ERIC

The
ERISA
Industry
Committee

April 28, 2016

CC:PA:LPD:PR
REG–125761–14
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Regulations – Nondiscrimination Requirements for Closed Defined Benefit Pension Plans

Ladies and Gentlemen:

The ERISA Industry Committee ("ERIC") is pleased to respond to the request of the U.S. Treasury Department and the Internal Revenue Service (collectively, the "Agencies") for comments regarding proposed regulations relating to nondiscrimination in the amount and availability of employer-provided contributions and benefits. The proposed regulations were published in the Federal Register on January 29, 2016. (The provisions of the proposed regulations that were intended to restrict qualified supplemental executive retirement plans were subsequently withdrawn.) ERIC appreciates the efforts of the Agencies to remove obstacles that prevent employers from providing on-going accruals under a defined benefit plan or additional contributions under a defined contribution plan to grandfathered groups of older, longer-service employees who have participated in a defined benefit plan in the past. Unfortunately, we have found that, because the proposals are narrowly tailored, the modifications will benefit only a limited number of plans unless they are substantially revised.

ERIC's Interest in the Proposed Regulations

ERIC is the only national trade association advocating solely for the employee benefit and compensation interests of the country's largest employers. ERIC supports the ability of its large employer members to tailor health, retirement, and other benefits for millions of employees, retirees, and their families. ERIC's members provide comprehensive benefit packages to tens of millions of active and retired workers and their families. ERIC has a strong interest in proposals, such as the proposed regulations, that would affect its members' ability to provide secure retirement benefits in a cost-effective manner.

Summary of Comments

The following is a summary of ERIC's comments, which are described in greater detail below:

- The Agencies should harmonize the rules for DC and DB/DC plans.
- The Agencies should not limit the proposed new rules for benefits, rights, and features in closed DB plans to DB plans that have implemented a significant formula change.

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- The Agencies should remove restrictions for DB plans with previous closure dates and multiple closure dates.
- The Agencies should not favor nonelective contributions to a DC plan over matching contributions.
- The Agencies should limit the application of the minimum participation requirement of Code § 401(a)(26) in the case of closed DB plans.
- The Agencies should make technical clarifications to the proposed regulations.

OVERVIEW

The Internal Revenue Code (the "Code") requires qualified retirement plans, including defined benefit ("DB") plans and defined contribution ("DC") plans, to be provided in a nondiscriminatory manner. In particular, the Code requires that the group of employees covered by a plan[1] as well as the contributions or benefits provided under the plan[2] not discriminate in favor of highly compensated employees ("HCEs"). Separately, the Code requires a DB plan to benefit a minimum number of employees.[3]

In response to economic and other concerns, some employers have modified the design of their retirement plans. Common modifications include: (1) closing the DB plan or a benefit formula under the DB plan to employees not previously participating in the plan or formula (a "soft freeze"); (2) converting from a traditional DB plan to a hybrid DB plan; and (3) ceasing all benefit accruals in the DB plan or ceasing accruals under a benefit formula for some or all employees who previously benefitted under that formula (a "hard freeze") and providing special contributions in a DC plan for employees who had previously participated in the hard frozen DB plan or formula. Some employers use a combination of these modifications, *e.g.*, soft freezing the traditional formula in a DB plan and adding a hybrid formula for new hires.

As a result, the number of active participants in DB plans has been steadily declining. A 2012 survey found that the percentage of closed or frozen plans had increased from 41% in 2010 to 57% in 2012.[4]

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[1] *See generally*, Code § 410(b).

[2] *See generally*, Code § 401(a)(4).

[3] *See generally*, Code § 401(a)(26).

[4] Vanguard, *Survey of Defined Benefit Plan Sponsors, 2012* (Nov. 2012), available at https://institutional.vanguard.com/iam/pdf/ICRSDB.pdf?cbdForceDomain=true.

