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Dear Mark and George:

The American Benefits Council (the “Council”) would like to thank you and all the Treasury and Internal Revenue Service officials who met with us on October 3, 2012 or March 13, 2013 regarding critical nondiscrimination issues that have arisen for many large and small companies across the country.

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council’s members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

Set forth below are (1) a brief discussion of the background of the nondiscrimination issues, (2) a description of the contexts in which the issues can arise, along with our proposed solutions (without anti-abuse rules), and (3) a recommendation regarding how best to implement our proposed solutions along with an updated anti-abuse rule. Our anti-abuse rule has evolved based on the excellent discussions we have had at our two meetings. Our recommendation regarding how to implement our proposed solutions has also changed based on our greater awareness of the urgency of the issues; decisions are being made regarding whether to announce full plan freezes. We believe that we have developed a very good and narrowly targeted way to address the urgency while at the same time allowing for a full public policy discussion.
BACKGROUND

Many companies are transitioning away from a traditional defined benefit plan benefit formula in one of various ways. This can arise, for example, by reason of (1) closing the plan to new hires, (2) converting the plan from a traditional plan to a hybrid plan, or (3) moving acquired employees from disparate benefit formulas to a uniform benefit formula. In the context of such transitions, it is not unusual for companies to grandfather some or all of the existing employees under the benefit formula in effect. A prime example is closing a traditional pension plan to new hires (who often receive an additional contribution under the company’s defined contribution plan), but allowing existing employees to continue to participate in the pension plan. This can help those existing employees realize the very significant benefits that are provided by traditional benefit formulas late in an employee’s career.

These “grandfathering” arrangements are very helpful to the older longer service employees who often have made retirement plans based on the benefit formula previously in effect. However, these arrangements can, over time, cause nondiscrimination testing problems.

For example, assume that a pension plan is closed to new hires who receive an additional nonelective contribution under the company defined contribution plan. In general, the defined benefit plan and defined contribution plan, if tested together on the basis of benefits provided, will satisfy all applicable coverage and nondiscrimination tests. However, over time, the participants in the defined benefit plan can become disproportionately highly compensated. This happens not by design, but simply by reason of the fact that (1) turnover among nonhighly compensated employees (“NHCEs”) tends to be higher than among highly compensated employees (“HCEs”), and (2) many grandfathered NHCEs become HCEs by reason of gaining experience and seniority.

Under the regulations, if the defined benefit plan does not have enough NHCEs in it, it is no longer permitted for the two plans to be tested together on a benefits basis. Without such combined testing, the defined benefit plan will likely fail to satisfy the applicable tests. Please note that if permitted to be tested together, the plans generally pass. So the problem is not created by an arrangement that is discriminatory overall.

Unfortunately, as a practical matter, in the vast majority of cases, the most workable solutions to the discrimination problem described above for the employer in these financially challenging times are to (1) remove some or all of the HCEs from the defined benefit plan, or (2) more likely, completely freeze the defined benefit plan. This is a very unfortunate result for defined benefit plan participants who can lose the most beneficial years of pension plan participation. In fact, by losing such beneficial years, older, longer service participants could experience the “worst of both worlds” by also not benefiting
from higher allocations earlier in their career that they would have received had the higher allocations been in effect earlier.

PROBLEMS AND SOLUTIONS

Conceptually, the problem described above can arise in several different contexts. Those contexts are very briefly described below, along with a brief description of our proposed solutions (“Proposed Solutions”).

- **Closing plan to new hires:** The defined benefit plan is closed to new hires and, in some cases, to a subset of existing employees, such as employees who do not have many years of service. Those who will not benefit under the defined benefit plan may receive additional contributions under the defined contribution plan. The testing issues in this situation are described above.

  **Proposed solution:** Very generally, if (1) the group (or groups) of grandfathered employees in the defined benefit plan is permitted to be tested on a benefits basis with the defined contribution plan as of the date the plan is closed, and (2) neither the group (or groups) nor the benefits of the defined benefit plan are enhanced (or reduced in a discriminatory manner) after the plan is closed, the two plans would continue to be permitted to be tested together on a benefits basis indefinitely. The prohibition on enhancement of the group (or groups) or the benefits would not apply to enhancements only applicable to NHCEs.

  A reduction in coverage would be considered discriminatory for this purpose (but not for any other purpose) unless the ratio of highly compensated participants who cease to be covered compared to all highly compensated participants in the closed group or groups, is at least as great as the same ratio with respect to nonhighly compensated participants. A reduction in benefits would be considered discriminatory for this purpose (but not for any other purpose) unless it applies uniformly to a set of participants that meets the test in the preceding sentence.

