The ERISA Industry Committee

February 8, 2005

By Hand

Internal Revenue Service
CC:PA:LPD:PR (REG-114726-04)
Courier's Desk
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Distributions from a Pension Plan under a Phased Retirement Program

Ladies and Gentlemen:

We are pleased to submit the enclosed comments of The ERISA Industry Committee ("ERIC")[1] on the proposed rule regarding distributions from a pension plan under a phased retirement program.

If you have any questions about our comments, or if we can otherwise be of assistance, please let us know.

Respectfully submitted,

Mark J. Ugoretz
President

cc: William F. Sweetnam, Jr.
Cathy A. Vohs

[1] ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their costs and effectiveness, and the role of those benefits in the American economy.

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COMMENTS OF
THE ERISA INDUSTRY COMMITTEE

THE PROPOSED REGULATIONS
ON
PHASED RETIREMENT PROGRAMS

February 8, 2005

The ERISA Industry Committee ("ERIC")[1] is pleased to submit the following comments on the proposed regulations on distributions from a pension plan under a phased retirement program.

The proposed regulations were published in the November 10, 2004, issue of the Federal Register. 69 Fed. Reg. 65,108. The preamble to the proposed regulations states that comments on the proposed regulations must be submitted by February 8, 2005.

I. Summary of Comments

1. ERIC commends the Treasury Department (the "Treasury") and the Internal Revenue Service (the "Service") for their efforts to accommodate phased retirement programs. Although ERIC has significant concerns about provisions of the proposed regulations, ERIC very much appreciates the time, effort, and thought that the Treasury and the Service have devoted to formulating a concrete proposal on this important subject. ERIC looks forward to working with the Treasury and the Service to facilitate phased retirement programs.

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[1] ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health care coverage, incentive, and other economic security benefits directly to some 25 million active and retired workers and their families. ERIC has a strong interest in proposals affecting its members' ability to deliver those benefits, their costs and effectiveness, and the role of those benefits in the American economy.

2. The proposed regulations should preserve the current-law definition of "normal retirement age." The proposed new definition should be withdrawn because it (a) conflicts with established law, (b) conflicts with the anti-cutback rule in Code § 411(d)(6), (c) imposes a legal standard that is vague, unclear, and inadministrable, and (d) punishes cash balance plans that credit participants' accounts with favorable rates of return.

3. The complexity and restrictiveness of the proposed regulations should be reduced.

4. The proposed regulations' pro rata rule should be replaced by a simpler and more administrable rule.

5. The Treasury and the Service should consider adopting a rule that makes a plan's ability to distribute benefits depend on whether a specified event has occurred rather than on the employee's status over time as a part-time employee.

6. The proposed regulations' age 59-1/2 rule should be changed to an age 55 rule.

7. The proposed regulations should be revised to allow part-time employees to participate in a phased retirement program.

8. Reconsideration should be given to the possibility of allowing phased retirement benefits to be paid in the form of an eligible rollover distribution.

9. The proposed regulations' voluntariness requirement should be clarified.

10. The proposed regulations' nondiscrimination rule should be clarified or revised to tailor it to the circumstances of phased retirement programs.

11. The proposed regulations' benefit accrual requirement should be revised to make it consistent with the customary and appropriate treatment of part-time employees.

12. The Treasury and the Service should withdraw the proposed rule requiring a partially retired employee to be treated automatically as a highly compensated employee ("HCE") during the employee's phased retirement period if the employee was an HCE immediately before partially retiring.

13. The proposed regulations should be revised to make clear that a phased retirement program is not required to distribute social security supplements.

14. The Treasury and the Service should clarify how the retroactive annuity starting date regulation (§ 1.417(e)-1) applies to a participant in a phased retirement program.

II. Comments

1. ERIC commends the Treasury and the Service for their efforts to accommodate phased retirement programs. Although ERIC has significant concerns about provisions of the proposed regulations, ERIC very much appreciates the time, effort, and thought that the Treasury and the Service have devoted to formulating a concrete proposal on this important subject. ERIC looks forward to working with the Treasury and the Service to facilitate phased retirement programs.

