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March 13, 2003

By US Mail and Email

Internal Revenue Service
CC:ITA:RU (REG-209500-86)
Room 5226
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington, DC 20044

Re: Proposed Age Discrimination Regulations

Dear Sir or Madam:

We request your consideration of our comments to the proposed regulations regarding age discrimination and cash balance plans published in the Federal Register on December 11, 2002 (67 FR 76123) (the "Proposed Regulations"). At this time, we limit our comments to several issues of major importance to cash balance plan sponsors and a few brief comments regarding the overall structure of the Proposed Regulations. We may provide comments on other aspects of the Proposed Regulations at a later date.

The Groom Law Group practices in all areas of employee benefits law. We handle a wide range of sophisticated benefits and tax matters for some of the nation's largest companies and nonprofit organizations. We represent many sponsors of defined benefit pension plans, a number of whom have made (or considered

making) the transition from a traditional pension formula to a cash balance formula.

We believe the Proposed Regulations are an important first step in the development of reasonable and practical solutions to current controversies regarding cash balance plans. We believe it is important that the Internal Revenue Service, Department of Treasury, Department of Labor, and Equal Employment Opportunity Commission (the "Agencies") acknowledge that cash balance formulas are not inherently discriminatory, while establishing rules that protect older participants from plan designs that reduce the rate of "an employee's benefit accrual" on account of "the attainment of any age." Internal Revenue Code ("Code") § 411(b)(1)(H).

The comments that follow focus primarily on several Proposed Regulation provisions that affect typical cash balance plan designs. However, we want to preface those specific comments with some overall observations regarding the structure and approach of the Proposed Regulations with respect to cash balance plans and age discrimination.

From an overall perspective, we do not see support in the statute or its legislative history for the idea, apparently underlying the structure of the Proposed Regulations, that basic cash balance plan designs (i.e., level pay credits earning a reasonable rate of interest) should be tested for age discrimination on the basis of projected normal retirement age ("NRA") benefits. Although the Employee Retirement Income Security Act ("ERISA") and the Code use several terms, outside the age discrimination context, that are tied to NRA benefits (e.g., the terms "accrued benefit" and "normal retirement benefit"), the age discrimination rules use a concept not tied to NRA benefits – "benefit accruals" – in prohibiting reductions on account of age. See Code §§ 411(a)(7) ("accrued benefit" defined), 411(a)(9) ("normal retirement benefit" defined), and 411(b)(1)(H)(i) (use of "benefit accrual" in age-discrimination rules).

Once it is recognized that "benefits" accrued under a cash balance plan need not be converted to NRA benefits in order to test whether the rate of accruals is reduced on account of a participant's age, it is easy to reach the common-sense conclusion that a cash balance plan that provides the same pay credits to younger participants that it provides to older participants does not discriminate against older participants on account of those pay credits. Similarly, it is easy to conclude that a cash balance plan that provides lower pay credits (or lower interest credits) to older participants would violate the age discrimination rules. With this understanding, we believe there is no need for the Proposed Regulations to set out complicated mathematical/actuarial rules for converting a participant's cash balance benefits to NRA, or for establishing complicated mathematical rules for justifying not converting a participant's benefits to NRA. Instead, compliance with the age-discrimination rules can be tested simply by looking at a plan's stated formulas for accruing benefits (whether or not expressed as NRA benefits), and determining whether those formulas provide decreasing benefits on account of age.

We believe that the Agencies can better meet their goals of preventing age discrimination by establishing a general rule against age discrimination based on the structure of a plan's benefit formulas, and establishing special rules to prevent any perceived abuses. We urge the Agencies to consider taking this more common-sense approach in issuing a second round of proposed regulations. It is more consistent with statutory language, and requires fewer costly mathematical/actuarial calculations.

Turning to particular cash balance issues raised under the Proposed Regulations, we believe the proposed rules would unnecessarily limit the ability of employers to implement special provisions primarily intended to benefit older workers. In our experience, plan sponsors who consider changing from a traditional to a cash balance design intend to design the transition in a way that is equitable with respect to employees who have been participants under the existing plan formula for a significant period of time. By providing more flexibility in the regulations, we believe the intent behind

the statutory limitation on age discrimination can be fulfilled, while giving employers the latitude to develop appropriate features to ease the cash balance transition for older, longer-service employees.

