AMERICAN ACADEMY of ACTUARIES

Mr. W. Thomas Reeder
Benefits Tax Counsel
Office of Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

September 6, 2007

Subject: Application of the 133-1/3% Anti-backloading Test to Multiple Benefit Formulas

Dear Mr. Reeder:

The American Academy of Actuaries Pension[1] Committee appreciates this opportunity to address a very important defined benefit plan matter. Several of our members are aware of situations in which the Internal Revenue Service (IRS), with the support of the Department of Treasury, has said that they will disqualify certain cash balance plan sponsors because of purported violations of the 133-1/3% anti-backloading test of IRC 411(b)(1)(B) caused by the transition provisions included in the plan conversions. The plans in question have one attribute in common — they provide that some or all employees at the conversion date will receive the greater of the cash balance benefit and the prior plan benefit. In some instances, the prior plan benefit continues indefinitely; in others, it is temporary (e.g., for five years following conversion). We are aware that IRS officials have asserted that the 133-1/3% test should be run by combining the two formulas rather than by testing each separately.

This same subject was addressed in a broader context in our 2000 letter to Paul Shultz, then-Director of Rulings and Agreements in Employee Plans at the IRS, which is attached to this letter. The Pension Committee wishes to reiterate its strong disagreement with the IRS position on both technical and policy grounds. We stand by the analysis and recommendations made in our 2000 letter, and offer these additional observations.

- While the positions recently taken by IRS officials seem targeted at cash balance conversions, the issues are broader. As discussed in our 2000 letter, there are many other "greater-of" plan designs not involving a cash balance formula. There is no justification to single out cash balance plans.

- We understand that the IRS is taking the position that a pure wear-away design (i.e., where the cash balance formula with opening balance is subject to a minimum equal to the prior plan benefit frozen at conversion) does not cause a violation of the 133-1/3% test. We agree with that position since it is consistent with the amendment rule in IRC 411(b)(1)(B)(i). However, we understand that the IRS is also taking the position that a temporary "greater-of" design, where benefits under the prior plan formula cease to accrue at a stipulated future date (e.g., five years after conversion), can cause a violation of the 133-1/3% test because the freeze of the prior formula must be anticipated in the testing. In light of the combination of the amendment rule noted above and the deferred effective date rule in IRC 411(b)(1)(B)(ii), as well as the explicit example in Regulation 1.411(b)-1(b)(2)(ii)(B) clearly demonstrating that future changes in accrual rates are to be ignored in current testing, we see no basis to treat these "deferred wear-away" situations any differently than the pure wear-

[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession

aways. That is, before the deferred prior plan formula freeze takes effect, testing should be performed as if the freeze will not take effect (per subparagraph (ii)); and once the freeze has occurred, testing should be done without regard to the prior plan formula (per subparagraph (i)). This is the same testing approach that would be required had the prior plan freeze been implemented by a separate amendment immediately before it becomes effective, and the only approach that is consistent with the IRS's position regarding pure wear-away situations.

- Our 2000 letter presented the possibility of an accrued-to-date alternative for testing, if the IRS could not agree with separately testing the "greater-of" formulas. Given the inconsistent positions being asserted by the IRS with respect to pure and deferred wear-away situations, we would stress that such an alternative should be accompanied by clear guidance that the amendment rule and the deferred effective date rule would be honored. That is, the test would not be based on actual accrued benefits (or, therefore, account balances). Rather, the test would assume that whichever formulas are in effect for the testing year have always been in effect, and all items such as pay and interest crediting rates would be held constant throughout the testing period (consistent with IRC 411(b)(1)(B)(iv)).

- We acknowledge that the IRC 411(b)(1)(B) has been in effect for 30 years. However, in the past IRS has, on more than one occasion, revised or updated old regulations. As pointed out in our 2000 letter, we think it can be interpreted to support the separate testing of benefit formulas in "greater-of" situations. We also suggested that Example 3 in the regulations be changed to no longer penalize plans for front-loading benefits. We appreciate that there may be a hesitancy to change the conclusion in that example after all these years, but the context surrounding the example has changed considerably since then. When the regulation was first issued, there were few plans that were designed along the lines of Example 3, so there was little if any challenge from employers and practitioners on the conclusion reached.

- We are concerned that after all these years during which cash balance plans and their sponsors have been stuck in regulatory limbo, and after Congress thought it had clarified the legal issues for these plans with the passage of the Pension Protection Act (PPA), the IRS is now trying to impose a result that is totally inexplicable. Apparently employers who voluntarily designed their plans to be more generous than what Congress ultimately required in PPA are being penalized for that generosity. This is contrary to our understanding of public policy intent of Congress. At the very least, the IRS should recognize the lack of any notable enforcement or publicizing of the position it is now advancing, coupled with the silence given to sponsors who formally requested plan-specific guidance via determination letter requests over the past nine years. The harsh threat of disqualification for sponsors who made a good faith attempt to comply with the law in a vacuum does not strike us as reasonable or rational. The IRS and Treasury could consider delaying implementation of these changes until all parties have a chance to work out a more suitable policy solution.

In closing, given the significant number of plans that would be adversely affected by this requirement, the negative policy implications of that action, and the unsupported public policy need for creating the requirement, we strongly urge the Treasury and the IRS to reconsider their position in this matter.

We would appreciate the opportunity to meet with you in order to answer any questions you may have or to discuss any of the concerns expressed in this letter. If you have any specific questions or would like more information, please contact Samuel Genson, the American Academy of Actuaries' pension policy analyst, at 202-223-8196. Thank you for your consideration of this matter.

Sincerely,

James F. Verlautz, FSA, EA, MAAA, FCA
Chairperson, Pension Committee
American Academy of Actuaries