

# **HYBRID PLAN REGULATIONS FOLLOW-UP ON CRITICAL ISSUES**

American Benefits Council  
Business Roundtable  
Coalition to Preserve the Defined Benefit System  
ERISA Industry Committee  
National Association of Manufacturers  
United States Chamber of Commerce

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We are providing the recommendations in this submission to memorialize and elaborate on the recommendations we made to representatives of the Treasury Department and Internal Revenue Service during meetings with them on April 7, and May 10, 2011. These recommendations are not intended to supersede the separate comments made by any of the trade associations listed above or their individual members. Except as noted below, these recommendations do not address certain issues that are specific to pension equity plans, which are the subject of separate discussions with the Treasury and Service.

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## WHIPSAW & HYBRID PLAN BENEFITS

### 1.1. *Clearly State That Whipsaw Is No Longer Required*

**Issue:** As drafted, the proposed regulations appear to require a hybrid plan to calculate benefits using the whipsaw method if the plan fails to satisfy one or more of the conditions set forth in the proposed regulations. See Prop. Reg. § 1.411(a)(13)-1(b)(2)(i)-(ii), (b)(3)(v).

**Recommendation:** The final regulations should state unconditionally that hybrid plans are not required to calculate benefits using the whipsaw method. The final regulations should provide that, if a hybrid plan fails to satisfy any condition in the final regulations (such as a condition designed to protect the account balance), the appropriate remedy is to modify the terms and operation of the plan so that the plan satisfies the condition. Thus, for example, if the final regulations bar hybrid plans from reducing the account balance except for certain enumerated reasons, the proper remedy for violating this condition should be to increase the account balance to the level it would have attained had the impermissible reduction not occurred. In no event should the remedy be to calculate plan distributions using the whipsaw method.

**Discussion:** Congress believed that whipsaw is not an appropriate remedy for violations of law, and, for that reason, enacted § 411(a)(13)(A). We understand that the drafters appreciate this concern and did not intend to require hybrid plans to calculate benefits using the whipsaw method. Rather, the conditions in the proposed regulations were intended to ensure that the account balance in a hybrid plan is protected and has integrity, much like the accrued benefit in a traditional defined benefit plan.

## **1.2. *Extend the Deadline for Eliminating the Whipsaw Calculation from Existing Hybrid Plans That Include It and Clarify That the Calculation Is Lawful***

**Issue:** Many existing hybrid plans include a whipsaw calculation but were not in a position to eliminate the calculation by the administrative deadline imposed by Notice 2007-6.

**Recommendation:** The final regulations should permit hybrid plans that include a whipsaw calculation to be amended to eliminate the calculation by the effective date of the final regulations. The final regulations should provide anti-cutback relief for such amendments to the extent they reduce previously accrued benefits. The final regulations should also permit hybrid plans that include a whipsaw calculation to retain the calculation if the plan sponsor so wishes. In addition, the final regulations should provide that hybrid plans that include a whipsaw calculation do not violate any prohibition against age discrimination in the Code as a result of calculating benefits using the whipsaw method at any time either before or after the effective date of the final regulations. The final regulations, issued in consultation with the Equal Employment Opportunity Commission and the Department of Labor, should ensure that this protection also applies under ADEA and Title I of ERISA. Finally, the regulations should make clear that, if a plan retains the whipsaw calculation after the effective date, the plan can be amended at any time to eliminate the calculation with respect to future accruals, subject to applicable notice requirements.

**Discussion:** Many existing hybrid plans include a whipsaw calculation. Typically, the calculation was added to the plan at the insistence of the IRS as a condition of receiving a favorable determination letter or closing an employee plans audit. In other cases, the calculation was added by the plan sponsor in the reasonable belief that the IRS would require it as a condition of tax qualification. Notice 2007-6, § III.B.3, provides that a hybrid plan that includes a whipsaw calculation may be amended to eliminate the whipsaw calculation, provided that the amendment is adopted by the last day of the 2009 plan year (in order to qualify for anti-cutback relief under § 1107 of the PPA for any resulting decrease in distribution amounts).

Congress did not contemplate that final regulations under § 411(a)(13)(A) would be delayed beyond the latest date for adopting such amendments under § 1107 of the PPA. The final regulations should therefore provide that the latest date for adopting such amendments is extended to the effective date of the final regulations under § 411(a)(13)(A). Because IRS required many hybrid plans to include a whipsaw calculation, the final regulations should also provide that a hybrid plan that included a whipsaw calculation before the effective date of the final regulations does not violate any prohibition against age discrimination in the Code as a result of calculating lump sums or other forms of distribution using the whipsaw method at any time either before or after the effective date of the final regulations. In consulting with the Equal Employment Opportunity Commission and the Department of Labor, Treasury and IRS should ensure that this protection also applies under ADEA and Title I of ERISA.

### 1.3. *Permit Hybrid Plans to Subsidize Benefits*

**Issue:** The proposed regulations appear to prohibit hybrid plans from offering subsidized benefits, such as subsidized early retirement benefits, subsidized joint and survivor annuities (QJSAs), and subsidized window and plant closing benefits. See Prop. Reg. § 1.411(a)(13)-1(b)(3).

**Recommendation:** The final regulations should permit hybrid plans to offer any form of distribution that (a) is permissible in a defined benefit plan (and thus satisfies the subsidy limits described below), and (b) is equal to, or greater than, the actuarial equivalent of the account balance (or accumulated percentage of final average pay) on the annuity starting date. As under the proposed regulations, actuarial equivalence should be determined using reasonable actuarial assumptions. In the case of a cash balance plan, the final regulations should explain the method for projecting the account balance and calculating the estimated single life annuity payable at normal retirement age for purposes of applying the limit in § 411(a)(9). The appropriate projection rate is discussed in Sections 2.1-2.3 below. *Although not legally warranted, if Treasury and IRS are uncomfortable permitting subsidies in lump sums and other closely related forms of distribution, the final regulations could bar hybrid plans from subsidizing distributions that are eligible rollover distributions under § 402(c) (or would be eligible rollover distributions if they were not required minimum distributions under § 401(a)(9)).*

**Discussion:** Subsidies benefit participants, and many broad-based hybrid plans offer them. Early retirement subsidies help smooth the transition to a hybrid plan from a prior traditional plan for older, longer-service employees. Subsidized QJSAs encourage participants and their spouses not to reject statutory survivor benefits; other subsidized death and survivor benefits reduce or eliminate otherwise permissible forfeitures on death. And window and plant closing subsidies ease the financial burden of premature job loss.

