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September 2, 2008

Hand Delivered

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Room 5203
Internal Revenue Service
P.O. Box 7604
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Washington, DC 20044

Re: Proposed Regulations relating to Accrual Rules for Defined Benefit Pension Plans

On behalf of Alston & Bird, LLP, we appreciate this opportunity to comment on the proposed regulation under § 411(b)(1) of the Internal Revenue Code (the "Code") published in the Federal Register on June 18, 2008. The proposed regulation would amend existing regulation § 1.411(b)-1 relating to the backloading rules applicable to defined benefit pension plans.

In addition to submitting comments, we also request the opportunity to testify at the public hearing scheduled for October 15, 2008. A summary of topics to be discussed at the hearing is being submitted separately.

Alston & Bird LLP is an AmLaw 100 law firm with over 900 lawyers and offices in eight cities in the US. We have represented pension plans in class action litigation relating to backloading. We also advise numerous pension plans, collectively with many billions of dollars in assets, and their sponsors with respect to backloading issues and have represented many of those sponsors before the IRS with respect to backloading. David Godofsky is the leader of the firm's Employee Benefits and Executive Compensation practice group, and Carolyn Smith is a counsel in the Employee Benefits and Executive Compensation practice group.

The backloading rules found in § 411(b)(1)(A), (B), and (C) of the Code include three mathematical formulas intended to give meaning to the vesting rules by preventing an employer from delaying or "backloading" the accrual of benefits until late in an

employee's career. Without the backloading rules, the vesting rules could be easily circumvented through plan design.

Unfortunately, as currently formulated in regulations, the backloading rules also seem to prohibit common and non-controversial practices that do not involve the type of vesting problems the statutory rules were designed to prevent. In fact, certain plans that front-load benefits fail all three mathematical tests. This is particularly true of plans that provide the greater of two or more different benefit formulas. "Greater of" plans are becoming more common every day, as employers merge or look for ways to update their retirement benefits, while attempting to preserve benefits for employees near retirement.

The IRS and Treasury are to be commended for already recognizing the "greater of" problem. Welcome, but limited, relief was provided in Revenue Ruling 2008-7 through December 31, 2008. The proposed regulation provides an important further step in the right direction by expanding the relief provided in the Ruling.

However, the proposed relief falls significantly short of what is needed. Without expansion of the relief provided in the proposed regulation, employers who did the most to protect workers by providing the greater of two benefit formulas will face additional costs, penalties, lawsuits, complexity and uncertainty. Plan sponsors who did little to protect benefits conversely (and perversely) avoid these issues. Without further relief, the backloading rules run counter to public policy – they encourage plan sponsors to freeze participation, discourage or prohibit "greater of" benefits, encourage litigation, and discourage the sponsorship of pension plans.

SUMMARY OF COMMENTS

To alleviate the flaws in the backloading rules, we request that the final regulations:

- Permit plans to use the greater of two or more benefit formulas, provided that no formula is impermissibly backloaded when looked at separately, subject to an anti-abuse provision.
- Permit plans to be tested by looking only at actual participants rather than hypothetical participants.
- Permit cash balance plans (and other statutory hybrid plans) to be tested using a long-term average of the index used for the interest crediting rate.
- Allow plans to use a compensation averaging period of more than 10 years under certain controlled circumstances. Under this exception, if a plan would pass the 3% test or the fractional test except that the compensation averaging period is more than 10 years, the plan would be deemed to pass the backloading rules, subject to an anti-abuse provision.

If modified in this way, the regulations will preserve the goals sought to be addressed by the backloading rules in the first place and will eliminate the current flaws that encourage employers to freeze participation or provide less generous benefits in plan transitions. Without these changes, further erosion in defined benefit plan coverage is likely to occur. These changes will encourage employers to maintain defined benefit pension plans and provide more generous benefits in the event of corporate transactions or plan design changes.

