April 16, 2007

CC: PA: LPD:DRU (Notice 2007-6)
Room 5203
Internal Revenue Service
P.O. Box 7604 Ben Franklin Station
Washington, DC 20044

Dear Sir or Madam:

On behalf of the American Benefits Council (the "Council"), I am writing with comments regarding issues affecting cash balance plans, pension equity plans, and other hybrid defined benefit plans. Our comments relate to issues addressed by IRS Notice 2007-6, issues with respect to which comments were requested by Notice 2007-6, and additional important issues relating to hybrid plans. Before turning to our comments, we first want to applaud Treasury and the IRS for the rapid development of IRS Notice 2007-6 and for their announced intention to move forward quickly with regulatory guidance. Hybrid plan guidance is very much needed. Also, although we have concerns about certain elements of Notice 2007-6, we believe that the Notice was a very constructive and helpful first step toward comprehensive guidance.

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

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Market Rate of Return.

Under the Pension Protection Act of 2006 (the "PPA"), an "applicable defined benefit plan" is treated as failing to satisfy the applicable age discrimination rules unless the plan provides that any interest credit (or an equivalent amount) shall not exceed a market rate of return. The issues regarding what constitutes a market rate of return are among the more important issues for hybrid plans.

Effect of minimum rates on the market rate determination. The statute states:

> 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.

This statutory provision is clear. Assume, for example, that a cash balance plan credits interest at the greater of 3% or the third segment rate described in Code section 430(h)(2)(C)(iii), and assume further that the third segment rate is exactly a market rate. The statutory provision clearly states that the third segment rate will not fail to be a market rate solely because of the 3% minimum. In other words, in this case, no adjustment to the third segment rate would be necessary to satisfy the market rate of return rule.

This result is squarely supported by a colloquy between Senator Enzi and Senator Gregg on August 3, 2006:

> 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.

This colloquy is consistent with the clear statutory language. And the colloquy demonstrates Congress' intent. Congress did not want to force employers across the country to reduce their interest crediting rates by reason of the existence of a reasonable floor rate. Any contrary interpretation of the statute would harm participants and would be inconsistent with the statutory language and Congress' expressed intent.

Minimum rates. Guidance is needed with respect to what constitutes a "reasonable minimum guaranteed rate of return". We urge you to clarify that any fixed crediting rate that would, on its own, be treated as not exceeding a market rate of return would be a reasonable minimum guaranteed rate of return for purposes of the above-quoted provision. See the discussion below of what fixed rates should be treated as not exceeding a market rate. Any other rule would require an entirely new and artificial economic analysis regarding minimum rates that are sufficiently below market to qualify as "reasonable". And there is nothing in the legislative history indicating that Congress intended to establish such an artificial set of new rules.

We believe that the approach described in the preceding paragraph is also appropriate where the plan's variable crediting rate is based on equity returns, but the plan guarantees a minimum rate. However, we would add one caveat. In such cases, the minimum should only be applicable at benefit commencement, not on an annual basis. (In the context of non-equity rates, the minimum should be permitted to be applied on an annual basis, or less frequently, at the option of the employer, and still be "reasonable.") Because of the annual fluctuations of equity returns, it would not be reasonable to guarantee a minimum each year, but it would be eminently reasonable to guarantee a minimum over the life of the equity investment with respect to any participant. Accordingly, if a plan has an equity-based crediting rate and applies a minimum rate on a more frequent basis (such as annually), it may be appropriate to require a "haircut", i.e., a reduction of the equity-based rate to make up for the more frequent application of the minimum rate.

Interaction with the backloading rules. As discussed further in a subsequent part of this letter, it is critical that the backloading rules be revisited in the context of the upcoming hybrid plan guidance. One way in which those rules are being interpreted is in conflict with the pro-participant conversion techniques in use today. And there is a tension between one aspect of the current interpretation of the backloading rules and the PPA's market rate rule.

Our understanding is that if a plan uses a variable interest crediting rate, the IRS generally requires that the backloading rules be applied by using the plan's minimum guaranteed rate of return, rather than the variable rate. This requires in many instances the establishment of a relatively high minimum crediting rate. It would be inappropriate and unfair for the backloading rules to be interpreted to require a minimum crediting rate that is so high that it creates problems under the market rate requirement. Also, the current interpretation of the backloading rules can require minimum rates that are so high that the employer is effectively compelled, for economic reasons, to adopt a variable crediting rate that is less favorable to participants than the variable crediting rate that the employer would otherwise choose.

In our view, this issue should be resolved as follows. Whether a minimum crediting rate is reasonable should be determined based on the principles discussed above. And the backloading rules should be applied based on the level of the variable crediting rate at the time that the plan or plan amendment, as applicable, is adopted, determined as if the current level applies indefinitely. Alternatively, for purposes of the backloading rules, a plan should be permitted to use an average of the variable crediting rates during a period prior to such adoption, such as a period up to three years. If the plan uses equity rates of return, the backloading rules would be applied based on historical average rates of return for the equity class at issue. Otherwise, the backloading rules could be skewed by an abnormally high or low rate of return for the most recent period.

Capital preservation rule: date of application. The PPA provides with respect to applicable defined benefit plans:

> An interest credit (or an equivalent amount) of less than zero shall in no event result in the account balance or similar amount being less than the aggregate of contributions credited to the account. ["capital preservation rule"]

Similarly, with respect to all defined benefit plans, the PPA provides that a plan shall not fail to satisfy the age discrimination rules solely because the plan provides for indexing of accrued benefits. The PPA then states:

> Except in the case of any benefit provided in the form of a variable annuity, clause (i) [which permits indexing] shall not apply with

> respect to any indexing which results in an accrued benefit less than the accrued benefit determined without regard to such indexing. ["loss protection rule"]

The first question is: when are those rules applied? The answer is clear: at the time of benefit distribution. There is no other time when the amount of a participant's benefit has any concrete relevance to the participant. In other words, the only date on which a benefit amount is relevant is the date of distribution. A contrary argument might be made that the preservation of capital rule should be applied annually. Why? Why not daily? Why not monthly? There is just as much theoretical logic - - or more - - for a daily rule as there is for an annual rule. If Congress had intended an annual or monthly or daily rule, it would have said so. Congress' silence demonstrates that the determination should be made at the only date relevant to the participant.

