The
ERISA
Industry
Committee

COMMENTS OF
THE ERISA INDUSTRY COMMITTEE

THE PROPOSED REGULATIONS ON HYBRID RETIREMENT PLANS

April 2008

1400 L Street, N.W.
Suite 350
Washington, DC 20005
TEL: (202) 789-1400
FAX: (202) 789-1120
www.eric.org

TABLE OF CONTENTS

TABLE OF CONTENTS

COMMENTS OF
THE ERISA INDUSTRY COMMITTEE

THE PROPOSED REGULATIONS
ON HYBRID RETIREMENT PLANS

April 2008

The ERISA Industry Committee ("ERIC")[1] is pleased to submit the following comments on the proposed regulations promulgated by the Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS" or "Service") under Title VII and section 1107 of the Pension Protection Act of 2006 ("PPA"). The proposed regulations apply for purposes of sections 411(a)(13) and 411(b)(5) of the Internal Revenue Code (the "Code") as well as the applicable parallel provisions of Title I of the Employee Retirement Income Security Act of 1974 ("ERISA") and the Age Discrimination in Employment Act of 1967 ("ADEA"). The proposed regulations were published in the Federal Register on December 28, 2007. *See* 72 Fed. Reg. 73,680.

Because of the importance of these regulations to many ERIC members, ERIC requests that the Treasury and the IRS hold a public hearing on the proposed regulations. ERIC also requests that it be permitted to testify at the hearing.

Although the following comments recommend significant changes in the proposed regulations, ERIC is mindful of the enormous effort Treasury and IRS staff have devoted to developing the proposed regulations and other guidance needed to implement the PPA. ERIC wishes to take this opportunity to express its appreciation for the hard work Treasury and IRS staff have put into the proposed regulations.

I. SYSTEMIC IMPACT OF PROPOSED REGULATIONS

ERIC is deeply concerned that the proposed regulations would not effectuate Congress's intent to provide a predictable legal environment in which employers can safely offer retirement benefits to their employees through cash balance and pension equity plans ("hybrid plans"), as well as through other defined benefit plans that provide participants guaranteed indexing of their benefits. (We refer to all such plans, including hybrid plans, as "indexed plans.") If the proposed regulations are finalized without significant modification, they are likely to drown these plans in a regulatory morass and breed litigation and controversy for decades to come.

---

[1] 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.

Moreover, the likely result of the new limitations imposed by the proposed regulations would be to reduce benefits for participants. Just as Notice 96-8 resulted in lower interest credits for participants for over a decade and the backloading analysis in Revenue Ruling 2008-7 threatened to undo generous transition benefits for participants in hybrid conversions, so too the proposed regulations impose restraints that will push plan sponsors toward providing lower benefits to participants, or no benefits at all, contrary to Congress's intent to foster these plans. To take but a few examples:

- the preamble's proposed effective rate of return analysis almost certainly will discourage plans from offering reasonable minimum guaranteed rates of return, even though they are specifically authorized by the PPA;
- the proposed definition of interest credit will force employers to drop qualified disability and other similar benefits from their plans, even though ERISA has permitted such benefits for over three decades;
- the proposed expansive definition of conversion amendment will encourage plan sponsors simply to freeze all traditional pension accruals immediately upon conversion rather than extend them for some or all participants after the conversion; and
- the proposed minimum hurdle rate for variable annuity plans will result in higher hurdle rates and a corresponding increase in negative investment adjustments for participants, despite the fact that the PPA frowns on such adjustments.

The approach evidenced by the proposed regulations, as well as other guidance governing hybrid plans (such as Notice 96-8 and Rev. Rul. 2008-7), has led employers and other stakeholders to infer a skepticism on the part of the Treasury and the IRS that hybrid plans can satisfy the rules for tax-qualification. At bottom, this inference stems from an apparent unwillingness on the part of the Treasury and the IRS to accept guaranteed indexing of benefits as an integral part of the defined benefit system. Indeed, the proposed regulations do not provide rules for pension equity plans but, instead, raise questions in the preamble about whether the form of indexing benefits in pension equity plans can satisfy various tax-qualification rules, most of which are not even the subject of the proposed regulations.

This uncertainty is both unfortunate and unacceptable for at least two reasons. First, the guaranteed indexing in hybrid plans provides an important protection for participants by helping to preserve the economic value of the retirement benefits they have earned, a feature that is particularly important to the vast majority of workers who change jobs multiple times before retiring and who are likely to live longer in retirement than ever before. Second, guaranteed indexing of benefits, both before and after retirement, has been with us since at least the 1930's in the form of contributory defined benefit plans, variable annuity plans, indexed career average pay plans, living pension plans, automatic post-retirement COLA's, and, last but not least, Social Security, which indexes benefits both before and after retirement. The Internal Revenue Code has managed to accommodate guaranteed indexing of benefits without controversy for nearly a century.

In the PPA, Congress has given the Treasury and the IRS the opportunity to embrace guaranteed indexing of benefits as an integral part of a healthy defined benefit system, particularly with respect to hybrid plans. Unless the Treasury and the IRS accept this opportunity, the future of defined benefit plans, the ability of participants to receive their benefits as life annuities, the availability of benefit protections against disability, plant shutdowns, and other contingencies, and the long-term financial solvency of the PBGC are jeopardized. We encourage the Treasury and the IRS to take up this challenge, and we hope our comments prove helpful in meeting it. A summary of our specific comments follows.

II. SUMMARY OF COMMENTS

Regulatory Process. The determination letter and audit programs should not be used to adopt major interpretations of the law governing hybrid plans in its determination letter and audit programs. Rulemaking should be done through the regular notice and comment process.

PPA Age Discrimination Test. For purposes of applying the age discrimination test in section 411(b)(5)(A), the final regulations should permit comparisons among benefits expressed as deferred annuities, cash balance accounts, and PEP accumulations. The final regulations should also permit benefit comparisons among participants, some of whom have been offered a choice of benefit formulas, and others of whom have not. Benefit comparisons that are allowed under the final regulations and that satisfy the section 411(b)(5)(A) standard should satisfy the age discrimination rules, even if the final regulations do not permit other benefit comparisons under the same plan to be made.

Interest Credits. The final regulations should allow for the full range of market rates of return and should not penalize hybrid plans that offer fixed rates of return or reasonable guaranteed minimum rates of return, including the zero cumulative floor required under section 411(b)(5)(B)(i)(III). The definition of interest credit should be modified to limit its scope to credits that operate like interest credits and to exclude from the definition such standard benign plan features as pay credits granted (1) during disability, military, family, vacation, or other leaves of absence, (2) for past, pre-participation, or imputed service, or (3) as an ad hoc benefit increase for retired participants.

Pension Equity Plans. The indexing adjustments to participants' accrued benefits under pension equity plans are legal and operate in much the same way as well-established features in other types of defined benefit plans. The final regulations should implement Congress's intent and recognize the legitimacy of pension equity plans. The Treasury and the IRS should not create new rules that would threaten the legitimacy of pension equity plans.

Indexed Plans. The proposed regulations limit the definition of recognized indexing methods under section 411(b)(5)(E) to a fraction of the indexing methods long recognized in federal statutes, regulations, rulings, and case law. The final regulations should expand the definition to include all previously recognized indexing methods, including, in particular, the interest adjustments in cash balance, pension equity, and contributory defined benefit plans, as the statute requires and Congress intended.

Treatment of Non-Hybrid Indexed Plans. Contrary to the statute and Congressional intent, the proposed regulations treat all non-hybrid indexed plans, unless specifically exempted, as having an effect similar to an applicable defined benefit plan. Based on this misclassification, the proposed regulations extend all of the PPA benefit mandates to all non-exempt non-hybrid indexed plans, but deny all of the PPA's benefit protections to those same plans. This is a result that Congress never envisioned and that the text of the statute forecloses. The final regulations should modify the definition of plans that have an effect similar to an applicable defined benefit plan to include only hybrid plan designs that Congress was unaware of at the time it enacted the PPA. The final regulations should adopt a definition of a hybrid plan design (or a hybrid formula) as one that (1) determines benefits by reference to a current value rather than a deferred annuity, and then (2) indexes that value for all or part of the period before benefit payments begin. This is, in any event, how Congress perceived them.

Variable Annuity Plans. As non-hybrid indexed plans, no variable annuity plan should be treated as having an effect similar to an applicable defined benefit plan. If the final regulations nonetheless continue to treat variable annuity plans with hurdle rates below a specified threshold as having an effect similar to an applicable defined benefit plan, the final regulations should lower the 5% threshold in the proposed regulations to 3% to match the hurdle rates historically used in variable annuity plans.

Floor-Offset Arrangements. The final regulations should provide that a plan that is not a statutory hybrid plan is not subject to the 3-year vesting requirement in section 411(a)(13)(B) merely because the plan is part of a floor-offset arrangement that includes a statutory hybrid plan.

Hybrid Plan Benefits. The final regulations should clarify that section 411(a)(13)(A) applies for purposes of all benefits determined under a hybrid formula, including both lump sum and periodic forms of distribution. The final regulations should also clarify that an applicable defined benefit plan includes a plan that expresses the accrued benefit as an annuity that is determined by reference to a participant's cash balance or PEP accumulation. For this purpose, it should not matter whether the plan expresses the accrued benefit as an immediate or deferred annuity, or whether the annuity is the actuarial equivalent of the cash balance account or PEP accumulation.

Three-Year Vesting Requirement. The final regulations should limit the 3-year vesting requirement in section 411(a)(13)(B) to benefits accrued under a hybrid formula.

Minimum Conversion Requirements. The proposed regulations would discourage plans from offering generous benefits to participants in hybrid conversions. The final regulations should (1) modify the definition of conversion amendment to conform to the statute's intended scope, (2) clarify that changes in the law do not trigger conversion amendments, (3) provide that the effective date of a conversion amendment is the date hybrid accruals begin and not the date non-hybrid accrual cease or decline, and (4) permit plans to satisfy the minimum conversion requirements for early retirement benefits and retirement-type subsidies by crediting the additional value of such benefits or subsidies to a participant's account regardless of whether the participant actually retires on, or continues working after, the date on which he or she qualifies for such benefits or subsidies.

Effective Date Issues. The proposed regulations contain a number of surprising and unexpected requirements. If these or any similar requirements appear in the final regulations, their effective date should be delayed until the later of (1) six months after the final regulations are issued, or (2) the first day of the first plan year to begin after the final regulations are issued. The final regulations should also make clear that no whipsaw calculations are required for distributions made after August 17, 2006, including so-called "corrective distributions" that are designed to add whipsaw amounts to pre-PPA distributions. The final regulations should clarify that a conversion amendment is adopted on or before June 29, 2005, if the plan sponsor made a legally enforceable commitment to implement a hybrid conversion, such as through the adoption of a binding resolution of its board of directors or other similar action, even though modifications to the language of the plan document to reflect the plan sponsor's action were not adopted until a later date.