The proposed regulations respond affirmatively to widespread employee and employer interest in phased retirement programs that allow employees who are approaching, or who are have reached, retirement age to receive retirement benefits while working a reduced schedule. Phased retirement programs can help to advance a number of important interests, including:

- Employee interest in making a smoother and more gradual transition from employment to retirement;
- Employee interest in trying retirement before fully retiring;
- Employer interest in retaining the services of valuable employees who would otherwise retire from the employer -- especially employees who are interested in continuing to work, perhaps at a firm that competes with the employer; and
- The interests of both employees and employers in developing more flexible work arrangements that allow employees to remain active but to spend more time away from work.

ERIC is gratified that the Treasury and the Service have attempted to address these interests by identifying the conditions under which a pension plan may offer a phased retirement program.

Because the proposed regulations do not address all of the interests of employees and employers, and because they impose requirements that do not meet many employee and employer needs, ERIC recommends that the proposed regulations be revised, in accordance with the following comments, to meet employees' and employers' needs. ERIC looks forward to working with the Treasury and the Service as they consider the comments that ERIC and others have submitted on the proposed regulations.

2. The proposed regulations should preserve the current-law definition of "normal retirement age." The proposed new definition should be withdrawn because it (a) conflicts with established law, (b) conflicts with the anti-cutback rule in Code § 411(d)(6), (c) imposes a legal standard that is vague, unclear, and inadministrable, and (d) punishes cash balance plans that credit participants' accounts with favorable rates of return.

(a) Conflicts with established law. Proposed § 1.401(a)-1(b)(1)(i) provides in part that:

> ". . . normal retirement age cannot be set so low as to be a subterfuge to avoid the requirements of section 401(a), and, accordingly, *normal retirement age cannot be earlier than the earliest age that is reasonably representative of a typical retirement age for the covered workforce*" (emphasis added).

This requirement -- that normal retirement age not be earlier than the earliest retirement age that is reasonably representative of a typical retirement age for the covered workforce -- is contrary to Code § 411(a)(8), which states simply that normal retirement age means the earlier of (A) the time designated as the normal retirement age under the plan or (B) the later of age 65 or the fifth anniversary of the commencement of participation in the plan.

Section 411(a)(8) was added to the Code by ERISA in 1974. Before the enactment of ERISA, the Service had ruled that ordinarily the normal retirement age under a pension plan was age 65, but that a lower age could be specified as the normal retirement age if it represented the age at which employees customarily retired in the particular company or industry and was not a device to accelerate funding. *See* Rev. Rul. 71-147, 1971-1 C.B. 116.

In 1978, in light of the enactment of § 411(a)(8) just four years earlier, the Service changed the position it had taken in Rev. Rul. 71-147 and ruled that § 411(a)(8) did not limit a plan's ability to designate an age lower than 65 as the plan's normal retirement age:

> "In view of the definition of normal retirement age, and in the absence of any statutory prohibition or limitation, *a plan may specify any age that is less than 65 as the normal retirement age*." Rev. Rul. 78-120, 1978-1 C.B. 117 (emphasis added).

Similarly, in Rev. Rul. 78-331, the Service recognized that a plan may designate a normal retirement age that is younger than the age at which employees typically retire. The Service ruled that if the designated normal retirement age is younger than the age at which employees typically retire, an actuarial assumption that all employees retire at that age might cause the plan's actuarial assumptions, in the aggregate, not to be reasonable and could result in the failure to meet the Code's minimum funding requirements or in the nondeductibility of contributions to the plan. Rev. Rul. 78-331 thus expressly recognized that a qualified pension plan could designate a normal retirement age that was younger than the employees' typical retirement age. *See* 1978-2 C.B. 158.

