

**COALITION TO PRESERVE
THE DEFINED BENEFIT SYSTEM**



The ERISA Industry Committee

October 1, 2009

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Dear Mark, Nan, and Andy:

This letter, which is submitted by the Coalition to Preserve the Defined Benefit System (the “Coalition”), the American Benefits Council (the “Council”) and The ERISA Industry Committee (“ERIC”), identifies key transition and process issues with respect to upcoming hybrid plan guidance.

The Coalition is an employer organization with 75 member companies ranging from modest-sized enterprises to some of the largest corporations in the country, all of which sponsor hybrid pension plans. Together, Coalition members provide retirement benefits for more than 1.5 million American workers. 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. ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and welfare benefit plans of America’s largest employers. ERIC’s members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a

strong interest in proposals affecting its members' ability to deliver those benefits, their costs and effectiveness, and the role of those benefits in the American economy.

Our organizations applaud the commitment of the Treasury Department ("Treasury") and the Internal Revenue Service (the "Service") to provide guidance regarding hybrid plans. Plan sponsors, plans, and participants all benefit from clear administrable rules.

It is our understanding that Treasury and the Service are expecting soon to issue final regulations with respect to substantially all of the hybrid plan amendments contained in the Pension Protection Act of 2006 (the "PPA"). However, we understand that two areas may be separately addressed in proposed regulations: (1) the requirement that a hybrid plan's interest crediting rate not exceed a market rate of return, and (2) the rules regarding pension equity plans ("PEPs"). We strongly support this three-part approach to hybrid plan guidance.

Our organizations appreciated the opportunity to comment on the hybrid plan regulations proposed in late 2007, and all three organizations submitted extensive comments on a range of substantive issues that are critically important for our member companies. We would be pleased to discuss those substantive comments or address questions you may have about them at any time, but the specific purpose of this letter is to supplement those comments with a discussion of transition and process issues that have arisen.

As discussed in more detail below, we ask you to consider doing the following:

- Issuing the market rate of return and PEP guidance in proposed, not final, form, as referenced above, and doing so as soon as practicable.
- In light of the timing of the market rate of return regulations, extending the applicable anti-cutback relief at least through the end of the 2010 plan year.
- Applying a "reasonable interpretation of the statute" standard prior to the effective date of the final regulations, with respect to all upcoming hybrid plan guidance. Without such a standard, compliance is almost impossible.
- Making the upcoming final hybrid plan regulations effective no earlier than for plan years beginning at least 12 months after the issuance of the regulations.
- In the proposed market rate of return regulations, addressing the interaction of the interest crediting rules and the backloading rules, so that new requirements are imposed through the regulatory process rather than through the determination letter process.

I. Market Rate of Return.

Proposed guidance on market rate and PEPs. We believe that guidance with respect to the market rate of return requirement and the legitimacy and operation of PEPs should be in proposed, not final, form, and that these proposed regulations should be issued as soon as possible. With respect to these topics, the initial proposed regulations provided some basic guidance and outlined some possible issues in the preamble, but did not set forth a comprehensive set of proposed rules that could be commented on. Our informal understanding is that Treasury and the Service are inclined to issue proposed regulations on these topics, and we would applaud that. One reason the proposed regulations are so urgently needed in the case

of PEPs is because the Service continues to apply an informal moratorium on the issuance of determination letters to these plans. We hope this moratorium can be lifted as soon as possible given that some PEP determination letter applications have been pending for more than seven years.

Extension of anti-cutback relief. With respect to PPA's hybrid plan amendments, there is a clear need to extend the anti-cutback relief currently provided by PPA section 1107, at least through the end of the 2010 plan year. That relief is currently scheduled to expire at the end of the 2009 plan year, and we cannot envision final market rate of return guidance being able to be implemented by January 1, 2010. Accordingly, plans will need to be amended after 2009 to conform to the market rate of return requirement, which may entail, in some cases, a reduction in the interest crediting rate with respect to previously accrued benefits. Relief from the rules of Code section 411(d)(6) is needed in order for companies to adopt such amendments. Clearly, Treasury and the Service have the authority to provide such relief. See, e.g., Regulation § 1.411(d)-4 Q/A-2(b)(2)(i).