We understand that Treasury and IRS are concerned that subsidies in hybrid plans might undermine the integrity of the account balance, which is deemed to equal the present value of the accrued benefit under § 411(a)(13)(A). However, defined benefit plans are permitted to offer benefits that are more valuable than the accrued benefit, up to well-defined limits established under current law. These limits apply equally to hybrid plans and are sufficient to protect the integrity of both the account balance and the accrued benefit. Under these rules:

- The periodic amount of the single life annuity payable at early retirement age cannot exceed the periodic amount of the single life annuity payable at normal retirement age. See Code § 411(a)(9); Reg. § 1.411(a)-7(c).
- The periodic amount of the joint portion of the QJSA cannot exceed the periodic amount of the single life annuity commencing at the same age. See Code § 417(a)(5)(B) & (b); Reg. § 1.401(a)-20, Q&A-38(a)(2) Ex. 2.
- The periodic amount of the survivor portion of the QJSA cannot exceed the periodic amount of the joint portion of the QJSA. See Code §§ 401(a)(9), 417(b)(1).
- In the case of a married participant, no form of benefit may be more valuable than the QJSA payable commencing at the same age. See Reg. § 1.401(a)-20 Q&A-16.

#### **1.4. Provide Transition Relief for Benefit Distributions in Excess of Those Permitted under the Final Regulations**

**Issue:** To the extent the final regulations under § 411(a)(13)(A) prohibit subsidies, existing hybrid plans might provide distributions in excess of those permitted, either because the distributions are intended to be subsidized or because they are based on actuarial assumptions or factors that have become outdated. Without transition relief, amending these plans to reduce such distributions could violate the anti-cutback rule to the extent they affect previously accrued benefits.

**Recommendation:** The final regulations should grant transition relief to existing hybrid plans that provide distributions in excess of those permitted under the final regulations. This relief could come in either of two forms. One option would be to exempt distributions of already accrued benefits from any distribution limits in the final regulations. Doing so would allow plans to comply with the final regulations without violating the anti-cutback rule, because only distributions of benefits accrued after the effective date would be subject to the limits. The second option would be to extend any distribution limits in the final regulations to benefits accrued before the effective date but grant anti-cutback relief to bring distributions of those benefits into compliance with the limits.

Either option would avoid violating the anti-cutback rule. However, the first option would require plans to calculate affected distributions in two pieces—one piece accrued before the effective date that is eligible for subsidies and another piece accrued after the effective date that is not eligible for subsidies. The second option would avoid bifurcating benefit calculations in this fashion but would force hybrid plans to reduce benefit distributions that participants have already accrued a right to.

**Discussion:** The PPA contemplates that plan sponsors will be able to amend existing hybrid plans to bring them into compliance with the requirements of the statute and implementing regulations. Benefits that have already accrued could be protected by limiting PPA-related amendments to apply only to benefits accrued after the effective date of the final regulations. To the extent Treasury and IRS decide that the new rules apply to benefits that have already accrued, the PPA also contemplates that necessary anti-cutback relief will be granted. See PPA § 1107. If Treasury and IRS conclude that statutory anti-cutback relief is no longer available under PPA § 1107, they should exercise their authority to provide regulatory anti-cutback relief under Reg. § 1.411(d)-4, Q&A-2(b)(1).

### **1.5. Clarify That the Dollar Amount of a Participant's Accumulated Percentage of Final Average Pay May Decline Due to Pay Decreases and Social Security Increases**

**Issue:** Under the proposed regulations, it is unclear whether the dollar amount of a participant's accumulated percentage of final average pay may decline under a pension equity plan due to decreases in the participant's final average pay or to automatic<sup>1</sup> increases in the Social Security integration level under the plan. See Prop. Reg. § 1.411(a)(13)-1(b)(2)(iv).

**Recommendation:** The final regulations should clarify that the dollar amount of a participant's accumulated percentage of final average pay may decline under a pension equity plan due to decreases in the participant's final average pay or to automatic increases in the integration level under the plan. However, as with any defined benefit plan, increases in the plan's integration level should not be taken into account after the participant separates from service or, if earlier, commences benefits that have already accrued.

**Discussion:** Under a pension equity formula, a participant typically earns a percentage of final average pay for each year of accrual service. If the formula is integrated, the participant also earns an additional percentage of the portion of final average pay in excess of the plan's integration level, which typically is defined as either the Social Security wage base or Social Security covered compensation. If the participant's final average pay decreases or the Social Security wage base or covered compensation increases, the dollar amount of the participant's accumulated percentage of final average pay might decline.

The final regulations should not impose special limits on pension equity plans that do not apply to other defined benefit plans. The proposed regulations limit the reasons for which a participant's accumulated percentage of final average pay may decline. It is unclear whether this restriction applies just to the percentage itself (say, a reduction from 170% to 165% of final average pay), or whether it also prevents the dollar amount of the accumulated percentage from declining (say, from \$250,000 to \$235,000). We understand that Treasury and IRS are concerned that unwarranted reductions might undermine the integrity of the accumulated percentage of final average pay, which is deemed to equal the present value of the accrued benefit under § 411(a)(13)(A). However, a participant's accrued benefit under a defined benefit plan may decline due to both decreases in final average pay, see Reg. § 1.411(a)-7(c)(5) & (c)(6) Ex. 4, and increases in the Social Security wage base or benefit levels that occur before the participant separates from service or commences benefits, see Code § 401(a)(15). Moreover, the structure and legislative history of ERISA make clear that such reductions do not violate § 411(b)(1)(G). These current-law rules apply equally to pension equity plans and are sufficient to protect the integrity of both the accrued benefit and the accumulated percentage of final average pay in pension equity plans. The final regulations should therefore make clear

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<sup>1</sup> These increases are "automatic" in the sense that the plan document incorporates by reference changes in the Social Security factor used in the plan's benefit formula, so that increases in that factor are reflected in the benefit formula automatically, *i.e.*, without the need for a plan amendment. Cf. Reg. § 1.410(b)-3(b) (automatic COLA's vs. ad hoc COLA's).

that the list of permitted reductions in Prop. Reg. § 1.411(a)(13)-1(b)(2)(iv) includes reductions in the dollar amount (but not the percent) of the participant's accumulated percentage of final average pay due to decreases in the participant's final average pay or to automatic increases in the integration level under the plan.



