ERIC

The ERISA Industry Committee

February 28, 2014

CC:PA:LPD:PR
Notice 2014-5
Room 5203
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, DC 20044

RE: Notice 2014-5 - Nondiscrimination Relief for Closed Defined Benefit 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 Notice 2014-5 relating to Nondiscrimination Relief for Closed Defined Benefit Plans (the "Notice").[1] ERIC appreciates the efforts of the Agencies to provide temporary relief for defined benefit plans that provide ongoing accruals but that have been amended to limit those accruals to some or all of the employees who participated in the plan on a specified date ("closed" or "soft frozen plans") and to update the rules relating to nondiscrimination testing. Unfortunately, we have found that, because both the temporary relief and the proposals for permanent relief are narrowly construed, the relief will apply only to a limited number of plans.

ERIC'S INTEREST IN THE PROPOSED REGULATIONS

ERIC is a nonprofit association committed to the advancement of the employee retirement, health, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals that would affect its members' ability to provide secure pension 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 issue guidance to provide plans with permanent relief as soon as possible.
- Additional relief should be provided with respect to benefits, rights and features.

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[1] 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).

- The Agencies should provide soft frozen defined benefit plans with additional options to satisfy the nondiscrimination requirements.

- Defined contribution plans that provide enhanced benefits to former defined benefit plan participants should be provided with additional options for satisfying the nondiscrimination requirements.

- Contributory plans that otherwise satisfy the nondiscrimination requirements should not be considered discriminatory merely because some highly compensated employees ("HCEs") contribute more than some non-highly compensated employees ("NHCEs").

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 provides that the group of employees covered by a plan[2] as well as the contributions or benefits provided under the plan[3] must not discriminate in favor of HCEs.

In response to a variety of concerns, some employers have modified the design of their retirement plans. Common modifications include: (1) closing the DB plan to employees not previously participating in the plan and/or placing limits on future benefit accruals for some or all active participants (that is, "closed" or "soft frozen plans"); (2) converting from a traditional DB plan to a hybrid DB plan; and (3) ceasing benefit accruals in the DB plan (a "hard freeze") and providing special contributions in a DC plan for employees who had previously participated in a DB plan.

As a result, the number of DB plans has been steadily declining. The U.S. Department of Labor reports that the number of DB plans has decreased from over 175,000 plans in 1983 to around 45,000 plans in 2011.[4] A 2012 survey found that the percentage of closed or hard frozen plans had increased from 41% in 2010 to 57% in 2012.[5]

Over time, employees who continue to participate in a soft frozen plan are more likely to become HCEs due to increases in compensation and promotions. In addition, NHCEs may have higher turnover than HCEs. Consequently, a DB plan that once easily satisfied the Code's nondiscrimination requirements may begin to experience difficulty satisfying them. Large companies' plans are set up to provide generous benefits to their employees and are designed to be non-discriminatory. However, when DB plans are closed to new entrants, these plans may begin to have difficulty satisfying the nondiscrimination requirements, particularly the significant hurdle imposed by the gateway minimum contribution. When a DB plan is at risk of failing to satisfy the Code's nondiscrimination requirements using available options, many large plan sponsors are often more inclined to cease benefit accruals for participants ("hard frozen plans").

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[2] *See generally*, Code § 410(b).
[3] *See generally*, Code § 401(a)(4).
[4] U.S. Dep't of Labor, *Private Pension Plan Bulletin Historical Tables and Graphs*, Table E1 (Jun. 2013) (showing the number of defined benefit plans as 175,143 in 1983 and 45,256 in 2011).
[5] Vanguard, *Survey of Defined Benefit Plan Sponsors, 2012* (Nov. 2012), available at https://institutional.vanguard.com/iam/pdf/ICRSDB.pdf?cbdForceDomain=true.

Similarly, the employees who receive higher benefits in a hybrid plan or DC plan due to past participation in a DB plan are also more likely to become HCEs. Although these workers are no longer participating in a traditional DB plan, the employer needs to be able to continue to provide incentives for these workers to remain with the employer when it is able to do so. These workers tend to be older with longer service and are often critical to the ongoing success of the business.

The Agencies provided temporary relief in limited circumstances for closed DB plans and also proposed several options for permanent relief in the Notice. The Agencies have indicated that these proposals for permanent relief are not limited to closed DB plans and that they are also interested in alternative ideas. However, we understand that the Agencies want to ensure that any proposals do not provide opportunities for individuals to abuse the rules and do not inadvertently encourage any company to freeze or terminate its DB plan.