Over time, a group of employees that (1) continues to accrue benefits in a soft frozen DB plan or formula or (2) receives additional allocations in a DC plan due to past participation in a hard frozen DB plan or formula (in each case, a "grandfathered group of employees"), is likely to include a higher concentration of highly compensated employees ("HCEs") due to intervening increases in compensation. In addition, non-highly compensated employees ("NHCEs") may experience higher turnover than HCEs. Consequently, a plan benefiting a grandfathered group of employees that once easily satisfied the Code's nondiscrimination requirements may begin to experience difficulty satisfying them. When this happens, many large plan sponsors are often more inclined to cease benefit accruals for the grandfathered group of employees in the DB plan or eliminate or reduce the additional allocations for the grandfathered group of employees in the DC plan. In addition, the number of covered employees in most closed DB plans will eventually drop below the minimum required number of covered employees.

Notice 2014-5[5] provided temporary nondiscrimination rules applicable in limited circumstances for soft frozen and hard frozen DB plans and also proposed several options for permanent rule changes. The proposed regulations implement many of the options proposed in Notice 2014-5.

DETAILED COMMENTS

I. Summary of existing rules.

a. Cross-Testing for DC Plans

The basic general test rules require amounts testing to be performed for DC plans on the basis of contributions and for DB plans on the basis of benefits. The cross-testing rules allow amounts testing to be performed for DC plans on the basis of benefits and for DB plans on the basis of contributions.[6] However, a DC plan cannot be cross-tested on a benefits basis unless it meets one of several gateway requirements (the "DC gateway requirements"), though no such restrictions apply to cross-testing a DB plan on a contributions basis.

A DC plan may be cross-tested if it provides broadly available allocation rates. Generally, a DC plan provides broadly available allocation rates if each allocation rate under the plan satisfies 410(b) without regard to the average benefit percentage test. For this purpose, defined benefit replacement allocations ("DBRAs") are ignored. Generally, a DBRA is an allocation designed to replace a DB plan's benefits for a group of employees who formerly benefitted under that DB plan if it was an established nondiscriminatory DB plan of the employer or of a prior employer that provided

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[5] Internal Revenue Service, Notice 2014-5: Temporary Nondiscrimination Relief for Closed Defined Benefit Plans and Request for Comments, 2014-2 I.R.B. 276 (Jan. 6, 2014)

[6] Treas. Reg. § 1.401(a)(4)-8.

equivalent allocation rates that increased from year to year based on age. Detailed requirements for DBRAs are provided in Rev. Rul. 2001-30.[7]

A DC plan may also be cross-tested if it provides age-based allocation rates based on either a gradual age or service schedule or a uniform target benefit allocation.

Finally, a DC plan may be cross-tested if it provides a minimum allocation rate for all NHCEs equal to the lesser of (1) one-third of the allocation rate of the HCE with the highest allocation rate or (2) 5%. Generally, only nonelective contributions are taken into account to determine whether this gateway is satisfied due to the mandatory disaggregation rules for elective and matching contributions.[8]

A DC plan that satisfies a DC gateway requirement may perform amounts testing on a benefits basis. However, as with the minimum allocation gateway, only nonelective contributions are taken into account for amounts testing due to the mandatory disaggregation rules for elective and matching contributions.[9]

b. Testing aggregated DB and DC plans on a benefits basis

An employer aggregating its DB and DC plans (a "DB/DC" plan) may perform amounts testing for the DB/DC plan on the basis of either benefits or contributions.[10] However, a DB/DC plan may not be tested on the basis of benefits unless it meets one of three gateway requirements (the "DB/DC gateway requirements").

A DB/DC plan may be tested on a benefits basis if it is primarily defined benefit in character. Generally, a DB/DC plan is primarily defined benefit in character if a majority of NHCEs in the DB/DC plan receive greater benefits under the DB component of the plan than under the DC component (measured on a benefits basis).

A DB/DC plan may also be tested on a benefits basis if it consists of broadly available separate plans. Generally, a DB/DC plan consists of broadly available separate plans if the DC and DB components could satisfy coverage and amounts testing on their own, assuming that the average benefit percentage test were satisfied.

