PENSION RIGHTS CENTER

1350 CONNECTICUT AVENUE, NW SUITE 206 WASHINGTON, DC 20036-1722
TEL: 202-296-3776 FAX: 202-833-2472
WWW.PENSIONRIGHTS.ORG

April 9, 2008

The Honorable Henry M. Paulson, Jr.
Secretary of the Treasury
Main Treasury Building, Room 3330
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Paulson:

We are writing to ask that you withdraw Revenue Ruling 2008-7. The Ruling seeks to legitimize the unfair pension practice of "wearaway" in cash balance conversions that occurred before the enactment of the Pension Protection Act of 2006 contrary to congressional intent. The Ruling also misreads the plain language of the statute and conflicts with a long-standing Treasury regulation.

"Wearaway." The practice of "wearaway" in cash balance conversions refers to a sophisticated pension maneuver that was used by companies to increase profits at the expense of their older employees. Companies amended their plans to: (1) freeze benefits earned under a plan's traditional defined benefit formula; (2) provide an opening cash balance account with an amount less than the present value of the frozen defined benefit; and (3) provide a benefit formula under which an employee receives the greater of the frozen traditional benefit or the new cash balance benefit.

The effect of the wearaway resulting from these conversion amendments was that older employees did not earn any new benefits until the benefits accrued under the cash balance formula caught up with the frozen benefits earned under the old formula. As a result of this "wearaway," many employees worked for a number of years without earning pension benefits even though their younger counterparts did.

The Pension Protection Act. In response to the protests of thousands of older employees who stood to lose hundreds of thousands of dollars in expected pension benefits as the direct result of this unfair practice, Congress included provisions in the Pension Protection Act expressly outlawing wearaway for all future cash balance conversions. Despite intensive lobbying by employers and their consultants who urged Congress to legitimize conversions that had occurred before the PPA, the provisions were not made retroactive. It was left to the courts to determine the legality of pre-PPA conversions.

The court cases. Numerous lawsuits were filed challenging the wearaway resulting from pre-PPA cash balance conversions. These lawsuits were brought under several different theories. Among them are claims that the formulas resulting from the conversion amendments violate the "backloading" provisions of the federal private pension law, the Employee Retirement Income Security Act of 1974 (ERISA).

ERISA's backloading provisions are highly technical provisions that were enacted in 1974 in order to ensure that pension benefits are accumulated no slower than relatively evenly over an employee's career. The provisions were necessary to prevent employers from doing an end-run around ERISA's vesting standards. The employees' claims include the contention that the formulas used by their plans violate the 133 1/3% backloading rule.

ERISA's 133 1/3% backloading rule. The 133 1/3 % rule, set forth in ERISA Section 204(b)(1)(B), states that the benefits "accrued" by a participant in any year must not exceed the accrual in any earlier year by more than 133 1/3 %. In a typical wearaway scenario, where the value of the employees' opening cash balance account is less than their frozen traditional plan benefit, there is an automatic violation of the 133 1/3 % rule. This is because employees earn zero accruals for a number of years until the amounts accumulated in their cash balance accounts catch up with the traditional benefit amounts, and accruals begin again. Since the new accruals are greater than 133 1/3% of zero, this is a violation of ERISA's 133 1/3% backloading rule.

The Internal Revenue Code's 133 1/3% backloading rule. A 133 1/3% backloading rule virtually identical to the ERISA provision is also included in the Internal Revenue Code as Section 411(b)(1)(B). It is the Internal Revenue Code's 133 1/3% backloading rule that is analyzed in Revenue Ruling 2008-7.

Revenue Ruling 2008-7. The Revenue Ruling addresses a specific factual situation in which a company amends its traditional final average pay pension plan to provide alternative formulas for three different groups of employees. Our concern in this letter is with the second group of employees analyzed by the Revenue Ruling. These are employees working at the time of the conversion amendment who did not meet age and service requirements that would have allowed them to stay under the more-generous-to-them traditional pension formula for additional years. The Revenue Ruling refers to these employees, who were subject to immediate wearaway, as "non-grandfathered" employees.