This interpretation is again squarely supported by a colloquy on the Senate floor:

> Mr. Burr: At what point are the [capital preservation and loss protection]
> rules applied?
>
> Mr. Enzi: The capital preservation and loss protection rules are intended to provide long-term protection to employees, so the determination of whether the rules are satisfied is made at the time benefits commence but not beforehand.

Also, at the time of benefit distribution, the minimum benefit required by the preservation of capital rule should be the sum of all contribution credits. For example, if a plan previously credited interest at a fixed rate, then switched to an equity-based rate, all contribution credits at all times should be taken into account (and none of the interest credits should be taken into account) in determining the required minimum benefit.

<u>Effect of capital preservation rule on market rate determination.</u> Under the analysis set forth above, the capital preservation rule is simply a reasonable long-term floor on the interest crediting rate. As such, for the reasons discussed above with respect to minimum rates, the capital preservation rule should not require that a rate that is otherwise considered to be a market rate - - such as a rate based on equity returns - - must be reduced.

<u>How to apply the capital preservation rule.</u> There are administrative issues with respect to the application of the capital preservation rule. For example, if a cash balance plan has changed recordkeepers in the past, the new recordkeeper may only have received information on account balances, not on past contribution credits. Thus, the new recordkeeper will be unable to determine the aggregate amount of contribution

credits. Because of situations like this, the regulations should include the following rule. If a plan administrator cannot reasonably determine the aggregate amount of contributions credited to a participant, and such inability is attributable to a reasonable cause (such as the failure to receive the needed information from a prior recordkeeper), then the plan administrator may either:

(1) Determine the aggregate contribution credits based on reasonable estimates, or
(2) Treat the entire current account balance as attributable to contribution credits.

Variable annuity plans. Variable annuity plans are specifically excepted from the loss protection rule, but are not referenced in the capital preservation rule. In light of the specific intent not to apply the loss protection rule to variable annuity plans, it would make little sense to apply the capital preservation rule to hybrid variable annuity plans. This is especially true since hybrid plans could satisfy the age discrimination rules by use of the non-hybrid plan rules, such as the provision permitting indexing.

Fixed rates of returns. There are generally thought to be two types of interest crediting rates: fixed and variable. We think of there being three types: (1) fixed by reference to a number (such as 6%), (2) pure variable rates (such as floating with the return on the S&P 500 index), and (3) variable rates that are fixed for specific periods (such as a provision under which for each year, accounts are credited with interest at a specified long-term investment grade corporate bond rate, determined as of a specified date in the prior year). The third category is generally thought of as a variable rate, and in fact we refer to it as such above in the discussion of minimum rates. However, for one purpose below, the third category is best analyzed as a fixed rate.

As noted, plans often use a fixed percentage as an interest crediting rate, with wide variations as to how frequently the rate is adjusted, if at all. Two questions arise in this regard. First, how is it determined whether a fixed rate is at or below market? Second, does a fixed rate have to be adjusted to take into account economic changes and, if so, how often? With respect to the first question, the third category of rates described above should be analyzed as a fixed rate.

In answer to the first question, we believe that any rate of return fixed by reference to a rate (or average of rates) recently available in the market - - such as a long-term or short-term corporate bond rate - - should be considered a market rate, provided that (1) there is not an unreasonable risk to principal associated with the market rate and (2) “recently available” is interpreted to include at least the three preceding years. Certainly, all investment grade corporate bonds would fall in this category, as would many non-investment grade corporate bonds. We would urge you to adopt a safe harbor for investment grade corporate bonds, but we do not believe that there should be an absolute rule precluding the use of non-investment grade corporate bonds. Certainly, the rate on any government bond should also be treated as a market

rate. The rates referenced in IRS Notice 2007-6, section III.D.2, should also be permitted, of course.

In addition, a plan should be permitted to base its interest crediting rate on equity indices determined over a stated period of no more than a few years, provided that such process is applied consistently. The consistency requirement ensures that such interest crediting rates are not used only during good economic times, which would result in above market crediting rates.

The second issue is: how often does a final rate have to be adjusted? Obviously, economic conditions change constantly, but plans need consistency and predictability. Accordingly, we believe that fixed rates, if at or below market when set, should be permitted to be applied indefinitely. If the regulations do require periodic reevaluations of fixed rates, it would be appropriate to permit fixed rates to remain in effect for at least five years before they must be reevaluated in the context of changed economic conditions.

If periodic reevaluations of fixed rates are required, the section 411(d)(6) rules need to be clarified with respect to any needed adjustments of those rates. A plan should be permitted to provide that the rate of return shall be adjusted in accordance with economic conditions at the end of specified period (which, as noted should be permitted by law to be at least five years)[1]. If the methodology for adjustment is specified in the plan document in such a way as to preclude any material employer discretion, the adjustment should be permitted under section 411(d)(6). However, since plans with fixed rates do not today contain such plan terms, plans should be permitted under PPA section 1107 to add such terms without any violation of section 411(d)(6), as long as the adjustment methodology is conceptually consistent with the fixed rate in effect.

If periodic reevaluations of fixed rates are required, additional transitional guidance is needed. For example, assume that reevaluations are required every five years. In that case, any fixed rate placed in effect more than five years before the effective date of the market rate rule would need to be reevaluated as of such effective date. Any fixed rate placed in effect more recently would, if at or below market when established (determined under the above standards), not need to be reevaluated until the expiration of five years from the date placed in effect. Guidance confirming these points would be helpful.

Predetermined actual investments. An interest crediting rate based on a predetermined actual investment (including, for example, a predetermined index such

[1] It should be clarified that for purposes of the backloading rules, the current fixed rate may be treated as applicable indefinitely.

as an equity index or a bond index) should also be permitted, since such investments are, by definition, in the market.