Large plan sponsors do not engage in "gaming the system" by establishing, funding and freezing plans over a short period of time. Large plans cover participants numbering in the tens or hundreds of thousands. Large employers implement benefit arrangements with careful planning and analysis. The high costs associated with large plan compliance and with executing changes to such plans provide real disincentives to the "gaming" concerns of the Agencies. We also understand that the Agencies are concerned that providing relief in this area will provide incentives (although inadvertent) for companies to institute soft freezes in their DB plans. Based on member feedback, we understand that the current risk is that employers will feel pressure to institute a hard freeze in a plan that is currently in a soft freeze status unless the Agencies issue meaningful relief in this area. Therefore, we encourage the Agencies to issue permanent and meaningful guidance in this area as soon as possible to avoid adverse effects on older employees with longer service credits in closed DB plans.

DETAILED COMMENTS

I. The Agencies should issue guidance to provide plans with permanent relief as soon as possible.

In the Notice, the Agencies provide temporary relief for closed DB plans and propose permanent relief for retirement plans. Under the temporary relief, a DB/DC plan can generally satisfy the nondiscrimination in amount requirement of Treasury Regulation § 1.401(a)(4)-1(b)(2) on the basis of equivalent benefits (i.e., cross-testing) if:

- The plan is a DB plan that was amended before December 13, 2013;
- The amendment provides that only employees who participated in the DB plan on a specified date continue to accrue benefits under the plan; and
- Each of the DB plans in the DB/DC plan:
    - Was part of a DB/DC plan that either was primarily defined benefit in character or consisted of broadly available separate plans for the plan year beginning in 2013; or

- If the plan was amended to provide that only employees who participated in the DB plan on a specified date continue to accrue benefits under the plan, the DB plan was not part of a DB/DC plan for the plan year beginning in 2013 because the DB plan satisfied the coverage and nondiscrimination requirements without aggregation with any DC plan.

ERIC appreciates the provision of temporary relief for DB plans. However, given the limited nature of the relief, we understand that it will not be useful to many plans. Data from Aon Hewitt indicates that only 54 percent of the soft frozen plans would be eligible to benefit from the temporary relief for 2014 and 2015.

In the Notice, the Agencies also propose permanent relief, which would provide alternatives:

- For DC plans with age- and/or service-graded contribution rates;
- For DC plans with a combination of nonelective and matching contributions;
- For DC plans that could satisfy nondiscrimination using a lower interest rate; and
- Under which plans can request permission to disregard outliers (known as the safety valve alternative).

The Agencies also indicate that they are considering permanent relief for benefits, rights and features and additional use of matching contributions. The Agencies have indicated that this permanent relief is not limited to closed plans.

ERIC appreciates the Agencies' consideration with respect to long-term relief in this area. The risk of failing to satisfy the nondiscrimination requirements is a significant concern for many plans and has caused plan sponsors to consider hard-freezing their plans. As additional time passes, nondiscrimination issues become problematic for an increasing number of closed defined benefit plans.

The permanent proposals suggested by the Agencies would provide valuable relief to the plans that could use those options. However, we are concerned that there would be relatively few plans that could satisfy the proposed requirements. Data received from Aon Hewitt with respect to the Notice indicates that 89% of the soft frozen plans they examined would not be able to benefit from any of the four alternatives included in the Notice; and only 39% would be able to benefit if the proposals could be combined. For example, few plans would be able to satisfy the nondiscrimination requirements using the alternative that provides for a lower interest rate. Additionally, ERIC is concerned that the proposed process for the safety valve alternative would be administratively unworkable given the length of time needed to obtain the approval of the Commissioner. We are concerned that the Commissioner may ultimately deny the request several years later and that the plan will have been in noncompliance that entire time.[6]

[6] We are also concerned that the Agencies may adopt an approach similar to that used for demonstrating satisfaction of the safety valve test under Treasury Regulation § 1.401(a)(4)-3(c)(3). We understand that plans are expected to use the ruling letter process to obtain a determination from the IRS, which costs thousands of dollars in user fees.

