AMERICAN BENEFITS COUNCIL

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Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2012-25)
Room 5203
P.O. Box 7603
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2012-25

Dear Sir or Madam:

Pursuant to IRS Notice 2012-25, on behalf of the American Benefits Council, I ask that the Department of Treasury ("Treasury") and the Internal Revenue Service (the "Service") consider adding a regulatory project to the 2012-2013 Guidance Priority List. Very generally, the project would involve modifying the current nondiscrimination and minimum participation regulations to protect older, long-service participants from very adverse and unintended effects.

Based on an unexpected amount of input from plan sponsors and plan service providers, we believe that the need for this project is becoming very acute, as discussed further below.

BACKGROUND

For a variety of reasons, the defined benefit plan system has been undergoing major changes for a number of years. Many companies have, for example, felt the need to freeze their plan or convert their plan into a different type of plan, such as a

hybrid plan. In this context, older employees can often lose the greatest amount of benefits, because the benefit accrual pattern under a traditional defined benefit plan provides greater current value to older employees than to younger employees. To help older employees with the transition to the new system, many approaches are used. For example, in many cases, plan freezes are made inapplicable to all or a subset of existing employees, so that the freeze may only apply to new hires. Where the freeze applies to everyone, older employees who were in the plan as of the date of the freeze may be provided with special additional contributions in a defined contribution plan. (This is part of a general trend toward greater consideration of the retirement security effects of each type of plan as well as the combined effects where an employer maintains both types.) In the context of conversions to hybrid plans, some or all of the existing participants may remain covered by the traditional formula (e.g., by exercising a choice to remain covered by the traditional formula).

The transition designs described above are intended to benefit older workers, and thereby address some concerns that have been raised by both older workers and commentators. However, as explained below, each of these transition designs is inconsistent with current regulations.

The discussion below is divided into four parts. The first part deals with issues raised when a group of existing participants continue to accrue specified benefits that are not available to other participants, such as a situation where existing employees remain covered by the traditional formula while new hires are covered by a hybrid formula. The second part addresses issues that arise when a plan is closed to new hires, and new hires may receive additional contributions under a defined contribution plan. The third part of the discussion below addresses the effect of a complete freeze of a plan combined with a special schedule of defined contribution plan contributions designed to make some or all of the existing employees whole for the loss of benefit accruals under the defined benefit plan. The final part of this letter discusses similar issues that arise in the context of the minimum participation rule.

We raised these issues with our members in connection with the development of H.R. 4050, the Retirement Plan Simplification and Enhancement Act of 2012, introduced by Congressman Neal. See section 407 of the bill, which we strongly support. The response from our members, as noted, has been that these issues have become major problems that have already forced many employers to take away important benefits on a prospective basis and will have much broader adverse effects in the coming years if not corrected. In fact, because these issues have already forced benefit reductions in many cases, we would urge you to not only fix the problems prospectively, but also to consider permitting employers to restore benefits previously taken away, even if the employees affected by the take-away and benefiting from the restoration would generally be older, longer service highly compensated employees.

I. PROTECTING GRANDFATHERED EMPLOYEES FROM HAVING THEIR GRANDFATHERED BENEFITS TAKEN AWAY PROSPECTIVELY

As noted above, it is common in many contexts for employers to grandfather some or all of their existing employees under existing plan terms so that prospective plan changes do not apply to them. We illustrate below the technical issue raised by those arrangements, first in the context of conversions to hybrid plans, and then in a broader context. Then we set forth a specific proposal to address the problem in all contexts.

Conversions to hybrid plans. As you know, in the context of conversions to hybrid plans, many plan sponsors, for example, (1) grandfather all existing employees in the traditional plan, or (2) provide some or all existing employees with a choice between the old benefit formula or the new formula, or with the greater of the two. Under all of these pro-participant arrangements, a closed class of employees receives benefits under the old traditional formula. (For convenience of presentation, all employees who continue to be covered by the traditional formula by reason of transition arrangements are referred to in this letter as "grandfathered employees".) In almost all cases, the traditional formula will have benefits, rights, and features that are not available under the new formula. The most notable example is an early retirement subsidy, which is very common in traditional formulas and much less common in hybrid plans.

