



AMERICAN BENEFITS COUNCIL

November 15, 2012

J. Mark Iwry
Senior Advisor to the Secretary
Deputy Assistant Secretary
(Retirement & Health Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mark:

On behalf of the American Benefits Council (the “Council”), I wanted to thank you for the meeting on October 3 with respect to the challenges being faced by companies that have, through various means, grandfathered groups of employees from certain defined benefit plan amendments. The meeting was a follow-up to the Council’s letter of April 24, 2012.

The purpose of this letter is to respond to some of the excellent questions raised at our meeting. In order to give context to our answers, summaries of the problem and our proposed solutions are set forth below.

We very much appreciate the opportunity to discuss this issue further. We hope that we can jointly explore ways to solve a problem that has already begun to have adverse effects and has ongoing potential to do significant harm to participants in the future. The recent growth of this issue creates a challenge for all of us to work on together.

BRIEF SUMMARY OF THE PROBLEM

As discussed in our meeting and in more detail in our April 24 letter, the fundamental problem is as follows. Many companies are transitioning away from a 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 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, as discussed in more detail in our April 24 letter, 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 non-elective 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 non-highly 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 becomes too disproportionately highly compensated, 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 solution to the discrimination problem described above is 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.

Contexts in which the problems can arise: Conceptually, the problem described above can arise in several different contexts, as more fully described in our April 24 letter. Those contexts are very briefly described below, along with an equally 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 have fewer 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 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) the coverage and benefits of the defined benefit plan are not expanded after the plan is closed, the two plans will continue to be permitted to be tested together on a benefits basis indefinitely. A special rule is needed where the defined contribution plan contributions are made in the form of matching contributions. Please see the April 24th letter for a description of possible special rules to address this issue.

- **Modification of benefit formula:** The benefit formula under the defined benefit plan is modified for new hires and possibly a subset of existing employees. 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 § 401(a)(4)-4.

Proposed solution: Very generally, if (1) the group 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 nor the benefits are enhanced after the formula is closed, any benefits, rights, and features available to the closed group are deemed to continue to satisfy the current and effective availability tests indefinitely.

- **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 non-discriminatory, yet over time such testing generally becomes unavailable.

Proposed solution: Very generally, if (1) the group receiving the make-whole contribution satisfies the nondiscriminatory classification test as of the date the group is closed, and (2) neither the group nor the contributions are enhanced after such date, the contributions should continue to be permitted to be tested on a benefits basis indefinitely.

- **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 should satisfy 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 in part, and (2) neither the grandfathered group nor the benefits are enhanced after the closing, the plan should continue to be treated as satisfying the minimum participation test indefinitely.

PREVALENCE OF THE ABOVE ISSUES

We are continually learning more about how widespread the above issues are, especially the first two, and how imminent the problem is for many companies. Our national consultant members have communicated those points to us very clearly. And when we recently asked for more information on the prevalence of the issue, we heard from a surprisingly high number of large companies that are very concerned about the issue, many with the problem rather imminent.

POLICY QUESTIONS

At our meeting, there was a good discussion of the policy issues in the context of a plan being closed to new hires. The policy question was generally as follows. In the context of the cross-testing discussion that took place just over 10 years ago, there was discomfort over the ability of plans to pass nondiscrimination testing on a benefits basis except in limited circumstances. Difficult lines were drawn in defining the limited circumstances where benefits testing would be permitted. The question is whether those difficult decisions should be revisited.

We are not asking for any major modifications of the difficult decisions that were made in the context of the cross-testing rules. We respect the lines that were drawn. But when those lines are crossed solely because of the natural evolution of a closed class of employees, that merits further examination. And in this case, that examination leads to a conclusion that if the rules are not modified, a huge number of older, longer service employees will lose the most valuable years of defined benefit plan participation.

In this context, policy considerations seem to clearly favor the type of modifications we have been discussing. This is especially true in light of the fact that the plan arrangement started as a defined benefit plan and the employer is attempting to avoid departing too abruptly from the defined benefit plan system. This point is helpful in demonstrating the appropriateness of benefits testing. Second, our Proposed Solutions

do not, of course, in any case eliminate the fundamental requirement that overall benefits must be nondiscriminatory.

AUTHORITY

We briefly discussed the question as to whether Treasury and the Service have the authority to modify the regulations to adopt our Proposed Solutions. There is certainly nothing in the very general statutory language that would preclude such modifications. In fact, for example, the Proposed Solution with respect to the first issue – the closing of a defined benefit plan to new hires and testing the plan with a defined contribution plan on a benefits basis – is consistent with the regulatory structure in effect until the 2002 plan year. As another example, the Proposed Solution regarding the second issue – dealing with benefits, rights, and features – is based entirely on an existing regulatory provision in a very similar context, i.e., the merger and acquisition rule of Regulation § 1.401(a)(4)-4(d)(1).

If a further discussion of the authority issue would be helpful, please let us know.

ANTI-ABUSE RULE

Anti-abuse concern: Concerns have been raised about the potential for abuse of our Proposed Solutions discussed above. For example, as at our meeting, we will illustrate that potential in the context of the first issue discussed above, i.e., the closing of a defined benefit plan to new hires.

Assume that a small employer establishes a defined benefit plan with relatively small benefits. After more than five years, the plan benefits are dramatically enhanced. Shortly thereafter, the plan is closed to new hires who instead receive a non-elective contribution under a defined contribution plan.