Changing rates. One of the most important issues is the extent to which employers may change the applicable interest crediting rate. A simple answer -- which we do not recommend - - is that all changes are restricted by the anti-cutback rule of Code section 411(d)(6). Under this construct, an interest crediting rate in effect could not be eliminated with respect to previously accrued benefits unless the new rate is in all cases higher (such as a 6% rate replacing a 5% rate).

The above answer is simple and, on its face, seems to be the most protective of participants' rights. We maintain the opposite: in the long run, this answer is the most harmful for participants. Consider this issue in historical context. Because of two factors, many plan sponsors have been unable to raise interest crediting rates to the level they want: (1) the whipsaw issue, and (2) the use of the artificially low 30-year Treasury rate as the whipsaw measure. Many plans sponsors would welcome the opportunity to modify their interest rates to provide a more favorable crediting rate. However, if the anti-cutback rule is applied in a mechanical fashion, such modifications - - even if very favorable to employees based on historical data - - would only be permitted through the use of a wear-away approach. Use of a wear-away approach is administratively cumbersome, which will dissuade many employers from modifying their interest crediting rate in an employee-favorable fashion.

The choices for Treasury and the IRS are simple: either (1) permit employers to update and improve outdated interest crediting rates or (2) generally freeze existing rates. It would be sad if the latter were chosen.

There are many regulatory structures that could be applied to permit interest crediting rate changes without triggering the anti-cutback rules. For example, where a change in the interest crediting rate is made by the employer, such a change could be permitted if, based on historical data, the following is true: the new rate of return is comparable to the old rate (e.g., within a specified number of basis points), and the new rate does not pose a materially higher risk than the old risk. We would be happy to submit further thoughts on how to define "comparable" and "materially higher risk" if that would be helpful, since employers will need clear guidance on issues like this.

Also, it should be confirmed that where any change in the interest crediting rate is made at the election of the employee, the change is permitted unless the new rate is systematically less favorable than the old rate. In this regard, it would be helpful for the regulations to clarify that employers have flexibility to decide how often employee elections may be made and the date on which such elections become effective.

Plan amendments. Section 1107 of the PPA provides that plan amendments made pursuant to PPA provisions shall not violate the anti-cutback rule, except as

otherwise provided by Treasury. We believe that this provision authorizes the following types of plan amendments: (1) a reduction of an above-market interest rate to a market interest rate, and (2) as under IRS Notice 2007-6, elimination of a provision entitling participants to a whipsaw calculation.

With respect to the both types of reductions, the guidance should confirm that such reduction would, of course, apply to previously accrued benefits as well as to future benefits. Also, the guidance should not impose any requirement of a "make-up benefit" to compensate for the reduction. There is no hint in the legislation or legislative history that such a make-up benefit is intended, which is significant in light of the long and detailed legislative process. Requiring a make-up benefit would also be an inappropriate punishment of employers that (1) had tried to provide a beneficial rate to employees but are required to reduce it, or (2) felt compelled to add the whipsaw provision. Finally, any such make-up benefit would on its face be age discriminatory because it would be compensating younger employees immediately for the future time value of money.

There will also be questions regarding whether an interest crediting rate is above market and thus can be reduced pursuant to section 1107 of the PPA. We recommend that an interest crediting rate be treated as above market if it can reasonably be shown that, under the rules set forth above, the rate is above market. Solely for purposes of determining the applicability of the anti-cutback relief, any fixed rate should be tested solely on the basis of the highest rate under long-term investment grade corporate bonds that are available during the one-year period immediately preceding the effective date of the plan amendment. This provides a clear, fair, administrable rule for determining whether a rate can be reduced. In addition, the reduction cannot be greater than the reduction reasonably necessary to satisfy the above test. In applying this test, plans should not be required to do exhaustive searches of all bond rates, but should be permitted to rely on generally available indices.

It should also be provided that any plan that, as of the date of enactment, provided the whipsaw benefit to its participants shall not fail to satisfy the age discrimination rules by reason of retaining that benefit. Some employers may not wish to eliminate the whipsaw feature, which participants may view favorably. It would be unfortunate and unfair if the whipsaw provision - - which the government required - - is now treated as age discriminatory unless it is promptly taken away from participants. On the other hand, as noted above, as under IRS Notice 2007-6, employers should be free to eliminate the whipsaw benefit under section 1107 of the PPA.

Whipsaw Effective Date.

The legislative elimination of whipsaw applies "to distributions made after the date of enactment of [the PPA]". We believe that this language is clear on its face: no

distribution after the date of enactment should be required to take into account the whipsaw calculation.

The issue that has been raised relates to distributions made prior to the date of enactment. The following argument has been made: if a plan should have provided a whipsaw benefit but did not, that is a plan defect with respect to a pre-PPA distribution. Because that distribution occurred prior to the PPA, it is not affected by the prospective elimination of whipsaw. That argument is fundamentally flawed. We assume arguendo that whipsaw was the law prior to the PPA (although we do not agree with that). Accordingly, we assume arguendo that the prior distribution was erroneous. We strongly believe that those points are irrelevant. The relevant point is that Congress clearly intended that there be no post-enactment "correction" of those "erroneous distributions." In other words, the language of the statute is clear. The new law applies to all distributions after the date of enactment, regardless of whether the distribution is the first one made to a participant or a claim for a "correction" to a prior distribution. The clear statutory language should be followed.

Vesting.

Three-year vesting. The PPA requires that, under an applicable defined benefit plan, all employees with at least three years of service must be 100% vested in their employer-derived benefit. The PPA defines an applicable defined benefit plan to mean:

> a defined benefit plan under which the accrued benefit *(or any portion thereof)* is calculated as the balance of a hypothetical account maintained *for the participant* or as an accumulated percentage of *the participant's* final average compensation. [emphasis added]

Under regulations, an applicable defined benefit plan also includes any defined benefit plan (or any portion thereof) which has an effect similar to an applicable defined benefit plan.