Moreover, it is critical that relief not be limited to reductions in the interest crediting rate. A hybrid plan's interest crediting rate is interrelated with almost every other feature of the plan, such as pay credits, backloading compliance, nondiscrimination testing under section 401(a)(4), funding, and distribution options. We believe that it would be inappropriate to narrow the scope of the relief before there is a full appreciation of the possible effects of the final rules on all aspects of hybrid plan designs.

Reasonable interpretation standard. A large number of companies have very reasonably waited to amend their interest crediting rate until guidance is issued. Assume, for example, that a plan provides a fixed 6% interest crediting rate. We strongly believe that such a rate should satisfy the market rate of return requirement. And there is no clear guidance to the contrary. In this context, the employer would naturally feel very uncomfortable amending its plan to reduce that 6% rate because, if that rate does satisfy the market rate of return rule, the amendment may not be protected by PPA section 1107 and thus could violate Code section 411(d)(6)¹.

So, a large number of employers—some with fixed interest crediting rates like 6%, 7%, or higher—have been waiting for guidance. They cannot reduce their rate without the risk of violating Code section 411(d)(6). This is especially true since the regulations under section 401(a)(4) require the use of a standard interest rate that is between 7.5% and 8.5% for purposes of converting allocations into accruals. It is difficult for an employer to conclude that a 7% rate of return is above market if such rate is below the rate that the government requires to be assumed in converting allocations into accruals.

¹ We understand that some at Treasury and the Service believe that PPA section 1107 protects any amendment that could reasonably be viewed at the time adopted as necessary to comply with the market rate of return rule. We agree that this is a very reasonable and appropriate interpretation of the PPA. However, this view is not supported by any written guidance from Treasury and the Service; moreover, we are not certain that this view is shared by others at Treasury and the Service. Accordingly, many plan sponsors have not been comfortable relying on this interpretation.

In this context, it is critical that the proposed market rate of return regulations permit any reasonable interpretation of the statutory market rate rule to be treated as compliance with the law prior to the effective date of the final market rate regulations. As discussed in more detail below with respect to the upcoming final regulations, the absence of such a reasonable interpretation standard could be read to require all the companies “on hold”—i.e., companies that have reasonably felt compelled to wait for guidance before amending their plans—to eventually have to retroactively amend their plans back to the beginning of the 2008 plan year to conform to the final market rate of return rules. It would be inappropriate for final regulations issued, for example, in late 2010 to require retroactive amendments back to January 1, 2008 for all such companies. Such retroactive amendments would be extremely burdensome and expensive to implement. For example, such amendments could mean that distributions since January 1, 2008 were higher than they should have been (raising difficult issues regarding recovery of overpayments), and could trigger retroactive backloading problems that would require a plan’s entire pay credit structure to be redesigned retroactively.

II. Final Regulations.

Effective date. The upcoming final hybrid plan regulations would require (1) careful review of such regulations by employers and plan advisors, (2) interpretation of how the rules apply to particular facts, (3) consideration of how plans need to be modified in form and operation to comply with the rules, as so interpreted, (4) determination of how to communicate any such changes to participants, and (5) implementation of such changes. These steps cannot be achieved overnight. In fact, we understand from our members that for many plan sponsors, it is already too late to implement these types of changes by January 1, 2010. Accordingly, we strongly urge you to provide that the final regulations shall not be effective until plan years beginning at least 12 months after the publication of such regulations.

Reasonable interpretation standard. Above we discussed the need for a reasonable interpretation standard prior to the effective date of the final market rate of return regulations. The same standard is also badly needed with respect to the issues addressed by the upcoming final hybrid plan regulations. In order to fully appreciate this issue, it is important to analyze how the law would apply without such a standard. Assume, for example, that the hybrid plan regulations are finalized this year, effective for plan years beginning on or after January 1, 2011. In that case, the issue is what standard applies in determining whether a plan was in compliance with the new PPA rules (some of which apply back to 2005) in earlier years. Technically, a plan has two choices for such earlier years: (1) comply with the proposed regulations (which is expressly permitted by such regulations), or (2) comply with the statute. The question: how does a plan show compliance with the statute in such earlier years? One answer is: comply with the final regulations. Since no one knows or could have known what those final regulations are going to say, that was not a possibility. The other answer is: comply with a reasonable interpretation of the statute. In our view, that is clearly the right answer. But Treasury and the Service have very clearly declined to confirm that this is permissible. This is quite troubling, especially in light of the fact that Treasury and the Service have expressly applied the reasonable interpretation standard in other areas, such as funding and benefit restrictions.

