COMMENTS CONCERNING SECTION 204(h) OF ERISA AND SECTION 4980F OF THE CODE

The following comments (the “Comments”) are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These Comments were prepared by individual members of the Committee on Employee Benefits of the Section of Taxation of the American Bar Association (the “Section”). Principal drafting responsibility was exercised by Pam Scott. Substantive contributions were made by Bruce Barth, Kyle Brown, Alberto Calafell, David Cowart, William Evans, Judith Mazo, Priscilla Ryan, Marc Sandberg, Max Schwartz, Norma Sharara, Peter Shinevar, Robert Stevenson, Mark Vogel, Carol Weiser and John Wendeln. The Comments were reviewed by Thomas A. Jorgensen of the Section’s Committee on Government Submissions and Stuart M. Lewis, Council Director.

Although members of the Section who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.

Contact:

Pamela C. Scott Phone: (914) 745-4278
Email: scottpc@towers.com
Fax: (914) 745-4310

February 4, 2002
I. Executive Summary

Section 659 of the Economic Growth and Tax Reform Reconciliation Act of 2001 ("EGTRRA") amends section 204(h) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and provides for new section 4980F of the Internal Revenue Code of 1986, as amended (the "Code"). The legislation provides that when a defined benefit plan (or money purchase plan) is amended to significantly reduce the future rate of benefit accrual, then the plan administrator must furnish participants with a written notice that contains sufficient information to understand the effect of the amendment. The legislation also provides for significant penalties if the notice is not timely provided. Section 659 of EGTRRA and related legislative history contemplate Treasury regulations on several subjects. Set forth below are our comments on some of those subjects and additional issues arising under Section 659 of EGTRRA.

Our recommendations may be summarized as follows:

1. Thirty days should be considered a reasonable notice period for all amendments covered by section 204(h)(3) of ERISA and section 4980F(e)(3) of the Code, with shorter periods being considered reasonable on a facts and circumstances basis.

2. Treasury should issue regulations clarifying that section 4980F of the Code applies only to plans subject to the minimum funding requirements of section 412 of the Code.

3. Regulations should require that as a general rule, the notice should explain the effect of the amendment in words, and provide one or more examples covering the circumstances of one or more illustrative employees. Such examples would be required to show only the normal retirement benefit at normal retirement age before and after the amendment. A similar rule should apply to plan amendments reducing early retirement benefits or retirement-type subsidies for future accruals. Specific exemptions from this general rule would be available for plan terminations or complete freezes in accruals, or other circumstances in which the effect of the plan amendment may be explained adequately in words.

4. Unless compelling evidence is available regarding burdens imposed on small plans, the notice requirement should be generally applicable to all plans.

5. An exemption from the notice requirement should be available to the extent that a plan sponsor offers choice between the new benefit formula and the old benefit formula.

6. Treas. Reg. § 1.411(d)-6, Q&A-13 and -14, regarding penalties under section 204(h), should be made expressly applicable to section 204(h) as amended by EGTRRA. Such regulations should be coordinated with new section 4980F of the Code.

7. Treasury should affirm that other provisions of Treas. Reg. § 1.411(d)-6, Q&A-13 and –14 continue to apply to section 204(h) of ERISA and are applicable in interpreting section 4980F of the Code.
II. Background

Under section 204(h) of ERISA as amended by EGTRRA and new section 4980F of the Code, if a pension plan sponsor adopts a plan amendment that has the effect of significantly reducing the rate of future benefit accrual for one or more participants, the sponsor must distribute a written notice to each affected individual and any employee organization representing such affected individuals. In addition, a plan amendment which eliminates or significantly reduces an early retirement benefit or retirement-type subsidy (as protected under section 411(d)(6) of the Code) is treated as having the effect of significantly reducing the rate of future benefit accrual.

The notice must provide “sufficient information” to allow affected individuals to understand the effect of the amendment, and must be written in a manner calculated to be understood by the average plan participant. Future regulations may provide that any notice required by the new law may be delivered by new technologies.

