ASPPA Comments on IRS Cash Balance Proposed Regulations

Comments on
Reductions of Accruals and Allocations Because of the Attainment of Any Age Application of Nondiscrimination Cross-Testing Rules to Cash Balance Plans

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26 CFR Part 1

Federal Register
Vol. 67, No. 238
of December 11, 2002
pp 76123-76142

March 13, 2003

The American Society of Pension Actuaries ("ASPPA") offers the following comments on the proposed regulations under Internal Revenue Code Sections 401 and 411, issued on December 10, 2002 ("proposed regulations").

ASPPA is a national organization of approximately 5,000 members who provide actuarial, administrative, consulting, legal, and other professional services for qualified and other retirement plans.

The importance of promoting defined benefit plan coverage for our nation's workers cannot be understated. Due to the decline in the stock market, millions of American workers relying solely on defined contribution vehicles for retirement savings have been forced to either delay retirement or seriously reevaluate their retirement standard of living expectations. These unfortunate consequences would have been greatly diminished if these Americans had been covered by a defined benefit plan providing guaranteed retirement benefits, not subject to the whims of investment markets. Any legislative or regulatory policy must keep in mind the vital role defined benefit plans play in providing working Americans with a more secure retirement. ASPPA strongly believes the intent and spirit of the proposed regulations is wholly consistent with this critical objective.

ASPPA commends the Service for issuing the much-needed guidance, particularly those aspects of the proposal that deal with account-based defined benefit plans. These account-based plans constitute vital and powerful tools for building a stronger and more effective national retirement system. Until now, a large and difficult impediment to the growth of account-based defined benefit plans has been the uncertainty over how age discrimination rules apply to them. By publishing proposed guidance, IRS and Treasury have taken an important first step towards removing this roadblock.

It is imperative that a distinction be made between the issues surrounding so-called "conversions" to cash balance plans from traditional defined benefit plans as opposed to cash balance plans in and of themselves. There are tens of millions of American workers, particularly those who work at small to mid-sized companies, who have no defined benefit plan coverage at all. For these workers, coverage under a cash balance plan, with employer-funded contributions and guaranteed rates of return, would be a welcome change from 401(k) plan account statements showing dramatic losses. No rational or cogent policy argument could possibly be made that these workers without any preexisting defined benefit plan are somehow not better off with a cash balance plan. Consequently, these comments intentionally focus on cash balance issues not pertaining to conversions. This is not to suggest that ASPPA is not concerned with any of the issues raised by the portions of the proposed regulations applicable to conversions. Rather, since we recognize that many other commentators will be discussing those issues, we wanted to emphasize the important role these regulations will play toward the creation of new defined benefit plans providing millions of Americans with the opportunity for a more secure retirement.

ASPPA urges IRS and Treasury to issue final regulations as rapidly as careful deliberation will permit. While the proposed regulations focus on only one variety of account-based plans—namely, conventional cash balance plans—ASPPA believes the final regulations should emphasize flexibility in acceptable plan designs. The proposed regulations already move significantly towards this goal. For example, in discussing interest credits, ASPPA applauds the use of words like “reasonable” and the avoidance of specified arbitrary interest rate boundaries.

ASPPA cautions that decisions on age discrimination, whipsaw, accrual rule requirements, and nondiscrimination requirements are likely to have a profound effect on efforts to craft reasonable phased retirement programs.

Given the convergence of rules under Section 417(e) and these proposed regulations, ASPPA believes it is imperative that the Section 417(e) whipsaw issue be resolved before any further amendments are made to the Section 401(a)(4) regulations for cash balance plans.

Summary of Comments

In summary, ASPPA’s comments on the proposed regulations recommend that final regulations:

Include rules that permit (i) age discrimination tests to be optionally applied using either accrued-to-date (or average) benefit rates or year-to year accrual rates, (ii) fresh start rules similar to those in the Section 401(a)(4) nondiscrimination regulations, and (iii) plan sponsors to ignore actuarial increases in testing Section 411(b)(1)(H) compliance following normal retirement date.

