ERIC

The ERISA Industry Committee

May 18, 2007

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Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Ladies and Gentlemen:

The ERISA Industry Committee ("ERIC") is pleased to submit this response to IRS Notice 2007-6, 2007-3 I.R.B. (January 16, 2007) regarding cash balance and other hybrid defined benefit pension plans.

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.

ERIC commends the Congress, the Department of the Treasury ("Treasury") and the Internal Revenue Service ("Service") for their efforts to clarify the legality and appropriateness of cash balance plans, pension equity plans, and other defined benefit plans that provide for guaranteed indexing of participants' benefits ("hybrid plans"). We believe that hybrid plans represent the future of the defined benefit retirement system. It is critical that regulations issued by Treasury and the Service fully adopt the intent of Congress in ensuring that these plans continue to provide secure retirement benefits to millions of American workers.

The Congress, as a part of the Pension Protection Act of 2006 ("PPA"), prospectively rejected many of the challenges and objections to hybrid plans. In doing so, Congress recognized the legitimacy of hybrid plans and that the vitality of the defined benefit system in the future might depend upon the ability of employers to offer their employees hybrid plans. ERIC strongly encourages Treasury and the Service to bear in mind the clear mandate of Congress as they draft regulations that may limit the ability of employers to provide these plans.

As the Treasury and Service begin to craft future guidance, ERIC's comments focus on a number of important concerns with the notice and any future guidance, including:

- The availability of a good faith standard in any proposed regulations;

- The application of the backloading tests to hybrid plans;

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- The definition of market rates of return;
- The treatment of early retirement subsidies; and
- The crediting rate for variable annuity plans.

ERIC urges the Treasury and the Service to ensure that any future regulations address these concerns so that common hybrid plan design features, of which Congress was fully aware, are acceptable designs. ERIC strongly believes that rules can be drafted that serve this purpose and that are fully consistent with the legislative intent and the statutory language. ERIC looks forward to working with the Treasury and the Service as they consider future guidance on these issues, as well as, other issues of concern with the treatment of hybrid plans.

I. Good Faith Standard

ERIC understands that Treasury and the Service face a considerable task in drafting the substantial number of regulations required in response to PPA. As such, we expect the Treasury and Service may not be able to provide comprehensive final regulations with regard to the law's hybrid plan provisions before the relevant effective dates. The unavailability of regulations upon which employers and employees can rely creates significant issues for both.

These problems are both legal and human resources in nature. Legal issues include substantial exposure to liability for decisions made on a good faith understanding of the provisions of the PPA. In addition, plans may be disqualified resulting in substantial tax liabilities. Plan participants would similarly be caught in a "catch-22." They will be forced to make retirement decisions based on what they perceive the rule to be, only to find out later that the rule was not what they believed. Employees will be burdened with understanding the shifting legal ground and their inability to rely on advice from their employers would make them susceptible to schemes designed by unethical individuals to scare employees into rushing decisions. ERIC members have already reported their employees being approached by such individuals.

ERIC urges Treasury and the Service to adopt a good-faith compliance standard in any proposed regulations that they issue. Such a standard will allow employers to provide accurate and reliable information to employees regarding the status of their retirement benefits prior to the promulgation of final regulations. Without such a standard, neither employers nor employees will have reliable information on which to make informed decisions. Moreover, employers will be at risk for making decisions based on inadequate guidance and pressures will mount to abandon their plans rather than accept that risk and its consequences.

While Treasury and the Service work to finalize regulations, plan sponsors must continue to operate their plans on a daily basis—making decisions about the payment of lump sums, funding, and other matters. It is critical that an employer's good faith effort to comply with the statute prior to the issuance of final regulations be recognized. Failure to include a transition good faith standard could lead employers to freeze any further accruals under their plans in order to limit any additional legal or regulatory jeopardy.

II. Application of the Backloading Tests

Of critical importance to both the current determination letter process and future guidance governing conversions of traditional defined benefit plans to hybrid defined benefit plans is the application of the backloading tests.

a. Application of the Backloading Tests to "Greater of" Conversions

ERIC members have raised concerns that the Service's current application of the 133 $^{1}/_{3}$ % test to hybrid plans is disallowing some of the most participant-favorable methods of conversion.

In converting from a traditional defined benefit plan to a hybrid plan, many employers have adopted a "greater of" approach for current plan participants. Under such an approach, plan participants, upon retirement, are entitled to the greater of the two benefit formulas—the formula in the traditional defined benefit plan and the formula in the new hybrid plan. This structure ensures that all current participants receive the benefit they would have earned had the conversion not taken place if that benefit is larger than the one earned under the new hybrid design. This structure has proven especially helpful to many participants in plans with generous early retirement provisions under the traditional formula. Moreover, in this respect, it should be noted that early retirement benefits are not subject to the backloading tests and thus such tests should not be used as a means to preclude such "greater of" formulations.