Except as may be provided in regulations, the notice must be provided within a reasonable time before the effective date of the amendment. The notice may be distributed to participants before the adoption of the amendment if no material modification of the amendment occurs once the amendment is adopted.

The affected individuals who must receive the notice are participants in the plan and alternate payees under a QDRO whose rate of future benefit accrual may reasonably be expected to be significantly reduced by the plan amendment. The new law says that the notice may be provided to a person designated, in writing, by the person to whom it would otherwise be provided.

The requirements apply to defined benefit plans and money purchase pension plans, except for governmental plans not covered by ERISA, and church plans that have not elected to be covered by ERISA. Treasury regulations may provide for a simplified form of notice or for a complete exemption for plans with fewer than 100 participants or for an amendment that offers participants a choice between accruing benefits under the new plan formula or the old plan formula.

These amendments to the Code and ERISA are effective for plan amendments taking effect on or after the date of enactment of EGTRRA -- June 7, 2001. The new notice rules would not apply to any plan amendment taking effect on or after the date of enactment if, before April 25, 2001, notice was provided to participants and beneficiaries adversely affected by the plan amendment (or their representatives) which was reasonably expected to notify them of the nature and effective date of the plan amendment. EGTRRA provides that until Treasury regulations are issued interpreting the new provisions of the Code and ERISA, a plan shall be treated as meeting the requirements of such sections if it makes a good faith effort to comply with the new laws. EGTRRA provides for an additional transition rule that gives all plan sponsors at least three months to comply with the new laws. Section 659(c)(3)(A) of EGTRRA provides that the period for providing any notice required by the new laws does not end before three months after the date of enactment.

The penalty provisions for noncompliance differ under the Code and ERISA. New section 4980F of the Code imposes an excise tax of $100 per day per participant for each day that an
affected individual fails to receive the 204(h) notice. For plan sponsors who exercise reasonable
diligence in attempting to comply, the maximum tax in any taxable year is $500,000. There are
three possible exceptions. First, no tax may be imposed for any period for which it is established
to the satisfaction of the Secretary of the Treasury that an employer exercised reasonable
diligence in compliance, and the employer did not know about a particular failure to notify.
Second, no tax may be imposed on an employer who exercises reasonable diligence in
compliance, and the notice is provided within 30 days after the employer knew, or exercising
reasonable diligence would have known, that the failure existed. Finally, in the case of failure
due to reasonable cause and not to willful neglect, the Secretary of the Treasury may waive all or
part of the tax to the extent that the payment of the tax would be excessive or otherwise
inequitable relative to the failure involved.

Additional sanctions apply under section 204(h) of ERISA. It would appear that if a plan
sponsor violates section 204(h), the plan amendment is not effective (except to the extent that
relief provided in the current IRS regulations applies). Furthermore, in the case of any egregious
failure to meet any of the requirements of section 204(h), all individuals who are entitled to a
notice receive the greater of the benefits under the plan without taking the amendment into
account, or taking the amendment into account. The statute provides that there is an egregious
failure if such failure is within the control of the plan sponsor and is (a) intentional, (b) a failure
to provide most of the individuals with most of the information that they are entitled to under
section 204(h), or (c) “egregious” under regulations to be issued. The statute also provides that
an intentional failure includes any failure to promptly provide the required notice or information
after the plan sponsor discovers an unintentional failure to meet the new notice requirements.

III. Comments

A. Reasonable period for notice

1. Issue

Section 204(h)(3) of ERISA and section 4980F(e)(3) of the Code require that
sponsors of applicable plans provide a notice to affected individuals within a
“reasonable time” prior to the effective date of a plan amendment regulated by
those provisions. In the absence of Treasury regulations, the length of a
reasonable notice period is uncertain.

2. Analysis

EGTRRA changed the period in which the required notice must be given. Section
204(h) of ERISA, as in effect prior to EGTRRA, required that plan sponsors issue
a notice to participants after the plan amendment was adopted, but no later than
15 days before the effective date of the amendment. In contrast, section 204(h) as
amended by EGTRRA does not require that the notice be issued after the plan
amendment is adopted, but there is a requirement that the notice be issued at some
point before the effective date of the amendment.

