The Honorable Henry M. Paulson, Jr.
Secretary
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Paulson:

We write to you about an issue of critical importance. The issue relates to the Internal Revenue Service’s (the “Service”) application of the “anti-backloading” rules to hybrid pension plans.

The Pension Protection Act of 2006 (“PPA”) was signed into law on August 17, 2006. In general, the PPA changes the funding rules for single-employer and multiemployer defined benefit pension plans, requires increased pension plan disclosure, and includes a number of changes relating to defined contribution plans. The PPA also provides clarification and adds new rules for cash balance pension plans.

The underlying intent of enacting the rules applicable to cash balance plans is to protect longer-service older workers while providing legal certainty when a defined benefit plan sponsor converts a traditional pension plan to a cash balance plan. In particular, the PPA provides that on or after June 29, 2005, any conversion from a traditional pension plan to a cash balance plan must provide that a participant’s accrued benefit after the amendment can be no less than the participant’s accrued benefit prior to the conversion plus the participant’s accrued benefit under the cash balance or hybrid plan for years of service after the conversion. This requirement results in a conversion formula of “A+B.”

Prior to the enactment of the PPA, defined benefit plan sponsors converting their traditional pension plan to a cash balance plan adopted a range of transition benefits. Specifically, many of these plan sponsors have offered a “greater of” transition benefit. Under this approach, benefits available under the traditional pension plan formula and the cash balance formula are calculated to determine which formula provides the greatest benefit. The participant’s accrued benefit at any and all times after the conversion is equal to the “greater of” the accrued benefit under each of the two formulas at that point in time. The rules relating to a cash balance conversion set forth in the PPA were not intended to prohibit this pro-participant practice.
It has come to our attention that the Service has adopted a position that the “greater of” approach violates the backloading rules as set forth in section 411(b)(1)(B) of the Internal Revenue Code. The 133-1/3% rule, as originally enacted under the Employee Retirement Income Security Act of 1974 (“ERISA”), is intended to prevent pension plans from circumventing ERISA’s minimum vesting rules. The 133-1/3% rule is violated if a participant’s accrual rate in later plan years exceeds 133-1/3% of the accrual rate in any previous plan year. We do not believe that a “greater of” transition benefit is an end-run around ERISA’s vesting rules, nor do we believe that the 133-1/3% rule is violated under the “greater of” approach.

The heart of the issue is drawn from the Service’s interpretation of Treasury regulation section 1.411(b)-1(a), which provides:

“a defined benefit plan may provide that accrued benefits for participants are determined under more than one plan formula. In such a case, the accrued benefits under all such formulas must be aggregated in order to determine whether or not the accrued benefits under the plan for participants satisfy one of the alternative methods [(e.g., the 133-1/3% rule)].”

The Service is interpreting this guidance to apply the 133-1/3% rule to the accrual pattern that results from the comparison of the two formulas in the context of a “greater of” cash balance conversion transition benefit. This interpretation is not the only reasonable result, and conflicts with the Service’s position in other transition situations. A more reasonable and consistent interpretation would be to aggregate two benefit formulas in situations where one formula applies to a participant for a period of time, and a second formula applies after that date. No aggregation should occur when only one benefit formula applies to any participant at any time, and therefore, only the applicable benefit formula, standing alone, should be tested under the 133-1/3% rule. Thus, in the context of the “greater of” approach, if the benefit formula under the traditional pension plan standing alone satisfies the 133-1/3% rule, and similarly, the cash balance benefit formula in isolation meets the rule’s standards, a violation should not be found.

We note that aggregating the “greater of” two benefit formulas in the context of cash balance plan conversions is inconsistent with how the Service treats other “greater of” formulas. For example, the Service formally ruled in Notice 88-131 that non-highly compensated employees were permitted to accrue the “greater of” benefits payable under the benefit formula subject to the law prior to the enactment of the Taxpayer Relief Act of 1986 (“TRA ’86”) and the formula under post-TRA ’86 law during the 1989 plan year. In addition, the rules relating to a notice of significant reduction in benefit accruals require that participants receive the “greater of” benefits determined under pre-amendment terms and post-amendment terms of the plan if a notice is not provided within the statutory time frame (see ERISA section 204(h)(6)(A)). A parallel rule is set forth in Treasury regulation section 54.4980F-1, Q&A-14(a)(1). Under no circumstances has Treasury or the Service aggregated these benefit formulas and ruled that the “greater of” two benefit formulas violates the anti-backloading rules.
The implication that the Service contemplated the application of accrual rules independently with respect to “greater of” constructs in hybrid pension plans, in particular, is bolstered by Treasury’s inclusion of a five-year “greater of” formula in 2002 proposed cash balance regulations (later withdrawn at our request for reasons unrelated to this transition rule). There was no mention of potential accrual violations in the proposed rules. It is disturbing to us that Treasury encouraged “greater of” transition benefits, and now the Service may penalize employers who provided a “greater of” transition rule.

Based on these findings, it appears that Treasury and the Service have chosen to apply the 133-1/3% test separately to each formula in a “greater of” arrangement in the past. As a result, we see no reason why Treasury and the Service should depart from its earlier practice, especially in the context of a “greater of” cash balance conversion transition benefit. The use of a “greater of” formula to protect older workers from a loss of future accruals in a conversion should be encouraged, not penalized. Plan sponsors that offered the “greater of” transition benefit should not be faced with the potential of paying millions of dollars to avoid plan disqualification while those who offered no such protection face no sanctions. Moreover, those plan sponsors considering a cash balance plan conversion in the future should not be faced with the decision to provide less generous benefits upon conversion or terminate their traditional pension plan altogether and offer a defined contribution plan. Either result is contrary to Congress’ efforts to preserve the defined benefit plan system and to protect the retirement security of defined benefit plan participants.

We request that Treasury and the Service re-consider the application of the anti-backloading rules as related to the “greater of” transition benefit offered in conjunction with a cash balance plan conversion. We emphasize that Congress recognized the need to protect plan participants in the event of a cash balance conversion under the PPA by requiring that participants receive a benefit that is no less than the benefit they had earned under the traditional pension plan for past service, plus the benefit earned under the new formula for future service. A “greater of” transition benefit is more favorable for participants than this “A+B” rule and the Service should not set up unnecessary roadblocks to this pro-participant practice. Any re-consideration of this position should be communicated to plan sponsors that are currently seeking determination letters for their cash balance plans as soon as possible. Additionally, the Treasury regulation should be amended to reflect this clarification in the normal course of the regulation process.
Thank you for your prompt attention and cooperation in this matter.

Sincerely,

Max Baucus
Chairman
Senate Committee on Finance

Charles E. Grassley
Ranking Member
Senate Committee on Finance

Edward M. Kennedy
Chairman
Senate Committee on Health, Education, Labor and Pensions

Michael B. Enzi
Ranking Member
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