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MEMORANDUM TO CLIENTS

Re: <u>Pension Proposals in Bush Administration Fiscal Year 2005 Budget</u>

On February 2, the Bush Administration released its fiscal year 2005 budget proposals, including –

- significant new legislative proposals regarding cash balance plans;
- a revised version of the far-reaching retirement and savings proposals contained in last year's budget; and
- proposed 30-Year Treasury replacement and other pension funding proposals.

A. Cash Balance Proposals

The Bush Administration's budget includes a major new legislative proposal regarding cash balance plans and conversions. The release of the proposal follows the enactment in January of legislation that directed Treasury to present Congress with legislative proposals to provide transition relief for older and longer-service participants affected by cash balance conversions. The proposal is fairly even-handed in its approach – giving assurances that cash balance plans are viable options for plan sponsors, while adding protections for employees affected by cash balance conversions.

The proposal addresses the following three areas:

- Clarifies that the typical cash balance formula does not violate age discrimination rules.
- Provides new protections for participants following a cash balance conversion.
- Removes existing limitations on the interest rate at which cash balance accounts can grow.

The proposal would be "effective prospectively" for periods after the date of enactment – the legislative history would state that there would be no inference as to the status of cash balance plans or cash balance conversions under current law.

1. Application of Age Discrimination Rules to the Cash Balance Formula

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The proposal would clarify that a cash balance plan formula will satisfy the age discrimination rules as long as the pay credit rates satisfy the rules that generally apply to defined contribution plans, i.e., the crediting rates under a plan are not reduced on account of a participant's age. The proposal would also clarify that certain strategies designed to ease the transition to the new formula for existing employees do not violate the age-discrimination rules. In particular, additions to the opening cash balance accounts designed to reflect the value of early retirement subsidies earned under the prior formula would not be prohibited. The proposal would provide similar rules for other types of hybrid plans (e.g., pension equity plans).

The proposal refers to these new provisions as clarifications under the law, implying that the existing age discrimination laws do not prohibit the cash balance formula. In fact, in the introductory part of the proposal, the Administration states that "[a]lthough cash balance plans and cash balance conversions are not inherently age-discriminatory, current law does not provide adequate protection for older workers in every conversion." The Administration also points out that "removing uncertainty about the basic legality of cash balance plans is critical to preserving the vitality of the defined benefit system … ." Thus, the Administration strongly suggests that cash balance plans are not inherently age discriminatory under existing law, and – because of the IBM decision – the law on this point needs to be clarified so there can be no doubt as to this issue in the future. Nevertheless, as noted above, the proposal specifies that there would be no inference as to the status of cash balance plans or conversions under current law.

2. New Participant Protections Following Cash Balance Conversion

The proposal acknowledges that adverse effects of a cash balance conversion may fall more heavily on older participants than younger participants because traditional plans usually provide more valuable accruals to older and longer-service employees. The proposal also recognizes that many plan sponsors have adopted strategies to mitigate the effect of a conversion on the existing employees, but that "such strategies have been voluntary, as current law generally gives the plan sponsor broad authority to amend a plan for any reason at any time." Thus, the proposal would limit a plan sponsor's ability to implement a conversion that involved the wear-away of existing benefits, and would encourage employers to adopt "grandfathering" or employee choice as conversion strategies.

More specifically, the proposal would address conversions in the following manner:

- **Five-Year Hold Harmless Rule With No Wear-Away.** For each of the first five years after a cash balance conversion, the benefits earned by any current participant would have to be at least as valuable as the benefits that the participant would have earned under the traditional plan. Also, there could be no wear-away at any time of the normal or early retirement benefits earned by any current participant as of the end of the five-year transition period.

- **New Excise Tax.** If there is a violation of these new conversion requirements, a 100% excise tax, payable by the sponsor, would apply to the difference between the benefits required under the proposal and the benefits actually provided by the cash balance plan. However, the excise tax would be limited to the greater of the amount of the plan's surplus assets at conversion or the sponsor's taxable income. Also, no

excise tax would apply if participants are given a choice between the traditional formula and the cash balance formula, or if current participants are permanently grandfathered under the traditional formula.

- **No Plan Disqualification.** The proposal indicates that a failure to implement the new transition protections would not result in the disqualification of the plan. Also, it does not appear that the proposal would provide participants with a right to enforce the new benefit protections (i.e., there would not be conforming changes to ERISA or ADEA) – although such a right could be provided when and if Congress actually considers the proposals.