Under Regulation § 1.401(a)(4)-4, any benefit, right, or feature must be "currently available" to a group of employees that satisfies the nondiscriminatory classification test. At the time of the conversion to a hybrid plan, the grandfathered employees generally satisfy this test. The problem is a function of two factors: (1) typically, the turnover rate among nonhighly compensated employees ("NHCEs") is higher than among highly compensated employees ("HCEs"), and (2) generally, some of the grandfathered NHCEs become HCEs over time. Accordingly, many years after the conversion, the grandfathered employees will typically fail to satisfy the nondiscriminatory classification test.

Many plans are now reaching the point where the grandfathered employees fail the nondiscriminatory classification test. And it is almost inevitable that such failures will become widespread in a few years.

Any company confronting this situation will, as a practical matter, have little choice regarding how to solve this problem. The companies will need to remove HCEs from the traditional plan prospectively, or at least make the problematic benefit, right or feature inapplicable to them. *Companies do not want to do this,* but may have no choice if the current section 401(a)(4) regulations are not amended.

Other plan amendments grandfathering employees. The problem described above with respect to conversion amendments occurs in a broad array of other situations (including situations described in subsequent sections of this letter, such as part II), i.e., any amendment affecting plan benefits, rights, or features that grandfathers a group of employees so that the amendment does not apply to them. For example, under a plan amendment, existing early retirement subsidies could be preserved on a prospective basis only for existing employees or another nondiscriminatory subset of employees. Eventually, the grandfathered group will likely fail the nondiscriminatory classification test, as discussed above.

Proposal. The regulatory solution is straightforward. Very generally, in the case of a business merger or acquisition, a benefit, right, or feature available to the "acquired group of employees" is, under current law, treated as satisfying the current and effective availability tests if that acquired group satisfied those tests at a specified date shortly after the acquisition. See Regulation § 1.401(a)(4)-4(d)(1). This rule generally permits a company that acquires another company and its plan to preserve the acquired plan's benefits, rights, and features for the acquired employees.

This rule would work very well to solve the problem with respect to conversions and any other plan amendment that results in a benefit, right, or feature being limited prospectively to a grandfathered group of employees. If the availability of a benefit, right, or feature to a grandfathered group of employees satisfies the current and effective availability tests as of the effective date of the plan amendment creating the grandfathered group, such benefit, right, or feature should be deemed to continue to satisfy those tests (subject to all the existing safeguards in Regulation § 1.401(a)(4)-4(d)(1), such as the rule generally requiring that the availability of the benefit, right, or feature not be modified after the conversion).

We do not envision potential abuse of our proposed rule, especially since the most significant benefits, rights, and features (i.e., early retirement benefits and retirement type subsidies) are subject to amounts testing under Regulation § 1.401(a)(4)-3.[1]

In short, we see a real problem descending upon us for (1) almost all hybrid plans that have provided "choice", "greater of", or simple grandfathering of all existing employees, and (2) almost all other plans that grandfather a closed class of employees so that a prospective amendment does not apply to them. The problem

[1] Because subsidies are tested under Regulation § 1.401(a)(4)-3, we see no reason for them to also be subject to the current and effective availability tests. In our view, this is an anomaly that is inconsistent with the structure of the section 401(a)(4) regulations. Accordingly, we would urge you to fully correct this anomaly by exempting from Regulation §1.401(a)(4)-4 any benefit, right, or feature that is taken into account under Regulation § 1.401(a)(4)-3. But regardless, the rule in the text needs to be adopted.

will adversely affect older, longer service employees unless Treasury and the Service step in to solve it.