## PROJECTING VARIABLE INTEREST CREDITS INTO THE FUTURE

### 2.1. *Provide a Viable General Rule for Projecting Variable Interest Credits into the Future*

**Issue:** For various purposes, it is necessary to project variable interest credits into the future, typically to normal retirement age. Hybrid plans with variable interest credits cannot be operated with legal certainty without a viable method for making such projections. Projection can be required, for example, in applying the § 401(a)(4) nondiscrimination rules, the § 410(b)(2) average benefit percentage test, the § 411(a)(7) definition of accrued benefit, the § 411(a)(9) limit on early retirement subsidies, the § 411(b)(1)(A)-(C) anti-backloading rules, the § 412 minimum funding rules, the § 404(o) deduction limits, and the § 415(b) benefit limits.

In Sections 2.1-2.3 of this document, we recommend (a) adopting a general rule to govern the projection of variable interest credits (Section 2.1), (b) establishing safe harbor projection methods that are consistent with the general rule (Section 2.2), (c) taking account of the fundamental difference between projecting bond yields and projecting investment returns (Section 2.2), and (d) applying the general rule and safe harbors to terminating plans that credit investment returns (Section 2.3).

**Recommendation:** The final regulations should provide a general rule for projecting variable interest credits into the future. Under the general rule, a plan's projection method would be required to satisfy two conditions. First, it should fairly reflect the value to participants of the right to receive the plan's interest crediting rate into the future. *Esden v. Bank of Boston*, 229 F.3d 154, 166-67 (2d Cir. 2000). Thus, the method should be economically sound and reasonably reflect long-term expectations about the future performance of the plan's interest crediting rate. Second, the method should ensure stability from year to year and avoid undue reliance on short-term variations when doing so would distort the value of the benefit promise.

**Discussion:** Any assumption used for projecting future interest credits must be reasonable. It makes no sense to base benefits, compliance, funding, or any other aspect of a retirement plan on an assumption that is unreasonable and could not be defended. How do we assess reasonableness? We ask if the method fairly measures the value of the plan's benefit promise. When a projection is required, its purpose is to measure the value of the benefit appropriately at different points in time. For instance, in testing for backloading, we need to show that the value of accruals in later years is not disproportionately greater than the value of accruals in earlier years, when both are measured at normal retirement age. Under the nondiscrimination rules, we need to "normalize" the value of accruals at various ages to a single value at a testing age.

To project the value of a cash balance benefit, the benefit's value at different times should include an estimate of the plan's future interest credits. Unless the projection fairly reflects the value to participants of the right to receive the plan's interest crediting rate in the future, we risk undermining the legal requirements for which the projection is required in the first place. Following this approach will insure that the projection rate is neither too high nor too low. A rate that is too high will inflate projected benefits, which could permit excessive subsidies, discriminatory benefits, and inflated funding requirements and deductions, among others. A

rate that is too low would also raise concerns, including lowering benefits, unduly restricting subsidies, undermining the § 415 limits, and possibly leading to plan underfunding.

Stability is also important. The results of compliance testing should not change dramatically from year to year based solely on fluctuations in a variable index. Excessive year-to-year volatility in compliance testing increases administrative complexity, while granting windfalls to some participants and imposing unwarranted reductions on others. Stability is a reasonable objective in that expectations about an interest crediting rate's future performance will change with market conditions, but usually not by nearly as much as the year-to-year change in the rate itself.

## **2.2. Provide Safe Harbor Alternatives for Projecting Variable Interest Credits into the Future That Are Consistent with the General Rule**

**Issue:** The proposed regulations suggest that, at least for some purposes, the exclusive rate for projecting variable interest credits is the interest crediting rate for the most recent plan year. See Prop. Reg. § 1.411(b)-1(b)(2)(ii)(H). Projecting at this rate (or, when negative, at a substitute 0% rate) will frequently produce anomalous, volatile projections that do not fairly reflect the value to participants of the right to receive the plan's interest crediting rate in the future.

**Recommendation:** The final regulations should provide safe harbor alternatives for projecting variable interest credits into the future that are consistent with the general rule in Section 2.1. These safe harbors should apply for all purposes, including demonstrating compliance with the anti-backloading rules. The safe harbor rates should include the following:

- A reasonable estimate of the long-term equivalent rate, and
- The average interest crediting rate over a specified historical period of at least 10 years.

In determining a reasonable estimate of the long-term equivalent rate, the final regulations should recognize that there is a fundamental difference between projecting bond yields (such as those specified in Reg. § 1.411(b)(5)-1(d)(3) & (4)(ii)) and projecting the rate of return on an actual investment (as specified in Reg. § 31.3121(v)(2)-1(d)(2)(i)(B)). In the case of bond yields, a reasonable estimate of the long-term equivalent rate often will include the interest crediting rate for the most recent period. However, in the case of investment rates of return, the interest crediting rate for the most recent period generally will not be a reasonable estimate of the long-term equivalent rate. For reasons explained below, we recommend that the final regulations permit a plan to project all investment rates of return at a single rate, such as a risk-free rate of return like the yield on 20-year Treasury constant maturities.

**Note on Nomenclature:** Discussion of investment rates of return is often muddled by references to "equity" rates of return. To be sure, actual investments may consist of equity securities. However, they may also consist of debt securities, money market and savings accounts, commodities, derivatives, and real estate, to name but a few. The rate of return on aggregate, diversified plan assets, as contemplated by Reg. § 1.411(b)(5)-1(d)(5)(ii), for example, most assuredly is not a rate based exclusively on equity returns. For precision, we refer to rates of return on actual investments as "investment rates of return."