Treas. Reg. § 1.411(b)-1(a) states:

> "A defined benefit plan may provide that accrued benefits for participants are determined under more than one plan formula. In such a case, the accrued benefits under all such formulas must be aggregated in order to determine whether or not the accrued benefits under the plan for participants satisfy one of the alternative methods."

The regulation is intended to cover situations in which an employee's benefits are determined under multiple plan formulas in order to mask backloading. In the case of "greater of" cash balance conversions, if the two or more formulas each separately satisfy the anti-backloading rules, the aggregate will always be more frontloaded than any of them separately and therefore should also satisfy the rules. ERIC has addressed this issue with Treasury in the past and was assured that the issue would be resolved. Our objections to the Service's current interpretation are outlined in the attached comment filed with the Treasury Department in June 2001. ERIC's interpretation appropriately ensures that a plan is not designed to deny substantial benefits from being earned until late in an employee's tenure.

Applying this rule to conversions that have adopted a "greater of" approach can create results that are detrimental to plan participants. Employees earning benefits after a "greater of" conversion do not have an accrued benefit determined under multiple formulas. The employee's accrued benefit is determined under only one formula—the formula that produces the greatest benefit. Correctly realizing that a "greater of" conversion does not create accrued benefits under multiple formulas eliminates the concern that such an arrangement could result in backloading.

ERIC urges Treasury and the Service to issue guidance that specifies that when examining a "greater of" conversion during the determination letter process, each formula will be evaluated under the backloading tests individually. Doing so will not create a possibility of benefit backloading and will allow employers to continue to offer these participant-favorable conversion designs. ERIC also urges that this interpretation be included in any proposed or final hybrid plan regulations.

b. Application of the Backloading Tests to Market-Rate Hybrid Plans

ERIC is also concerned that, either through rulemaking or activities in audits and determination letter proceedings, Treasury or the Service may apply the backloading rules to market rate cash balance plans in a manner that undermines the intent of Congress with respect to these plans. Congress, in the PPA, clearly intended to encourage cash balance plans that allow variable market interest credits, including designs that could from time to time have negative credits in a given year. Although market cash balance plans must comply with all design requirements applicable to defined benefit plans, it is not feasible to think that Congress would clearly authorize the use of market rate interest credits, if they were prohibited by some other existing rule.

A prospective backloading test is performed by "treat[ing] as remaining constant" "all relevant factors used to compute benefits." Treas. Reg. 1.411(b)-1(b)(2)(ii)(D). ERIC believes that this requirement must be applied in a manner that is consistent with the intent of the backloading rules—preventing discriminatory patterns in the *form* of benefit accrual with respect to service. The requirement to treat calculation factors as remaining constant, if applied correctly, prevents the abuse in form without adding requirements to make burdensome benefit adjustments when fluctuations in interest credits (or other factors such as pay, inflation factors, etc.) occur over the course of an employee's career.

ERIC believes that regulating these fluctuations—which Congress intended to allow—by use of the backloading rules does not address any potential abuse targeted by the backloading rules. Moreover, this will significantly complicate plan administration for sponsors and discourage adoption of market rate cash balance plans. ERIC urges Treasury and the Service to clarify this in any future guidance.

III. Market Rate of Return

Congress, in enacting the PPA, sought to allow plan sponsors to include a variety of interest crediting methods in hybrid plans. Treasury and the Service should embrace this position in any regulations.

a. Variable Rates of Returns

Notice 2007-6 provides for a few variable rates of return that qualify for market rate of return under the PPA:

- The rate of interest on long-term investment grade corporate bonds (as described in §412(b)(5)(B)(ii)(II) prior to amendment by PPA for plan years beginning prior to January 1, 2008).
- The rate of interest on long-term investment grade corporate bonds (the third segment rate described in §430(h)(2)(C)(iii) for plan years beginning on or after January 1, 2008).

- The rate of interest on 30-year Treasury securities as described in §417(e)(3) prior to amendment by PPA.
- The sum of any of the standard indices and the associated margin for that index as described in Notice 96-8.

ERIC applauds Treasury and the Service for providing guidance on what rates are considered market rates of return. The rates provided represent a small number of the rates that ERIC believes to be appropriate for hybrid plans. ERIC believes that 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, similar to the approach taken in Treas. Reg. § 31.3121(v)(2)-1(d)(2)(i)(B).

The legislative history and the language of the statute support this approach. Any regulations issued by Treasury and the Service should not serve to artificially restrict the number of interest crediting rates that are available to employers and employees. Congress intended that hybrid plans be able to include a wide variety of interest crediting rates. ERIC encourages the Treasury and the Service to recognize this in any future regulations.

b. Minimum Rates of Returns

ERIC is concerned that Treasury and the Service might determine that the presence of a guaranteed minimum rate of return in a hybrid plan requires a reduction in the plan's variable rate. This interpretation is unsupported in both the statutory language and the legislative history of the PPA.