Since the issuance of Rev. Rul. 78-120 and Rev. Rul. 78-331, Congress has incorporated § 411(a)(8) by reference (in the Retirement Equity Act of 1984),[2] and has modified and reenacted § 411(a)(8) (in the Omnibus Budget Reconciliation Act of 1986 and the Omnibus Budget Reconciliation Act of 1989).[3] At no time did Congress revise, or express the slightest doubt about, the Service's published interpretation of § 411(a)(8). In view of this history of IRS action, virtually on the heels of the enactment of ERISA in 1974, and implicit Congressional ratification of the Service's interpretation, the position taken by the Service in 1978 must be regarded as authoritative. Having received Congressional approval, the position taken by the Service can now be overruled only by Congress; it cannot be changed by regulation.[4]

(b) Conflicts with the anti-cutback rule. Although many employers have, in reliance on Rev. Rul. 78-120 and Rev. Rul. 78-331, established normal retirement ages that are younger than the standard prescribed by the proposed regulations, the regulations fail to provide § 411(d)(6) relief for an amendment that raises the plan's normal retirement age. Because these plans provide unreduced retirement benefits at normal retirement age and often allow participants who have reached normal retirement age to make in-service withdrawals, the anti-cutback rule would bar a plan amendment from reducing the dollar amount of a participant's accrued benefit or from curtailing a participant's right to withdraw previously accrued benefits. However, the proposed regulations do not allow an amendment to a plan's definition of normal retirement age to reduce accrued benefits. The absence of § 411(d)(6) relief will put many employers in an untenable position: they must adopt an amendment that violates § 411(d)(6) or adopt no amendment at all (in contravention of the new definition of normal retirement age).[5]

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[2] P.L. No. 98-397, § 204(b) (adding Code § 414(p), which provided in § 414(p)(4)(B) that, in the case of a defined contribution plan, the earliest retirement age was 10 years before the normal retirement age (within the meaning of Code § 411(a)(8)).

[3] P.L. No. 99-509, § 9203(b)(2) (amending Code § 411(a)(8)(B)); P.L. No. 101-239, § 7871(b)(1) (same).

[4] "Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change [citations omitted]. So too, where, as here, Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute." *Lorillard v. Pons*, 434 U.S. 575, 580-81 (1978). "A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent." *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 477 (1979).

[5] If a plan's normal retirement age is raised, issues also could arise under Code § 411(a)(10), governing changes in a plan's vesting schedule.

(c) Vague, unclear, and inadministrable legal standard. The proposed regulations provide that --

> ". . . [first clause:] normal retirement age cannot be set so low as to be a subterfuge to avoid the requirements of section 401(a), and, [second clause:] accordingly, *normal retirement age cannot be earlier than the earliest age that is reasonably representative of a typical retirement age for the covered workforce*" (emphasis added).

This provision is vague, unclear, and inadministrable. First, it is not clear whether the first clause prescribes a legal standard (with the second clause containing an example) or whether the first clause presents a rationale (with the second clause containing the legal standard). Second, the provision does not make clear what "typical retirement age" means: it might mean (1) termination of employment from the employer, (2) termination of employment in the employer's industry, (3) termination of employment altogether, or (4) the commencement of retirement income from the defined benefit plan. Third, if "typical retirement age" means termination of employment in the industry or termination of employment altogether, it is not clear how an employer can as a practical matter determine what that age is. Fourth, regardless of how "typical retirement age" is defined, the proposed regulations fail to take into account changes in employee behavior. The regulations suggest that if, because of changes in the economy, changes in personal preferences, changes in the employer's line of business and workforce, or other reasons, the typical retirement age for the covered workforce increases, the plan's normal retirement age must also increase, but the regulations fail to explain how that can be done without violating § 411(d)(6). *See also* § 411(a)(10) (change in vesting schedule).