**Discussion:** We do not believe that the approach that the IRS has used for some purposes of presuming the current rate remains in effect for all future years is an advisable method because it is not stable and often will be unreasonable—particularly for investment rates of return. For example, the fact that an S&P 500 mutual fund or any other investment returned -20% last year does not necessarily mean that the expectation for future returns has changed, and it certainly does not mean that the future expected rate of return is -20%. If that were the case, no one would hold the investment. If the projection rates used for various purposes under the rules are not based on sound economic reasoning, the operation of the plans will not be sound either. Aside from the self-evident fact that setting unreasonable assumptions is never advisable, such assumptions have the potential to harm employees and to drive more

employers away from defined benefit plans. The fluctuation of projection rates from year to year will also frustrate the objectives of stability, predictability, and simplicity that employers and employees badly need for hybrid plans to survive and expand.

Due to the wide variety of interest crediting rates used by hybrid plans, arguments can be made for a number of different projection methods. However, the safe harbor approach we would recommend over all others is one that can be applied to all plans and that uses a projection rate equal to a reasonable estimate of the long-term future value of the plan's interest crediting rate (taking into account any minimums or maximums in the plan). By definition, this is a reasonable assumption and, in practice, it would meet the criterion of stability. We understand that the IRS has resisted such an approach in the past, perhaps because of the subjectivity potentially involved in determining the expected value. However, we observe that actuaries and plan sponsors routinely make such estimates for valuation purposes and furthermore are required to perform many compliance activities under broad rules requiring the use of reasonable assumptions, without such term being defined. We see no reason why the process of projecting future interest credits should be any different. A plan sponsor could be required to specify the projection method in the plan document, and the IRS could require the sponsor to defend the reasonableness of its assumptions in the determination letter process or on audit, just as it could in any other context.

The second safe harbor we recommend would permit a plan's interest crediting rate to be projected at a long-term (at least 10 years) historical average of the actual rate. Current law supports the general concept of historical averaging to project future interest credits. *See, e.g.,* Code § 411(b)(5)(B)(vi) (5-year averaging); Reg. § 1.401(a)(4)-8(c)(3)(v)(B) (same); *see also* anti-backloading discussion below. A reasonability check might be included that would prevent use of this approach where the historical average deviates significantly from any reasonable estimate of the future value of a plan's interest crediting rate. Like the first approach, averaging has the advantage of enabling advance planning and smoothing out volatility, both of which are critically important to plan sponsors, fiduciaries, and participants.

The ability of a plan to modify its projection method would be governed by the current-law rules applicable with respect to the particular purpose for which the projection is being made.

*Reasonable Estimate of Long-Term Future Value of Investment Rates of Return.* Projecting an investment rate of return into the future involves taking a rate that will vary up or down in accordance with the dictates of the market and converting it into a guaranteed rate of return, *i.e.*, a single rate of return that is assumed to apply for all future years. We recommend that a plan be permitted to project all investment rates of return at a single risk-free rate of return. For administrative ease and fairness, that rate should correspond to a single maturity that is representative of the average time to normal retirement for hybrid plan participant populations, which typically would be around 20 years. For this purpose, the final regulations should specify that a rate at least equal to the current or historic yield on 20-year Treasury constant maturities may be used. In the case of the plan that credits only a portion of a full investment rate of return (*e.g.*, 75% of the rate of return on plan assets), the projection rate should be adjusted proportionately.

Effect of Capital Preservation Rule and Other Minimum Rates of Return. Another point to consider is whether any increase in a safe harbor rate is warranted due to the capital preservation rule of § 411(b)(5)(B)(i)(II) or any higher minimum rate of return adopted by the plan under § 411(b)(5)(B)(i)(I). In light of Congress' intent (discussed below) that the capital preservation rule not affect whether a rate is treated as above market, we believe no adjustment in a safe harbor rate is warranted on account of the capital preservation rule. With respect to any higher minimum rate of return under § 411(b)(5)(B)(i)(I), we believe the simplest approach is to project at the greater of the minimum rate adopted by the plan or the safe harbor rate of return.

Projection for Anti-Backloading Purposes. Treasury and IRS officials have suggested that the anti-backloading rules require a projection based on the most recent rate of return because these rules are applied assuming that "all relevant factors" are "treated as remaining constant." Code § 411(b)(1)(B)(iv); Reg. § 1.411(b)-1(b)(1)(ii)(B). This approach interprets holding all relevant factors constant to mean holding the current *spot* rate constant. A better reading would be to hold the current *projection* rate constant since that is, in fact, how the plan would determine its projected benefits. Following this approach to testing for backloading would eliminate the need for the special rule in the proposed regulations permitting a plan with a negative rate of return in a year to project assuming a 0% return for all future years.

Section 411(a)(9). For purposes of applying § 411(a)(9), we recommend that the rules be applied only on a prospective basis. In other words, a plan would be tested upfront based on its design. If a participant's benefit satisfies § 411(a)(9) based on the plan design and the plan's projected interest credits, the participant's benefits satisfy § 411(a)(9), without the need for any further testing in the absence of a plan amendment modifying the benefit calculation in a manner that would have affected the original calculation.

### **2.3. Do Not Use the Third Segment Rate to Project Investment Rates of Return Following Plan Termination**

**Issue:** Section 411(b)(5)(B)(vi)(I) sets the interest crediting rate following plan termination at the average of the plan's interest crediting rates during the 5-year period preceding plan termination. In calculating this average for a plan that credits an investment rate of return, the proposed regulations would replace the plan's actual interest credits with the applicable third-segment rates during the 5-year period. This approach dramatically overstates the value of future investment rates of return in the post-termination context.

**Recommendation:** The final regulations should not substitute third segment rates for the plan's actual interest credits in calculating the 5-year average under § 411(b)(5)(B)(vi)(I). If Treasury and IRS wish to deviate from the statute, the final regulations could instead set the 5-year average equal to the projection rate for the plan determined under the rules of Sections 2.1 and 2.2 above.

**Discussion:** Use of the third segment rate would impose large, unjustified costs on the Pension Benefit Guaranty Corporation in distress terminations of hybrid plans that credit an investment rate of return, since PBGC would need to underwrite a guaranteed fixed rate of return following plan termination. For the same reason, it would lead to sharp, artificial increases in the price of terminal annuities in standard terminations. In one situation, we observed annuity quotes from insurers that were 40-50% higher than the account balance for terminal annuities.

We understand that Treasury and IRS might wish to deviate from the statute because they are concerned that some plan sponsors might manipulate the timing of plan termination to follow a 5-year period of aberrationally low investment returns. Use of the projected rate determined under the rules of Sections 2.1 and 2.2 addresses this concern.