Below we address specific areas of concern. Briefly summarized, we recommend that:

- the regulations permit plans to "grandfather" the prior benefit formula for a group of participants over a specified age where the grandfathered group as a whole is expected to receive a greater benefit;

- the regulations permit opening account balance enhancements that limit the wear-away period otherwise caused by the prior formula's early retirement subsidies;

- the heightened HCE/non-HCE testing requirements be eliminated because such rules discourage provisions that favor older employees; and

- the regulations be clarified to indicate that they do not have any impact on the legality of prior plan conversions and accruals.

A. Requirement That Cash Balance and Traditional Formulas in a Single Plan Separately Satisfy Code Section 410(a)(2) Discourages Plan Provisions That Favor Older Participants

The Proposed Regulations provide that, if a DB plan includes a cash balance formula for certain participants and a traditional formula for other participants, the cash balance formula can qualify for special treatment as a separate "eligible" cash balance formula only if both formulas satisfy Code section 410(a)(2). Prop. Treas. Reg. § 1.411(b)-2(b)(2)(iii)(C)(1) and (4). Thus, neither formula may be limited to a younger group of participants.

We understand the Agencies' goal that a plan sponsor not be permitted to limit a generous plan benefit formula to younger plan participants.

However, in our experience, this provision in the Proposed Regulations would prevent plan sponsors from implementing common plan designs that are structured to be more generous for older plan participants. For example, plan sponsors that convert a DB plan from a traditional formula to a cash balance formula (sometimes in combination with improvements to DC plans or stock option plans) often are concerned that current participants approaching retirement age will not have sufficient time to implement a retirement strategy that takes into account the cash balance formula. Consequently, plan sponsors often "grandfather" the traditional formula for participants over a specified age (or combination of age and service) on the conversion date, and limit the cash balance formula to individuals under that specified age. Under the Proposed Regulations, because the cash balance formula is limited to younger participants and thus does not satisfy Code section 410(a)(2), this plan could not qualify as an "eligible" cash balance plan and would typically fail to satisfy the general age discrimination test set out in the Proposed Regulations.

We believe that the Agencies could further their goal of preventing discriminatory eligibility requirements for generous plan formulas, without dissuading plan sponsors from implementing grandfathering rules that are more generous for older participants, by replacing the section 410(a)(2) test with a facts and circumstances test. The facts and circumstances test would provide that traditional and cash balance formulas may not be tested separately for age discrimination if eligibility criteria for one or more of the formulas is designed to discriminate against older participants. The regulations could then provide two safe harbors under this facts and circumstances test. First, a plan would satisfy the facts and circumstances test if each formula satisfies Code section 410(a)(2) rules. Second, a plan would satisfy the facts and circumstances test if a grandfathered traditional formula applies only to participants who satisfy age and/or age-and-service requirements and a cash balance formula applies only to participants who do not satisfy such requirements, so long as the grandfathered formula provides benefits that are at least as valuable to participants as the benefits that would be available under the cash balance formula. Whether the grandfathered traditional benefit provides equal or more-valuable benefits would be

determined by comparing the present value of all expected benefits under the grandfathered formula with respect to the grandfathered group to the present value of hypothetical expected benefits under the cash balance formula with respect to the grandfathered group. For this purpose, present value would be calculated as of the date of the establishment of the cash balance formula using reasonable actuarial assumptions with respect to compensation patterns, termination patterns, interest rates, mortality assumptions and other relevant factors.

B. Limits on Opening Account Balances Discourage Enhancements That Favor Older Employees

The Proposed Regulations permit a plan to establish opening cash balance accounts in transitioning from a traditional benefit formula to a cash balance formula. This is permitted only if the balance in the opening account is not less than the actuarial present value of the participant's accrued benefit payable in the normal form of benefit under the plan. To reduce the wear-away period caused by the cash balance transition, many employers include in the opening account additional amounts that are based on the value of early retirement subsidies from the old benefit formula. Unfortunately, under the Proposed Regulations, these enhancements would be viewed as illegal age discrimination. We believe that employers should be permitted to offer these types of enhancements.

The establishment of opening accounts is a common approach used in transitioning from a traditional benefit formula to a cash balance formula. In establishing an opening account, the plan sponsor will typically begin with each participant's accrued benefit payable at normal retirement age under the plan. This is generally permitted under the Proposed Regulations. However, this ignores the value of any early retirement subsidy that the participant may have accrued under the traditional formula. The failure to include the value of the early retirement subsidy will increase the likelihood that some participants will experience a wear-away period, during which the annuity benefit available under the plan will not increase.