Anti-Cutback Relief. The proposed regulations misstate the anti-cutback rule as it applies to amendments that change a plan's interest crediting rate. The final regulations should correct this misstatement. As suggested in the preamble, the final regulations should grant anti-cutback relief (retroactively, if necessary), so that a plan can be certain that it complies with the regulations' restrictions on permissible interest credits. Eligibility for this relief should not require a finding or admission that the plan's earlier interest crediting rate violated such restrictions. Similarly, a plan should be able to change from one interest crediting rate to another, as long as (1) the new rate is reasonably expected to equal or exceed the old rate on a cumulative basis over time, or (2) the new rate is an actual market rate of return and the old rate was a risk-free rate of return, or vice versa. Anti-cutback relief should be granted for any other purpose needed to bring plans into compliance with the requirements of the final regulations.

III. RULEMAKING PROCESS

A. Proper Role of IRS Determination & Exam Functions

The determination letter program and audit process are inappropriate and improper mechanisms for adopting major interpretations of the law governing hybrid plans. Using the determination letter program and audit process for this purpose inappropriately shields the rulemaking process in the cloak of taxpayer confidentiality, undermines the transparency of the rulemaking process, bypasses the notice and comment procedures required for major rulemakings, and virtually guarantees that significant interpretations of the law will develop in a disjointed and inconsistent manner. We believe that the use of the determination letter process for this purpose should cease.

A key example of this practice occurred last year when the IRS began disqualification proceedings against a large number of plans that had converted from traditional to cash balance designs by granting some or all participants the right to receive the greater of the benefits provided under the new cash balance formula and the prior traditional formula. Although the legal questions involved ultimately were brought within the appropriate rulemaking process, *see* Treasury Press Release HP-796 (Feb. 1, 2008) (accompanying publication of Rev. Rul. 2008-7), this correction occurred only after the Treasury and the IRS had received sustained and extraordinary adverse comment from the Congressional committees of jurisdiction as well as representatives of employers, unions, and older Americans.

Another example, which has not been corrected, involves the IRS's use of the determination letter program and audit process to implement a position regarding the effective date of the PPA's anti-whipsaw provisions. We understand that the IRS is, in many cases, requiring plans to make corrective whipsaw distributions after the effective date of the PPA with respect to lump sum distributions that plans made before the effective date of the PPA. The IRS's proposed interpretation of the PPA's anti-whipsaw provisions should be addressed in the rulemaking process and not left to ad hoc resolution in individual cases in the determination letter program and audit process. We address the substance of this issue in our comments on page 31 below.

ERIC strongly urges the Treasury and the IRS to resolve all major interpretations of the law governing hybrid plans through the traditional rulemaking process in which all relevant stakeholders and interested members of the public can participate. Bypassing the notice and comment process deprives affected parties of the opportunity to comment on the legal and practical issues that Treasury and IRS positions raise and also to identify issues that the Treasury and the IRS should be addressing in greater depth.

B. Additional Proposed Regulations

ERIC understands that the Treasury and the IRS intend to issue additional proposed regulations covering subjects not addressed in the current proposed regulations. ERIC endorses this approach.

The current proposed regulations do not address a number of fundamental issues that the Treasury and the IRS acknowledge must be covered in the final regulations. These issues include, among others, guidance on pension equity plans, participant choice, market rates of return, alternative conversion methods, anti-cutback relief, and floor-offset arrangements. This guidance should be issued in proposed form, and not in temporary or final form, so that the Treasury and the IRS have an opportunity to receive and evaluate public comments on the rules before they are finalized. Our comments below on page 14 address in greater detail additional proposed regulations regarding pension equity plans.

IV. PPA AGE DISCRIMINATION TEST

The proposed regulations include many provisions that unnecessarily prohibit many hybrid retirement plans from using the age discrimination test in section 411(b)(5)(A). In order to fully effectuate Congress's intent to clarify that hybrid retirement plans are not age discriminatory, the final regulations should allow this test to be applied more broadly.

A. Plans with Multiple Formulas

For purposes of applying the age discrimination test in section 411(b)(5)(A), the proposed regulations provide that benefits expressed in the form of a deferred annuity may not be compared to either (1) benefits expressed in the form of an account balance or (2) benefits expressed in the form of a current value equal to an accumulated percentage of final average compensation ("PEP accumulation"). The IRS routinely requires such comparisons for other purposes, and the final regulations should permit such comparisons here as well. At the very least, the final regulations should permit plans to be amended to express benefits in alternative forms for purposes of applying the age discrimination test in section 411(b)(5)(A).

The IRS currently requires cash balance plans to restate participants' accrued benefits as deferred annuities, even if those benefits are expressed as account balances. The IRS imposes this requirement for numerous tax-qualification and funding purposes, including satisfying section 411(a)(7)(A)(i) and testing for backloading under section 411(b)(1)(A)-(C). *See, e.g.,* Rev. Rul. 2008-7, 2008-7 I.R.B. 419. The preamble to the proposed regulations appears to approve of this requirement. *See* 72 Fed. Reg. 73683 (preamble).

Similarly, even where defined benefit plans express their benefits as deferred annuities, the IRS has long required such plans to determine the present value of participants' accrued benefits for numerous tax-qualification and funding purposes, including calculating lump sums under section 417(e), applying the section 415(b) limits to optional forms of benefit, determining actuarial equivalence in many contexts, and measuring the plan's benefit liabilities. *See, e.g.,* Treas. Reg. § 1.417(e)-1(d) (present value requirement for lump sums); Treas. Reg. § 1.415(b)-1(c)(2)&(3) (application of § 415(b) limits to optional forms of benefit); Treas. Reg. § 1.401(a)(4)-12 (two benefits are "actuarially equivalent" if they have the same "actuarial present value"); Prop. Treas. Reg. § 1.430(d)-1(f)(7) (examples using present value of accrued benefits to determine target normal cost).

For the purpose of applying the age discrimination test in section 411(b)(5)(A), the final regulations should permit plans to compare benefits that are expressed in different forms by converting them to the same form (either deferred annuity, account balance, or PEP accumulation) on an actuarially equivalent basis. The proposed regulations already recognize this principle for very closely related purposes. *See* Prop. Treas. Reg. §§ 1.411(b)(5)-1(c)(3) & (c)(5) Ex. 2 (calculation of present value of prior plan deferred annuity benefit as opening cash balance account), 1.411(b)(5)-1(e)(2) (allowing plan to express benefit subject to age testing as account balance or PEP accumulation, even though plan defines accrued benefit as actuarially equivalent deferred annuity). In determining actuarial equivalence for this purpose, it would be appropriate to use either generally applicable actuarial assumptions or the specific indexing and annuity conversion assumptions used by the hybrid formula involved in the comparison. In addition, when converting a deferred annuity to a current value such as an account balance or PEP accumulation, the current value should be derived by assuming that no participant is older than normal retirement age to avoid inappropriately penalizing traditional plans that follow the suspension-of-benefit rules in Code § 411(a)(3)(B) and ERISA § 203(a)(3)(B).

At a minimum, the final regulations should permit plans to be amended to express benefits in alternative forms for the purpose of applying the age discrimination test in section 411(b)(5)(A). Section 1107 of the PPA permits plans to be amended retroactively in response to changes in the law made by the PPA.

B. Choice Formulas

The final regulations should make clear that a plan does not fail to satisfy the age discrimination test in section 411(b)(5)(A) merely because the plan grants older participants, but not similarly situated younger participants, the choice between (1) accruing future benefits under a hybrid benefit formula or (2) accruing future benefits under a traditional deferred annuity benefit formula.

When the benefit formula under a defined benefit plan is converted from a traditional deferred annuity benefit formula to a hybrid formula, the plan often offers participants a choice between accruing future benefits under the hybrid formula or accruing future benefits under the prior traditional deferred annuity formula. In some cases, the choice is offered to all participants. In other cases, the choice is offered to older participants, but not to similarly situated younger participants. The final regulations should make clear that, in the latter case, the plan satisfies the age discrimination test in section 411(b)(5)(A) if:

> (1) the account balance (or PEP accumulation) of each older participant would be equal to or greater than that of each similarly situated younger participant, assuming that each older participant elected to accrue future benefits under the hybrid formula, and
>
> (2) the deferred annuity benefit of each older participant would be equal to or greater than the deferred annuity benefit of each similarly situated younger participant, assuming that each older participant who was eligible to do so elected to accrue future benefits under the traditional deferred annuity formula.

For purposes of the test in paragraph (2), above, a similarly situated younger participant should be treated as having accrued a deferred annuity benefit of zero for periods after the conversion if he or she did not have the right to elect to accrue future benefits under the deferred annuity benefit formula. Prop. Treas. Reg. § 1.411(b)(5)-1(b)(1)(ii)(B) grants this treatment to "greater-of" and "sum-of" formulas, and the same treatment should apply to plans that offer choice. Footnote 4 of the preamble presents an example that seems to be relevant only to plans offering choice to all participants and does not appear to be relevant to other plans that offer choice to fewer than all participants.

C. Comparisons Between Benefits of Same Type

If, contrary to ERIC's recommendations, the final regulations continue to bar comparisons among deferred annuity, cash balance, and pension equity benefits, at the very least the final regulations should permit comparisons between benefits of the same type, even if the plan includes more than one type of benefit and is barred from comparing benefits of different types.

Under this approach, the benefits of an older participant who elected to accrue benefits under a cash balance formula can, for example, be compared to the benefits of a similarly situated younger participant who is accruing accrue benefits under a cash balance formula, even though the benefits of another older participant who elected to accrue benefits under a deferred annuity formula in the same plan cannot be compared to the benefits of a similarly situated younger participant who is accruing benefits under the cash balance formula. There is no reason for the final regulations not to permit the first type of comparison even though they bar the second type of comparison.

V. INTEREST CREDITS

The use of interest and similar adjustments to index participants' benefits in cash balance and pension equity plans is an integral feature of these plans.[2] These adjustments are known generically as "interest credits" but have never been limited to just interest. *See, e.g.,* Notice 96-8, § IV.A, 1996-1 C.B. 359 (permitted interest credits include rate of increase in the CPI, plus an associated margin of 300 basis points). The proposed regula-

[2] *See* discussion beginning on page 21 below.

tions regulate interest credits in a number of ways, first by specifying permissible rates and combinations of rates under the PPA, second by defining what constitutes an interest credit and thus counts against the market rate of return limitation, and finally by explaining how the minimum cumulative rate of return permitted under the statute operates. The following comments address each of these issues in turn.

