ERIC

THE
ERISA
INDUSTRY
COMMITTEE

ERIC COMMENTS ON

PROPOSED & FINAL REGULATIONS ON HYBRID RETIREMENT PLANS

Click on title below to view:

1400 L Street, N.W.
Suite 350
Washington, DC 20005
TEL: 202.789.1400
FAX: 202.789.1120
www.eric.org

January 2011

The
ERISA
Industry
Committee

ERIC COMMENTS ON PROPOSED AND FINAL REGULATIONS ON HYBRID RETIREMENT PLANS

EXECUTIVE SUMMARY

January 2011

Cash balance and pension equity plans cover approximately one out of every four participants in a defined benefit plan in the United States. They also account for roughly 40 percent of the assets held in defined benefit plans nationwide. As a result, these plans provide the primary source of retirement income for a significant number of American workers. As traditional defined benefit plans have become increasingly less attractive, cash balance and pension equity plans have provided a welcome exception to this troubling trend.

Congress recognized these facts and, in the Pension Protection Act of 2006 (the "PPA"), adopted comprehensive legislation to encourage employers to adopt and maintain cash balance and pension equity plans. To safeguard the retirement income of the numerous Americans covered by these plans, it is critical that Treasury and IRS draft regulations that reflect Congress' intent to encourage and facilitate the creation and maintenance of cash balance and pension equity plans. The ERISA Industry Committee ("ERIC")[1] stands ready to assist Treasury and IRS in this effort. Toward that end, ERIC is pleased to present a series of six comments on the proposed and final Treasury regulations implementing the cash balance and pension equity plan provisions of the PPA.

Market Rate of Return. ERIC's first comment focuses on the ability of hybrid plans under the PPA to credit interest up to a "market rate of return." This permits hybrid plans to provide more generous interest credits to employees. Furthermore, the PPA protects employees from full exposure to the market by ensuring that their cumulative rate of return cannot be negative, a feature that protects, in particular, older employees. In addition, the PPA permits hybrid plans to provide reasonable minimum guaranteed rates of return. We submit the following comments on the implementation of these provisions in the proposed and final regulations:

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[1] ERIC is a non-profit association committed to the advancement of employee retirement, health, and welfare benefit plans of America's largest employers. ERIC represents exclusively the employee benefits interests of major employers who, collectively, provide comprehensive retirement, healthcare coverage and other economic security benefits directly to tens of millions of active and retired workers and their families in all 50 states. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in the American economy.

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- The regulations should recognize that the rate of return on any predetermined, actual investment constitutes a "market rate of return."
- The rates listed in the regulations should constitute a safe harbor and not an exclusive list of permissible rates.
- The addition of a minimum cumulative floor, which favors older employees, should not impose a ceiling on the market rates that employees can earn under hybrid plans. Neither should reasonable minimum guaranteed rates of return.
- ERIC urges Treasury and IRS not to force plans to reduce benefits already accrued by employees as a condition of complying with the PPA. To the extent they do not heed this advice, the final regulations should provide broad transition relief and should not be effective before the first plan year that begins at least 12 months after the final regulations are issued.

Anti-Whipsaw Rules. ERIC's second comment focuses on the PPA's anti-whipsaw rules. "Whipsaw" refers to the IRS's prior administrative practice of requiring cash balance plans to pay out lump sums in excess of some participants' account balances if the plans credited interest that exceeded relatively low rates set by the IRS. Because of the peculiarities of the calculation, whipsaw provided much larger lump sums to younger employees than to otherwise similarly situated older employees. Litigation ensued, and the IRS succeeded in convincing the courts that whipsaw was required by federal law. Congress disagreed, and, in the PPA, eliminated it for distributions after August 17, 2006.

In a proposed regulation issued last October, Treasury and IRS interpret the PPA as merely providing an exception from whipsaw for plans that meet certain conditions spelled out in the regulation but not the statute. Among these conditions, the proposed regulation would bar cash balance and pension equity plans from subsidizing annuities and other distributions to participants. This comment explains how the proposed regulation fundamentally misconstrues the PPA's anti-whipsaw rules, and that current law already permits (and regulates) the maximum amount of subsidy that may be offered in any distribution from a defined benefit plan, including a cash balance or pension equity plan.

Age Discrimination Testing. ERIC's third comment focuses on the PPA's age discrimination testing safe harbor and indexing rule. In brief, this comment recommends the following:

- The age discrimination safe harbor should permit plans to compare benefits of similarly situated individuals covered by different benefit formulas by reducing each participant's benefit to its present value.
- The final regulations should make clear that benefits consisting of two parts, each relating to different periods of service, may be tested separately under the "sum of benefit formulas" rule and that each part of the benefit may, itself, be tested under one of the safe harbor rules governing multiple formulas. This approach would apply, for example, if a traditional final average pay plan were converted to a cash balance plan,

and older employees were offered a choice to remain under the final average pay formula.

- The PPA's rule that indexing does not constitute age discrimination should apply to all defined benefit plans, including hybrid pension plans, and the definition of indexing should be expanded.

Vesting, Plan Termination, and Conversion Rules. ERIC's fourth comment focuses on the PPA's vesting, plan termination, and plan conversion requirements and the treatment of non-hybrid, indexed plans. In brief, these comments include the following:

- *Vesting*: The final regulations should limit the 3-year vesting rule to benefits accrued under a hybrid formula and clarify that the 3-year vesting requirement does not apply to non-vested participants who are rehired after prior hybrid formula benefits have been lost under the plan's break-in-service rules.
- *Plan Termination*: The final regulations should clarify the rule requiring a plan that uses variable interest rates to apply, upon plan termination, the 5-year average of the variable interest rates. For example, guidance is needed with respect to annuity conversions, annuities commencing before normal retirement age, plans that have a fixed rate in effect at plan termination, and plans with non-market rates during the averaging period.
- *Conversion Amendments*: The final regulations should clarify when and how the requirements regarding plan conversions apply. For example, guidance is needed with respect to the definition of "conversion amendment," the treatment of early retirement benefits following a conversion amendment, the timing of a conversion amendment, and how the conversion amendment rules apply in the context of a merger or acquisition.
- *Non-Hybrid Indexed Plans*: Plans that provide an indexed benefit but do not express the benefit by reference to a current value do not share key similarities with hybrid plans and therefore should not be subject to the vesting, plan termination, and plan conversion rules that apply uniquely to hybrid plans.

Participant-Directed Cash Balance Plans. ERIC's fifth comment focuses on participant-directed cash balance plans. These plans permit each participant to direct the investment of his or her cash balance account across a broad array of asset classes. The options available to the participant in each asset class are based strictly on the performance of actual investment funds that most frequently mirror the investment choices available under the employer's 401(k) plan. In this sense, participant-directed cash balance plans resemble 401(k) plans, but with one critical difference—they address the shortcomings that prevent 401(k) plans from becoming a comprehensive retirement income solution and, for that reason, offer an important improved retirement plan option that Treasury and IRS should approve in the final regulations. This comment examines the technical issues raised by participant-directed cash balance plans and explains why none of those issues poses an obstacle to their approval in the final regulations.

Pension Equity Plans. ERIC's sixth comment focuses on pension equity plans. Undoubtedly, the PPA was intended to provide legal certainty and clarity in the law to cash balance plans and pension equity plans alike. When enacting the PPA, Congress specifically, and for the first time, formally recognized the viability—and indeed the desirability—of pension equity plans. Yet despite this clear Congressional intent, the proposed and final regulations do not provide adequate guidance for PEP sponsors. ERIC recommends that the Treasury and IRS develop a comprehensive, workable set of rules that provide PEPs with legal certainty and a clear path to compliance.

ERIC

The
ERISA
Industry
Committee

First Comment in a Series of Six Comments on
Proposed and Final Regulations on Hybrid Retirement Plans

MARKET RATE OF RETURN

January 12, 2011

EXECUTIVE SUMMARY

Cash balance and pension equity plans cover approximately one out of every four participants in a defined benefit plan in the United States. They also account for roughly 40 percent of the assets held in defined benefit plans nationwide. As a result, these plans provide the primary source of retirement income for a significant number of American workers. As traditional defined benefit plans have become increasingly less attractive, cash balance and pension equity plans have provided a welcome exception to this troubling trend. Congress recognized these facts and, in the Pension Protection Act of 2006 (the "PPA"), adopted comprehensive legislation to encourage employers to adopt and maintain cash balance and pension equity plans. To safeguard the retirement income of the numerous Americans covered by these plans, it is critical that Treasury and IRS draft regulations that reflect Congress' intent to encourage and facilitate the creation and maintenance of cash balance and pension equity plans. The ERISA Industry Committee ("ERIC")[1] stands ready to assist Treasury and IRS in this effort.

Toward that end, ERIC is pleased to present the first in a series of six comments on the proposed and final Treasury regulations implementing the cash balance and pension equity plan provisions of the PPA. This comment focuses on the ability of hybrid plans under the PPA to credit interest up to a "market rate of return." This permits hybrid plans to provide more generous interest credits to employees. Furthermore, the PPA protects employees from full exposure to the market by ensuring that their cumulative rate of return cannot be negative, a feature that protects, in particular, older employees. In addition, the PPA permits hybrid plans to provide reasonable minimum guaranteed rates of return. We submit the following comments on the implementation of these provisions in the proposed and final regulations:

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- The regulations should recognize that the rate of return on any predetermined, actual investment constitutes a "market rate of return."
- The rates listed in the regulations should constitute a safe harbor and not an exclusive list of permissible rates.
- The addition of a minimum cumulative floor, which favors older employees, should not impose a ceiling on the market rates that employees can earn under hybrid plans. Neither should reasonable minimum guaranteed rates of return.
- ERIC urges Treasury and IRS not to force plans to reduce benefits already accrued by employees as a condition of complying with the PPA. To the extent they do not heed this advice, the final regulations should provide broad transition relief and should not be effective before the first plan year that begins at least 12 months after the final regulations are issued.

I. INTRODUCTION

ERIC is pleased to submit the first in a series of six comments on the proposed and final regulations issued by the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS" or "Service") under Title VII and section 1107 of the PPA, as amended by the Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA"). The regulations apply for purposes of sections 411(a)(13), 411(b)(1)(B), 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 regulations were published in the Federal Register on October 19, 2010. *See* 75 Fed. Reg. 64,123 (final regulations); 75 Fed Reg. 64,197 (proposed regulations). Corrections to the regulations were published in the Federal Register on December 28, 2010. *See* 75 Fed. Reg. 81,456 (final regulations); 75 Fed. Reg. 81,543 (proposed regulations).

ERIC recognizes that the 2010 proposed and final regulations revised and clarified the 2007 proposed regulations in helpful ways and appreciates the consideration that Treasury and IRS have given to ERIC's earlier comments on the 2007 proposed regulations. ERIC offers the following comments to address remaining concerns regarding the proposed and final regulations set forth in Treas. Reg. (and Prop. Treas. Reg.) §§ 1.411(b)(5)-1(d) ("Market rate of return"), 1.411(b)(5)-1(e) ("Other rules regarding market rates of return"), and 1.411(b)(5)-1(f) ("Effective/applicability date"). This letter also addresses the proposed regulation set forth in Prop. Treas. Reg. § 1.411(b)-1(b)(2)(ii)(H) ("Variable interest crediting rate under a statutory hybrid benefit formula").

ERIC is submitting five additional separate comments on other aspects of the regulations. 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 regulations. ERIC also requests that it be permitted to testify at the hearing.

II. Summary of Comments

Market Rates of Return. The final regulations should expand the rates of return that a plan is permitted to offer to include the full range of market rates of return. Whether a rate constitutes a market rate should be determined without regard to either the reasonable minimum guaranteed rates allowed under the statute or the zero cumulative floor. Market rates listed in the regulations should constitute a safe harbor and not an exclusive list of permissible market rates. The list of permissible rates should be expanded. The list should include 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 list should also include the actual rate of return on the subset of plan assets associated with hybrid plan liabilities, assuming the assets are invested in accordance with the diversification requirements of Title I of ERISA.

Stability and Lookback Periods. The final regulations should allow plans to use stability and lookback periods other than those applicable under section 417(e) of the Code. The final regulations should retain the stability and lookback periods required under section 417(e) of the Code as a safe harbor and should expand the safe harbor to include lookback periods that vary from any single day within the current plan year to the average over a period as long as the prior plan year.

Clarification of the Anti-Cutback Rule. The final regulations should be clarified to provide that the right to an interest credit is not itself a benefit protected from cutback under section 411(d)(6) of the Code but instead is merely one element among many taken into account in calculating the benefits protected from cutback under section 411(d)(6) of the Code. An amendment reducing interest credits would violate the anti-cutback rule only if it results in a reduction in a 411(d)(6)-protected benefit.

Transition Relief. The final regulations will, in many cases, require substantial changes to plan design and plan administration. The final regulations should not take effect until at least the first day of the plan year that begins at least 12 months after the regulations are issued. Furthermore, the final regulations should provide broad anti-cutback relief, which is consistent with the PPA and is particularly warranted because delayed regulations, rather than actions by plans or plan sponsors, created the need for relief. The final regulations should provide retroactive anti-cutback relief, but should not require participants to repay any excess interest credits that are distributed prior to the regulatory effective date.

Pre-Regulatory Effective Date Issues. The final regulations should be clarified to provide that a plan may rely on a reasonable interpretation of the statute between the statutory effective date and the regulatory effective date. The final regulations should also provide that for the period between the statutory effective date and the regulatory effective date, the interest crediting rate will be evaluated based only on the period between the PPA's effective date and the regulatory effective date.

ERISA § 204(h) Notice. The final regulations should clarify that ERISA § 204(h) does not require advance notice of a reduction of an interest crediting rate with respect to a right to interest crediting that has already been accrued.

Zero Cumulative Floor and Multiple Annuity Starting Dates. The final regulations should provide that the rule regarding the application of the zero cumulative floor to multiple annuity starting dates does not apply to a participant who has had a bona fide termination of employment.

Backloading. To apply the 133-1/3% anti-backloading test to a plan that credits interest based on the return on an actual investment or investments, the plan should be required under the final regulations to calculate every year a participant's accrued benefit payable at normal retirement age by projecting future interest using the yield on Treasury securities of appropriate durations.

III. MARKET RATE OF RETURN

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

The proposed and final regulations regulate interest credits in a number of ways. This section of this comment focuses on the way in which the proposed and final regulations specify permissible rates and combinations of rates under the PPA.

A. Range of Market Rates of Return

<u>The proposed and final regulations restrict permissible interest crediting rates in ways that are contrary to the language of the statute and Congressional intent. In particular, the proposed and final regulations restrict the PPA's "market rate of return" principle to an artificially narrow, exclusive list of rates of return and base this limitation on the PPA's participant-protective zero cumulative floor and permitted guaranteed minimum rates of return. As a result, the proposed and final regulations turn what Congress intended to be a boon to participants into a new form of restriction on hybrid plans. The final regulations should effectuate Congress' intent to permit hybrid plans to offer a wide array of interest crediting rates.</u>

Congress, in enacting the PPA, sought to allow plan sponsors to include a variety of interest crediting methods in hybrid plans. In particular, 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. Congress sought this expansion "to allow plans to adjust benefits in ways that benefit participants." 152 Cong. Rec. S8756 (daily ed. Aug. 3, 2006) (statement of Chairman Gregg).

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 PPA does not define "market rate of return," and because the term is not defined in the statute, it should be construed "in accordance with its ordinary or natural meaning." *See Federal Deposit Ins. Co. v. Meyer*, 510 U.S. 471, 476 (1994). The ordinary or natural meaning of "market rate of return" is a rate an investment can earn in the market.

The term also suggests that the *market*, and not Treasury or IRS, will regulate the rates of return hybrid plans offer to participants. Although the PPA grants the Secretary the authority to promulgate rules governing "the calculation of a market rate of return" and "for permissible methods of crediting interest to the account (including fixed or variable interest rates) resulting in effective rates of return meeting the requirements of subclause (I)," the PPA does not give Treasury or IRS the authority to modify the meaning of "market rate of return" to a limited subset of actual market rates of return. *See* Code § 411(b)(5)(B)(i)(III). Otherwise, the statutory references to the "calculation of" market rates and the "methods of" crediting interest would be superfluous. If Congress had intended to give Treasury and IRS the authority to determine the range of market rates or to modify what constitutes a market rate of return, aside from its natural meaning, Congress could have provided such authority in the statute. *See, e.g.*, Code § 417(e)(3)(B) (defining "applicable mortality table" as "a mortality table, modified as appropriate by the Secretary . . ."); Code § 6621(b)(1) (providing that "[t]he Secretary shall determine the Federal short-term rate for the first month in each calendar quarter.").

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

The final regulations expand the permissible rates of return from those provided in the proposed regulations published on December 28, 2007 at 72 Fed. Reg. 73,680 (the "2007 proposed regulations"), to include the following:

- Long-term investment grade corporate bond rates consisting of the first, second, and third segment rates used under the funding rules or the lump sum valuation rules. See Treas. Reg. §§ 1.411(b)(5)-1(d)(3), (4)(ii).
- Treasury security rates similar to those approved in Notice 96-8, including associated margins. See Treas. Reg. § 1.411(b)(5)-1(d)(4)(ii).
- Rate of increase in the Consumer Price Index plus 300 basis points. See Treas. Reg. § 1.411(b)(5)-1(d)(4)(iii).
- For non-hybrid indexed plans as described in Treas. Reg. § 1.411(b)(5)-1(b)(2), rate of return on aggregate plan assets, assuming the assets are invested in accordance with the prudence requirements of Title I of ERISA. See Treas. Reg. § 1.411(b)(5)-1(d)(5)(ii).
- Rate of return on an annuity contract issued by a state-licensed insurance company. See Treas. Reg. § 1.411(b)(5)-1(d)(5)(iii).

To the rates permitted under the final regulations, the proposed regulations would add the following:

- Rate of return on diversified regulated investment company. See Prop. Treas. Reg. § 1.411(b)(5)-1(d)(5)(iv).
- For all hybrid plans, rate of return on aggregate plan assets, assuming the assets are invested in accordance with the prudence requirements of Title I of ERISA. See Prop. Treas. Reg. § 1.411(b)(5)-1(d)(5)(ii).

ERIC appreciates that additional rates of return have been added to the list of permissible rates, and ERIC supports the inclusion of the above-described rates in the final rule. In particular, ERIC applauds the inclusion of rates of return that are actual market rates of return (*e.g.*, return on plan assets, return on diversified regulated investment company).

However, many market rates of return do not appear on the list of permissible rates. For example, the prime rate clearly is a market rate of return, yet it is not included on the list of permissible rates. The reason for its exclusion, and the exclusion of many other rates, is unclear. It would be absurd to suggest that crediting interest at the prime rate would be age discriminatory, while crediting at the third segment rate, for example, would not be. ERIC recommends 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).

The legislative history and the language of the statute support this approach. This approach also has the benefit of allowing hybrid plans to evolve with the market. By artificially limiting the rates that qualify as market rates of return, plans will ossify and have difficulty offering a rational balance of risk and reward to participants. Rational accumulation of retirement savings is at the heart of the PPA, and a flexible, more generic approach to the market rate of return principle would allow plans to achieve this goal. The proposed regulations, without revision, could prevent the creation of new or modified plan designs that could be very beneficial to participants, such as cash balance designs under which interest credits are based on participant direction among multiple investment options or the rate of return on target date funds or a managed account. A flexible approach to the meaning of market rate of return is not only consistent with the language and spirit of the PPA, it allows for a new class of defined benefit plan that could achieve one of the main goals of federal retirement policy, namely rational lifetime savings coupled with guaranteed income for participants during retirement (and even pre-retirement disability).

Further, considering any rate of return on a predetermined actual investment specified by the plan to be a market rate of return, as provided in Treas. Reg. § 31.3121(v)(2)-1(d)(2)(i)(B), would encourage investment-based hybrid plans, which provide an excellent retirement option that meets many of the policy goals set by Congress and the Departments of Labor and Treasury. Investment-based hybrid plans permit employees' retirement wealth to grow with the market, while offering the security of a defined benefit plan, including the ability to obtain a guaranteed lifetime annuity. Investment-based hybrid plans are also attractive to employers. Many employers who offer investment-based hybrid plans are able to minimize funding volatility by investing plan assets so as to track the investment that is the basis for the investment-based interest crediting rate. This provides plan sponsors with a tool that allows them to better budget and plan for their retirement program expenses. Over time, plans like investment-based hybrid plans that provide greater control over funding volatility may encourage employers to maintain and adopt defined benefit plans, one of the original goals of ERISA.

If finalized without revision, the proposed regulations would serve to artificially restrict the number of interest crediting rates that are available to employers and employees. Congress intended that hybrid plans include a wide variety of interest crediting rates, and the proposed regulations should be revised consistent with that intent.

2. <u>The final regulations should provide that the specific interest crediting rates listed in the regulation are not the only rates not in excess of a market rate of return</u>.

The final regulations take the position that, for plan years that begin on or after January 1, 2012, a rate, no matter how reasonable, will violate the requirement that a plan not credit interest in excess of the market rate of return unless it appears on the list of approved rates in the regulations or is less than an approved rate. *See* Treas. Reg. § 1.411(b)(5)-1(d)(1)(iii), (v); 75 Fed. Reg. 64,134.

ERIC does not take issue with the inclusion of a safe harbor concept in the regulations, and it appreciates the certainty provided by a list of particular rates. However, construing the permissible rates listed in the regulations as the exclusive list of rates is inconsistent with Congress' intent in enacting the PPA because, as proposed, the regulations artificially restrict the rates of return allowed under the PPA to a subset of actual market rates of return.

ERIC strongly recommends that the proposed regulations be revised prior to finalization to provide that the rates listed do not constitute the exclusive list of rates. Instead, the final regulations should effectuate Congress' intent that hybrid plans include a wide variety of interest crediting rates by also including any rate of return on a predetermined actual investment specified by the plan, as provided in Treas. Reg. § 31.3121(v)(2)-1(d)(2)(i)(B). The final regulations could accomplish this by making permanent the status of the rates for plan years that begin before January 1, 2012. That is, the rates set forth in the regulations constitute safe harbor rates but plan sponsors may also use any other market rate of return if the plan sponsor is comfortable choosing a rate outside the safe harbor.

3. The final regulations should expand the rates of return a plan is permitted to offer to include the full range of market rates of return, and this expansion should be made without regard to the reasonable minimum guaranteed rates allowed under the statute.

The proposed regulations provide that a plan may determine interest credits based on the greater of two or more different crediting rates without providing an effective interest crediting rate in excess of the market rate of return if the plan provides the following:

- The greater of a fixed interest crediting rate of 4% and a variable interest crediting rate equal to one of the Treasury security rates, investment-grade corporate bond rates or the CPI rate as set forth in Treas. Reg. §§ 1.411(b)(5)-1(d)(3), (4). See Prop. Treas. Reg. § 1.411(b)(5)-1(d)(6)(ii).
- The greater of a cumulative fixed interest crediting rate of 3% and any of the variable interest crediting rates permitted under the regulations, including investment-based rates of return (such as the rate of return on plan assets, on a diversified regulated investment company, or on an annuity contract). *See* Prop. Treas. Reg. § 1.411(b)(5)-1(d)(6)(iii).

The preamble to the proposed regulations indicates that Treasury and IRS believe that the presence of these reasonable minimum guaranteed rates can, in their interaction with a variable rate, create an effective rate of return in excess of the market rate of return. *See* 75 Fed. Reg. 64,205. As a result, only in certain limited circumstances may a plan provide interest credits based on the greater of two or more interest crediting rates without exceeding the market rate of return. *Id*. As explained in the preamble to the proposed regulations, the minimum guaranteed rates set forth in the regulations are, based on historical data, expected to "only infrequently" be lower than the respective variable rates. *Id*. The preamble to the proposed regulations also indicates that Treasury and IRS believe that the potential presence of a minimum guaranteed rate limits the range of rates deemed to be not in excess of a market rate of return — the preamble requests that any recommendations for additional rates of return "justify how those rates meet a market rate of return, taking into account the minimum guarantee rules." *See* 75 Fed. Reg. 64,209.

The notion that a reasonable minimum guaranteed rate interacts with the variable rate in a way that can cause a variable rate to be in excess of the market rate of return is unsupported by either the text of the statute or the legislative history of the PPA. Similarly, the notion that because a plan may choose to offer a reasonable minimum guaranteed rate, the range of rates deemed to be not in excess of the market rate of return available to all plans is limited, is unsupported by the text of the statute and the legislative history of the PPA.

The text of the PPA directly addresses plans that provide a reasonable minimum guaranteed rate of return, and the statute expressly states that such a plan satisfies the market rate of return standard. Code § 411(b)(5)(B)(i)(I). The statute requires only that the minimum guaranteed rate of return be reasonable; it does not indicate that the presence of a floor would create an effective rate of return in excess of a market rate of return. *Id*.

A colloquy between Chairman Enzi of the Senate HELP Committee and Chairman Gregg of the Senate Budget Committee confirms that Congress did not intend the presence of a reasonable minimum floor to affect or limit the variable rate of return: "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).