## MARKET RATE OF RETURN

### 3.1. *Replace Exclusive List of Market Rates with an Expanded Safe Harbor List*

**Issue:** The proposed regulations set forth an exclusive list of rates that qualify as market rates of return. Hybrid plans would be prohibited from crediting any other rate, no matter how reasonable the rate is, and regardless of whether the rate would qualify as a “market rate of return” under any reasonable interpretation of the statute.

**Recommendation:** The final regulations should include a list of permissible interest crediting rates. However, the list should not be an exclusive list, but rather a safe harbor list. The final regulations should expand the number and types of rates included on the list, as explained further in the recommendations that follow. The final regulations should also acknowledge that other rates, not included on the list, can qualify as market rates of return under the statute. To ease administration, the IRS might caveat the determination letters it issues to not cover interest crediting rates not included on the list. This would encourage plan sponsors to select safe harbor rates. However, it is critical that the list of permissible rates be expanded for this approach to work. Additional safe harbor rates are recommended in Sections 3.3-3.5 below.

**Discussion:** The statute does not authorize Treasury and IRS to limit interest crediting rates to only a subset of market rates of return. The concern that some plan sponsors might adopt extremely speculative interest crediting rates is an issue for Congress, which did not express any such concern in the statute or legislative history. If, however, Treasury and IRS believe that there is a statutory basis to address the issue, the following could be considered:

- IRS could caveat determination letters to not cover interest crediting rates not included on the safe harbor list. While plan sponsors could seek to establish that particular non-safe harbor rates are permissible, they would have an incentive to select a safe harbor rate.
- Treasury and IRS could also reserve the right to prospectively prohibit rates of return that are designed to evade the purposes of the market rate of return rule. This would permit any future abuses to be prohibited in a manner that is consistent with the statute.

### **3.2. Determine Market Rate of Return Without Regard to PPA's Minimum Rates of Return**

**Issue:** The proposed regulations would limit permissible interest crediting rates to only a narrow subset of market rates of return that are expected to experience relatively little volatility. This approach is based on the premise that (1) more volatile market rates of return are more likely to trigger the minimum rates of return provided for in the PPA, and (2) a market rate that is more likely to trigger one of the PPA's minimum rates provides a rate of return that is, in the aggregate, above-market and therefore age discriminatory.

**Recommendation:** The final regulations should determine whether an interest crediting rate satisfies the "market rate of return" standard without taking into account the minimum rates of return provided for in the PPA.

**Discussion:** The PPA's minimum rates of return consist of the capital preservation rule of § 411(b)(5)(B)(i)(II), which requires hybrid plans to credit a cumulative minimum rate of return of 0% (the so-called "zero cumulative floor"), and the last sentence of § 411(b)(5)(B)(i)(I), which permits hybrid plans to adopt a "reasonable minimum guaranteed rate of return" that is higher than the zero cumulative floor. Congress intended these minimum rates to protect participants from the full rigors of the market. They should not be viewed as a rationale for denying participants access to rates of return that are clearly available in the market.

Taking the zero cumulative floor into account in determining whether a rate of return is at or below market would cause most rates of return available in the market to be treated as above-market. If most rates of return available in the market are indeed not market rates of return, one would have expected this point to be reflected somewhere in the structure or the legislative history of the PPA. Yet there is no hint of this point anywhere. On the contrary, the statute itself says one is to ignore minimum rates of return in determining whether a rate qualifies as a market rate of return. See § 411(b)(5)(B)(i)(I) (last sentence); see also further statutory analysis in Section 3.6 below. And the legislative history makes clear that a plan may offer a market rate of return and, in addition, provide a reasonable minimum guaranteed rate of return without having to reduce the market rate of return:

*Mr. GREGG.* My understanding is that the term "market rate of return" is intended to allow plans to adjust benefits in ways that benefit participants. For example, 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. . . . is this correct?

*Mr. ENZI.* Yes, it is.

152 Cong. Rec. S8747, S8756 (Aug. 3, 2006).

Aside from these strong technical arguments, policy considerations also support this recommendation. The purpose of the market rate of return rule is to prohibit hybrid plans from promising an above-market rate of return over a longer period for a younger employee (who is farther from normal retirement age and therefore has a longer investment horizon)



than for an otherwise similarly situated older employee (who is closer to normal retirement age and therefore has a shorter investment horizon). For this purpose, two employees are similarly situated if they are identical in every respect (service, compensation, etc.) except age. See § 411(b)(5)(A)(ii). However, minimum guaranteed rates of return—particularly cumulative minimum rates such as the zero cumulative floor—are expected to provide benefits primarily to employees with shorter investment horizons, and, as discussed above, it is older employees who have shorter investment horizons, once all non-age factors are held constant.

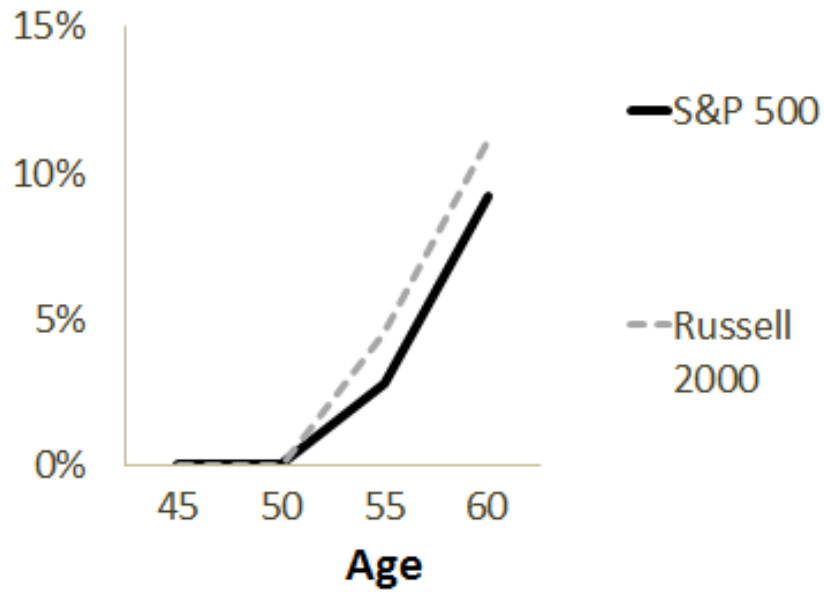
The graphs on the next page illustrate the relationship between increasing age and both the likelihood that the zero cumulative floor will apply and the average increase that the zero cumulative floor will provide in an employee's final account balance. In particular, the graphs show that:

- The older an employee is, the greater the likelihood the zero cumulative floor will benefit the employee.
- The older an employee is, the larger the average percentage increase the zero cumulative floor will provide in the employee's final account balance.
- Employees below age 50 are unlikely to derive any benefit from the zero cumulative floor.