Under EGTRRA, the notice appears to be intended to give the participant
sufficient time to understand the effect of the amendment and discuss the notice
with another person (perhaps a financial advisor). Discussions of the amendment with others are clearly contemplated by EGTRRA; section 204(h)(4) of ERISA allows a sponsor to send the notice to a person designated in writing by the affected individual. Moreover, depending on the nature of the amendment and the participant’s circumstances, a participant may want to take action on the basis of the information contained in the notice. He or she may decide to accept another offer of employment, ask additional questions of the employer, discuss the effects of the amendment with other employees, or ask management for a change in the amendment.

Implicit in the requirements of this provision of EGTRRA is the notion that the notice period must take into account the plan sponsor’s obligations to deliver sufficient information to the participant, and to use language that is clear. The more time a sponsor has to work on the details of the amendment and the details of the communication, the more likely the sponsor is to deliver the best possible notice. Accordingly, the notice period should balance the needs of the sponsor to draft compliant notices with the possible need of the participants to take actions before the effective date of the amendment. Treasury might consider at least four options as a standard:

**15 days** – This time period was set forth in section 204(h) prior to amendment by EGTRRA. Because EGTRRA replaced the specific 15-day time period with a more flexible standard (i.e., “within a reasonable time” before the effective date of the amendment), there is an implication that 15 days might not be a sufficient period of time in a few circumstances. However, there will be many cases in which 15 days will be a sufficient period of time for participants to understand the effect of the amendment and take action.

**30 days** – This period should be a sufficient period of time for participants to review the notice and consult with advisors in all cases. It may be that responses of participants to information in the notice will not be complete within the 30-day period. However, sponsors are typically able to adjust amendments in response to participant concerns – if they view such adjustments as appropriate – well after the effective date of an amendment. Moreover, 30 days is viewed as a sufficient period for other important notice provisions of the Code. For example, plan sponsors must give participants at least 30 days notice of a 401(k) plan’s safe harbor status. See section 401(k)(12)(D) of the Code; IRS Notice 98-52, 1998-46 I.R.B. 16; IRS Notice 2000-3, 2000-4 I.R.B. 1. Also, under section 402(f) of the Code, a 30-day notice of the tax consequences of rollover-eligible distributions is considered to be a “reasonable” notice period. See Treas. Reg. § 1.402(f)-1, Q&A-2(a). Finally, the minimum period for spousal consent to distributions and providing the related written explanation is 30 days. See section 417(a)(7) of the Code.

**45 days or longer** -- This standard appeared in certain earlier versions of Section 659 of EGTRRA, but did not appear in the final version. This failure
may well be indicative of Congressional intent to not have a notice period of this length. We believe that although there might be circumstances in which a 45-day period would be appropriate, a notice period of such duration would be unnecessarily long in many circumstances. Moreover, no other pension provision of the Code or ERISA uses 45 days as the standard for measuring time, so using this period would not serve the goal of streamlining compliance rules. Thus, we urge that time period not be adopted as a standard.

Facts and circumstances – Plan sponsors and participants will need a bright line safe harbor to determine whether the notice is reasonable. Having solely a facts and circumstances basis for determining the notice period would lead to unnecessary litigation in many cases. In addition, it is bad tax policy to have excise taxes imposed based upon a facts and circumstances test. However, it might be possible to provide that if a plan sponsor failed to issue the notice within the period specified in regulations as a safe harbor, the notice period would be determined on a facts and circumstances basis.

Also, having different safe harbors for different types of plan amendments would add unnecessary degrees of complexity and ambiguity, as plan amendments may be covered by section 204(h) for a variety of reasons. For example, a single plan amendment may both reduce the rate of future benefit accrual and reduce early retirement subsidies with respect to benefits to be accrued in the future.

3. Recommendation

Thirty days should be considered a reasonable notice period for all amendments covered by section 204(h)(3) of ERISA and section 4980F(e)(3) of the Code, with shorter periods being considered reasonable on a facts and circumstances basis.