The language of the PPA directly addresses plans that credit the greater of a variable rate of return or a fixed rate of return. The law states that a plan satisfies the market rate of return standard if it provides a "return equal to the greater of a fixed or variable rate of return." This interpretation is also supported in the legislative history by a floor colloquy between Chairman Enzi and Senator Gregg. Chairman Enzi confirmed Senator Gregg's understanding that under the PPA " . . . 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. August 3, 2006) (italics added).

It is clear that any interpretation requiring a reduction in the variable market rate of return due to the presence of a minimum fixed rate of return would be contrary to both the legislative history and the statutory language. A guaranteed fixed rate of return should not be disallowed 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). Providing this type of arrangement underscored the defined benefit nature of hybrid plans since this type of arrangement would not be available to participants in 401(k) or other defined contribution plans.

ERIC urges Treasury and the Service to faithfully implement the clear intent of Congress and the language of the PPA when enacting any regulations.

c. Capital Preservation and Loss Protection Rules

The PPA requires that a participant's account balance may not be less than the aggregate of contributions credited to the account (capital preservation rule). In addition, the PPA prohibits pre-retirement indexing that would reduce a participant's accrued benefit (loss protection rule).

ERIC believes that the legislative history supports an interpretation that both rules apply only at benefit commencement and not on an annual or other periodic basis. This interpretation will protect the credits to the participant's hypothetical account over his or her entire career. Any other approach would result in a significant change in plan operation and benefit accrual for participants.

Chairman Enzi confirmed this interpretation of the two rules during an exchange with Senator Richard Burr during Senate floor consideration of the PPA. He said that the capital preservation rule "requires that the cumulative effect of all the interest credits to an employee's hypothetical account may not reduce the account balance below the sum of all the pay credits made to the account." 152 Cong. Rec. S8756 (daily ed. August 3, 2006). Reading the law as requiring any form of short-term limit on the application of negative interest crediting rates is contrary to the legislative intent that the test would be related to the "cumulative effect of *all* the interest credits." This test can only be performed at the time benefits commence and interest credits cease.

Chairman Enzi explicitly stated that this was the test intended by Congress. He said that "[t]he capital preservation and loss protection rules are intended to provide long-term protection to employees, so the determination of whether the rules are satisfied is made at the time benefits commence but not beforehand. . . ." *Id*. Given the legislative history and clear intention of Congress, ERIC believes that the capital preservation and loss protection rules are designed only as a long-term floor on the interest-crediting rate. For these reasons, the capital preservation and loss protection rules should not be read to require that a rate that is otherwise considered to be a market rate — such as a rate based on equity returns —cannot have the effect of reducing a participant's hypothetical account balance in any one year but rather such rule is only applicable at the time of commencement of a participant's benefit.

IV. Treatment of Early Retirement Subsidies

ERIC is concerned about several issues regarding the treatment of early retirement subsidies in the context of the PPA's prohibition of wear-away in future hybrid conversions. ERIC believes that guidance is needed to confirm that any early retirement-type subsidy may be included in the participant's accumulation account or similar amount or may continue to be provided as part of the benefit earned before the conversion occurred. Requiring the value of the early retirement-type subsidy to be included in the accumulation account balance would result in several potential administrative, compliance, and communications difficulties for plan sponsors.

Because plan sponsors commonly change the distribution options available under a hybrid plan from those available under the earlier traditional plan design, requiring early retirement-type subsidies to be included in the accumulation account could result in a potential violation of §411(d)(6). In addition, the complexity required to provide the early retirement subsidy as part of the accumulation account balance would greatly complicate communication with participants resulting in participant confusion. Future guidance should make clear that plan sponsors are not forced to choose between violating the anti-cutback rules and the conversion rules and that any early retirement-type subsidies may be protected in either the accumulation account or as part of the benefit earned prior to conversion. Any other interpretation would appear to result in either an impermissible cutback or a windfall of having to include the subsidy twice.

V. Assumed Interest Rate for Variable Annuity Plans

ERIC is concerned by the guidance provided in Notice 2007-6 related to the treatment of variable annuity plans. ERIC believes the selection of a five percent rate in part III E(2)(ii)(II) of the guidance is not only arbitrary, but is unsupported by the language and legislative history of the Pension Protection Act. The legislative history of the Pension Protection Act makes clear that Congress recognized these plans as valid defined benefit plan designs. Any regulations from Treasury should recognize that the Pension Protection Act fully authorizes the indexing of benefits—like in variable annuity plans. These plans should not be curtailed by onerous regulations not mandated or supported by the Act.

ERIC appreciates the opportunity to submit these comments. We will continue to reflect on these important issues and supplement our comments with additional feedback as necessary. If the Treasury or the Service has any questions about our comments, or if we can otherwise be of assistance, please let us know.

Sincerely,

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