DISCUSSION

1. Permit Plans To Use The Greater Of Two Or More Benefit Formulas, Provided That No Formula Is Impermissibly Backloaded When Looked At Separately, Subject To An Anti-Abuse Provision

The proposed regulation permits plans to provide benefits equal to the greater of two or more formulas, provided that each separate formula satisfies the backloading rules. However, this is subject to two significant limitations: (a) each separate formula must satisfy the 133- $\frac{1}{3}$ % test in Code § 411(b)(1)(B); and (b) the formulas must use a different basis for determining benefits. Both of these limitations unduly restrict use of the “greater of” rule and should be eliminated.

The final regulations should extend the relief to all three of the mathematical tests in the Code. There is no sound reason to limit the proposed regulation to the 133- $\frac{1}{3}$ % test; the preamble indicates only that relief is not needed with respect to the other tests because the 3% test and the fractional test are generally passed where a plan uses the “greater of” and each formula passes the same test. However, there are compelling reasons not to limit relief to the 133- $\frac{1}{3}$ % test:

- Determining whether a “greater of” formula satisfies the 3% test or the fractional test requires complex expensive analysis, with the attendant risk of error. In this case, where there is clearly no public policy to prohibit such “greater of” formulas and considerable public policy favoring them, plan sponsors should be able to design “greater of” formulas without the expense and risk.
- If a plan uses the 3% test for one formula and the fractional test (or the 133- $\frac{1}{3}$ % test) for the other formula, there is no assurance that the “greater of” formula will pass any test.
- Plans that rely on the 3% test or the fractional test may not pass either where the two formulas that form the “greater of” use different averaging periods for compensation.

Suppose, for example, that two formulas each satisfy the fractional test. Formula A uses 3-year average compensation while formula B uses 10-year average compensation. The employer “tests” the “greater of” formula by projecting 10-year average compensation. However, formula A is guaranteed to pass the fractional test only if 3-year average compensation is projected, while formula B is guaranteed to pass only if 10-year average compensation is projected. The test allows the employer to pick which average to project – 3 year or 10 year – but there is no mechanism for projecting both, and in fact those two projections are mathematically mutually exclusive. So, the combined formula – the greater of A or B – is not guaranteed to pass the fractional test.

“Greater of” formulas that use the 3% or fractional method are not likely to be more abusive than other formulas. In addition, there is no apparent reason why the “greater of” test should not be applied where the formulas utilized different tests – e.g., where one relies on the 133- $\frac{1}{3}$ % test and the other on the 3% test.

The final regulations should provide that the relief for “greater of” formulas is available regardless of which statutory test each formula relies on and passes.

The final regulations should also eliminate the requirement that the two formulas have different bases for determining benefits. The proposed regulation provides two examples of what constitute different bases – (a) a formula that uses highest average compensation has a different basis than a formula that uses career average compensation; and (b) a formula that uses highest average compensation has a different basis than a formula that involves a statutory hybrid plan that provides for pay credits on the basis of each year’s compensation. If two formulas have the same basis, they must be combined into a single formula for testing purposes under the proposed regulation.

Here again, the proposed regulation does not give an indication of why the restriction is imposed. Relief in this situation is needed – it is possible for plans that have more than one benefit formula with the same basis to fail the backloading rules when combined, even though they provide for much faster accruals in the beginning of a worker’s career than other formulas that pass the test. Such formulas are not backloaded in any common-sense understanding of the term, yet the relief would not be available.

From a broader perspective, the issue is that a combination of multiple formulas can appear in a plan for many reasons, and the interplay of formulas that each satisfy the backloading rules, causing the formulas together to fail the backloading rules, is neither unusual nor abusive. Such multiple formulas appear when employers merge and give all or a grandfathered group a “greater of” benefit based on the two formulas used by the two employers before the merger. Similarly, multiple formulas appear when an employer makes a fundamental benefit change and grandfathers a group of employees. With multiple mergers and plan design changes to accommodate changing workforce and financial conditions, it is not unusual for a company to accumulate three or four formulas in a single pension plan. Many of the resulting benefits are not backloaded in any common-sense understanding of the term, but prohibited nonetheless.