B. Application of IRC § 4980F excise tax

1. Issue

Section 204(h)(8)(B) of ERISA provides that an “applicable pension plan” – one covered by these rules – is (i) any defined benefit plan, or (ii) an individual account plan which is subject to the funding standards of section 412 of the Code. Section 204 of ERISA does not apply to all defined benefit plans; only ERISA-covered pension plans that are not exempt from Title I, Part 2 of ERISA are regulated by section 204(h) of ERISA. Accordingly, there are several important categories of defined benefit plans, including most nonqualified pension plans, which are not subject to section 204(h) of ERISA.

Section 4980F(f)(2) of the Code contains the same language as section 204(h)(8)(B) in defining “applicable pension plan,” but does not reference the exclusions inherent in section 204(h) of ERISA. Therefore, many plans not covered by section 204(h) of ERISA could be covered by section 4980F of the Code, in a manner that does not appear to reflect Congressional intent.
2. Analysis

Congress clearly intended that the same amendments be covered by both section 204(h), as amended, and section 4980F of the Code. That intent is expressed in the legislative history, as well as section 659 of EGTRRA. Section 4980F(f)(2) of the Code makes an attempt to carve out some categories of plans not subject to section 204(h) of ERISA, presumably on the assumption that those plans were the only plans that required specific mention. Also, Section 659(a)(1) of EGTRRA amends Chapter 43 of the Code in a way that indicates an intent to cover qualified plans only (“Chapter 43 [relating to qualified pension, etc. plans] is amended by adding at the end the following new section…”).

Furthermore, it should be possible to read section 4980F(f)(2) of the Code as meaning that only plans that are subject to the funding standards of section 412 are covered by that Code section, regardless of whether they are defined benefit plans or individual account plans. Although that reading is not consistent with usual interpretations of similar statutory punctuation, it may be reflective of Congressional intent.

3. Recommendation

Treasury should issue regulations clarifying that section 4980F of the Code applies only to plans subject to the minimum funding requirements of section 412 of the Code.

C. “Sufficient” information

1. Issue

One key issue arising under the new law involves identifying the information that must be provided to affected individuals. The notice must provide “sufficient information” to allow affected individuals to understand the effect of the amendment.

2. Analysis

Under prior law, the notice simply had to summarize the amendment or furnish the actual amendment text. It did not have to explain how the benefits of participants would be affected. See Treas. Reg. § 1.411(d)-6, Q&A-10.

The version of EGTRRA approved by the Senate would have included significantly more detailed disclosure requirements. The Senate bill would have required a summary of the amendment and the effective date of the amendment, a statement that the amendment is expected to significantly reduce the rate of future benefit accrual, a description of the classes of employees reasonably expected to be affected by the amendment, and examples illustrating the changes for these employees. In addition, in the event of an amendment that resulted in the significant restructuring of the benefit formula, the sponsor would have been
required to provide a “benefit estimation toolkit.” That benefit estimation toolkit
would have enabled a participant to estimate his or her benefits both before and
after the amendment. The toolkit would have had to include sufficient
information to enable the participant to estimate the value of a single life annuity
at various ages and, where appropriate, the value of a lump sum.

The House version, which was ultimately enacted into law with few
modifications, rejected this detailed approach. However, at page 170 the Joint
Committee Explanation to EGTRRA provides that the IRS guidance interpreting
new section 204(h) “… may be relatively detailed because of the need to provide
for alternative disclosures rather than a single disclosure methodology that may
not fit all situations, and the need to consider the complex actuarial calculations
and assumptions involved in providing necessary disclosures.” Although
Congress rejected requiring the distribution of complex software (as would have
been necessary in connection with the benefit estimation toolkit), it is apparent
that Treasury may require relatively detailed information in some circumstances.