A. Market Rate of Return

<u>The proposed regulations restrict permissible interest crediting rates in ways that are contrary to the language of the statute and Congressional intent. In particular, the proposed regulations turn the PPA's "market rate of return" principle from the boon to participants that Congress intended it to be, into a new form of restriction on hybrid plans. The final regulations should implement the language and spirit of the PPA to permit hybrid plans to offer a wide array of interest crediting rates, including, if plan sponsors wish, reasonable minimum guaranteed rates of return in excess of the minimum cumulative rate of return permitted under the statute.</u>

In enacting the PPA, Congress sought to expand the universe of interest crediting rates available to hybrid plans beyond the limited set of rates permitted under Notice 96-8. As a starting point, the PPA allows hybrid plans to credit any rate not in excess of a "market rate of return." Code § 411(b)(5)(B)(i)(I). The use of the term "market rate of return" suggests that Congress intended the market, rather than the Treasury and the IRS, to regulate the rates of return cash balance and pension equity plans offer to participants. Rates of return in the market span the gamut from the rate of interest on insured savings accounts, where the depositor's principal and prior interest are not at risk of loss, to the rate of return on investments in securities and other assets, where the investor's principal and prior earnings are fully exposed to the risk of loss. Congress also explicitly permitted plans to provide reasonable minimum guaranteed rates of return to protect participants from the risk of loss up to a point, where plan sponsors choose to undertake this burden. Congress did not intend the use of such minimums to undercut the returns participants are otherwise permitted to earn under a hybrid plan.

1. Variable Rates of Return

<u>The final regulations should substantially expand the variable rates of return a plan is permitted to offer to include the full range of market rates of return.</u>

The proposed regulations provide for a few variable rates of return that qualify as a market rate of return under the PPA:

- The rate of interest on long-term investment grade corporate bonds (after 2007, the third segment rate described in section 430(h)(2)(C)(iii)). *See* Prop. Treas. Reg. § 1.411(b)(5)-1(d)(4).
- The rate of interest on certain specified Treasury debt securities of varying maturities, plus an associated margin. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(d)(5)(i).

- The rate of increase in the CPI, plus an associated margin of 300 basis points. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(d)(5)(ii).

The rates provided represent a fraction of the rates that the statute permits. Importantly, none of the rates included in the proposed regulations are actual market rates of return, but instead are yields on government debt instruments or cost-of-living escalators. ERIC believes that a substantial number of additional variable rates should qualify as market rates of return. Any rate of return on a predetermined actual investment specified by the plan should qualify as a market rate of return, as provided in Treas. Reg. § 31.3121(v)(2)-1(d)(2)(i)(B). Such rates would include, but not be limited to, the rate of return on the actual assets of the plan, as suggested by the preamble, or a subset of those assets, as described on page 23 below.

The legislative history and the language of the statute support this approach. Any regulations issued by the Treasury and the Service should effectuate Congress's intent by allowing hybrid plans to include a wide variety of interest crediting rates.

2. Variable Rates of Return with Minimum Rates of Return

<u>In accordance with Code § 411(b)(5)(B)(i), the final regulations should not penalize a plan by forcing it to reduce its variable market rate of return, merely because the plan also provides a reasonable minimum guaranteed rate of return or the greater of a fixed rate of return and the variable market rate of return.</u>

The preamble to the proposed regulations suggests that the Treasury and the IRS believe that the presence of a reasonable minimum guaranteed rate of return in a hybrid plan may require the plan's variable market rate of return to be reduced. *See* 72 Fed. Reg. 73680, 73687. Any such view is unsupported by either the text of the statute or the legislative history of the PPA.

The text of the PPA directly addresses plans that either provide a reasonable minimum guaranteed rate or return, or credit the greater of a variable rate of return or a fixed rate of return. The statute expressly states that such plans satisfy the market rate of return standard. Code § 411(b)(5)(B)(i)(I). A colloquy between then Chairman Enzi of the Senate HELP Committee and then Chairman Gregg of the Senate Budget Committee confirms that the statute means what it plainly says: "a plan could provide a variable market rate of return and, in addition, protect participants by preventing the rate of return in their accounts from falling below a reasonable, minimum level *without having to reduce the variable market rate of return*." 152 Cong. Rec. S8756 (daily ed. Aug. 3, 2006) (emphasis added).

Requiring a reduction in a variable market rate of return due to the presence of a minimum rate of return would conflict with both the text and the legislative history of the statute. ERIC urges the Treasury and the Service to effectuate the intent of Congress that is so clearly spelled out in the PPA.

3. Fixed Rates of Return

The final regulations should permit hybrid plans to offer participants a fixed rate of return that is no greater than the yield on long-term, investment-grade corporate bonds at any time during a reasonable period before the rate is first applied under the plan.

The preamble to the proposed regulations indicates that the final regulations may allow a plan to credit a fixed rate of return without regard to changing economic conditions if the plan uses either of two rates of return:

- A rate of return specified in the regulations, such as 4 or 5 percent, or
- A rate of return determined by a methodology for establishing a fixed rate based on the then-applicable permissible rate.

See 72 Fed. Reg. 73,687. The preamble indicates that the final regulation should not permit plans to set a fixed rate of return at a prevailing rate if interest rates are historically high at that time.

The language and history of the PPA do not support such a limitation. A fixed rate of return should be allowed so long as the rate is "no greater than the yield on long-term, investment-grade corporate bonds at any time during a reasonable period before the rate is first applied under the plan." 152 Cong. Rec. S8756 (daily ed. August 3, 2006) (colloquy between Chairman Enzi and Chairman Gregg).

B. Definition of Interest Credit

The final regulations should clarify the definition of interest credit in the proposed regulations to exclude pay credits provided to employees who are on disability, maternity, military, vacation, or other leaves of absence, who are credited with past, pre-participation, or imputed service under the plan, or who receive an ad hoc increase in their benefits following termination of employment.

The proposed regulations define an interest credit as any increase in a participant's benefit under a statutory hybrid plan that "is not conditioned on current service, regardless of how the amount of that increase is calculated." Prop. Treas. Reg. § 1.411(b)(5)-1(d)(1)(ii). This definition sweeps in a host of permissible plan practices that are either required by law or that otherwise bear no relation to an interest credit. The final regulations should clarify that these practices do not give rise to interest credits that could cause the plan's interest crediting rate artificially to exceed a market rate of return and the plan consequently to fail the age discrimination rules. *See* Code § 411(b)(5)(B)(i)(I).

ERIC assumes that pay credits are not interest credits if they are granted with respect to any period for which the participant is required or permitted to be credited with service under the service crediting rules, even though the participant is not currently performing services for the employer. *See, e.g.,* Code §§ 411(a)(6)(E) (hours of service required to be granted for periods of maternity and paternity leave), 414(u)(8)(A) (benefit accrual service required to be granted retroactively for periods of qualified military service); 29 C.F.R. § 2530.200b-2(a)(2) (hours of service required or permitted to be credited for periods during which employee is paid but does not perform services). Similarly, pay credits should not be treated as interest credits if they are granted with respect to a period for which the participant is granted past service, pre-participation service, or imputed service that otherwise complies with ERISA and the Code. *See, e.g.*, Treas. Reg. §§ 1.401(a)(4)-11(d)(3) (permissible grants of past, pre-participation, and imputed service), 1.401(a)(4)-8(c)(3)(viii) (grants of past service permissible under safe harbor cash balance plans). Finally, hybrid plans should not be barred from granting pay credits to disabled employees or ad hoc benefit increases to former employees merely because they are not currently performing services for the employer. *See, e.g.,* Code § 411(a)(9) (definition of "qualified disability benefit"); Treas. Reg. §§ 1.401(a)(4)-3(f)(2) (description of qualified disability benefits that result from crediting deemed service or compensation during periods of disability), 1.410(b)-3(b) (description of ad hoc cost-of-living adjustments that give rise to benefit accruals for former employees).

In their effort to enforce the market rate of return limitation, the Treasury and the IRS should recognize that hybrid plans, like other pension plans, are designed to deliver benefits to employees in a variety of circumstances. The definition of interest credit in the proposed regulations would hobble the ability of hybrid plans to operate like other defined benefit plans, to the detriment of employees and for no perceivable statutory purpose.

C. Capital Preservation and Loss Protection Rules

1. Required Time of Application

<u>Subject to one refinement, the final regulations should retain the provision in the proposed regulations that applies the capital preservation and loss protection rules at the time of benefit commencement. These rules prevent a participant's benefit in an indexed plan (including a hybrid plan) from being less than the benefit the participant would have accrued had no indexing been applied to the benefit at all. In a cash balance plan, for example, this means that a participant's account balance cannot be less than the sum of the pay credits made to the account (*i.e.*, as if no interest credits had been made to the account at all) measured at the time benefits commence.</u>

The proposed regulations are consistent with the statute in applying the capital preservation and loss protection rules at the time of benefit commencement. *See* Prop. Treas. Reg. §§ 1.411(b)(5)-1(b)(2)(iv) & (d)(2)(ii)(A); 152 Cong. Rec. S8756 (daily ed. August 3, 2006) (statement of Sen. Enzi). The final regulations should retain the rule in the proposed regulations with one refinement. The loss protection rule applicable to indexed plans applies not only to plans that index benefits before benefit commencement, but also to plans that index benefits after benefit commencement pursuant to, for example, an automatic post-retirement cost-of-living adjustment. In the case of plans that index benefits after benefit commencement, the loss protection rule is applied by reference to the benefit in effect at the time of benefit commencement, so that subsequent indexing adjustments can never reduce the benefit below the level in effect at the time benefits began. *See* 152 Cong. Rec. S8756 (daily ed. August 3, 2006) (statement of Sen. Enzi) ("In the case of plans that index benefits after benefits begin, the determination is made by reference to the benefit in effect at the time benefits begin."). In addition, in accordance with the statute, this rule does not apply to variable annuity plans. The final regulations should clarify that the loss protection rule works as described above when benefits are indexed after they commence.

2. Permissive Time of Application

<u>The final regulations should permit but not require a plan to apply the capital preservation rule, the loss protection rule, or both, more frequently than once at benefit commencement.</u>

Although not required by the statute, the final regulations should also permit the capital preservation and loss protection rules to be applied more frequently, for example, on an annual basis.

VI. SPECIFIC PLAN DESIGNS

The proposed regulations affect different plan designs in different ways. As discussed below, the proposed regulations' classification and treatment of various plan designs varies significantly from that contemplated by Congress in the PPA. The following comments highlight the proposed regulations' impact on specific plan designs—namely, pension equity plans, cash balance plans, non-hybrid indexed plans including variable annuity plans, and floor-offset arrangements.

