December 3, 2009

CONCERNS REGARDING H.R. 4126

On November 19, H.R. 4126 was introduced. The bill would radically alter the manner in which retirement plan benefits are tested for nondiscrimination. In many cases, the bill's requirements would force employers to either greatly expand benefits or cease providing benefits. In this economic climate, the vast majority of employers would be unable to expand benefits and thus would be forced to simply cease providing benefits. The bill would also have a devastating effect on older workers by prohibiting very common benefit formulas that favor older workers. Finally, the bill would undermine employers' incentives to provide retirement benefits to part-time workers.

If this bill is adopted in whole or in part without hearings and a careful review, the effects on the private retirement system would be devastating.

Vested Benefit Rule Would Force a Very Large Number of Plans to Freeze Immediately.

Under the vested benefit rule in H.R. 4126, only vested benefits of nonhighly compensated employees ("NHCEs") may be taken into account for purposes of nondiscrimination testing. On the other hand, all benefits of highly compensated employees ("HCEs") must be taken into account.

- ***Forced Freezing of Plans.*** Most defined benefit plans and many defined contribution plans would effectively be forced to cease providing benefits by this provision. For example, assume that a company maintains a defined benefit plan with five-year cliff vesting, which is typical. Assume further that 35% of the NHCEs are vested, which would not be unusual at all. In this case, the plan is treated as benefiting 35% of the NHCEs and 100% of the HCEs (regardless of their vested status). This plan will fail the nondiscrimination test. In addition, the only realistic way to cure this failure is to dramatically accelerate vesting. So in this time of economic hardship, this rule would require most companies to either vastly increase vested benefits (at considerable expense) or freeze. Sadly, that would be an easy choice in almost every case.

- ***New Plans Automatically Disqualified.*** Many new plans will be automatically disqualified under this rule. For example, assume that two partners start a business with five employees. They would like to establish a 401(k) plan with a profit-sharing contribution that is the same percentage of compensation for all seven individuals and that becomes vested after three years. <u>Under the proposed rule, that plan would be automatically disqualified. Thus, the new business cannot set up such a qualified plan.</u> The bill may have the same effect on new employers that would like to offer matching contributions; the bill is unclear in this regard.

<u>Prohibition on "Cross-Testing" Would Severely Harm Older Workers.</u>

The bill would prohibit "cross-testing". This would mean that defined contribution plans must be tested for discrimination based on the contributions made, rather than based on the benefits that would be generated by those contributions. This would prevent employers from favoring older, longer service workers in their defined contribution plans. For example, where an employer freezes its defined benefit plan, the employees most affected are the older employees. Accordingly, some employers try to make the older employees whole by providing them with higher contributions under a defined contribution plan. The prohibition on cross-testing would generally prohibit such designs, severely harming older workers.

<u>Cash Balance Plans That Favor Older Workers Would be Prohibited.</u>

The bill would require cash balance plans to be tested for discrimination based on contributions, rather than based on benefits. This would threaten the qualified status of the majority of cash balance plans, solely by reason of the fact that benefits increase for older, longer service workers. This would also disqualify cash balance plans that provide additional transition benefits for older workers to make up for the loss of the traditional defined benefit plan formula. In addition, it is unclear how the rule would apply where some defined benefit plan participants (such as new hires) are covered by the cash balance formula and some are covered by the traditional formula. It is possible that the bill would effectively force employers to move all employees to a cash balance plan formula that does not provide additional benefits to older workers. In short, the effects of this provision could be devastating for older workers.

<u>Treasury Authority to Avoid Harm to Older Workers is Generally Non-Existent.</u>

Technically, the bill provides Treasury with the authority to permit defined contribution plans and cash balance plans to be tested on the basis of benefits and thus avoid the problems described in the prior two sections. But the bill puts such tight restrictions on this authority that it is almost non-existent. In general, under the bill, such authority may only apply where the contribution or benefit under the plan of any participant, expressed as an annuity beginning at normal retirement age, is not less than a similarly expressed benefit of any younger participant. Almost no plan in existence would meet this test.

The Bill Would Discourage Plans from Covering Part-Time Employees.

The bill includes a rule under which employers would only receive partial credit for covering a nonhighly compensated part-time worker. For example, assume that an employer covers 100 workers who work half time. For purposes of the coverage tests, the bill would treat that group as the equivalent of 50 full-time workers; thus, for purposes of the coverage tests, the employer would only get credit for covering 50 workers. This would clearly undermine employers' incentives to cover part-time workers, which is very counter-productive. Also, it appears that employers could be required to count hours worked by all employees in order to apply this rule, which would be a very significant burden and would have a severely negative effect on employers' willingness to adopt a plan. Finally, the bill establishes one fixed definition of full-time: 2,080 hours during a year, which is inconsistent with many business practices across the country.