Through its rejection of the benefit estimation toolkit, Congress plainly rejected
any requirement that plan sponsors provide participants with the information
needed to perform multiple benefit calculations themselves. Instead, Congress
required plan sponsors to give participants an understanding of the effect of the
amendment on them. In some circumstances, this understanding may reasonably
be achieved without detailed individualized benefit calculations. For example,
changing a flat benefit formula from $20 per year of service to $15 per year of
service should be easy to describe in words without benefit calculations.
Similarly, the reduction of a money purchase pension plan contribution from 10%
of compensation to 8% of compensation can be clearly described in words.
Accordingly, an explanation in words of the differences between the old benefit
formula and the new benefit formula should be required and will in some cases be
sufficient, in and of itself, to satisfy the requirements of section 204(h) of ERISA
and section 4980F of the Code. Two examples of amendments which the
regulations should deem to be, per se, adequately explained in words are plan
termination amendments and plan freeze amendments.

In many cases, such explanation in words will need to be supplemented with
examples of the effect on representative participants in order to provide
participants with sufficient information to understand the effect of the amendment
on them. The number of examples included in the notice should be left to the
discretion of the plan sponsor. Some amendments may require fewer examples
than others, as some amendments will affect participants in a uniform manner,
and others will not. In keeping with Congress’s expressed intent to simplify
disclosures, a comparison of the accrued benefit at normal retirement age should
be the only required comparison where the rate of future benefit accrual is being
reduced. The only form of benefit required to be illustrated should be the form of
benefit in which the accrued benefit is expressed. This measure of the benefit is
involved in determining whether a section 204(h) notice is required to begin with.
See Treas. Reg. § 1.411(d)-6, Q&A-5(a).
There are some amendments that change the plan formula in a manner so that the effect on the benefits of a participant is not readily apparent to the participant. For example, some participants may benefit from the formula change while others may be hurt by the change -- as for example, in the case of a cash balance conversion. In such cases, we believe that the plan sponsor should be given substantial flexibility to decide on the manner to communicate the effect of the new formula on plan participants. Without limiting such flexibility, we believe that the regulations should deem it sufficient for the plan sponsor’s notice to contain three examples: one illustrating the group of participants who are projected by the plan’s actuary (using reasonable assumptions) to be most adversely affected by the formula change, one illustrating the group of participants who are projected by the plan’s actuary (using the same assumptions) to be most benefited by the formula change and one illustrating the group of participants, if any, who are projected by the plan’s actuary (using the same assumptions) to have the same level of normal retirement benefit under the new formula as they would have had under the prior formula. Such projections would be limited to illustrating the effect of the formula change on the specified group at their normal retirement date under the form of payment in which the old formula stated the accrued benefit. It would not be necessary to provide examples at early retirement ages unless the plan amendment also eliminates an early retirement benefit or reduces an early-retirement subsidy. As is standard practice within the actuarial community, the actuary should specify the actuarial assumptions used in identifying the groups who are projected to be adversely affected or substantially benefited by the amendment.

It has been a common practice under the pre-EGTRRA version of 204(h) for plan sponsors to give a notice where, under reasonable actuarial assumptions, the plan amendment does not represent a reduction in the rate of future benefit accruals but in some less likely events might result in a reduction in benefits. Plan sponsors have wanted to give the notice in such circumstances in order to foreclose any possible argument in the future in case one or more participants were, in fact, adversely affected by the amendment. The giving of such notices should be encouraged and plan sponsors should be given broad latitude in deciding how to best communicate the amendments. In such cases, we believe the regulations should deem it sufficient for a plan sponsor to include a statement in the notice identifying the circumstances where the amendment could result in a reduction in the rate of future benefit accruals or the elimination or substantial reduction in an early retirement benefit or a retirement-type subsidy.