Moreover, to the extent that a plan's normal retirement age is subject to change because of future changes in the retirement experience of the employer's workforce, the proposed regulations create great uncertainty for both employers and employees: uncertainty regarding the employer's future funding obligations and uncertainty regarding when employees will receive the benefits that the plan is scheduled to provide when they reach normal retirement age.

(d) Punishes cash balance plans with favorable rates of return. Some cash balance plan sponsors have chosen to provide interest-crediting rates that are more favorable to employees than the relatively low interest rate indices (and associated margins) proposed by IRS Notice 96-8, while mitigating or eliminating the costly and controversial "whipsaw" effect by designating a relatively early date as the normal retirement age under the plan. The proposed regulations punish these employers for their generosity by requiring them to

increase their plans' normal retirement ages -- thereby exposing these plans to potentially costly "whipsaw" claims.[6]

For all of these reasons, proposed regulations' definition of "normal retirement age" should be withdrawn.

3. The complexity and restrictiveness of the proposed regulations should be reduced. As we explain in greater detail below, the proposed regulations include a number of requirements that will prevent phased retirement programs from meeting the employer and employee needs that have sparked the interest in phased retirement programs. Unless these deficiencies are remedied, the proposed regulations will fail to achieve their objective of facilitating the adoption and implementation of phased retirement programs.

Specifically, under the proposed regulations, a phased retirement program --

- Must be based on an exacting hour-counting approach, even though hours of service are not recorded for many employees;

- Must exclude any employee who has not attained age 59-1/2, even though many employees under age 59-1/2 wish to have a phased retirement;

- May not pay benefits in a lump sum or as any other form of eligible rollover distribution, even though such forms of distribution are extremely popular among retirees and even though this rule is likely to cause many employees to favor full retirement over phased retirement;

- Would be extremely difficult to communicate to employees because of (among other things) the regulations' complex and inconsistent rules regarding benefit accruals during phased retirement; and

- Could be extremely difficult to maintain without violating the nondiscrimination requirements of § 1.401(a)(4)-4.

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[6] ERIC opposes the "whipsaw" theory, but recognizes that some appellate courts have endorsed it. ERIC is gratified that the Treasury has proposed legislation that would end the "whipsaw" effect, albeit only on a prospective basis. *See* Treasury Department, Office of Public Affairs, "Preserving Cash Balance Plans for Workers: Treasury Proposes Legislation to Protect Defined Benefit Plans and Ensure Fair Treatment of Older Workers in Cash Balance Conversions" (Feb. 2, 2004) (JS-1132); *see also* Letters from Secretary John W. Snow to Chairman Judd Gregg & Chairman John A. Boehner (Dec. 4, 2003) ("I share your concern that Notice 96-8 reaches the wrong policy result. . . . In my view, the notice undermines the defined benefit plan system . . .").

4. The proposed regulations' pro rata rule should be replaced by a simpler and more administrable rule. The proposed regulations permit a plan to pay a pro rata portion of an employee's benefit equal to the product of the employee's accrued benefit and the employee's work schedule fraction (the ratio of the hours the employee is reasonably expected to work during the phased retirement period to the hours that would be worked if the employee were full-time). Subject to a limited number of exceptions, the proposed regulations also require the plan to perform an annual comparison between the number of hours actually worked during a testing period and the number of hours the employee was expected to work; if the actual hours worked materially exceed the expected hours, the employee's phased retirement benefits must be prospectively reduced.

The proposed pro rata hour-counting approach requires a high level of precision that is wholly unsuitable for plans that do not track hours of service (*i.e.*, plans using the elapsed time approach for service-crediting).[7] A more flexible approach should be permitted, as illustrated by the following table:

Estimated Reduction in Work Schedule	**Permitted Phased Retirement Benefit**
Less than 10%	None
10% to 33-1/3%	25%
33-1/3% to 66-2/3%	50%
66-2/3% to 90%	75%
Over 90%	100%