The significant limitations on these new benefit protections seem to reflect a recognition by the Administration that existing law does not generally restrict the ability of a plan sponsor to reduce or freeze future accruals under an existing pension plan. In particular, the ceiling on the excise tax based on the plan's surplus and the plan sponsor's taxable income recognizes that some plan sponsors may be experiencing adverse business conditions at the time of a conversion. The thinking may be that a troubled company should not be unduly encouraged to freeze or terminate a plan when it is willing to implement a new cash balance formula, under which many employees will still earn additional pension benefits at some level.

For companies and plans that are financially healthy, the excise tax can be avoided in three ways: (1) comply with the five-year hold harmless rule, with no wear-away, (2) provide employees with a choice to be covered by either the old benefit formula or the new cash balance formula, or (3) continue to provide existing employees with the old plan formula. It appears that a sponsor could utilize a combination of these options as well, for example, with some employees given choice, some grandfathered, and some covered by the five-year transition rule.

Despite the exceptions to the five-year hold harmless rule, the proposal itself is problematic for a voluntary pension system under which employers are currently free to reduce or eliminate future pension accruals. Notably, the proposed rule would apply to the benefit earned by any current participant, not just older or longer-service employees. If adopted, it also may not be possible to effectively limit the rule to cash balance plan conversions, because there would be numerous ways for an employer to "get around' this restriction (e.g., an employer could first freeze the plan and then adopt a cash balance formula at some later date). If the proposal is further refined to eliminate various means to avoid its effect, it could lead to more expansive limitations on any benefit freeze or pension reduction. It is also very likely that cash balance opponents will push for more far-reaching conversion requirements, including mandatory "choice" requirements at least for certain older and longer-service employees.

3. More Interest Rate Flexibility – Elimination of "Whipsaw"

The current rules for calculating lump-sum benefits have been applied in a manner that requires some cash balance plans to pay lump-sum benefits that exceed a participant's cash balance account. This effect, called "whipsaw," is caused where the plan's cash balance account interest-crediting rate is greater than the 30-year US Treasury rate required under existing lump-sum valuation rules. The IRS describes the required whipsaw calculation in Notice 96-8, and a number of courts have upheld the whipsaw requirement. (Indeed, Xerox recently settled a class

action on this issue for $239 million.) The whipsaw effect can be avoided only if the plan applies a relatively low interest rate to cash balance accounts.

The proposal would permit plans to avoid the whipsaw calculation, and simply use the current cash balance account as the value of a lump-sum distribution, as long as the plan does not credit interest in excess of a market rate of return. Treasury would be authorized to provide safe harbors on what is a "market rate of return" and to prescribe conditions regarding the calculation of plan distributions. This change is intended to give plan sponsors the ability to provide higher interest credits, resulting in potentially larger retirement accumulations.

4. <u>Prospects for Action</u>

The proposal has received a relatively even reception from proponents and opponents to cash balance plans as a reasonable starting point in developing legislation in this area. Not surprisingly, however, both sides have offered some criticisms. Plan sponsor groups have complained about the precedent of requiring a minimum benefit after certain types of plan amendments, and have argued that the proposal should go further to give assurances that existing plans do not generally violate basic age discrimination rules. Participant-rights groups have argued for further protection of ongoing benefit accruals for employees affected by conversions. It is likely that these concerns and others will be raised when Committee hearings are held on the proposal. (House Education and the Workforce Committee Chairman John Boehner (R-OH) has stated that the Committee plans to examine cash balance reforms in the context of broader reforms to the defined benefit plan system.) Whether Congress is willing to tackle such a complex and controversial topic in an election year is doubtful, but remains to be seen.

B. <u>New Retirement and Tax-Free Savings Accounts</u>

The Administration's budget also includes a modestly scaled-down version of its February 2003 retirement and tax-free savings proposals. Like last year, the proposals would eliminate traditional and Roth IRAs and replace them with two new types of tax-favored savings accounts: Lifetime Savings Accounts (LSAs) and Retirement Savings Accounts (RSAs). They would also consolidate various types of employer-sponsored plans – including 401(k), 403(b) and governmental 457(b) plans – by creating Employer Retirement Savings Accounts (ERSAs), and simplify the nondiscrimination testing provisions applicable to these plans. A side-by-side summarizing the new proposals is enclosed.

Last year's proposals drew heavy criticism from Democrats, who claimed that they favored the wealthy, and by certain industry groups concerned that the proposed LSAs and RSAs could undermine the employer-provided retirement system, particularly in the case of small business plans. Last year's proposals also got a cold reception from Congress, in part because the Administration did not consult with key Congressional leaders in developing the proposals. In an attempt to address some of this criticism, the Bush Administration made numerous changes to its proposals, including:

<u>Lifetime Savings Accounts ("LSAs")</u>

- Lowering the annual contribution limit from $7,500 to $5,000.

