Testimony of J. Mark Iwry[1]

Before the Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
United States House of Representatives

Cash Balance Pension Conversions:
A Legislative Framework for Resolution

Chairman Johnson, Ranking Member Andrews and members of the Subcommittee, I am submitting this written statement in response to the Subcommittee's request for additional information regarding cash balance conversions following the Subcommittee's June 4, 2003 hearing on defined benefit pension plans.[2]

Responding to the Subcommittee's request, this statement illustrates a possible legislative framework for resolution of the cash balance pension issue. The framework is summarized in part III (pages 3-4) and part V (pages 11-13), below.

Of course, no resolution of this highly contentious issue would leave all parties fully satisfied. There is ultimately a sharp tradeoff between protecting older workers from certain changes in plans and preserving employers' flexibility to make changes in a private pension system where they are not required to adopt or continue plans. However, the approach outlined here seeks to illustrate how Congress might find common ground – or at least middle ground – by allowing cash balance plans and conversions, resuming the IRS review and approval process, and giving plan sponsors reasonable flexibility to choose how – but not whether – to protect older workers. In a sense, plan sponsors have already pointed the way: corporate "best practices" in a number of instances have sought to combine reasonable protection for employees with reasonable flexibility for the employer.

The material provided in this statement is illustrative, not prescriptive. It is intended to respond to the question framed by Congressman Wu, relating to how Congress could provide for cash balance conversion relief and employer

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[1] The witness served as the Benefits Tax Counsel of the U.S. Department of the Treasury from 1995 through 2001. He currently is a nonresident Senior Fellow at the Brookings Institution and a lawyer who has provided legal advice and assistance regarding issues referred to in this testimony. Any views expressed in this testimony are those of the witness alone. They should not be attributed to the staff, officers, or trustees of the Brookings Institution or to any other organization.

[2] At or after the June 4, 2003 hearing, where I testified on a panel that included Messrs. Gebhardtsbauer, Leary and VanDerhei, the witnesses were asked on behalf of members of the Subcommittee to submit additional statements regarding several other issues, including data on the incidence and uses of lump sum distributions from retirement plans and views regarding a possible approach that would provide relief from certain regulation of defined contribution plans to employers that also sponsor certain defined benefit plans. In addition, I was asked to submit my views regarding possible approaches to making better use of the saver's credit under section 25B of the Internal Revenue Code to expand pension coverage. Written statements addressing those three issues are being submitted separately to the Subcommittee.

flexibility, but not to make recommendations or offer opinions of the witness (or any other party).

I. Preliminary Matters

The cash balance pension issue has been the subject of sharply differing views, reflected in proposed legislation, legislative and policy debate, litigation, comments on regulations, academic writing, editorials, etc. In addition, the issues relating to cash balance plans and conversions of traditional defined benefit (DB) pension plans to cash balance plans and other hybrid pension programs are relatively involved.[3]

In the interest of brevity, therefore, and recognizing that the information request is in the nature of a followup to the June 4, 2003 hearing (most of which did not focus specifically on cash balance issues), this statement is intended only to sketch out a "broad-brush" response. It does not rehearse the legal or policy issues presented by cash balance plans and conversions; it does not go into detail regarding the specifics of the approaches outlined here; it certainly does not purport to illustrate how all of the important related issues and major questions in this area might be resolved; and, as noted, it is illustrative or descriptive rather than prescriptive. In the event that the Subcommittee wishes to have further information, I would be glad to respond.

II. Cash Balance Conversion Relief and Employer Flexibility

For purposes of this submission, I understand the request for information regarding conversion relief and employer flexibility to be asking essentially the following question: If Congress wished to allow cash balance pension plans to be maintained and cash balance conversions to take place, how might it do so while providing reasonable protection for employees and reasonable flexibility for employers?

A central policy concern raised by cash balance plans is whether and how conversions from traditional defined benefit to cash balance plans can be carried

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[3] Hybrid plans, such as cash balance pension plans are plans of one type – defined benefit (DB) or defined contribution (DC) – that also have characteristics of the other type. In some respects, cash balance plans resemble DC plans. They are presented to employees using DC plan concepts, with an account that increases over time as a result of interest and compensation credit. In addition, the pattern of economic accrual under a cash balance plan (i.e., each employee is credited with a hypothetical allocation which is a percentage of that employee's compensation for that year) is closer to the economic accrual under a traditional DC plan than under a traditional DB plan design. However, a cash balance plan is not a DC plan because an individual's benefits under a cash balance plan are not solely derived from the individual's allocated contributions plus attributable investment return. Therefore, cash balance plans are DB plans.