The regulations also should allow a plan to use a compensation-based approach. The proposed regulations already provide that an annual comparison is not required for a phased retirement period if the compensation paid to an employee during the phased retirement period does not exceed the compensation that would be paid if the employee maintained a full-time schedule multiplied by the work schedule fraction (as defined above). *See* Prop. Reg. § 1.401(a)-3(d)(4)(v)(D). The regulations should permit a

[7] Because the "equivalency" methods permitted by the Department of Labor regulations inflate an employee's hours of service, they are not an appropriate substitute for hour-counting in this context. *See* 29 C.F.R. § 2530.200b-3(e), (f).

plan to use a compensation-based approach as an alternative to hour-counting on the front-end as well (and not merely on the back-end). For example, the regulations might provide that an employee's work-schedule fraction is equal to the ratio of the employee's anticipated compensation to the estimated compensation that the employee would receive during the same period if he or she worked full time.

In addition, the regulations should allow an employee's work schedule fraction to be determined on a daily, weekly, or monthly basis rather than just on an hourly basis. For example, if an employee were scheduled to work three days out of every five working days during the phased retirement period, the employee's work schedule fraction would be 3/5. Likewise, if an employee were scheduled to work 6 out of 12 months during the phased retirement period, the employee's work schedule fraction would be 1/2.

The rigidity of the pro rata hour-counting approach should also be moderated by making the following changes to the exceptions to the annual comparison requirement:

- The annual comparison requirement should be changed to a tri-annual comparison requirement;

- The proposed regulations' 2-year rule[8] should be changed to a 3-year rule **and** supplemented by a rule that provides that no comparison is required if the employee is within 3 years of eligibility for unreduced social security retirement benefits;

- The proposed regulations' 3-month rule[9] should be changed to a 1-year rule.

These revisions will make the proposed regulations significantly more workable without subverting their objectives.

5. The Treasury and the Service should consider adopting a rule that makes a plan's ability to distribute benefits depend on whether a specified event has occurred rather than on the employee's status over time as a part-time employee. Much of the proposed regulations' complexity stems from their focus on the extent to which the retiree continues to maintain a part-time status after initially reducing his or her work schedule. The regulations'

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[8] Under the 2-year rule, no comparison is required during the first 2 years of phased retirement if (a) the employee has entered into a written agreement with the employer that the employee's phased retirement will not exceed 2 years and that the employee will fully retire at the end of the phased retirement period, and (b) the employee fully retires after a phased retirement period of no more than 2 years. The regulation should be revised to specify the consequences if the employee does **not** retire at the end of the phased retirement period.

[9] Under the 3-month rule, no comparison is required for any testing period ending within 3 months before the employee's normal retirement age or at any time thereafter.

focus on the retiree's on-going status differs sharply from the focus of the other permissible distribution triggers, which look to whether a specified event has occurred -- without regard to the employee's status thereafter (*e.g.*, severance from employment, disability, or the occurrence of a financial hardship).

The proposed regulations could be made less complex and more user-friendly if the regulations focus, for example, solely on whether the employee has reduced his work schedule by a designated percentage and attained a specified age. If the regulations focus on an event rather than on the employee's status over time, the regulations could avoid much of the complexity that is created by such provisions as the pro rata distribution requirement and the bar against participation by part-time employees.

We anticipate that the Treasury and the Service might be concerned that an event-based test might be abused: an employee might satisfy an event-based test for a brief period of time, but then resume full-time employment. If this is the concern, potential abuse can be addressed by an approach that is less cumbersome than that taken by the proposed regulations. For example, the regulations might require the employer and the employee to enter into an enforceable written agreement that requires a long-term reduction in the employee's work schedule, that may be amended only in the event of an unanticipated change in circumstances, and that requires any amendment to be maintained in the plan's books and records. Other approaches are already included in the proposed regulations: a rigorous age limit (currently age 59-1/2) and a bar against lump sums and other eligible rollover distributions. These rules are more than sufficient to guard against any potential abuses.

We believe that an event-based approach would be a major step forward, and we look forward to discussing it further with the Treasury and the Service.