  Special rules are needed where the defined contribution plan contributions are made in the form of matching contributions (as discussed in more detail in our April 24, 2012 letter) and where the defined contribution plan constitutes an ESOP. Please see the end of this letter for further discussion of these special rules.

- **Benefits, rights and features issue due to modification of benefit formula:** The benefit formula under the defined benefit plan is modified for new hires and possibly a subset of existing employees, such as in the case of a conversion of a traditional defined benefit plan formula to a cash balance plan formula. Over time, the group of employees covered by the original benefit formula becomes
too highly compensated, so that benefits, rights, and features that only apply to the original benefit formula may fail to satisfy the current availability test of Regulation § 1.401(a)(4)-4.

**Proposed solution:** Very generally, if (1) the group (or groups) to whom the original benefit formula is available satisfies the current and effective availability tests of Regulation § 1.401(a)(4)-4 as of the date the formula is closed, and (2) neither the group (or groups) nor the benefits are enhanced (or reduced in a discriminatory manner) after the formula is closed, any benefits, rights, and features available to the closed group (or groups) would be deemed to continue to satisfy the current and effective availability tests indefinitely. The prohibition on enhancement of the group (or groups) or the benefits would not apply to enhancements only applicable to NHCEs.

The same rule described above would apply with respect to what constitutes a discriminatory reduction in coverage or benefits.

- **Complete freeze with make-whole contributions in the defined contribution plan:** The defined benefit plan is completely frozen and some or all of the existing employees receive “make-whole contributions” under the defined contribution plan. The make-whole contributions are designed to make the existing employees whole, in sum or in part, for the loss of the future pension benefits. These make-whole contributions need to be tested on a benefits basis in order to be nondiscriminatory, yet over time such testing generally becomes unavailable.

**Proposed solution:** Very generally, if (1) the group (or groups) receiving the make-whole contribution satisfies the nondiscriminatory classification test as of the date the group (or groups) is closed, and (2) neither the group (or groups) nor the contributions are enhanced (or reduced in a discriminatory manner) after such date, the contributions would continue to be permitted to be tested on a benefits basis indefinitely. The prohibition on enhancement of the group (or groups) or the contributions would not apply to enhancements only applicable to NHCEs. Again, special rules are needed where the defined contribution plan includes matching contributions or an ESOP feature.

The same rule described above would apply with respect to what constitutes a discriminatory reduction in coverage or contributions.

- **Minimum participation issues:** A defined benefit plan is completely or partially frozen. Over time, the plan fails the minimum participation rule of Code section 401(a)(26).
**Proposed solutions:** If no employee benefits under a plan, the plan satisfies the minimum participation test. Also, very generally, if (1) a defined benefit plan satisfies the minimum participation test as of the date the plan is closed, and (2) neither the grandfathered group (or groups) nor the benefits are enhanced (or reduced in a discriminatory manner) after the closing, the plan would continue to be treated as satisfying the minimum participation test indefinitely. The prohibition on enhancement of the group (or groups) or the benefits would not apply to enhancements only applicable to NHCEs.

The same rule described above would apply with respect to what constitutes a discriminatory reduction in coverage or benefits.

**Proposal**

As noted above, more and more companies have alerted us to the importance of addressing the problems described above and the need to solve the problems quickly to avoid the need for a complete plan freeze. We thus propose the following means of implementing our Proposed Solutions.

**Notice:** Under our proposal, the Service would issue a Notice that would state that Treasury and the Service intend to modify the regulations under sections 401(a)(4) and 401(a)(26) in the ways described in the Notice. The Notice would then set forth our previously submitted Proposed Solutions outlined above. The Notice would go on to state that pending the updating of the regulations, taxpayers can rely on the Notice except as otherwise provided.

As has been discussed, because of the urgency of this issue, there is a clear need to maintain a narrow focus on the above issues, which are directly related to avoiding complete plan freezes. Adding any new issues would only ensure more complete plan freezes by slowing down this process very significantly.

**Anti-abuse rule: Part One:** The above description of the Notice is missing one significant element, i.e., the anti-abuse rule that we have been discussing. The core concern regarding potential abuse, as we understand it, is as follows. If our Proposed Solutions were adopted without an anti-abuse rule, a business could, for example, establish (or enhance) a traditional defined benefit plan and then, as part of a pre-arranged plan, shortly thereafter close the plan to new hires (or convert the plan to a hybrid plan).

