



AMERICAN ACADEMY *of* ACTUARIES

March 25, 2003

CC:ITA:RU (REG-209500-86)
Room 5226
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC

Re: Proposed regulations on reductions of accruals and allocations because of the attainment of any age; application of nondiscrimination cross-testing rules to cash balance plans

Dear Sir/Madam:

On behalf of the American Academy of Actuaries'¹ Pension Committee, I appreciate the opportunity to comment on the proposed regulations regarding reductions of accruals and allocations because of the attainment of any age. This letter provides our comments on the proposed regulations on issues related to cash balance plans. We are providing our comments on non-cash balance issues in a separate letter.

We agree with the conclusion that cash balance designs are not per se inappropriate, and appreciate that clarification of certain features of a cash balance are being addressed. On the other hand, we are concerned that the proposed regulations add another layer of complexity that could be avoided if general testing rules were applied only in a way that is consistent across all types of defined benefit (DB) plans. We also believe that age discrimination testing for *any* type of DB plan should be based on either equal cost (contributions) or equal benefits, rather than different tests for different types of plans.

A cash balance plan that meets the definition of an *eligible cash balance plan* appears to have the advantage, for age discrimination testing, of being able to look at the additions to the hypothetical account during the year and ignore accumulation of interest for purposes of determining the rate of benefit accruals. While we believe this is an appropriate change, this is a very restrictive definition because our understanding is that the plan must then also pass nondiscrimination tests as a defined contribution (DC) plan. In other words, once a plan elects either DC or DB treatment for age discrimination

¹ The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

testing, that treatment carries over to nondiscrimination tests. We are not convinced that a sufficient nexus exists between age discrimination and discrimination in favor of highly compensated individuals to warrant that requirement, and would respectfully suggest that cash balance plans, like any other DB plan, be allowed to use DB testing rules.

We would like further clarification of how the proposed regulations would amend the regulations under section 401(a)(4). Specifically, please explain the rules concerning the minimum allocation gateway. We would like to see testing permitted on the basis of average rates, as is currently allowed for DB plans.

There are many DB plans that have been converted to cash balance plans that would have difficulty passing nondiscrimination testing without averaging benefits. They were converted from final average earnings plans and as such, their accrual rates appear different from DC plans. Many of these plans were designed to minimize both the cost differences to the employer and the benefit differences for employees between the new and prior DB design. When you use the DC gateway tests, where you must look at individual accrual rates rather than averages, they may look discriminatory, whereas the day before the plan change (when tested as a DB plan), they were not. Many companies worked very hard to make the transition between plan formulas smooth and never imagined that their plan would be viewed as discriminatory.

In addition, many of these companies went through a lot of analysis in providing transition benefits for long-term and older employees to make the conversion more attractive. The gateway test would make it even harder for them to pass because employees with longer service tend to be the higher paid. Some of these plans also provided a "grandfather" benefit, which is a formula that is similar to the prior formula. This is often given to certain long-service, older employees who are close to retirement and provides them with a benefit of the greater of the grandfather or the new formula. It would be desirable to clarify how the proposed regulations handle these types of plans.

Many of the other common pension plan designs, not generally considered age discriminatory, mentioned in a separate letter on non-cash balance plans, as not meeting the requirements in the proposed regulations, also apply to various cash balance designs. They were listed under the following headings:

1. Testing approaches other than the annual method in the regulations: Allow participants who reach a certain age (or combination of age and service) to become immediately eligible for amounts they would otherwise have had to continue to work to accrue in the future.
2. Maximum of two nondiscriminatory formulas: When a plan has multiple formulas, as is often the case when a plan is amended to adopt a cash balance formula, the regulations should permit each formula to be tested separately. If each formula is nondiscriminatory, then all benefits under the plans should be considered nondiscriminatory.

3. Accruals after normal retirement: The regulations should allow existing plans to continue to calculate accruals using the methodology of the 1988 proposed regulations.
4. PIA and covered compensation offset plans: Allow integrated plan formulas to look to the gross benefit when testing age discrimination and that the amount of the offset meets the nondiscrimination rules of section 401(a)(4) and/or permitted disparity rules of section 401(l).
5. Plan amendments: The regulations should allow the accruals during the year of a plan amendment to be deemed not age discriminatory if both the new and old plan formulas, tested independently, are not discriminatory.
6. Plans with choice: The regulations should allow plans to provide a choice between benefit formulas, as long as each benefit formula under the plan would be nondiscriminatory if tested separately.

Regarding the requirements of an *eligible cash balance plan*, we have the following questions/comments:

- Normal form is equal to an immediate payment of the balance in a hypothetical account. Does this mean that it's acceptable to state the benefit in terms of an account balance rather than an accrued benefit? Please clarify.
- Right to future interest - We agree that the participant should receive interest credits without regard to future service until their distribution date. Please clarify what the proposed regulations are saying about future interest credits in the statement, "A participant is not treated as having the right to future interest credits if the plan provides that additions to the hypothetical account under the plan are reduced for the actuarial equivalent of any in-service distributions because, as discussed above, such a reduction is the equivalent of an offset for an actuarial adjustment."
- Appropriate conversion method is used - Please clarify why, when establishing a cash balance account for a participant over age 65, we must assume the participant is age 65 at conversion. Why mandate creation of a benefit that did not previously exist? We would think the opening balance should be the present value at actual attained age at conversion.

Finally, we believe this safe harbor definition (*eligible cash balance plan*) is too narrow. Employers make modifications to their plan designs from time to time due to changing employee and business needs. By steering away from creating safe harbors and adopting an appropriate general test for all plans, variety and evolution in plan design can be accommodated.

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While we are pleased that many design features were discussed in the regulations, we believe addressing other features is also appropriate. For example, guidance on plans that allow a participant to elect to have a portion of their future benefit accruals directed to their 401(k) account and 'grandfather' provisions designed to make a more equitable transition from a final average pay plan to cash balance should be addressed. If the general test was fixed to accommodate this flexibility, special rules would not be needed for cash balance plans - and probably not for other hybrid plans, either.

The regulations do not address retroactivity of any of these changes. We strongly suggest prospective changes only wherever possible, since many plans have been in existence for years, and to change benefits/balances previously accumulated would be an enormously expensive and onerous task, as well as very frustrating for employees. Many of these employers have operated their plans in good faith for many years, doing the best that they could without IRS guidance. We would appreciate it if the IRS would address which past practices are considered appropriate under "good faith" standards, and how to correct those that are not.

We appreciate your consideration of these comments. Please contact Heather Jerbi, the American Academy of Actuaries' pension policy analyst, at 202-223-8196 if you have any questions or would like more information.

Sincerely,

Donald J. Segal, FSA, MAAA
Chair, Pension Committee
American Academy of Actuaries