6. <u>The proposed regulations' age 59-1/2 rule should be changed to an age 55 rule</u>. The preamble states that the proposed rule prohibiting phased retirement benefits from being paid before age 59-1/2 is consistent with Code §§ 401(k) and 72(t)(3)(B). However, § 401(k) does not apply to pension plans, § 72(t)(3)(B) does not even mention age 59-1/2, and neither provision mentions or even contemplates phased retirement. At most, §§ 401(k) and 72(t) suggest that age 59-1/2 is an appropriate age for *full payment* of retirement benefits, regardless of any phased retirement arrangement that has been established. Although we can understand the Government's interest in imposing an *appropriate* age requirement on phased retirement programs, age 59-1/2 is excessively restrictive and highly inappropriate for a program that is designed to facilitate a gradual transition *into* retirement.

In our view, age 55 -- roughly 5 years before age 59-1/2 -- strikes the right balance: age 55 is a typical retirement age (*see* § 72(t)(2)(A)(v)), and it corresponds to the age Congress has set in § 401(a)(28) as the age by which employees should be free to prepare for retirement. Because age 59-1/2 is at or beyond the age at which many employees retire, it is well past the earliest age at which employees should be permitted to be eligible for phased retirement.

7. The proposed regulations should be revised to allow part-time employees to participate in a phased retirement program. Prop. Reg. § 1.401(a)-3(a)(3) provides that phased retirement benefits may be made available only to employees who, before the phased retirement period, normally maintain a full-time work schedule. This restriction would deny part-time workers the benefit of participation in a phased retirement program.

The part-time restriction is unjustified. Although appropriate adjustments would have to be made in the proposed regulations to reflect the employee's part-time schedule, we do not think that a part-timer should be denied eligibility for phased retirement. For example, we can think of no good reason for providing that a part-time worker who works 80% of a full-time schedule cannot switch to a 40% schedule and, if otherwise eligible, receive phased retirement benefits. The proposed regulations have the undesirable consequences of discouraging part-time employment and discriminating against part-time workers, many of whom are women. The proposed regulations might also require employers to make adequate disclosure to employees who are considering a shift to a part-time schedules that their part-time status could deprive them of eligibility for phased retirement. This could discourage part-time employment and increase the cost of offering phased retirement as an option. In addition, because the full-time requirement refers to employees who "normally" maintain a full-time work schedule, and does not define what "normally" means, it will be difficult, if not impossible, to know in many cases whether the requirement is satisfied. For example, it is unclear whether the "normally" requirement is satisfied where an employee has worked full-time for 35 years, but shifted to a part-time schedule two years before seeking phased retirement. The full-time requirement should be withdrawn.

8. Reconsideration should be given to the possibility of allowing phased retirement benefits to be paid in the form of an eligible rollover distribution. Under the proposed regulations, phased retirement benefits may not be paid as a single sum or in any other form that constitutes an eligible rollover distribution. The preamble states that this rule is designed to prevent the premature distribution of retirement benefits. Because the proposed rule would bar participants in phased retirement programs from using many plans' most popular forms of distribution and would, as a result, make phased retirement programs far less attractive to employees, we recommend that the proposed rule be reconsidered.

An alternative approach might be to permit phased retirement programs to make eligible rollover distributions after the employee has reached a retirement age at which he could typically receive a lump-sum distribution or other eligible rollover distribution: age 59-1/2. Here the analogy to §§ 401(k) and 72(t) has merit since these provisions permit (or do not penalize) lump-sum distributions after age 59-1/2 without regard to whether the employee has separated from service.

We recognize that the distribution of eligible rollover distributions under a phased retirement program raises additional issues -- especially where the distributions reflect an early retirement subsidy. We look forward to working with the Treasury and the Service to address those issues constructively.

9. The proposed regulations' voluntariness requirement should be clarified. The proposed regulations provide that an employee's participation in a phased retirement program must be voluntary. We are concerned that some might interpret this rule to mean that every eligible employee must have the right to phase into retirement. This does not appear to be what the drafters intended, and it should not be the rule.