A. Pension Equity Plans

1. Need for Additional Proposed Regulations

<u>Because the proposed regulations do not include any rules specifically relating to pension equity plans, any such rules developed by the Treasury and the IRS should first be issued in proposed form so that the Treasury and the IRS have an opportunity to receive and evaluate public comments on the rules before they are finalized.</u>

The proposed regulations do not include any rules specifically relating to pension equity plans. *See* 72 Fed. Reg. 73688 (preamble). When the Treasury and the IRS develop such rules, they should be issued in proposed form so that the Treasury and the IRS have an opportunity to receive and evaluate public comments on the rules before they are finalized. This opportunity should be afforded to any specific rules developed for pension equity plans, not only under sections 411(a)(13) and 411(b)(5), but also under other provisions of the Code, including those mentioned in the questions about pension equity plans posed on pages 73688-89 of the preamble. Our understanding is that this is how the Treasury and the IRS intend to proceed.

2. Definition of Pension Equity Plan

A pension equity plan is a defined benefit plan that determines benefits by reference to a current value equal to an accumulated percentage of a participant's final average compensation ("PEP accumulation"). This value is adjusted on a contingent basis by changes in the participant's final average compensation during employment[3] and thereafter on a guaranteed basis by interest.[4]

The preamble poses the question whether a pension equity plan should be treated as a variant of a cash balance plan once a participant's PEP accumulation begins to be adjusted by interest. While theoretically possible, analyzing pension equity plans in this way would miss the key distinction between them and cash balance plans. In a cash balance plan, a participant's benefit is adjusted by interest, both during and after employment. Changes in a participant's compensation affect the amount of periodic pay credits made to his or her account, but are not applied to adjust the entire benefit. By contrast, in a pension equity plan, a participant's entire benefit is first adjusted by changes in final average compensation during employment and then by interest following employment. Compensation adjustments almost always are contingent on service with the employer. Once contingent compensation adjustments end, the participant's benefit is adjusted by interest. These interest adjustments are almost always guaranteed, that is, the right to them accrues at the same time as the underlying benefit that is subject to adjustment. What distinguishes them from interest credits in a cash balance plan is that they do not commence immediately but instead are delayed until employment ends.

3. The Adjustments in Pension Equity Plans Are Legal

The sequential adjustment of a participant's benefit first by compensation and then by interest is the key distinguishing feature of pension equity plans. That feature also is responsible for many of the legal issues raised by pension equity designs. All of

[3] Adjustments by final average compensation generally end on termination of employment, but can end at a different time, for example, upon cessation of benefit accruals when the participant ends active participation in the plan through termination of employment, transfer to a nonparticipating affiliate, transfer to an uncovered job position, or other similar event. Interest adjustments generally begin as soon as compensation adjustments end.

[4] For the sake of brevity, references in the discussion above to "interest" are also to other similar factors that might be used to periodically adjust participants' benefits on a guaranteed basis in pension equity and cash balance plans. Such other factors can include, for example, a market rate of return other than interest. The use of alternatives to interest is not common in either type of plan, but occurs more frequently in cash balance plans than in pension equity plans. In addition, there are hybrid plans, including pension equity plans, that do not adjust participants' benefits by interest or other similar factor. Such plans still fall within the definition of an "applicable defined benefit plan" in section 411(a)(13)(C)(i), and the benefit formulas under these plans still qualify as lump sum-based formulas under Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3). These plans and formulas can be viewed as adjusting participants' benefits at a zero rate of interest.

the questions posed in the preamble about pension equity plans, in fact, focus on this feature. Yet the feature is perfectly legal because it operates in much the same way as well-established features in other types of defined benefit plans.

The questions posed in the preamble raise a common concern that it is impossible to predict when compensation adjustments will end and interest adjustments will begin in a pension equity plan. This uncertainty gives rise to questions about how benefit accruals are to be measured, whether they might decline when interest adjustments are forgone during employment, whether the decline is attributable to an increase in service, and whether the resulting uncertainties cause the accruals to become contingent in a manner not permitted in a qualified plan. *See* 72 Fed. Reg. 73688-89 (preamble).

The answer to all of these questions is that pension equity plans are legal because they operate in much the same way as well-established and lawful plan designs that have long been approved under the Code and ERISA. A simple example is provided by floor-offset arrangements under which a participant's pension benefit is subject to far more unpredictable variation than in any pension equity plan. In a floor-offset arrangement involving a final average pay plan, the participant's gross pension benefit will grow with additional years of service and increases in compensation (much as benefits grow in a pension equity plan during employment), but will be offset by the annuity equivalent of his or her vested account balance in a paired defined contribution plan (similar in effect to the "loss" of interest adjustments in pension equity plans during employment). It is entirely possible for the participant's net pension benefit in a floor-offset arrangement to gyrate wildly from one year to the next, declining or disappearing altogether one year if pay stagnates or investment returns in the paired defined contribution account accelerate, yet reappearing or even mushrooming the next year if pay increases or investment returns in the defined contribution account sag.

While floor-offset arrangements at first were disallowed as failing to provide definitely determinable benefits, Rev. Rul. 69-502, 1969-2 C.B. 89, the IRS subsequently changed its position and held that the arrangements are permissible under ERISA as long as the offset is calculated according to formula set forth in the plan document free from employer discretion, Rev. Rul. 76-259, 1976-2 C.B. 111. Years later floor-offset arrangements were attacked as providing benefit accruals that decline on account of age, but the Seventh Circuit rebuffed the challenge on the ground that benefits were calculated under the same nondiscriminatory formula at all ages. *See Lunn v. Montgomery Ward,* 166 F.3d 888 (7th Cir. 1999) (Posner, J.). Congress confirmed this result in the PPA. *See* Code § 411(b)(5)(C).

Many of the questions raised about pension equity plans echo those raised in earlier years about floor-offset arrangements, and the answer to those questions is the same: A defined benefit plan is permitted to calculate benefits under a formula that includes variables the value of which may shift over time, often unpredictably, but that are legal as long as the formula and the variables are set forth clearly in the plan document and are not subject to impermissible employer discretion. *See generally Alessi v. Raybestos-Manhattan, Inc.,* 451 U.S. 504 (1981).

B. Definition of Indexed Plans

The final regulations should expand the definition of a "recognized investment index or methodology" to include all recognized investment indices and methodologies, not just the limited subset of them acknowledged in Prop. Treas. Reg. § 1.411(b)(5)-1(b)(2)(ii). The restrictions imposed by the proposed regulations are inconsistent with the text of section 411(b)(5)(E)(iii) and Congressional intent. In particular, the final regulations should acknowledge all investment indices and methodologies for periodically adjusting pension benefits that have been previously recognized in federal statutes, regulations, rulings, and court cases, including those used in cash balance plans, pension equity plans, contributory defined benefit plans, variable annuity plans, living pension plans, and the federal Social Security retirement program, among others.

Section 411(b)(5)(E) recognizes that indexing benefits under a defined benefit plan protects the economic value of participants' benefits and is not a form of age discrimination. The statute defines indexing as "the periodic adjustment of the accrued benefit by means of the application of a recognized investment index or methodology." Code § 411(b)(5)(E)(iii). The proposed regulations virtually write this provision out of the statute by defining a recognized investment index or methodology to include only a small subset of all recognized investment indices and methodologies. Prop. Treas. Reg. § 1.411(b)(5)-1(b)(2)(ii). (For ease of reference, we refer in this comment to a recognized investment index or methodology as a "recognized index," and to plans that adjust benefits by a recognized index as "indexed plans.") Specifically, the proposed regulations limit recognized indices to only three types:

- Cost-of-living adjustments based on increases in the CPI permitted under Treas. Reg. § 1.401(a)(9)-6, Q&A-14(b)(2)&(3).
- So-called "living pension" adjustments based on increases in compensation for the position held by the employee at the time of retirement, but in the case of nongovernmental plans, only if the plan was in effect on April 17, 2002, as provided in Treas. Reg. § 1.401(a)(9)-6, Q&A-14(b)(4).
- The rate of return on the aggregate assets of the plan or on the annuity contract for the employee, such as in a variable annuity plan.

The proposed regulations explicitly exclude interest credits in cash balance plans and post-employment interest adjustments in pension equity plans from the definition of recognized indices, even though the legislative history specifically identifies both types of adjustments as recognized indices. *Compare* Prop. Treas. Reg. § 1.411(b)(5)-1(b)(2)(i) (excluding cash balance and pension equity formulas from PPA indexing rule) *with* 152 Cong. Rec. S8751 & S8756 (daily ed. Aug. 3, 2006) (statements of Sen. Enzi) (cash balance and pension equity plans are permitted to rely on PPA indexing rule).

Indeed, the PPA itself recognizes application of a "market rate of return" as a permissible method of indexing benefits under both cash balance and pension equity plans. Code § 411(b)(5)(B)(i). Furthermore, the proposed regulations' exclusion of cash balance plans from the indexing rule is contrary to longstanding Treasury and IRS guidance that has recognized a host of permissible indices that may be used to adjust benefits in cash balance plans, including:

- The discount rate on Treasury bills of varying maturities, plus an associated margin. *See* Treas. Reg. § 1.401(a)(4)-8(c)(3)(iv)(C)(2)(i)-(iii) (without associated margin); Notice 96-8, § IV.A, 1996-1 C.B. 359; Notice 2007-6, § III.D.2, 2007-3 I.R.B. 272; Prop. Treas. Reg. § 1.411(b)(5)-1(d)(5)(i).
- The yield on Treasury Constant Maturities and bonds of varying maturities, plus an associated margin. *See* Treas. Reg. § 1.401(a)(4)-8(c)(3)(iv)(C)(2)(iv)-(viii) (without associated margin); Notice 96-8, § IV.A, 1996-1 C.B. 359; Notice 2007-6, § III.D.2, 2007-3 I.R.B. 272; Prop. Treas. Reg. § 1.411(b)(5)-1(d)(5)(i).
- The yield on long-term investment grade corporate bonds. *See* Notice 2007-6, § III.D.2, 2007-3 I.R.B. 272; Prop. Treas. Reg. § 1.411(b)(5)-1(d)(4).
- PBGC interest rates. *See* Treas. Reg. § 1.401(a)(4)-8(c)(3)(iv)(B); Notice 96-8, § IV.A, 1996-1 C.B. 359; Notice 2007-6, § III.D.2, 2007-3 I.R.B. 272.
- A "standard interest rate" of between 7.5% and 8.5%, inclusive. *See* Treas. Reg. §§ 1.401(a)(4)-8(c)(3)(iv)(B), 1.401(a)(4)-12.
- The rate of increase in the CPI, plus an associated margin of 300 basis points. *See* Notice 96-8, § IV.A, 1996-1 C.B. 359; Notice 2007-6, § III.D.2, 2007-3 I.R.B. 272; Prop. Treas. Reg. § 1.411(b)(5)-1(d)(5)(ii).

