August 20, 2010

PENSION EQUITY PLANS

Background

The executive branch has worked very hard over many years to provide an immense amount of guidance on a wide range of critical retirement plan issues. In light of the amount of recent legislation, the government's ability to keep pace with administrative guidance has been remarkable.

Unfortunately, one byproduct of the burden on the executive branch is that some pre-existing guidance projects have been delayed. One key example is guidance with respect to pension equity plans ("PEPs"), which has been needed for many years. For several years, the retirement plan community has asked for such guidance. In late 2007, Treasury and the IRS stated in a preamble to proposed hybrid plan regulations that they were reviewing PEPs, including whether the way in which PEPs credit interest might violate section 411(b)(1)(G). The preamble recognized that the proposed regulations did not provide any rules relating specifically to PEPs.

Although no formal guidance addressing PEPs has been issued, the Internal Revenue Service has recently begun to process determination letters with respect to PEPs. The Service has apparently developed PEP rules that must be satisfied as a condition of receiving a favorable determination letter. Some of those positions may impose significant additional costs and burdens. As described below, we would like to propose a more public process to develop rules applicable to PEPs and interim procedures for those plans that have been waiting for the issuance of these rules.

The Service appears to be focusing on how PEP formulas satisfy Code section 411(b)(1)(G) in situations where interest credits that would apply to an employee's benefit after termination of employment exceed the additional benefits the employee accrues while continuing to work. Applying a purely mathematical approach, the IRS has suggested that section 411(b)(1)(G) requires a plan to provide a minimum, or floor benefit, equal to the benefit the participant would have had if the employee had terminated employment in any earlier year and begun earning interest credits from that time. However, as we will discuss, there is strong case law and statutory support for the position that no such floor is required.

Questions are also being raised about how PEPs with graded benefit formulas based on age and/or service satisfy the backloading rules. The IRS has suggested that it is not clear whether post-termination interest credits are taken into account for backloading purposes, and, if not, whether such graded formulas satisfy the backloading rules.

Process Issue

The application of the qualification rules to PEPs is a critical issue deserving of a public dialogue. This issue needs to be the subject of proposed regulations or other guidance that is subject to public comment. It is not appropriate to develop fundamental positions in the context of enforcement actions without the benefit of the public comment process.

We have understood that the government agrees that PEP issues need study and careful analysis. We ask only that that be done in an open rulemaking process and not in the closed process used in enforcement proceedings.

Proposal

In the event that Treasury and the IRS do not resolve outstanding PEPs issues in accordance with the strong arguments we outline below and intend to develop more fully in our meeting, we propose a similar approach that was recently used to address the "greater of" backloading issue. Plans that have taken reasonable positions should be protected for periods prior to the effective date of public guidance that is developed with an opportunity for public comment.

Specifically, the proposal would provide PEPs with protective section 7805(b) relief with respect to backloading issues and issues under Code 411(b)(1)(G). This approach would recognize the lack of clarity in this area, and not reflect that current practices violate the law. In other words, unlike Rev. Rul. 2008-7 (which set forth relief for "greater of" plans), the IRS would not, prior to granting protective section 7805(b) relief, first resolve with respect to the past the issues that will be the subject of future guidance.

Such relief would be conditioned on satisfaction of the following three requirements:

(1) The PEP benefit formula must satisfy the backloading rules taking into account any explicit or implicit post-termination of employment[1] interest credits.

(2) The PEP benefit formula must satisfy Code section 411(b)(1)(G) without regard to post-termination of employment interest credits. As discussed below, this reflects our view that the interest credits do not cause a violation of Code section 411(b)(1)(G).

(3) One of the following applies:

(a) As of September __, 2010, the plan's PEP benefit formula was the subject of a favorable determination letter;

(b) As of September __, 2010, a remedial amendment period under Code section 401(b) for the PEP benefit formula has not expired; or

(c) The plan is otherwise a "moratorium plan" as defined in IRS Notice 2007-6.

Under the section 7805(b) relief, if a plan meets the above requirements, such plan (1) would not fail to satisfy section 411(b)(1)(G) and (2) would not fail to satisfy the backloading rules. It is our belief that the interest credits, even if taken into account, do not cause a section 411(b)(1)(G) violation, and we would like to begin the dialogue addressing this issue. But

[1] For PEPs that credit interest following a termination of service covered by the Plan, references to termination of employment mean termination of covered service.

because this is an issue that the government would like to review further, we ask only that at this time plans not be harmed during the pendency of the government's review.

This section 7805(b) relief would continue to apply until the effective date of public guidance (subject to public comment) regarding the backloading and section 411(b)(1)(G) issues. Such public guidance would not affect accruals earned prior to such effective date.

Proper Approach to Section 411(b)(1)(G)

There is strong case law and statutory support for the position that a PEP is not required to provide a minimum, or floor, benefit as the IRS has suggested. The IRS suggestion is based on a purely mathematical approach to section 411(b)(1)(G); this approach is not appropriate. Section 411(b)(1)(G) does not prohibit *every* reduction in a participant's accrued benefit. Instead, this section prohibits only reductions that occur "on account of" increased age or service. A PEP formula credits interest beginning at termination of employment, regardless of age or years of service. As Judge Posner observed in *Lunn v. Montgomery Ward*, a plan does not violate section 411(b)(1)(G) when benefits accrue in "exactly the same way" at all times. If a plan provides the same benefit formula at all ages and years of service, any reduction in an employee's "accrued benefit" observed under a mathematical approach occurs not on account of increased age or service but because of other factors, such as a flattening of pay.

The mathematical approach relies on a projection of the employee's benefit to normal retirement age with interest. However, when an employee terminates employment, the employee's benefit ceases to be adjusted by changes in final average pay; post-termination interest merely adjusts the benefit to preserve the economic value of his or her accrued benefit until benefits begin to be paid. Adjustments for the time value of money are well-recognized and accepted features of defined benefit plans. *See Conkright v. Frommert* (U.S. Supreme Court) and *Cooper v. IBM* (7th Circuit). Furthermore, the projection included in the mathematical approach assumes that post-termination interest is included in the accrued benefit while an employee continues to work. However, pre-normal retirement age interest is contingent on an event -- the employee's actual termination of employment before normal retirement age -- and might not be part of an employee's accrued benefit unless and until the employee actually terminates employment before normal retirement age.

American Benefits Council
Coalition to Preserve the Defined Benefit System
ERISA Industry Committee