A different type of example may be required for a notice regarding a reduction in early retirement benefits or retirement-type subsidies, as such reductions do not affect the accrued benefit. One possibility might be to require an illustration of the benefits provided under the plan both before and after the amendment computed at the earliest retirement age or the most valuable early retirement age.
3. Recommendation

Regulations should require that as a general rule, the notice should explain the effect of the amendment in words and, if necessary, provide one or more examples covering the circumstances of one or more illustrative employees. Such examples would be required to show only the accrued benefit at normal retirement age before and after the amendment in the form that such accrued benefit is expressed. All assumptions would have to be clearly disclosed. Specific exemptions from this general rule would be available for plan terminations or complete freezes in accruals, or other circumstances in which the effect of the plan amendment may be explained adequately in words. Examples showing the effect of amendments on early retirement benefits or retirement-type subsidies should only be required for amendments actually reducing or eliminating such benefits and not for amendments changing the rate of accrual of normal retirement benefits.

D. Exemption for small plans

1. Issue

Section 4980F(e)(1) of the Code and section 204(h)(2)(A) of ERISA authorize the Secretary of the Treasury to provide for a simplified form of notice for, or exempt from any notice requirement, a plan which has fewer than 100 participants who have accrued a benefit under the plan. The issue this statutory language raises is whether such simplified notice or exemption should be authorized.

2. Analysis

ERISA contains numerous examples of circumstances in which small employee benefit plans are subject to less regulation than larger plans. In particular, several disclosure requirements are reduced for plans with fewer than 100 participants. See, for example, DOL Reg. § 2520.104-20 (limited exemption from reporting and disclosure for certain small welfare plans). The policy behind the lesser regulation is that benefit plan formation and continuation are encouraged by reducing the burdens on sponsors of smaller plans.

Nonetheless, the most fundamental protections of ERISA apply to small plans without exception. These requirements include all the fiduciary requirements of Title I of ERISA, and other specific notice requirements such as section 101(d) of ERISA (the notice of failure to meet minimum funding requirements) and section 101(e) of ERISA (notice of transfer of excess pension assets to health benefit accounts). Moreover, prior to amendment, section 204(h) of ERISA contained no exception for small plans. In light of the foregoing, and assuming that the regulations do not require burdensome levels of examples or individualized calculations or benefit calculation toolkits, the participants in smaller plans have the same need for the additional information as participants in larger plans, and it
would appear that the burdens imposed on sponsors of small plans do not outweigh these needs.

3. Recommendation

Unless compelling evidence is available regarding burdens imposed on small plans, the notice requirement should be generally applicable to all plans.

E. Exemption for plans that offer choice

1. Issue

Section 4980F(e)(2) of the Code and section 204(h)(2)(B) of ERISA authorize the Secretary of the Treasury to provide for a simplified form of notice for, or exempt from any notice requirement, a plan which offers the participants the option to choose between the new benefit formula and the old benefit formula. The issue this statutory language raises is whether such simplified notice or exemption should be authorized.

2. Analysis

Plan sponsors that offer all or a group of participants the right to choose between the new benefit formula and the old benefit formula will probably be subject to fiduciary standards in communicating with participants regarding that choice. In fact, the legislative history to EGTRRA contemplates that application. The legislative history provides:

“The House bill also authorizes the Secretary to provide a simplified notice requirement or an exemption from the notice requirement if participants are given the option to choose between benefits under the new plan formula and the old plan formula. In such cases, the House bill will have no effect on the fiduciary rules applicable to pension plans that may require appropriate disclosure to participants, even if no disclosure is required under the House bill.”

See Joint Committee Explanation to EGTRRA, p. 170.

Such fiduciary standards have evolved recently through judicial decisions. As stated in the Department of Labor’s Request dated September 14, 2000 for information regarding this issue:

“Recent court decisions have found that plan fiduciaries have a duty to disclose information not expressly required to be disclosed under Part 1 of Title I [of ERISA]. These cases have involved the fiduciary duty to act solely in the interest of plan participants and beneficiaries and the issue of the extent to which this fiduciary duty encompasses a collateral duty to provide participants and beneficiaries with information they need to exercise their rights under the plan, to protect their right under ERISA, or otherwise make informed decisions about their future.”
65 F.R. 55859. Such cases include Varity v. Howe, 516 U.S. 489 (1996) (holding that when a fiduciary communicates to participants and beneficiaries, the fiduciary has a duty to communicate truthfully); and Farr v. U.S. West, 151 F.3d 908 (9th Cir. 1998), cert. denied 120 S.Ct. 935 (2000) (finding fiduciary duty to disclose complete and accurate information regarding tax consequences of a distribution). In light of the foregoing more stringent requirements, requiring a notice where a participant may choose to have no change in his formula would be redundant, and could be confusing to participants.