Treasury officials have stated that they recognize that cash balance and pension equity plans provide indexed benefits, but that these plans were intentionally excluded from the indexing rule in the proposed regulations because Treasury officials felt the PPA's indexing rule and current value age discrimination test were duplicative in the case of cash balance and pension equity plans. The two rules are not duplicative, not least of all because the indexing rule applies for purposes of, not only the PPA age test in section 411(b)(5)(A), but also the pre-existing age test in section 411(b)(1)(H).

In any event, whether the indexing rule is duplicative or not should be irrelevant. Congress provided two rules in the PPA and intended both of them to apply to cash balance and pension equity plans. Congress could have chosen to exclude cash balance and pension equity plans from the indexing rule but their decision not to do so represents a policy judgment left to them. Treasury and the IRS should not upset that decision by creating regulations that limit the applicability of the two PPA rules to certain subsets of plans.

The proposed regulations' definition of recognized indices also excludes numerous other methods of indexing benefits that have long been recognized in federal statutes, regulations, rulings, and case law, including:

- Statutory and plan interest rates used to adjust participants' accumulated contributions under a contributory defined benefit plan. *See, e.g.,* Code § 411(c)(2); ERISA § 204(c)(2); Treas. Reg. § 1.411(c)-1(c)(3)(ii)-(iii).
- The rate of return on plan assets or an insurance reserve under a variable annuity plan. *See, e.g.,* Rev. Rul. 60-337, 1960-2 CB 151; *see also* discussion beginning on page 22 below regarding the proposed regulations' inappropriate restrictions on variable annuity plans.
- The change in the level of salary or wages in participants' former job positions as provided under so-called "living pension" plans, such as those established through collective bargaining, regardless of when the plan was established. *See, e.g., Shaw v. Int'l Assoc. of Machinists & Aerospace Workers,* 750 F.2d 1458, 1459 (9th Cir. 1985).
- The rate of change in national average wages used to adjust federal old-age retirement benefits under Social Security. *See* 42 U.S.C. § 415(b)(3)(A)(ii).
- Interest and mortality adjustments for delayed commencement of benefits. *See, e.g.,* Code § 401(a)(9)(C)(iii).

Congress intended to clarify that indexing features do not cause a plan to discriminate on the basis of age. The proposed regulations' severe restrictions on recognized indices frustrate Congress's intent and contravene the words of the statute which neither contain nor authorize such restrictions. The final regulations should correct this error by expanding the definition to include all methods of indexing pension benefits that have been recognized previously in federal statutes, regulations, rulings, and case law.

C. Treatment of Non-Hybrid Indexed Plans

1. Expansion of PPA Benefit Mandates

<u>The final regulations should exclude non-hybrid indexed plans from the definition of plans that have an effect similar to an applicable defined benefit plan within the meaning of section 411(a)(13)(C)(ii).</u>

The final regulations should exclude non-hybrid indexed plans from the definition of plans that have an effect similar to an applicable defined benefit plan within the meaning of section 411(a)(13)(C)(ii). The purpose of section 411(a)(13)(C)(ii) is to include in the definition of applicable defined benefit plan new hybrid plan designs of which Congress was unaware when the PPA was enacted. It was not intended to sweep in non-hybrid indexed plans of which Congress was aware and whose legality had never been called into question (at least prior to the district court decision in *Cooper v. IBM Personal Pension Plan,* 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (plan violates age discrimination rules because younger participants will accumulate more indexing adjustments (in this case, interest credits) by normal retirement age), *rev'd*, 457 F.3d 636 (7th Cir. 2006) (indexing by interest merely reflects age-neutral adjustment for time value of money), *cert. denied*, 2007 WL 91579 (Jan. 16, 2007)).

Congress recognized that all indexed plans are not age discriminatory in section 411(b)(5)(E) and, in the case of non-hybrid indexed plans, imposed only a loss protection requirement on them (from which variable annuity plans are exempt). Congress did not intend to impose additional requirements on non-hybrid indexed plans in the PPA.

By defining all indexed plans as having an effect similar to an applicable defined benefit plan unless specifically exempted by the Treasury, the proposed regulations impose on all non-exempt indexed plans all of the PPA's new benefit requirements, which Congress clearly intended to apply only to hybrid plans, including the new 3-year vesting and minimum conversion requirements. *See* Prop. Treas. Reg. §§ 1.411(a)(13)-1(d)(3)(ii)-(iii) (defining all indexed plans as having an effect similar to applicable defined benefit plans, subject to certain exemptions), 1.411(a)(13)-1(c) (extending 3-year vesting requirement to all non-exempt indexed plans), 1.411(b)(5)-1(c)(4) (extending minimum conversion requirements to all non-exempt indexed plans).

Moreover, the proposed regulations deny all non-exempt indexed plans the protections that the PPA provides to hybrid plans, including the anti-whipsaw and current value age discrimination provisions. *See* Prop. Treas. Reg. §§ 1.411(a)(13)-1 (b) (anti-whipsaw provision limited to cash balance and pension equity formulas), 1.411(b)(5)-1(b)(1) (current value age discrimination testing limited to cash balance and pension equity formulas).

The flaw in the proposed regulations is illustrated by their treatment of variable annuity plans. Congress was fully aware of variable annuity plans, as evidenced by the specific reference to them in section 411(b)(5)(E)(ii). If Congress had wished to include variable annuity plans in the definition of plans that have an effect similar to an applicable defined benefit plan, it would have done so by specifically referring to them in section 411(a)(13)(C) as it did in section 411(b)(5)(E)(ii). However, Congress's decision not to do this clearly reflects its view that it did not consider variable annuity plans to have an effect similar to an applicable defined benefit plan. Furthermore, Congress refused to impose even the loss protection requirement on variable annuity plans, much less the 3-year vesting and minimum conversion requirements as the proposed regulations do.

The proposed regulations fundamentally misconstrue section 411(a)(13)(C)(ii) by including non-hybrid indexed plans in the definition of plans that have an effect similar to an applicable defined benefit plan. The final regulations should exclude non-hybrid indexed plans from the definition of plans that have an effect similar to an applicable defined benefit plan and limit the definition to new hybrid plan designs of which Congress was unaware at the time of the PPA's enactment.

2. Correct Definition of Plans Having a Similar Effect

The final regulations should modify the definition of plans with an effect similar to an applicable defined benefit plan to include only new hybrid plan designs that Congress was unaware of at the time of the PPA's enactment. The key characteristics of a hybrid formula are that (1) it determines benefits by reference to a current value rather than a deferred annuity and then (2) indexes that value for all or part of the period before benefit payments begin.

Cash balance and pension equity plans meet both conditions and are the paradigm hybrid formulas.[5] A purely contributory defined benefit plan also meets both conditions: It determines benefits by reference to a participant's accumulated contributions — a current value rather than a deferred annuity — and indexes that value by interest until benefits begin. But Congress was well aware of contributory plans when it enacted the PPA, so there is no reason to categorize them as plans that have an effect similar to an applicable defined benefit plan. *Accord* Prop. Treas. Reg. § 1.411(b0(5)-1(e)(3)(ii) (exempting contributory plans from definition of lump sum-based formula). Non-hybrid indexed plans generally meet only the second of these two conditions, that is, they generally index benefits before benefit payments begin, but they determine benefits by reference to a deferred annuity rather than a current value.[6] In any event, Congress was well aware of non-hybrid indexed plans when it enacted the PPA and specifically provided for their treatment under the age discrimination rules, so there is no reason to categorize them as plans that have an effect similar to an applicable defined benefit plan either.[7]

3. Treatment If Final Regulations Retain Current Definition

If, contrary to ERIC's recommendations, the final regulations retain the proposed regulations' definition of plans that have an effect similar to an applicable defined benefit plan and include in that definition non-hybrid indexed plans, the final regulations should extend the PPA's anti-whipsaw and current value age discrimination testing provisions to those plans.

---

[5] See discussion in footnote 4 above regarding hybrid plans that can be viewed as adjusting participants' benefits at a zero rate of interest.

[6] Non-hybrid indexed plans that index benefits only after benefits commence meet neither condition.

[7] Query whether any plan that complies with section 401(a)(9)(C)(iii) has an effect similar to an applicable defined benefit plan. Section 401(a)(9)(C)(iii) requires that a plan that delays benefit commencement for participants who continue working after their required beginning date must actuarially adjust those benefits to reflect the delay in commencement. Plans that comply with this requirement probably have a formula "that includes the right to periodic adjustments . . . that are reasonably expected to result in a [smaller] annual benefit at . . . benefit commencement . . . for the participant than for a similarly situated, younger individual," at least at ages above 70½. Prop. Treas. Reg. § 1.411(a)(13)-1(d)(3)(ii).

At a minimum, the final regulations should reword the definition to refer to "periodic adjustments that result in an annual benefit commencing at normal retirement age (or benefit commencement, if later), *whose nominal dollar amount* is reasonably expected to be *smaller* for the participant than for a similarly situated younger individual."

D. Variable Annuity Plans

1. Minimum Hurdle Rate

<u>If, contrary to ERIC's recommendations, the final regulations continue to treat variable annuity plans and other non-hybrid indexed plans as statutory hybrid plans, the final regulations should at least modify the minimum 5% hurdle rate for a variable annuity formula to avoid being classified as a statutory hybrid formula. The modified threshold should reflect the hurdle rates historically used in variable annuity formulas, which we believe are closer to 3%.</u>

The final regulations should modify the minimum 5% hurdle rate for a variable annuity formula to avoid being classified as a statutory hybrid formula. The language of the PPA makes it clear that Congress was aware of variable annuity plans and did not intend to change their operation in the fundamental way contemplated by the proposed regulations. Furthermore, a high hurdle rate increases the likelihood of negative investment adjustments, which while permitted in a variable annuity plan, are clearly disfavored under the PPA. If it is retained, the minimum hurdle rate in the proposed regulations should be modified to reflect the hurdle rates historically used in variable annuity formulas, which we believe are closer to 3%. *See, e.g.,* Rev. Rul. 60-337, 1960-2 CB 151 (3% hurdle rate). In its comments, Mercer recommends an alternative minimum hurdle rate based on the real risk-free of return implicit in Treasury Inflation Protected Securities (TIPS). ERIC believes that this proposal merits serious consideration by the Treasury and the IRS.

2. Capital Preservation Rule

<u>If, contrary to ERIC's recommendations, the final regulations continue to treat some variable annuity plans as statutory hybrid plans, the final regulations should make clear that variable annuity formulas are exempt from the "preservation of capital" rule in section 411(b)(5)(B)(i)(II).</u>

The preamble is clear on this point, but the text of the proposed regulations is not. *Compare* 72 Fed. Reg. 73680, 73685 (exemption for variable annuity plans from "protection against loss" rule in section 411(b)(5)(E)(ii) also applies to "preservation of capital" rule in section 411(b)(5)(B)(i)(II)) *with* Prop. Treas. Reg. §§ 1.411(b)(5)-1(b)(2)(iv) & (d)(2).

