

Is the QSERP Dead? Proposed Rules Target Individual Benefit Formulas

On January 29, 2016, the IRS released [proposed regulations](#) that will, when finalized, make certain changes to the qualified retirement plan nondiscrimination rules. Most of these changes focus on closed defined benefit plans. But one of these changes could, if finalized as proposed, significantly restrict the use of special one-participant benefit formulas, including qualified supplemental executive retirement plans (QSERPs) that provide additional benefits to key executives under a qualified plan that would otherwise be provided under a nonqualified plan.

Proposed Changes Affecting Benefit Formulas for Individual Employees

Historically, the IRS has taken issue with benefit formulas for individual employees, but has never, to our knowledge, clearly articulated, until now, exactly how the tax rules prohibit this practice. The new proposed regulations focus on the general nondiscrimination testing rules.

Under these rules, each rate group – each highly compensated employee (HCE) and each nonhighly compensated employee (NHCE) with an equal or higher allocation or accrual rate – must pass one of two coverage tests, the ratio percentage test or the average benefits test. To pass the ratio percentage test, the rate group's ratio percentage – the percentage of benefiting NHCEs, divided by the percentage of benefiting HCEs – must be at least 70%.

To pass the average benefits test, two requirements must be met. First, the plan must pass coverage using the average benefits test. To pass this test, the average NHCE benefit percentage must be at least 70% of the HCE average. Second, the rate group's ratio percentage must be at least equal to a lower percentage – 30.75% to 45%, depending on the percentage of the employer's workforce who are NHCEs.

Unlike the average benefits coverage test, however, these rules don't currently subject the rate group to the "reasonable business classification" standard, a subjective facts and circumstances test under which the classification of employees who benefit must be reasonable and established under objective business criteria – this requirement is deemed satisfied so long as the rate group's



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ratio percentage passes the numeric test.

The proposed rules would change this. Under the proposed rules, to satisfy coverage using the average benefits test, the rate group must, in addition to passing the numeric tests, be based on a formula that applies not only to the HCE for whom the rate group is established, but also to a group that represents a reasonable business classification. According to the IRS, a benefit formula that applies solely to an HCE identified by name won't meet this requirement.

Impact of The Proposed Change

This proposed change will potentially impact QSERPs as well as other qualified plans with benefit or contribution formulas that apply solely to an HCE identified by name. While this change doesn't explicitly prohibit these types of arrangements, it may effectively prohibit many of them by making it more difficult to satisfy the nondiscrimination tests. As a result, the ratio percentage for a rate group established for an HCE, whose benefit or contribution is determined under a formula that applies only to that HCE, will have to be at least 70% to pass the nondiscrimination test.

What Should Plan Sponsors do Now?

If the rules in the proposed regulations become effective, the effective date would be the beginning of the first plan year on or after the final regulations are published. The IRS has requested comments on these rules, which will require additional time before the rules become effective. Furthermore, based on the recent pace of IRS guidance, the effective date could be a ways off. That said, employers that sponsor plans with QSERPs or other one-participant benefit formulas should review their nondiscrimination tests and, if necessary, consider alternative ways to structure these benefits to avoid failing these tests if and when these proposed rules are finalized. Plan sponsors may also want to submit comments to the IRS to request grandfathered status for existing QSERPs. The IRS also issued proposed regulations that provide nondiscrimination relief for certain closed defined benefit plans. An alert on that topic will follow.

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