ERIC understands that the Agencies are open to considering alternatives to the proposals included in Notice 2014-5. We have recommended solutions that address the nondiscrimination rules more broadly in order to encourage the Agencies to provide relief for a greater number of plans. We recommend that the Agencies adopt relief as described in sections II. - V. below as soon as possible. Although applicable to all plans, we believe that this relief will be particularly helpful to closed DB plans.

II. Additional relief should be provided with respect to benefits, rights and features.

The Code provides that the contributions or benefits provided under a plan may not discriminate in favor of HCEs.[7] 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.[8]

Each BRF must be both "currently available" and "effectively available" to a nondiscriminatory classification of employees.[9] Generally, a BRF will satisfy the current availability requirement only if the BRF is available to a minimum percentage of NHCEs based on the percentage of HCEs to whom the BRF is available. 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.

The nondiscrimination rules for BRFs are a significant problem for many plans, particularly with respect to early retirements. For example, an early retirement subsidy may have been available to participants in the company's traditional DB plan. If the company converts the traditional DB plan to a cash balance or other hybrid plan, some workers may not be eligible for the early retirement subsidy. Hybrid plans have been steadily increasing in usage by large companies. A recent study found that 19% of Fortune 100 companies had hybrid plans in 2012.[10] 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 who have knowledge and skills that are valuable to the employer. As more NHCEs become HCEs due to increases in compensation, the plan will increasingly have difficulty satisfying the requirements for BRFs. Similar challenges apply when BRFs are only available to a closed group of participants in a DC plan who previously participated in a DB plan that is now hard frozen. ERIC urges the Agencies to permit employers to manage their longer service workers effectively and exempt early retirement subsidies from the rules for BRFs.

The nondiscrimination rules also pose problems for other types of BRFs. Plan provisions that were permissible at the time the plan was closed to employees not previously participating in the plan may fail the nondiscrimination requirements over time due to increases in compensation, promotions, and employee turnover.

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[7] Code § 401(a)(4).
[8] Treas. Reg. § 1.401(a)(4)-4. We would also suggest that the special merger and acquisition rule applicable to BRFs be clarified to explicitly set forth that it applies to spinoffs.
[9] *Id.*
[10] Brendan McFarland, *Retirement Plan Types of Fortune 100 Companies in 2012*, Towers Watson (Oct. 2012), available at http://www.towerswatson.com/en/Insights/Newsletters/Americas/insider/2012/retirement-plan-type-of-fortune-100-companies-in-2012.

The Agencies have recognized that relief from the nondiscrimination rules for BRFs is appropriate in certain circumstances, such as after a merger or acquisition.[11]

ERIC requests that the Agencies provide treatment for BRFs similar to that provided for mergers and acquisitions.

If the Agencies are unwilling to provide this relief, ERIC would support requiring the relief to satisfy certain additional conditions, such as: (1) restricting the protected group to those employees who satisfy certain age or service conditions; (2) mandating that BRFs that are protected for HCEs be available on the same basis to all NHCEs in the protected group; or (3) requiring that the protected BRFs be associated with a preexisting benefit formula that was offered to a nondiscriminatory group of employees for at least two years. Alternatively, the Agencies could add an anti-abuse condition for cases that do not involve the protection of BRFs associated with a preexisting benefit formula.

III. The Agencies should provide soft frozen DB plans with additional options to satisfy the nondiscrimination requirements.

The Code requires the employees covered by a plan[12] as well as the contributions or benefits provided under the plan[13] to be provided in a nondiscriminatory manner. Treasury Regulations and related guidance provide a variety of tests, including the average benefits test, which are used to demonstrate the satisfaction of these provisions. In order to use some of the current testing options, companies must make a minimum nonelective contribution to NHCEs (known as a gateway minimum contribution).

While many large plans can easily satisfy these requirements when the plan is open, they increasingly have difficulty with the nondiscrimination requirements once the plan is closed to new entrants. Over time, increases in compensation and promotions, and higher employee turnover by NHCEs have resulted in increasing numbers of HCEs and decreasing numbers of NHCEs. Many of the workers in the DB plan are older workers with many years of service who are particularly valuable to the employer. Companies would like to be able to manage these workers effectively, while providing generous benefits to newer workers through their DC plans. As a result, some companies aggregate their DB plans with their DC plans to satisfy the nondiscrimination requirements.

Despite generous matching contributions, many of these plans still experience testing difficulties even if their DB and DC plans can be aggregated under the current rules. In order to recognize all of the benefits being received by workers, ERIC encourages the Agencies to allow the following alternatives to satisfy nondiscrimination testing.