3. Loss Protection Rule

The final regulations should make clear that the exemption from the loss protection rule in section 411(b)(5)(E)(ii) applies to *all* variable annuity formulas and not just to the subset of variable annuity formulas listed in Prop. Treas. Reg. § 1.411(b)(5)-1(b)(2)(iv)(B). If the Treasury nonetheless decides to retain the proposed regulations' limitation on the types of variable annuity formulas that are exempt from the loss protection rule, the final regulations should clarify the limitation to take into account plans that separately track the rates of return on different designated portions of a plan's assets.

The proposed regulations limit the types of variable annuity plans that are eligible for the exemption from the loss protection rule in section 411(b)(5)(E)(ii). *Compare* Prop. Treas. Reg. § 1.411(a)(13)-1(d)(4) (definition of "variable annuity benefit formula") *with* Prop. Treas. Reg. § 1.411(b)(5)-1(b)(2)(iv)(B) (limiting exemption to only a subset of variable annuity benefit formulas); *see also* 72 Fed. Reg. at 73685 (preamble) (same). This limitation is contrary to the statute, which apples the exemption to "*any* benefit provided in the form of a variable annuity." Code § 411(b)(5)(E)(ii) (emphasis added). The final regulations should make clear that the exemption is available to all, and not just some, variable annuity formulas, as required by the statute.

If the Treasury and the IRS nonetheless decide to retain the proposed regulations' limitation on the variable annuity formulas that are exempt from the loss protection rule, the final regulations should clarify the limitation in two ways:

- A plan might include both a variable annuity formula and another benefit formula that is not a variable annuity formula and follow a different investment policy for each formula. If the plan separately accounts for the rate of return on the predetermined portion of plan assets invested pursuant to the investment policy for the variable annuity formula, the plan should be permitted to ignore the rate of return on other plan assets when calculating periodic adjustments under the variable annuity formula.
- A variable annuity plan might subdivide plan assets into separate predetermined asset pools, each with its own investment policy. If the plan separately accounts for the rate of return on each asset pool, the plan should be permitted to base variable annuity adjustments for some employees on the rate of return on the pool that applies to them and for other employees on the rate of return on the pool for those employees. In addition, the plan might base adjustments on a predetermined mix of the rates of return on different pools, but in differing proportions for different employees. As long as the plan does not assign employees to different asset pools or asset mixes based on impermissible factors such as age or highly compensated status, the plan should be permitted to ignore the rate of return on other asset pools or asset mixes when calculating periodic adjustments for an employee under the applicable variable annuity formula. An analogous approach should apply to a plan that bases variable annuity adjustments on predetermined market indices. *See* Prop. Treas. Reg. § 1.411(a)(13)-1(d)(4). Also, a plan should be permitted to

establish separate assets pools and/or market indices for participants in pay status, without regard to whether the plan provides for variable annuity adjustments after benefit commencement.

These clarifications are consistent with the proposed regulations' treatment of variable annuity benefits provided under annuity contracts, which permits different employees to receive benefits under separate contracts. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(b)(2)(iv)(B).

E. Floor-Offset Arrangements

<u>The final regulations should make clear that a plan that is not a statutory hybrid plan is not subject to the 3-year vesting requirement of section 411(a)(13)(B) merely because the plan is part of a floor-offset arrangement that includes a statutory hybrid plan.</u>

In a floor-offset arrangement, one plan provides benefits independent of a second plan, while the second plan provides benefits only to the extent the benefits provided by the first plan fall short of the minimum or "floor" benefit guaranteed under the arrangement. The first plan can be referred to as the "independent" plan, and the second plan as the "floor" plan.

1. Floor-Offset Arrangements with a Defined Contribution Plan

Typically, the independent plan is a defined contribution plan, and the floor plan is a defined benefit plan. *See* Rev. Rul. 76-259, 1976-2 CB 111; Treas. Reg. § 1.401(a)(4)-8(d). In this case, there should be no concern that the PPA's 3-year vesting requirement will be circumvented merely because the floor plan is a statutory hybrid plan. First, the statutory hybrid plan clearly is subject to the 3-year vesting requirement. Second, under section 411(a)(2)(B), the independent plan, as a defined contribution plan, is already subject to either 3-year cliff vesting or 2-to-6-year graded vesting. Third, under Rev. Rul. 76-259, in determining whether the defined contribution plan provides the minimum level of benefits guaranteed under the arrangement, the statutory hybrid plan may take into account benefits under the defined contribution plan only to the extent they are vested.

2. Floor-Offset Arrangements with a Non-Hybrid Defined Benefit Plan

However, we understand that the Treasury and the IRS wish to solicit comments on an arrangement under which both of the plans in the floor-offset arrangement are defined benefit plans. The statutory hybrid plan might be either the independent plan or the floor plan. In either case, there should be no concern that the PPA's 3-year vesting requirement will be circumvented merely because the statutory hybrid plan participates in the arrangement.

The statute is clear that only applicable defined benefit plans are subject to the PPA's new 3-year vesting requirement. In determining whether a plan is an applicable defined benefit plan, the statute looks only to benefits provided by the plan. There is no statutory basis for imposing 3-year vesting on a plan that participates in a floor-offset arrangement if the plan provides no benefits under a statutory hybrid formula.

a. Where the Hybrid Plan Is the Independent Plan

If the statutory hybrid plan is the independent plan, the non-hybrid floor plan will provide benefits only to the extent the hybrid plan's benefits fall short of the minimum floor benefit guaranteed under the arrangement. This will not turn the non-hybrid plan's benefits into hybrid benefits. In a traditional floor-offset arrangement, benefits provided under the defined benefit floor plan are not transformed into defined contribution benefits merely because they apply only to the extent that the independent defined contribution plan's benefits fall short of the minimum floor benefit guaranteed under the arrangement. In any event, the participant will receive no less than the hybrid independent plan benefit under the enhanced 3-year vesting schedule, even if the non-hybrid floor plan vests benefits under a longer schedule.

b. Where the Hybrid Plan Is the Floor Plan

There is even less reason to subject the non-hybrid plan to 3-year vesting if it is the independent plan in the floor-offset arrangement since its benefits will be calculated under a non-hybrid formula and will be determined completely independently of the benefits under the hybrid floor plan. In a traditional floor-offset arrangement, benefits under the independent defined contribution plan do not become defined benefits merely because the defined benefit plan places a floor under them. In any event, if the individual is not vested in the non-hybrid independent plan, the hybrid floor plan will pay the entire benefit based on its more favorable 3-year vesting schedule, with the net result being no different than if both plans had a 3-year vesting schedule.

VII. HYBRID PLAN BENEFITS

A. Present Value of Benefits in Hybrid Plans

<u>The final regulations should clarify that section 411(a)(13)(A) applies for purposes of all benefits determined under a hybrid formula, including both annuity and lump sum forms of distribution. The proposed regulations reflect this position but an additional clarifying statement or example would be helpful.</u>

Section 411(a)(13)(A) provides that a hybrid plan does not fail to satisfy section 411(a)(2), 411(c), or 417(e) with respect to a participant's accrued benefit derived from employer contributions merely because the plan provides that the present value of the accrued benefit equals the participant's account balance or PEP accumulation. The proposed regulations implement this provision of the PPA by providing that a plan with a lump sum-based formula does not fail to satisfy section 411(a)(2), 411(c), or 417(e) with respect to a participant's accrued benefit derived from employer contributions, solely because "with respect to benefits determined under that formula, the present value of those benefits is, under the terms of the plan, equal to" the participant's account balance or PEP accumulation. *See* Prop. Treas. Reg. § 1.411(a)(13)-1(b).

The proposed regulations are clear that a plan with a lump sum-based formula need not provide a lump sum form of distribution. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3)(i). Thus, the "benefits determined under" a lump sum-based formula necessarily include periodic forms of distribution such as annuities. *See also* Code § 417(a) (plans must provide QJSA's). While section 411(a)(7)(A) still requires the plan to express its accrued benefit for certain purposes in the form of an annual benefit commencing at normal retirement age, *see* 72 Fed. Reg. 73683 (preamble), no violation of sections 411(a)(2), 411(c), or 417(e) will occur as long as the present value of each of the benefits available under the lump sum-based formula is, under the terms of the plan, equal to the participant's account balance or PEP accumulation. This would be the case, for example, where all forms of distribution equal either the account balance or PEP accumulation in the case of lump sums or the actuarial equivalent of the account balance or PEP accumulation in the case of periodic benefits such as annuities. *See* Treas. Reg. § 1.401(a)(4)-12 (two amounts or benefits with the same "actuarial present value" are "actuarially equivalent" to one another). Presumably, no violation of sections 411(a)(2), 411(c), or 417(e) will occur if the present value of some or all of those benefits exceeds the participant's account balance or PEP accumulation. It would be helpful if the final regulations included an additional statement or example on these points.

B. Expression of Accrued Benefit in Hybrid Plans

<u>The final regulations should clarify that an "applicable defined benefit plan" within the meaning of section 411(a)(13)(C)(i) includes a plan that expresses the accrued benefit as an annuity that is determined by reference to a participant's cash balance account or PEP accumulation. For this purpose, it should not matter whether the plan expresses the accrued benefit as an immediate or deferred annuity, or whether the annuity is the actuarial equivalent of the cash balance account or PEP accumulation, as long as the annuity is determined by reference to the cash balance account or PEP accumulation. The definition of "accumulated benefit" in Prop. Treas. Reg. §1.411(b)(5)-1(e)(2) should be modified accordingly.</u>

Section 411(a)(13)(C)(i) defines an applicable defined benefit plan as a defined benefit plan under which "the accrued benefit . . . is calculated as" a cash balance account or PEP accumulation. Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3)(i) uses its own terminology ("lump sum-based benefit formula") to define an applicable defined benefit plan as a defined benefit plan under which "a participant's accumulated benefit . . . is expressed as" a cash balance account or PEP accumulation. Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2) goes on to provide that a plan expresses a participant's "accumulated benefit" as a cash balance account or PEP accumulation, "even if the plan defines the participant's accrued benefit as an annuity beginning at normal retirement age that is actuarially equivalent to that balance or value."