Indeed, this legislative history shows that Congress intended reasonable minimum guaranteed rates to provide sometimes valuable protection to participants. Construing reasonable guaranteed rates to be part of the market rate of return counters this objective by permitting only guaranteed rates that are of little or no appreciable value. *See* 75 Fed. Reg. 64,205. The minimum, guaranteed annual rate on a bond-based interest crediting rate should therefore be higher than 4%. The final regulations should permit at least a 5% guaranteed minimum rate.[2]

Congress explicitly permitted plans to provide reasonable minimum guaranteed rates of return to protect participants from the risk of loss up to a point, where the 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 or to limit the market rates of return that qualify as rates not in excess of the market rate of return for purposes of the PPA. ERIC recommends that the final regulations expand the rates of return a plan is permitted to offer to include any rate of return on a predetermined actual investment specified by the plan, as provided in Treas. Reg. § 31.3121(v)(2)-1(d)(2)(i)(B). This expansion should be made without regard to the option under the PPA that a plan offer reasonable minimum guaranteed rates.

If, despite ERIC's recommendations, Treasury and IRS continue to view the presence of a reasonable minimum guaranteed rate as a justification to limit the range of rates deemed not to be in excess of the market rate of return, the final regulations should at the very least provide that plans that do not provide for the use of a reasonable minimum guaranteed rate of return (other than the zero

[2] In addition, a plan should be permitted to provide any guaranteed minimum rate with respect to a variable rate if the plan sponsor could identify an annuity contract issued by a state-licensed insurance company that would provide such a minimum rate of return with respect to such variable rate. The plan should be permitted to continue to provide such minimum and variable rates for the period that the insurance contract would guarantee such rates.

cumulative floor) may use the full range of market rates of return, including the rate of return on any predetermined actual investment.

4. <u>The final regulations should expand the rates of return a plan is permitted to offer to include the full range of market rates of return, and this expansion should be made without regard to the zero cumulative floor.</u>

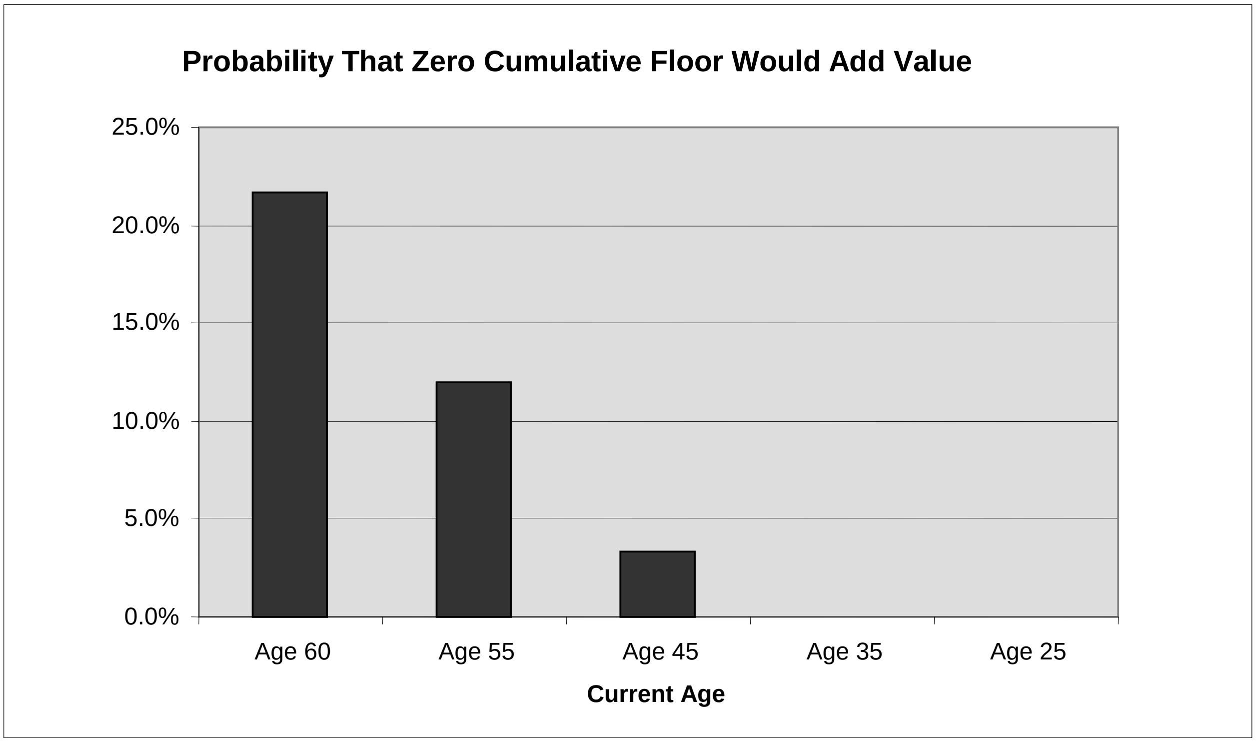
As a requirement under section 411(b)(5) of the Code, separate from the market rate of return rule, a plan must provide that an interest credit of less than zero shall not result in the account balance or similar amount being less than the aggregate amount of contributions credited to the account. Code § 411(b)(5)(B)(i)(II).

The final regulations provide that a plan that meets this rule is "not treated as providing the greater of two or more interest crediting rates." Treas. Reg. § 1.411(b)(5)-1(d)(6)(i). However, the preamble to the proposed regulations indicates that Treasury and IRS believe that the combination of a variable rate of return whose volatility is not constrained with the zero cumulative floor could result in an above market rate of return. *See* 75 Fed. Reg. 64,204. Based on this discussion, and a similar discussion in the preamble to the 2007 proposed regulations, Treasury and IRS appear to view the zero cumulative floor as a basis for limiting the rates of return deemed to be not in excess of a market rate of return. *See Id.*; 72 Fed. Reg. 73,688.

Using the zero cumulative floor to limit the meaning of market rate of return under the PPA is unsupported by the statute. Neither the statute, which addresses the market rate of return rule and the zero cumulative floor separately, nor the legislative history, indicate that the range of permissible rates is limited by the fact that Congress simultaneously enacted the zero cumulative floor to protect participants.

Indeed, the zero cumulative floor adds a feature to hybrid plans that favors older plan participants. The PPA regulates the interest crediting in hybrid plans because a younger participant is assumed to have a longer period of time to participate in a plan than a similarly situated, older participant. For example, a thirty year-old participant could receive interest credits on his or her account for thirty-five years before attaining age 65 while a similarly situated sixty year-old could receive interest credits for only five years before attaining age 65. Notably, a zero cumulative floor would be expected, based on historical data, to provide much greater value when interest is credited for a short period of time. Thus, the zero cumulative floor would favor the older employee, who has fewer years of interest crediting, than a similarly situated younger employee, who has more years of interest crediting.

For example, over the past century, cumulative equity returns on the S&P 500 index have been negative for 20% of the five-consecutive-year periods, 12% of the ten-consecutive-year periods, 3% of the twenty-consecutive-year periods, and 0% of the thirty-consecutive-year periods. *See* Crestmont Research, STOCK MATRIX (UPDATED THROUGH 2009), *available at* http://www.crestmontresearch.com/pdfs/Stock%20Matrix%20Index5%2011x17.pdf. The chart below shows the probability that the zero cumulative floor will affect a single year's pay credit at a given age, assuming the participant begins to receive his or her benefit (and therefore ceases to receive interest crediting) at age 65:



The zero cumulative floor therefore does not support limiting the permissible rates of return to an artificial subset of actual market rates of return, and to the extent that the proposed and final regulations are based on this rationale, they should be modified.

5. <u>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.</u>

The proposed regulations add to the safe harbor of interest crediting rates, an annual interest crediting rate equal to a fixed five percent. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(d)(4)(iv). The regulations deem a fixed five percent rate to be not in excess of the rate on long-term investment-grade corporate bonds. *Id*.

In the preamble to the proposed regulations, Treasury and IRS come to the conclusion that the PPA allows for a stand-alone fixed interest rate. *See* 75 Fed. Reg. 64,205. ERIC agrees with this conclusion, which is supported by the legislative history.

However, the PPA does not limit the permissible stand-alone fixed rate to five percent. 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. Aug. 3, 2006) (colloquy between Chairman Enzi and Chairman Gregg).

6. The final regulations should expand the list of permissible rates of return to include the actual rate of return on the subset of plan assets associated with hybrid plan liabilities, assuming the assets are invested in accordance with the prudence requirements of Title I of ERISA.

The final regulations include as a permissible rate, the rate of return on aggregate plan assets, assuming the assets are invested in accordance with the prudence requirements of Title I of ERISA, for non-hybrid indexed plans as described in Treas. Reg. § 1.411(b)(5)-1(b)(2). *See* Treas. Reg. § 1.411(b)(5)-1(d)(5)(ii). The proposed regulations allow all hybrid plans to use the rate of return on aggregate plan assets. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(d)(5)(ii).

ERIC appreciates the addition of this actual market rate of return to the list of permissible rates, and ERIC supports the inclusion of this rate in the final rule. However, the rate of return on aggregate plan assets may not be an option for plans with a subset of assets associated with traditional defined benefit plan liabilities and a subset of assets associated with hybrid plan liabilities. This is because the plan assets associated with the legacy liabilities are likely invested under a strategy that differs from the investment strategy related to the hybrid plan assets. That is, the assets associated with legacy liabilities may be invested with the goal of matching the plan's legacy liabilities, whereas the assets associated with the hybrid plan liabilities are invested to maximize participants' retirement savings.

With this type of plan in mind, ERIC recommends that the final regulations expand the list of permissible rates to include the rate of return on the subset of plan assets that are segregated in a separate account, provided that the separate account is invested in accordance with the prudence requirements of Title I of ERISA. This revision would allow hybrid plans that include legacy liabilities to use the rate of return on the portion of plan assets that are invested in a way to maximize the return for account-based benefits.

This revision is consistent with the statute. The rate of return on the hybrid-related plan assets is a market rate of return, and Congress intended hybrid plans to include a wide array of interest crediting rates. ERIC urges Treasury and IRS to make this change in the final regulations, which will allow plan sponsors to use the rate of return on the portion of plan assets invested consistent with participants' goals.

B. Stability and Lookback Periods

The final regulations should allow plans to use stability and lookback periods other than those applicable under section 417(e) of the Code.

To fall under the safe harbor prior to the regulatory effective date or to comply with the regulations after the regulatory effective date, for a plan that uses the long-term investment grade corporate bond rate or a safe harbor rate, if a plan determines interest credits for a stability period using a lookback month, the stability period and lookback month must satisfy the rules for selecting the stability period and lookback month under Treas. Reg. § 1.417(e)-1(d)(4). Treas. Reg. § 1.411(b)(5)-1(d)(1)(iv)(B). *See also* 75 Fed. Reg. 64,132.

Many of the safe harbor rates provided in the proposed and final regulations are based on rates that were allowed under Notice 96-8, but Notice 96-8 does not require that the stability period and lookback month satisfy the rules for selecting the stability period and lookback month under Treas. Reg. § 1.417(e)-1(d)(4).

Adding an additional constraint to the rates permitted under Notice 96-8 is contrary to the purpose of the PPA, in which 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. The constraint is arbitrary and unnecessary and should be removed as a market rate of return requirement. Instead, the requirement should be retained as a safe harbor, and the safe harbor should be expanded to include lookback periods that vary from any single day within the current plan year to the average over a period as long as the prior plan year.

If, contrary to ERIC's suggestion, the final regulations retain the requirement that a plan that determines interest credits for a stability period using a lookback month must satisfy the rules for selecting the stability period and lookback month under Treas. Reg. § 1.417(e)-1(d)(4), anti-cutback relief should be granted to allow a plan with an otherwise permissible rate to be amended to comply with these stability period and lookback month requirements. The final regulations should provide clear guidance as to how plan sponsors may take advantage of such anti-cutback relief.

IV. ANTI-CUTBACK RULE AND THE RIGHT TO FUTURE INTEREST CREDITS

The final regulations should be clarified to provide that the right to an interest credit is not a 411(d)(6)-protected benefit and 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.

The final regulations provide that "[t]he right to interest credits in the future that are not conditioned on future service constitutes a section 411(d)(6) protected benefit (as defined in § 1.411(d)-3(g)(14)). Thus, to the extent that benefits have accrued under the terms of a statutory hybrid plan that entitle the participant to future interest credits, an amendment to the plan to change the interest crediting rate must satisfy section 411(d)(6) if the revised rate under any circumstances could result in interest credits that are smaller as of any date after the applicable amendment date (within the meaning of § 1.411(d)-3(g)(4)) than the interest credits that would be provided without regard to the amendment." *See* Treas. Reg. § 1.411(b)(5)-1(e)(3)(i).

The preamble to the final regulations indicates that the above-described provision in the final regulations is at least in part a response to a comment made by ERIC to the 2007 proposed regulations. *See* 75 Fed. Reg. 64,133-134; *Comments of the ERISA Industry Committee – The Proposed Regulations on Hybrid Retirement Plans*, § X.B.1 (April 2008). ERIC commented that the 2007 proposed regulations should be corrected 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. In response, the final regulations provide that the right to interest credits in the future that are not conditioned on future service constitute a section 411(d)(6)-protected benefit. *See* Treas. Reg. § 1.411(b)(5)-1(e)(3)(i); 75 Fed. Reg. 64,134.

Because of the critical importance of this issue, ERIC strongly recommends that the final regulations be clarified to provide that the right to an interest credit is not a 411(d)(6)-protected benefit and 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.

To the extent that section 411(d)(6)-protected benefits have accrued, they are subject to the protection of section 411(d)(6) of the Code and, therefore, cannot be reduced or eliminated. *See* Code § 411(d)(6); Treas. Reg. § 1.411(d)-4, Q&A 1(a). A section 411(d)(6)-protected benefit is any of the following: (i) a participant's accrued benefit (*i.e.*, for a defined benefit plan, the benefit determined under the plan expressed in the form of an annual benefit commencing at normal retirement age); (ii) early retirement benefits and retirement-type subsidies; and (iii) optional forms of benefit. *See* Code § 411(d)(6)(A), (B); Treas. Reg. § 1.411(d)-4, Q&A 1(a); Code § 411(a)(7).

All amendments to the provisions of a plan affecting, directly or indirectly, the computation of accrued benefits (*e.g.*, provisions relating to years of service and compensation) are taken into account for purposes of determining whether a participant's accrued benefit is decreased. *See* Code § 411(d)(6)(A), (B); Treas. Reg. § 1.411(d)-3(a)(2)(i). Although the computational elements of the accrued benefit are considered in determining whether a cutback has occurred, the computational elements are not themselves 411(d)(6)-protected benefits — rather, it is the accrued benefit that is protected. *Id*. Therefore, an amendment reducing a particular computational element violates the anti-cutback rule only if it results in a reduction of a 411(d)(6)-protected benefit. The anti-cutback rule protects a participant's right to payment of a certain benefit; it does not create a right to have that benefit calculated in a particular way.

Interest credits are an element of a hybrid plan's benefit formula. Therefore, interest credits are not themselves a protected benefit. Amending a plan to change the interest crediting rate only violates the anti-cutback rule if, as a result of the amendment, an accrued benefit is decreased. 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 exceeds the prior interest crediting rate for a substantial period before the new rate drops 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.

In order to avoid unnecessary confusion regarding the proper scope and operation of the anti-cutback rule, it is critical that the final regulations clarify that a plan's interest crediting rate is not a stand-alone protected benefit. In particular, the final regulations should be amended to remove the statement "that the right to interest credits in the future that are not conditioned on future service constitutes a section 411(d)(6)-protected benefit (as defined in § 1.411(d)-3(g)(14))." Instead, the role of interest credits in anti-cutback analysis should be reflected by an amendment to Treas. Reg. § 1.411(d)-3(a)(2)(i) providing that for cash balance plans, the interest crediting rate is an example of a plan provision affecting the computation of accrued benefits to be considered in determining whether a cutback has occurred.

Consistent with these clarifications, the final regulations should be amended to provide that changing the interest crediting rate only violates the anti-cutback rule if, as a result of the amendment, an accrued benefit is decreased. Any other view is unsupported by the statute.

V. TRANSITION RELIEF

Due to its critical importance in promoting defined benefit plan coverage, ERIC urges Treasury and IRS in the final regulations to provide clear rules on how to transition existing hybrid plans into compliance with the final rules with the least possible disruption consistent with the PPA. The regulatory mechanisms needed to guide existing hybrid plans into compliance are not currently in place. The following issues are critical and guidance is particularly needed due to the delayed publication of substantive guidance.

Most importantly, plan sponsors need sufficient time to change plan designs, amend plans, and modify plan administration to respond to final rules. Many of the potential changes required by final rules could require redesigning key features of plans, which requires study, review, and employee communications. The final regulations should therefore take effect ***no earlier than the first plan year that begins at least 12 months after the final regulations are issued.***

A. Transition and the Anti-Cutback Rule

1. <u>The final regulations should provide broad anti-cutback relief. Broad anti-cutback relief is consistent with the PPA and is particularly warranted because delayed regulations, rather than actions by plans or plan sponsors, created the need for the relief</u>.

With the PPA, Congress put in place a transition scheme that gave plans until the end of the 2009 plan year to adopt amendments with anti-cutback relief retroactive to the applicable effective dates of the PPA. *See* PPA § 1107. Congress intended to provide broad anti-cutback relief — under the PPA, anti-cutback relief extended to any amendment made "pursuant to" the PPA. *See* PPA § 1107(b)(1)(A). In order to take advantage of the PPA's anti-cutback relief, plans were to operate in accordance with the PPA beginning on the statutory effective date. *See* PPA § 1107(b)(2)(A).

However, final guidance regarding the PPA hybrid provisions, including guidance on the market rate of return provisions, was not published until after the PPA's statutory effective date had passed. As a result, plans were left without the information needed to operate in compliance with the PPA beginning on the statutory effective date and, as a result, were unable to take advantage of the broad anti-cutback relief intended by Congress.

In addition, guidance published following the PPA signaled that the interpretation of the PPA hybrid provisions would not provide a predictable path to compliance for many plans after the effective date (*e.g.*, testing reasonable guaranteed minimum rates of return to see if their presence violated the market rate of return requirement). *See* 72 Fed. Reg. 73,688. This made it difficult for plan sponsors to predict what rules plans would be required to follow and therefore what amendments plan sponsors needed to adopt. Regulations on many of the market rate of return rules had not even been proposed by the deadline for adopting amendments to comply with the PPA. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(d) (Dec. 28, 2007) (reserving the provisions regarding reasonable minimum guaranteed rates of return, equity-based rates, combination of fixed and variable interest rates, and other combinations of rates). Plan sponsors therefore had no clear concept of (i) whether or not their existing interest crediting approach would comply with the PPA, or (ii) the full range of alternatives they would have for compliance.

Through no fault of their own, plan sponsors were left in the difficult position of: (i) not having final guidance regarding how to operate plans in compliance with the PPA until after the PPA statutory effective date and (ii) not knowing which amendments to adopt prior to the PPA amendment deadline. As a result, plan sponsors lost the opportunity to take advantage of the broad anti-cutback relief provided by section 1107 of the PPA. Failure to provide anti-cutback relief as broad as that intended by the PPA would penalize plan sponsors for the government's delay in issuing guidance. ERIC urges Treasury and IRS to provide plans with broad anti-cutback relief consistent with Congress' intent as expressed in the PPA.

2. <u>The final regulations should provide broad anti-cutback relief even taking into consideration the "to the extent necessary" requirement of Treas. Reg. § 1.411(d)-4, A-2(b)(2)(i).</u>

Guidance issued at the end of 2009, as the PPA anti-cutback relief was about to expire, stated that Treasury and IRS anticipated exercising the authority under Treas. Reg. § 1.411(d)-4, A-2(b)(2)(i), which allows the elimination or reduction of a section 411(d)(6)-protected benefit to be treated as necessary due to a change in a statutory requirement (thereby making the cutback permissible) if "the elimination or reduction is made only to the extent necessary to enable the plan to continue to satisfy the requirements for qualified plans" and if it is impossible "through other modifications to the plan . . . to satisfy the applicable qualification requirement." Treas. Reg. § 1.411(d)-4, A-2(b)(2)(i). *See also* Announcement 2009-82; Notice 2009-97, § IV.B.

In the preamble to the proposed regulations, Treasury and IRS reiterate that it is expected that relief from the requirements of section 411(d)(6) of the Code will be granted for a plan amendment that eliminates or reduces a section 411(d)(6)-protected benefit but only if the elimination or reduction is made to the extent necessary to enable the plan to meet the requirements of section 411(b)(5) of the Code. *See* 75 Fed. Reg. 64,208.

Due to the delayed substantive guidance, in particular on issues related to market rate of return, Treasury and IRS should interpret very broadly the types of changes that are made "to the extent necessary" to comply with the law. *See* Treas. Reg. § 1.411(d)-4, A-2(b)(2)(i). Treasury and IRS should deem any change which meets the PPA anti-cutback relief standard (*i.e.*, any amendment made "pursuant to" the PPA), to be made to the extent necessary to enable the plan to meet the qualification requirements. *See* PPA § 1107(b)(1)(A).

Interpreting "to the extent necessary" more narrowly would require a determination of what "to the extent necessary" means, which would create an arbitrary rule as to which amendments qualify for anti-cutback relief. For example, for a plan that has an interest crediting rate that is the greater of a fixed five percent rate and a 30-year Treasury rate, it is not clear what change is "necessary" to comply with the law. The range of possibilities includes a change to a fixed five percent rate, a change to a 30-year Treasury rate, or a change to the greater of a fixed four percent rate and a 30-year Treasury rate. It will be difficult for the regulations to articulate a clear standard that guides plan sponsors in each instance as to what is best for plan participants. Even the preamble to the proposed regulations acknowledges that the question of what "to the extent necessary" means is not easily resolved. 75 Fed. Reg. 64,209. Consequently, the PPA standard for anti-cutback relief should be applied.

Treasury and IRS have the ability to grant the requested broad anti-cutback relief. The exception set forth in Treas. Reg. § 1.411(d)-4, A-2(b)(2)(i) demonstrates that Treasury and IRS may issue exceptions to the anti-cutback rule with respect to changes in the law.

ERIC strongly urges Treasury and IRS to construe any amendment made pursuant to the PPA as being made "to the extent necessary" to satisfy qualification requirements, thereby allowing the amendment to qualify for the broad anti-cutback relief intended by the PPA.

3. <u>The final regulations should provide retroactive anti-cutback relief</u>.

The preamble to the proposed regulations states that it is expected that section 411(d)(6) relief "will be available in the case of an amendment that reduces *the future interest crediting rate* with respect to benefits that have already accrued" from an impermissible rate to a permissible rate. 75 Fed. Reg. 64,208 (emphasis added).

Consistent with one of the PPA's key purposes, which was to provide clarity as to the legality of hybrid plans, anti-cutback relief should be granted so that plans may be amended to comply with the clarified legal landscape provided by the PPA retroactive to the effective date of the PPA. *See* 152 Cong. Rec. S8751 (daily ed. Aug. 3, 2006) (statement of Chairman Enzi). As explained above, plan sponsors did not have the benefit of guidance on much of the substance of the market rate of return rules until very recently. As a result, retroactive anti-cutback relief is vital.

Neither the PPA's purpose nor plan sponsors' ability to comply with the PPA should be frustrated because of Treasury and IRS's delay in publishing guidance. ERIC urges Treasury and IRS to grant retroactive anti-cutback relief in the final regulations.

However, if retroactive anti-cutback relief is granted, ERIC urges Treasury and IRS to refrain from requiring participants to repay amounts that were distributed prior to the regulatory effective date that included interest credits provided in excess of a market rate of return. Requiring repayment in this circumstance would be burdensome for participants and, in some cases, impossible, and would be particularly unjustified due to the fact that retroactive corrections are the result of delayed guidance on the market rate of return. As a result, ERIC urges Treasury and IRS to allow plan sponsors to recharacterize any excess interest credits distributed prior to the regulatory effective date as principal credits, which would allow plan sponsors to avoid having to seek repayment from participants.

B. Pre-Regulatory Effective Date Issues

1. <u>The final regulations should be clarified to provide that a plan may rely on a reasonable interpretation of the statute between the statutory effective date and the regulatory effective date</u>.

The final regulations provide that from the statutory effective date through the regulatory effective date, a plan is permitted to rely on the provisions of the final regulations, the proposed regulations, the 2007 proposed regulations, and Notice 2007-6. *See* Treas. Reg. § 1.411(b)(5)-1(f)(2)(iii); 75 Fed. Reg. 64,134-35.

The final rule should clarify that between the statutory effective date and the regulatory effective date, a plan may also rely on "a standard of reasonable interpretation of the statute," which is the standard that will apply to plan provisions regarding section 411(b)(5) of the Code when submitted for a determination letter after February 1, 2012. *See* Notice 2010-77, § V.

ERIC acknowledges that, following the regulatory effective date, a court would likely defer to Treasury and IRS's interpretation of the PPA hybrid plan provisions, so long as their view was based on a permissible construction of the statute (and assuming that the court found that Congress had not directly addressed the matter in the statute). *See Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). However, prior to the regulatory effective date, the Treasury and IRS interpretation of the statute does not trump other reasonable good faith interpretations. Prior to the regulatory effective date, a plan sponsor should be considered to have been in compliance with the PPA so long as the plan was operated in accordance with a reasonable good faith interpretation of the statute even if, ultimately, following the regulatory effective date, Treasury and IRS choose to apply a different reasonable interpretation of the statute.

ERIC recommends that Treasury and IRS clarify that the standard of reasonable interpretation of the statute applies prior to the regulatory effective date for all purposes. Without this clarification, plan sponsors may be faced with seeking repayment of excess interest credits from participants who received distributions prior to the regulatory effective date, which would be difficult, if not impossible, and burdensome for both participants and plan sponsors.