A. Matching contributions should be included for more types of nondiscrimination testing for DB plans.

Nondiscrimination testing is designed to compare the amounts received from the plan sponsor by HCEs and NHCEs. Including matching contributions more broadly for nondiscrimination

[11] Treas. Reg. § 1.401(a)(4)-4(d).
[12] *See generally*, Code § 410(b).
[13] *See generally*, Code § 401(a)(4).

purposes would more accurately reflect the total amounts received by participants from plan sponsors. The inclusion of matching contributions does not lend itself to individuals attempting to exploit the rules as these contributions are also generally tested under the Average Contribution Percentage (ACP) test.[14] Additionally, companies would not be motivated to freeze plans under this alternative.

ERIC urges the Agencies to provide that plans have the option to include matching contributions for purposes of the gateway minimum contribution, Code section 410(b) minimum coverage requirements, and for purposes of the general nondiscrimination test. Companies should have the option to consider either the actual rate of matching contributions for a participant or the average rate of matching contributions.

B. A special alternative for mature plans should be provided.

Additionally, the Agencies should provide an alternative for certain plans that have been in existence for a number of years. Under this proposed alternative, a soft-frozen plan would be deemed to satisfy the coverage and nondiscrimination rules if it:

- was in existence for at least 5 years before it was closed to new participants (the "closure date");
- continued to satisfy minimum coverage and nondiscrimination tests for at least five years after the closure date;
- covers a closed group of participants that continues to accrue benefits under a preexisting benefit formula;
- did not have any changes made to the plan's benefit formula, accrual method, or benefits, rights, and features after the closure date, other than with respect to: (1) adverse changes that are made solely to HCEs; (2) beneficial changes that are made solely to NHCEs; and (3) changes required to comply with the law; and
- demonstrates that it is nondiscriminatory by satisfying the average benefits percentage test for every year the plan does not otherwise satisfy the Code section 410(b) minimum coverage and Code section 401(a)(4) nondiscrimination rules.

Plans that have been in existence for several years and provided meaningful benefits to workers for all those years would clearly not have been created to take advantage of these special rules. Additionally, the conditions proposed above would discourage companies from freezing plans.

ERIC urges the Agencies to allow this option as an alternative for mature plans.

[14] Matching contributions are not required to be tested for safe harbor plans.

C. Alternatively, the Agencies should provide special testing for aggregated mature plans.

If the Agencies do not wish to adopt the approach described in III.B. above, then ERIC recommends that the Agencies allow DB plans to be aggregated with one or more DC plans sponsored by the employer and tested on a benefits basis under the cross-testing rules as an alternative to the gateway minimum contribution if the plan satisfies the conditions in III.B. above.

Under this option, the conditions would serve as an alternative gateway into the cross-testing rules for the aggregated plan. In running the general test on a benefits basis, matching and nonelective contributions from the DC plan(s) could be taken into account. However, disparity could be imputed only with respect to DB accruals and nonelective DC contributions, and not with respect to matching contributions.

As with the prior alternative, plans would have been in existence for a number of years and provided meaningful benefits to employees during that time. As a result, they clearly would not have been created to exploit these special rules.

IV. DC plans that provide benefits to former DB plan participants should be provided with additional options for satisfying the nondiscrimination requirements.

In order to reflect the changing nature of the workplace, many companies have begun the process of replacing their traditional DB plan with a DC plan. These employers often want to recognize the benefits that their workers would have received in the DB plan and as a result, include more generous benefits for those employees in the DC plan. Although the provision of these benefits easily satisfies the nondiscrimination requirements at first, this can become more difficult to satisfy over time as the number of HCEs receiving these benefits will often become disproportionate compared to the NHCEs due to increases in compensation and promotions, and higher employee turnover by NHCEs.

Companies should be able to provide these benefits to workers who formerly participated in the company's DB plan (hard frozen plan). ERIC urges the Agencies to provide solutions that help companies maintain their workers. Consequently, we encourage the Agencies to provide the following alternatives.