Two broad issues have been raised with respect to this language. First, assume that some participants in a plan are covered exclusively by a traditional formula but other participants are covered by a hybrid formula. In that case, does the three-year vesting rule apply to the entire plan, including the participants covered exclusively by the traditional formula? The answer is clearly no. The existence of an applicable defined benefit plan is, under the clear terms of the statute (as italicized above), determined separately with respect to each participant. Participants who are covered exclusively by a traditional formula are not in an applicable defined benefit plan.

The second issue is as follows. Because of the italicized reference above, the argument has been made that if any portion of a participant's benefit is based on a

hybrid formula, the participant is wholly covered by an applicable defined benefit plan and, accordingly, the three-year vesting rule applies to the participant's entire benefit. This interpretation reflects an incorrect reading of the statute. If a participant's benefit has a hybrid portion and a traditional portion, the intent was clearly to treat the hybrid portion as an applicable defined benefit plan, not to treat the whole benefit as an benefit plan. Any contrary interpretation leads to results that do not make sense. For example, under a contrary interpretation, the market rate of return rule would apply to the entire benefit. This is not possible and was clearly not intended.

Moreover, a contrary interpretation would be inconsistent with the statutory direction to Treasury to:

> include in the definition of an applicable defined benefit plan any defined benefit plan *(or any portion of such a plan)* which has an effect similar to an applicable defined benefit plan. [emphasis added]

Under this language, it is clear that only the part of the plan that has the effect of a hybrid plan would be an applicable defined benefit plan, not any traditional components. It would not make sense to apply this rule in this context, but apply a conceptually different and unsound rule under the basic definition of an applicable defined benefit plan. The conceptually sound rule is that hybrid benefits are part of an applicable defined benefit plan, and traditional benefits are not. The statute supports that conceptually sound approach.

This approach, as applied to the following fact patterns, should yield the following results:

1. Some participants are covered by a traditional formula and others are covered by a hybrid formula: only the latter participants are subject to three-year vesting.
2. A participant's benefit is the sum of a traditional benefit and a hybrid benefit: only the latter benefit is subject to three-year vesting.
3. A participant's benefit is the greater of a hybrid benefit or a traditional benefit: the hybrid benefit is subject to three-year vesting, but the excess (if any) of the traditional benefit over the hybrid benefit is not.
4. A participant's benefit is a traditional benefit, offset by a hybrid benefit under <u>another</u> plan: none of the traditional benefit is subject to three-year vesting.

Vesting effective date. The three-year vesting rule should not be applied to participants who do not have an hour of service on or after the effective date of the new vesting rule. It is so burdensome and unusual for plans to be required to vest previously terminated employees that such a rule should only be applied where there is clear Congressional intent to apply such a rule. Since there is no evidence of any such intent in PPA section 701(e), such a rule should not be applied.

It should be clarified that the delayed effective date of the interest crediting and vesting rules under PPA section 701(e)(3) applies to any plan in existence on June 29, 2005, without regard to whether the plan was in whole or in part an applicable defined benefit plan on such date. The statutory language is clear in that regard.

It should also be clarified that under PPA section 701(e)(3), a plan sponsor may elect early application of the vesting and interest crediting rules as of any date on or after June 29, 2005 (and before the generally applicable effective date). For example, a plan sponsor should be entitled to elect application of such rules as of January 1, 2007.

Finally, it should be clarified that the reference in PPA section 701(e)(3) to "years beginning after December 31, 2007" is a reference to plan years beginning after such date, corresponding to the similar reference in PPA section 701(e)(4).

Age Discrimination.

Choice, greater of, and grandfathering. The new age discrimination safe harbor applies differently based on the type of benefit formula used by the plan. In this regard, there are three types of benefit formulas: (1) formulas expressed as an annuity payable at normal retirement age, (2) formulas expressed as a balance of a hypothetical account, and (3) formulas expressed as the current value of the accumulated percentage of the employee's final average compensation. If, for example, two (or more) groups of participants are covered by two (or more) different types of benefit formulas, the PPA's new age discrimination safe harbor should be available to demonstrate that there is no age discrimination within any of the groups. However, the safe harbor would not be available to compare participant in different groups since such different groups would not be treated as "similarly situated" for purposes of the new safe harbor. In our view, the pre-existing age discrimination rule applies to ensure that a plan's mechanism for assigning benefit formulas to participants is not age discriminatory.

Additional guidance, however, is needed regarding how the pre-existing age discrimination rule is applied when different participants are covered by different types of formulas. Under such additional guidance, if a participant has a choice between the old formula and the new formula, age discrimination should not exist based on an older participant's choice of one of the formulas, even if such formula may produce smaller

total benefits at any point in time[2]. It would make little sense to base a finding of age discrimination on an older participant's receipt of the X benefit instead of the Y benefit if the participant elected to receive the X benefit in lieu of the Y benefit (which could be more favorable than the X benefit at certain times or in certain situations). Also, if a conversion provides participants with the greater of the traditional formula or hybrid formula, an older participant's receipt of benefits under the "greater of" formula cannot be age discriminatory. On the other hand, the pre-existing age discrimination rule would be applicable to prevent age discrimination in determining which employees are entitled to choice or greater of. For example, if choice is only given to younger employees, and older employees are placed in the old formula, that can give rise to the issues described below with respect to grandfathered employees.

Assume that instead of providing "choice" or "greater of", certain older, longer-service employees are grandfathered under the old formula. There could certainly be cases where that is age discriminatory, such as a situation where the new formula is systematically more generous than the old formula. There are also cases where such grandfathering is clearly not age discriminatory, such as where the old formula is systematically more generous. But actual fact patterns may not fit neatly into either category.