ERIC believes that the formulation in the proposed regulations is too narrow. The legislative history is clear that the PPA "does not elevate form over substance" and that it is sufficient that the plan determine the accrued benefit "by reference to" or "based on" a cash balance account or PEP accumulation, even if the plan defines the accrued benefit as an annuity, such as one beginning at normal retirement age. *See, e.g.*, 152 Cong. Rec. S8751 (daily ed. Aug. 3, 2006) (statement of Sen. Enzi). The definition of "accumulated benefit" in the proposed regulations recognizes that the PPA does not elevate form over substance. Nonetheless, consistent with that principle, the definition should be modified to include plans that determine the accrued benefit by reference to a cash balance account or PEP accumulation, regardless of whether they express the accrued benefit as an immediate or deferred annuity, and regardless of whether the annuity is the actuarial equivalent of the cash balance account or PEP accumulation.

Some hybrid plans express the benefit as an immediate annuity, typically because they offer immediate annuities but not lump sums. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(e)(3)(i) (plans with lump sum-based formulas need not offer lump sums); *also* Treas. Reg. §§ 1.411(a)-7(a)(1)(ii) (plan need not provide accrued benefit in form of annual benefit commencing at normal retirement age), 54.4980F-1, Q&A-6(b) (same). Similarly, some hybrid plans provide a subsidy when converting the cash balance account or PEP accumulation into an annuity, so that, strictly speaking, the annuity is not the actuarial equivalent of the account or accumulation. Sometimes this occurs because the plan expresses the benefit as an immediate annuity and the immediate annuity includes an early retirement subsidy. S*ee* Treas. Reg. §§ 1.411(d)-3(g)(6)(iv) (early retirement subsidies), 1.411(b)(5)-1(b)(1)(iii) (early retirement subsidies in accumulated benefit ignored for purposes of PPA age test). Other times this occurs because the plan subsidizes the QJSA at all ages relative to the account balance or PEP accumulation. *See* Treas. Reg. §§ 1.411(d)-3(g)(6)(iv) (retirement-type subsidies, including subsidized QJSA), 1.401(a)-20, Q&A-25 (QJSA for unmarried participant is single life annuity), Q&A-36, 37, 38 (fully subsidized QJSA).

In each of these cases, the plan determines the accrued benefit by reference to the cash balance account or PEP accumulation and should, for that reason, be included in the definition of applicable defined benefit plan.

VIII. 3-YEAR VESTING REQUIREMENT

<u>The final regulations should limit 3-year vesting to benefits accrued under a hybrid formula.</u>

The proposed regulations impose 3-year vesting on a participant's entire accrued benefit if the participant is eligible to accrue benefits under a statutory hybrid formula, even if the participant's final benefit is determined under a formula that is not a statutory hybrid formula. Prop. Treas. Reg. § 1,411(a)(13)-1(c)(1). Congress did not intend to impose 3-year vesting on non-hybrid benefits, and the final regulations should reach the same result.

IX. MINIMUM CONVERSION REQUIREMENTS

A. Definition of Conversion Amendment

<u>The PPA bans wear-away in future hybrid plan conversions. To implement this simple requirement, the proposed regulations create a regulatory labyrinth that seeks to police real and imagined plan amendments that can occur years after a plan's actual conversion. Because of their over-breadth, the proposed regulations ironically will discourage plan sponsors from providing generous transition benefits in future hybrid conversions and, as a result, will harm participants rather than protect them as Congress intended. The final regulations should modify the definition of conversion amendment in the proposed regulations to conform to the statute's intended scope.</u>

The proposed regulations define a "conversion amendment" as one that reduces or eliminates a participant's future benefit accruals under a non-hybrid formula if the participant subsequently accrues a benefit under a hybrid formula. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(c)(4)(i). Each time a plan amendment reduces a participant's non-hybrid benefits, a new conversion amendment is deemed to occur. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(c)(4)(v)(B). This can happen, for example, where the plan grants some or all participants the greater of continuing accruals under both the hybrid and non-hybrid formulas for a 10-year transition period and then is amended during the transition period to change the non-hybrid formula's definition of compensation such that one or more participants accrue a smaller non-hybrid benefit during the remainder of the transition period. Even if there is no actual amendment to the plan, the proposed regulations deem an amendment to occur if the conditions of the participant's employment change in any way that causes the participant to accrue a smaller non-hybrid benefit after the change. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(c)(4)(ii)(C). In the prior example, this might occur, for instance, if the participant experiences a drop in compensation during the transition period as a result of a demotion rather than as a result of an actual plan amendment. The proposed regulations provide an example of a conversion amendment that is deemed to occur when a participant is transferred from a division covered by a non-hybrid formula to one covered by a hybrid formula. *Id.*

Under the proposed definition of conversion amendment, if a plan sponsor introduces a hybrid formula and opts to continue accruals under a non-hybrid formula for some or all participants for any length of time, the sponsor will be required to establish an elaborate administrative apparatus to monitor the effect on individual participants of any future amendments to the non-hybrid formula and of every change in employment status of every participant eligible to accrue benefits under the non-hybrid formula. Without such a monitoring system, the plan sponsor will have no way of knowing whether a conversion amendment has occurred and thus no way to protect the plan from disqualification under the age discrimination rules.

Faced with the prospect of establishing such a costly and complex monitoring system, plan sponsors simply will structure conversions to avoid providing future benefit accruals of any kind under a non-hybrid formula. This approach will allow plan sponsors to adopt a single conversion amendment with a one-time "A+B" benefit calculation for all affected participants, with no possibility that a subsequent conversion amendment will be deemed (or alleged) to occur. While less generous to participants, this approach will be the inevitable result if the final regulations retain the definition of conversion amendment in the proposed regulations.

B. Effective Date of Conversion Amendment

The final regulations should provide that the effective date of a conversion amendment is the date on which hybrid accruals begin under the amendment and not, as the proposed regulations provide, the date on which non-hybrid accruals end or decline. Retaining the approach in the proposed regulations will only discourage plan sponsors from providing generous transition benefits to participants in future hybrid conversions.

By treating a conversion amendment as effective when non-hybrid accruals end or decline rather than when hybrid accruals begin, the proposed regulations force plans to increase the minimum "A+B" post-conversion benefit (by requiring that it be calculated at a later point in time) whenever the plan sponsor opts to continue non-hybrid accruals for some or all participants for any period after hybrid accruals begin. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(c)(4)(vi); *also* 72 Fed. Reg. 73686 (preamble). This treatment penalizes plan sponsors for providing more generous transition benefits to participants than the law requires. To avoid discouraging sponsors from providing generous transition benefits, the final regulations should treat a conversion amendment as effective on the date hybrid accruals begin or, if later, the date the amendment adding the hybrid accruals is adopted.

C. Conversion Amendments Triggered by Changes in Governing Law

The final regulations should not treat as a conversion amendment any amendment adopted in response to a change in governing law, whether by statute, regulation, or other guidance of general applicability, even though the amendment results in a reduction in benefit accruals under a non-hybrid formula. More specifically, the final regulations should clarify that an amendment changing the plan's actuarial assumptions for section 417(e) and other purposes from GATT to PPA assumptions does not constitute a conversion amendment, including in instances where the plan is amended to temporarily calculate forms of distribution subject to section 417(e) as the greater of the benefit produced by GATT and PPA assumptions.

The example given above illustrates how the overly broad definition of conversion amendment in the proposed regulations could give rise to a conversion amendment in circumstances that Congress never contemplated as being subject to the PPA's minimum conversion requirements. In a plan that offers a lump sum distribution with respect to benefits accrued under a non-hybrid formula, the required switch to PPA assumptions under section 417(e) will result in smaller lump sums than would have been paid using the previously applicable GATT assumptions. Under the proposed regulations, this change would result in a new conversion amendment even if the plan underwent a hybrid conversion years ago and had not provided non-hybrid accruals since. This result is inappropriate, and the final regulations should correct it.

D. Early Retirement Subsidies

<u>The final regulations should clarify that in satisfying the minimum conversion requirements, a plan is permitted to add the value of subsidized early retirement benefits associated with a non-hybrid formula to a participant's account balance or PEP accumulation, regardless of whether the participant retires at the age at which such subsidies are available or continues to work thereafter.</u>

Section 411(b)(5)(B)(iv) requires that a participant's minimum "A+B" post-conversion benefit be calculated by crediting his or her account balance or PEP accumulation "with the amount of any early retirement benefit or retirement-type subsidy for the plan year in which the participant retires if, as of such time, the participant has met the age, years of service, and other requirements under the plan for entitlement to such benefit or subsidy." This provision sets the minimum benefit to which a participant must be entitled following a hybrid conversion. A plan should be permitted to satisfy this requirement by providing this benefit on terms that are more generous to the participant than the minimum terms specified in the PPA. One way to do so is to provide the benefit at the time the participant could retire and receive the early retirement benefit or retirement-type subsidy regardless of whether the participant actually retires. Another way is to provide transition pay credits or supplemental interest credits that are designed to track or approximate the value of the early retirement benefit or retirement-type subsidy as the participant approaches or attains early retirement eligibility. Such arrangements are common in past conversions and should be permitted in future conversions that are subject to the PPA.

X. TRANSITION ISSUES

A. Effective Date Issues

1. Pre-Effective Date Conversions

<u>For purposes of the effective date of the minimum conversion requirements in section 701(e)(5) of the PPA, the final regulations should clarify that a conversion amendment is considered adopted as of the date the plan sponsor made a legally enforceable commitment to implement a hybrid conversion, such as through the adoption of a binding resolution of its board of directors or other similar action, even though modifications to the language of the plan document to reflect the plan sponsor's action were not adopted until a later date.</u>

Section 701(e)(5) of the PPA provides that the new minimum conversion requirements apply to "plan amendments adopted after, and taking effect after, June 29, 2005." Plan sponsors often amend their plans through board resolutions or other binding corporate actions that describe the plan changes being made. As long as such actions are binding on the plan sponsor, it should not matter that modifications to the language of the plan document are not specified until later—the plan has been amended as of the date of the binding board or other corporate action. The final regulations should recognize this common practice.

2. Effective Date of Anti-Whipsaw Provision

<u>The final regulations should make clear that no whipsaw calculations are required for distributions made after August 17, 2006, including so-called "corrective distributions" that are designed to add whipsaw amounts to pre-PPA distributions that did not include them. At the very least, the IRS should cease administrative enforcement of Notice 96-8, which Congress explicitly rejected nearly two years ago.</u>

ERIC has previously provided extensive comments to the Treasury and the IRS on this issue and reincorporates those comments here. The Treasury and IRS's continued endorsement of whipsaw in the preamble to the proposed regulations after the effective date of the PPA is deeply troubling. *See* 72 Fed. Reg. 73682. The IRS's apparent enforcement of Notice 96-8 after the enactment of the PPA is even more troublesome. ERIC is aware of the decision in *West v. AK Steel Corp. Ret. Accumulation Pension Plan*, 484 F.3d 395 (6th Cir. 2007), *pet. for cert. filed*, No. 07-663 (Nov. 16, 2007). However, that decision at best left it to the courts, not the IRS, to adjudicate claims seeking corrective whipsaw distributions, *id.* at 412 (legislative history leaves the issue to the courts), and at worst fundamentally misconstrued the adverse age effects of whipsaw, which so troubled Congress, as "really nothing more than the time value of money," *id.* at 410. Even the *West* plaintiffs admit that, to effectuate their view, the PPA effective date should be re-written to refer to "annuity starting dates" after August 17, 2006, rather than "distributions made" after that date. *See* Statement for the Record of Thomas R. Theado, House Committee on Ways & Means (Nov. 1, 2007), *available at* http://waysandmeans.-house.gov/hearings.asp?formmode=view&id=6692.