Finally, a DB/DC plan may be tested on a benefits basis if it provides a minimum aggregate allocation rate (including allocation rates under the DC plan and equivalent allocation rates under the

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[7] Internal Revenue Service, *Revenue Ruling 2001-30: Employee benefit plan qualification requirements—nondiscrimination—cross-testing*, 2001-2 C.B. 46 (June 29, 2001).

[8] Treas. Reg. § 1.410(b)-7(c)(1).

[9] *Id.*

[10] Treas. Reg. § 1.401(a)(4)-9(b).

DB plan) to all NHCEs. The minimum aggregate allocation rate varies depending upon the aggregate allocation rate of the HCE with the highest aggregate allocation rate, but it is capped at 7.5%.

Again, for the DC plan components of a DB/DC plan, only nonelective contributions can be taken into account (1) to determine whether the minimum aggregate allocation gateway is satisfied and (2) if a DB/DC gateway requirement is satisfied, for amounts testing.

c. Nondiscrimination testing rules for benefits, rights, and features

The Code provides that the contributions or benefits provided under a plan may not discriminate in favor of HCEs. The Agencies have interpreted this provision as generally requiring benefits, rights, and features ("BRFs") provided under a plan to be made available in a nondiscriminatory manner.

Each BRF must be both "currently available" and "effectively available" to a nondiscriminatory group of employees.[11] Generally, a BRF will satisfy the current availability requirement only if the BRF benefits a minimum percentage of NHCEs compared to the percentage of HCEs who benefit under the plan. A BRF will satisfy the effective availability requirement if the group of employees to whom the BRF is effectively available does not substantially favor HCEs, based on all the facts and circumstances.

d. Minimum participation requirements.

The Code also requires a DB plan to cover the lesser of (1) 50 employees of the employer, or (2) 40 percent of all employees of the employer.[12]

II. Summary of proposed changes to regulations.

The proposed regulations provide special rules for "closed defined benefit plans" by modifying the rules for testing DC plans and DB/DC plans on a benefits basis, and for testing BRFs.

a. Definition of "Closed Defined Benefit Plan"

The proposed regulations define a "closed defined benefit plan" (hereinafter, a "closed DB plan") as a DB plan that has been amended to (1) cease accruals under a benefit formula provided by the DB plan for some or all employees whose benefits were previously determined under that benefit formula, or (2) limit participation in the DB plan to a group of employees that consists of some or all of the plan participants who participated in the plan as of the closure date. In other words, the special rules in the proposed regulations for closed DB plans generally apply to hard frozen DB plans, soft

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[11] Treas. Reg. § 1.401(a)(4)-4.

[12] Code § 401(a)(26)(A). A defined benefit plan of an employer with more than one employee but fewer than five employees must benefit at least 2 employees. *Id.*

frozen DB plans, and DB plans with hard frozen formulas. The special rules for closed DB plans in the proposed regulations do not apply to a DB plan with a soft frozen formula unless either (1) the DB plan also has a hard frozen formula or (2) all benefit formulas under the DB plan are either soft frozen or hard frozen.

b. Modifications to DC Gateway Requirements

The proposed regulations modify the definition of a DBRA, which is excluded from consideration under the "broadly available allocation rates" DC gateway requirement. Under both the current and the proposed rules, the DBRA definition contains three sets of requirements, which apply respectively to (1) the allocation, (2) the closed DB plan with respect to which the allocation is provided, and (3) the group of employees to whom the allocation is provided.

The current rules state that, to be a DBRA, an allocation must be "reasonably calculated, in a consistent manner, to replace the retirement benefits" provided under the DB plan.[13] The proposed regulations clarify that a DBRA must be "reasonably expected to replace some or all of the value of" accruals under a closed DB plan. The proposed regulations also add the requirement that the replacement allocation be provided in a consistent manner to all similarly situated employees.