The regulations should not obligate an employer that sponsors a phased retirement program to accommodate every request for phased retirement that it receives from its employees An employer could not run its business if this were the rule and every eligible employee could elect to reduce his or her work schedule and collect phased retirement benefits.

As we understand it, the voluntariness requirement means only that no employee who meets the phased retirement program's eligibility requirements can be compelled to receive, or to begin receiving, phased retirement benefits. To put it another way, employees' work schedules are not regulated by Code § 401(a), and the regulations do not require an employer to grant every request for phased retirement that it receives; the voluntariness requirement applies only to an eligible employee's decision to apply for phased retirement benefits.

10. The proposed regulations' nondiscrimination rule should be clarified or revised to tailored it to the circumstances of phased retirement programs. The proposed regulations provide that the right to receive a phased retirement benefit is a benefit, right, or feature that is subject to § 1.401(a)(4)-4. Under § 1.401(a)(4)-4, a benefit, right, or feature must pass both a current availability requirement and an effective availability requirement. Age and service conditions may be disregarded in applying the current availability requirement only with respect to optional forms of benefit and social security supplements and not with respect to other benefits, rights, and features. *See* Treas. Reg. § 1.401(a)(4)-4(b)(2)(ii).

Because phased retirement programs are necessarily limited to older employees (and often long-service) employees, phased retirement programs tend to apply to a great extent to highly compensated employees (since pay level is positively correlated with age and service). It is essential, therefore, that the Treasury and the Service make clear that phased retirement is an optional form of benefit for purposes of § 1.401(a)(4)-4 and that, as a result, the phased retirement program's age and service conditions are disregarded in determining whether it is currently available to an employee. If a phased retirement program's age and service programs are disregarded, the plan will be able to take into account the fact that younger (and, normally, less highly-paid) employees will eventually become eligible for phased retirement.

Our recommendation is consistent with the regulatory definition of "optional form of benefit." *See* Treas. Reg. § 1.401(a)(4)-4(e)(1)(i) ("The term optional form of benefit means a distribution alternative . . . that is available under a plan with respect to benefits described in section 411(d)(6)(A) or a distribution alternative that is an early

retirement benefit or a retirement-type subsidy described in section 411(d)(6)(B)(i) . . . . [D]ifferent optional forms of benefit may result from differences in terms relating to the payment schedule, timing, commencement, . . . or the portion of the benefit to which the distribution alternative applies"). A phased retirement program is thus an optional form of benefit because it offers an eligible employee an alternative date on which to begin receiving a portion of his or her accrued retirement benefit.

11. The proposed regulations' benefit accrual requirement should be revised to make it consistent with the customary and appropriate treatment of part-time employees. Under the proposed regulations, during the phased retirement period, the employee must be entitled to participate in the plan in the same manner as if the employee were still maintaining a full-time schedule (including the calculation of his or her average earnings), and upon full retirement, the employee must be entitled to the same benefits that a similarly situated employee who did not elect phased retirement would be entitled to, except that his or her years of service during the phased retirement period are prorated based on either hours of service or compensation. As a result, under a plan requiring the completion of at least 1,000 hours of service in order to accrue a benefit in a year, an employee participating in a phased retirement program must accrue additional benefits even if he or she completes fewer than 1,000 hours of service.

The approach taken by the proposed regulations should be revised so that a plan may provide that, during the phased retirement period, the employee's benefit accruals (if any) are based on his or her actual compensation, service, and job position. It makes no sense to require a plan to grant benefits to someone who has not met the conditions for earning those benefits. An employee who is working part-time under a phased retirement program should accrue benefits at the same rate as a part-time employee who does not elect phased retirement. Similarly, an employee who, during a phased retirement period, takes a job that is not covered by the plan (*e.g.*, a position in Division A when the plan covers only employees in Division B) should not be entitled to accrue additional benefits under the plan during the phased retirement period.

