the amount of the full final retirement benefit will be reduced by the amount received during the phased retirement benefit, and the benefit accrual will be reduced during the phased retirement period because of the reduced hours worked. Given the nondiscrimination rules’ original purpose of increasing pension coverage and access to benefits and contributions for rank and file workers, this result would seem particularly ironic.

Possible Modifications to the BRF Test for Bona Fide Phased Retirement Programs

The above examples show that it may be problematic to apply the current BRF test to bona fide phased retirement programs if the government wishes to encourage employers to offer such programs while at the same time protecting certain employees. Over the past twelve months, various ideas from different constituencies with whom Workplace Flexibility 2010 has spoken have emerged.

¹³ For example, a study on employers who do or could offer phased retirement programs found that a significant percentage of employers indicated that the employer could make arrangements for a phased retirement program for white-collar workers, many of whom most likely would be highly compensated employees. See generally Hutchens, R. (2003). “The Cornell Study of Employer Phased Retirement Policies: A report on Key Findings.” Ithaca, NY: School of Industrial and Labor Relations, Cornell University available at <http://www.ilr.cornell.edu/extension/files/20031219112155-pub1251.pdf>.

Below is a brief description of each modification and the possible consequences of each.

- **Modification One:** Exempt phased retirement distributions from the benefits, rights or features nondiscrimination test.

This change may encourage employers to offer bona fide phased retirement programs. However, this modification may limit the employees to whom such programs are offered – namely, only to highly compensated employees.

- **Modification Two:** Lower the percentage for phased retirement distributions for the benefits, rights or features nondiscrimination test from 70 percent for the currently available test and allow a limited exemption for the effective availability test.

Depending on the reduction in the percentage test for the current availability test and the type of exemption under the effective availability test, this modification may also encourage employers to offer bona fide phased retirement programs. Furthermore, this modification may also encourage employers to offer such benefits to, at least, a limited number of nonhighly compensated employees.

- **Modification Three:** Provide an exemption for phased retirement distributions from the benefits, rights or features nondiscrimination test for a limited number of years after such a program is established.

This modification may encourage employers to offer phased retirement distributions on a trial basis to see if such programs, in fact, work for both the employer and employees. Furthermore, it may be possible that after this trial period, the employer could open such programs to the general employee population.

- **Modification Four:** Exempt bona fide phased retirement programs from the benefits, rights or features nondiscrimination test and create an entirely new statutory or regulatory provision in the Code explicitly designed to achieve the dual social goals at play: permitting the creation of bona fide phased retirement programs that meet an employer's business needs and yet open access to such programs to the greatest number of employees who may want to participate in them.

This change (depending on the approach of the new rule) might be able to maintain the social policy behind the benefits rights and features test, while specifically tailoring the legal requirements to match the realities of bona fide phased retirement programs.

Conclusion

When the Code's nondiscrimination rules were introduced in 1942, the concept of phased retirement did not exist. In fact, pension plan coverage was still a relatively new concept in American society. As today's demographics change with individuals living longer and wanting and needing to continue work in some capacity, it may be time to reexamine how the benefits, rights and features nondiscrimination test poses barriers to keeping workers in the workforce longer.