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AMERICAN ACADEMY *of* ACTUARIES

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February 28, 2014

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

RE: Comments related to Notice 2014-5

To Whom It May Concern:

The American Academy of Actuaries<sup>1</sup> Pension Committee (committee) respectfully asks for your consideration of this response to the Internal Revenue Service's request for comments regarding nondiscrimination relief for closed defined benefit plans as published in Notice 2014-5.

We are pleased that the Service has recognized the basic problem that needs to be addressed: the freezing of future benefit accruals, otherwise known as "hard freezing" in closed defined benefit plans because of impending nondiscrimination test failures. The result of such freezes is that grandfathered participants often suffer disproportionately if they cannot retain the benefit structure they were originally hired under. Once the plan is hard frozen, the grandfathered participants will not be able to accrue benefits comparable to the participants who retired in the past under the pre-existing traditional plan formula. Moreover, if the plan is hard frozen, those who were grandfathered will often receive smaller benefits than new hires who will be covered by a hybrid formula or a defined contribution formula for their entire career. Freezing accruals in the plan eliminates the very protections that grandfathering was meant to ensure in the first place.

We also recognize that addressing this problem is a difficult task. The regulations related to nondiscrimination testing are already extremely complex. Any changes should be made with an eye toward simplification. In general, we believe it is better to remove the restrictions that are causing problems, rather than to add new rules, unless those rules come in the form of additional safe harbors. In addition, it is important that changes be available to all plan sponsors and not just those in a particular market segment or those whose plans fit a particular fact pattern.

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<sup>1</sup> The American Academy of Actuaries is an 18,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States

We observe that there are four significant difficulties that sponsors of closed plans and plans with grandfathered employees in traditional formulas most often face when trying to satisfy nondiscrimination rules:

1. Inability to satisfy the regulatory tests of benefits, rights and features (BRFs) that relate specifically to a grandfathered defined benefit formula (e.g., early retirement subsidies when the ongoing plan formula is a cash balance plan).
2. Inability to satisfy IRC §410(b) and/or 401(a)(4) when closed defined benefit plans are unable to be aggregated with defined contribution plans, because the cross-testing gateways cannot be satisfied.
3. Inability to satisfy IRC §401(a)(26) requirements as the number of participants in the defined benefit plan declines.
4. Inability to reflect §403(b) contributions when testing qualified plans.

This letter will address all of these in the context of the proposals included in Notice 2014-5.

### **Ability of a DB/DC Plan to Satisfy Nondiscrimination Requirements on a Benefits Basis**

#### *Alternative for DC plans with age- and/or service-graded contribution rates*

We generally support the averaging of allocation rates for DC plan benefits in the minimum aggregate allocation gateway. However, we believe that by itself this change would help only a limited number of situations due to the high equivalent allocation rates for older, long service employees in DB plans. We offer additional ideas in the following section on how to make this approach more useful.

#### *Alternative for DC plans with combination of non-elective and matching contributions*

We observe that when a defined benefit plan is closed to new entrants, the plan administrator almost always resorts to using the minimum aggregate allocation gateway in order to attempt to satisfy the cross testing rules when the “primarily DB in character” gateway becomes inapplicable.

This particular gateway requires *every* non-highly compensated employee (NHCE) benefiting under the plan to have a minimum allocation rate based on the highest highly compensated employee (HCE) rate. In practice, we have found that when there is a grandfathered final average pay formula, the required NHCE allocation rate will almost always be 7.5% of IRC §415(c) compensation due to the high accrual rate produced by an older, longer service HCE who receives even a modest pay increase.

An employer DC contribution of 7.5% is an above-market retirement benefit in many industries, and providing 7.5% to all NHCEs is not feasible in many instances. Plan sponsors that do provide contributions of at least 7.5% often do so in the form of a §401(m) match, to encourage employees to save. Currently the rules do not permit employer matching contributions to be counted because they are based on the contingency that the employees must save in order to receive the benefit. In addition, hospital systems, universities and other organizations that sponsor §403(b) plans cannot take §403(b) employer contributions into account for this purpose, and contributions to ESOPs must also be disregarded.