For example, assume the following facts. The plan grandfathers in the old traditional formula all participants who had attained age 50 by the date of the conversion. Assume further that grandfathered participants who remain employed for at least five years will fare better under the traditional formula (on a present value basis), but if they terminate earlier, they would have fared better under the hybrid formula (on a present value basis). We urge you to treat this type of grandfathering arrangement as satisfying the pre-existing age discrimination rule. Unless there is some clear expectation of widespread employee turnover by reason of a publicly anticipated event, it should be permitted to cover older employees under a formula that will be more favorable for them in the long term (on a present value basis).

A contrary rule could in effect ban grandfathering in some cases. Assume, for example, a rule prohibiting any grandfathered employee from receiving a less valuable benefit in any year than any non-grandfathered employee. That rule could be difficult to satisfy in some conversion cases. Thus, an employer in this situation that would like to use grandfathering to avoid the administrative burdens and cost involved in "choice" or "greater of" would likely use none of these transition approaches. This is yet another example of how an overly restrictive rule that appears to be protective of participants would have exactly the opposite effect.

Determination of a plan's formula. As noted above, the new age discrimination safe harbor applies differently based on whether the "accrued benefit [is], under the

[2] An alternative way to achieve a similar result would be to apply the "similarly situated" test by assuming that all participants made the same choice.

terms of the plan, . . . expressed as an annuity payable at normal retirement age, the balance of a hypothetical account [cash balance], or the current value of the accumulated percentage of the employee's final average compensation [pension equity]." The issue is: under what circumstances will a plan be considered to "express" an accrued benefit as a cash balance amount or a pension equity amount? We believe that IRS Notice 2007-6 addresses this issue well. If the "accumulated benefit" is determined under a cash balance formula or a pension equity formula, the age discrimination safe harbor should apply on that basis without regard to whether "the plan defines the participant's accrued benefit as an annuity at normal retirement age that is actuarially equivalent to" the benefit as otherwise determined. The approach in the Notice is conceptually sound, avoids elevating form over substance, and is consistent with Congressional intent as reflected in Chairman Enzi's floor statement:

> How a plan expresses the accrued benefit for purposes of the age discrimination rules is not contingent upon how the plan document defines the term "accrued benefit." For example, a cash balance plan may, for purposes of the age discrimination rules, express the accrued benefit as the current balance of the hypothetical account determined under the terms of the plan, even if the plan defines the term "accrued benefit" in a different form, such as an annuity commencing at normal retirement age that is based on the hypothetical account.
>
> Similarly, a pension equity plan may express the accrued benefit as a current value equal to an accumulated percentage of the employee's final average pay as determined under the terms of the plan, even if the plan defines the term "accrued benefit" in a different form, such as an annuity commencing at normal retirement age that is based on that current value. This flexibility is important because pension plans will often define the "accrued benefit" in different fashions. For example, the IRS has frequently insisted that plans define the term "accrued benefit" as "an annuity commencing at normal retirement age", even though the annuity is determined by reference to a hypothetical account or a current value equal to an accumulated percentage of an employee's final average pay.

The analysis set forth above should not be affected by a change in the plan terms on or after termination of employment. For example, some cash balance plans have worked as follows in order to avoid whipsaw issues. The benefit is determined under a cash balance formula, with an interest crediting rate equal to the section 417(e) interest rate. At termination of employment, the cash balance account is converted to an

annuity beginning at normal retirement age. It is clear that this type of plan determines the accumulated benefit under a cash balance formula and thus should be treated as such for purposes of the age discrimination safe harbor.

Participants working post-normal retirement age. In the context of a traditional, non-hybrid formula that "expresses" the accrued benefit as an annuity payable at normal retirement age, it is important that, for purposes of the new age discrimination safe harbor, the accrued benefit of a participant who is older than the plan's normal retirement age be determined as of the participant's age.

Other types of formulas. Some benefit formulas do not fit within any of the three categories described above (as set forth in Code section 411(b)(5)(A)(iv)). Treasury should exercise its inherent regulatory authority to permit such formulas to be tested under the new age discrimination safe harbor based on plan's formula. For example, some pension equity plans ("PEPs") base the lump sum benefit on a percentage of each year's pay. Such plans should be permitted to apply the new age discrimination safe harbor by reference to whether such formula contains any element that favors similarly situated younger participants.

Conversion Issues.

Applicability of conversion rule. In the case of an applicable plan amendment adopted after June 29, 2005, the PPA deems the amendment to be age discriminatory unless the accrued benefit is at least a minimum amount. The first issue is: what constitutes an applicable plan amendment? In general, under the statute, an "applicable plan amendment means an amendment to a defined benefit plan which has the effect of converting the plan to an applicable defined benefit plan." As discussed above, the existence of an applicable defined benefit plan is determined separately with respect to each participant. Accordingly, it is clear that the existence of applicable plan amendment is also determined separately with respect to each participant.

Within this statutory framework, we urge you to clarify the following. If certain participants are grandfathered under the old formula, there has clearly been no applicable plan amendment with respect to such participants. The analysis is more complicated where participants are given a choice of coverage under the old or new formula. Certainly, there has not been an applicable plan amendment with respect to any participant who elects to remain under the old formula. Our view is that there is also no applicable plan amendment with respect to participants who elect coverage under the new formula. The reason is that it is not the amendment that "converted" the participant but rather the participant's election that did so. There is no evidence of any Congressional intent to apply the new minimum benefit rules to formulas voluntarily elected by a participant.

Also, in our view, there is no applicable plan amendment with respect to participants who are given the "greater of" the old formula or the new formula. From any conceptual perspective, there has not been a conversion. Each such participant is guaranteed to receive a minimum of the benefit determined under the old formula. So in no sense has that benefit formula been converted to something else. Instead, a new benefit has been added to the old benefit.

Where the "greater of" provision expires after a certain period time, the analysis changes. In those cases, there is an applicable plan amendment. In those cases, it should be clarified that for purposes of applying the new minimum benefit requirement, the effective date of the amendment is the effective date of the plan amendment itself, not the expiration date of the "greater of" provision.