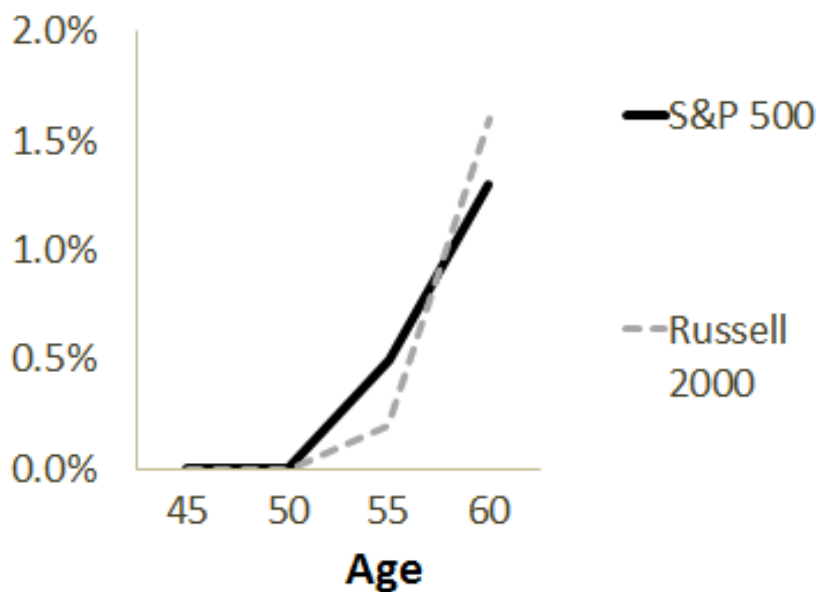
The graphs on the next page are based on historical data for the S&P 500 and Russell 2000 indices. However, the trends appear to hold for other investments as well. In particular, we have looked at historical data for seven large American corporations that have been in existence long enough to derive meaningful investment return data over multiple decades. The data for these individual company securities show the same relationship between increasing age and the expected benefits of the zero cumulative floor. If anything, the increased volatility of these individual company securities *accentuates the benefits provided to older employees*.

Further information is available upon request about the data underlying the graphs on the next page.

## How Frequently ZCF Applies



## How Much ZCF Increases Average Final Account Balance



### **3.3. Market Rate Rules Should Permit Rational Retirement Portfolios**

**Issue:** The proposed regulations do not appear to contemplate that hybrid plans should have the ability to provide participants with hypothetical accounts that are invested in accordance with the principles of modern portfolio theory—that is, in retirement portfolios that reflect participants’ changing needs and tolerances for risk and return over time.

**Recommendation:** The final regulations should permit hybrid plans to offer a range of interest crediting rates (whether as part of a safe harbor or an exclusive list) that are sufficient to allow the plan’s hypothetical accounts to function as a rational retirement portfolio for each participant. The permissible interest crediting rates under the final regulations should include the rate of return on a qualified default investment alternative (“QDIA”) under ERISA § 404(c)(5), including target retirement date funds and managed accounts. In the case of target date funds, the final regulations should allow a plan to include a range of such funds and to assign each participant to a specific fund based on his or her individual election or, in the absence of an election, based on objective criteria. The safe harbors should also include any investment option offered under a broad-based defined contribution plan maintained by the plan sponsor, other than company securities, stable value funds (which are difficult to replicate in a defined benefit plan), or investments available through a brokerage window.

Under the final regulations, a hybrid plan should be permitted to change investment options for any appropriate reason, including (1) the option is no longer available in the market, (2) the option is no longer considered prudent to offer, or (3) pursuant to the participant’s directions. The final regulations should provide that such changes do not violate the definitely determinable benefits requirement or the anti-cutback rule, as long as the potential reasons are specified in advance in the plan document and the plan provides that a participant’s interest crediting rate is subject to change for any such reason. The final regulations should permit plan sponsors to add such plan provisions in connection with making plan changes to conform to the final regulations.

**Discussion:** All of the rates discussed above are available in the market and have satisfied fiduciary screening as sound investment options. It is troubling that, under the regulations as currently drafted, participants would not have access to rational retirement portfolios. For example, if a plan credited the return on an S&P 500 index mutual fund, the plan would, under the regulations, provide this return to all participants at all ages and stages in their careers. However, investing entirely in only an S&P 500 index mutual fund at every age might not be considered a rational investment strategy in all cases. Plans should be permitted to offer dynamic portfolios that can be tailored to a participant’s varying needs over time.

### **3.4. Market Rates Should Include Returns on Collective Investment Vehicles Other than the Plan, a Regulated Investment Company, or an Insurance Contract**

**Issue:** The proposed regulations would limit permissible investment rates of return to the rate of return on the aggregate assets of the plan, a regulated investment company, or an insurance contract.

**Recommendation:** Among permissible interest crediting rates, the final regulations should permit (whether as part of a safe harbor or an exclusive list) the rate of return on a separate account, a collective investment trust, or any similar investment vehicle that functions in a manner analogous to a regulated investment company or an insurance contract. If Treasury and IRS wish, such investment vehicles could be limited to those that are available under the plan sponsor's defined contribution plan.

**Discussion:** Nothing in the statute or legislative history indicates that a "market rate of return" excludes the rate of return on a separate account, a collective investment trust, or any similar investment vehicle. Indeed, many 401(k) plans achieve material reductions in fees and other costs that benefit participants by using separate accounts, collective investment trusts, and other similar investment vehicles. Hybrid plans that credit an investment rate of return should similarly be permitted to offer rates of return on actual investment vehicles even if the vehicle is not a regulated investment company or insurance contract.