We support the use of employer matching contributions to satisfy the minimum aggregate allocation gateway as well as other nondiscrimination in amount tests. For purposes of the gateway, we suggest the maximum match be used, while for purposes of the amounts testing, the actual matching contributions would be used. If NHCEs do not save, this will be reflected adversely in the §401(a)(4) general test results. Allowing the match to be included will therefore provide an incentive for employers to ensure NHCEs receive match levels sufficient to pass the tests. Matching contributions have become extremely prevalent, and we believe that they are an essential tool in encouraging participants relying on account-based plans to save enough for retirement. As such, they should be included in full and treated in the same manner as non-elective contributions.

To make the above suggestions more effective, we offer other possible additional changes for consideration:

- Ease the criteria for the minimum aggregate allocation gateway so that every NHCE need not receive a 7.5% allocation when a final average pay DB plan is closed. Easing of this gateway could be accomplished through some combination of:
  - Reducing the maximum required allocation for NHCEs below 7.5%.
  - Permitting non-elective employer contributions to §403(b) and ESOPs to be reflected in the test.
- Allow cross-testing of aggregated DB/DC plans for a DB plan that satisfied the gateways at the time the plan was closed, even if the plan would no longer satisfy the gateway. The logic is that if the DB plan is closed, there may very well be a long service, older grandfathered employee with a very large equivalent allocation rate. The presence of this employee requires the 7.5% minimum aggregate allocation for all NHCEs. As we noted earlier, new entrants will have the benefit of being covered by a DC plan their entire careers, and thus will have significant opportunity to accumulate retirement savings. Pegging the allocation to the gateway required by the equivalent allocation rate for a 65-year old HCE with 40 years of service is inordinately generous and typically untenable.

*Alternative for aggregated DB/DC plans that could satisfy nondiscrimination using a lower interest rate*

While we believe this would be helpful, it will clearly further increase the complexity of an already difficult set of regulations. We would prefer other, more direct alternatives as discussed previously.

*Safety valve alternative under which plans can request permission to disregard outliers*

Although we always appreciate the opportunity to request situational rulings by the Commissioner, we also recognize that historically these types of requests are often impractical. Many plan sponsors find the current IRS user fees to be cost prohibitive and the time necessary to obtain a ruling to be problematic. Although situational rulings may be a viable option for larger plan sponsors, the vast majority would not view this as a practical option unless costs were

significantly reduced and additional time was granted to retroactively correct a situation if the ruling was unfavorable.

## **Other Possible Related Modifications to Other Nondiscrimination Requirements**

### *Benefits, Rights and Features (BRFs) under DB plans with grandfathered formulas*

BRF testing issues are often encountered in plans that change to a hybrid formula for future service due to the existence of plan features, primarily subsidized early retirement factors, which are not normally associated with hybrid formulas.

One effective approach would be to extend the treatment currently allowed in §1.401(a)(4)-4(d)(1)(i). This current regulatory provision permits BRFs available to closed acquired groups that satisfied testing when they were closed, to be deemed to continue to satisfy BRF testing in all future years as long as the BRFs are not changed and their availability is not extended to additional participants or taken away from any participants. We recommend that these provisions be extended to apply to BRFs under a formula that is closed to new entrants so that the BRFs would be deemed to continue to satisfy BRF testing if they passed at the time the formula was closed to new entrants. We believe that this treatment should also apply when the entire DB plan is closed to new entrants (e.g., new entrants are in a DC plan rather than a hybrid DB formula).

In addition, 2012 Gray Book Q&A 21 is potentially very helpful with respect to the testing of BRFs in plans where the formula has changed from a traditional formula to a hybrid formula. That Gray Book Q&A indicates that frozen final average pay and updated final average pay are nothing more than “differences in the benefit formula or accrual method or other factors like definition of compensation and service computation methods” and thus do not give rise to separate option or early retirement factors, as provided in §1.401(a)(4)-4(e)(1)(ii)(A) and reinforced by Example 3 in §1.401(a)(4)-4(e)(1)(iii). We believe that Q&A 21 would also imply that continuing service (rather than frozen service) is a service computation method in the same way that updated final average pay (rather than frozen final average pay) is a definition of compensation. Therefore, there is a single BRF that applies to the entire final average pay formula. There would be no need to distinguish whether or not a participant is in the frozen group or the non-frozen group.

If this is an accurate interpretation of the regulations in the Service’s view, then guidance to that effect would alleviate many of the BRF testing concerns relating to these designs, and we request that IRS make this clear, particularly if this treatment could be deemed to apply irrespective of whether new entrants receive hybrid formula accruals or DC accruals

Use of the special BRF testing rules available in §1.401(a)(4)-9(b)(3) for aggregated DB/DC plans, in conjunction with changes to the cross-testing gateways (as discussed above), would enable more plan sponsors to aggregate defined benefit and defined contribution plans for testing, and thereby reduce BRF testing issues.