- Eliminating the ability to convert Archer Medical Savings Account ("MSA") balances.
- Imposing new limitations on conversions from a Coverdell Education Savings Account or Qualified Tuition Plan (Section 529 Plan).
- Restricting rollovers by permitting only a married individual to roll-over amounts from an LSA to their spouse's LSA (previously, an LSA owner could roll-over amounts from an LSA to the LSA of any member of the individual's family).
- Permitting a 529 Plan to exist within an LSA.
- Excluding LSA contributions from qualifying for the saver's credit.

Retirement Savings Accounts ("RSAs")

- Decreasing the annual contribution limit from $7,500 to $5,000.
- Imposing a 5-year holding period (to avoid 10% early distribution tax) for amounts converted from a traditional IRA or ERSA.
- Counting RSA contributions as qualifying for the saver's credit.
- Permitting tax-free rollovers between spouses' RSAs.

Employer Retirement Savings Accounts ("ERSAs")

- Providing relief for small employers (10 or fewer employees) from the trust requirement by allowing use of a custodial account.
- Eliminating proposed changes to the minimum coverage requirements, top-heavy rules, permitted disparity and cross-testing rules, and to the definitions of compensation and highly compensated employee.

It remains to be seen whether the Administration's new version of retirement and savings proposals will get more traction in Congress this year than last year's version. The reaction to the proposals to date has been mixed. Both the Investment Company Institute and American Society of Pension Actuaries released statements in support of the Administration's proposals, while the American Council of Life Insurers has criticized LSAs as reducing retirement savings and undermining employer-sponsored plans. The proposals – particularly the LSA proposal – have drawn criticism from certain key Democrats, including moderates like Senate Finance Committee Ranking Member Max Baucus (D-MT) and Ways and Means Member Earl Pomeroy (D-ND).

It does appear that the revised proposals at least will be formally introduced as legislation by certain members of Congress. Rep. Sam Johnson (R-TX) and Sen. Craig Thomas (R-WY) are planning to introduce the Administration's LSA, RSA, and ERSA proposals, possibly as three separate bills. Separately, Reps. Rob Portman (R-OH) and Ben Cardin (D-MD) are working on a revised version of their pension reform legislation (H.R. 1776) that could incorporate some

version of the RSA proposal, proposals to eliminate some differences among the various types of employer-sponsored plans, and a vastly expanded version of the saver's credit enacted as part of EGTRRA. The new Portman-Cardin bill likely will not include either the LSA or ERSA proposal.

C. 30-Year Interest Rate Replacement and Other Funding Proposals

The budget also includes a series of proposed pension funding changes that largely track the package of funding proposals released by Treasury last July.

30-Year Treasury Replacement Proposals

- For two years (2004-05), the 30-Year Treasury rate would be replaced with a blend of high-quality corporate bond rates.
- A corporate bond "yield curve" (with maturities selected to match the amounts and timing of when benefit payments are expected to be made) would then be phased-in, and would become the exclusive rate for calculating liabilities and contributions beginning in 2008.
- Lump-sum payouts would be computed using the 30-Year Treasury rate as under current law in the first two years (2004-05). A corporate bond yield curve would then be phased in and would be fully applicable beginning in 2008.

Benefit Restrictions

- Beginning in 2005, plans sponsored by companies with a below-investment grade credit rating, and that fall below 50 percent funded on a termination basis, would be frozen (except service could still be earned for vesting and eligibility) and prohibited from paying lump sums.

Disclosure Proposals

- The disclosure proposals proposed by Treasury last July were not specifically included in this year's budget, but were generally referred to as part of the Department of Labor section of the budget.

The Administration is continuing its comprehensive review of the pension funding rules, and likely will release a larger package of funding reform proposals later this year. Meanwhile, the Senate has now approved a motion to go to conference and appointed conferees on the pension funding legislation (H.R. 3108) it passed in January. The House has not yet agreed to a conference or appointed conferees, but may do so in the near future.

D. Other Proposals

The budget also contains the following other pension and nonqualified deferred compensation proposals carried over from last year's budget –

- Repeal of the longstanding limitation (sec. 132 of the Revenue Act of 1978) on the issuance of Treasury guidance on nonqualified deferred compensation, and authorization for Treasury to issue rules to address "inappropriate nonqualified deferred compensation arrangements."
- Tax-free withdrawals of post-age 65 distributions from IRAs (including Roth IRAs) that are made directly to charitable organizations. No charitable contribution deduction would be allowed (except for otherwise excludible Roth IRA distributions). These amounts would count toward minimum distribution requirements, however.

In addition to these specific proposals, the Administration recommends that all of the tax provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (including the pension and retirement provisions) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) be made permanent.