### **3.5. Increase Margins on Notice 96-8 Rates**

**Issue:** The regulations permit rates described in Notice 96-8, but without increasing the applicable margins.

**Recommendation:** The margins incorporated from Notice 96-8 should be increased to reflect the fact that the reference point under current law is the third segment rate, not the 30-year Treasury bond.

**Discussion:** The margins set forth in Notice 96-8 were developed based on “the historical relationship between each of [the indices in the Notice] and the rate of interest on 30-year Treasury securities.” The interest rate described under Code § 417(e) has since been changed from 30-year Treasury securities to the first, second, and third segment rates. The relationship between the third segment rate and the 30-year Treasury rate is that the third segment rate will almost certainly be higher, although the differential may vary. The margins should be increased to reflect this as the 96-8 rates are clearly below the market rate limitation. If the margins are not increased, some hybrid plans will be forced to reduce their interest crediting rates, to the detriment of participants. There are, for example, hybrid plans that credit interest at a 96-8 rate plus a margin that exceeds that permitted under 96-8, but that does not exceed the third segment rate.

### **3.6. The Cap on Minimum Annual Rates of Return Should Be Increased to at Least 5%**

**Issue:** The proposed regulations would limit a minimum annual rate of return to 4%.

**Recommendation:** Under the final regulations, the highest permissible minimum annual rate of return should be at least 5%.

**Discussion:** The statute provides that:

“A plan shall not be treated as failing to meet the requirements of this subclause merely because the plan provides for a reasonable minimum guaranteed rate of return or for a rate of return that is equal to the greater of a fixed or variable rate of return.”

Code § 411(b)(5)(B)(i)(I); ERISA § 204(b)(5)(B)(i)(I); ADEA § 4(i)(10)(B)(i)(I).

As discussed above, Congress clearly intended that this language be interpreted so that a reasonable minimum rate of return does not affect the ability of an otherwise market rate of return to qualify as a market rate of return. Instead, the proposed regulations interpret the above-quoted sentence as a virtual nullity. They effectively interpret the sentence to provide that if an interest crediting rate with a minimum is in the aggregate a market rate of return, the existence of the minimum will not cause the interest crediting rate to fail to be treated as a market rate. Under that interpretation, the above-quoted sentence would have no effect; it would simply be saying that a market rate of return shall not fail to be treated as a market rate of return. The only plausible interpretation of the sentence is that it was meant to enable plans with permissible interest crediting rates which separately meet the market rate of return requirement to also maintain a reasonable minimum guarantee.

The regulatory preamble articulates the thinking behind the proposed 4% level, stating that the “Treasury Department and the IRS have modeled the historical distribution of rates of interest on long-term investment grade corporate bonds and have determined that those rates have only infrequently been lower than 4% and, when lower, were generally lower by small amounts and for limited durations.” Such an approach is fundamentally inconsistent with the concept of a reasonable minimum and instead creates an “immaterial” minimum based on the erroneous interpretation of the statute described above.

### **3.7. The Cap on Fixed Annual Rates of Return Should Be Increased to at Least 6%**

**Issue:** The proposed regulations would limit a fixed annual rate of return to 5%.

**Recommendation:** Under the final regulations, the highest permissible fixed annual rate of return should be at least 6%.

**Discussion:** We understand that Treasury and IRS proposed a 5% maximum fixed annual rate of return to ensure that the highest permissible fixed rate would rarely, if ever, exceed in any year the third segment rate. Even under that standard, the highest permissible fixed rate should be 6%, not 5%, because the third segment rate almost never falls below 6%. However, the PPA authorizes Treasury and IRS to determine “effective rates of return” that meet the requirements of a market rate. These rates should not systematically be below market but instead should be designed to replicate the market over time. A rate is considered to be above market, and therefore age discriminatory, if, over time, it would provide a greater benefit to a younger employee than to an otherwise similarly situated older employee, when the benefit is adjusted to reflect the time value of money. If in a single year a plan’s interest crediting rate exceeds the third segment rate, the plan would not provide a greater benefit to younger employees; that would occur only if the plan provided an above-market rate over many years. Conversely, if a fixed rate never, or almost never, exceeds the third segment rate, the rate is systematically below market. Under this analysis, the cap on fixed rates should be increased to at least 6%.

## TRANSITION

### 4.1. *Effective Date of Regulations Should Be Delayed*

**Issue:** Proposed regulations are expected to take effect for the first plan year beginning after December 31, 2011.

**Recommendation:** The effective date of the regulations should be no earlier than the first plan year beginning at least 12 months after the later of (a) the date the final regulations are published in the *Federal Register* or (b) the issuance of associated anti-cutback relief under § 411(d)(6) that is described in the preambles.

**Discussion:** For many large plans, the regulations will require substantial modifications. Many plans will have to reduce interest crediting rates and other plan benefits, triggering difficult employee relations and communications issues. Some companies may look at replacing lost interest credits with other benefits. For many other companies, far more work will be required. The entire plan will have to be redesigned—or may well be frozen—since the plan formula may depend on the interest-crediting level to satisfy the backloading rules.

These changes cannot be fully assessed until all the rules are known. Once the rules are known, there will, in many cases, be more than one way to modify a plan to comply, and the various alternatives will need to be evaluated. Once a plan sponsor determines a path to compliance, the new structure will need to be programmed, incorporated into administrative systems, and communicated to participants. Participants, in turn, may need to adjust their retirement strategies.

To require that all of this be done in perhaps a few months is not workable. A minimum of 12 months is needed between the time final regulations are issued and the beginning of the first plan year to which the regulations will apply.



#### **4.2. Regulations Should Provide Broad Anti-Cutback Relief for Transition**

**Issue:** The regulations will set forth new limits on market rates. Treasury and IRS have indicated that they will issue guidance permitting plan amendments “to the extent necessary” to comply with the new rules.