Technically, this arrangement would qualify under our Proposed Solutions so that the two plans could be tested together on a benefits basis. Our Proposed Solutions, however, were not intended to apply in this type of situation. This situation is not preserving longstanding benefits that employees might have been counting on. On the contrary, this arrangement would simply be an attempt to use our Proposed Solutions in an unintended way to do an end-run around the intent of the cross-testing rules.

Proposed anti-abuse rule: So the next question is how to prevent this abuse. One logical starting point in this regard is Revenue Ruling 2001-30, which addresses the make-whole contribution issue described above and includes the following anti-abuse rule:

The defined benefit plan was in effect for at least the 5-year period ending on the date benefit accruals for the employees under the defined benefit plan cease (with one year substituted for 5 years in the case of a defined benefit plan of a former employer), and neither the plan formula nor the coverage of the plan has been substantially changed during such period.

This requirement would prevent the abuse, but it would also prevent a large number of clearly non-abusive arrangements from using our Proposed Solutions. For example, assume that an employer reduced defined benefit plan benefits three years before in an effort to “save” the plan? Or the employer recently engaged in major downsizing, which could be viewed as having substantially changed the coverage of the plans? Neither of these situations is in any way abusive, yet the above anti-abuse rule could prohibit a plan in these situations from using an appropriate and necessary solution to a problem.

Under our proposed anti-abuse rule, our Proposed Solutions would only apply to (1) plan benefits without regard to any benefit enhancements within the five years prior to the closing of the plan or plan benefit formula, and (2) participants without regard to plan amendments expanding coverage within the five years prior to the closing of the plan or plan benefit formula. So, in the abusive situation described above, the benefit increase shortly before the closing of the plan would not qualify for our Proposed Solutions. In other words, the defined benefit plan without regard to the benefit enhancement would qualify for our Proposed Solutions. The enhancement could then be aggregated with the unenhanced portion of the plan to determine if the “entire” defined benefit plan qualifies for benefits testing, based on the law in effect today. If not, the plan sponsor may have to find another means to satisfy the applicable rules with respect to the enhanced portion, which could include freezing the enhancement on a prospective basis.

As is clear from the above, in many cases, the enhancement may need to be prospectively frozen. Accordingly, as our discussion becomes more detailed, it would be very helpful to discuss safe harbor enhancements that can qualify for our Proposed Solutions, such as enhancements that primarily benefit NHCEs or are unrelated to a subsequent freezing of the plan.

The above rule arrives at the right result from a policy perspective with respect to the abusive situation noted above and discussed at our meeting: the portion of the defined benefit plan that had provided certain benefits for over five years could qualify for our Proposed Solutions; the benefit enhancement adopted shortly before the closing of the plan would not so qualify.

No selective reductions: This general anti-abuse rule, however, needs two refinements to make it work correctly. First, as discussed in our meeting, a plan sponsor should not be permitted to reduce benefits in a “selective” manner shortly before the closing of the plan. For example, assume that a benefit formula had been in effect for many years. Shortly before the closing of the plan, the plan sponsor reduces the benefits in a manner that has a disproportionately adverse effect on NHCEs. In this example, the plan sponsor is not attempting to protect and grandfather “participants” as a whole. On the contrary, the plan sponsor is primarily attempting to protect HCEs. This arrangement should not be eligible for protection under our Proposed Solutions.

Accordingly, we recommend that examples of this type of arrangement be added to Regulation § 1.401(a)(4)-5(a) regarding plan amendments. We believe that this issue is better addressed by a facts and circumstances anti-abuse rule – like the discrimination amendment rule of Regulation § 1.401(a)(4)-5(a) – than by a complex, detailed mechanical rule. In this regard, it would be very helpful if there could be examples of arrangements that do not fail, as well as arrangements that fail. For instance, reductions that primarily affect HCEs or are neutral in application could be included as examples of arrangements that do not fail.

Exception for uniform benefit amendments: Second, our Proposed Solutions regarding benefit or coverage enhancements within the past five years should not apply to enhancements that are designed to provide a more uniform benefit formula. For example, assume that a company sponsors three different defined benefit plans with different benefit formulas. The company decides to move to a uniform company-wide plan by merging plans “B” and “C” into plan “A”, and applying the plan A formula to all participants. This is clearly an expansion of A’s coverage and may provide a benefit enhancement for some or all of the former B and C participants. Three years later, due to changed economic conditions, the plan sponsor closes the plan to new hires. This is not an abusive situation and thus should qualify for our Proposed Solutions.

Again, we do not recommend the adoption of a complex, detailed mechanical rule to address this issue. Instead, we would recommend that our Proposed Solutions include an exception from the “no benefit or coverage enhancement rule” for coverage or benefit enhancements designed to make benefits more uniform. An example like the one set forth above could be included in the regulations.

TRANSITION ISSUES

In the ongoing discussions of our Proposed Solutions, we would like to explore the transition issues that will arise. We anticipate a need to include appropriate transition rules to ensure that our Proposed Solutions apply in an appropriate manner regardless of when the triggering plan event occurred and regardless of whether a plan sponsor was previously compelled to take actions inconsistent with helpful rules that

are added later. The need for the transition rules and how best to craft them are best analyzed after there is greater clarity regarding the exact nature of the new rules and after we gather more information about the different fact patterns that exist. So we look forward to addressing the transition issues as our discussions continue.

* * *

Thank you again for the opportunity to discuss these important issues with you. We look forward to our next meeting.

Sincerely,

A handwritten signature in cursive script that reads "Lynn D. Dudley". The signature is fluid and elegant, with the first letters of each word being capitalized and prominent.

Lynn D. Dudley
Senior Vice President, Policy