Early retirement benefits typically are most valuable at certain middle ages (e.g., between age 50 and 60, depending on the terms of the plan), and decrease in value at older ages (e.g., over 60). This is permitted under the age discrimination rules because the value of the subsidized portion of any early retirement benefit is generally disregarded in determining benefit accruals.[1] Code § 411(b)(1)(H)(iv). At the time of transition to a cash balance formula, a participant's prior benefit must be protected under the anti-cutback rules of the Code and ERISA. Code § 411(d)(6); ERISA § 204(g). If a participant retires after the cash balance transition and after qualifying for the early retirement provisions of the old formula, his or her annuity benefit must be no less than the subsidized early retirement benefit under the old formula with respect to benefits accrued up to the date of the cash balance amendment. Where the cash balance formula does not include any value attributable to the prior early retirement subsidy, many participants who retire at an early retirement age may find that their "frozen" early retirement benefit exceeds their cash balance account.

To limit this wear-away effect, plan sponsors may consider a variety of approaches to enhance the opening cash balance account for an early retirement subsidy. Some examples include:

- The opening account could be based on the present value of the monthly early retirement benefit the participant would have received if he retired immediately.

- The opening account could be initially established based on the normal retirement benefit and increased by a specified dollar amount or percentage developed as an estimate for the value of the early retirement subsidy.

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1 ADEA also provides a safe harbor for "payments that constitute the subsidized portion of an early retirement benefit," which recognizes the benefit of such subsidies to a limited group of retirees. ADEA § 4(l)(1)(B).

- The opening account could be established by assuming that the participant would receive the normal retirement benefit unreduced as of a certain age prior to normal retirement age.

Under the Proposed Regulations, these additional amounts are treated as current year accruals. They would not be permitted under the proposed rules because, like early retirement subsidies, they are typically higher for middle-aged participants than they are for employees closer to or over the plan's normal retirement age.

Certainly, if a cash balance formula provided pay credits at a rate of 5% through age 59, and then at a rate of 3% for years after age 59, the formula should fail the age discrimination requirements. However, where a one-time credit to a participant's account is made as a means to cause a more even transition to the cash balance formula, the enhancement should not be illegal.

The Proposed Regulations permit the establishment of opening account balances and permit the possibility of a wear-away period for some participants. In fact, the limitations on establishing the opening account balances have the effect of ensuring that some participants will experience a wear-away period as a result of the early retirement subsidies earned prior to the conversion. Employers that wish to limit this wear-away period should be permitted to do so. It certainly would be an odd result for the age discrimination regulations to permit the establishment of opening account balances, but only in a way that, for a large group of older employees, results in the wear-away of prior early retirement subsidies.

At the time of conversion, many older employees may have already passed the age at which they would have received a certain level of early retirement subsidy. These employees had already made the decision to forego the early retirement subsidy and to continue working with the employer. Other employees, however, would have had the opportunity, if they would have elected to retire at a future, specified date, to receive the benefit of the early retirement subsidy. Where a plan sponsor has decided to implement a new benefit design (e.g., a cash balance design) that does not have an early

retirement subsidy, it makes perfect sense that the employer would consider providing some means to ensure that the transition from subsidy to no subsidy is softened, especially for older, longer service employees. As written, the regulations would not permit this.

The Proposed Regulations should be modified to allow plans to provide the value of early retirement subsidies, or other similar amounts, in opening cash balance accounts. Opening account enhancements should be permitted provided that they represent all or a portion of the value, or a reasonable estimate of the value, of early retirement subsidies (or other similar amounts) previously provided under the plan formula. An account balance enhancement that satisfies these standards should not be considered in determining a participant's "rate of benefit accrual" for the year. As the Preamble to the Proposed Regulations indicates, the statutory provisions do not define the "rate of benefit accrual." Thus, it is within Treasury's regulatory authority to specify how the rate of benefit accrual is to be determined under a plan, including what type of benefits should be taken into account in making that determination. We do not see any statutory limitation that would prevent the regulations from providing that certain benefit amounts will not be considered in determining the rate of benefit accrual.

C. Requirement That Eligible Cash Balance Plans Satisfy Heightened HCE/Non-HCE Nondiscrimination Requirements Discourages Plan Provisions That Favor Older Participants

As discussed above, the Proposed Regulations permit age discrimination testing of cash balance formulas under less restrictive testing rules if a cash balance formula can qualify as an "eligible" cash balance formula. In other words, a formula that would generally be treated as age discriminatory under the Proposed Regulations can escape this treatment if it satisfies certain requirements.