Under the current rules, the closed DB plan with respect to which the DBRA is provided must have provided equivalent normal allocation rates that increased from year to year based on age.[14] The proposed regulations would also allow a closed DB plan to satisfy this requirement if it provided equivalent normal allocation rates that increased from year to year based on years of service.

The current rules require the group of employees receiving a DBRA to be nondiscriminatory (*i.e.*, to satisfy the requirements of Code section 410(b) without regard to the average benefit percentage test).[15] The proposed regulations would modify this rule so that the group of employees receiving the DBRA only needs to satisfy this requirement for five years after the DB plan is closed.

The proposed regulations also permit DBRAs to be disregarded under the "gradual age or service schedule" DC gateway requirement.

c. Modifications to DB/DC Gateway Requirements for DB/DC Plans with a Soft Frozen DB Component

A DB/DC plan with a soft frozen DB component does not need to satisfy the DB/DC gateway requirements to test on a benefits basis for a plan year beginning five years after the closure date if it meets all of the following requirements:

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[13] Rev. Rul. 2001-30.

[14] *Id.*

[15] *Id.*

1. The closed DB plan must be in effect for five years before it is closed.
2. With some exceptions, neither the benefit formula nor the coverage of the closed DB plan is significantly changed by an amendment with an applicable amendment date during the period that begins five years before the closure date and ends on the last day of the plan year.
3. For each of the first five years after the closure date, the DB/DC plan satisfies one of the following requirements:
    i. Each DB plan in the DB/DC plan passes amounts testing without cross-testing or aggregation with any DC plan.
    ii. The DB/DC plan passes amounts testing on the basis of allocations.
    iii. The DB/DC plan passes satisfies either the "primarily defined benefit in character" or "broadly available separate plans" DB/DC gateway requirement.

d. Modifications to DB/DC Gateway Requirements, Generally

The proposed regulations contain several modifications that apply to all DB/DC plans (regardless of whether there is a closed DB component):

1. The gateway requirements are eliminated for DB/DC plans that can satisfy nondiscrimination testing on the basis of benefits using a 6% interest rate rather than a standard interest rate (7.5% to 8.5%).
2. Employers may apply the minimum aggregate allocation gateway on the basis of average NHCE equivalent normal allocation rates and average NHCE allocation rates.
3. Employers may take into account the average matching contribution rate in the DC component (up to 3%) in determining whether a DB/DC plan satisfies the minimum aggregate allocation gateway.

e. Modifications to BRF availability testing requirements

The proposed regulations modify the BRF rules so that certain BRFs provided to a grandfathered group of employees are exempt from nondiscriminatory availability requirements. A BRF provided only to a grandfathered group of employees is treated as satisfying the nondiscriminatory availability requirements beginning five years after the closure date of the closed DB plan if--

1. No amendment has affected the availability of the BRF since the closure date, and
2. Either--
    i. The BRF is provided under the closed DB plan, and
        a. No amendment affecting the availability of the BRF (other than the closure amendment) has an applicable amendment date within the 5-year period ending on the closure date, and

b. The closure amendment also provided a significant change in the benefit formula under the closed DB plan, or

ii. The BRF is a rate of matching contributions provided under a DC plan, and

a. The match is reasonably designed to replace some or all of the closed DB plan's benefits,

b. The closed DB plan satisfies the same requirements applicable under the DBRA rules, and

c. The rate of matching contributions is provided in a consistent manner to all similarly situated employees.

III. The Agencies should harmonize rules for DC and DB/DC plans.

ERIC appreciates that the Agencies are trying to increase the number of plans that satisfy the DC and DB/DC gateway requirements by providing alternatives. However, given the stringent eligibility requirements in the proposed regulations, we understand that many plans will be unable to avail themselves of the alternatives.

For example, the modifications to the DC gateway and DB/DC gateway requirements are unlikely to be useful to hard frozen plans that need alternatives to satisfy the gateway requirements. Aon Hewitt conducted a study of 165 employers with closed DB plans. Thirty-five percent of employers with hard frozen DB plans indicated that (1) they need alternatives to satisfy the DC gateway requirements, and (2) the proposed rule changes do not help them satisfy such requirements.