Recognize that a benefit is nondiscriminatory if it is the sum of, or the greater of, two or more nondiscriminatory benefit formulas whether the benefits are provided in the same or different plans. Furthermore, the ability to aggregate and disaggregate plans for purposes of age discrimination testing should be available.

Provide rules that a pension equity plan, which could have satisfied Section 411(b)(1)(H) if reasonable interest credits had replaced pay change adjustments, be deemed to satisfy Section 411(b)(1)(H).

Discussion

Annual versus Accrued-to-Date Testing

The preamble to the proposed rules requests comments regarding whether an averaging method should be permitted. ASPPA believes it should. A final rule that looks to the entirety of what has been accrued rather than a slice based on a 12-month period addresses the anomalies that have been presented in the proposed rule. Testing based on the benefit accrued to date (from a fresh start date where relevant), or an annualized rate developed by dividing that accrued benefit by the period of service or participation used to determine benefits under the plan, should be recognized as suitable alternatives.

Existing methodologies for developing accrual rates, including rules for “fresh starts,” exist in the extensive Section 401(a)(4) regulations. These regulations, like Section 411(b)(1)(H), require an examination of what is happening year-by-year. The Section 401(a)(4) regulations permit performance of year-by-year tests using averages (accrued-to-date). Regulations under Section 411(b)(1)(H) should permit the same approach.

It is difficult to isolate the cause of the decrease in the rate of accrual when accrual is tested on an annual basis. In many cases, the fluctuation is due not to age but to the salary pattern or to amounts earned in earlier years. Amounts earned in an earlier year that might have influence on a current accrual should not be treated as illegally age-related if the earlier accruals are a function of the number of years of service worked, for example, or if the earlier accruals had actually left older workers better off.

Consider proposed regulation Section 1.411(b)-2(b)(3)(iii), Example 8. The essence of what occurs in this example is that for the first 20 years of service “O” (age 70) accrued a benefit of 2% of pay per year, while

"N" (age 64) accrued a benefit of 1.9524% of pay per year. "O" accrued this additional amount because the plan, by design, provides more generous accruals to employees who enter after age 45. Over the first 20 years, "O" accrued a benefit of 40% of pay, while "N" accrued 39.0476% of pay. In year 21, "O" accrues an additional 1% of pay for a total of 41% of pay; "N" continues to accrue at the rate of 1.9524% of pay and achieves a total accrual of 41% of pay. At this point the total accrued benefit for both employees, who are the same in all respects except for age, is the same.

Favoring a worker who becomes employed at an older age should not be discriminatory under the ADEA.

Ironically, one solution the plan could apply is to accelerate the accrual for "N." If "N" accrued the benefit at 2% of pay for the first 20 years, then "O" would only need to accrue 1% in year 21. The logic of this example is that "O" is discriminated against because younger employee "N" received a smaller amount in earlier years, which merely proves that the older employee had, in fact, enjoyed a better deal up to the point when the benefits become equal.

ASPPA recommends that age discrimination tests be optionally applied using accrued-to-date benefits (average accruals), year-by-year accruals, and fresh start rules similar to those currently found in the Section 401(a)(4) nondiscrimination regulations.

Post NRA Accruals

Actuarial increases past normal retirement age should not be the source of additional problems or plan design pitfalls. The granting of actuarial increases during postponed retirement is generally viewed as favoring older workers, not discriminating against them.

In the case of post normal retirement accruals (i.e., prior to age 70½), examining compliance with the nondiscrimination rules on an aggregate (accrued-to-date) method would eliminate the possibility that an employer be "punished" for choosing to provide an actuarial increase to reflect interest and mortality gains lost by a participant who continues in service while foregoing current pension payments. Such an employer could have distributed "suspension of benefit" notices and given no such increase. The proposed regulation includes examples [see, proposed regulation §1.411(b)-2(b)(3)(iii), Example 12] that demonstrate that a formula that is acceptable in a plan requiring suspension of benefits can suddenly fail the year-by-year rule solely because of the actuarial increase.