2. <u>The final regulations should provide that for the period between the statutory effective date and the regulatory effective date, the acceptability of an interest crediting rate will be analyzed based only on the four-year period before the regulatory effective date.</u>

ERIC recommends that the final regulations provide that pre-regulatory effective date compliance be based on whether the rate of return that applied solely from the period of January 1, 2008 through December 31, 2011 (for a calendar year plan) was age discriminatory.

The concern with an above-market rate of return is that the long-term benefit provided to younger employees is not available to older employees. This concern is not present where the interest rate is compounded over a short, fixed period because older and younger employees earn the same amount of interest over the same short, fixed interval of time, such as the four-year period from January 1, 2008 through December 31, 2011, as opposed to the longer, unequal interval of time between employees' current ages and normal retirement age.

Because plan sponsors would reasonably expect to change the rate, if necessary, once the regulations are finalized and, indeed, Treasury and IRS sought to ensure plan sponsors that anti-cutback relief would be provided, *see, e.g.*, Notice 2009-97, § IV.B, the promised interest prior to the regulatory effective date should be evaluated only with respect to the pre-regulatory effective date. More specifically, the interest crediting rate that applied during the period between the statutory effective date and the regulatory effective date should not be considered to be age discriminatory if the aggregate adjustments made to a participant's accrued benefit under the plan (determined as a percentage of the unadjusted accrued benefit) for the relevant period would not be less than the aggregate adjustments for any similarly situated, younger participant. This test would require a comparison, for the relevant period, of the aggregate adjustments for each individual who is or could be a participant in the plan for the relevant period with the aggregate adjustments of each other similarly situated, younger individual who is or could be a participant in the plan for the relevant period.

ERIC recommends that Treasury and IRS apply this test to determine whether the interest crediting rate that applied between the statutory effective date and the regulatory effective date was age discriminatory. Without this test, plan sponsors may be faced with seeking repayment of excess interest credits from participants who received distributions prior to the regulatory effective date, which would be difficult, if not impossible, and burdensome for both participants and plan sponsors.

C. Rate Reasonable When Set Prior to Regulatory Effective Date

<u>The final regulations should provide that if a plan set a fixed rate of return prior to the regulatory effective date which was no greater than the yield on long-term, investment-grade corporate bonds at any time during a reasonable period before the rate first applied under the plan, the rate continues to be not in excess of the market rate of return</u>.

Even if fixed rates set in the future must not exceed 5%, the final regulations should provide that if a plan set a fixed rate of return prior to the regulatory effective date which was no greater than the nominal yield on long-term, investment-grade corporate bonds at any time during a reasonable period before the rate first applied under the plan, the plan's interest crediting rate continues to qualify as a rate not in excess of the market rate of return, even if in some subsequent years the prevailing rate on long-term, investment-grade corporate bonds declines.

The language and history of the PPA—as well as fundamental principles of economics and finance—support the position that a fixed rate should continue to be deemed to be not in excess of the market rate as long as the rate was not in excess of the yield on long-term, investment-grade corporate bonds when set. Congress intended to allow a fixed rate of return 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. Aug. 3, 2006) (colloquy between Chairman Enzi and Chairman Gregg). Neither the PPA nor its legislative history suggest that a rate that is a market rate when set becomes age discriminatory because of subsequent fluctuations in interest rates.

Even if Treasury and IRS find ERIC's position on this issue debatable, ERIC strongly urges Treasury and IRS to refrain from forcing plan sponsors to cut participants' interest credits where such action is not clearly required by the PPA. Although, as commented above, ERIC generally urges Treasury and IRS to grant broad anti-cutback relief to allow existing hybrid plans to transition into compliance with the PPA, ERIC does not advocate for the ability of plan sponsors to cut interest crediting rates that have been promised to participants. Rather, ERIC urges Treasury and IRS to clarify that because such action is not clearly required by the PPA, Treasury and IRS will not force such an action.

ERIC strongly recommends that the final regulations provide that if a plan set a fixed rate of return which was no greater than the yield on long-term, investment-grade corporate bonds at any time during a reasonable period before the rate first applied under the plan, the rate continues to be not in excess of the market rate of return, and, as a result, plan sponsors will not be forced to reduce these rates.

D. ERISA § 204(h) Notice

The final regulations should clarify that the notice requirement of ERISA § 204(h) does not apply to amendments to interest crediting rates on previously accrued benefits which themselves have already accrued as well.

Announcement 2009-82 states that the IRS anticipates providing a special timing rule regarding ERISA § 204(h) notice where plan sponsors amend plans to change interest crediting rates prior to the plan amendment deadline for anti-cutback relief under section 1107 of the PPA. This indicates that Treasury and IRS believe that ERISA § 204(h) notice might be required for PPA amendments that receive anti-cutback relief. The final regulations issued in November 2009 under section 4980F of the Code state that Treasury and IRS anticipate issuing guidance in the near future regarding the application of section 4980F of the Code to plan amendments that are adopted in accordance with section 1107 of the PPA to comply with section 411(b)(5)(B)(i) of the Code relating to market rates of return. *See* 74 Fed. Reg. 61,275 (Nov. 24, 2009).

A notice is required pursuant to ERISA § 204(h) only when a plan is amended to provide for a significant reduction in the rate of future benefit accruals. ERISA § 204(h). The final regulations should clarify that ERISA § 204(h) notice is not required for an amendment that reduces the interest crediting rate that applies to amounts that participants accrued a right to in the past (*i.e.*, where *future* benefit accruals are not the subject of the amendment). For example, a plan that is frozen should not be required to provide ERISA § 204(h) notice if the plan is amended to reduce the interest crediting rate that applies to amounts that participants previously accrued. The plan will, of course, still be required within the applicable time frame to provide notice in a summary of material modifications and ultimately in the summary plan description.

VI. ZERO CUMULATIVE FLOOR AND MULTIPLE ANNUITY STARTING DATES

The final regulations should provide that the rule regarding the application of the zero cumulative floor to multiple annuity starting dates does not apply to a participant who has had a bona fide termination of employment.

The proposed regulations provide a rule as to how the zero cumulative floor of section 411(b)(5)(B)(i)(II) of the Code applies to a participant with multiple annuity starting dates. *See* Prop. Treas. Reg. § 1.411(b)(5)-1(d)(2)(ii). Under the proposed regulations, at each annuity starting date, the plan sponsor is required to compare: (a) the sum of the participant's benefit as of the current annuity starting date, any offset attributable to any prior distribution, and any increase that resulted from the application of the zero cumulative floor, with (b) the sum of all principal credits credited to the participant under the plan. If the sum of all principal credits credited under the plan exceeds the sum of the items listed in part (a) of the prior sentence, the participant's benefit must be increased by an amount equal to the excess. *Id*.

To comply with this rule, plan sponsors are required to keep a record, indefinitely, of the sum of all principal credits credited under the plan for each participant. This requirement is unduly burdensome, particularly because it requires indefinite recordkeeping of a particular element of a participant's benefit (*i.e.,* principal credits), as opposed to a record of the entire benefit. *See, e.g.*, Prop. Reg. § 1.415(b)-2(a)(3) (May 31, 2005) (applying the multiple annuity starting date rule under section 415 of the Code based on annual benefits).

ERIC recommends that Treasury and IRS revise the final regulations to provide that the multiple-annuity-starting-date zero cumulative floor rule does not apply where the participant has experienced a bona fide termination of employment and is later rehired. The statute does not indicate that such a revision to the rule would be inappropriate, and this revision would avoid burdensome recordkeeping that is not required by the statute.

If Treasury and IRS decline to implement this recommendation, ERIC recommends that the multiple-annuity-starting-date zero cumulative floor rule not apply to any participant who has experienced a one-year break-in-service. This revision would both prevent manipulation of the zero cumulative floor and would avoid undue burden on plan sponsors.

VII. BACKLOADING

To apply the 133-1/3% anti-backloading test to a plan that credits interest based on the return on an actual investment or investments, the plan should be required under the final regulations to calculate every year a participant's accrued benefit payable at normal retirement age by projecting future interest using the yield on Treasury securities of appropriate durations.

The proposed regulations would permit a hybrid plan that uses a variable interest crediting rate to project an interest crediting rate of zero for the purposes of satisfying the backloading rules if the plan's interest crediting rate was below zero in the prior plan year. Prop. Treas. Reg. § 1.411(b)-1(b)(2)(ii)(H). Because no market investment has a long-term expected return of zero, ERIC strongly recommends that the final regulations include a more economically sound rate for projection that more fairly approximates the value of future interest credits. As described below, the appropriate rate is the risk-free rate of return. Any variable rate chosen by the plan sponsor is expected to provide at least a nominal long-term cumulative gain regardless of the volatility of the option, and, in general, should be expected to provide a long-term return at least equal to that of the risk-free rate of return.

Current regulations require a plan to hold all factors constant, including interest rates, as of the beginning of the plan year for purposes of satisfying the 133-1/3% backloading test. Treas. Reg. § 1.411(b)-1(b)(2)(ii)(D). If a hybrid plan uses an annual bond yield to determine the interest crediting rate, this rate is typically the bond's yield for the prior plan year. This makes sense. Holding all factors constant eliminates market risk, and, absent market risk, a bond's return is based solely on its yield. Because the risk of default is low, the current rate approximates fairly the value of future interest credits. On the other hand, with respect to investment-based rates of return, the prior year's return would not approximate the expected value when risk is eliminated. Using the risk-free rate of return[3] (approximated by the yield on Treasury securities) more fairly approximates the value of future interest credits and accurately risk adjusts market returns for purposes of the projection.

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[3] ERIC notes that the risk-free rate of return is, in other areas as well, the proper rate to use when projecting investment-based interest crediting rates (*e.g.*, projection for purposes of nondiscrimination testing).

Furthermore, a reasonable projection rule is necessary to enable investment-based plans to provide additional benefits to older and longer-service employees. Many hybrid plan sponsors reward long-tenured employees by providing service-graded pay credits that increase with years of service. Other sponsors attempt to aid older participants who are nearing retirement by providing age-graded pay credits that increase as a participant ages. Still others may use a combination of points based on age and service to increase pay credits with increasing age and/or service. Under the proposed regulations, many of these designs would not be able to satisfy the 133-1/3% test. A plan that utilizes a variable interest crediting rate that can be negative (such as any true variable market rate) and age- or service-graded pay credits cannot satisfy the test unless the plan's highest pay crediting rate does not exceed its lowest pay crediting rate by more than one-third. Certainly, when specifically permitting investment-based plans in the PPA's age-discrimination rules, Congress did not intend to force plans to reduce benefits to older, longer-service employees. Even with graded pay credits, these plans provide retirement benefits that are more front-loaded than traditional final average pay plans.

Even if Treasury and IRS do not accept the recommendation to use the risk-free rate of return for projecting interest credits that are investment-based, there are other, more reasonable alternatives than projecting assuming a zero percent rate of return. For example, a plan sponsor could be permitted to use the same projection rate that is required under Treas. Reg. § 1.430(d)-1(f)(5), which requires a plan's actuary to project account balances forward to the anticipated date of payment based on reasonable actuarial assumptions for funding purposes.

* * * * *

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

Sincerely,

Mark J. Ugoretz
President & CEO
THE ERISA INDUSTRY COMMITTEE

ERIC

The
ERISA
Industry
Committee

Second Comment in a Series of Six Comments on
Proposed and Final Regulations on Hybrid Retirement Plans

PPA ANTI-WHIPSAW RULES

January 12, 2011

EXECUTIVE SUMMARY

Cash balance and pension equity plans cover approximately one out of every four participants in a defined benefit plan in the United States. They also account for roughly 40 percent of the assets held in defined benefit plans nationwide. As a result, these plans provide the primary source of retirement income for a significant number of American workers. As traditional defined benefit plans have become increasingly less attractive, cash balance and pension equity plans have provided a welcome exception to this troubling trend. Congress recognized these facts and, in the Pension Protection Act of 2006 (the "PPA"), adopted comprehensive legislation to encourage employers to adopt and maintain cash balance and pension equity plans. To safeguard the retirement income of the numerous Americans covered by these plans, it is critical that Treasury and IRS draft regulations that reflect Congress' intent to encourage and facilitate the creation and maintenance of cash balance and pension equity plans. The ERISA Industry Committee ("ERIC")[1] stands ready to assist Treasury and IRS in this effort.

Toward that end, ERIC is pleased to present the second in a series of six comments on the proposed and final Treasury regulations implementing the cash balance and pension equity plan provisions of the PPA. This comment focuses on the PPA's anti-whipsaw rules. "Whipsaw" refers to the IRS's prior administrative practice of requiring cash balance plans to pay out lump sums in excess of some participants' account balances if the plans credited interest that exceeded relatively low rates set by the IRS. Because of the peculiarities of the calculation, whipsaw provided much larger lump sums to younger employees than to otherwise similarly situated older employees. Litigation ensued, and the IRS succeeded in convincing the courts that whipsaw was required by federal law. Congress disagreed, and, in the PPA, eliminated it for distributions after August 17, 2006.

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[1] ERIC is a non-profit association committed to the advancement of employee retirement, health, and welfare benefit plans of America's largest employers. ERIC represents exclusively the employee benefits interests of major employers who, collectively, provide comprehensive retirement, healthcare coverage and other economic security benefits directly to tens of millions of active and retired workers and their families in all 50 states. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in the American economy.

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

In a proposed regulation issued last October, Treasury and IRS interpret the PPA as merely providing an exception from whipsaw for plans that meet certain conditions spelled out in the regulation but not the statute. Among these conditions, the proposed regulation would bar cash balance and pension equity plans from subsidizing annuities and other distributions to participants. This comment explains how the proposed regulation fundamentally misconstrues the PPA's anti-whipsaw rules, and that current law already permits (and regulates) the maximum amount of subsidy that may be offered in any distribution from a defined benefit plan, including a cash balance or pension equity plan.

INTRODUCTION

ERIC is pleased to submit the second in a series of six comments on the proposed and final regulations issued by the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS" or "Service") under Title VII and section 1107 of the Pension Protection Act of 2006 ("PPA"), as amended by the Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA"). The regulations apply for purposes of sections 411(a)(13), 411(b)(1)(B), 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 regulations were published in the Federal Register on October 19, 2010. *See* 75 Fed. Reg. 64,123 (final regulations); 75 Fed Reg. 64,197 (proposed regulations). Corrections to the regulations were published in the Federal Register on December 28, 2010. *See* 75 Fed. Reg. 81,456 (final regulations); 75 Fed. Reg. 81,543 (proposed regulations).

ERIC recognizes that the 2010 proposed and final regulations revised and clarified the 2007 proposed regulations in helpful ways and appreciates the consideration that Treasury and IRS have given to ERIC's earlier comments on the 2007 proposed regulations. In particular, ERIC appreciates the explicit recognition in the 2010 proposed regulations that section 411(a)(13)(A) applies to all forms of distribution from a hybrid plan and not just distributions in the form of a lump sum. ERIC offers the following comments to address remaining concerns about the regulations' implementation of the anti-whipsaw provisions of section 411(a)(13)(A). ERIC is submitting five additional separate comments on other aspects of the regulations.

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

I. THE PPA ELIMINATED WHIPSAW

The final regulations should clarify that section 411(a)(13)(A) rejected Notice 96-8 and eliminated whipsaw for hybrid plan distributions after August 17, 2006. Congress was deeply troubled by the effects of whipsaw and sought to eliminate any requirement to apply whipsaw in the future through the adoption of section 411(a)(13)(A) and its ERISA counterpart. Revising the regulations to make clear that no whipsaw calculations will be required in the future will accomplish one of the principal goals of Title VII of the PPA. This recommendation would also bring the regulations into accord with the plain language of section 411(a)(13)(A).

Contrary to Congressional intent and the PPA's statutory mandate, the proposed regulations suggest that section 411(a)(13)(A) provides for a mere exception from the whipsaw calculation described in Notice 96-8, rather than its complete elimination.[2] Section 411(a)(13)(A), added by the PPA, abolishes whipsaw effective for distributions made after August 17, 2006. PPA § 701(e)(2). Under the provision, a plan does not violate section 411(a)(2), 411(a)(11), 411(c), or 417(e), solely because, under the terms of the plan, the present value of the accrued benefit is equal to the balance of a hypothetical account (the "account balance") or an accumulated percentage of final average compensation (a "PEP accumulation"). The intent of this provision was to reject Notice 96-8 and to eliminate any requirement for whipsaw in future distributions. *See* 152 Cong. Rec. S8747, 8751-52 (Aug. 3, 2006) (statement of Senator Enzi) ("The hybrid language also corrects the so-called pension whipsaw for distributions after the date of enactment. The parties to the pension discussions took the view that the position taken by the IRS in Notice 96-8 was an incorrect interpretation of present law.").

In enacting the PPA, Congress intended to relieve hybrid plans from Notice 96-8 and federal case law following it, which required cash balance plans to pay out lump sums in excess of some participants' account balances if the plan credited interest in excess of the relatively low rates proposed by the IRS in Notice 96-8. Because of the peculiarities of the calculation, whipsaw provided much larger lump sums to younger employees than to otherwise similarly situated older employees. As a result, participants who deferred receipt of their benefit until normal retirement age often received a smaller lump sum than if they had elected to receive it earlier. *See* 152 Cong. Rec. S8747, S8751-52 (Aug. 3, 2006). The House Ways and Means Committee, in its report on H.R. 2830,[3] characterized whipsaw as an "undue restriction" that "provides a larger benefit for a participant who takes a distribution before normal retirement age" and "penalizes employees who wait for their benefits until retirement, which is a perverse result for a retirement plan." H.R. REP. NO. 109-232, pt. II, at 126-27 (2005).

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[2] *See* 75 Fed. Reg. 64,201 ("the proposed regulations would provide that the relief of section 411(a)(13)(A) does not apply with respect to benefits determined under a lump-sum based formula unless certain requirements are satisfied."). Although the proposed regulations are not clear on what happens if the "certain requirements" are not satisfied, the description of Notice 96-8 in the preamble at 75 Fed. Reg. 64,200 suggests that Treasury and IRS view Notice 96-8 as surviving the enactment of section 411(a)(13)(A) and continuing to apply with full force absent the limited relief they perceive as provided in section 411(a)(13)(A).

[3] Rep. John Boehner introduced H.R. 2830 on June 9, 2005. The bill was referred to the Education and Workforce Committee, which reported the bill, as amended, on September 22, 2005. H.R. REP. NO. 109-232, pt. I (2005). The bill was also referred to the Ways and Means Committee, which reported the bill, as amended, on December 6, 2005. H.R. REP. NO. 109-232, pt. II (2005). On December 14, 2005, the Rules Committee adopted a manager's amendment to H.R. 2830 in the nature of a substitute and reported the bill. H.R. REP. NO. 109-346 (2005). On December 15, 2005, the House passed the bill.

On March 3, 2006, the Senate called up H.R. 2830 and adopted, as an amendment in the nature of a substitute, the text of S. 1783, the Pension Security and Transparency Act of 2005, which Senator Grassley had introduced on September 28, 2005. The Senate and House versions of H.R. 2830 then went to conference, but the conferees were unable to reach agreement on all aspects of the bill and thus did not issue a report. Thereafter, on July 26, 2006, Rep. Boehner replaced the text of H.R. 4 (a pending welfare bill) with text reflecting those aspects of the Senate and House versions of H.R. 2830 on which the conferees had been able to agree. *See* 152 Cong. Rec. S8747, 8747-48 (Aug. 3, 2006) (statement of Senator Enzi) (H.R. 4 "is nearly identical to the product and agreements made by members of the conference committee in a bipartisan manner."). H.R. 4 was then enacted without further hearings or amendment.

Senator Michael Enzi, then-Chairman of the Senate Health, Education, Labor, and Pensions Committee, and of the Conference Committee on H.R. 2830, and a floor manager of H.R. 4, described the anti-whipsaw provision in H.R. 4 as a "clarification of the law" which was necessary because "the position taken by the IRS in Notice 96-8 was an incorrect interpretation of present law." *See* 152 Cong. Rec. S8747, 8751-52 (Aug. 3, 2006). Senator Enzi agreed with the House Ways and Means Committee's view, stating that "the approach taken in Notice 96-8 can actually harm many participants. In addition to its other flaws . . . Notice 96-8 would penalize an employee who waits to take a distribution. This is a perverse result for a rule governing retirement plans." *Id*. The only plausible inference from the Congressional legislative record is that section 411(a)(13)(A) was intended to overrule Notice 96-8 and abolish whipsaw from all future distributions from hybrid plans.

The language of section 411(a)(13)(A) accomplishes Congress's stated intent to reject Notice 96-8. The section states unequivocally that an applicable defined benefit plan does not fail to meet the requirements of sections 411(a)(2), 411(a)(11), 411(c), and 417(e), solely because the present value of the accrued benefit (or any portion of the accrued benefit) of any participant is, under the terms of the plan, equal to the amount expressed as an account balance or PEP accumulation. The language in section 411(a)(13)(A) eliminates whipsaw, with no strings attached and no conditions, other than that the plan be an "applicable defined benefit plan." The "requirements" alluded to in the preamble to the proposed regulations and included in Prop. Reg. § 1.411(a)(13)-1(b) are not found in the statute, and there is no basis in the statute for Treasury and IRS to create such requirements out of whole cloth by regulatory fiat.

Notice 96-8 and the whipsaw approach described therein also should no longer apply because the PPA sets forth a carefully constructed and comprehensive regulatory framework for interest crediting in hybrid plans. Notice 96-8 set forth a method for cash balance plans to satisfy the Code's anti-forfeiture and present value requirements when making lump sum distributions. Notice 96-8, §§ III & IV. The main byproduct of the whipsaw requirement was to regulate the interest crediting rates offered under cash balance plans. The proposed safe harbor in section IV of Notice 96-8 provided an incentive to plan sponsors to limit the interest crediting rate to no more than the rate that was applicable under section 417(e) at that time. If a plan limited its interest crediting rate in this manner, the whipsaw requirement was avoided.

Section 411(a)(13)(A) provides a new, simple, and unambiguous method for satisfying sections 411(a)(2), 411(a)(11), 411(c), and 417(e). Lumps sums and other distributions at least equal in value to the current account balance or PEP accumulation on the date of distribution will satisfy the anti-forfeiture and present value requirements of the Code and ERISA. Because of the PPA's anti-whipsaw provisions, there is no further need to look to Notice 96-8 to provide guidance on distributions from hybrid plans. Furthermore, plans are no longer limited to crediting interest at the rate applicable under section 417(e). Instead, they may credit interest up to a market rate of return. Interest crediting rates that are too high are now regulated under the PPA's age discrimination rules. *See* Code § 411(b)(5)(B)(i)(I). As a result, the sanction for an excessive interest rate under the PPA is an age discrimination remedy, not whipsaw. While the parameters of the age discrimination remedy are not laid out in the statute, they most assuredly do not involve paying out larger lump sums to younger employees than to otherwise similarly situated older employees, as was the case with whipsaw under Notice 96-8. Congress found whipsaw offensive and unambiguously rejected it as a remedy for excessive interest rates. Treasury and IRS should revise the proposed regulations accordingly.

II. ESTABLISHING A REASONABLE RELATIONSHIP BETWEEN THE ACCOUNT BALANCE AND BENEFIT DISTRIBUTION AMOUNTS

<u>The final regulations should be revised to clarify how benefit amounts are calculated under applicable defined benefit plans. Specifically, the final regulations should state that all optional forms of benefit must be no less than (rather than equal to) the actuarial equivalent of the then-current account balance or PEP accumulation. Revising the final regulations in this manner will permit hybrid plans to provide optional forms of benefit with time-based and form-based subsidies and will accurately reflect the intent of section 411(a)(13)(A).</u>

The proposed regulations seek to regulate the relationship between the account balance (or PEP accumulation) and benefit amounts paid to participants. Prop. Reg. § 1.411(a)(13)-1(b)(2) & (b)(3). ERIC agrees in principle with Treasury and IRS that this relationship should be regulated; however, present law already does so and provides different, and more generous, limits than the proposed regulations would apply. Consequently, the final regulations should clarify the present law limits on subsidies in defined benefit plan distributions as applied to hybrid plans, and not create new regulatory requirements that are inconsistent with those limits.

A. Concerns about the Approach in the Proposed Regulations

As a condition of whipsaw "relief," the proposed regulations require that a participant's account balance or PEP accumulation may be reduced in only limited circumstances. *See* Prop. Reg. § 1.411(a)(13)-1(b)(2)(iv); *see also* Part III, *infra*. One of these limited reduction requirements is that benefits must be paid from the plan in accordance with the rules in Prop. Reg. § 1.411(a)(13)-1(b)(3). *See* Prop. Reg. § 1.411(a)(13)-1(b)(2)(iv)(A). Under these rules, a hybrid plan is permitted to either pay benefits in the form of a lump sum equal to the then-current account balance or PEP accumulation, or in the form of an annuity that is, directly or indirectly, the actuarial equivalent, calculated using reasonable actuarial assumptions, of the then-current account balance or PEP accumulation. Prop. Reg. § 1.411(a)(13)-1(b)(3)(i) through (b)(3)(iii). Thus, the proposed regulations would, as a condition of whipsaw relief, prevent the payment of an annuity with an actuarial present value greater than the then-current account balance or PEP accumulation. This rule would prevent hybrid plans from providing subsidized annuity forms to participants, when present law permits defined benefit plans to provide such subsidies. *See, e.g.,* Treas. Reg. § 1.411(d)-3(g)(6)(iv) (early retirement and QJSA subsidies); Treas. Reg. § 1.401(a)-20, Q&A 36, 37, 38 (fully subsidized QJSAs).