ERIC urges the Agencies to harmonize the modifications to the cross-testing restrictions for DC and DB/DC plans. The final regulations should (1) permit use of average matching contributions to satisfy DC minimum allocation gateway, (2) permit use of average allocation rates to satisfy DC minimum allocation gateway, and (3) permit cross-testing for a DC plan using a 6% interest rate without satisfying additional gateway requirements. The final regulations should also reduce the DB/DC minimum aggregate allocation gateway cap, which is currently 7.5%. Reducing the cap to 5% would harmonize the minimum aggregate allocation gateway with the minimum allocation gateway applicable to DC plans, and an even greater reduction would allow more plans to test on an aggregated basis.

IV. The Agencies should not limit the proposed new rules for benefits, rights, and features in closed DB plans to DB plans that have implemented a significant formula change.

The nondiscrimination rules for BRFs are a significant problem for many plans, particularly with respect to early retirement subsidies. For example, an early retirement subsidy may have been available to participants in the company's traditional DB plan. If the company freezes the traditional DB plan and/or converts the traditional DB plan to a cash balance plan, some workers may not be eligible for the early retirement subsidy. While the availability of the early retirement subsidy is beneficial to the workers who had participated in the traditional DB plan, it may cause the plan to fail the nondiscrimination requirements. These workers are often older employees with longer service. As NHCEs become HCEs due to increases in compensation, the plan will increasingly have difficulty satisfying the nondiscriminatory availability requirements.

The proposed BRF rules apply to (1) BRFs provided to a grandfathered group of employees under a closed DB plan that has implemented a significant formula change for other participants, and (2) matching contributions under a DC plan provided to a grandfathered group of employees.

In Aon Hewitt's survey, 51% of closed DB plans indicated a need for alternatives to pass nondiscriminatory availability testing for BRFs in a soft frozen DB plan, but only 10% of those plans would be eligible to pass using the new rules in the proposed regulations. An additional 78% of those plans would be able to take advantage of the new BRF rules in the proposed regulations if the significant formula change requirement were eliminated.

ERIC urges the Agencies to extend the proposed rule for BRFs provided under closed DB plans to DB plans for which a significant formula change is not part of the plan closure amendment.

V. The Agencies should remove restrictions for DB plans with previous closure dates and multiple closure dates.

ERIC appreciates the Agencies' request for comments on nondiscrimination requirements for plans with multiple closure dates. The retroactive application of the amendment restrictions in the proposed regulations make the rules in the proposed regulations unusable for many DB plans, including those that have already been closed, and the restrictions pose special problems for DB plans with multiple closure dates. In order to allow these plans to use the rules for closed DB plans, ERIC urges the Agencies to add the following types of amendments to the lists of permitted amendments in Prop. Treas. Reg. §§ 1.401(a)(4)-4(d)(8)(iv), -8(b)(1)(iii)(D)(5), and -9(b)(2)(v)(F)(3): (i) closure amendments; (ii) amendments adopted before January 29, 2016; (iii) amendments implementing plan mergers, spinoffs, transfers, and other transactions described in Code § 414(*l*); (iv) amendments that expand participation to prevent a closed DB plan from failing the nondiscrimination tests or the minimum participation requirements of Code § 401(a)(26); and (v) amendments adopted after the closure date if the plan satisfies nondiscrimination testing in the year of the amendment.

In addition, the Agencies should allow an employer that engages in a corporate transaction during the five-year period following a closure date for a DB plan that is part of a DB/DC plan to perform amounts testing for the DB/DC plan without regard to the change in the controlled group caused by the corporate transaction.