The concern that the proposed approach to post normal retirement date actuarial increases can lead to plan design errors is illustrated by Example 11 in proposed regulation §1.411(b)-2(b)(3)(iii). Consider an employee with 15 years of service. The actuarially increased benefit for an employee age 66 is $627.50, while the age 65 benefit would have been $560 ($40 x 14). The resulting increase is $67.50. On the other hand, if the participant were age 80 the $40 plan formula would produce a benefit larger than a benefit at NRA of $0, actuarially increased. If the 80 year old had been younger, the actuarial increases would have produced a larger accrual, such as the $67.50 credited to the participant who is 66. Contrary to the statement made in the example, this plan fails the bright line test established by the proposed rule.

ASPPA recommends plan sponsors be given the option of ignoring actuarial increases after the plan's normal retirement date in testing compliance with Section 411(b)(1)(H).

Multiple Formulas

Plans sponsors should be able to provide multiple formulas in a single plan. Plan formulas often can be alternatively expressed as the sum of, or the better of, two or more provisions, each of which is acceptable under the proposed regulations. The final regulations should allow a plan to be analyzed as a combination of two or more formulas regardless of whether or not the combination involves different plan types (e.g., cash balance and traditional).

The concept that a design is nondiscriminatory if it could have been done in separate plans was embraced in the development of the Section 401(a)(4) nondiscrimination rules. Thus, for example, employers can provide various levels of benefits for salaried employees in the same plan as employees for whom benefits are

collectively bargained. The Section 401(a)(4) regulations went further still by memorializing three “wearaway” rules for transitioning from one plan formula to another. Floor-offset plans also support the concept that “greater of” designs have long been viewed as acceptable (note that each participant in a floor-offset design gets whichever of the two benefits—gross defined benefit or defined contribution—is better).

The ability to combine or split out elements of formulas into separate pieces should lead to reasonable approaches for dealing with special circumstances that are not otherwise addressed by the proposed rule. Final rules need to address:

- Floor offset plans,
- Traditional plan amendments with Section 411(d)(6) protected benefits,
- Plans with multiple formulas for the same group,
- Plans with multiple formulas for different groups of employees,
- Employees transferred from a group covered by one formula to a group covered by another plan type,
- Employees who make an election to be covered by one formula or another, where one or both formulas are amended after the election date, and
- Plans with different normal retirement ages for different groups of employees.

ASPPA recommends that a benefit be considered nondiscriminatory if it is the sum of, or the greater of, two or more formulas where each underlying formula is nondiscriminatory. Furthermore, it should be permissible to aggregate and disaggregate plans for purpose of testing for age discrimination.

ASPPA further recommends that final age nondiscrimination rules include a facts and circumstances safety valve that can be triggered by a specific request to the Commissioner. Proposed regulation §1.411(b)-2(b)(3)(i) states that plans must satisfy the requirements not only for the actual participants but also for any potential participants. ASPPA is concerned that this requirement might be unreasonable, particularly in the case of closed groups.

Pension Equity Plans

Under the typical pension equity plan, a participant's retirement benefit is a function of his or her years of service, multiplied by a percentage of final average compensation that frequently increases with years of participation. No interest credit applies in most pension equity plans. Instead, the benefit tends to increase over the participant's career due to increasing years of participation or service and increases in final average pay. Ignoring the impact of pay changes, the benefit accrues in annual units that are equal when measured in terms of the current value of the expected pension benefit, not in terms of the amount of pension to be provided. The participant's benefit is converted to an actuarial equivalent annuity commencing at normal retirement age when he or she leaves employment.

A pension equity plan design will not pass the proposed regulation’s test for traditional plan designs because the traditional plan test focuses on the increase in the normal retirement benefit even if the plan’s normal form of benefit is not a normal retirement annuity (as in a pension equity plan). Similar to a traditional cash balance plan, the pension equity plan provides a normal retirement benefit for a younger participant that will be greater than the normal retirement benefit of a similarly situated older participant simply because of the greater number of years between current age and normal retirement age at the time of termination. Thus, the pension equity plan fails to satisfy the traditional plan age discrimination requirement for the very same reason that a cash balance plan would fail.