Minimum benefit. Under the PPA and Notice 2007-6, the minimum post-conversion benefit is the sum of (1) the participant's accrued benefit under the old formula for pre-conversion years of service, and (2) the participant's accrued benefit under the new formula for post-conversion years of service. In addition, the minimum benefit must be increased as follows. If, as of the date of the participant's retirement, the participant has qualified for an early retirement benefit or retirement-type subsidy with respect to his or her pre-conversion benefit, the amount of such benefit or subsidy (referred to here as the "subsidy benefit") shall be credited to the participant's post-conversion benefit described above.

This provision raises a host of issues. First, the crediting of the subsidy benefit should occur as of the annuity starting date, which was what was clearly intended by the PPA. In this regard, we believe that the transitional guidance in Notice 2007-6 should be reflected in the regulations.

Second, the PPA does not prescribe any rules for purposes of determining the value of the subsidy benefit. In light of the detailed, intricate rules set forth in PPA section 701, this leads to the conclusion that any reasonable assumptions may be used in this regard. We urge you to confirm this in the regulations and to provide safe harbor conversion techniques, including (1) the use of section 417(e) rates, and (2) the use of the plan's interest crediting rate (or a reasonable proxy for such rate based on historical data, in the case of an equity-based rate) and the mortality table used by the plan for purposes of determining actuarial equivalence between different annuity forms of distribution. Of course, if a participant elects to receive his or her benefit in an annuity form, it would only be fair to require the subsidy benefit to be converted back to the annuity form using the same assumptions used to convert the subsidy benefit into a post-conversion benefit.

Flexibility. The conversion requirement could be interpreted mechanically to require that the minimum benefit be calculated only pursuant to the listed terms of the statute. We urge Treasury to exercise its inherent regulatory authority to permit a rule

that permits design flexibility consistent with the statutory intent. The statutory intent is clear: upon conversion, a participant should be entitled to the sum of (1) the old formula benefit for past years, (2) the new formula benefit for future years, and (3) any applicable early retirement benefit or subsidy. This intent could be achieved in any of the following ways (without any required "top-up benefit"), all of which should be permitted by the regulations:

- Pure A plus B: the old formula benefit for past years, including any applicable early retirement benefit or subsidy, plus the new formula benefit for future years.
- Opening account plus subsidy: the sum of (a) the old formula benefit for past years converted to a new formula benefit as of the date of conversion, using assumptions no less favorable to the participants than the section 417(e) assumptions, plus (b) the new formula benefit for future years, plus (c) any applicable early retirement benefit or subsidy.
- Opening account including subsidy: the sum of (a) the old formula benefit for past years, including some or all of any applicable early retirement benefit or subsidy, converted to a new formula benefit as of the date of conversion, using assumptions no less favorable to the participant than the section 417(e) assumptions, plus (b) the new formula benefit for future years, plus (c) any applicable early retirement benefit or subsidy not previously incorporated into the opening new formula benefit.

With respect to the third methodology listed above and as a general rule, it should be clarified that early retirement benefits or subsidies may be disregarded under Code section 411(b)(5)(A)(iii) even if incorporated into the opening new formula benefit or into transitional credits under the hybrid formula that are designed to make up, in whole or in part, for such benefits or subsidies. The statute can be read either way on this point, but the narrower reading will simply result in lower benefits to participants. This is yet another example of how a narrow interpretation of the law that on its face is protective of participants will in practice result in lower benefits.

And it should, of course, be clarified that the minimum benefit described above is simply that, a minimum. So it should be permitted to provide additional benefits by, for example, (1) in the context of a service-weighted new benefit formula, taking pre-conversion years of service into account in applying the new formula, (2) increasing the old formula benefit by taking into account post-conversion compensation increases, or (3) providing the greater of a benefit under a formula described above or the benefit the participant would have had if the hybrid formula had always been in effect.

Mergers and acquisitions. Under PPA section 702, Treasury and the IRS shall prescribe regulations within 12 months of the date of enactment regarding the application of the new hybrid plan rules in the content of a conversion related to a merger, acquisition, or similar transaction. The clear intent was to make the rules

simpler in this context in light of the changes in the plan sponsor and the corresponding administrative system. The flexibility described in the preceding section (entitled "Flexibility") is essential in the context of mergers and acquisitions. Continued maintenance of the seller's benefit formula and administrative system is often not practicable where the individuals with knowledge of how to administer that system are no longer employed by the successor employer. In that context, it becomes critical that the regulations permit, for example, the conversion technique labeled above as "opening account including subsidy" (or at the very least "opening account plus subsidy").

Pre- and post-June 29, 2005, conversions. Some post-June 29, 2005, conversions have already occurred, including some prior to the date of enactment of the PPA. Other conversions may take place before regulatory guidance is issued clarifying the numerous unclear conversion issues. All of these conversions need a transition period to conform in operation to the new statutory requirements. (With respect to plan amendments, the PPA's delayed amendment date applies, of course.) The operational transition period should not end until at least 12 months after the issuance of final regulations regarding conversions. Any earlier date would simply mean that the plan sponsors would have to guess as to how the numerous regulatory issues will be resolved.

Also, it should be clarified that for purposes of determining whether a plan amendment was "adopted" on or before June 29, 2005, a plan amendment should be considered adopted when a legally enforceable commitment is made to amend the plan, such as a binding resolution of a company's board of directors. The statutory language is clearly intended to turn not on the ministerial act of reducing a plan amendment to writing; the key substantive act is the legally binding commitment of a company. At that point, the company can no longer walk away from the amendment. Thus, the plan amendment is "adopted" at that time from a substantive perspective.

Section 401(a)(4) issue. For many years, there has been a serious section 401(a)(4) issue hanging over conversions to hybrid plans. That issue needs to be fixed to avoid creating a major disincentive for employers to adopt generous transition approaches.

The transition approaches at issue are: a choice between the traditional formula and the new formula, a provision providing the greater of the two formulas, or a straightforward grandfather provision. (For convenience of presentation, all employees who continue to be covered by the traditional formula by reason of such transition arrangements are referred to in this part of our letter as "grandfathered employees".) In almost all cases, the traditional formula will have benefits, rights, and features that are not available under the new formula. The most notable example is an early retirement subsidy, which is very common in traditional formulas and extremely rare in hybrid plans.