It should be noted that, in light of the fact that the law in this area is developing, some lawyers would argue that any such duty is vague and difficult to apply, if it exists at all. Such lawyers would argue that regulations under section 204(h) would provide welcome clarity to a troublesome area, particularly if disclosures under such regulations were deemed to satisfy all requirements of Title I of ERISA (including any fiduciary requirements). It might also be noted that there are different remedies for violations of section 204(h) of ERISA and violations of fiduciary duties, so it may be difficult to provide for a uniform standard of compliance with both rules.

3. Recommendation

An exemption from 204(h) of ERISA and section 4980F of the Code should be available to the extent that a plan sponsor offers choice between the new benefit formula and the old benefit formula. Sponsors must supply the information required by 204(h) of ERISA and section 4980F of the Code under the developing fiduciary duty to communicate with participants, so the requirements of 204(h) of ERISA and section 4980F of the Code are redundant in this context.

F. New penalty provisions

1. Issue

EGTRRA’s amendments to section 204(h) of ERISA changed the manner in which employers may be penalized for failing to comply with section 204(h) of ERISA, and EGTRRA created section 4980F of the Code to provide for additional penalties if a plan sponsor fails to issue the required notice. These penalty provisions need to be coordinated with each other and with existing regulations.

2. Analysis

Prior to amendment by EGTRRA, the statutory language of section 204(h) of ERISA might have been construed to invalidate any amendment subject to section 204(h) where the sponsor failed to issue a single notice, even inadvertently, to a single affected individual. Treasury regulations provided for more reasonable and practical penalties in the event of noncompliance. Treas. Reg. § 1.411(d)-6, Q&A-13 and –14 provide for important relief from the penalties of section
204(h), where such penalties would be disproportionate to the nature of the violation. Although invalidation of the entire amendment remained a possibility, these Q&As provided relief to plan sponsors who attempted to comply with the law.

Q&A –13 addresses a situation in which more than a de minimis percentage of the affected individuals failed to receive the notice, but the plan administrator nonetheless made a good faith effort to comply with section 204(h). In such a case, and provided that any employee representative has received a notice, the amendment will become effective as to those affected individuals to whom notice was in fact provided.

Q&A-14 addresses the circumstances of a plan administrator who fails to issue the notice to a de minimis percentage of participants. In such a case, the amendment will become effective as to all affected individuals in accordance with its terms, provided that the plan administrator (a) made a good faith attempt to comply, (b) provided notice to the applicable employee organizations, and (c) provides the 204(h) notice to those who did not receive the notice promptly upon discovering the oversight.

Under section 204(h) of ERISA as amended, the statutory language that can be construed to invalidate the entire amendment for even minor violations remains intact. Section 204(h)(1) of ERISA provides that an applicable pension plan “may not be amended so as to provide for a significant reduction in the rate of future benefit accrual unless the plan administrator provides the [required] notice…..” This statutory language is identical to the pre-EGTRRA version, and accordingly, it is not clear that Congress intended to eliminate the prior law remedy for noncompliance. This would suggest that the existing regulations (Q&A-13 and –14) providing relief under that language may have some continuing meaning after EGTRRA.

New section 204(h)(6)(A) provides for an additional penalty that may be more severe than invalidation in cases of “egregious” violation of section 204(h). Under the new rule, in the event of an egregious violation, participants would receive benefits calculated as the better of the benefits calculated with and without the amendment.