II. Protecting Grandfathered Employees Where Non-Grandfathered Employees Receive Additional Contributions Under A Defined Contribution Plan

In many cases, instead of converting to a hybrid plan, a company will close its defined benefit plan to, for example, new hires, and such new hires may receive additional allocations under a defined contribution plan. The arrangement is designed to be nondiscriminatory: if the two plans can be tested together, the benefits would in combination satisfy the nondiscrimination requirements. The problem is that there are inappropriate barriers to combined testing. The result of these barriers is that the employer can be effectively forced to remove employees from the grandfathered class, an unfair and unfortunate result.

Prohibited aggregation of plans: issues. Assume, for example, that a defined benefit plan is closed to new hires, and such new hires are provided with a 3% nonelective contribution under a defined contribution plan. Assume further that if the two plans could be aggregated for testing purposes, the benefits provided would satisfy the nondiscrimination testing requirements. However, in order to test the plans together on a benefits basis, the plans have to satisfy one of three tests under Regulation § 1.401(a)(4)-9(b)(2)(v):

- The combined plan is “primarily defined benefit in character”. A combined plan will automatically fail this test if half or more of the NHCEs benefiting under the combined plan receive half or more of their benefits under the defined contribution plan. So over time, this test will eventually be failed as the closed class of NHCEs in the defined benefit plan terminate or retire.

- The defined benefit plan and the defined contribution plan must each be a “broadly available separate plan”, i.e., each plan tested separately must satisfy the nondiscriminatory classification test (and section 401(a)(4)). As explained above, it is very common for the group grandfathered in defined benefit plans to eventually fail the nondiscriminatory classification test due (1) to the higher turnover rate among NHCEs than among HCEs and (2) the fact that generally some grandfathered NHCEs become HCEs.

- All NHCEs must have an allocation rate of at least 5% and, in many cases, must have an allocation rate of at least 7.5%. Any rate in that range and is very high, and is prohibitively expensive for many companies.

Thus, although initially it may be permissible to test the combined plan on a benefits basis, it will likely become impermissible over time as the grandfathered group shrinks and naturally becomes more highly paid. When that happens, the employer can be effectively forced to remove HCEs from the defined benefit plan, including long-service employees who became HCEs long after the plan was closed to new hires. This is not appropriate.

Prohibited aggregation of plans: solution. The solution is essentially the same solution proposed with respect to the first issue. If the two plans are either "broadly available separate plans" or "primarily defined benefit in character" as of the effective date of the closing of the defined benefit plan, the "broadly available separate plan rule" or the "primarily defined benefit in character" rule should be treated as satisfied indefinitely, subject to safeguards similar to those cited in part I above regarding subsequent changes to plan benefits or coverage with respect to the closed defined benefit plan.

Please note that this proposal does not in any way permit discriminatory benefits. On the contrary, all this does is permit the two plans to be tested together to determine if the benefits provided are nondiscriminatory. It is inappropriate to force an employer to remove employees from a grandfathered group to cure a nondiscrimination problem that does not exist in reality; the problem appears to exist only because of a testing regime that does not permit combined plan to be tested together on a benefits basis.

Matching contributions: issue. There is one variation on the above issue that merits separate attention. In some cases, the additional contributions for new hires are in the form of enhanced matching contributions, such as dollar for dollar matches instead of 25¢ or 50¢ on the dollar. In this case, there is an additional obstacle to overcome. Aggregation with the defined contribution plan is generally not available because the matching contribution part of a plan generally may not be aggregated with any other type of plan for purposes of coverage or nondiscriminatory testing.

This is not an appropriate result. Because of the general prohibition on aggregation, many employers may be forced to remove employees from the grandfathered group once the defined benefit plan (or one of its rate groups) ceases to satisfy the nondiscriminatory classification test. This might be appropriate if the benefits provided to the overall workforce were discriminatory. But such benefits very well may not be discriminatory. It is simply the regulatory testing regime that prohibits testing a defined benefit plan and matching contributions together.