If the reasonable interpretation of the statute standard is not available for past years, then the only permissible approach in prior years was compliance with the proposed regulations. That would mean that the proposed regulations would effectively be functioning as temporary regulations. This would be inappropriate. The proposed regulations were published on December 28, 2007, more than two years after many of the rules took effect and just days before the other rules generally became effective. In an area as complex and difficult as hybrid plans, it would not be appropriate to issue retroactively effective temporary regulations. For example, the proposed regulations interpreted the new PPA rules regarding “conversions” to a hybrid plan to treat, under certain circumstances, an amendment to a traditional formula to delete bonuses from the definition of compensation as a conversion. In 2005, before the PPA was even enacted and when the conversion rule first became effective, no one could possibly have foreseen this expansive interpretation of “conversion” (nor do we believe that it is a reasonable interpretation of the statute). To adopt a legal scheme that effectively treats the proposed regulations’ extremely expansive proposed definition of “conversion” as a retroactive temporary regulation is wrong.

It is insufficient to argue that “three-party rules”—i.e., regulations affecting the Service, plan sponsors, and participants—are ill-suited to a reasonable interpretation standard. Almost every rule in the retirement plan area affects participants. For example, the funding and benefit restriction rules clearly affect participants, yet the Service has established a reasonable interpretation standard in that area. The absence of a reasonable interpretation standard does not protect participants’ rights. On the contrary, such absence simply ensures non-compliance with the law, as illustrated above, and undermines respect for the legal system. We urge you to remedy this by confirming that a reasonable interpretation standard is applicable prior to the effective date of the final hybrid plan regulations.

This discussion of the need for a reasonable interpretation standard applies with at least equal force to PEP guidance.

III. Use of the Regulatory Process.

As discussed above, the market rate of return rule affects almost every aspect of a hybrid plan. In particular, in recent years, controversy has emerged with respect to the relationship between a plan’s interest crediting rate and the plan’s ability to demonstrate compliance with the backloading rules. This controversy has generally been playing out in the determination letter process.

The determination letter process is not the place to break new substantive ground. New substantive positions should be explored and settled in a public manner through the regulatory process. Accordingly, we urge you to include, in the proposed market rate of return regulations, proposed regulations regarding how a hybrid plan’s interest crediting rate affects backloading testing.

If these two projects are not combined in this manner, the system could suffer greatly. The proposed regulations indicate that Treasury and Service intend to take the position that the existence of a reasonable minimum interest crediting rate can cause an otherwise at-market rate

of return to be above market. As noted in our prior comments, this position is squarely contrary to the statute, and we hope that Treasury and the Service have reconsidered. But if Treasury and the Service stay with that position, it could lead to the anomalous results discussed below.

In the context of the determination letter process, the Service has been requiring many plans with variable interest crediting rates to adopt fixed minimum interest crediting rates in order to comply with the backloading rules. We disagree with the Service's position in this regard. But if the position continues, employers would be faced with the following problematic situation. First, the Service requires the application of a minimum interest rate to demonstrate compliance with the backloading rules. Second, the Service takes the position that the Service-required minimum interest rate causes the plan's market rate of interest to cease to be a market rate of interest, triggering a required decrease in such rate of interest. This will seem unfair to plan sponsors and participants. At a minimum, it is important to combine the two sets of rules into one rulemaking project, so that this problematic combination of results can be the subject of a public dialogue.

We very much appreciate your openness to our comments. We hope to have the opportunity to meet with you to discuss these issues. In the meantime, should you have any questions, please feel free to contact Alan Glickstein for the Coalition (alan.glickstein@watsonywyatt.com; 214-530-4538), Lynn Dudley for the Council (ldudley@abcstaff.org; 202-289-6700), or Kathryn Ricard for ERIC (kricard@eric.org; 202-789-1400).

Sincerely,

Coalition to Preserve the Defined Benefit System

American Benefits Council

The ERISA Industry Committee

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