A. Matching contributions should be included for more types of nondiscrimination testing for DC plans.

As discussed above, nondiscrimination testing is designed to compare the amounts received from the plan sponsor by HCEs and NHCEs and should therefore include matching contributions for all plans. Companies should have the option to consider either the actual rate of matching contributions for a participant or the average rate of matching contributions. The inclusion of matching contributions in DC plans does not lend itself to individuals attempting to exploit the rules as these contributions are also tested under the ACP test.[15]

[15] As noted above, matching contributions are not required to be tested for safe harbor plans.

ERIC urges the Agencies to provide that plans have the option to include matching contributions (as well as nonelective contributions) for purposes of the gateway minimum contribution, Code section 410(b) minimum coverage requirements, and for purposes of the general nondiscrimination test with respect to DC plans.

B. The Agencies should provide a special alternative for DC plans where the company sponsors a hard frozen DB plan.

Some companies have hard frozen their DB plans and now offer enhanced benefits to those workers in a DC plan. Although those employees are no longer participating in the DB plan, it is often critically important for the employer to continue to provide incentives to these workers with respect to their retirement. They tend to be older employees with longer service and therefore are often critical to the employer's business.

ERIC proposes the following alternative for DC plans that include nonelective contributions allocated to a closed group of participants who previously participated in a DB plan that is now hard frozen ("Special DC Plans"). These Special DC Plans would be deemed to continue to satisfy the Code section 410(b) minimum coverage and Code section 401(a)(4) nondiscrimination requirements with respect to these special contributions for all years in which the following requirements are satisfied:

- The DC plan must provide this closed group of participants nonelective contributions that are higher than those provided to participants who are outside the closed group;

- No changes may be made to the plan's nonelective contribution allocation formula or benefits, rights, and features applicable to the closed group after the closure date, other than with respect to: (1) adverse changes that apply solely to HCEs; (2) beneficial changes that apply solely to NHCEs; and (3) changes required to comply with the law;

- The mandatorily disaggregated portion of the Special DC Plan that consists of nonelective contributions allocated to the closed group must have satisfied the minimum coverage and nondiscrimination tests for at least five years after the closure date (without taking into account any other nonelective contributions unless those contributions also are not changed adversely to NHCEs or in favor of HCEs in the future);

- The DB plan must have been in existence for at least 5 years before the date it was closed; and

- The DC plan must demonstrate that it is not discriminatory by satisfying the average benefits percentage test for every year the disaggregated portion of the DC plan does not otherwise satisfy the Code section 410(b) minimum coverage and Code section 401(a)(4) nondiscrimination rules.

Plans are unlikely to be created just to take advantage of these special rules or to freeze existing plans due to the imposition of proposed conditions.

C. Alternatively, the Agencies should allow these plans to be tested on a benefits basis.

If the Agencies are unwilling to adopt the alternative in section IV.B. above, then the Agencies should allow the disaggregated portion of the Special DC Plan to be tested on a benefits basis under the cross-testing rules and deemed to continue to satisfy the Code section 410(b) minimum coverage requirements if the plan satisfies the conditions in section IV.B. above.

The conditions would serve, in effect, as an alternative gateway into the cross-testing rules for the disaggregated portion of the plan. In running the general test on a benefits basis, all matching and nonelective contributions should be taken into account. However, disparity could be imputed only with respect to nonelective DC allocations, and not with respect to matching contributions.

As noted above, combined plans would have been in existence for a number of years and have provided meaningful benefits to employees during that time and would not have been created to exploit these special rules. Companies would also not be motivated to freeze plans due to the proposed conditions that would apply.

V. Contributory plans that otherwise satisfy the nondiscrimination requirements will not be considered discriminatory merely because some HCEs contribute more than some NHCEs.

Treasury Regulations provide additional nondiscrimination conditions for plans that require contributions by employees ("contributory plans").[16] Among other provisions, the regulations require a uniform rate of employee contributions.

Some plans would prefer to require certain HCEs to contribute to the plan at a higher rate of pay, which would benefit all of the participants by providing the plan with additional assets. The Code ensures that these plans would continue to provide generous benefits to NHCEs through the nondiscrimination requirements that generally apply to DB plans.

ERIC urges the Agencies to provide that contributory plans that otherwise satisfy the nondiscrimination requirements will not be considered discriminatory merely because some HCEs contribute more than some NHCEs.

ERIC appreciates the opportunity to provide comments on the Notice. 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,

Kathryn Ricard

Kathryn Ricard
Senior Vice President, Retirement Policy

[16] Treas. Reg. § 1.401(a)(4)-6.