Plans may also accumulate multiple formulas in order to comply with statutory requirements. For example, a pension plan that is top heavy will be required by Code § 416 to have a “greater of” formula. If that plan’s normal formula has a compensation basis other than the highest five top heavy years, the plan will almost invariably fail the backloading test. Similarly, any plan with employee contributions is required to have a “greater of” formula where one formula is the value of accumulated employee contributions. Such plans are not otherwise backloaded or in any way abusive, but will often fail the backloading test merely because of the minimum benefit for employee contributions. There is no logic to having benefits that are simultaneously mandated and prohibited.

Providing the relief we request would also have the positive effect of eliminating a conflict that currently exists between the regulations and rulings (in particular, Rev. Rul. 2008-7) and Federal court decisions. For example, the latest Circuit Court backloading decision (as of the date of this letter) specifically rejects the “greater of” analysis in Revenue Ruling 2008-7 (relating to temporary grandfathering) and concludes that the grandfathered benefit may be ignored, even if it continues to accrue for a time. *See, Hurlic v. Southern California Gas*, No. 06-55599, 2008 WL 3852685 (9th Cir., Aug. 20, 2008). By providing the sensible relief we request, the final regulation can provide welcome and overdue clarity to this area of law.

Concerns that particular benefit combinations under an expanded “greater of” rule may be abusive can be addressed with an anti-abuse provision. The proposed regulation already contains such a rule, which could be modified so that separate testing is not available if the plan’s use of different formulas is determined to be abusive.

2. Permit Plans To Be Tested By Looking At Actual Participants Rather Than Hypothetical Participants

Under the current regulations, a plan must satisfy the backloading rules with respect to every participant *and* every hypothetical person who could ever become a plan participant, regardless of how unlikely that hypothetical person is to actually exist. This requirement can produce odd results in some cases, causing some plans that are intuitively less backloaded to fail the tests when other plans with formulas that provide greater backloading pass the tests. In addition, as clarified by Revenue Ruling 2008-7, the portion of the test relating to hypothetical participants is inapplicable to plans with frozen participation, because no hypothetical person *could* become a participant. This makes it significantly easier for a frozen plan to pass the tests.

From a policy perspective, the requirement to look at hypothetical participants is bizarre and destructive. By definition, a defect that affects only hypothetical participants, but not actual participants, could not possibly harm any real person. There is no logical policy behind the protection of individuals who do not actually exist. Even worse, protecting hypothetical people can harm real people. Many plans can avoid this

backloading problem by freezing participation, which eliminates the possibility of hypothetical employees and limits the analysis to real employees. Freezing participation harms those individuals who might have been able to obtain a pension benefit, and cuts against the policy of providing broad participation in the private pension system, and fails to address the vesting issue that backloading is intended to solve.

3. Permit Cash Balance Plans (And Other Statutory Hybrid Plans) To Be Tested Using A Long-Term Average Of The Index Used For The Interest Crediting Rate

The proposed regulation does not adequately address the interaction of the backloading rules with the cash balance provisions of the Pension Protection Act of 2006 ("PPA"). Among other things, PPA is intended to permit a cash balance plan to use a market rate of return in crediting interest, while the backloading rules prohibit the use of a market rate of return.

Code § 411(b)(5)(B)(i)(I) as added by § 701(b) of PPA provides that a cash balance plan may use a market rate of return as its interest crediting rate. One hallmark of a market rate of return is that it may be negative in any one year, although presumably it is expected to be positive over a long period of time. As explained in Revenue Ruling 2008-7, the interest rate crediting in a given year is projected for all future years in the 133- $\frac{1}{3}$ % test. (This also means the test must be done every year, as the interest crediting rate changes.)

So, for example, suppose plan A, a cash balance plan, gives pay credits of 5% of pay, and credits interest equal to the rate earned by the S&P 500 index. Suppose in the year 2012 the S&P 500 returns a negative rate of return of 15%. For backloading purposes, plan A is assumed to have interest credits of negative 15% for all years after 2012.