ERIC believes that this approach is unnecessary, and that Treasury and IRS can use existing law to ensure that there is a reasonable relationship between the account balance (or PEP accumulation) and the amount of any distribution made under the plan. Accordingly, ERIC recommends that the final regulations be revised to clarify that all forms of benefit payable under a hybrid plan be no less than the actuarial equivalent, calculated using reasonable actuarial assumptions, of the then-current account balance or PEP accumulation.

B. Current Law Adequately Regulates the Relationship between an Account Balance or PEP Accumulation and Annuities

The Treasury and IRS are right to be concerned about the actuarial relationship between annuities available under a hybrid plan and the plan's account balance or PEP accumulation.

However, the approach in the proposed regulation misinterprets existing law, which clearly permits a defined benefit plan to subsidize annuity forms of benefits without subsidizing the lump sums available under the plan. *See* Treas. Reg. § 1.411(a)-11(a)(2). Furthermore, current law provides appropriate limits on the amount of subsidy permitted in any particular optional form of benefit. Thus, current law provides all of the protections necessary to regulate account balances, PEP accumulations, and forms of distribution, without conditioning whipsaw "relief" on compliance with rules like those in Prop. Reg. § 1.411(a)(13)-1(b)(3). Accordingly, the final regulations should be revised to eliminate the requirement that optional forms be equal to the actuarial equivalent of the account balance or PEP accumulation (directly or indirectly). In addition, ERIC suggests that it would be useful for the final regulations to clearly explain how the other rules in the Code and regulations regulate hybrid plans and distribution amounts.

Accordingly, ERIC recommends that the regulations under section 411(a)(13)(A) and section 411(a)(13)(C) be clarified to affirmatively provide the following:

- As of a participant's normal retirement age, the periodic amount of the single life annuity payable at normal retirement age is equal to the actuarial equivalent of the account balance or PEP accumulation on that date, calculated using reasonable actuarial assumptions. Code § 411(a)(13).

- All optional forms of benefit must be "at least" the actuarial equivalent, calculated using reasonable actuarial assumptions, of the then-current account balance or PEP accumulation. Code § 411(a)(13).

- The periodic amount payable under a single life annuity commencing before normal retirement age may not exceed the periodic amount of the single life annuity the participant would receive if he or she deferred commencement until normal retirement age. Code § 411(a)(9).

- The periodic amount of the joint portion of the QJSA may not exceed the periodic amount of the single life annuity commencing at the same age. Code § 417(a)(5)(B) & (b); Treas. Reg. § 1.401(a)-20, Q&A-16 & -38(a)(2) Ex. 2.

- The periodic amount of the survivor portion of the QJSA may not exceed the periodic amount of the joint portion of the QJSA. Code §§ 401(a)(9), 417(b)(1).

- No other optional form of benefit may exceed the actuarial equivalent, calculated using reasonable actuarial assumptions, of the QJSA commencing at the same age. Treas. Reg. § 1.401(a)-20, Q&A-16.

Section 411(a)(13)(A) states that an applicable defined benefit plan does not fail to satisfy the requirements of sections 411(a)(2), 411(a)(11), 411(c), and 417(e), solely because the present value of the accrued benefit (or any portion thereof) of any participant is, under the terms of the plan, equal to the account balance or PEP accumulation. Section 411(a)(13)(C)(i) defines an "applicable defined benefit plan" as a "defined benefit plan under which the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of the participant's final average compensation."

If the present value of the accrued benefit is equal to the account balance or PEP accumulation, then it follows that, at normal retirement age, the account balance or PEP accumulation must be the actuarial equivalent, calculated using reasonable actuarial assumptions, of the single life annuity commencing at that age. It also follows that no optional form of benefit commencing at any age may be less than the actuarial equivalent of the account balance on the date the option is scheduled to commence (*i.e.,* the annuity starting date with respect to that option).

This is partially reflected in Prop. Reg. § 1.411(a)(13)-1(b)(3)(ii), which provides that optional forms of benefit must be the actuarial equivalent, calculated using reasonable actuarial assumptions, of the then-current account balance or PEP accumulation. Similarly, Prop. Reg. § 1.411(a)(13)-1(b)(3)(iii), provides an alternative rule for optional forms of benefit not subject to section 417(e) in plans that express the immediate annuity as the actuarial equivalent of another annuity. This rule requires that the optional form be the actuarial equivalent of the accrued benefit as of the annuity starting date, which is in turn the actuarial equivalent of the then-current account balance, all calculated using reasonable actuarial assumptions. Prop. Reg. § 1.411(a)(13)-1(b)(3)(iii). Essentially, the proposed regulations establish an identical "floor" and "ceiling" for all distributions under a hybrid plan. ERIC agrees with the level of the floor; however, we disagree with the proposed ceiling, which is lower than the law permits.

The Code and ERISA permit defined benefit plans to provide subsidized annuities in excess of the actuarial equivalent of the accrued benefit, subject to a ceiling imposed by various statutory and regulatory constraints. *See* Treas. Reg. § 1.411(d)-3(g)(6)(iv) (early retirement and QJSA subsidies); Treas. Reg. § 1.401(a)-20, Q&A 36, 37, 38 (fully subsidized QJSAs) ; *see also* Code § 401(a)(9) (distributions must be made at least as rapidly as the required minimum distributions and MDIB rules require); Code § 411(a)(9) (periodic amount of early retirement annuity cannot exceed periodic amount of normal retirement annuity); Treas. Reg. § 1.401(a)-20 Q&A-16 (no form of benefit may be more valuable than the QJSA). These subsidies may be related to both time and form of payment. *Id*.

A time-based subsidy (or "early retirement subsidy") is a subsidy that provides participants with a larger periodic amount than would otherwise be paid to the participant if a full actuarial reduction were taken to reflect commencement before normal retirement age. Treas. Reg. § 1.411(d)-3(g)(6)(v). Early retirement subsidies are expressly permitted by the Code and are protected from cutback under section 411(d)(6). Treas. Reg. § 1.411(d)-3(b)(1). More importantly, the regulations under section 411(a)(11) and 417(e) expressly permit defined benefit plans to include subsidies in early retirement annuities even though those subsidies are not available if the participant elects a lump sum form of payment. *See* Treas. Reg. § 1.411(a)-11(a)(2) (subsidies may, but are not required to be, included in the value of a single sum distribution); Treas. Reg. § 1.417(e)-1(d)(1) (the present value of any optional form of benefit (including a lump sum) cannot be less than the present value of the normal retirement benefit). Under a defined benefit plan, then, including a hybrid plan, the maximum possible time-based subsidy would be an unreduced annuity that pays participants the same periodic amount they would receive if they deferred commencing distributions until normal retirement age. The subsidy could not be any greater, because section 411(a)(9) prevents the periodic amount of the early retirement benefit from exceeding the periodic amount of the normal retirement benefit.

Defined benefit plans are also permitted to subsidize the qualified joint and survivor annuity. Treas. Reg. § 1.411(d)-3(g)(6)(iv) ("retirement-type subsidy" includes that in a subsidized QJSA). The largest subsidized QJSA permitted under current law would pay participants the same periodic amount they would receive under the single life annuity commencing at the same age, plus a survivor benefit equal to 100% of the periodic amount payable to the participant (subject to the requirements of section 401(a)(9), which act as an additional cap on form-based subsidies).

Form-based subsidies are also permitted in forms of distribution other than single life annuities and QJSA's, subject to the requirement that the QJSA be the most valuable form of benefit (and any other restrictions that apply under section 401(a)(9)). *See* Treas. Reg. § 1.401(a)-20 Q&A-16; Treas. Reg. § 1.417(e)-1(d)(1).

The statutory and regulatory limits on subsidies apply equally to traditional and hybrid defined benefit plans. These limits operate to produce a reasonable relationship between the value of the plan's accrued benefit and the benefit amounts payable to participants under the plan commencing at any time and in any form of distribution. Accordingly, there is no need to condition whipsaw relief on new rules that go farther than required under the rules outlined above, which provide the following:

- The life expectancy and MDIB requirements under section 401(a)(9) limit a subsidized survivor death benefit to an absolute maximum of 100% of the participant's periodic benefit amount.

- Section 411(a)(9) limits the periodic amount of a subsidized early retirement benefit to the periodic amount the participant would receive if he deferred commencement until normal retirement age. In a hybrid plan, this means that the plan would determine the cap on the early retirement subsidy by projecting the participant's account balance or PEP accumulation forward to normal retirement age at a rate that fairly reflects the value of future interest credits.[4] The projected amount would be converted into a single life annuity, which would act as the ceiling for the periodic amount of a single life annuity at the earlier age. However, if the participant defers commencement until normal retirement age, the participant's section 411(a)(9) benefit at normal retirement age would be the actuarial equivalent of the account balance or PEP accumulation at normal retirement age, and not the projected single life annuity calculated at an earlier age for purposes of determining a subsidy limit. In other words, there is no need to increase a participant's single life annuity at normal retirement age to reflect a projection from an earlier age that turned out to be inaccurate. If this were not the case, it would be impossible to satisfy section 411(a)(13)(A), because the accrued benefit would not be the actuarial equivalent of the account balance or PEP accumulation at normal retirement age.

- The "most valuable" requirement applicable to the QJSA under Treas. Reg. § 1.401(a)-20 prevents any optional form of benefit, including the single life annuity, from exceeding the

[4] In hybrid plans that use a fixed interest crediting rate, the account balance would be projected using the fixed rate. In hybrid plans that use variable rates based on actual investment returns, the appropriate projection rate is the risk-free rate in effect on the date of the projection. If a hybrid plan uses a variable rate based on bond yields, the appropriate projection rate is the current bond yield on the date of projection (or an average of the yields over the recent past).

actuarial equivalent of the qualified joint and survivor annuity. This limitation, coupled with the section 411(a)(9) limitation, limits the periodic amount of the QJSA to the periodic amount of the participant's single life annuity commencing at the same age.

- A lump sum equal to the account balance or PEP accumulation would also be permitted, because lump sums are not required to include subsidies. *See* Treas. Reg. § 1.411(a)-11(a)(2) (subsidies may, but are not required to be, included in the value of a single sum distribution); Treas. Reg. § 1.417(e)-1(d)(1) (lump sum must not be less than present value of accrued benefit; no requirement that subsidies be included).

ERIC's proposal also addresses any Treasury or IRS concern that the account balance or PEP accumulation could be artificially depressed and still satisfy section 411(a)(13). If a plan provided for an account balance that accrued at an artificially depressed rate with a high interest credit at or near normal retirement age, the interest credit would violate the market rate of return rules under section 411(b)(5). In addition, the backloading rules would prevent a plan from providing for an artificially high pay credit at or near normal retirement age.

ERIC urges Treasury and IRS to revise the final regulations to eliminate the requirement that an optional form of benefit always be the direct (or indirect) actuarial equivalent of the then-current account balance or PEP accumulation. Present law provides adequate constraints on subsidized benefits, and there is no statutory or regulatory basis for preventing hybrid plans from paying subsidized benefits, even if the lump sum does not include any subsidies. Indeed, subsidized benefits encourage employees to elect lifetime income payments, which eliminate the longevity risk associated with taking a lump sum distribution, and provide true retirement income for participants. This change, along with ERIC's other recommended clarifications, will guarantee a reasonable relationship between the account balance or PEP accumulation and any subsidized form of distribution.

III. NO STATUTORY CONDITIONS ON THE ELIMINATION OF WHIPSAW

Notwithstanding ERIC's position that the PPA unequivocally rejected whipsaw from future hybrid distributions, ERIC objects to the specific conditions the proposed regulations would impose on the statutory abrogation of whipsaw. The conditions are not found in the statute, exceed the Treasury's regulatory authority under the statute, and place hybrid plans in an inferior position relative to traditional plans. Revising the regulations to eliminate or limit conditions on the statutory abrogation of whipsaw would more closely follow the PPA's plain language, satisfy congressional intent, and place hybrid plans on an equal footing with traditional plans.

Section 411(a)(13)(A) of the Code requires only that a hybrid plan be an "applicable defined benefit plan" in order to be free from whipsaw. The conditions in Prop. Reg. § 1.411(a)(13)-1(b)(2)-(b)(4) are not found in the statute and exceed Treasury's regulatory mandate under section 701(d) of the PPA. The conditions attempt to regulate the relationship between the account balance or PEP accumulation and the accrued benefit under section 411(a)(7) by threatening whipsaw as a consequence of failing to satisfy various sections of the Code; however, these requirements have their own penalties for noncompliance that are unrelated to whipsaw. It is unreasonable to argue that Congress intended the violation of other Code provisions to trigger whipsaw under Notice 96-8 when its clear intent was to overturn Notice 96-8 and eliminate whipsaw. Accordingly, using whipsaw as a penalty for failing to comply with a section of the Code other than section 411(a)(13)(A) directly contradicts the language, structure, and intent of the statute. The conditions should be removed, or at least limited, in the final regulations.

A. Accrued Benefit on and before Normal Retirement Age

The proposed regulations state that a hybrid plan receives "relief" under section 411(a)(13)(A) only if at all times on or before normal retirement age, the then-current value of the account balance, or the PEP accumulation, is not less than the present value of the portion of the participant's accrued benefit (*i.e.,* an annual benefit for the participant's lifetime commencing at normal retirement age) attributable to the lump sum based formula, using reasonable actuarial assumptions. Prop. Reg. § 1.411(a)(13)-1(b)(2). As an alternative, the regulations deem the requirement satisfied so long as the account balance or PEP accumulation is, at normal retirement age, the actuarial equivalent of the accrued benefit. Prop. Reg. § 1.411(a)(13)-1(b)(2).

Treasury's approach under the default rule requires plans to: (i) project the account balance (or PEP accumulation) forward to normal retirement age using the plan's interest crediting rate, (ii) convert the projected account balance into an annual benefit for the participant's lifetime commencing at normal retirement age (a "single life annuity"), and (iii) calculate an actuarial present value of the single life annuity, using reasonable actuarial assumptions. Under the proposed regulations, the plan would receive whipsaw "relief" only if the actuarial present value is equal to or greater than the account balance or PEP accumulation. Prop. Reg. § 1.411(a)(13)-1(b)(2).

The statute does not require this convoluted, multi-step calculation in order to satisfy section 411(a)(13)(A). Instead, section 411(a)(13)(A) states that a plan does not violate the anti-forfeiture and present value requirements solely because the present value of the accrued benefit (or any portion thereof) of any participant is, under the terms of the plan, *equal to* the account balance or PEP accumulation. (emphasis added). Section 411(a)(13) does not say "the actuarial equivalent of", but instead uses the phrase "equal to," which indicates that section 411(a)(13) is not intended to create a testing requirement with respect to the "accrued benefit" under section 411(a)(7), but is instead designed to allow plans to define the present value of the accrued benefit as an account balance or PEP accumulation. *See* 152 Cong. Rec. S8747, 8751-52 (Aug. 3, 2006) (statement of Senator Enzi) ("it is important to clarify that Congress does not intend to require a plan document to include a specific definition of the term "accrued benefit" to apply the standard set forth in this legislation"). An "actuarial equivalence at all times" standard is clearly not contemplated by the statute. Accordingly, Treasury should eliminate the actuarial equivalence requirement from the final regulations.

B. Accrued Benefit after Normal Retirement Age

The proposed regulations state that for each annuity starting date after the participant reaches normal retirement age, the then-current account balance or PEP accumulation must satisfy section 411(a)(2), or would satisfy section 411(a)(2) but for a permitted forfeiture under section 411(a)(3)(B). Prop. Reg. § 1.411(a)(13)-1(b)(2)(iii). The preamble elaborates on the requirement by stating that a plan might not satisfy the proposed regulations if the plan does not provide that a participant receives the "greater of" continued interest credits (and pay credits, if applicable) or actuarial adjustments to reflect any delay in commencement. *See* 75 Fed. Reg. 64,201. If the plan fails to meet the requirement in Prop. Reg. § 1.411(a)(13)-1(b)(2)(iii), the plan would ostensibly be subject to whipsaw.

Similarly to the proposed regulations' other conditions on the statutory abrogation of whipsaw, this condition is not reflected in section 411(a)(13)(A). Treasury and IRS have no statutory basis for conditioning application of section 411(a)(13)(A) on providing participants who have reached normal retirement age (and whose benefits have not been suspended under section 411(a)(3)(B)) with the greater of an actuarial increase or continued benefit accruals and interest credits. In addition, Congress gave no indication that it intended for whipsaw to result if a hybrid plan fails to satisfy section 411(a)(2). The final regulations should clarify that providing the greater of an actuarial adjustment or continued interest credits is not a condition for whipsaw relief under section 411(a)(13), but is instead a condition of satisfying section 411(a)(2).

If the regulations are not revised to adopt either of ERIC's recommendations, the final regulations should at least provide a safe harbor interest crediting rate that would automatically satisfy the actuarial increase requirement under section 411(a)(2). The proposed regulations provide no guidance on how a plan could meet the requirement without conducting a "greater of" calculation.

C. Reductions

The proposed regulations condition whipsaw "relief" on a requirement that plans permit reductions to the account balance or PEP accumulation only in limited circumstances. Prop. Reg. § 1.411(a)(13)-1(b)(2)(iv). Specifically, a reduction may only occur: (i) by paying benefits in accordance with Prop. Reg. § 1.411(a)(13)-1(b)(3), (ii) pursuant to a qualified domestic relations order ("QDRO"), (iii) pursuant to a permitted forfeiture under Section 411(a), (iv) in connection with a permitted reduction under section 411(d)(6) of the Code, and (v) in connection with negative interest credits under Prop. Reg. § 1.411(b)(5)-1. Prop. Reg. § 1.411(a)(13)-1(b)(2)(iv).

The statute does not provide for any of these limitations as a condition of satisfying section 411(a)(13)(A). The payment of benefits restriction is discussed in more detail at Part II, above; however, the statute is clear that section 411(a)(13)(A) is not conditioned on how a plan pays benefits. The qualified domestic relations order condition is inappropriate because plans are already required to comply with section 414(p) and to reduce a participant's benefit only to the extent required by the QDRO. Violation of section 414(p) carries its own consequences, none of which are (or should be) related to the present value of the accrued benefit in a hybrid plan. Congress did not condition its abrogation of whipsaw on complying with unrelated sections of the Code, and neither should the Treasury or the IRS. If it was not Treasury's intent to condition the application of section 411(a)(13)(A) on compliance with section 414(p), the regulations should be revised to reflect that.

The same logic applies to the reduction conditions as they relate to permitted forfeitures under section 411(a) and permitted cutbacks under section 411(d)(6). All qualified plans are already under an obligation to comply with these sections of the Code in every respect. Threatening whipsaw for failure to comply with these sections is unwarranted and not permitted under the PPA. The conditions should be removed in the final regulations. However, if it was not Treasury's intent to condition the application of section 411(a)(13) on compliance with these sections, the regulations could simply be revised to reflect that.

The only condition in Prop. Reg. 1.411(a)(13-1(b)(2)(iv) that is arguably related to section 411(a)(13) is the ability to reduce accruals to reflect negative interest credits under Prop. Reg. § 1.411(b)(5)-1. However, the same argument applies here. The statute does not condition its abrogation of whipsaw on restricting reductions to the account balance or PEP accumulation. Hybrid plans will otherwise be required to comply with Prop. Reg. § 1.411(b)(5)-1 as a condition of satisfying the age discrimination rules, so there is no valid concern that a plan could institute negative interest credits and somehow escape the application of Prop. Reg. § 1.411(b)(5)-1. It is unnecessary and unwarranted to add whipsaw as a punishment for failing to satisfy another section of the Code that has its own enforcement mechanism. As with the other conditions, this reduction limitation should be removed in the final regulations.

IV. TRANSITION RULES

A. Amendments to Eliminate Whipsaw Provisions

In the preamble to the proposed regulations, Treasury and IRS have indicated that the relief under section 411(d)(6) of the Code that will be granted under the proposed regulations will not extend to amendments related to section 411(a)(13)(A). 75 Fed. Reg. 64,208. Treasury and IRS should extend section 411(d)(6) relief for this purpose, because Treasury's and IRS's delay in promulgating regulations created an uncertain environment that made it impossible for hybrid plan sponsors to amend their plans to eliminate provisions requiring whipsaw calculations or to adopt any of the other amendments that might be required under the final regulations under section 411(a)(13)(A).

Section 1107 of the PPA provides that an amendment to a hybrid plan that is made pursuant to the PPA does not violate section 411(d)(6) of the Code, so long as the amendment is adopted by the last day of the first plan year beginning on or after January 1, 2009. PPA § 1107(b)(1). This relief extended to amendments eliminating whipsaw calculations under section 411(a)(13)(A); however, the relief expired at the end of the 2009 plan year, before the Treasury and the IRS issued the current proposed regulations under section 411(a)(13)(A). In Announcement 2009-82 and Notice 2009-97, the IRS indicated that it intended to extend section 411(d)(6) relief for certain purposes, but explicitly mentioned that it would not extend relief for amendments eliminating whipsaw. Notice 2009-97 § II. The Treasury and the IRS reiterated this intent to provide limited anti-cutback relief in the preamble to the proposed regulations, stating that relief from section 411(d)(6) would be granted "only to the extent necessary to enable the plan to meet the requirements of section 411(b)(5)." 75 Fed. Reg. 64,208.

Limiting the extension of section 411(d)(6) relief in this fashion is unreasonable for several reasons, which are in large part connected to Treasury's and IRS's delay in issuing definitive guidance on hybrid plans. The PPA was enacted in 2006, and Treasury and IRS have taken over four years to issue these proposed regulations. Because of this delay, hybrid plan sponsors could not timely amend their plans to eliminate whipsaw with any certainty that the amendments would pass regulatory muster. Accordingly, Treasury and IRS should revise the proposed regulations to grant section 411(d)(6) relief to hybrid plans that wish to eliminate whipsaw calculations, on the same terms and subject to the same deadlines that apply for purposes of amendments to comply with section 411(b)(5).

B. Amendments to Eliminate Subsidized Annuities

In the event that Treasury and IRS choose to prohibit hybrid plans from offering subsidized annuities as a condition of satisfying section 411(a)(13), ERIC requests that limited anti-cutback relief under section 411(d)(6) be included in the final regulations for amendments that eliminate subsidized annuity forms of payment to the extent necessary to satisfy the final regulations. Most hybrid plans offer time- or form-based subsidies, and have done so for many years without any indication that these subsidies would be prohibited by regulation. Neither the plain language of section 411(a)(13) or the guidance issued previously by Treasury and IRS after the enactment of the PPA suggested that subsidized annuities would be prohibited as a condition of eliminating whipsaw. If Treasury and IRS had warned hybrid plans that they were considering this action, sponsors could have amended their plans by the end of the statutory relief period provided under section 1107 of the PPA. However, sponsors were not afforded this opportunity. Accordingly, Treasury should provide anti-cutback relief if our recommendation that hybrid plans be permitted to continue offering subsidized annuities is not adopted in the final regulations.

* * * *

The regulatory obstacles in the proposed regulations, combined with other statements from Treasury and the IRS indicating that hybrid plans might have difficulty satisfying the tax-qualification rules send a strong message to employers that there is substantial uncertainty about these plans—and that 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 Treasury and IRS to adopt final regulations that are fully consistent with Congress's intent to foster the creation and continued maintenance of hybrid plans, to provide a positive environment in which those plans may operate, to abolish the practice of whipsaw, and to 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.

Sincerely,

Mark J. Ugoretz
President & CEO
THE ERISA INDUSTRY COMMITTEE

ERIC

The
ERISA
Industry
Committee

Third Comment in a Series of Six Comments on Proposed and Final Regulations on Hybrid Retirement Plans

AGE DISCRIMINATION TESTING

January 12, 2011

EXECUTIVE SUMMARY

Cash balance and pension equity plans cover approximately one out of every four participants in a defined benefit plan in the United States. They also account for roughly 40 percent of the assets held in defined benefit plans nationwide. As a result, these plans provide the primary source of retirement income for a significant number of American workers. As traditional defined benefit plans have become increasingly less attractive, cash balance and pension equity plans have provided a welcome exception to this troubling trend. Congress recognized these facts and, in the Pension Protection Act of 2006 (the "PPA"), adopted comprehensive legislation to encourage employers to adopt and maintain cash balance and pension equity plans. To safeguard the retirement income of the numerous Americans covered by these plans, it is critical that Treasury and IRS draft regulations that reflect Congress' intent to encourage and facilitate the creation and maintenance of cash balance and pension equity plans. The ERISA Industry Committee ("ERIC")[1] stands ready to assist Treasury and IRS in this effort.

Toward that end, ERIC is pleased to present the third in a series of six comments on the proposed and final Treasury regulations implementing the cash balance and pension equity plan provisions of the PPA. This comment focuses on the PPA's age discrimination testing safe harbor and indexing rule. In brief, this comment recommends the following:

- The age discrimination safe harbor should permit plans to compare benefits of similarly situated individuals covered by different benefit formulas by reducing each participant's benefit to its present value.