We believe that the Notice could address this potential abuse in the following manner. First, the abuse described above is premised on an employer taking advantage of our Proposed Solutions. In other words, the establishment or enhancement of the
traditional defined benefit plan would be implemented with the knowledge that it would be “undone” shortly thereafter by the closing of the plan. The abuse is the establishment or enhancement of a plan in contemplation of closing the plan and taking advantage of our Proposed Solutions.

This type of abuse cannot occur before our Proposed Solutions are officially adopted by Treasury and the IRS. Before our Proposed Solutions are adopted, it is impossible for a plan to be established or enhanced in contemplation of the plan being closed in order to take advantage of a rule that does not exist.

Thus, there is no need for an anti-abuse rule with respect to a plan that has already been closed (or converted to a hybrid plan.) We propose accordingly that our Proposed Solutions apply to any plan closing, conversion, or other amendment that is adopted prior to the issuance of the Notice.

This approach makes great sense from several perspectives. First, as discussed above, an employer that has already closed a plan (or converted a plan) cannot have acted to take advantage of a rule that did not exist when it acted. Second, adopting this approach enables the government to issue guidance quickly enough to save the benefits of thousands of employees. Third, this approach gives the government time to carefully design an anti-abuse rule for future plan closings and conversions.

Anti-abuse rule: Part Two: Under our approach, there is also a need for an anti-abuse rule with respect to plan closings and conversions that are adopted after the Notice is issued. Based on our March 13 meeting and further discussions, we would propose a new anti-abuse approach. Under our new approach, the abuse potential would be addressed through a series of examples in the § 1.401(a)(4)-5(a) regulations dealing with discrimination in the timing of plan amendments. (A similar approach could be taken under the section 401(a)(26) regulations.) The Notice would include these examples and invite comments on the examples in the expectation that those comments would be taken into account in developing proposed modifications of the current regulations.

Set forth below are suggestions for examples that could be included in the Notice.

- **Example 1**: An employer maintains a plan with a relatively low rate of benefit accrual. The employer increases that rate dramatically. Then within a year, the business closes the plan to new hires, who are provided additional allocations under a defined contribution plan. During the period between the enhancement of the plan and its closing, there were no significant events (or combination of events) that could reasonably have been viewed as triggering a need to close the plan. In this case, the timing of the benefit enhancement and plan closing indicate an attempt to circumvent the applicable restrictions on cross-testing defined
contribution plan allocations. Therefore, our Proposed Solutions would not apply to this plan.

- **Example 2:** An employer acquires a new business unit with a defined benefit plan. The employer merged the acquired defined benefit plan with the employer’s own defined benefit plan, so that the acquired employees become subject to the same benefit formula as the employer’s other employees, which had been in place for many years. The acquiring company’s benefit formula is more generous than the acquired company’s formula, so the acquired employees experience a material benefit increase. The merger of the acquired plan into the acquiring company’s plan is consistent with a practice that the employer had generally used with respect to past acquisitions in order to maintain uniformity in its plan benefits. Then within a year, the employer closes the plan to new hires who are instead covered under the employer’s defined contribution plan. There is evidence that the possible closing of the plan had been under consideration for more than a year, but in the meantime, all benefits were kept uniform. In this case, the timing of the plan amendment making benefits uniform and closing of the plan does not indicate an attempt to circumvent the applicable restrictions on cross testing defined contribution plan allocations. Therefore our Proposed Solutions would apply to this plan.

- **Example 3:** An employer converts a traditional defined benefit plan to a cash balance plan primarily to (1) reduce funding and accounting volatility, and (2) make the plan easier to communicate to participants. For some employees, the conversion represents a potential increase in future benefits; for others, the conversion would reduce future benefits. Then three years later, the plan is closed to new hires who are instead covered under the employer’s defined contribution plan. The closing of the plan had been considered prior to the conversion, but rejected. However, during the three-year period, business conditions had grown slightly worse, and funding and accounting volatility had continued to be a concern. In this case, the timing of the conversion and the closing of the plan do not indicate an attempt to circumvent the applicable restrictions on cross testing defined contribution plan allocations. Therefore, our Proposed Solutions would apply to this plan.

- **Example 4:** In order to reduce funding and accounting volatility, and to lower costs, an employer amends its defined benefit plan to base benefits on career average pay rather than final pay. Two years later, the employer closes the plan to new hires (who are instead covered under the employer’s defined contribution plan), due to increasing competitive pressures and an emerging trend in its industry to enhance defined contribution plan allocations. In this case, the timing of the defined benefit plan amendment and the closing of the plan do not indicate an attempt to circumvent the applicable restrictions on cross testing
defined contribution plan allocations. Therefore, our Proposed Solutions would apply to this plan.

