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

Dear Mr. Shultz:

In certain instances, IRS officials recently have been interpreting the anti-backloading tests of Internal Revenue Code section 411(b)(1) in ways that the American Academy of Actuaries Pension Committee (committee) believes produce illogical results not required by the statute. Such interpretations seem inconsistent with congressional intent and with longstanding practice in running the tests. Until recently, we do not believe that the IRS had imposed such interpretations in determination letter reviews or in plan audits.

The heart of the matter relates to how the 133-1/3% test should be applied to a plan that has two or more benefit formulas such that the employee receives the greatest of the amounts produced under the formulas. The IRS seems to be taking the position, at least lately, that the way such a plan must satisfy the 133-1/3% test is by determining benefit accrual rates taking into account the combined effect of all the formulas.

We understand that this interpretation is based on IRS Reg. 1.411(b)-1(a), which states:

“A defined benefit plan may provide that accrued benefits for participants are determined under more than one plan formula. In such a case, the accrued benefits under all such formulas must be aggregated in order to determine whether or not the accrued benefits under the plan for participants satisfy one of the alternative methods.”

This provision clearly is applicable when one formula applies to a participant for a period of time (e.g., until a specified age or service is attained) and a second formula after such date. However, we believe that the regulation should be interpreted not to require the combination of multiple “greatest-of” benefit formulas because only one of the benefit formulas actually applies to any individual (i.e., the one that happens to produce the highest result).

To illustrate the impact that the IRS interpretation can have, consider a simple example. A plan provides a benefit of 1% of final five-year average pay, multiplied by years of service. Clearly, this plan satisfies the 133-1/3% test. The plan is amended to provide a minimum benefit equal to

10% of final five-year average pay. If viewed separately, each formula satisfies the 133-1/3% test. However, if viewed together, the plan might be considered to fail the test because the accrual rates are 10% in year 1, 0% in years 2 through 10, and 1% in each year thereafter. The 1% rate in the later years is infinitely higher than the 0% rate that applies in years 2 through 10 – obviously more than a 33-1/3% differential. [See the discussion below related to an alternative way of determining accrual rates for this purpose.]

A fundamental question is whether this plan should be viewed as violating the anti-backloading rules. We took a plan that provides level annual accruals and superimposed a minimum benefit formula that serves to “front-load” plan benefits in the first 10 years. Yet to say that this plan fails the 133-1/3 test is tantamount to an assertion that the plan is impermissibly back-loaded.

This outcome seems to be contrary to the clear purpose of the anti-backloading rules – to assure that a plan could not be designed to delay too much of the benefit accruals to the later years of service. Front-loading, as in the above example, has just the opposite effect. Moreover, there is ample evidence in the legislative history that Congress did not intend to restrict the front-loading of benefit accruals through the application of the anti-backloading rules.

One response we have heard from the IRS to this paradox is that the plan could satisfy the fractional rule so there is no concern that it fails the 133-1/3% test. This response is unsatisfactory for at least two reasons. First, while the fractional rule is convenient when the plan actually accrues benefits using the projected and pro-rated approach, in other instances its application is administratively burdensome and difficult to explain to employees. In some of those latter cases, it will be possible to demonstrate arithmetically that the plan formula will always produce benefits that equal or exceed the pro-rated projected benefits, suggesting that it would not be necessary to actually determine plan benefits under the fractional rule. However, in other cases, it would be necessary to incorporate the fractional benefit in the plan (at least as a minimum benefit) in order to assure compliance.

The second problem with relying on the fractional rule is that it often is not available. Consider three examples where the plan would not satisfy the IRS interpretation of the 133-1/3% test and also would not satisfy the fractional rule:

1. The plan provides the greater of (1) 1% of career average pay multiplied by years of service and (2) 10% of final five-year average pay. The fractional rule would not be satisfied for the typical employee who has more than 10 years of service – due to the statutory ten-year limit on the number of years of compensation that may be recognized in projecting benefits to normal retirement age.
2. The plan provides the greater of (1) 1% of final five-year average pay multiplied by the first 20 years of service, plus 1-1/3% of final five-year average pay multiplied by service over 20 years and (2) 10% of final five-year average pay.
3. The plan provides the greater of (1) 1% of final five-year average pay multiplied by years of service and (2) 2% of final five-year average pay multiplied by the first 10 years of service during which the plan is top-heavy.

Thus, under the recent IRS interpretation, all three plans could not satisfy either of the tests. Until recently, the committee does not believe that the IRS has questioned any of these design types under the 133-1/3% test.

We understand that the IRS is considering drawing a distinction between a true career average pay plan (e.g., 1% of career average pay, times years of service) and an accumulation plan (e.g., the sum of 1% of each year's pay). The apparent reason for this distinction is to get around the 10-year statutory limit in the fractional rule for virtually all career pay type plans – since there are very few that are not expressed as accumulation plans. However, even if this distinction is made, it is not clear to us how that would help a plan (like plan 1 above) that has two or more formulas, one of which is an accumulation plan, satisfy the fractional rule.

We understand that the IRS is also considering an exemption from the combined formula interpretation under the 133-1/3% test with respect to top-heavy minimums (i.e., plan 3 above), apparently on the grounds that top-heavy provisions are required by another provision of the law. This appears to be another way of justifying past acquiescence with respect to many top-heavy plans and contingent minimum top-heavy formulas in many other plans.