Under Regulation § 1.401(a)(4)-4, any benefit, right, or feature must be "currently available" to a group of employees that satisfies the nondiscriminatory classification test. At the time of the conversion to a hybrid plan, the grandfathered employees generally satisfy this test. The problem is that typically the turnover rate among nonhighly compensated employees (NHCEs") is higher than among highly compensated employees ("HCEs"). Accordingly, many years after the conversion, the grandfathered employees will typically fail to satisfy the nondiscriminatory classification test.

Since the widespread conversion to cash balance plans has occurred relatively recently, few plans have reached the point where the grandfathered employees fail the nondiscriminatory classification test. But it is starting to happen. And it is almost inevitable that such failures will become widespread in a few years.

Any company confronting this situation will, as a practical matter, have little choice regarding how to solve this problem. The companies will need to remove HCEs from the traditional plan prospectively, or at least make the problematic benefit, right, or feature inapplicable to them. Companies do not want to do this, but may have no choice if the current section 401(a)(4) regulations are not amended.

The regulatory solution is straightforward. Very generally, in the case of a business merger or acquisition, a benefit, right, or feature available to the "acquired group of employees" is, under current law, treated as satisfying the current and effective availability tests if that acquired group satisfied those tests at a specified date shortly after the acquisition. See Regulation § 1.401(a)(4)-4(d)(1). This is an eminently sensible rule that permits a company that acquires another company and its plan to preserve the acquired plan's benefits, rights, and features for the acquired employees.

This rule would work very well to solve the conversion problem. If the availability of a benefit, right, or feature to a group of grandfathered employees satisfies the current and effective availability tests as of the date of the conversion, such availability should be deemed to continue to satisfy those tests (subject to all the existing safeguards in Regulation § 1.401(a)(4)-4(d)(1), such as the rule generally requiring that the availability of the benefit, right, or feature not be modified after the conversion).[3]

In short, our proposed rule would apply to any conversion that results in a benefit, right, or feature being limited prospectively to a frozen group of employees.

[3] There is no policy or technical rationale to limit this rule to conversions from a traditional plan to a hybrid plan. That is currently the most common situation where the issue arises, but there are many other situations where an employer is making significant changes to its plan and wishes to provide transition relief to older, longer service employees. The current rules can prevent such transition relief and there is no policy justification for this.

The proposal would require the group of plan participants who continue to be eligible for the benefit, right, or feature to be identified solely by a reference to their age, their service, or a combination of their age and service. (Of course, transition provisions applicable to all current participants or employees would fit within this rule.) Under the proposal, if the availability of the benefit, right, or feature to the grandfathered group of employees satisfies the current and effective availability tests on the effective date of the plan amendment, such availability would be deemed to continue to satisfy the tests (subject to the safeguards noted above).

We do not envision potential abuse of our proposed rule, since the most significant benefits, rights, and features (i.e., early retirement benefits and retirement-type subsidies) are subject to amounts testing under Regulation § 1.401(a)(4)-3. Amounts testing ensures that NHCEs are provided benefits comparable to those available to HCEs, taking into account any subsidies. Accordingly, if the subsidies are too generous and/or the grandfathered group is too disproportionately highly compensated, the plan will fail to satisfy Regulation § 1.401(a)(4)-3.[4]

In short, we see a crisis looming ahead for almost all hybrid plans that have provided "choice", "greater of", or simple grandfathering. The crisis will hurt older, longer service employees unless Treasury and the IRS step in to solve this problem.

Backloading issue. As briefly referenced above, there is a problem with the way that the IRS has been interpreting the backloading rules; in general, the IRS interpretation invalidates "greater of" formulas. The IRS interpretation is inconsistent with the clear purposes of the backloading rules and if not corrected, could well have very adverse affects on participants. It would be a great shock to Congress, participants, participant groups, and employers if the IRS were to formalize -- or continue -- its interpretation that "greater of" is illegal.

The issue is simply stated. In the context of hybrid plan conversions, certain participants may be given the greater of the old traditional formula or the new hybrid formula. In practice, this "greater of" arrangement has been tested by employers for backloading by ensuring that each of the formulas, tested separately, satisfies the backloading rules. The IRS has, however, informally insisted that the formulas be tested together, creating a failure of the 133-1/3% rule (which is the one clearly best suited to hybrid plans) because of the accrual rate in the year following the "crossover"

[4] Because subsidies are tested under Regulation § 1.401(a)(4)-3, we see no reason for them to also be subject to the current and effective availability tests. In our view, this is an anomaly that is clearly inconsistent with the structure of the section 401(a)(4) regulations. Accordingly, we would urge you to fully correct this anomaly by exempting from Regulation § 1.401(a)(4)-4 any benefit, right, or feature that is taken into account under Regulation § 1.401(a)(4)-3. But if the government is not prepared to take this step, we urge at a minimum that the rule in the text be adopted.

with respect to the participant (i.e., the point in time where one formula ceases to give rise to the larger benefit).

We can understand how one can read the current regulations in the manner that the IRS has. However, that only reflects the fact that the regulations can be read to reach a clearly flawed result. We urge the IRS to cease interpreting the regulation in this manner, and we urge Treasury and the IRS to reform the regulations to confirm the clear right answer.

The policy analysis can be best illustrated through a simple example. Assume that a plan provides the greater of (a) 1% of career average pay multiplied by years of service or (b) 5% of final average pay. In that case, the projected accrual pattern (based on an assumption that compensation does not increase) is on an annual basis: 5%, 0%, 0%, 0%, 0%, 1%, 1%, etc. The projected jump from 0% in year 5 to 1% in year 6 causes a backloading failure under the IRS view. This conclusion does not make policy sense. No one would dispute that, if the 5% minimum is disregarded, the 1% part of the formula does not violate the backloading rules. Thus, solely by reason of <u>frontloading</u> the first five years of accruals, the IRS' informal interpretation would conclude that there is a backloading violation. This conclusion is inconsistent with the statute and Congress' clear intent.