One approach to reconciling the regulations and the new provisions of ERISA would be to classify violations into four categories:

“Egregious” violations, where all affected individuals would receive the greater of the benefits calculated with and without the amendment. In many cases, this penalty could result in more benefits to participants than invalidation of the amendment. For example, in the typical conversion from a final average pay plan to cash balance, all participants in the plan at the time of conversion are considered to be affected individuals. However, benefits for shorter service workers are often greater under a cash balance formula in the short-term than under a final average pay formula. In such a case, the penalty
for violation would be much more expensive to the sponsor than a mere invalidation of the amendment.

?? Cases where sponsors did not act in good faith. The applicable penalty would be invalidation of the amendment as to all affected individuals, under section 204(h)(1). If the conduct of the sponsor was also egregious (as presumably would be the case in most instances), the penalty for “egregious” violations would apply instead.

?? Good faith compliance by sponsors, but involving a case in which more than a de minimis number of participants were not notified. As provided in current Q&A-13, these circumstances result in suspension of the amendment until such time as the affected individuals receive the notice.

?? Good faith compliance by sponsors, where only a de minimis number of participants were not notified. As provided in current Q&A-14, these circumstances would result in the application of the amendment to all affected individuals.

These categories should furthermore be coordinated with section 4980F of the Code. That Code section generally provides for an excise tax of $100 per day per participant for failure to issue the section 204(h) notice, but also provides for relief in specific cases. Section 4980F(c)(1) provides for a complete exemption from the tax for “any period in which it is established to the satisfaction of the Secretary” that any person subject to liability under the excise tax did not know about the failure and “exercised reasonable diligence” to meet the statutory notice requirement. Also, section 4980F(c)(2) of the Code provides for a complete exemption from the tax where reasonable diligence was exercised and failures to issue the notice were corrected within 30 days after the person knew or should have known that the failure existed.

In coordinating penalties under section 204(h) of ERISA and section 4980F of the Code, it should be noted that a similar standard of good conduct already exists under both provisions. Exercising “reasonable diligence” under section 4980F provides for meaningful relief, and acting in “good faith” provides for meaningful relief under section 204(h) under current regulations. It would be anomalous to provide for penalties under one statute and not the other in cases where sponsors are trying to comply with applicable law. Although the legislative history to EGTRRA appears to suggest that Congress intended to apply different but overlapping penalties to single violations, Treasury should be able to provide for a single standard of conduct to which the conscientious sponsor may adhere.

3. Recommendations

?? Current Treas. Reg. § 1.411(d)-6, Q&A-13 and –14 should be made expressly applicable to section 204(h) as amended by EGTRRA.

?? Treasury regulations should provide that “good faith” compliance under section 204(h) regulations and “reasonable diligence” under section 4980F constitute the same standard. Alternatively, Treas. Reg. § 1.411(d)-6, Q&A-
13 and –14 should be amended to provide for “reasonable diligence” instead of “good faith” compliance.

G. Status of other provisions of the existing regulation interpreting section 204(h) of ERISA

1. Issue

Treas. Reg. § 1.411(d)-6, issued in final form on December 11, 1998, provides extensive guidance regarding section 204(h) of ERISA as in effect prior to EGTRRA. Many of the provisions of that Treasury regulation would appear to be unaffected by EGTRRA, but the status of the regulations should be clarified. In particular, the applicability of the regulation to new section 4980F of the Code needs to be established.

2. Analysis

In addition to the Q&As on penalties, there are other Q&As in the regulation that should be updated for EGTRRA. These include Q&A-5 through –9 and Q&A-15 and –16. These Q&As provide for fundamentally sound rules of interpreting statutory language that has not changed as a result of EGTRRA. These Q&As identify plan amendments that are subject to the notice requirements (including amendments in sales of businesses and plan terminations), and help sponsors select recipients of the notice. The regulations have been very useful to plan sponsors in determining when a section 204(h) notice is required, and in identifying proper recipients of the notice. There does not appear to be any policy reason to vary these interpretations for purposes of section 4980F of the Code.

3. Recommendation

Treasury should affirm in regulations that Treas. Reg. § 1.411(d)-6, Q&A-5 though –9 and Q&A-15 and –16 continue to apply to section 204(h) of ERISA and are applicable in interpreting Code section 4980F.