[1] ERIC is a non-profit association committed to the advancement of employee retirement, health, and welfare benefit plans of America's largest employers. ERIC represents exclusively the employee benefits interests of major employers who, collectively, provide comprehensive retirement, healthcare coverage and other economic security benefits directly to tens of millions of active and retired workers and their families in all 50 states. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in the American economy.

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

- The final regulations should make clear that benefits consisting of two parts, each relating to different periods of service, may be tested separately under the "sum of benefit formulas" rule and that each part of the benefit may, itself, be tested under one of the safe harbor rules governing multiple formulas. This approach would apply, for example, if a traditional final average pay plan were converted to a cash balance plan, and older employees were offered a choice to remain under the final average pay formula.

- The PPA's rule that indexing does not constitute age discrimination should apply to all defined benefit plans, including hybrid pension plans, and the definition of indexing should be expanded.

INTRODUCTION

ERIC is pleased to submit the third in a series of six comments on the proposed and final regulations issued by the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS" or "Service") under Title VII and section 1107 of the Pension Protection Act of 2006 ("PPA"), as amended by the Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA"). The regulations apply for purposes of sections 411(a)(13), 411(b)(1)(B), 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 regulations were published in the Federal Register on October 19, 2010. *See* 75 Fed. Reg. 64,123 (final regulations); 75 Fed Reg. 64,197 (proposed regulations). Corrections to the regulations were published in the Federal Register on December 28, 2010. *See* 75 Fed. Reg. 81,456 (final regulations); 75 Fed. Reg. 81,543 (proposed regulations).

ERIC recognizes that the final regulations revised and clarified the 2007 proposed regulations in numerous significant and helpful ways and appreciates the consideration that Treasury and IRS have given to ERIC's earlier comments on the 2007 proposed regulations. ERIC offers the following comments to address remaining concerns regarding certain aspects of the regulations, including the application of the age discrimination test in section 411(b)(5) and the application of the indexing rule in Treas. Reg. § 1.411(b)(5)-1(b)(2). ERIC is submitting five additional separate comments on other aspects of the regulations.

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 regulations. ERIC also requests that it be permitted to testify at the hearing.

I. PPA AGE DISCRIMINATION SAFE HARBOR

A. Plans with Multiple Formulas

<u>The age discrimination safe harbor should be revised to permit plans to compare the benefits provided to similarly-situated individuals covered by different benefit formulas by reducing each participant's benefit to its present value. Revising the safe harbor in this manner would make</u>

the test design-neutral and would reflect the principle that the time value of money should not be considered age-discriminatory.

Under the final regulations, the section 411(b)(5) age discrimination safe harbor cannot be satisfied with respect to an older participant if any similarly situated, younger participant receives a benefit under a different formula, except in limited circumstances. These limited circumstances include offering the older participant the greater of the two formulas, a choice between the two formulas, or a benefit based on the sum of the two formulas, and requiring that the terms of such offer be at least as favorable to the older participant as to the similarly situated, younger participant. Thus the age discrimination safe harbor is only available for a subset of plans. A plan that provides one formula for older participants and a different formula for younger participants will not qualify for the safe harbor, even if in all circumstances the older participants would receive a more valuable benefit than the younger participants.

The age discrimination safe harbor should be modified to permit plan sponsors to compare benefits that are expressed in different forms. At its core, the prohibition on age discrimination is based on the idea that an older participant should not receive less than a younger participant, and the design of the plan should be irrelevant to this determination. A design-neutral test would be consistent with the purpose of section 411(b)(5): To provide clarity with respect to age discrimination for all plans, to provide age discrimination tests appropriate to hybrid plans in particular, and to affirm that the time value of money is not age discriminatory. A design-neutral test that compares the present value of participants' benefits would also be consistent with past IRS practice. The IRS recognizes that benefits expressed as a deferred annuity can be reduced to a present value for various purposes, including calculating lump sums under section 417(e), applying the section 415(b) limits to optional forms of benefit, determining actuarial equivalence, 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"); Treas. Reg. § 1.430(d)-1(f)(9) (examples using present value of accrued benefits to determine target normal cost).

If the regulations are not amended to permit the comparison of different benefit formulas, the Treasury and IRS should issue additional guidance clarifying that plans may be amended to express all benefits in the same form for purposes of applying the age discrimination safe harbor. For example, a plan that includes both a cash balance formula and a traditional final average pay formula could be amended to express participants' final average pay benefits as equivalent hypothetical accounts, which then could be compared to the plan's cash balance account benefits.

In addition, if the regulations are not amended to permit the comparison of different benefit formulas, it would be helpful if Treasury and IRS would include an example illustrating how a plan which offers different benefit formulas to older and younger participants may be amended to fall within the age discrimination safe harbor. In some cases, plans have been amended to preserve the original benefit formula for a group of older employees so as to minimize disruption for those individuals. For example, a plan converting from a final average pay formula to a cash balance formula might preserve the final average pay formula for participants who had reached age 55 at the time of the conversion amendment. If the final regulations do not permit the plan to compare the present value of the older participants' final average pay benefit to the cash balance account offered to younger employees, the final regulations should make clear how such a plan could be amended to comply with the final regulations.

B. Clarify that Sum-of Rules Can Be Used on Consecutive as well as Simultaneous Components of a Benefit Formula

The regulations should be clarified to confirm that the sum-of benefit formulas described in Treas. Reg. § 1.411(b)(5)-1(b)(1)(ii)(B) include both benefits expressed as the sum of two benefit formulas based on different periods of service as well as benefits expressed as the sum of two benefit formulas both of which relate to the same period of service, and that the age discrimination multiple-formula safe harbor may be applied to each component of successive formulas.

Often, when a plan sponsor amends a plan to change the benefit formula, the resulting benefit is bifurcated into two or more benefit formulas that run consecutively. Because the age discrimination safe harbor is applied to an individual's accumulated benefit, defined as the individual's benefit as expressed under the terms of the plan accrued to date, the regulations should clarify that such plans are permitted to apply the safe harbor to each portion of the benefit formula separately.

1. Consecutive Formulas

The regulations state that a plan providing an older participant with the sum of two benefits determined by different safe-harbor benefit formulas can satisfy the multiple-formula age discrimination safe harbor if the plan meets certain criteria. To satisfy the safe harbor, each of the benefit formulas being added to reach the total benefit must satisfy the age discrimination safe harbor under Treas. Reg. § 1.411(b)(5)-1(b)(1)(i) and no similarly-situated younger individual may receive his benefit as other than the sum of the two benefit formulas, the greater of the two benefit formulas, his or her choice of the two benefit formulas, or only one of the two benefit formulas.

Because the age discrimination safe harbor is applied to the entire accumulated benefit, the Treasury and IRS should further clarify that plans are permitted to use the "sum of" rules to apply the safe harbor to each successive portion of the benefit formula. The rules which permit plans to offer older participants the "sum of" different benefit formulas should be applicable both to plans in which the benefit is expressed as the sum of two benefit formulas based on different periods of service ("consecutive formulas"), as well as to plans where the benefit is expressed as the sum of two benefit formulas both of which relate to the same period of service ("simultaneous formulas"). A consecutive formula arises at any time that the benefit formula is changed, including a change from a benefit expressed as a deferred annuity to a benefit expressed as a hypothetical account or an accumulated percentage of compensation (the latter, a "PEP accumulation"). The regulations clearly contemplate that plans will offer consecutive benefits, so the regulations should be clarified to provide guidance on how the multiple-formula age discrimination safe harbor applies in such cases. *See, e.g.,* Treas. Reg. § 1.411(b)(5)-1(c)(5), Ex. 1.

For example, assume a plan provides all participants with a benefit expressed as a single life annuity payable at normal retirement age calculated as one percent of the participant's final average pay multiplied by years of service (the "FAP Formula"). The plan is then amended to provide that all participants will receive the sum of this benefit, calculated under the FAP Formula based on pay and service determined as of the date of the amendment, and a second benefit calculated using a cash balance benefit formula (providing a pay credit of 3 percent of pay and an interest credit of 5 percent per year) based on post-amendment compensation and service (the "Cash Balance Formula"). The plan would be permitted to satisfy the age discrimination safe harbor by treating the accumulated benefit as the sum of the FAP Formula and the Cash Balance Formula under Treas. Reg. § 1.411(b)(5)-1(b)(1)(ii)(B).

To determine if this plan satisfies Treas. Reg. § 1.411(b)(5)-1(b), the rules for sum-of benefit formulas would be applied as follows: each participant's accumulated benefit is the sum of the pre-amendment benefit (the FAP formula applied to pay and service before the amendment) and the post-amendment benefit (the Cash Balance Formula applied to pay and service after the amendment). The accumulated benefit would satisfy Treas. Reg. § 1.411(b)(5)-1(b)(1)(ii)(B) because (a) the pre-amendment benefit under the FAP Formula is a safe harbor formula measure under Treas. Reg. § 1.411(b)(5)-1(b)(1)(i)(A); (b) the post-amendment benefit under the Cash Balance Formula is a safe harbor formula measure under Treas. Reg. § 1.411(b)(5)-1(b)(1)(i)(B); and (c) the older participants are being offered the sum of the two benefits, and the younger participants are being offered the sum of the same two benefits, as permitted under Treas. Reg. § 1.411(b)(5)-1(b)(1)(ii)(B).

2. Application of Age Discrimination Multiple-Formula Safe Harbor to Each Component of Consecutive Formulas

The Treasury and IRS should also clarify that the age discrimination multiple-formula safe harbor in Treas. Reg. § 1.411(b)(5)-1(b) can be satisfied if each component of a "sum-of" benefit formula satisfies Treas. Reg. § 1.411(b)(5)-1(b), including subsections (B) (sum-of benefit formulas), (C) (greater-of benefit formulas) and (D) (choice-of benefit formulas). Treas. Reg. § 1.411(b)(5)-1(b)(1)(iv) Example 5 suggests that a component of a "sum-of" benefit formula can comply with the safe harbor if older participants are offered the choice of two benefit formulas, but Treasury should provide clear guidance that such treatment is permissible.

Expanding on the example above, assume that all participants receive the FAP Formula. The plan is then amended to provide that all participants will receive the sum of their benefit, calculated under the FAP Formula based on pay and service determined as of the date of the amendment, and a second benefit. For participants who are under age 55, the second benefit is the Cash Balance Formula. Participants who are age 55 and older at the time of the amendment are given the choice between continuing, post-amendment, to accrue a benefit under the FAP Formula or accruing, post-amendment, a benefit under the Cash Balance Formula. Thus, the benefit for older participants could be described as FAP Formula plus choice of FAP Formula or Cash Balance Formula, and the benefit for younger participants could be described as FAP Formula plus Cash Balance Formula.

For the sake of illustration, assume that at the time of the amendment, a participant had 15 years of service, and had final average pay as of the amendment date of $50,000 per year, and he works for 10 years at the same final average pay after the amendment date. His benefit under the plan as of the amendment date would be determined under the FAP Formula regardless of his age (1% of $50,000 multiplied by 15, or $7,500). If the participant was younger than 55 at the time of the amendment, his accumulated benefit would be the sum of an annuity of $7,500 per year and his future accruals under the Cash Balance Formula (3% of $50,000 multiplied by 15 ($22,500) plus interest at 5%). If the participant was age 55 or older at the time of the amendment, his accumulated benefit would be the sum of an annuity of $7,500 per year and, depending on his choice of formulas, either the Cash Balance Formula ($22,500 plus interest at 5%) or continued accruals under the FAP Formula (1% of $50,000 multiplied by 10, or $5,000).

To determine if this plan satisfies Treas. Reg. § 1.411(b)(5)-1(b), the rules for sum-of benefit formulas would be applied as follows: the benefit would be bifurcated into the pre-amendment and post-amendment benefits. The pre-amendment benefits would be evaluated under Treas. Reg. § 1.411(b)(5)-1(b)(1)(i), because all participants receive a benefit under the same FAP Formula. The post-amendment benefits would be evaluated under Treas. Reg. § 1.411(b)(5)-1(b)(1)(ii)(D) because the older participants are offered the choice of the FAP Formula or the Cash Balance Formula. Because younger participants accrue benefits only under the Cash Balance Formula, the post-amendment portion of the benefit formula would satisfy the regulation.

II. APPLICATION OF INDEXING RULE

The age discrimination rule for indexed benefits in Treas. Reg. § 1.411(b)(5)-1(b)(2) should be expanded to express the broad principle that indexing is not age-discriminatory and should be applicable to all defined benefit plans, including hybrid plans, plans with alternate indexing methodologies, and plans that do not comply with the requirements imposed on statutory hybrid plans.

A. The Indexing Rule Should Include Hybrid Plan Formulas

The age discrimination rule for indexed benefits in Treas. Reg. § 1.411(b)(5)-1(b)(2) should be expanded to cover all plans, including hybrid plans and plans that do not meet the criteria for statutory hybrid plans.

Treas. Reg. § 1.411(b)(5)-1(b)(2) provides that a plan that meets certain criteria will not be deemed age discriminatory solely because benefits under the plan are indexed. The regulation specifically excludes hybrid benefit formulas, *i.e.*, so-called "lump sum-based benefit formulas," from this relief, even though Congress intended the underlying statutory provision to act as a general rule holding that indexing was simply accounting for the time value of money and therefore should not be deemed age discriminatory under any circumstances.

In section 411(b)(5)(E), Congress clarified that the indexing of a participant's accrued benefit should not be treated as age discrimination, provided that that benefit was protected from losses due to a negative rate of return. This language was intended to state a broad principle and is consistent with the consensus among the Circuit Courts that indexing benefits to reflect the time value of money is not age discriminatory. *See, e.g., Cooper v. IBM Personal Pension Plan*, 457 F.3d 636 (7th Cir. 2006).

The regulation significantly narrows the scope of section 411(b)(5)(E), turning a broad principle into a specific test. Specifically, the regulation limits the plans to which the principle applies to plans that comply with the rules for statutory hybrid plans and omits hybrid benefit plans. There is nothing in section 411(b)(5)(E) that suggests that Congress intended to exempt some plans from the relief contained in the indexing rule. To the contrary, the legislative history clearly shows that Congress intended for the indexing rule to apply to cash balance plans and PEP accumulations. *See* 152 Cong. Rec. S8571 & S8756 (daily ed. Aug. 3, 2006) (statements of Sen. Enzi) (cash balance and pension equity plans are permitted to rely on PPA indexing rule). Treasury and IRS have not articulated a reason to override Congress on this issue and deny relief to cash balance plans and PEP accumulations. Moreover, under Treas. Reg. § 1.411(b)(5)-1(b)(2)(i), a plan offering an indexed benefit must comply with the qualification requirements applicable to a statutory hybrid plan in order to receive the benefit of section 411(b)(5)(E). Like the exclusion of hybrid plans, this requirement is not found in the statute and is inconsistent with Congressional intent. The regulation should be revised to apply the indexing rule to all plans that include indexing, regardless of the other elements of the plan design.

B. The Indexing Rule Should Not Be Limited to Plans that Base the Index on a Market Rate of Return

<u>The indexing rule should be applicable to all plans, including plans that adjust benefits using an index or methodology that is recognized under Treasury, IRS, or other legal guidance.</u>

Under Treas. Reg. § 1.411(b)(5)-1(b)(2), the indexing rule is only applicable to plans that use a "market rate of return" to index benefits. While the final regulation provides a greater range of options than the proposed regulation, the limitation is contrary to the intent of Congress, and the rule should be expanded to cover all plans that use an index or methodology that is recognized under other Treasury or IRS guidance.

As discussed above, Congress drafted section 411(b)(5)(E) as a broad rule of general applicability, not a limited exception for a certain subset of plans. In section 411(b)(5)(E)(iii), Congress specified that the indexing is defined as "the periodic adjustment of the accrued benefit by means of the application of a recognized investment index or methodology." The statute does not specify that the plan apply a market rate of return, even though the concept of a market rate of return is used in the same section of the Code. *See* Code § 411(b)(5)(B)(i)(III).

The regulation should be revised to include all indices that have been permitted for the purposes of adjusting benefits in a defined benefit plan:

- 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.

- 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 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).

* * *

ERIC appreciates the opportunity to present these additional comments on the hybrid plan regulations and would welcome a discussion of the issues raised in this letter. Please let us know if the Treasury or the IRS would like additional information on any of the views or recommendations described in this letter.

Sincerely,

Mark J. Ugoretz
President & CEO
THE ERISA INDUSTRY COMMITTEE

ERIC

The ERISA Industry Committee

Fourth Comment in a Series of Six Comments on Proposed and Final Regulations on Hybrid Retirement Plans

PPA VESTING, PLAN TERMINATION, CONVERSION RULES, AND NON-HYBRID INDEXED PLANS

January 12, 2011

EXECUTIVE SUMMARY

Cash balance and pension equity plans cover approximately one out of every four participants in a defined benefit plan in the United States. They also account for roughly 40 percent of the assets held in defined benefit plans nationwide. As a result, these plans provide the primary source of retirement income for a significant number of American workers. As traditional defined benefit plans have become increasingly less attractive, cash balance and pension equity plans have provided a welcome exception to this troubling trend. Congress recognized these facts and, in the Pension Protection Act of 2006 (the "PPA"), adopted comprehensive legislation to encourage employers to adopt and maintain cash balance and pension equity plans. To safeguard the retirement income of the numerous Americans covered by these plans, it is critical that Treasury and IRS draft regulations that reflect Congress' intent to encourage and facilitate the creation and maintenance of cash balance and pension equity plans. The ERISA Industry Committee ("ERIC")[1] stands ready to assist Treasury and IRS in this effort.

Toward that end, ERIC is pleased to present the fourth in a series of six comments on the proposed and final Treasury regulations implementing the cash balance and pension equity plan provisions of the PPA. This comment focuses on the PPA's vesting, plan termination, and plan conversion requirements and the treatment of non-hybrid, indexed plans. In brief, these comments include the following:

[1] ERIC is a non-profit association committed to the advancement of employee retirement, health, and welfare benefit plans of America's largest employers. ERIC represents exclusively the employee benefits interests of major employers who, collectively, provide comprehensive retirement, healthcare coverage and other economic security benefits directly to tens of millions of active and retired workers and their families in all 50 states. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in the American economy.

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

- ***Vesting:*** The final regulations should limit the 3-year vesting rule to benefits accrued under a hybrid formula and clarify that the 3-year vesting requirement does not apply to non-vested participants who are rehired after prior hybrid formula benefits have been lost under the plan's break-in-service rules.

- ***Plan Termination**:* The final regulations should clarify the rule requiring a plan that uses variable interest rates to apply, upon plan termination, the 5-year average of the variable interest rates. For example, guidance is needed with respect to annuity conversions, annuities commencing before normal retirement age, plans that have a fixed rate in effect at plan termination, and plans with non-market rates during the averaging period.

- ***Conversion Amendments**:* The final regulations should clarify when and how the requirements regarding plan conversions apply. For example, guidance is needed with respect to the definition of "conversion amendment," the treatment of early retirement benefits following a conversion amendment, the timing of a conversion amendment, and how the conversion amendment rules apply in the context of a merger or acquisition.

- ***Non-Hybrid Indexed Plans**:* Plans that provide an indexed benefit but do not express the benefit by reference to a current value do not share key similarities with hybrid plans and therefore should not be subject to the vesting, plan termination, and plan conversion rules that apply uniquely to hybrid plans.

INTRODUCTION

ERIC is pleased to submit the fourth in a series of six comments on the proposed and final regulations issued by the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS" or "Service") under Title VII and section 1107 of the PPA, as amended by the Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA"). The regulations apply for purposes of sections 411(a)(13), 411(b)(1)(B), 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 regulations were published in the Federal Register on October 19, 2010. *See* 75 Fed. Reg. 64,123 (final regulations); 75 Fed Reg. 64,197 (proposed regulations). Corrections to the regulations were published in the Federal Register on December 28, 2010. *See* 75 Fed. Reg. 81,456 (final regulations); 75 Fed. Reg. 81,543 (proposed regulations).

ERIC recognizes that the 2010 proposed and final regulations revised and clarified the 2007 proposed regulations in helpful ways and appreciates the consideration that Treasury and IRS have given to ERIC's earlier comments on the 2007 proposed regulations. ERIC offers the following comments to address remaining concerns regarding: (1) the three-year vesting requirement under section 411(a)(13)(B) of the Code, (2) the provisions of section 411(b)(5)(B)(vi) of the Code related to determining a plan's interest crediting rate and annuity conversion assumptions after the plan terminates, and (3) the conversion amendment requirements of sections 411(b)(5)(B)(ii) through (v) of the Code. ERIC is submitting five additional separate comments on other aspects of the regulations.

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 regulations. ERIC also requests that it be permitted to testify at the hearing.

I. THREE-YEAR VESTING REQUIREMENT

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

The final 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. *See* Treas. Reg. § 1.411(a)(13)-1(c)(1). As noted in ERIC's comments on the 2007 proposed regulations, Congress did not intend to impose 3-year vesting on non-hybrid benefits, and the final regulations should be revised to reach the same result.

B. <u>The final regulations should make it clear that the 3-year vesting requirement does not apply to non-vested participants who are rehired if previously accrued benefits have been lost under the rule of parity before rehire occurs</u>.

The final regulations provide that the 3-year vesting requirement "does not apply to a participant who does not have an hour of service after section 411(a)(13)(B) but[2] would otherwise apply to the participant…." *See* Treas. Reg. § 1.411(a)(13)-1(e)(1)(iii)(E). Assume that a participant (1) earned a benefit under a statutory hybrid formula in an applicable defined benefit plan and (2) subsequently terminated employment before the applicable effective date after completing 3 years of service, but less than the service required to be vested under the plan. The fact that the participant is later rehired and completes an hour of service after the applicable effective date should not cause his prior benefit to become vested if he is rehired after the benefit has been lost under the plan's rule of parity provisions in effect when he terminated employment. The final regulations should be revised to include an example clarifying this point.

C. <u>The new example in the final regulations relating to floor-offset arrangements should be revised to reflect that its conclusion (*i.e.*, that the vesting requirement applies to a plan that is part of a floor-offset arrangement only if the plan provides benefits under a statutory hybrid formula) would not be different if the independent plan in the example were a defined contribution plan or if, under the example, the floor plan contained a statutory hybrid benefit formula but the independent plan did not.</u>

The final regulations include a new example providing that, for a floor-offset arrangement under which the independent plan provides benefits under a statutory hybrid formula and the floor plan provides benefits under a non-hybrid formula, only the independent plan providing benefits under a statutory hybrid formula is subject to the 3-year vesting requirement. *See* Treas. Reg. § 1.411(a)(13)-1(c)(2), Example (3). This example should be expanded to reflect that the conclusion would be the same (*i.e.*, that, in a floor-offset arrangement, the vesting requirement applies to a plan

[2] The inclusion of the word "but" seems to be an error.

included in the arrangement only if the plan provides benefits under a statutory hybrid formula) if the facts were changed so that either (1) the independent plan was a defined contribution plan or (2) the independent plan provided benefits solely under a non-hybrid formula and the floor plan provided benefits solely under a statutory hybrid formula. In ERIC's separate comment on age discrimination testing and non-hybrid indexed plans, we have commented that non-hybrid indexed plans should not be treated as statutory hybrid plans; if Treasury makes this change, then only the reference to the defined contribution plan would be required.

II. PLAN TERMINATION PROVISIONS

A. The final regulations should clearly state how the rule requiring use of a 5-year average interest rate upon termination of a statutory hybrid plan is applied with respect to annuity conversion factors.

Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(i) states that the rule in Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(ii) applies if (1) the interest crediting rate used to determine a participant's accumulated benefit during the 5-years preceding plan termination or (2) the interest rate used, as of the plan termination date, to determine the amount payable in an annuity at normal retirement age is a variable rate. However, the provisions of Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(ii) address interest crediting rates only, making it difficult to determine precisely how the rule applies to annuity conversion rates. For example, among other things, the final regulations should:

(1) include an example describing how the 5-year average must be calculated when the plan uses the Code section 417(e) segment rates for annuity conversions;

(2) clarify *if* or *when* the rule described in Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(ii)(C), requiring substitution of the third segment rate for the plan rate to determine the 5-year average, would apply for annuity conversions (for which plans may, but are not required to, use the bond-based or fixed rates that satisfy the market rate of return requirements);

(3) explain how the 5-year averaging rule is applied if the plan uses one variable rate to convert to a single life annuity and another variable rate to convert the life annuity to one or more optional annuity forms; and

(4) include, when addressing each plan termination issue identified below, how the resolution of the issue would apply to annuity conversions and not just to interest crediting (when the issue could affect annuity conversions).

B. The final regulations should clarify that the 5-year average interest rate applied on and after the termination date for a statutory hybrid plan is used to determine, as applicable, (1) interest credits for periods with interest crediting dates on and after the plan termination date and/or (2) normal retirement age annuities commencing on annuity starting dates occurring on and after the plan termination date.

The proposed regulations state that, as a general rule, the specified 5-year average interest rate must be applied as "the interest crediting rate used to determine the participant's accumulated benefit under the plan after the date of plan termination." *See* Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(ii)(A). The examples in the proposed regulations indicate that the average rate is "used to determine accrued benefits under the plan on and after the date of plan termination." *See* Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(iv), Example (1)(ii). Although not entirely clear, it seems that the proposed regulations intend that the 5-year average interest rate will be applied, as appropriate, to determine (1) interest credits for periods with interest crediting dates on and after the plan termination date (but not for periods with earlier interest crediting dates) or (2) normal retirement age annuity amounts payable on annuity starting dates occurring on and after the plan termination date (but not with respect to earlier annuity starting dates). The final regulations should provide clarification.