Moreover, there is no statutory reason why the matching contribution part of a plan cannot be aggregated with the defined benefit plan to help the latter satisfy the

applicable rules. In fact, the regulations already permit this aggregation in one context—the average benefit percentage test. See Regulation § 1.401(b)-7(e)(1). There is no apparent reason not to permit the same aggregation for other coverage and nondiscrimination testing purposes.

Matching contributions: solution. There are different possible solutions to this problem. The broader solution would be to revise the regulations to permit the matching contribution portion of a plan to be aggregated with other plans to help such other plans satisfy the coverage and nondiscrimination tests. This would only apply with respect to other plans to which the mandatory disaggregation rules do not apply; for example, this would not apply if the other plan were a 401(k) plan. Moreover, the aggregation could not be used in reverse to help the matching contribution part of a plan satisfy the applicable rules.

We see no policy or statutory reason not allowing such aggregation. If this is done and the rule described above (regarding plan aggregation generally) is also adopted, that would solve the problem.

However, there is a solution more tailored to the problem at hand. Under the more tailored solution, aggregation with the matching contribution part of a plan could be limited to defined benefit plans that (1) have been closed and (2) are part of a combined plan that satisfies either the broadly available separate plan rule or the primarily defined benefit in character rule as of the effective date of the closing, again subject to safeguards similar to those cited in part I above regarding subsequent changes to plan benefits or coverage with respect to the closed defined benefit plan. Again, such aggregation would only apply to help the non-matching contribution plan satisfy the applicable rules.

Again, neither of these solutions would permit discrimination. They would simply eliminate testing barriers that currently are hurting only or primarily long-service older employees.

Possible alternative approach with respect to the matching contribution issue. There is a very simple alternative to the proposal set forth above with respect to the aggregation of the matching contribution portion of a plan. Under this simple alternative, if the closed defined benefit plan satisfies the coverage and nondiscrimination rules for, for example, five years after it is closed, it can be deemed to satisfy the coverage and nondiscrimination tests thereafter, provided that (1) the plan thereafter satisfies the average benefit percentage test, and (2) the plan satisfies safeguards similar to those cited in part I above regarding subsequent changes to plan benefits or coverage.

This alternative ensures nondiscriminatory benefits by requiring that the average benefit percentage test be satisfied on an ongoing basis. This alternative also has the significant advantage of avoiding the quirky results that can be generated by testing a shrinking plan on a rate group basis, where for example, the promotion of one person to HCE status could cause the entire plan to fail, which hardly makes sense. Finally, there is precedent for a five-year testing regime. See Reg. § 1.401(a)(4)-13(d)(5)(ii)(A).

In short, this approach would (1) be very fair and simple, (2) take into account the unique aspects of a shrinking plan, and (3) follow a precedent in a somewhat similar context where a prior formula is being phased out. This approach would render unnecessary the matching contribution proposal described above, but not the general aggregation proposal. So we would ask that both this alternative and the general aggregation proposal be available to plans.

III. FACILITATING THE PROVISION OF MAKE-WHOLE CONTRIBUTION IN DEFINED CONTRIBUTION PLANS

There is a related issue that is less common than the issues described above but no less important to the employees affected. For numerous reasons, many plan sponsors have needed to completely freeze their defined benefit plan. However, some of these plan sponsors may wish to provide some or all of the existing employees in the defined benefit plan with make-whole contributions under a defined contribution plan. For example, assume that a defined benefit plan is completely frozen and is replaced with a 3% nonelective contribution under a defined contribution plan. That 3% nonelective contribution is likely to be much more valuable to younger employees than their defined benefit plan accrual would have been. However, for older employees, the accrual may have had more value.