Now consider the accrual for Abby, who in 2012, at age 55, has a pay credit of \$1,000. In calculating how much Abby accrued in 2012, one would project her \$1,000 pay credit to normal retirement date assuming negative 15% returns each year. This yields \$196.87 after the effect of 10 years of negative 15% returns.¹

One then assumes a \$1,000 pay credit in each future year, also then earning negative 15% each year until age 65. Abby's assumed pay credit in 2014 has only 8 years of negative 15% returns, and has a projected value of \$272.49. Because \$272.49 is 38% more than \$197.86, plan A fails the 133- $\frac{1}{3}$ % test (and cannot use either of the other tests because its compensation basis exceeds 10 years).

¹ The preservation of capital rule would not necessarily help, because it is based on the entire account balance, including accruals in prior years. If there is a significant build up of interest before the current year, the preservation of capital rule might not have an effect.

Of course, the assumption itself makes no sense. If it made sense to expect that the S&P 500 would truly return negative 15% each year, forever into the future, no one would invest in it. In the case of a fluctuating rate of return, it would make more sense to project a long term average consistent with one or more full market cycles. However, the artificial assumption that the one-year interest crediting rate will continue forever into the future means that, whenever a particular rate of return is negative for one year, nearly all cash balance plans using that rate will fail the backloading rules.

In order to accommodate crediting of interest in cash balance plans at a market rate as provided by the PPA, cash balance plans (and other statutory hybrid plans) should be permitted to apply the backloading rules using a long-term average of the index used for the interest crediting rate under the plan.

4. Permit Plans To Use a Compensation Averaging Period of More Than 10 Years, Subject To An Anti-Abuse Provision

As discussed above, many plans that are not backloaded in any intuitive sense are unable to pass the 133- $\frac{1}{3}$ % test, and any plan that uses a compensation averaging period of greater than 10 years will generally fail the 3% test and the fractional test. In general, such plans are less backloaded than plans with a shorter compensation averaging period, so it is counter-productive to have them automatically fail two of the three tests.

Consider the example of plans A1 and A2.

$$\text{NRB}^2 = 1\% \times \text{Average Compensation ("AC")} \times \text{Years of Service ("YOS")} \text{ up to } 33 \text{ years}^3$$

Plan A1 uses this formula, and defines average compensation as the average over the employee's entire career.⁴

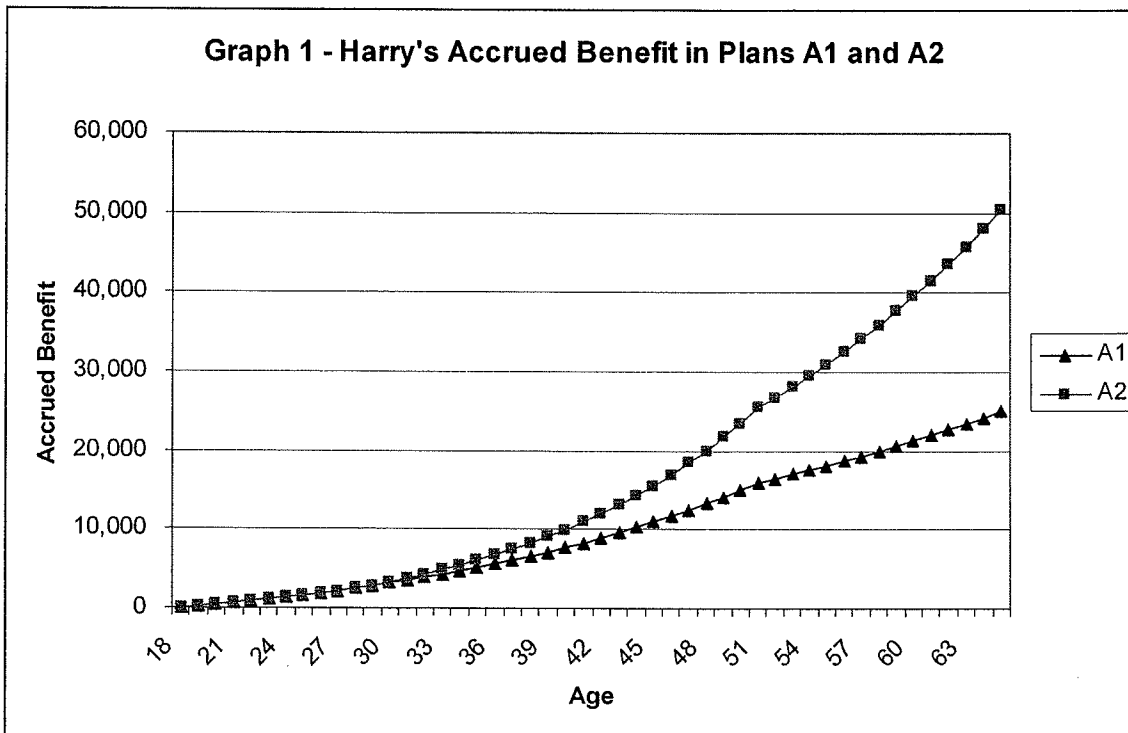
Plan A2 uses the same formula, but defines average compensation as the average over 10 years.