### *Coverage Testing (IRC §410(b))*

Closed groups often become more HCE-concentrated over time. The statutory threshold of \$115,000 (for 2014) may not be difficult to exceed for a career employee originally employed as an NHCE as that employee gains more experience and assumes a role with more responsibility.

In addition, employees who are already HCEs are less likely to leave the employer than those who are NHCEs. Consequently, there are fewer new HCEs needed to fill the positions vacated by departing HCEs, and so the newly hired population is disproportionately NHCE. Thus even a plan that is closed only to new hires is eventually likely to begin to have difficulties satisfying coverage testing, often resulting in the cessation of grandfathering protection for employees who were originally granted such protection to prevent them from doing worse than both employees who already retired and new employees.

Following are some potential solutions:

- Plans that satisfy coverage requirements at certain minimum levels when they are closed to new entrants could be deemed to satisfy coverage thereafter. The criteria could be similar to the criteria in §1.401(a)(4)-13(d) now used to enable pay increases to continue to be reflected after a fresh start date without testing the accruals caused by the pay increases (i.e., this approach would permit future accruals to be provided only in a DC plan if the DB plan satisfied coverage at the 70% level at the time of the amendment, or satisfied coverage at the safe harbor level for at least 5 years thereafter).
- Plans could be permitted to use the unsafe harbor testing threshold less five percentage points, without regard to the 20% minimum (as is now permitted under §1.414(r)-8(b)(2)(iii) for QSLOBs when testing against the entire controlled group if the coverage ratio within the QSLOB is at least 90%; a similar 90% requirement could apply to coverage of the closed DB plan and the new hire DC plan combined).
- Solving the cross-testing gateway issues discussed above would enable more closed defined benefit plans to be aggregated with the defined contribution benefits provided to new entrants and thereby satisfy coverage testing.

#### Amounts Testing

Many of the cross-testing remedies mentioned above would allow more aggregated DB/DC plans to pass amounts testing on a benefits basis. However, other approaches could also be taken to enable closed plans to satisfy the General Test on a standalone basis.

Under current rules, once a plan begins to have difficulties passing coverage, rate groups in the General Test will also begin to fail even if plan benefits do not discriminate in favor of HCEs participating in the plan compared to NHCEs participating in the plan. We believe that plan formulas that do not provide benefits that discriminate in favor of the HCEs who participate in the plan compared to the NHCEs who participate in the plan should be acceptable. There are a number of ways to accomplish this:

- Allow the General Test for a closed plan to be performed disregarding employees who do not currently benefit under the plan. In this way, the testing would be more analogous to ADP/ACP testing, where the amounts test compares benefits earned by HCEs in the plan to those earned by NHCEs in the plan.
- Allow a plan that was frozen (for all but grandfathered employees) and/or closed to new entrants to be deemed to satisfy the General Test if certain conditions are met. These conditions could include some or all of the following:

- The plan satisfies the General Test with all rate groups passing at the 70% level for a specified period of time before the plan change
  - The plan satisfies the General Test with each rate group passing at the safe harbor level for a specified period of time after the plan change
  - No changes are made to the benefit formula or BRFs, other than required changes or changes that could separately satisfy IRC §410(b) and §401(a)(4)
  - The plan determines benefits using a definition of compensation that satisfies IRC §414(s)
  - The plan uses elapsed time for benefit accrual purposes or otherwise demonstrates that NHCEs do not fail to accrue benefits due to termination with less than 1,000 hours of service.
- As we suggested above for IRC §410(b) coverage testing, we believe that new guidance should permit plans to test rate groups in the General Test using the unsafe harbor testing threshold less five percentage points, without regard to the 20% minimum, under the same conditions discussed above.
  - Permit a special modification for soft-frozen plans that recognize final average pay increases but do not permit future benefit service accruals. In these cases, we recommend disregarding the increases under the fresh-start rules of §1.401(a)(4)-13(d) without regard to the meaningful ongoing coverage requirement of §1.401(a)(4)-13(d)(5), or with §1.401(a)(4)-13(d)(5) modified so that meaningful ongoing coverage can take into account enhanced employer contributions to a defined contribution plan.