**Recommendation:** Treasury and IRS should grant broad anti-cutback relief to ensure that plans may be amended to comply with the PPA without undue exposure to litigation or undue difficulty in coming into compliance. Regulations or other guidance should provide a list of safe harbor amendments that will not violate the anti-cutback rule, including: (a) any amendment to change a non-compliant or non-safe harbor interest crediting rate to the third segment rate, the highest permissible fixed rate, or any rate specified in Notice 96-8 (with the updated margins described earlier); (b) any amendment to eliminate one or more alternative rates when the combination of the alternative rates would not comply (for example, when a plan offers the greater of two market rates that, together, are considered to be above market); and (c) any amendment to replace an investment-based rate that is not compliant (or not within a safe harbor) with any investment rate of return that is within a safe harbor (including, without limitation, the actual rate of return on plan assets allowable under Prop. Reg. § 1.411(b)(5)-1(d)(5)(ii) and the rate of return on a rational retirement portfolio recommended in Section 3.3). The transition approach in (c) will work more effectively if the list of permissible interest crediting rates is expanded as recommended in Sections 3.1-3.4.

In addition, for purposes of the anti-cutback transition relief, a plan sponsor should be permitted to treat a crediting rate as above market if the rate is neither (1) one of the safe harbor rates specified in the regulations, nor (2) the rate of return on an actual investment available in the market.

If a plan with participant direction has one or more non-compliant (or non-safe harbor) rates, the plan should, with respect to each non-compliant (or non-safe harbor) rate, be permitted to (A) eliminate the non-compliant (or non-safe harbor) rate, leaving only options that are compliant (or within a safe harbor), (B) change any non-compliant (or non-safe harbor) rate using one of methods in (a), (b), or (c), above, as applicable, or (C) eliminate participant direction and adopt any rate a plan is permitted to switch to under (a) or (c), above.

**Discussion:** Congress intended plan sponsors to have broad anti-cutback relief to respond to the PPA. Under § 1107 of the PPA, Congress provided sponsors three years to amend plans to comply with the PPA, during which time Congress presumably expected Treasury and IRS to promulgate regulations so that plan amendments could be adopted. The anti-cutback relief was intended to be broad: any amendment was permitted that was “pursuant to” the PPA. Should Treasury and IRS offer anti-cutback relief for amendments “to the extent necessary” to comply, this standard should be interpreted (a) in light of the Congressional intent for broad anti-cutback relief, and (b) in recognition of the fact that in many cases, there will be more than one way to amend a plan to comply with the final rules.

The above recommendation contemplates that Treasury and IRS will adopt our safe harbor approach in Section 3.1, as opposed to the “closed list” approach. Under the recommendation, the regulations should nevertheless recognize the distinction between safe harbor and non-safe harbor rates, and provide anti-cutback protection to change rates that are not safe harbors but that are also not above market. In addition, we are proposing an approach without knowing what the final criteria for interest crediting will be; accordingly, we recommend that the anti-cutback relief be initially issued in proposed form, so that there is an opportunity for comment after the final interest crediting regulations are finalized.

#### **4.3. Confirm Reasonable Interpretation Standard Before Regulatory Effective Date**

**Issue:** The PPA's market rate of return rules generally took effect beginning January 1, 2008 (for calendar year plans in existence on June 29, 2005). However, final regulations will not be effective until January 1, 2012 (or later). Treasury and the IRS should provide guidance regarding the market rate of return standard that applies during this interim period.

**Recommendation:** The regulations should make clear that, during the period from the effective date of the PPA's market rate rules until the effective date of final market rate regulations, a reasonable interpretation of the statute applies. The regulations should further state that it would have been reasonable for a plan sponsor to maintain the rate that had been in effect in the plan when the PPA was enacted if the rate was reasonable when it was established.

**Discussion:** An interest crediting rate that is above market causes age discrimination under the PPA because the rate is offered for longer periods to younger participants (assuming younger participants have longer investment horizons than older employees). However, once the PPA was enacted, hybrid plans in existence at that time no longer promised interest crediting rates indefinitely; instead, the rate was expected to be reduced (and would be required to be reduced) to the extent required to comply with the market rate rules. Accordingly, if a rate was established before the enactment of the PPA and was a reasonable rate at the time it was established, it should not be considered to be above market and therefore age discriminatory during the interim period while the plan sponsor merely waited for final guidance from Treasury and the IRS. Any other reasonable interpretation of the market rate standard during the interim period should also be compliant.

To hold otherwise would require retroactively reducing benefits for participants and/or exposing employers who acted in good faith to unnecessary and costly litigation. In addition, the proposed regulations will have functioned in effect as temporary regulations since they would provide the only clearly acceptable means of compliance before the issuance of the final regulations.

For example, assume that as of December 31, 2007, a calendar year plan credits interest at a fixed 6.5% rate. Assume further that this rate was established at a time when interest rates were higher than they are today. What should such an employer have done as of January 1, 2008? The employer had only two choices (1) treat the proposed regulations (issued a few days before January 1, 2008) as temporary regulations and reduce the 6.5% rate even though the proposed market rate rules were proclaimed in the preamble to be incomplete and did not address fixed rates of return at all, or (2) wait for final guidance. To reduce the 6.5% rate instantly based on self-proclaimed incomplete proposed regulations hardly seems prudent or appropriate, especially in light of the fact that a 6.5% interest rate seems to be a market rate. In fact, generally such a reduction would have been illegal due to the absence of a timely § 204(h) notice. And in some cases, a reduction would have required an instantaneous plan redesign in order to comply with the backloading rules. Finally, there was no guidance regarding the scope of the anti-cutback relief, leaving the plan sponsor with no help on what the 6.5% rate could be reduced to.

Moreover, there were many types of interest crediting rates for which no guidance whatsoever was included in the first set of proposed rules and for which there was incomplete guidance in the 2010 proposed and final regulations. For instance, the section for market rate of return was marked “reserved” in the 2007 proposed regulations and is still proposed currently, meaning that many plan sponsors could reasonably be thinking that more options could possibly be available to them in the final regulations. Indeed, they would not know whether or not their current interest crediting rate would exceed a market rate of return when all is said and done. This means that they could not move to an alternate available rate without a possible anti-cutback violation. Thus, many plan sponsors have had no feasible option to change their plan before full guidance becomes available.

So for these very good reasons, many plans would have been well-advised not to modify their rate as of the effective date of the market rate rule or any date between the statutory effective date and the ultimate regulatory effective date. In this context, it is important that the final regulations establish a transitional rule under which any reasonable interpretation of the market rate requirement will be treated as compliance with the statute prior to the regulatory effective date. In addition, the regulations should state that for periods after the statutory effective date and before the regulatory effective date, a rate of return shall be treated as a market rate if it was a reasonable rate under the economic circumstances in effect when the rate was set.