The Revenue Ruling accurately describes the impact of the wearaway resulting from the amendment on these employees: "If for a period of years the [new cash balance] formula does not provide a greater benefit than the frozen accrued benefit under the pre-conversion formula… then there is a period where the annual rate of accrual is zero. After that period, there will be a period of a positive annual rate of accrual as the [new cash balance] formula begins to provide a benefit that exceeds the frozen accrued benefit under the pre-conversion formula."

The Ruling goes on to correctly state that **"Ordinarily, a period of zero annual rate of accrual followed by a period of positive annual rates of accrual would result in a plan failing to satisfy the 133 1/3% rule."**

However, instead of logically concluding that application of the 133 1/3% rule makes the conversion amendment unlawful under Code Section 411(b)(1)(B), the Ruling looks to a subsection of this provision, Section 411(b)(1)(B)(i), to "save" the conversion amendment. In so

doing, the Ruling misreads the plain language of the law and disregards the controlling Treasury regulation.

The Revenue Ruling misreads the law. Section 411(b)(2)(B)(i) is a subsection within the 133 1/3% backloading provision. This "special rule" provides that:

> "Any amendment to the plan which is in effect for the current year shall be treated as in effect for all other plan years."

The Revenue Ruling reasons that the conversion amendment does not violate the 133 1/3% rule because the employees cannot earn additional benefits under the frozen traditional plan formula. According to the Revenue Ruling, that leaves the new cash balance formula as "the only formula under the plan" applicable to the employees. It cites the "special rule" in subsection 411(b)(2)(B)(i) as saying that the cash balance formula in effect for the current year "shall be treated as in effect for all other plan years." Since the cash balance formula standing alone passes the 133 1/3% test, the Ruling concludes that the conversion amendment is lawful.

This strained reading of the law does not survive analysis. As a practical matter, if the cash balance formula was, in fact, "the only formula under the plan" applicable to them, the employees would have continued to earn benefits under the cash balance formula after the conversion. But, as the Revenue Ruling points out, the employees received no new accruals for a number of years following the conversion.

The reality is that for these employees the "amendment to the plan which [was] in effect for the current year," (which the "special rule" requires to be "treated as in effect for all other years,") was the formula specifying that their "accrued benefit at any point in time [be] determined as the greater of" the frozen accrued benefit under the traditional plan formula and the new cash balance formula.[1]

The Revenue Ruling disregards the controlling regulation. The controlling Treasury regulation confirms that the actual formula "in effect for the current year" for the employees was the "greater of" the traditional and cash balance formulas, rather than the cash balance formula standing alone. Regulation 1.411(b)-1(a), which applies to the 133 1/3% backloading rule, as well as two other backloading provisions, expressly provides:

> A defined benefit plan may provide that accrued benefits for participants are determined under more than one plan formula. In such a case, **the accrued benefits under all such**

[1] Treating the "greater of" formula, not the new cash balance formula, as the amendment in effect for the current year, is consistent with the purpose of the "special rule." As the ERISA Conference Report makes plain, the "special rule" was included in the law so that employers would not be prohibited from *improving* benefit accruals by plan amendment. It was necessary to make sure that an employer who improved a benefit formula – for example, from 1% to 2% of final pay – would not be in technical violation of the 133 1/3% rule solely because the 2% accrual would be more than 133 1/3% of the 1% accrual in earlier years. The "special rule" was not meant to license employers to adopt amendments that would result in the very harm that the 133 1/3 rule was designed to prevent: the backloading of benefits.

> **formulas must be aggregated** in order to determine whether or not the accrued benefits under the plan for participants satisfy one of the alternative [backloading] methods.