Surprisingly, one of the requirements that a cash balance plan must satisfy, in order for it to qualify for the exception to the general age discrimination rule, is that the plan satisfy more stringent nondiscrimination testing rules under Code section 401(a)(4) with respect to highly compensated employees ("HCEs") than would ordinarily apply. Prop. Treas. Reg. §§ 1.401(a)(4)-3(g) and –9(b)(2)(vi). In particular, a plan sponsor can test accruals under an "eligible" cash balance plan on a benefits basis, for purposes of HCE/Non-HCE nondiscrimination testing, only if the plan satisfies restrictive cross-testing rules that normally apply only to defined contribution plans and were aimed at plans of closely held companies dominated by owners.

Older employees tend to be more highly compensated than younger employees, primarily because they have longer work careers and more experience. Consequently, any rule that limits plan sponsors' ability to satisfy HCE/Non-HCE testing rules will generally discourage plan sponsors from implementing plan provisions that favor older employees. In effect, the HCE/Non-HCE nondiscrimination testing provisions of the Proposed Regulations discourage plan sponsors from implementing provisions favorable for older employees.

We believe that this makes no sense from a policy standpoint. We can think of no policy justification for interpreting the age discrimination rules of Code section 411(b)(1)(H) in a way that discourages plan sponsors from implementing rules that favor older employees, merely because older employees tend to be better compensated. It seems inconceivable that Congress adopted rules against age discrimination in order to limit a plan sponsor's ability to favor better-compensated, generally older, employees. We believe that, as long as a cash balance plan can satisfy generally-applicable HCE/Non-HCE nondiscrimination testing requirements, the plan's qualified status should not be threatened on account of the plan's method of complying with age-discrimination rules. In short, we believe that HCE/Non-HCE testing rules set out in the Proposed Regulations should be dropped from final regulations.

D. The Regulations Should Clarify That They Do Not Affect the Legality of Prior Conversions

The Preamble indicates that the regulations are proposed to be applicable to plan years beginning after the date final regulations are published. However, we believe that the rules should be clarified to expressly indicate that they do not apply to cash balance features implemented before the effective date of the regulations and that no inference is intended as to prior plan conversions or accruals.

Under the Proposed Regulations, a plan that was amended to adopt a cash balance formula can qualify as an "eligible" cash balance plan as to future accruals only if the amendment provides for the transition to the cash balance formula under one of two permitted approaches. As written, the Proposed Regulations do not indicate whether a plan that was converted to cash balance before the regulatory effective date could qualify as an "eligible" cash balance plan if the prior conversion did not comply with the cash balance amendment requirements. A similar question arises where a plan was previously amended to limit participation in the prior benefit formula to a limited group of participants and such eligibility requirements do not separately satisfy the requirements of Code section 410(a)(2), as they would be applied under the Proposed Regulations.

We believe that it is inappropriate to apply the new rules to conversions that occurred prior to the effective date of the regulations. Further, we do not believe that existing plans should be required to take any remedial action in order to "fix" the manner in which a prior conversion was implemented. In most situations, such remedial action would be tremendously burdensome, and, in some cases, virtually impossible to implement given the passage of time since the original cash balance conversion. Further, many existing cash balance plans have received one or more favorable determination letters from the IRS that cover the qualification of the prior cash balance conversion amendment. To change the rules on plan sponsors after the passage of many

years, and possibly even after receiving IRS approval of the original conversion, would be unreasonable.

We believe that the regulations should be changed to expressly indicate that, for prior conversions, a plan should be treated as an "eligible" cash balance plan if it complies, going forward, with the "plan design" and "right to future interest" requirements generally applicable to all cash balance plans under the Proposed Regulations. See Prop. Reg. § 1.411(b)-2(b)(iii)(B)(1), (2). The requirements in the regulations for plan amendments adopting the cash balance formula or setting eligibility requirements for the prior benefit formula should be expressly limited to plan amendments adopted or effective after the effective date of the final regulations. See Prop. Reg. § 1.411(b)-2(b)(iii)(B)(3). Finally, the regulations should state that no inference of noncompliance is intended with respect to any prior plan conversion or accrual.

We appreciate this opportunity to provide comments and would be pleased to respond to questions or provide additional information.

Sincerely,

William M. Evans

Mark L. Lofgren