#### IRC §401(a)(26)

For smaller employers, IRC §401(a)(26) will typically be violated once the percentage of employees covered drops below 40%, as the 50-employee rule cannot be satisfied due to the size of the employer. While the statutory language of IRC §401(a)(26) includes the 40% rule, we believe this problem could be addressed by permitting plans that have been closed to new entrants or frozen for non-grandfathered employees to also be aggregated with replacement DC plans in order to satisfy IRC §401(a)(26). Currently, once the grandfathered plan fails this minimum, accruals must be hard-frozen and the remaining participants in this group suffer more than new hires or previous retirees.

#### IRC §403(b) and ESOPs

We believe that employer contributions to IRC §403(b) plans and ESOPs should be permitted to be taken into account, at the plan sponsor's election, when testing qualified plans both (a) in the Average Benefit Percentage Test (ABPT) (including an ABPT completed on a benefits basis) and (b) in aggregation with qualified plans for purposes of coverage and amounts testing and for purposes of the cross-testing gateways.

### **Retroactive Application**

Because many closed plans have already been hard frozen (for all grandfathered employees or for selected HCEs) to avoid nondiscrimination testing problems, any changes made should be

permitted to be adopted retroactively by such plans to the date of the freeze. Thus, benefit accruals could be restored via amendment without the amendment being treated as discriminatory, provided that the plan would have satisfied the revised nondiscrimination requirements had those accruals been earned during the years to which they relate. Such an amendment should be permitted to be either retroactive or prospective only, and, if retroactive, to provide for an offset of the value of any DC plan enhancements that were provided since the plan was originally frozen. Note that the pre-existing prohibition in §1.401(a)(4)-5 against timing plan amendments to discriminate significantly in favor of HCEs would prevent the plan sponsor from timing such an amendment to primarily benefit the HCEs among the originally grandfathered population.

### **Protections Against Abuse**

The members of the Academy's Pension Committee understand Treasury and the Service's concern about easing the rules in a way that could lead to abusive situations. In particular, we do not want to reward plan sponsors for freezing defined benefit pension plans, but we believe that adequate protections can be designed to prevent inappropriate use of the rules. Any of the special rules we will discuss below to address particular testing issues could be made available only to plan sponsors who meet certain criteria. For example, some combination of the criteria discussed below could be required to be met:

- A concentration test that confirms that the grandfathered group does not consist predominantly of owners and the highest level executives. For example, no more than a specified percentage of the grandfathered participants in the plan could be "high-25" employees. An additional test could be added to ensure that the originally grandfathered group was not chosen to support continued accruals for key employees by grandfathering the lowest-cost non-highly compensated employees (NHCEs). For example, the originally grandfathered group could be required to have been defined to include all participants who met objective age, service or points conditions (or to have been offered to such a group where choice was involved).
- A test could be imposed demonstrating that before the plan formula was closed or frozen for non-grandfathered participants, a single plan formula applied to the active participants in the plan (with exceptions for acquired groups). Such a test would exclude from favorable treatment plans that were originally designed to apply different formulas to different groups of employees, unless the groups were based on reasonable and objective classifications uniformly applied (e.g., hourly vs. salaried, hired before or after a certain date, etc.)
- Plan provisions could be required to remain unchanged after the plan was closed or the plan formula was changed to a hybrid formula (as is required under §1.401(a)(4)-4(d)(1)(i) for closed acquired groups for which BRFs are permitted to be retained without regard to testing). Exceptions would be needed for required changes (including changes needed to ensure that actuarial equivalence factors remain reasonable).

- An objective test that confirms that the employer did not take steps in the period leading up to the closing of the plan or the change in benefit formula to enhance benefits in discriminatory ways or expand the group covered by the plan in a discriminatory manner. For example, favorable treatment could be denied to plan sponsors that improved or implemented benefits for subsets of the plan population within the five years preceding the plan closure or change to a hybrid formula, unless each subset satisfied coverage at the 70% level and within that subset the benefit enhancements were identical (e.g., formula changes that affected everyone within that subset in the same manner).

The Pension Committee appreciates the opportunity to provide input to the IRS and Treasury. We would be happy to discuss any of these items with you at your convenience. Please contact David Goldfarb, the Academy's pension policy analyst (202-223-8196, [goldfarb@actuary.org](mailto:goldfarb@actuary.org)) if you have any questions or would like to discuss these items further.

Sincerely,

Michael Pollack, FSA, MAAA, EA, FCA  
Chairperson, Pension Committee  
American Academy of Actuaries