Hypothetical participant Harry is hired at age 18 at a salary of \$20,000 per year. Harry receives pay increases of 5% each year. By age 35, Harry is making \$45,840 per year. Graph 1 shows Harry's accrued benefit under plan A1 and plan A2 over his entire career, to age 65.

² Normal Retirement Benefit.

³ The maximum benefit under the plan is 33% of average compensation.

⁴ The example is not dependent on the averaging period being the entire career. Any period of time that could exceed 10 years will produce essentially the same results.



Graph 1 shows that plan A2 is significantly more backloaded than plan A1. However, plan A2 passes the 3% test. Plan A1, which is much less backloaded, fails. To see why this is so, consider Harry at age 35.

Plan A1 – Harry at Age 35 – 3% Test

- Average Compensation = \$30,400
- Years of Service = 17
- Accrued Benefit = 1% x 17 x \$30,400 = \$5,168
- Service at Age 65 = 47
- 10 year average compensation (used to calculate the projected NRB) = \$35,397
- Projected average compensation = \$33,590⁵
- Projected NRB = 1% x \$33,590 x 33 = \$11,085
- Minimum accrued benefit to pass the test = \$11,085 x 3% x 17 = \$5,653

As can be seen, the less backloaded plan fails. The same counter-intuitive results can be achieved with the fractional test simply by increasing the averaging period from 10 years or less to more than 10 years. Further, increasing the averaging period will always make a plan less backloaded if participants are getting regular salary increases, as is almost always the case.

⁵ This is the average of the compensation for the past 17 years and 30 more future years at the 10 year average rate.

We suggest that the final regulations permit a plan that has a compensation averaging period of more than 10 years to be deemed not to be backloaded, provided all of the following conditions are met:

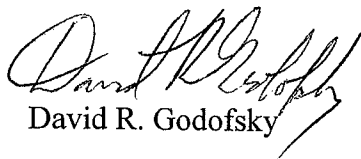
- The compensation average is based on a fixed number of years of compensation that is greater than 10 (or career compensation).
- The compensation average gives equal weight to each year in the averaging period.
- The plan would pass either the 3% test or the fractional test if the averaging period were reduced to 10 years and no other change were made to the plan.
- The plan has not been designed to use this exception to evade the purposes of the backloading rules.

CONCLUSION

The proposed regulation takes important steps toward the relief necessary with respect to the backloading rules, particularly with respect to plans that provide benefits that are the greater of two or more formulas. However, the proposed regulation needs to go further in order to preserve the policy objectives of Congress and the Administration. Under the current backloading rules, too many plan sponsors may take the road of freezing plan participation in order to avoid complex issues under the backloading rules. In cases of corporate mergers or other plan design changes, employers may decide to take a less generous approach to grandfathering benefits, as preserving benefits for those near retirement may create backloading issues. These perverse results are particularly troublesome at a time when Congress and the Treasury are seeking to slow or even reverse the decline of pension coverage for workers. The changes suggested in these comments would further Congressional and Administration policy goals for broad-based pension coverage.

Please contact either one of us if you have any questions or comments. Thank you for your consideration of these comments.

Sincerely,


David R. Godofsky

Sincerely,


Carolyn E. Smith