The solution is simply stated. Each formula referenced by a "greater of" plan provision must independently satisfy the backloading rules. Another way to articulate the rule would be to compare every year the average accrual rate on an accrued-to-date basis with future accrual rates. In the above example, the average accrued-to-date accrual rate would be: 5%, 2.5%, 1.67%, 1.25%, 1%, 1%, 1%, etc. Clearly, this formula is frontloaded; it is not backloaded in any sense.

Finally, this solution should apply not only to greater of formulas, but also to any other formulas that are viewed by the IRS as raising the same backloading issue, such as plans that permit ongoing periodic choices by participants regarding whether to be covered by the new formula or the old formula.

<u>Effect Similar to an Applicable Defined Benefit Plan.</u>

Under Code sections 411(b)(5)(B)(v)(IV) and 411(a)(13)(C)(ii), Treasury is to issue regulations that include in the definition of an applicable defined benefit plan any defined benefit plan (or portion thereof) that has an effect similar to an applicable defined benefit plan. Subject to two exceptions, IRS Notice 2007-6 provides that a plan will be treated as having such a similar effect if "a participant's accrued benefit (payable at normal retirement age) is expressed as a benefit that includes automatic periodic increases through normal retirement age that results in the payment of a larger amount at normal retirement age to a similarly situated participant who is younger". The two

exceptions in the Notice are for (1) plans with only post-retirement adjustments, and (2) variable annuity plans with an assumed interest rate ("AIR") of at least 5%.

We believe that in general IRS Notice 2007-6 provides a workable framework with respect to this issue, subject to the following recommended clarifications and modifications. First, it should be clarified that the reference to "automatic periodic increases through normal retirement age" is a reference to increases that are not conditioned on continued service.

Also, with respect to variable annuity plans, the requirement of a minimum AIR of 5% is not appropriate. We understand the rationale for having a minimum, but 5% is too high. The use of a 5% minimum would treat most existing variable annuity plans as statutory hybrid plans. That in itself is quite significant. These plans were not established to avoid statutory hybrid plan status, because obviously they were designed before such status existed. On the contrary, the AIRs of these plans were generally based on conservative estimates of risk-free future rates of return. This is eminently reasonable, as it can give a plan or participant the ability to avoid benefit reductions. It also gives plans and participants the ability to enjoy the upside if more aggressive investments yield higher rates of return. And there is no reason to think that the AIRs were set artificially low, as that would establish artificially low initial benefit levels, which would be difficult to sell.

The floor on AIRs should be reduced to 3%, which would be consistent with the standard for variable annuity plans set forth in the minimum distribution rules; such rules address an analogous issue, as they identify payments that are nonincreasing. Regulation §1.401(a)(9)-6 Q/A-14(d)(3)(iv). This change would treat variable annuity plans with AIRs at the low end as statutory hybrid plans while preserving the current status of the majority of variable annuity plans.

The above approach to variable annuity plans is also consistent with the statutory structure. Congress was clearly aware of variable annuity plans, as evidenced by the explicit reference to such plans in the loss protection rule. If Congress had meant to treat the majority of variable annuity plans as statutory hybrid plans, it would have been natural for Congress to provide, for example, that "except as otherwise provided by the Secretary, variable annuity plans shall be treated as applicable defined benefit plans."

In addition, it would be helpful for the regulations to confirm that the variable annuity rule set forth in the Notice - - permitting pre-retirement adjustments if the AIR is at a minimum level - - also applies for purposes of Code section 411(b)(5)(E)(ii).

Finally, we would urge you not to treat career average plans that are indexed through normal retirement age (without regard to continued service) as statutory hybrid plans. Again, these plans have been in existence for a long time and Congress

certainly would have explicitly treated them as statutory hybrid plans if that were intended. And treating such plans as statutory hybrid plans would only serve to discourage such designs and lead to more plans where indexing is conditioned on continued service.

PEP Issues.

Aside from the one issue discussed above regarding other types of PEP formulas, we do not have issues to raise that relate uniquely to PEPs. Like the statutory provisions, the foregoing discussions in this letter are intended to apply to both cash balance plans and PEPs. We appreciate the ongoing attention provided to both types of plans and hope to continue our dialogue if PEP-specific issues arise.

Plan Termination Issues.

Under Code section 411(b)(5)(B)(vi), if the interest crediting rate under an applicable defined benefit plan is a variable rate, then upon plan termination, the rate of interest used to determine accrued benefits shall be equal to the average of the rates used under the plan during the 5-year period ending on the plan termination date. Numerous issues arise under this provision.

First, assume that the rate in effect at plan termination is a fixed rate (such as 6%) but such rate has been changed during the past five years. Is such a plan subject to this provision? The statutory answer appears to be no; confirmation would be helpful.

Second, is the above rule applied separately with respect to each participant or to the plan as a whole? For example, assume that different participants are or have been subject to different interest crediting rates. It should be confirmed under the statute, the rule applies on a plan-wide basis, not separately to each participant. With respect to such situations, it is important for the regulations to provide that any reasonable means of determining a plan-wide rate should be permitted, including reliance on reasonable estimates.

Third, if there has been a change in the crediting rate during the 5-year period, guidance should confirm that the 5-year lookback takes into account the crediting rates actually in effect, not what the new crediting rate would have been if the change had been in effect at all times.

Fourth, a special rule should be applied in the case of equity rates of return. Under the special rule, the interest crediting rate at plan termination should be based on historical rates of return for the equity class at issue. Reliance on the 5-year period alone can lead to terribly skewed results, including very high or very low -- even negative -- rates of return. (Since the capital preservation rule only applies at benefit commencement, a 5-year period can have negative returns.)

We very much appreciate the opportunity to provide our views on these important issues and look forward to continued discussions as the regulatory process moves forward.

Sincerely,

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