Accordingly, the employer in this example may create a special schedule of additional contributions under the defined contribution plan that is carefully designed to make some or all of the existing employees whole for the loss of the defined benefit plan accruals. Such make-whole contributions can be very helpful in ensuring a smooth transition from the defined benefit plan to a defined contribution plan, especially for older employees.

In order to satisfy section 401(a)(4), such a defined contribution plan must in many cases test contributions on the basis of an equivalent accrual rate in accordance with Regulation § 1.401(a)(4)-8(b). In order to be able to use that regulatory provision with respect to the type of make-whole contributions described above, the special schedule of additional contributions will in most cases need to qualify as

"defined benefit replacement allocations." In order to qualify as such, there are two problematic requirements, as discussed below.

Nondiscriminatory group: issue. First, pursuant to Regulation § 1.401(a)(4)-8(b)(1)(iii)(D)(4), the grandfathered group of employees must be a nondiscriminatory group. Under Revenue Ruling 2001-30, the Service has interpreted that rule to mean that the grandfathered group must satisfy the nondiscriminatory classification test. As in the situations described above, the grandfathered group of employees can generally satisfy the nondiscriminatory classification test as of the effective date of the special schedule of contributions. However, for the same reasons noted above — the typically higher turnover rate among NHCEs than among HCEs and the fact that some grandfathered NHCEs can become HCEs — the grandfathered group of employees will often fail the test after a number of years. This will force the employer to eliminate some or all HCEs from the grandfathered group, thus taking away a benefit that would make these older employees whole for the loss of the defined benefit accrual. This is again a very unfortunate result that is at odds with the desire of older employees and many commentators that plan sponsors compensate older employees for the loss of future defined benefit plan benefits.

Nondiscriminatory group: proposal. The solution to the nondiscriminatory group problem is basically the same solution described with respect to the first issue noted above. If the grandfathered group satisfies the nondiscriminatory classification test as of the date that the group is closed, the group should be treated as a nondiscriminatory group indefinitely, subject to the anti-abuse rules set forth in Regulation § 1.401(a)(4)-8(b)(1)(iii). For example, if the grandfathered group is enlarged, the favorable treatment of the make-whole contributions would be lost.

Issue regarding changes to plan formula or coverage. Revenue Ruling 2001-30 adds certain additional requirements for a schedule of contributions to qualify as a defined benefit replacement allocation. One requirement in particular is not appropriate or workable. Under section III(2)(a)(iii) of the Ruling, the defined benefit plan must have been in effect for at least five years (one year in the case of a plan maintained by a former employer), and "neither the plan formula nor the coverage of the plan has substantially changed during such period."

We understand the rationale for the basic five-year rule. The rationale for the special treatment of defined benefit replacement allocations is to help employers make employees whole for a benefit that they might have been relying on. If a defined benefit plan had only been adopted a year earlier, there is unlikely to have been any significant "reliance", and by definition no long-term reliance.

But the “no substantial change in plan formula or coverage rule” does not make sense. What if the plan sponsor engaged in a major downsizing within the five-year period? That would have had a substantial effect on the coverage of the plan. Why should that affect the ability of the remaining employees to be made whole? What if the employer reduced benefits three years earlier in an effort to “save” the plan? The current rule seems to be based on the idea that if the employees have already suffered a loss of prospective benefits, there is no reason to protect their remaining benefits. That is very unfortunate reasoning underlying a rule that should clearly be changed.

Proposal regarding changes to plan formula or coverage. We would propose a very simple rule to better achieve the purpose of the “no substantial change” rule. The defined benefit replacement allocation must be based on the plan formula and coverage, disregarding any formula improvements or coverage expansions occurring during the last five years (one year in the case of the plan of a former employer). This rule prevents the abuse involved in an employer trying to set up or enhance a plan a few months before freezing it in order to use the special rule for defined benefit replacement allocations. On the other hand, this rule does not have the inappropriately harsh effects of current law, which denies make-whole treatment where such treatment is clearly appropriate.