The IRS apparently is also considering an exemption from the combined formula interpretation in the typical situation where a new benefit formula is applied to all service, subject to a minimum equal to the prior formula accrued benefit – the wear-away transition approach. We have not heard of any rationale for plan 2 above to satisfy any of the accrual rule tests.

The committee finds it particularly ironic that the IRS is seeking to impose this interpretation of the 133-1/3% rule at a time when members of Congress and others are encouraging minimum benefit formulas (e.g., continuation of the prior benefit formula) in hybrid plan conversions. Employers that wish to grant these protections apparently would be viewed by the IRS as being in violation of the anti-backloading rules.

**The committee believes that the most straightforward approach for avoiding these types of irregularities and exceptions is to simply allow or require that each benefit formula in a “greatest of” situation be tested under the anti-backloading rules separately.** If each formula satisfies one of the tests, the plan is considered to satisfy the anti-backloading rules. We think that the current regulations are properly interpreted to allow for this treatment, although a formal clarification from the IRS would be helpful.

One criticism we have heard of the separate formula treatment is that it would allow for certain plan designs that clearly would not satisfy the 133-1/3% test as a single benefit formula to satisfy the test using multiple formulas. For example, the very first plan discussed above, when stated as a single benefit formula -- provides a 10% accrual in year 1, 0% in years 2-10 and 1% in each subsequent year. We agree that such a plan seems to violate IRS Reg. 1.411(b)-1(b)(2) – see Example 3 in (iii). However, we believe that such a formula is not in violation of the 133-1/3% test as articulated in the statute. A way to get the “right” answer is simply to allow any front-loading to be spread over future years of service for purposes of running the test. In effect, this approach would be analogous to using the accrued-to-date method for determining accrual rates in the section 401(a)(4) general test. Actually, to assure no abuse, the accrual rate for any given year would be the greater of the accrual rate under the annual method (i.e., the stated plan rate) and the rate under the accrued-to-date method. For example, apply this approach to the benefit

formula described below (Formula 1) and to a variation where the accrual rate in year one is 5% rather than 10% (Formula 2):

<b>Formula 1</b>				<b>Formula 2</b>		
End of Year	Annual Method	Accrued to Date Method	Greater of Two Methods	Annual Method	Accrued to Date Method	Greater of Two Methods
1	10.00%	10.00%	10.00%	5.00%	5.00%	5.00%
2	0.00%	5.00%	5.00%	0.00%	2.50%	2.50%
3	0.00%	3.33%	3.33%	0.00%	1.67%	1.67%
4	0.00%	2.50%	2.50%	0.00%	1.25%	1.25%
5	0.00%	2.00%	2.00%	0.00%	1.00%	1.00%
6	0.00%	1.67%	1.67%	0.00%	0.83%	0.83%
7	0.00%	1.43%	1.43%	0.00%	0.71%	0.71%
8	0.00%	1.25%	1.25%	0.00%	0.63%	0.63%
9	0.00%	1.11%	1.11%	0.00%	0.56%	0.56%
10	0.00%	1.00%	1.00%	0.00%	0.50%	0.50%
11	1.00%	1.00%	1.00%	1.00%	0.55%	1.00%
12	1.00%	1.00%	1.00%	1.00%	0.58%	1.00%
13	1.00%	1.00%	1.00%	1.00%	0.62%	1.00%
14	1.00%	1.00%	1.00%	1.00%	0.64%	1.00%

Formula 1 satisfies our suggested application of the 133-1/3% test because the accrual rates never increase from one year versus any future year. Formula 2 fails this test because the 1.00% accrual rate in years after the tenth year exceed the accrual rates in years seven, eight and nine by more than 33%.

In order for Formula 1 to satisfy the 133-1/3% rule, the provisions in the IRS regulations, particularly Example 3, would have to be changed. In the meantime, if the IRS decides it can interpret the existing regulations to permit multiple formulas to be tested separately, Formula 1 could be restated into two formulas and would pass. Of course, in the longer-term, we recommend that the regulations be amended to change Example 3 and any related language.

The committee believes it is critical for the IRS to rethink its apparent interpretation of how the 133-1/3% test should be applied. Otherwise, there are scores of existing plans and many others that might arise in the future that will be subject to a rule that seems contrary to congressional intent and good public policy.

As a final note, based on the collective experience of the committee members, the standard approach used in practice to prove compliance with the 133-1/3% test is to separately test the plan benefit formulas. Until very recently, we were not aware of any IRS official – in determination letters or audits – questioning such approach. In fact, it also is standard practice to disregard old grandfather benefit formulas and 411(d)(6) protected benefits from prior formulas that do not apply to new employees. Practitioners have relied upon IRS Reg. 1.411(b)-1(b)(2)(ii)(A) to use the “new employee” approach in applying the 133-1/3% test: “Any

amendment to the plan which is in effect for the current plan year shall be treated as if it were in effect for all other plan years.” The new employee approach avoids the multiple benefit formula problems but only to the extent that the ongoing plan does not have more than one benefit formula.

We would be pleased to discuss this issue with you and your staff. I can be reached at (212) 251-5317 if you would like to discuss this further.

Sincerely,

Donald J. Segal  
Chair  
Pension Committee

*Members of the American Academy of Actuaries Pension Committee include:*

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