The Revenue Ruling itself acknowledges that there are two formulas in effect for the these employees following the conversion, and that they must be aggregated to determine **"at any point in time"** whether the employees' traditional plan frozen benefits or their new cash balance plan benefits are larger.[2] In a wearaway context, the aggregation results in subtracting, or offsetting, the benefits accrued under one formula from the benefits accrued under the other. The regulation specifies that these aggregated benefits are to be tested under the 133 1/3% backloading rule. Significantly, the Treasury regulation is ignored in the Revenue Ruling's "Analysis" of the impact of the 133 1/3 % ruling on this group of employees, although it is mentioned earlier.[3]

The impact of the Revenue Ruling. Although there is no legal justification for the Revenue Ruling, there is plainly a political justification. When reports surfaced last year that the Internal Revenue Service might rule that certain cash balance conversion amendments might be ruled unlawful under the backloading rules, employers involved in pending litigation and others began an intensive lobbying effort to persuade the Department of the Treasury and Internal Revenue Service to legitimize pre-Pension Protection Act amendments that included wearaway provisions.

The employers were concerned that an IRS ruling that their plans violated the 133 1/3% backloading rule of the Internal Revenue Code would have an adverse effect both on litigation brought under the parallel provision of ERISA and also on the tax qualification of their plans. Although their concerns are understandable, two years ago, Congress, **after hearing the arguments of both employers and employees**, made the determination that issues relating to the legality of pre-Pension Protection Act conversions should be decided by the courts.

The Treasury/IRS response to the industry pressure was to disregard congressional intent, and issue Revenue Ruling 2008-7 without any opportunity for the views of affected employees to be heard. Although the Ruling purports only to address the tax qualification of plans that apply for determination letters, its impact on the thousands of employees whose cases are now in litigation could be devastating. Not surprisingly, employers have already begun citing the Ruling as authority for legitimizing wearaway in pending litigation.

---

[2] This is how the Revenue Ruling describes the formula for determining an employee's accrued benefit: [The] Plan . . . provides that the accrued benefit at any point in time is determined as the greater of (1) the accrued benefit determined under the terms of the plan under the pre-conversion formula immediately before the amendment . . . and (2) the accrued benefit provided by the hypothetical account balance at the age 65 normal retirement age." Rev. Rul. 2008-7, at page 3. Inexplicably, the Revenue Ruling later ignores what it first said was the formula and instead holds that the formula is the cash balance formula alone. Id. at page 12. The Revenue Ruling was correct on page 3 and wrong on page 12.

[3] The only defense of the Ruling we have heard is that, in the past, in the context of particular amendments to traditional pension plans that did not involve cash balance conversions, the IRS may have issued determination letters to some traditional defined benefit plans that used wearaway as a bridge between an original and an amended benefit formula. If such rulings were, in fact issued, we do not know whether the plans that received determination letters relied on the 133 1/3% rule or on one of the other two alternative accrual rules. We also do not know whether the wearaway situations were as abusive as those presented in cash balance situations or whether there were the kinds of protests by employees that prompted Congress to outlaw this unfair practice. There was certainly no invitation for public comment on the issue.

The Ruling Should be Withdrawn Unless you withdraw Revenue Ruling 2008-7, the tens of thousands of older, longer-service employees whose legal rights to their expected pensions are now being determined in federal courts around the country will be seriously jeopardized. We ask that you undertake this action immediately.

In order to address the tax qualification concerns of employers, we suggest that you direct the Internal Revenue Service to delay issuing determination letters for plans that used wearaway in their cash balance conversions until the courts have made a final determination of the backloading issues. In the alternative, we ask that you reinstitute the moratorium on such cash balance conversions until the completion of a regulatory proceeding that would allow the views of employees to be heard.

Please do not hesitate to contact us if you have any questions about this letter.

Sincerely,

Karen W. Ferguson
Director
(202) 296-3776

Norman P. Stein
Senior Policy Advisor
(205) 410-0989

cc: The Honorable Max Baucus
The Honorable Charles E. Grassley
The Honorable Charles B. Rangel
The Honorable Jim McCrery
The Honorable Edward M. Kennedy
The Honorable Michael B. Enzi
The Honorable George Miller
The Honorable Howard P. McKeon
W. Thomas Reeder, Benefits Tax Counsel, Department of the Treasury
William Bortz, Associate Benefits Tax Counsel
Harlan Weller, Government Actuary
Joseph H. Grant, Director, Employee Plans Division, Internal Revenue Service
Nancy J. Marks, Division Counsel/Associate Chief Counsel Internal Revenue Service