C. <u>The final regulations should provide that the plan termination rule does not affect a statutory hybrid plan's ability to qualify to pay benefits based on the current account balance or lump-sum value determined under a lump sum-based benefit formula.</u>

Prop. Treas. Reg. §§ 1.411(a)(13)-1(b)(2) and (3) require that an amount payable other than as a lump sum must equal the actuarial equivalent, determined using "reasonable actuarial assumptions," of the current value of the hypothetical account or accumulated percentage of final average pay provided under a statutory hybrid plan's lump sum-based benefit formula. In ERIC's separate comment on the whipsaw provision, we have commented that amounts payable as other than a lump sum ought to be no less than (rather than equal to) the actuarial equivalent of the hypothetical account or accumulated percentage of final average pay. In either case, the final regulations should clarify that the 5-year average interest rate that is required to be applied for annuity conversions on and after plan termination is deemed to be a reasonable actuarial assumption for this purpose.

D. <u>The final regulations should describe how annuity amounts payable before normal retirement age should be calculated for annuity starting dates on and after a statutory hybrid plan's termination date.</u>

The proposed regulations provide for use of the specified 5-year average interest rate on and after plan termination to determine "the amount of any benefit payable in the form of an annuity commencing at or after normal retirement age." *See* Prop. Treas. Reg. 1.411(b)(5)-1(e)(2)(i)(B). However, there is nothing in the proposed regulations describing the calculation of annuity amounts payable commencing before normal retirement age. The final regulations should reflect how annuity amounts payable before normal retirement age must be calculated on and after the plan termination date.

E. <u>The final regulations should provide that a plan that has a fixed interest rate in effect for interest crediting or annuity conversions as of the plan termination date is not subject to the 5-year averaging rule, even if another rate was previously in effect for the same purpose during the 5 years preceding termination, as long as there is no violation of section 411(d)(6) of the Code or Title IV of ERISA.</u>

The statute applies the 5-year averaging rule if, "upon termination of the plan," the plan's interest crediting rate or interest rate for annuity conversions is a variable rate. *See* Code § 411(b)(5)(B)(vi). By contrast, Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(i) would require averaging of the fixed rates for periods during the 5 years ending on the plan termination date in "any case in which the rate was not the same fixed rate during all such periods." The final regulations should follow the statute and should not require use of 5-year averaging if the interest crediting or annuity conversion rate is a fixed rate on the plan termination date, as long as the fixed interest crediting rate was established without violating section 411(d)(6) of the Code or Title IV of ERISA.

F. <u>The final regulations should provide guidance for calculating the 5-year average interest rate when the 5-year averaging period includes periods during which a statutory hybrid plan's interest crediting rate was not a rate permitted under the final regulations.</u>

Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(ii)(B) describes how to calculate the 5-year average interest rate when the variable interest crediting rate is based on an interest rate described in Treas. Reg. § 1.411(b)(5)-1(d)(3) or (4) (i.e., a permissible bond-based rate or fixed rate). Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(ii)(C) describes how to calculate the 5-year average interest rate when the variable interest crediting rate is based on a variable rate described in Treas. Reg. § 1.411(b)(5)-1(d)(5) (i.e., the rate of return on plan assets, on a diversified regulated investment company, or an annuity contract). However, since the 5-year averaging period could include periods before the January 1, 2012 effective date of the final regulations, the final regulations should indicate how the average must be calculated when a plan's interest crediting rate for all or part of the averaging period is not a market rate described in the regulations. The preamble to the proposed regulations suggests that substitution of the third segment rate for the plan's interest crediting rate will be required, but the proposed regulations are not clear on this point. The reason why a particular rate fails to qualify as a market rate might influence the answer to this question. For example, a true investment-based rate of return that is not included in the exclusive list (if the exclusive list is maintained) should be projected at the risk-free rate. See ERIC's separate comment on participant-directed hybrid plans.

G. <u>The final regulations should clarify whether the mortality table in effect for annuity conversions on a statutory hybrid plan's termination date must remain constant.</u>

The proposed regulations provide that a statutory hybrid plan must provide that "the … mortality table (including tabular adjustment factors) used on and after plan termination for purposes of determining the amount of any benefit under the plan payable in the form of an annuity commencing at or after normal retirement age [must be] the … mortality table specified under the plan for that purpose as of the termination date." *See* Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(i)(B). The final regulations should clarify whether a plan that determines annuity amounts using the "applicable mortality table" under section 417(e) of the Code is required to use the applicable mortality table in effect under section 417(e) as of the plan termination date instead of the applicable mortality table in effect as of the annuity starting date, even if the annuity starting date occurs after the plan termination date.

H. <u>The final regulations should clarify how to apply the special 5-year average interest rate for participants whose benefits at plan termination are determined by a 411(d)(6) protected benefit.</u>

The proposed regulations provide that "if, at the end of the last interest crediting period prior to plan termination, the participant's accumulated benefit is based on a section 411(d)(6) protected benefit that results from a prior amendment to change the rate of interest crediting applicable under the plan, then, for purposes of determining the average interest crediting rate…, the pre-amendment interest crediting rate is treated as having applied for each interest crediting period after the date of the interest crediting rate change." *See* Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(iii)(A). The final regulations should clarify whether the average interest rate calculated under this rule is applied on and after the plan termination date for purposes of determining interest credits and annuity conversions for both the 411(d)(6) protected benefit and the current formula benefit.

I. <u>The final regulations should provide that a floor, ceiling, or reduction applied to an investment-based interest crediting rate should be treated as applying in the same manner to the third segment rate for purposes of determining the 5-year average interest crediting rate applied on and after plan termination.</u>

The preamble to the proposed regulations poses the question: "For purposes of the plan termination rules, should a floor, ceiling, or reduction that applied to an equity-based rate in an interest crediting period be treated as applying in the same manner to the third segment rate or is it appropriate for such adjustment to be disregarded or otherwise modified for purposes of such rules?" Our view is that, if any rate is to be used as a proxy for an investment-based rate of return, then any floor, ceiling, or reduction to the investment-based rate of return should be applied in the same manner to the substitute rate. To do otherwise would result in unnecessary increases or reductions in plan benefits due to the plan termination. Any unnecessary increase would be to the financial detriment of the Pension Benefit Guaranty Corporation ("PBGC") in the case of distress terminations; any unnecessary decrease would redound to the financial detriment of plan participants.

J. <u>The final regulations should permit a plan sponsor to elect, for purposes of determining the 5-year average interest rate, to use (1) the plan's actual average crediting rate, (2) the average of the risk-free rate of return (especially for plans that credit investment-based rates of return), (3) the average of third segment rate, or (4) 5%.</u>

The proposed regulations recognize that, for purposes of applying the plan termination provisions in section 411(b)(5)(B)(vi), the 5-year average interest rate under a plan is not necessarily the 5-year average of the rate actually credited under the plan. Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(ii)(C) generally requires a statutory hybrid plan that determines interest credits using the rate of return on plan assets, an annuity contract, or a diversified regulated investment company to substitute the third segment rate for the plan rate for purposes of determining the 5-year average interest rate used to determine post-termination interest credits. However, Treasury should consider whether substitution of the third segment rate for investment-based rates of return is appropriate:

(1) There does not seem to be a statutory basis for substituting any interest rate (the third segment rate or otherwise) for the plan's interest rate.

(2) Using the third segment rate as the substitute rate might increase the cost of plan terminations unnecessarily. From an economic perspective, it might be more appropriate to substitute a risk-free rate of return, such as the return on Treasury securities with appropriate maturity, since on a risk-adjusted basis there is no forfeiture vs. the post-termination go-forward guarantee.

(3) Treasury and the IRS should investigate how insurance companies would price annuity contracts to fund individual participants' benefits if use of the third segment rate applies to determine the guaranteed 5-year average interest rate. In today's market, that would

require a 6%-7% guaranteed return under the contracts. The annuity contracts might be prohibitively expensive or not obtainable in the market.

Indeed, plan sponsors should have the flexibility, in standard terminations, to elect to use the 5-year average of actual plan credits or the risk-free rate of return as the most reasonable proxy for market rates of return. This would be particularly true for investment-based plans and especially for participant-directed hybrid plans, where it would be administratively burdensome to recreate each participant's individual investment-based credits for the preceding five years.

Furthermore, assuming that plan assets would be sufficient to provide any additional benefits that may result, the final regulations should permit plan sponsors to elect to substitute, if higher than the plan's actual 5-year average, the 5-year average of the third segment rate or 5%, because both of those rates are market rates. The PPA's plan termination provision was not intended to prohibit plan sponsors from increasing benefits at the time of a standard plan termination.

Permitting plan sponsors a choice of approaches to the plan termination rule would achieve the following objectives:

(1) <u>A uniform post-termination interest crediting rate and/or annuity conversion rate</u>. Although the statute does not require a participant-by-participant approach, the proposed regulations generally require determination of the 5-year average interest rate on a participant-by-participant basis. This participant-by-participant approach would be a significant administrative burden for plans (a) covering different groups of participants by different formulas, (b) that are the result of plan mergers or have received asset transfers from prior employer plans, or (c) permit participants to choose from a menu of hypothetical investments. Furthermore, having to apply varying interest rates could make purchasing annuity contracts to cover benefit obligations significantly more costly than it would otherwise be. The final regulations should permit a plan sponsor to alleviate this administrative burden and facilitate annuity purchases by opting to substitute an average based on the third segment rate (or other applicable substitute rate) for the 5-year average interest rate that would otherwise apply in order to achieve a uniform post-termination interest crediting and/or annuity conversion rate for all participants. (ERIC is separately submitting a comment describing the way in which many of the PPA's hybrid plan rules apply to participant-directed cash balance plans.)

(2) <u>Elimination or reduction of a decrease in benefits that could result from the interest rate change</u>. Because higher interest rates result in larger interest credits and larger annuity amounts, application of a 5-year average interest rate that is lower than the current value of the plan interest rate would result in a reduction in benefits payable to participants. The final regulations should, in a situation in which use of the 5-year average interest rate would reduce benefits, allow a plan sponsor to elect to calculate the 5-year average interest rate using the third segment rate or 5% if all or part of the benefit reduction would be avoided.

III. CONVERSION AMENDMENTS

A. As noted in ERIC's comments on the 2007 proposed regulations, the definition of conversion amendment should be revised to conform to the statute's intended scope.

The final 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* 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* 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 final 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* 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 final 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 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 definition of conversion amendment in the final regulations is retained.

B. As noted in ERIC's comments on the 2007 proposed regulations, 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. In addition, the final regulations should clarify that a conversion amendment does not result solely because of an amendment for which there is regulatory or other relief from the requirements of section 411(d)(6) of the Code.

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) of the Code resulted in smaller lump sums than would have been paid using the previously applicable GATT assumptions. Under the final regulations, this change could 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 be revised to correct it. The example given above illustrates how the overly broad definition of conversion amendment in the final 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 addition, the final regulations should clarify that a conversion amendment does not occur solely by reason of a plan amendment for which there is regulatory or other relief from the requirements of section 411(d)(6) of the Code (such as an amendment to eliminate an optional payment form to the extent permitted under Treasury regulations). Although Treas. Reg. § 1.411(b)(5)-1(c)(2)(ii) addresses the treatment of the permissible elimination of optional forms when a conversion amendment occurs, the regulations should make clear that such elimination, by itself, would not constitute a conversion amendment.

C. <u>As noted in ERIC's comments on the 2007 proposed regulations, the final regulations should be clarified to provide 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) of the Code 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.

D. <u>As noted in ERIC's comments on the 2007 proposed regulations, for purposes of the effective date of the minimum conversion requirements, 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>

Treas. Reg. § 1.411(b)(5)-1(f)(1)(ii) provides that the PPA minimum conversion requirements apply to "a conversion amendment…that is both adopted on or after June 29, 2005, and takes effect on or after June 29, 2005." As clarification, Treas. Reg. § 1.411(b)(5)-1(c)(4)(ii)(C) provides that for "purposes of applying the effective date rule of paragraph (f)(1)(ii) of this section, the date that the relevant plan terms were adopted is treated as the adoption date of the amendment." 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 and, at least with respect to actions taken before June 29, 2005, should not require adoption of actual plan terms before the statutory effective date.

E. <u>The final regulations should be revised to clarify whether a conversion amendment occurs when a participant earning benefits under a plan's non-hybrid formula terminates employment and subsequently is rehired and begins to accrue benefits under that plan's hybrid formula.</u>

The final regulations provide that a conversion amendment occurs with respect to a participant if there is a reduction in the benefits that "the participant would have accrued after the effective date of the amendment under a benefit formula that is not a statutory hybrid benefit formula (and under which the participant was accruing benefits prior to the amendment)." *See* Treas. Reg. § 1.411(b)(5)-1(c)(4)(i)(A). Should the parenthetical in the preceding sentence be read to require benefit accrual under the non-hybrid formula "immediately" prior to the amendment, in which case a conversion amendment would <u>not</u> occur for the rehired participant described above?

F. <u>The final regulations should be revised to clarify how the minimum "A+B" benefit that is required following a conversion is to be calculated when the effective date of the conversion amendment occurs at the end of a transition period during which the greater of benefits under the prior non-hybrid formula and the new statutory hybrid formula are provided.</u>

Under a common conversion design, plan sponsors adopt a hybrid benefit formula but allow some or all existing participants to continue accruing benefits under the prior traditional formula during a transition period and to receive the greater of the benefits determined under the hybrid and traditional formulas when they retire. The final regulations follow the 2007 proposed regulations and continue treating the effective date of the conversion amendment in such cases as occurring at the end, rather than the beginning, of the transition period. The final regulations should clarify how the minimum "A+B" benefit should be calculated when the effective date is at the end of such a transition period. Would the "A" part of the minimum "A+B" benefit equal the greater of the traditional or hybrid formula benefits determined as of the end of the transition period?

G. <u>The final regulations should be revised to clarify the application of the conversion amendment requirements to participants who have terminated employment after the effective date of a conversion amendment effective on or after June 29, 2005, but before the regulatory effective date</u>.

The final regulations state: "With respect to a conversion amendment (within the meaning of paragraph (c)(4) of this section), where the effective date of the conversion amendment (as defined in paragraph (c)(4)(vi) of this section) is on or after the statutory effective date set forth in paragraph (f)(1)(ii) of this section, the requirements of paragraph (c)(2) of this section apply only to a participant who has an hour of service on or after the regulatory effective date set forth in paragraph (f)(2)(i) of this section." *See* Treas. Reg. § 1.411(b)(5)-1(f)(2)(ii). What does this mean for a participant affected by a conversion amendment adopted on or after June 29, 2005 who terminated in 2010? Is a good faith standard applied?

H. <u>The final regulations should confirm that the adoption of a plan provision before June 29, 2005 prevents that provision from causing a conversion amendment by operation of plan terms with respect to all plan participants affected by the provision in the future.</u>

A plan provision adopted before June 29, 2005 does not constitute a conversion amendment under the final regulations. *See* Treas. Reg. § 1.411(b)(5)-1(f)(1)(ii). However, is this true for all groups of employees, even those who first become subject to the provision after June 29, 2005? For example, assume that an employer's pension plan provides (and has provided since 1995) that hourly employees who are transferred to salaried status accrue benefits after the transfer under the statutory hybrid formula that applies to the employer's salaried employees. Further assume that a group of hourly employees who were not previously eligible to accrue pension benefits become covered by a traditional formula under the employer's pension plan on January 1, 2012, pursuant to collective bargaining. Is an hourly employee in the latter group who is transferred to salaried employment after January 1, 2012 excepted from the conversion amendment requirements because the hourly-to-salaried transfer provision predates June 29, 2005?

I. <u>The final regulations should be revised to clarify how the minimum "A+B" benefit is divided between the plans of the seller and the buyer in merger and acquisition situations.</u>

The final regulations provide that, if an employee's employer changes as a result of an acquisition, the old and new employers are treated as a single employer for purposes of the conversion amendment rules. *See* Treas. Reg. § 1.411(b)(5)-1(c)(4)(iv). Accordingly, the preamble states: "Thus, for example, in an acquisition, if the buyer adopts an amendment to its statutory hybrid plan under which a participant's benefits under the seller's plan (that is not a statutory hybrid plan) are coordinated with benefits under the buyer's plan, such as through a reduction (offset) of the buyer's plan benefits, the seller and the buyer would be treated as having adopted a conversion amendment."

The final regulations should clarify how the minimum "A+B" benefit is to be calculated in this situation. For example, if the participant has not satisfied the requirements for an early retirement subsidy at termination with the seller, it would seem that the "A" portion of the minimum "A+B" benefit provided under the seller's plan should not have to determine eligibility for the subsidy based on service with the buyer. Furthermore, it would seem that the effect of the conversion amendment rules on the buyer's plan would be limited to requiring that the buyer's plan provide a benefit equal to the larger of (1) a benefit under the statutory hybrid formula under the buyer's plan for post-conversion service determined as if the employee had no service with the seller, or (2) the benefit under the buyer's plan's statutory hybrid formula taking pre- and post-conversion service into account, reduced by the pre-conversion benefit under the seller's plan determined when the employee terminated employment with the seller.

J. <u>The final regulations should be revised to provide that a conversion amendment does not occur solely because benefit accruals are frozen by operation of plan provisions reflecting the</u>

<u>funding-based benefit restrictions of section 436 of the Code and subsequently resume (by plan amendment or operation of plan terms), as long as benefit accruals resume under the same benefit formula(s) in effect before benefit accruals were frozen, and even if benefit accruals are not restored for the period during which the freeze was in effect.</u>

The final regulations treat as a conversion amendment any amendment or operation of plan terms that reduces benefits that a participant would have accrued under a formula that is not a statutory hybrid formula and following which all or part of the participant's benefit accruals are determined under a statutory hybrid formula. Therefore, under the regulatory definition, a defined benefit plan under which a participant's benefits accrue under multiple formulas, including formulas that are and are not statutory hybrid formulas, could be considered to have a conversion amendment if benefit accruals stop due to operation of the restrictions of section 436 of the Code and, after the plan's funding status improves (whether by plan amendment or operation of plan terms), benefit accruals resume under the same benefit formulas. Because the intent of the PPA conversion amendment provisions was to prevent wear-away and no wear-away would occur in this situation, the final regulations should be revised to clarify that a conversion amendment does not occur in the circumstances described in the immediately preceding sentence, even if benefit accruals are not restored for the period during which the freeze was in effect.

IV. TREATMENT OF NON-HYBRID INDEXED PLANS

<u>Plans that provide an indexed benefit but do not express the benefit by reference to a current value, *i.e.* non-hybrid indexed plans, do not share key similarities with hybrid plans and therefore should be excluded from the definition of a statutory hybrid plan. These plans should therefore not be subject to the vesting, plan termination, and plan conversion rules that apply uniquely to hybrid plans.</u>

Under the final regulations, a statutory hybrid benefit formula includes any formula that is not a hybrid benefit formula but that is deemed to have an effect similar to a hybrid benefit formula. The plans are therefore treated as having an effect similar to an applicable defined benefit plan within the meaning of section 411(a)(13)(C)(ii) of the Code. In Treas. Reg. § 1.411(a)(13)-1(d)(4), a statutory hybrid benefit formula is defined as any formula which includes the right to adjustments for a future period which could result in a smaller cumulative adjustment for an older participant than for a younger participant. This definition would include any benefit formula that is indexed to account for the time value of money. In effect, the regulation takes the position that any plan that indexes a participant's benefit is inherently age discriminatory. This interpretation is contrary to Congressional intent, the underlying rationales for greater regulation of hybrid plans, and existing legal precedent.

The term "future period" is confusing. Based on comments made by Treasury and IRS staff, it apparently does not refer to a uniform fixed interval of time, such as 5 years, but rather to intervals of differing lengths of time based on a participant's current age, such as the period that begins in the present and ends when the participant attains a fixed age in the future, such as normal retirement age. If so, the regulation should be clarified to reflect this rather specialized meaning. Furthermore, it is puzzling that actuarial adjustments post-normal retirement age do not render a plan a statutory hybrid plan while the same adjustments pre-normal retirement age would. *See* Treas. Reg. § 1.411(b)(5)-1(b)(1)(iv), Ex. 1. It would not make sense for a test for age discrimination to consider "future periods" ***other than periods after normal retirement age***. Indeed, the definition of "future periods" illustrates why indexing alone should not bring a plan into the scope of a statutory hybrid plan.

Congress designed the rules for applicable defined benefit plans to address concerns specifically related to plans that define the benefit by reference to a hypothetical account or an accumulated percentage of final average pay; in other words, to cover cash balance formulas, pension equity formulas, and other benefit formulas that calculate the participant's benefit in a manner that could be viewed as a defined benefit plan mimicking the account balance structure of a defined contribution plan. In addition, Congress was concerned that, after the passage of the PPA, plan sponsors might develop new variations on this theme, just as a pension equity formula could be viewed as a variation on a cash balance formula. Section 411(a)(13)(C)(ii) of the Code was designed to give the IRS the ability to address new forms of benefit that were not in existence at the time that the PPA was passed, or at least of which Congress was unaware at the time. It was not a blank check to apply the hybrid plan rules to any plan that shares some point of similarity with a cash balance plan or a pension equity formula.

Treasury and IRS have provided a rationale for deeming all indexed plans to be similar to hybrid plans that is inconsistent with Congressional intent. In the preamble to the regulations, the IRS and Treasury state that "a key purpose of sections 411(a)(13) and 411(b)(5) is to address defined benefit plan formulas where younger participants receive a larger annual benefit at normal retirement age when compared to similarly situated, older participants." 75 Fed. Reg. 64,127. Congress defined an applicable defined benefit plan as a plan that bases the benefit on a hypothetical account or an accumulated percentage of final average pay; it did not define an applicable defined benefit plan to include any plan under which a younger participant receives a larger benefit in nominal dollars at normal retirement age when compared to a similarly-situated older participant. If Congress had wished to include all indexed plans in the definition of an applicable defined benefit plan, it could have done so by defining an applicable defined benefit plan in the same manner that indexed plans are defined in section 411(b)(5)(E) of the Code: plans that "provide indexing of accrued benefits." A statute should not be interpreted to apply one definition (indexed plans described in section 411(b)(5)(E)) of the Code to another part of the statute (definition of "applicable defined benefit plan" in sections 411(a)(13)(C) and 411(b)(5)(B)) where Congress declined to do so.

In addition, the rationales behind the specific mandates imposed on hybrid plans are not applicable to non-hybrid indexed plans. The vesting and conversion rules imposed by sections 411(a)(13) and 411(b)(5) of the Code were drafted to address specific aspects of hybrid plans that generally are not present in non-hybrid plans.

Section 411(a)(13)(B) of the Code imposes a 3-year vesting schedule on applicable defined benefit plans, in lieu of the 5-year vesting schedule generally applicable to defined benefit plans. This accelerated vesting was imposed in response to concerns that an account-based benefit with interest credits resembles a defined contribution plan with non-elective contributions. Thus, the PPA applied similar vesting schedules to both types of benefits. A non-hybrid indexed plan, by definition, does not describe the benefit as a hypothetical account or present value and therefore is not similar to a defined contribution plan. There is no reason to subject a non-hybrid indexed plan to a special vesting schedule.

The conversion rules in section 411(b)(5)(B) of the Code were designed to address conversions from an annuity-based benefit to a hypothetical account or pension equity plan accumulation. They were added to the PPA in response to specific concerns regarding the conversion of traditional defined benefit plans to cash balance plans. Whenever a benefit formula changes, there may be a period where a participant's benefit does not increase because the benefit under the new formula has not yet caught up with the benefit under the old formula that is protected by section 411(d)(6) of the Code; the participant is often referred to as experiencing "wear-away" during such period. However, Congress did not prohibit wear-away with respect to all plan amendments. Instead, Congress addressed particular concerns about wear-away that occurs when converting from an annuity-based benefit to a hybrid benefit, which were the subject of litigation. These concerns are not present with respect to annuity-based benefits that happen to include pre-retirement indexing.

Finally, the implication that any plan that indexes benefits is inherently age discriminatory, absent an exception provided in section 411(b)(5)(E) of the Code, is contrary to the settled case law in this area. Courts have repeatedly held that adjusting a participant's benefit to reflect the time value of money is not inherently age discriminatory. *See, e.g., Cooper v. IBM Personal Pension Plan*, 457 F.3d 636 (7th Cir. 2006); *Hurlic v. So. Cal. Gas Co.*, 539 F.3d 1024 (9th Cir. 2008); *Hirt v. Equitable Ret. Plan for Employees, Managers and Agents*, 533 F.3d 102 (2d. Cir. 2008); *Register v. PNC Fin. Services Group, Inc.*, 477 F.3d 56 (3d Cir. 2007); *Drutis v. Rand McNally & Co.*, 499 F.3d 608 (6th Cir. 2007).

If the current definition of a statutory hybrid benefit formula is retained, the provisions of the statute and regulations that provide relief to hybrid benefit formulas should be extended to all statutory hybrid benefit formulas. In particular, the whipsaw relief described in Treas. Reg. § 1.411(a)(13)-1(b) and the age discrimination safe harbor in Treas. Reg. § 1.411(b)(5)-1(b) should be revised to accommodate a statutory hybrid plan that expresses the participant's benefit as a deferred annuity. Even if Congress had intended to regulate all non-hybrid indexed plans as statutory hybrid plans, it is difficult to believe that Congress intended to treat such plans in an even less favorable manner than cash balance and pension equity plans.