- **Example 5:** In a cost-cutting effort, an employer reduces benefits under its defined benefit plan primarily for nonhighly compensated employees without corresponding reductions for many of its highly compensated employees. Two years later, the employer closes the plan to new hires who are instead covered under the employer’s defined contribution plan. Focusing the benefit reduction on nonhighly compensated employees indicates a desire to increase the difference between the benefits of highly compensated employees and nonhighly compensated employees. In the absence of identified bona fide business reasons for focusing the benefit reductions on nonhighly compensated employees and separate independent business reasons for later closing the plan, the timing of the plan amendment and the closing of the plan indicate an attempt to circumvent the applicable restrictions on cross testing defined contribution plan allocations. Therefore, our Proposed Solutions would not apply to this plan.

- **Example 6:** An employer maintains a traditional defined benefit plan for employees working in different business units across the country. For competitive reasons, the employer freezes all benefit accruals for employees at one of the business units, which has a mix of highly compensated and nonhighly compensated employees. Two years later, to reduce funding and accounting volatility, and to make benefits easier to communicate, the employer converts the plan to a pension equity plan, but grandfathers existing participants in the traditional plan, which has benefits, rights, and features that are not available under the pension equity plan. In this case, the timing of the partial freeze and subsequent conversion do not indicate an attempt to circumvent the applicable restrictions on benefits, rights, and features. Therefore, our Proposed Solutions would apply to the plan.

**Theoretical support for our proposal and our anti-abuse rules:** During our March 13 meeting, we had a very helpful discussion of the theoretical underpinnings of our Proposed Solutions. The point was made that if the argument supporting our proposed rule is the need to protect employee expectations, why should the rule apply if there have been any “substantial” changes to the defined benefit plan’s benefit formula or coverage in the last five years prior to the plan closing? (Reference was made to a five-year rule found in Rev. Rul. 2001-30 that would render certain favorable treatment inapplicable if there have been any substantial changes to the defined benefit plan’s benefit formula or coverage in the five years preceding a similar event.) In other words, if there was a substantial decrease, then that is evidence that the company is comfortable not meeting employees’ expectations. If there has been a substantial increase, then that increase should not be protected, because the increase has not been in place long enough to create reasonable reliance.
In our judgment, the above concerns with our proposal unfortunately do not reflect the key issues at stake here. First, and most importantly, our proposal is not only about protecting expectations. The core point underlying our proposal is that employers should not be effectively forced to terminate accruals for a large number of participants where there is no argument that the plan amendments have been adopted in order to avoid the spirit of the cross-testing restrictions in the nondiscrimination rules.

The “protecting expectations” argument also does not recognize another element of our proposal. Especially in a final average pay plan, the value of accruals for a young employee is very low and the value of accruals for an older employee is very high. Defined contribution plan allocations are generally more level over a working lifetime. So if an older employee is forced out of a defined benefit plan late in his or her career (because our solution is not adopted), the older employee will get the “worst of both worlds” in terms of their level of benefits—low defined benefit plan benefits in the early years without either enhanced defined contribution allocation in those early years or large defined benefit plan benefits in later years.

Open issues: We look forward to discussing the above proposal with you. In addition, our prior discussions have not touched on a key element of our proposal, which is the ability to use matching contributions to help a defined benefit plan satisfy the coverage and nondiscrimination tests, as outlined on page 7 of our April 24, 2012 letter under the subheading “Matching contributions: solution.” We look forward to discussing this issue.

Further, we would like to discuss the need to apply the same solution applicable to matching contributions to ESOPs, so that ESOP allocations can, at least under certain circumstances, be used to help a defined benefit plan satisfy the coverage and nondiscrimination tests.

It is important that the matching contribution and ESOP issues are also addressed in the Notice. Many employers that have closed their defined benefit plans to new hires provide defined contribution plan allocations under an ESOP and/or in the form of matching contributions. If those allocations can help the defined benefit plan satisfy the coverage and nondiscrimination tests, many employers will not be effectively forced to completely freeze a defined benefit plan that currently provides critical benefits to grandfathered participants.

Finally, as noted in our prior letter, we would like to explore transition rules that may arise. Appropriate transition rules may be needed to ensure that our Proposed Solutions apply in an appropriate manner regardless of when the triggering event occurred and regardless of whether a plan sponsor was previously compelled to take action inconsistent with helpful rules that were developed later.
We look forward to meeting with you to discuss these issues, which are so critically important to participants and plan sponsors across the country.

Sincerely,

Lynn D. Dudley

Senior Vice President, Retirement and International Benefits Policy