Many pension equity plan designs also will fail to satisfy the eligible cash balance option due to the requirement in the definition of “eligible cash balance plans” in proposed regulation §1.411(b)-2(b)(2)(iii)(B) that a participant's hypothetical account balance have a right to annual interest credits for all future periods. Crediting interest to the hypothetical account is not an indicator of age discrimination. Moreover, a pension equity plan design could be viewed as being less age discriminatory than a typical cash balance plan, in that

a cash balance plan's guaranteed right to future interest credits favors younger participants whereas account growth in a pension equity plan is tied to growth in final average pay. Therefore, final age discrimination regulations should recognize that accruals under pension equity plans are satisfactory.

ASPPA recommends that the Service issue guidance confirming that pension equity plans that could have satisfied Section 411(b)(1)(H) if reasonable interest credits had replaced pay change adjustments are deemed to satisfy Section 411(b)(1)(H).

Traditional Plans

Benefit Design

As currently structured, the proposed age discrimination rules would call into question the legitimacy of many widespread "traditional" plan designs including PIA offset plans, plans that use participation-based fractional accrual with a service-based formula, plans mimicking Social Security, contributory plans, floor-offset plans, and plans offset by traditional benefits in paired plans.

The problem that exists with these plan designs is due to the arbitrary application of a plan year-to-plan year measurement period in the proposed regulations, and because actuarial adjustments in excess of what a suspension of benefits rule would allow are provided. Such issues can be solved by permitting plan aggregation and use of a "whichever benefit is better" approach.

Any rule that punishes the employer who returns the value of interest and mortality benefits to employees is undesirable. An actuarial adjustment should not be treated as an additional benefit. It is meant to compensate for the value lost by the participant because the benefit does not commence at the normal date, comparable to the investment experience of a participant in a defined contribution plan.

The calculation of a one-year increase in a plan that provides full value on death is simply the present value at age 1, times 1 plus the interest rate (note the parallelism to defined contribution of 1 plus investment return rate), with the resulting present value divided by an annuity factor at age 2 (which is how a defined contribution account balance would be converted to an annuity benefit). If it were not for the specific statutory rule offering an exception to permit using this increase as an offset, plans would have to provide both the increase and the fresh accrual because this is not an additional benefit. Because it is not an additional benefit, it does not lead to the creation of an age discriminatory pattern.

ASPPA recommends that the annual accrual test and approach to actuarial increases be reconsidered and made just one of several permitted alternatives.

Offsets for Distributions

There is merit to using the benefit that would have been payable in the normal form to determine the adjustments to ongoing accruals in the normal form. However, as with plans that provide an actuarial increase in lieu of a suspension of benefits, the proposed regulations use of an approach of limiting the offset in any year to the value of the benefit paid in the year (in its life only form), rather than basing it on the accumulated payments, is not supported by statute. The result for these situations should be comparable to the rule for plans (or participants) that defer benefit commencement. An additional accrual occurs when, and to the extent, the benefit under the plan's formula exceeds the previously accrued benefit with actuarial increase (or presumed increase in the case of participant actually in receipt of benefits).

The final rule should clarify that the offsets dealt with in this regulation are separate and apart from offsets to the accrued benefit to prevent duplication of benefits. Clearly, the accrued benefit of a participant who leaves employment prior to normal retirement and receives a lump sum or receives annuity payments prior to returning to employment and earning additional benefit accruals is not the same as the accrued benefit of a participant with the same formula accrual who did not receive payments. At normal retirement, the accrued benefit of the individual who left and returned is just the net benefit under the plan's nonduplication of benefit clause.

ASPPA recommends that final rules observe this distinction and explain how the two rules interrelate.

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These comments have been prepared principally by Edward Burrows, Lawrence Deutsch, and Marjorie Martin of the Actuarial Subcommittee of ASPPA's Government Affairs Committee and Fred Singerman. We appreciate the opportunity to provide these comments, and are available to discuss them with you further.

Sincerely,

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