* * * * *

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.

Sincerely,

Mark J. Ugoretz
President & CEO
THE ERISA INDUSTRY COMMITTEE

The ERISA Industry Committee

Fifth Comment in a Series of Six Comments on Proposed and Final Regulations on Hybrid Retirement Plans

PARTICIPANT-DIRECTED CASH BALANCE PLANS

January 12, 2011

EXECUTIVE SUMMARY

Cash balance and pension equity plans cover approximately one out of every four participants in a defined benefit plan in the United States. They also account for roughly 40 percent of the assets held in defined benefit plans nationwide. As a result, these plans provide the primary source of retirement income for a significant number of American workers. As traditional defined benefit plans have become increasingly less attractive, cash balance and pension equity plans have provided a welcome exception to this troubling trend. Congress recognized these facts and, in the Pension Protection Act of 2006 (the "PPA"), adopted comprehensive legislation to encourage employers to adopt and maintain cash balance and pension equity plans. To safeguard the retirement income of the numerous Americans covered by these plans, it is critical that Treasury and IRS draft regulations that reflect Congress' intent to encourage and facilitate the creation and maintenance of cash balance and pension equity plans. The ERISA Industry Committee ("ERIC")[1] stands ready to assist Treasury and IRS in this effort.

Toward that end, ERIC is pleased to present the fifth in a series of six comments on the proposed and final Treasury regulations implementing the cash balance and pension equity plan provisions of the PPA. This comment focuses on participant-directed cash balance plans. These plans permit each participant to direct the investment of his or her cash balance account across a broad array of asset classes. The options available to the participant in each asset class are based strictly on the performance of actual investment funds that most frequently mirror the investment choices available under the employer's 401(k) plan. In this sense, participant-directed cash balance plans resemble 401(k) plans, but with one critical difference—they address the shortcomings that prevent 401(k) plans from becoming a comprehensive retirement income solution and, for that reason, offer an important improved retirement plan option that Treasury and IRS should approve in the final regulations. This comment examines the technical issues raised by participant-directed cash balance plans and explains why none of those issues poses an obstacle to their approval in the final regulations.

[1] ERIC is a non-profit association committed to the advancement of employee retirement, health, and welfare benefit plans of America's largest employers. ERIC represents exclusively the employee benefits interests of major employers who, collectively, provide comprehensive retirement, healthcare coverage and other economic security benefits directly to tens of millions of active and retired workers and their families in all 50 states. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in the American economy.

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

SUBSTANTIVE COMMENT

ERIC is pleased to submit the fifth in a series of six comments on the proposed and final regulations issued by the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS" or "Service") under Title VII and section 1107 of the Pension Protection Act of 2006 ("PPA"), as amended by the Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA"). The regulations apply for purposes of sections 411(a)(13), 411(b)(1)(B), 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 regulations were published in the Federal Register on October 19, 2010. *See* 75 Fed. Reg. 64,123 (final regulations); 75 Fed Reg. 64,197 (proposed regulations). Corrections to the regulations were published in the Federal Register on December 28, 2010. *See* 75 Fed. Reg. 81,456 (final regulations); 75 Fed. Reg. 81,543 (proposed regulations).

ERIC recognizes that the 2010 proposed and final regulations revised and clarified the 2007 proposed regulations in helpful ways and appreciates the consideration that Treasury and IRS have given to ERIC's earlier comments on the 2007 proposed regulations. ERIC offers the following comments to address remaining concerns regarding the proposed regulations set forth in Prop. Treas. Reg. §§ 1.411(b)-1(v)(2)(ii)(H) ("Variable interest crediting rate under a statutory hybrid benefit formula"), 1.411(b)(5)-1(d) ("Market rate of return"), 1.411(b)(5)-1(e) ("Other rules regarding market rates of return"), and 1.411(b)(5)-1(f) ("Effective/applicability date"), as they relate to participant-directed cash balance plans. In addition, the following comments address the application of the anti-cutback and age discrimination rules to participant-directed cash balance plans.

ERIC is submitting five additional separate comments on other aspects of the regulations. 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 regulations. ERIC also requests that it be permitted to testify at the hearing.

Participant-Directed Cash Balance Plans

Participant-directed cash balance plans provide an important development in the evolution of retirement plan design that meet many of the policy goals that have occupied Congress and the Departments of Labor and the Treasury for the last several years. These plans permit employees to participate in building their retirement savings (as in a participant-directed 401(k) plan), without requiring participants to fund their own retirement. At the same time, these plans offer the security of a defined benefit plan, including the ability to obtain a guaranteed lifetime annuity. In addition, the zero cumulative floor provided by a hybrid plan offers protection from losses, particularly for older workers as they approach retirement who, by necessity, have shorter retirement horizons than do younger workers.

Participant-directed cash balance plans offer many advantages when compared to participant-directed 401(k) plans.[2] A cash balance plan can provide a lifetime income (annuity) option, without the fees associated with commercial annuities provided by insurance companies. Participant-directed

[2] For simplicity, we use the term "401(k) plans" to refer to defined contribution plans, including ones that do not include elective deferrals.

cash balance plans, like other defined benefit plans, also may provide participants protection against income loss due to disability. Because distributions from participant-directed hybrid plans are subject to spousal consent requirements of section 417 and the joint and survivor annuity and pre-retirement survivor annuity requirements of section 401(a)(11), participants' spouses also have substantial protections.

Like other forms of hybrid plans, participant-directed plans may provide participant benefits relative to traditional defined benefit plans. The increased portability of the retirement benefit promotes a more efficient labor market by reducing the sometimes substantial loss of future benefits when employees terminate employment in final-average pay plans. The more linear accrual pattern of hybrid plans also provides increased value to a mobile workforce.

Participant-directed cash balance plans are also attractive to employers. Many employers who offer participant-directed cash balance plans are able to minimize funding volatility by investing plan assets so as to track participants' hypothetical investment elections. This provides plan sponsors with a tool that allows them to better budget and plan for their retirement program expenses. Over time, plans like participant-directed cash balance plans that provide greater control over funding volatility may encourage employers to adopt and maintain defined benefit plans, one of the original goals of ERISA.

Participant-directed cash balance plans are consistent with existing statutes, including the Pension Protection Act. The final regulations provide an important opportunity to clarify how the various qualification requirements apply to participant-directed cash balance plans, including (I) the anti-cutback rule, (II) the market rate of return requirements, (III) the age discrimination tests, (IV) the anti-backloading rules, and (V) the plan termination requirements.

I. Anti-Cutback Rule

Participant-directed cash balance plans have been in place for over 15 years. Congress was well aware of these long-standing plans when it passed the PPA, and nothing in the statute or legislative history changes the Service's previous analysis that these plans are permissible and do not violate the anti-cutback rule.

The preamble to the proposed regulations poses questions concerning whether several events in a participant-directed cash balance plan might present issues under the anti-cutback rule. These events include: (1) a participant electing to switch from one investment option to another, (2) a bond index or regulated investment company underlying one of the investment options ceasing to exist, (3) amending a plan to eliminate an investment option, and (4) a participant electing to switch from an investment option with a cumulative minimum to an investment option without a cumulative minimum (or *vice versa*).[3] None of these events would violate the anti-cutback rule. Section 411(d)(6) of the Code generally provides that the accrued benefit of a participant may not be decreased by an *amendment* to the plan. Section 411(d)(6)(B) of the Code provides that a plan

[3] Typically, participant-directed cash balance plans do not offer hypothetical investment options each with cumulative minimum returns. Instead, these plans typically offer investment options that mirror actual investment options in a 401(k) plan that is sponsored by the same employer. A cumulative minimum return would apply to the entire account balance and then only at the point of benefit commencement and not to a single investment option or at any other time.

amendment that has the effect of eliminating or reducing an early retirement benefit or a retirement type subsidy, or eliminating an optional form of benefit, is treated as impermissibly reducing the accrued benefit.

The right to direct investments is included from the outset in a participant-directed cash balance plan: no amendment is needed for participants to modify their elections. Section 411(d)(6) of the Code makes clear that a violation of the anti-cutback rule can occur only as the result of a plan amendment. Because a participant's election of a different hypothetical investment is not a plan amendment (and, in fact, is pursuant to existing plan terms), such an election cannot violate the anti-cutback rule. By contrast, if a hybrid plan grants participants the right to select among hypothetical investments as the basis of determining the participants' interest crediting rates, amending the plan to eliminate this right (with regard to the participants' pre-existing account balances) could well violate the anti-cutback rule.

Furthermore, a participant's election to change his or her hypothetical investment option does not constitute a cutback or waiver of any protected right. The protected right in a participant-directed cash balance plan with respect to future interest credits is the right to an interest credit determined on the basis of the participant's hypothetical investment(s) from the time the election is made (or the participant is defaulted into the investment) until the time the election is changed or no longer available in the plan. Regardless of any subsequent election made by the participant, the participant's protected right (the right to elect among a menu of hypothetical investment options) is preserved.

Similarly, the substitution or elimination of a hypothetical investment option does not violate the anti-cutback rule in most situations. If the plan provides in advance that investment options can be changed, there is no violation of the anti-cutback rule because no particular menu of hypothetical investments was ever promised to participants. This is especially true if the hybrid plan provides that the menu of hypothetical investments will mirror the options available in the sponsor's 401(k) plan. Because the investment line-up in the sponsor's 401(k) plan has independent significance, such discretion is comparable to the employer's discretion over an employee's compensation in a final average pay plan. Any changes in the menu of investment options in a hybrid plan that mirrors a 401(k) plan will reflect the decisions made by fiduciaries fulfilling their Title I obligations under the employer's 401(k) plan.

Some participant-directed cash balance plans are designed to provide participants with a right to invest in certain asset classes, *e.g.*, large cap index funds, mid cap index funds, small cap index funds, stable value funds, employer stock funds, value funds, growth funds, international equity funds, investment-grade bond funds, and others. Although the elimination of one of the enumerated asset classes in a plan might be an impermissible cutback, the substitution of one investment option for another within a class would not be. This is because the plan only provides participants with the right to choose among a menu of hypothetical investments that includes at least one option in each class. Such a plan does not promise any participant that specific hypothetical investment options will be available, and therefore the elimination or substitution of options within each class does not violate the anti-cutback rule, provided that at least one hypothetical investment option remains in each asset class.

Alternatively, the employer could design the plan so that investment options are subject to change periodically (*e.g.*, every year, quarter, or month). Such a plan would not promise any particular investment option beyond the current period and thus no change in the plan's promised benefits occurs when a change in the fund line-up is made. Just as the specific investment options in a 401(k) plan are not protected benefits, a participant's right to select any specific hypothetical investment option in a participant-directed cash balance plan ought not to be protected by the anti-cutback rule.

Any decline in future interest credits due to a change in the participants' hypothetical investment options is equivalent to a decline in future interest credits in a hybrid plan with a variable interest crediting rate. A hybrid plan that credits interest at the 30-year Treasury rate may provide an interest credit of 4% during one plan year and 3% during a later plan year. Treasury and the PPA have implicitly recognized that such a decline is not a reduction in the accrued benefit and does not violate the anti-cutback rule. There is no waiver of the higher interest crediting rate, because the participant did not have a right to interest at 4% every year; the participant only had a right to interest at the variable rate. A decline in interest crediting rate from one year to the next because of a change in participants' hypothetical investment options or elections is not analytically distinct: the participant's right is limited to the right to receive interest each year based on his or her hypothetical investment elections.

Furthermore, even if a participant's selection of a different hypothetical investment were considered a plan amendment, it would not reduce the participant's accrued benefit. A dollar invested in one market-based investment option is worth the same as a dollar invested in another market-based option; the market values each option, and neither is inherently worth more than the other. For this reason, a participant's election to switch, for example, from an equity index fund to a long-term bond fund neither increases nor decreases the participant's accrued benefit as of the time of the election. At the time the election is made, the participant's accrued benefit is based on his or her account balance regardless of the hypothetical investment option chosen. In that sense, the change in a participant's hypothetical investment election operates in much the same manner as a change in a 401(k) plan's actual investment election. Indeed, Treasury and IRS have recognized this point by making clear in regulations that a change in an actual investment option would not violate the anti-cutback rule. *See* Treas. Reg. § 1.411(d)-4, Q&A-1(d)(7) (defined contribution rule).

Congress implicitly recognized that the particular investment option offered under a hybrid plan does not provide additional value: Congress eliminated whipsaw in section 411(a)(13)(A) of the Code, thereby permitting a plan to distribute an amount equal to the participant's current account balance, without projecting the balance to normal retirement age. As long as the plan merely credits interest based on a market rate of return, there is no need to value any particular investment option because all market options have the same present value.

That a riskier investment option may have a potentially higher return than an option with less risk does not mean that the riskier investment is more valuable than the other investment. If that were the case, all investors would choose to invest only in high-return, high-risk investments. Instead, both investments have the same value when adjusted for risk. Indeed, that is the function of the market—to adjust the value of investments based on their relative risk and return characteristics. Consequently, investors choose investments based on a balance of risk and return so that all "good" investments have the same value on a risk-adjusted basis. This means that there is no forfeiture of value when an investor moves assets from one investment to another. Indeed, this is a normal part of sound retirement investing, as investors normally choose to move to less risky investments with lower expected volatility as they near retirement.

II. Market Rate of Return

As ERIC noted in its comment on the proposed rule on market rates of return, the final regulations should allow for the full range of market rates of return, and neither reasonable guaranteed minimum rates nor the zero cumulative floor should be used as a basis for limiting the range of interest crediting rates deemed not to exceed a market rate of return to a subset of actual market rates of return. Congress, in enacting the PPA, sought to allow plan sponsors to include a variety of interest crediting methods in hybrid plans. In particular, 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. Congress sought this expansion "to allow plans to adjust benefits in ways that benefit participants." 152 Cong. Rec. S8756 (daily ed. Aug. 3, 2006).

The PPA allows hybrid plans, including participant-directed cash balance plans, to credit any rate not in excess of a "market rate of return." Code § 411(b)(5)(B)(i)(I). The PPA does not define "market rate of return." Because the term is not defined in the statute, it should be construed "in accordance with its ordinary and natural meaning." *See Federal Deposit Ins. Co. v. Meyer*, 510 U.S. 471, 476 (1994). The natural meaning of the "market rate of return" is a rate an investment earns in the market. The natural meaning of the phrase "market rate" also indicates that the market, and not Treasury or the Service, determines the range of rates of return.

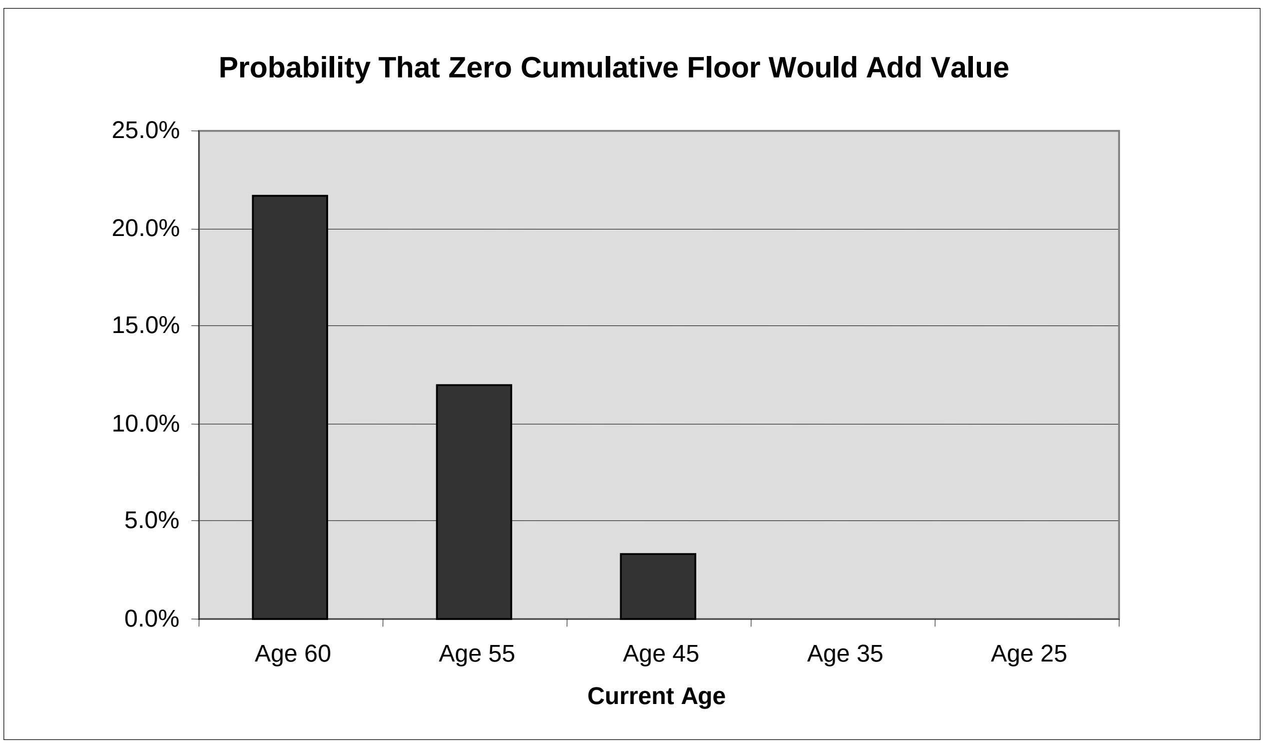
Although the PPA grants the Secretary the authority to promulgate "rules governing the calculation of a market rate of return for purposes of subclause (I) and for permissible methods of crediting interest to the account (including fixed or variable interest rates) resulting in effective rates of return meeting the requirements of subclause (I)," section 411(b)(5)(B)(i)(III) of the Code does not give Treasury or the Service the authority to determine what constitutes a market rate of return or to promulgate an exclusive list of rates which are market rates.

ERIC strongly recommends that the final regulations recognize that a substantial number of additional variable rates are market rates of return. The final regulations should adopt the position that 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). In addition, the final regulations should make clear that participants in participant-directed cash balance plans should be permitted to elect any hypothetical investment that would qualify as a market rate of return that was selected for inclusion in the plan's menu of hypothetical investment options.

Furthermore, the final regulations should acknowledge that the zero cumulative floor in section 411(b)(5)(B)(i)(II) of the Code was not intended to limit the universe of permissible interest rates. Using the zero cumulative floor to limit the meaning of market rate of return under the PPA is unsupported by the statute. Neither the statute, which addresses the market rate of return rule and the zero cumulative floor separately, nor the legislative history, indicate that the range of permissible rates is limited by the fact that Congress simultaneously enacted the floor to protect participants. The rule is instead a defined benefit plan feature of hybrid plans that applies at the time the participant's account balance is converted into his or her benefit.

Indeed, the zero cumulative floor adds a feature to hybrid plans that favors older plan participants. The PPA regulates the interest crediting in hybrid plans because a younger participant is assumed to have a longer period of time to participate in a plan than a similarly situated, older participant. For example, a thirty year-old participant could receive interest credits on his or her account for thirty-five years before attaining age 65 while a similarly situated sixty year-old could receive interest credits for only five years before attaining age 65. Notably, a zero cumulative floor would be expected, based on historical data, to provide much greater value when interest is credited for a short period of time. Thus, a zero cumulative floor would favor the older employee, who has fewer years of interest crediting, than a similarly situated younger employee, who has more years of interest crediting.

For example, over the past century, cumulative equity returns on the S&P 500 index have been negative for approximately 20% of the five-consecutive-year periods, 12% of the ten-consecutive-year periods, 3% of the twenty-consecutive-year periods, and 0% of the thirty-consecutive-year periods. *See* Crestmont Research, STOCK MATRIX (UPDATED THROUGH 2009), *available at* http://www.crestmontresearch.com/pdfs/Stock%20Matrix%20Index5%2011x17.pdf. The chart below shows the probability that the zero cumulative floor will affect a single year's pay credit at a given age, assuming the participant begins to receive his or her benefit (and therefore ceases to receive interest crediting) at age 65:



The zero cumulative floor therefore does not support limiting the permissible rates of return to an artificial subset of actual market rates of return, and to the extent that the proposed and final regulations are based on this rationale, they should be modified.

Participants in a participant-directed cash balance plan should be permitted to choose among a wide array of hypothetical investments that individually qualify as market rates of return. This is essential to allowing participants to build sufficient retirement savings in these types of plans and adjust their risk exposure as they near retirement. A common plan design for these plans is to mirror the investment options available in the employer's 401(k) plan. While we believe any actual market investment should be a permissible interest crediting rate, at a minimum, any investment available in the employer's 401(k) plan(s) should be a permissible hypothetical investment option in a participant-directed cash balance plan.

Permitting sponsors of participant-directed cash balance plans to create hypothetical investment line-ups composed of actual investment options in the employer's 401(k) plan(s) regardless of whether those options are mutual funds, collective trusts, or other investment vehicles will not result in the type of participant abuse with which Treasury and the Service have expressed concern. Because the funds' inclusion in a 401(k) plan line-up will have subjected them to the selection and periodic review processes required by the fiduciary obligation under Title I, with limited exceptions, these options are unlikely to include highly volatile investments.

While ERIC recognizes Treasury's concerns regarding highly volatile investment options, the Service must not attempt to use the zero cumulative floor to turn participant-directed cash balance plans into 401(k) plans. Congress recognized that participant-directed cash balance plans are not 401(k) plans and any attempt by the Service to limit participants' right to receive a market rate of return to reflect the plans' defined benefit status would be inappropriate. The zero cumulative floor was included in PPA to reinforce the defined benefit status of investment-based hybrid plans by placing a portion of the downside investment risk on the plan sponsor. Treasury and the Service should not attempt to value this feature of a hybrid plan and limit the universe of interest crediting rates that can be used within a participant's account to ensure that a participant cannot achieve a greater return in a hybrid plan than in a 401(k) plan. Congress' effort to protect participants' accumulated pay credits was not intended to function as a limitation on which hypothetical investment options could be included in a participant-directed cash balance plan. Congress did not intend for—and the Service should not use— this feature to limit a participant's ability to seek high returns within a hybrid plan.

To address the Service's concerns regarding highly volatile investments, ERIC strongly encourages the Service to specifically exclude certain types of investments rather than allowing only an overly restrictive list of hypothetical investment options. This would allow participants in these plans to elect between a full array of investments that do not provide participants with opportunities for abuse. For example, the final regulations might exclude investment options in the sponsor's 401(k) plan(s) that were not selected by a plan fiduciary. Such a restriction would generally exclude the types of options most likely to raise concerns, such as employer stock (and employer stock funds), investments available in brokerage windows, and, in some cases, funds available in mutual fund windows. While these options can be appropriate in a 401(k) plan, they most directly reflect the types of investments that the Service believes would encourage participants to take excessively volatile positions in light of the zero cumulative floor.

If the Service believes that further limitations on hypothetical investment options are necessary, ERIC strongly recommends that, at a minimum, any option that would qualify as a qualified default investment alternative ("QDIA") should be permitted. QDIAs are by definition appropriate investment options for meeting an employee's long-term retirement savings needs. By law, they are not the type of investments that are likely to be overly volatile, excessively risky, or prone to participant abuse. While limiting the menu of hypothetical options in a participant-directed cash balance plan to QDIAs would exceed the limits necessary to address the Service's concerns, it would still provide participants with a meaningful choice among investment options.

Alternatively, the Service could impose a diversification requirement on participants in a participant-directed cash balance plan. Under this option, participants would be required to invest in (a) a broadly-diversified investment option (such as an index fund, balanced fund, target-date or lifecycle fund), (b) a professionally managed account, (c) an investment option intended to protect principal, or (d) in a combination of securities that provides an appropriate level of diversification. For example, a participant who elects to choose several available options might be allowed to place no more than 25% of his or her account balance in any one hypothetical investment option that is not a broadly-diversified investment option, a professionally managed account, or an investment option intended to protect principal. However, this option would impose a higher administrative burden on plan sponsors than permitting participants to choose any fiduciary-selected investment in the 401(k) plan, and for that reason is by far not the preferred solution.

III. Age Discrimination

The final regulations should make clear that using a default investment that takes into account the participant's age for the purposes of determining the interest crediting rate for a participant who fails to elect a hypothetical investment in a participant-directed cash balance plan does not violate the age discrimination requirements.

Differences between participants' interest crediting rates in a participant-directed cash balance plan generally are not related to participants' ages, but are instead the result of participants' individual selections of hypothetical investment options. However, like participant-directed 401(k) plans with non-elective contributions or auto-enrollment, participant-directed cash balance plans must use a default hypothetical investment to determine the interest crediting rate if the participant fails to make his or her own election. Participant-directed cash balance plans generally use hypothetical investment options that track the default investment election in the employer's 401(k) plan(s). Because these hypothetical investments are, in many cases, designed to protect a participant's account balance as the participant nears retirement, these options might experience lower interest crediting rates as a participant's age increases in exchange for a reduced risk of loss.

The final regulations should make clear that a participant-directed cash balance plan does not fail to satisfy the age discrimination requirements if it uses a default hypothetical investment for participants who fail to make an investment election in a target-date or lifecycle fund that is actually available in the 401(k) plan according to the participant's age. The final regulations should also make clear that a participant-directed cash balance plan does not fail to satisfy the age discrimination requirements if it places a participant who does not submit a hypothetical investment election into a hypothetical investment that takes into account the participant's age and that would qualify as a QDIA under a 401(k) plan.