The preamble states that the proposed regulations' approach precludes the need for extensive disclosure requirements. We have no objection to a *permissive* rule that allows a plan to take the approach described by the proposed regulations. But a plan should not be *required* to take this approach. A plan should be free, for benefit accrual purposes, to treat an employee who elects phased retirement just like any other similarly situated part-time employee. In any event, under either approach (the approach that we recommend or the approach taken by the proposed regulations), there will undoubtedly be a need to make extensive disclosure; we suspect that participants will find the approach that we recommend easier to understand than the fictional approach taken by the proposed regulations.

12. The Treasury and the Service should withdraw the proposed rule requiring a partially retired employee to be treated automatically as an HCE during the employee's phased retirement period if the employee was an HCE immediately before partially retiring. Proposed § 1.401(a)-3(e)(1) provides that an employee who partially

retires under a phased retirement program and who was an HCE immediately before partially retiring is considered to be an HCE during the phased retirement period, without regard to his or her compensation during the phased retirement period.

Employees who work part-time under a phased retirement program should be treated like other part-time employees: their status as HCEs should be determined on the basis of their actual compensation during the period of part-time service, not on the basis of what their compensation was at some point in the past. This is consistent with the proposed regulations' general perspective: the employee is regarded as retired to the extent of the reduction in the employee's work schedule and active to the extent that the employee is working. *See* Prop. Reg. §§ 1.401(a)-3(a)(1), (2), (d)(2).

13. The proposed regulations should be revised to make clear that a phased retirement program is not required to distribute social security supplements. Proposed § 1.401(a)-3(a)(2)(ii) provides that, in general, "all early retirement benefits, retirement-type subsidies, and optional forms of benefit available upon full retirement must be available" under a phased retirement program. *See also* Prop. Reg. § 1.401(a)-3(d)(2)(ii) (plan may provide that ancillary benefits (other than death benefits) will be paid during phased retirement period).

The Treasury and the Service should revise the regulations to make clear that they do not require a plan to distribute social security supplements to employees who retire under a phased retirement program. Social security supplements are not part of a participant's accrued benefit and are not "early retirement benefits," "retirement-type subsidies," or "optional forms of benefit." *See* Treas. Reg. § 1.411(d)-4, A-1; *see also* Code § 411(a)(9); Treas. Reg. §§ 1.401(a)(4)-4(e)(2), 1.411(a)-7(c)(4); S. Rep. No. 575, 98th Cong., 2d Sess. 30 (1984); GCM 39896 (April 6, 1992); Prop. Reg. § 1.411(d)-3(f)(1), (4).

14. The Treasury and the Service should clarify how the retroactive annuity starting date regulation (§ 1.417(e)-1) applies to a participant in a phased retirement program. Treas. Reg. § 1.417(e)-1(b)(3)(iv)(B) provides that a participant may not "elect a retroactive annuity starting date that precedes the date upon which the participant could have otherwise started receiving benefits (e.g., in the case of an ongoing plan, the earlier of the participant's termination of employment or the participant's normal retirement age) . . . ." The proposed phased retirement regulations do not address their impact on the retroactive annuity starting date regulation.

We expect the retroactive annuity starting date regulation to be interpreted to conform to the phased retirement regulations so that a retroactive annuity starting date could be elected with respect to a phased retirement benefit. We cannot think of any reason for forbidding a participant in a phased retirement program from electing a retroactive annuity starting date with respect to a phased retirement benefit. We urge the Treasury and the Service to amend either the retroactive annuity starting date regulation or the phased retirement regulations to make this clear.

We appreciate the opportunity to submit these comments. We reserve the right to supplement these comments as our members accumulate greater experience in working with the proposed regulations.

If the Treasury or the Service has any questions about our comments, or if we can otherwise be of assistance, please let us know.

THE ERISA INDUSTRY COMMITTEE