VI. The Agencies should not favor nonelective contributions to a DC plan over matching contributions.

Many employers consciously choose to use a match instead of a nonelective contribution in order to encourage their employees to contribute more to their own retirement savings. These employers often do so because they believe that nonelective contributions sometimes discourage employees from contributing to a DC plan. Other employers may believe that nonelective contributions are a better means of delivering retirement benefits. Because both methods are reasonable choices, the nondiscrimination rules should allow employers to choose which type of contribution to make rather than favoring one over the other.

ERIC appreciates that the agencies have recognized the importance of allowing matching contributions to be taken into account for purposes of the DB/DC minimum aggregate allocation

gateway. However, the proposal does not permit employers to take into account more than a 3% match. There does not appear to be any policy reason why there should be a cap on the amount of matching contributions used for this purpose. In addition, unless matching contributions can also be used for amounts testing, employers that provide matching contributions (instead of nonelective contributions) under a DC plan will continue to be unfairly penalized for choosing to deliver retirement benefits to their employees in the form of a match.

VII. The Agencies should limit the application of the minimum participation requirements of Code § 401(a)(26) for closed DB plans.

Most closed DB plans will eventually fail to cover the minimum required number of employees due to participant attrition. In many cases, an employer may be forced to terminate a closed DB plan to avoid such a failure. ERIC urges the Agencies to limit the application of Code § 401(a)(26) for closed DB plans to prevent such terminations. In order to prevent abuse, the Agencies could provide that the requirements of Code § 401(a)(26) continue to apply unless the closed DB plan satisfied Code § 401(a)(26) for at least five years before it was closed.

VIII. The Agencies should make technical clarifications to the proposed regulations.

ERIC requests that the Agencies make several technical clarifications to the proposed regulations.

1. In order to use the proposed new rules regarding DBRAs and matching contribution rates provided to a grandfathered group of employees, the closed DB plan with respect to which such contributions are provided must have provided equivalent normal allocation rates that increased from year to year based on age or years of service. The final rules should clarify that a cap on years of service or that otherwise limits the amount of a participant's benefit accruals is disregarded for purposes of determining whether the closed DB plan met this requirement.
2. The Agencies should eliminate the vague additional requirement to provide DBRAs and matching contribution rates to a grandfathered group of employees "in a consistent manner to all similarly situated employees." The other requirements applicable to DBRAs and matching contribution rates are sufficient to ensure that they are provided on a nondiscriminatory basis. DBRAs are subject to amounts testing and must be provided to a nondiscriminatory group of employees for at least five years after the closure date of the closed DB plan with respect to which the DBRAs are provided. Matching contributions are subject to ACP testing, and matching contribution rates provided to a grandfathered group of employees must pass BRF availability testing for at least five years following the plan closure date of the closed DB plan with respect to which such matching contribution rates are provided.
3. The final rules should expand the definition of "closed defined benefit plan" to include a defined benefit plan with one or more soft frozen benefit formulas and one or more open benefit formulas, *i.e.*, a defined benefit plan that has been amended to limit participation in a benefit formula provided by the defined benefit plan to a group of employees that consists of some or all of the plan participants who participated in the plan as of the closure date.

4. The final rules should clarify in the definition of "grandfathered group of employees" what it means to "continue accruals under the closed defined benefit plan's benefit formula." ERIC assumes that this means "continue accruals under the closed defined benefit plan's **closed** benefit formula."
5. The final rules should clarify that the same data is used to determine ratio percentages both before and after an amendment to determine whether the amendment is nondiscriminatory for purposes of Prop. Treas. Reg. § 1.401(a)(4)-8(b)(1)(iii)(D)(6)(i).
6. The closed plan rule for DB/DC plans in Prop. Treas. Reg. § 1.401(a)(4)-9(b)(2)(v)(F) should be modified so that the requirements for passing amounts testing during the five years following the closure date include passing using the temporary rules under Notice 2014-5.

ERIC appreciates the opportunity to provide comments on the proposed regulations. If the Agencies have any questions concerning our comments, or if we can be of further assistance, please contact us at (202) 789-1400.

Sincerely,

Will Hansen

Senior Vice President, Retirement Policy