IV. Backloading Rules

To apply the 133-1/3% anti-backloading test to a plan that credits interest based on the return on an actual investment or investments, the plan should be required under the final regulations to calculate every year a participant's accrued benefit payable at normal retirement age by projecting future interest using the yield on Treasury securities of appropriate durations. This approach would be consistent with projecting bond-based returns using the yield in effect before the current plan year.

The proposed regulations would permit a hybrid plan that uses a variable interest crediting rate to project an interest crediting rate of zero for the purposes of satisfying the backloading rules if the plan's interest crediting rate was below zero in the prior plan year. Prop. Treas. Reg. § 1.411(b)-1(b)(2)(ii)(H). Because no market investment has a long-term expected return of zero, ERIC strongly recommends that the final regulations include a more economically sound rate for projection that more fairly approximates the value of future interest credits. As described below, the appropriate rate is the risk-free rate of return. Any variable rate chosen by the plan sponsor is expected to provide at least a nominal long-term cumulative gain regardless of the volatility of the option and, in general, should be expected to provide a long-term return at least equal to that of the risk-free rate of return.

Current regulations require a plan to hold all factors constant, including interest rates, as of the beginning of the plan year for purposes of satisfying the 133-1/3% backloading test. Treas. Reg. § 1.411(b)-1(b)(2)(ii)(D). If a hybrid plan uses an annual bond yield to determine the interest crediting rate, this rate is typically the bond's yield for the prior plan year. This makes sense. Holding all factors constant eliminates market risk, and, absent market risk, a bond's return is based solely on its yield. Because the risk of default is low, the current rate approximates fairly the value of future interest credits. On the other hand, with respect to investment-based rates of return, the prior year's return would not approximate the expected value when risk is eliminated. Using the risk-free rate of return (approximated by the yield on Treasury securities) more fairly approximates the value of future interest credits and accurately risk adjusts market returns for purposes of the projection.

The rate of projection for purposes of satisfying the 133-1/3% test is especially critical for participant-directed cash balance plans. Participants in those plans are allowed to choose among a menu of hypothetical investment options, all of which reflect actual market rates of return. It is therefore likely that a participant will in some years experience a negative rate of return.

Furthermore, a reasonable projection rule is necessary to enable participant-directed plans (and other investment-based plans) to provide additional benefits to older and longer-service employees. Many hybrid plan sponsors, including sponsors of participant-directed cash balance plans, reward long-tenured employees by providing service-graded pay credits that increase with years of service. Other sponsors attempt to aid older participants who are nearing retirement by providing age-graded pay credits that increase as a participant ages. Still others may use a combination of points based on age and service to increase pay credits with increasing age and/or service. Under the proposed regulations, many of these designs would not be able to satisfy the 133-1/3% test. A plan that utilizes a variable interest crediting rate that can be negative (such as any true variable market rate) and age- or service-graded pay credits cannot satisfy the test unless the plan's highest pay crediting rate does not exceed its lowest pay crediting rate by more than one-third. Certainly, when specifically permitting investment-based plans in the PPA's age-discrimination rules, Congress did not intend to force plans to reduce benefits to older, longer-service employees. Even with graded pay credits, these plans provide retirement benefits that are more front-loaded than traditional final average pay plans.

Even if Treasury and the IRS do not accept the recommendation to use the risk-free rate of return for projecting interest credits that are investment-based, there are other, more reasonable alternatives than projecting assuming a zero percent rate of return. For example, a plan sponsor could be permitted to use the same projection rate that is required under Treas. Reg. § 1.430(d)-1(f)(5), which requires a plan's actuary to project account balances forward to the anticipated date of payment based on reasonable actuarial assumptions for funding purposes.

V. TERMINATION ISSUES

For purposes of determining the 5-year average interest rate applicable to a standard or distress termination, the final regulations should permit a participant-directed cash balance plan sponsor to elect to use either the plan's actual average crediting rate for all participants or the average of the risk-free rate of return. For standard terminations, the average third segment rate and 5% should also be permissible uniform post-termination interest crediting rates.

Although PPA arguably provides Treasury no authority to allow the use of substitute rates in place of the rate specified by the statute, if the final regulations allow for substitution, it should do so at a rate that fairly reflects the value of future interest credits. Prop. Treas. Reg. § 1.411(b)(5)-1(e)(2)(ii)(C) generally requires a hybrid plan that determines interest credits using the rate of return on plan assets, an annuity contract, or a diversified regulated investment company to substitute the third segment rate for the plan rate for purposes of determining the 5-year average interest rate used to determine post-termination interest credits. As ERIC has stated in its separate comment that addresses termination issues generally, the third segment rate is an unreasonably high rate that does not fairly reflect the value of future interest credits because it fails to account for the elimination of all future investment risk from the fixed rate going forward. From an economic perspective, it would be more appropriate to substitute a risk-free rate of return, such as the return on Treasury securities with appropriate maturity, since there is no risk of future negative interest credits once the plan is terminated.

Using the third segment rate as the substitute rate would increase the cost of plan terminations unnecessarily. Treasury and IRS should investigate how insurance companies would price annuity contracts to fund individual participants' benefits if use of the third segment rate applied to determine the guaranteed 5-year average interest rate. In today's market, that would require a 6-7% guaranteed return under the contracts. The annuity contracts might be prohibitively expensive or not obtainable in the market.

Indeed, plan sponsors should have the flexibility, in standard or distress terminations, to elect to use the 5-year average of actual plan interest credits for all participants or the risk-free rate of return as the most reasonable proxy for market rates of return. This would be generally true for investment-based plans, but especially for participant-directed cash balance plans, where it would be administratively burdensome to recreate each participant's individual investment-based credits for the preceding five years. Although the statute does not require a participant-by-participant approach, the proposed regulations generally require determination of the 5-year average interest rate on a participant-by-participant basis. This participant-by-participant approach would be a significant administrative burden for participant-directed cash balance plans. Furthermore, having to apply varying interest rates could make purchasing annuity contracts to cover benefit obligations significantly more costly than it would otherwise be.

Furthermore, in a standard termination and assuming that plan assets would be sufficient to provide any additional benefits that may result, the final regulations should permit plan sponsors to elect to substitute, if higher than the plan's actual 5-year average, the 5-year average of the third segment rate or 5%, because both of those rates are market rates. The PPA's plan termination provision was not intended to prohibit plan sponsors from increasing benefits at the time of a standard plan termination.

VI. Anti-cutback Relief and Effective Date

To the extent that the final regulations require changes in existing participant-directed cash balance plans, plan sponsors will need anti-cutback relief and transition relief to come into compliance with the final regulations. The final regulations must provide plan sponsors with a clear avenue for bringing these plans into compliance.

A. Section 411(d)(6) Relief

Participant-directed cash balance plans have been in existence for more than a decade and a half. If Treasury and the Service determine that these plans no longer satisfy the Code's qualification requirements or require changes to comply with new rules, the Service must provide anti-cutback relief. However, ERIC urges Treasury and the IRS, in the strongest possible terms, not to force plans to reduce participants' accrued benefits or existing rights (such as participant direction) under any hybrid plan unless they are absolutely certain that such reductions are required under the statute.

The proposed regulations state that the IRS expects to provide anti-cutback relief provided that the amendment is adopted before those final regulations apply to the plan, and the elimination or reduction is made only to the *extent necessary* to enable the plan to meet the requirements of section 411(b)(5). *See* 75 Fed. Reg. 64,208. As stated in our other comments, this standard is too narrow. In many cases, plans that have an interest crediting rate that is deemed impermissible under the final regulations will have numerous options for bringing the plan into compliance. This may be particularly true for participant-directed cash balance plans depending upon the content of the final regulations: the plans may be required to eliminate participant direction and adopt a plan-wide interest crediting rate, add restrictions on participant elections, eliminate some current hypothetical investment options, add new hypothetical investment options, or make other changes. At the very least, plan sponsors of participant-directed plans should be permitted to (a) eliminate hypothetical investment options that are no longer permissible, and (b) if the final regulations substantially restrict participant direction, switch to a plan design without participant direction and select any permissible interest crediting rate.

B. Effective Date

The final regulations should be prospective only and should be effective for the first plan year that begins more than 12 months after the final regulations are published in the Federal Register.

The final regulations must provide plan sponsors with the time needed to interpret the regulations and make decisions regarding how they will bring their plans into compliance. In many cases, plan sponsors will have to hold meetings with their boards of directors and adopt corporate resolutions significantly amending their plans in several meaningful ways. Many of the rules in the proposed regulations, if left unchanged, will require substantial time for third-party administrators to reprogram systems and train administrative staff. These issues are even more substantial for participant-directed cash balance plans that could face some of the largest changes based on the proposed regulation's narrow definition of market rate of return and the questions raised in the regulation's preamble.

Most importantly, plan sponsors will need sufficient time to prepare participant communications and inform participants about the changes in their retirement plan. For participants in a participant-directed cash balance plan, those changes could be more significant than for other participants given the potential need to rebalance other sources of retirement savings if participant direction in the hybrid plan is meaningfully restricted or discontinued. For all of these reasons, ERIC strongly recommends that the final regulations not be effective until the first plan year that begins more than 12 months after the date on which final regulations are published in the Federal Register.

* * * * *

ERIC appreciates the opportunity to submit our views on the proposed regulations and recommendations on how the final regulations should address participant-directed cash balance plans. We look forward to working with you to create workable rules that reflect the statutory language of the Pension Protection Act and fully effectuate Congress's intent in adopting it. If we can be of further assistance to the Treasury and IRS, please let us know.

Sincerely,

Mark J. Ugoretz
President & CEO
THE ERISA INDUSTRY COMMITTEE

ERIC

The
ERISA
Industry
Committee

Sixth Comment in a Series of Six Comments on
Proposed and Final Regulations on Hybrid Retirement Plans

PENSION EQUITY PLANS

January 12, 2011

EXECUTIVE SUMMARY

Cash balance and pension equity plans cover approximately one out of every four participants in a defined benefit plan in the United States. They also account for roughly 40 percent of the assets held in defined benefit plans nationwide. As a result, these plans provide the primary source of retirement income for a significant number of American workers. As traditional defined benefit plans have become increasingly less attractive, cash balance and pension equity plans have provided a welcome exception to this troubling trend. Congress recognized these facts and, in the Pension Protection Act of 2006 (the "PPA"), adopted comprehensive legislation to encourage employers to adopt and maintain cash balance and pension equity plans. To safeguard the retirement income of the numerous Americans covered by these plans, it is critical that Treasury and IRS draft regulations that reflect Congress' intent to encourage and facilitate the creation and maintenance of cash balance and pension equity plans. The ERISA Industry Committee ("ERIC")[1] stands ready to assist Treasury and IRS in this effort.

Toward that end, ERIC is pleased to present the sixth in a series of six comments on the proposed and final Treasury regulations implementing the cash balance and pension equity plan provisions of the PPA. This comment focuses on pension equity plans. Undoubtedly, the PPA was intended to provide legal certainty and clarity in the law to cash balance plans and pension equity plans alike. When enacting the PPA, Congress specifically, and for the first time, formally recognized the viability—and indeed the desirability—of pension equity plans. Yet despite this clear Congressional intent, the proposed and final regulations do not provide adequate guidance for PEP sponsors. ERIC recommends that the Treasury and IRS develop a comprehensive, workable set of rules that provide PEPs with legal certainty and a clear path to compliance.

[1] ERIC is a non-profit association committed to the advancement of employee retirement, health, and welfare benefit plans of America's largest employers. ERIC represents exclusively the employee benefits interests of major employers who, collectively, provide comprehensive retirement, healthcare coverage and other economic security benefits directly to tens of millions of active and retired workers and their families in all 50 states. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their cost and their effectiveness, as well as the role of those benefits in the American economy.

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

INTRODUCTION

The ERISA Industry Committee ("ERIC") is pleased to submit the last in a series of six comments on the proposed and final regulations issued by the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS" or "Service") under Title VII and section 1107 of the Pension Protection Act of 2006 ("PPA"), as amended by the Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA"). The regulations apply for purposes of sections 411(a)(13), 411(b)(1)(B), 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 regulations were published in the Federal Register on October 19, 2010. *See* 75 Fed. Reg. 64,123 (final regulations); 75 Fed Reg. 64,197 (proposed regulations). Corrections to the regulations were published in the Federal Register on December 28, 2010. *See* 75 Fed. Reg. 81,456 (final regulations); 75 Fed. Reg. 81,543 (proposed regulations).

ERIC recognizes that the 2010 proposed and final regulations revised and clarified the 2007 proposed regulations in helpful ways and appreciates the consideration that Treasury and IRS have given to ERIC's earlier comments on the 2007 proposed regulations. ERIC offers the following comments to address remaining concerns regarding the proposed and final regulations as they relate to pension equity plans (PEPs). ERIC is submitting five additional separate comments on other aspects of the regulations.

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 regulations. ERIC also requests that it be permitted to testify at the hearing.

I. PEP SPONSORS NEED GUIDANCE THAT PROVIDES LEGAL CERTAINTY

The proposed and final regulations offer only minimal guidance on pension equity plans (PEPs). This puts PEP sponsors in an awkward position, knowing they will have to comply with the rules in the near future with limited guidance on how to do so.

The regulations leave even the fundamental characterization of PEPs in doubt. The regulations appear to treat PEPs as a distinct plan type until accruals under the PEP formula end. Thereafter, they treat PEPs as either: (1) a cash balance plan, if the plan explicitly credits interest on PEP accumulations, or (2) a traditional deferred annuity plan, if the plan does not explicitly credit interest and instead uses an actuarial calculation to convert the PEP accumulation into immediate and deferred benefits.

Analyzing PEPs in this way misses the key distinction between PEPs 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 the periodic pay credits made to his or her account, but are not applied to adjust the entire benefit. By contrast, in a PEP, a participant's entire benefit is first adjusted by changes in final average compensation during employment and then (either explicitly or implicitly) by interest following employment. What distinguishes PEP interest from interest credits in a cash balance plan is that PEP interest does not commence immediately but instead is delayed until employment ends. Therefore, the amount of interest credited under a PEP generally is contingent upon when the participant terminates employment.

In some PEPs, interest commences when PEP accruals cease if that occurs before the participant's employment ends. This might occur, for example, when the participant transfers to an affiliated employer that does not participate in the plan or to another job position that is not otherwise covered under the plan. For the sake of brevity, the following discussion refers to PEP interest as beginning when employment ends as shorthand for when interest starts under the plan, be that when employment ends or when PEP accruals cease.

The regulations impose the PPA's principal mandates on PEPs, including 3-year vesting and minimum conversion requirements. Yet the regulations appear to deny PEPs the ability to qualify to pay benefits based on the current value of the accumulated percentage of final average compensation (the "PEP accumulation") unless they explicitly credit interest on PEP accumulations. The preamble to the proposed regulations states that PEPs that implicitly credit interest are "eligible for the relief of section 411(a)(13)(A) with respect to the PEP value as of every period before cessation of PEP accruals" (when most distributions would be barred as prohibited in-service distributions) but that relief does not apply after PEP accruals stop (when most distributions generally would be paid). It is not clear what it means to have relief for distributions only during the period when most distributions cannot be made. Furthermore, it is unclear whether PEPs that do not explicitly credit interest on PEP accumulations qualify for the safe harbor age discrimination tests for statutory hybrid plans.

Because PEPs that implicitly credit interest provide benefits that are not significantly different from (and could be identical to) the benefits provided by PEPs that explicitly credit interest, this distinction between explicit-interest and implicit-interest PEPs seems to place form over substance, contrary to Congressional intent. *See* 152 Cong. Rec. S8751 (daily ed. August 3, 2006) (statement of Sen. Enzi) (the bill does not elevate form over substance). Even if there is a difference in substance for some implicit-interest PEPs, the implicit interest is simply an adjustment (or indexing) for the time value of money, which the statute says is permissible. *See* Code § 411(b)(5)(E). Congress clearly intended that PEPs would be covered by the general PPA indexing rule. *See* 152 Cong. Rec. S8751 & S8756 (daily ed. August 3, 2006) (statements of Sen. Enzi) (cash balance and pension equity plans are permitted to rely on the PPA indexing rule).

It would be unfortunate if uncertainties created by gaps in the regulations were to leave PEPs exposed to potential disqualification or costly litigation. Therefore, ERIC recommends that the Treasury and IRS develop a comprehensive, workable set of rules that provide PEPs with legal certainty, a clear path to compliance, and under which PEPs can actually operate. ERIC stands ready to work with Treasury and IRS in developing these rules.

II. SUMMARY OF PEP DESIGNS

In order to be comprehensive and workable, any set of rules developed for PEPs must take into account the most significant features of PEP designs. The summary below describes PEP designs maintained by ERIC members.

A PEP is a defined benefit plan that determines a participant's benefit by reference to an amount equal to an accumulated percentage of the participant's final average compensation (the "PEP accumulation"). The PEP accumulation amount is adjusted on a contingent basis by changes in the participant's final average compensation during employment. After employment ends, the PEP benefit, determined based on the PEP accumulation amount, is adjusted for interest either explicitly (by adding interest to the PEP accumulation amount) or implicitly (by using an actuarial calculation that takes interest into account).[2]

The annual PEP credits that determine a participant's PEP accumulation may be age- and/or service-graded and may be integrated with Social Security. It is not uncommon for a PEP to cap the percentage of final average compensation that a participant may accumulate over his or her career. Also, annual transition or other credits may be provided for some or all participants to make up for differences between the new PEP formula and a prior traditional formula.

In general, PEPs determine the benefit payable to a participant based on his or her PEP accumulation using one of the following approaches:

> Approach 1 (explicit interest): Benefits payable as of a given annuity starting date equal the actuarial equivalent of the PEP accumulation amount as of termination of employment plus interest. Interest is credited starting at termination of employment and ending on the annuity starting date.
>
> Approach 2A (implicit interest to annuity starting date): Benefits payable as of a given annuity starting date equal the actuarial equivalent of the PEP accumulation amount as of termination of employment. Although no interest is explicitly credited, the actuarial factors or assumptions used to convert the PEP accumulation amount at termination of employment into the benefit payable on the annuity starting date take pre-annuity starting date interest into account. Pre-retirement mortality may or may not be taken into account as well.
>
> Approach 2B (implicit interest to normal retirement date): Benefits payable as of a given annuity starting date are based on the benefit payable commencing at normal retirement age (the "normal retirement benefit") in a manner similar to that applied by traditional defined benefit plans. The normal retirement benefit equals the actuarial equivalent of the PEP accumulation amount as of termination of employment. Although no interest is explicitly credited, the actuarial factors or assumptions used to convert the PEP accumulation amount at termination of employment into the normal retirement benefit take interest into account. Pre-retirement mortality may or may not be taken into account as well.

Differences in the benefits provided under these approaches are not great since most PEPs use fixed rather than variable interest assumptions. In fact, a PEP using Approach 1 could provide benefits identical to those provided by a PEP using Approach 2A or 2B if both PEPs use the same fixed interest rate and the PEP using Approach 2A or 2B does not take pre-retirement mortality into account. Although fixed interest rates are more common, there are PEPs that use variable interest rates. For example, a PEP using Approach 2B might determine the normal retirement benefit using the value of the variable interest rate specified by the plan as of termination of employment and yet

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[2] Some plans that determine benefits based on an amount equal to an accumulated percentage of final average compensation do not adjust participants' benefits by explicit or implicit interest. ERIC believes that such plans are not PEPs and therefore should be excluded from the definition of statutory hybrid plan.

determine a benefit payable on an annuity starting date before the normal retirement date by determining the actuarial equivalent of the normal retirement benefit using the value of that variable interest rate as of the annuity starting date.

Some PEPs attempt to smooth accruals by applying a cap or a floor to PEP accruals or by fractionally accruing the projected benefit at normal retirement age. PEPs that apply a cap to smooth accruals generally restrict the normal retirement annuity accrued as of any point in time to the actuarial equivalent of the lesser of (1) the current PEP accumulation amount projected to normal retirement age with interest but no further PEP credits or changes in final average compensation, or (2) the current PEP accumulation projected to normal retirement age with all additional PEP credits that would be earned through normal retirement age but with no interest and no further changes in final average compensation after the current year.

PEPs that apply a floor to smooth accruals generally do so by calculating a participant's benefit as the greatest of the benefits derived from (a) the participant's PEP accumulation amount in the year employment ends, or (b) his or her PEP accumulation amount in each prior year brought forward with interest from that year but with no additional PEP credits or changes in final average compensation after that year. In some PEPs, the floor is expressed as an algorithm under which the floor amount is determined when employment ends. This might be the case, for example, for a PEP with integrated PEP credits, under which the integration level is determined when employment ends and is used to calculate the comparison PEP accumulation amounts for each prior year.

PEPs that use the fractional method to smooth accruals generally do so by determining a participant's accrued benefit at any point in time as the projected normal retirement annuity multiplied by a fraction equal to the participant's service to date over his or her projected service at normal retirement age (assuming continued employment until normal retirement age). For this purpose, the projected normal retirement annuity equals the actuarial equivalent of the participant's current PEP accumulation projected to normal retirement age with all PEP credits that would be earned through normal retirement age but no interest and no further changes in final average compensation.

As a general rule, unless part of a smoothing function described above, the amount of PEP interest (explicit or implicit) is not guaranteed (*i.e.*, is not part of the accrued benefit) and is contingent upon when employment terminates. PEPs generally satisfy backloading using the fractional accrual rule; however, some PEPs use the 133-1/3% rule.

Many PEPs provide benefits including time-based subsidies and/or form-based subsidies. The discussion regarding subsidized forms of benefit in ERIC's comments on the "whipsaw" provisions of the regulations applies to all hybrid plans, including PEPs, and describes the universe of subsidies provided by these plans.

The paragraphs above describe the most significant features of PEP designs. In addition to the above, it may be appropriate to have PEP rules addressing issues related to post-normal retirement age accruals and calculating PEP benefits following suspension and/or rehire.

III. TRANSITION

Because PEPs are the principal source of retirement income for a significant number of employees, ERIC recommends that Treasury and IRS develop a comprehensive, workable set of rules that will provide PEPs with legal certainty. These rules should provide PEP sponsors with a roadmap that, if followed, will ensure compliance with the PPA and help avoid any traps for the unwary under other tax-qualification rules. When Treasury and IRS develop such rules, they should be issued in proposed form so that Treasury and IRS have an opportunity to receive and evaluate public comments on the proposed rules before they are finalized. This opportunity should be afforded to any specific rules developed for PEPs.

The effective date of any PEP rules should be deferred until the later of (1) twelve months following issuance of final regulations, or (2) the first day of the first plan year to begin after issuance of final regulations. The final regulations should make clear that PEPs are not required to comply with these requirements, on a good-faith basis or otherwise, during any period before the delayed effective date.

Finally, Treasury should provide anti-cutback relief to allow PEP sponsors to amend their plans to comply with the final rules, but should not force sponsors to unduly reduce participants' accrued benefits as a condition of satisfying those rules. PEPs are the principal source of retirement income for a significant number of employees and operate in much the same way as well-established and lawful plan designs that have long been approved under the Code and ERISA.[3] Congress intended the PPA to encourage continued coverage for participants under cash balance and PEPs. For example, when some of the PPA provisions were being considered, Senator Burr observed: "As you know, it is the cash balance pension design that has been at the center of the congressional discussion about the need to provide legislative clarity for hybrid plans. Yet, another leading variety of hybrid plan, called the pension equity plan, is in equal need of congressional attention." 151 CONG. REC. S12,915 (daily ed. Nov. 16, 2005).[4] Providing PEPs with legal certainty and a clear path to compliance with the PPA is a *sine qua non* to meeting that Congressional goal.

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[3] As noted in ERIC's comments on the 2007 proposed regulations, many of the questions raised about PEPs 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).

[4] *See also* 151 CONG. REC. S12,913 (daily ed. Nov. 16, 2005) (statement of Mr. Levin) ("Legal questions surrounding hybrids like cash balance and pension equity plans should not stand in the way of companies offering the best pension plans that they can."); 151 CONG. REC. S12,917 (daily ed. Nov. 16, 2005) (statement of Mr. Bond) ("Hybrid plans whether cash balance or pension equity - are a modern form of defined benefit plan that combines the best features of defined contribution plans, such as 401(k)s, with the best features of traditional defined benefit programs."); 151 CONG. REC. S12,917 (daily ed. Nov. 16, 2005) (statement of Mr. Bond) ("In addition, while clarifying the age discrimination rules for hybrid plans prospectively and retroactively, it is my hope that the future conferees of this legislation will considering making a specific reference to pension equity plans - a type of hybrid plan other than cash balance plans - in the statutory language."); 151 CONG. REC. S12,920 (daily ed. Nov. 16, 2005) (statement of Mr. Hatch) ("These cash-balance and pension equity plans, in which over 9 million Americans currently participate, incorporate the attractive features of a defined contribution plan while offering much of the security associated with the

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ERIC appreciates the opportunity to present its 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.

Sincerely,

Mark J. Ugoretz
President & CEO
THE ERISA INDUSTRY COMMITTEE

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traditional defined benefit plans."); 152 Cong. Rec. S8751 (daily ed. Aug. 3, 2006) (statement of Mr. Enzi) ("For purposes of applying the age discrimination test, the bill permits a plan to express an employee's accrued benefit 'under the terms of the plan' as an account balance or current value of the accumulated percentage of the employee's final average compensation. This rule was intended to limit, for purposes of age discrimination testing, the use of an account balance to cash balance plans and the use of a current value to pension equity plans.").