Additional issues. Especially in light of the change in the determination letter process with respect to nondiscrimination issues, it would be helpful for Treasury and the Service to provide more guidance on the requirement that the make-whole contributions be “reasonably calculated, in a consistent manner, to replace the retirement benefits that the employee would have been provided under the defined benefit plan if the employee had continued to benefit under the plan.” Regulation § 1.401(a)(4)-8(b)(1)(iii)(D)(2). Examples of permissible means of making this calculation would be very helpful. For instance, the examples should clarify that precise replacement on an employee-by-employee basis is not required. If a replacement is adopted that generally makes employees whole in an imprecise but simplified manner, that should be permitted. It would also be helpful if it could be clarified that the make-whole contribution need not replace the entire accrual under the defined benefit plan as long as the portion replaced is consistently and uniformly determined.

IV. MINIMUM PARTICIPATION ISSUES

Grandfathered group: issue. The final regulatory issues arise under Code section 401(a)(26). Assume that an employer with 200 employees closes the plan to new hires but existing employees can continue to benefit under the plan. Or alternatively assume that the employer only grandfathers 100 of the older longer service

employees and freezes the plan for all others. After several years, the number of employees benefiting under the plan falls under 50. That forces the employer to remove all HCEs from the plan. What policy goal is served by such a rule? Why should an employer be prohibited from grandfathering older, longer service employees (who may even grow into HCE status long after the closing of the plan occurs)? Why should pure attrition cause a plan to fail this test?

Grandfathered group: proposal. Our proposal in this regard is the same as the proposals in the earlier parts of this letter. If a plan is closed to new entrants, the determination of whether the plan satisfies section 401(a)(26) should be made as of the effective date of the closing, subject to safeguards similar to those cited in parts I and III above regarding subsequent changes to plan benefits or coverage.

Hard freeze: issue. Assume that a company with 200 employees completely freezes its defined benefit plan. Over a number of years, (1) all employees entitled to benefits terminate employment and (2) the number of former employees still entitled to benefits falls under 50. At that point, under the regulations, the general rule, subject to one exception, is that the plan is simply disqualified. See Regulation § 1.401(a)(26)-3(c). The employer did not do anything wrong in any sense. The vast majority—or even all—of the former employees still entitled to benefits may have been NHCEs. Still, this plan is disqualified unless the plan can fit into one exception.

Generally, under that exception, there must be an actuarial report that the "plan does not have sufficient assets to satisfy all liabilities under the plan (determined in accordance with section 401(a)(2))." See Regulation § 1.401(a)(26)-1(b)(3). In other words, if the plan has enough assets to terminate, it must be terminated, or it will be disqualified.

This "terminate or be disqualified" rule does not seem to be appropriate. First, not a single employee is benefiting under the plan. What substantive harm would the threat of disqualification prevent? Second, why force termination? For example, assume interest rates are at historic lows, as they are today. Why force companies to terminate at a very disadvantageous time? Third, the "terminate or be disqualified" rule is not only inappropriate but also very expensive and burdensome to apply, as it can require expensive actuarial work on an annual basis. (At a minimum, proxies, based on funded status, for the inability to terminate should be developed that make the rule less expensive to apply.)

Moreover, this rule is not conceptually consistent with the rest of the regulation. Assume that all former employees entitled to benefits were NHCEs. If just one NHCE were actively benefiting under the plan, the plan would satisfy section

401(a)(26). But if that one NHCE terminates employment and is no longer benefiting under the plan, the plan can be disqualified. Why?

Hard freeze: proposal. If no employee benefits under a plan, the plan should satisfy section 401(a)(26). We see no rationale for forcing a plan termination in this situation.

* * *

Thank you for your consideration of our views. We would appreciate the opportunity to meet with you to discuss these issues.

Sincerely,

Lynn D. Dudley
Senior Vice President, Policy

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