The statute written by Congress and enacted into law in section 701(e)(2) of the PPA refers to "distributions made" after August 17, 2006, and not to "annuity starting dates" after that date. The time when a "distribution" is "made" is well-established under the Code. For example, under section 402, a benefit distribution from a qualified plan is taxable to the recipient when the distribution is made, and a distribution is made at the time it is actually paid. Similarly, the Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, 106 Stat. 290 (1992) (UCA), amended section 402 to change the rollover rules for distributions made after December 31, 1992. The Treasury and the IRS interpreted this effective date and found, unsurprisingly, that a distribution is made after December 31, 1992, if it is actually paid after that date, even if it is part of a series of payments that began, and therefore had an annuity starting date, before December 31,

1992. *See* Treas. Reg. § 1.402(c)-2, Q&A-1(c)(1). The IRS was even more explicit and ruled that an amount paid from a qualified plan after December 31, 1992, was a distribution after the UCA effective date, even though it was intended to "correct" the shortfall in an earlier lump sum distribution made to the participant before December 31, 1992. *See* PLR 199633041 (Aug. 16, 1996).

The final regulations should recognize that the plain language of the statute bars all whipsaw distributions after August 17, 2006, including so-called "corrective" distributions for pre-PPA lump sums. To do otherwise would fly in the face of long-standing Treasury precedent and wreak havoc with the tax treatment of participants who receive such corrective distributions, which presumably would be taxed at the time the original pre-PPA lump sum was paid. At the very least, the IRS should cease administrative enforcement of Notice 96-8, which Congress rejected nearly two years ago.

3. Effective Date of Novel or Unexpected Requirements

<u>The final regulations should delay the effective date of any surprising or unexpected requirements until the later of (1) six months following issuance of the final regulations, or (2) the first date of the first plan year to begin after issuance of the final regulations.</u>

The effective date of any surprising or unexpected requirements contained in the final regulations (regardless of whether they first appeared in the proposed regulations) should be deferred until the later of (1) six months following issuance of the final regulations, or (2) the first day of the first plan year to begin after issuance of the final regulations. The final regulations should make clear that plans are not required to comply with these requirements, on a good-faith basis or otherwise, during any period before the delayed effective date. Examples of such surprising or unexpected requirements include any requirement to (1) reduce a plan's market rate of return because the plan also credits a reasonable guaranteed minimum rate of return, (2) treat as an interest credit any amount that previously would not been considered an interest credit, and (3) classify variable annuity and other non-hybrid indexed plans as "statutory hybrid plans." ERIC hopes that this delayed effective date will not be necessary because the final regulations do not include any novel or unexpected requirements.

B. Anti-Cutback Issues

1. Misstatement of Anti-Cutback Rule

<u>The proposed regulations state that an amendment reducing interest credits during any future period violates the anti-cutback rule without requiring that the amendment also result in a reduction in a 411(d)(6)-protected benefit. The final regulations should correct this misstatement to provide that an amendment reducing interest credits violates the anti-cutback rule only if it results in a reduction in a 411(d)(6)-protected benefit.</u>

The proposed regulations state that an amendment changing a plan's interest crediting rate on existing balances violates the anti-cutback rule "if the revised rate under any circumstances could result in a lower interest crediting rate as of any date after the applicable amendment date." Prop. Treas. Reg. § 1.411(b)(5)-1(d)(8)(i).[8] Treasury regulations are quite clear that, in order for an amendment to violate the anti-cutback rule, the amendment must reduce a 411(d)(6)-protected benefit. *See generally* Treas. Reg. §§ 1.411(d)-3, 1.411(d)-4. An amendment that reduces the interest crediting rate on existing balances at a given point in time need not result in the reduction of a 411(d)(6)-protected benefit. This could occur for any number of reasons, including the following: (1) the plan's new interest crediting rate exceeded the prior interest crediting rate during the period before the new rate dropped below the prior rate; (2) the amendment adopted improvements to other plan provisions that offset the reduction in interest credits, or (3) the amendment ended pay credits to existing account balances and added a new all-service account balance that receives future pay credits but reduced interest credits. It is critical that the final regulations correct the misstatement of the anti-cutback rule in the proposed regulations in order to avoid unnecessary confusion regarding the proper scope and operation of the rule.

2. Anti-Cutback Relief for Interest Crediting Rates

<u>The final regulations should adopt the proposals for anti-cutback relief identified in the preamble to permit a plan to reduce its interest crediting rate either to conform to the new market rate of return limitation or to switch to a new interest crediting rate that is expected to be higher than the plan's current interest crediting rate. In addition, if the plan is currently crediting interest at a rate that is no more than the risk-free rate of return, it should be permitted to switch to any interest crediting rate that is a market rate of return. Finally, a plan should be permitted to reduce its interest crediting rate to the extent necessary to eliminate any "funding whipsaw" that would otherwise be required under the PPA funding rules.</u>

As discussed above, the proposed regulations seek to define a market rate of return in ways that are contrary to the language of the statute and Congressional intent. If the final regulations continue this approach, it will be particularly important to provide a clear path for plans to conform their interest crediting rates to the requirements in the final regulations. In any event, the Treasury and the IRS should grant, as they propose in the preamble, 72 Fed. Reg. 73689 (preamble), anti-cutback relief that permits a plan to change the interest crediting rate on existing balances to a new rate that is certain to comply with the requirements of the final regulations, including, if necessary, on a retroactive basis. Where a plan offers participants the ability to select from a range of hypothetical investment options, such relief should include the ability to eliminate any hypothetical investment option that the plan cannot be certain satisfies the requirements

[8] Certain passages in the preamble compound this misstatement. *See* 72 Fed. Reg. 73689 (barring amendments that reduce account balances, PEP accumulations, or certain interest crediting rates without a corresponding requirement that the amendments reduce a 411(d)(6)-protected benefit).

of the final regulations. Eligibility for the relief described in this paragraph should not require a finding or admission that the plan's existing interest crediting rate or hypothetical investment option violated such requirements.

As the preamble notes, a plan should also be permitted to switch to a new interest crediting rate on existing balances that is expected to equal or exceed the plan's existing interest crediting rate. It is not clear how this latter determination will be made. The preamble suggests that a switch to an equity-based rate of return might be expected to produce a higher return than a plan's existing interest crediting rate. However, the expected rate of return on any investment, equity or otherwise, should not exceed the risk-free rate of return once the risks associated with the investment are taken into account. ERIC therefore suggests that a plan that is currently crediting interest at a rate not in excess of the risk-free rate of return should be permitted to switch to any rate that is a market rate of return. For this purpose, an interest crediting rate should be deemed to be not in excess of the risk-free rate of return if it is described in Prop. Treas. Reg. § 1.411(b)(5)-1(d)(5) or was otherwise permitted under Notice 96-8, 1996-1 C.B. 359.

In its separate submission on the proposed regulations under section 430, ERIC has recommended that those proposed regulations be modified to eliminate so-called "funding whipsaw" in the valuation of hybrid plan liabilities. If the final regulations under section 430 do not eliminate funding whipsaw, then the Treasury and the IRS should grant anti-cutback relief under section 1107 of the PPA to permit plans to reduce their interest crediting rates to the extent necessary to avoid funding whipsaw.

3. Anti-Cutback Relief for Other Purposes

<u>The final regulations should grant anti-cutback relief for purposes other than adjusting a plan's interest crediting rate. Because the final regulations could mandate changes in multiple aspects of a plan's design and operation other than its interest crediting rate, the final regulations should provide any anti-cutback relief needed to conform the plan to the regulations' requirements.</u>

For example, if, despite ERIC's recommendations, the final regulations continue to treat a variable annuity plan as a statutory hybrid plan if it has hurdle rate below a minimum set in the regulations, then anti-cutback relief should be granted (retroactively, if necessary) to permit a variable annuity plan to bring its hurdle rate into compliance with the minimum.

C. Advance Notice Requirements

<u>The Treasury and the IRS should not undermine the anti-cutback relief provided in section 1107 of the PPA by requiring plans to do the impossible, namely, provide advance notice of retroactive amendments. Nor should the Treasury and the IRS seek to undermine the effective dates in section 701(e) of the PPA by prohibiting plans from adopting amendments needed to secure the benefits of the PPA until advance notice of</u>

<u>those amendments has been given. This is especially so where the delay in providing advance notice is attributable to the lack of guidance from the Treasury and the IRS.</u>

On March 21, 2008, the Treasury and the IRS issued proposed regulations under section 4980F of the Code and section 204(h) of ERISA, among other purposes, to coordinate the requirements of those sections with section 1107 of the PPA. *See* 73 Fed. Reg. 15101, 15103 (Mar. 21, 2008). ERIC is studying these proposed regulations and will provide comments on them in a separate submission.

* * * * *

Additional regulatory obstacles imposed on hybrid plans combined with other statements from the Treasury and the IRS indicating that these plans might have difficulty satisfying the tax-qualification rules send a strong message to employers that there is substantial uncertainty about these plans—and it is therefore not worthwhile to dedicate hundreds of millions or even billions of dollars to provide benefits to their employees under hybrid plans. ERIC urges the Treasury and the IRS to adopt final regulations that are fully consistent with Congress's intent to foster the creation of the plans and answer the previously outstanding questions regarding their legality.

ERIC appreciates the opportunity to present our views and recommendations on these critically important issues. If we can be of any further assistance to the Treasury or the IRS, please let us know.

Respectfully Submitted,

Mark J. Ugoretz
President
THE ERISA INDUSTRY COMMITTEE

CC: Thomas Reeder
Benefits Tax Counsel
Office of Assistant Secretary for Tax Policy
U. S. Department of Treasury

William Bortz
Associate Benefits Tax Counsel
Office of Assistant Secretary for Tax Policy
U. S. Department of Treasury

Linda S.F. Marshall
Employee Plans, Tax Exempt and Government Entities Division
Office of Chief Counsel
Internal Revenue Service

Lauson C. Green
Employee Plans, Tax Exempt and Government Entities Division
Office of Chief Counsel
Internal Revenue Service