The material in this footnote is quoted essentially verbatim from prior testimony of the witness (while serving in the Treasury Department):Testimony of J. Mark Iwry, Benefits Tax Counsel, Office of Tax Policy, U. S. Department of the Treasury, before the Committee on Health, Education, Labor and Pensions, United States Senate, page 4. That testimony contains further discussion of cash balance plans and conversions.

out in a manner that sufficiently protects older and long-tenured employees who would otherwise be adversely affected -- without unduly limiting employer flexibility to change their plans and without stifling innovation and creativity in the market and in pension design.[4] In fact, among the significant legal issues that have been raised regarding cash balance plans are whether the plans are inherently age discriminatory and whether conversions are age discriminatory -- particularly whether the plans or conversions violate the age-related proscriptions of section 411(b)(1)(H) of the Internal Revenue Code (IRC) and its counterpart provisions under the Employee Retirement Income Security Act of 1974 (ERISA) and the Age Discrimination in Employment Act (ADEA).

Plan sponsors undertaking cash balance conversions have adopted a range of provisions intended to provide varying degrees of transition protection to current employees.[5] Some of these protective provisions might be described as corporate "best practices" that are generally similar to the "choice" requirements that would be imposed by H. R. 1677, the Pension Benefits Protection Act, introduced by Congressman Bernie Sanders and this Committee's Ranking Member, Congressman George Miller, and co-sponsored by other Members. The bill requires companies that convert to cash balance plans to allow workers who are either at least 40 years old or have at least 10 years of service the choice to remain in the traditional defined benefit plan.

Other converting employers have provided protection that would not meet the standard established in H.R. 1677, but would substantially exceed the requirements that would be imposed by the December 2002 proposed Treasury regulations.[6] Of course Congress should not view the proposed regulations as a source of potential guidance concerning the appropriate policy balance here. Treasury is operating under a major constraint:: it is required to interpret the current statute. While there is controversy as to whether the proposed regulations represent an appropriate interpretation, Treasury is not entirely free to publish regulations reflecting what it believes to be the best policy because of course the regulations generally must give effect to or interpret existing statutory provisions.

III. Possible Framework for a Legislative Solution

As noted, a possible legislative resolution of the cash balance issue could allow cash balance plans and conversions, resume the IRS review and approval process, and give plan sponsors reasonable flexibility to choose how – but not whether – to protect older workers.

By way of illustration, legislation could include the following ten elements:

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[4] The material in this paragraph is drawn largely from the witness's June 4, 2003 testimony, written statement, pages 5-6, 18-19.

[5] U. S. General Accounting Office, Cash Balance Plans: Implications for Retirement Income, pages 34-36 (2000).

[6] See id.

1. Provide that cash balance plans will not be treated as inherently age discriminatory, i.e., that new or steady-state cash balance plans do not per se violate the age discrimination laws if they would satisfy the defined contribution plan age discrimination standard of IRC section 411(b)(2).
2. As a condition of treating a conversion as not violating the statutory age discrimination provisions, require the plan to give older workers a reasonable level of protection from the adverse effects of the conversion, including protection from normal and early retirement benefit wearaway.
3. Prescribe the minimum level of protection in a manner that maximizes employers' flexibility to choose among a specified array of "safe harbor" alternatives for designing their protective arrangements (discussed below).
4. Give employers further flexibility by providing a "safety valve", allowing individual plan sponsors to demonstrate to the IRS that their conversion provisions are substantially as protective of older participants as at least one of the safe harbors. This could include a "facts and circumstances" demonstration.
5. Give IRS specified additional FTE and budgetary resources to help it address the cash balance backlog, provided Treasury/IRS concur. A conversion that is the subject of such a safety valve application (see #4, above) could not be implemented before IRS had received such additional FTEs and funds or without an IRS determination letter. IRS would be authorized to prescribe reasonable conditions to limit the volume of such case-by-case applications.
6. Direct Treasury to propose, after consultation with EEOC and DOL, regulations implementing the safe harbors and related legislation (replacing the December 2002 proposed regulations, at least to the extent they are inconsistent with the new legislation) and, after issuance of final regulations, to resume the IRS determination letter review process for cash balance conversions.
7. Possibly authorize Treasury to publish additional safe harbors that are not less protective of older or longer-service participants than the statutorily described safe harbors and that would not go into effect until after a longer than usual period following their submission to Congress in proposed form.
8. Direct Treasury to fine tune the safe harbors to the extent necessary to coordinate conversion protections for older workers with other plan qualification rules, including the prohibitions on discrimination in favor of highly compensated employees and restrictions on "backloading" of benefits.
9. Provide that the legislation is intended to have no effect on existing or possible future litigation relating to conversions that have received IRS determination letters (including a congressional decision as to the regime to apply to the past conversions that IRS has not processed) and is intended to have no effect on the application or interpretation of the age discrimination laws beyond the limited sphere of hybrid pension plans and conversions.
10. To the extent practical, take steps to clarify the application of related plan qualification provisions to hybrid plans.

IV. Building Blocks for Constructing Conversion Safe Harbors

A. In General

In considering how to design options that employers can use to protect current employees affected by a conversion, it is important to bear in mind that employer flexibility to choose among a menu of alternatives means that, in many instances, the protection will be only as strong as the weakest alternative. In accordance with the Subcommittee's request for information and hence the character of this submission as descriptive rather than prescriptive, this comment is not intended to advocate or recommend a particular approach regarding the degree or specific nature of the conversion protection Congress should require. Determining how much protection to require for current employees from the potential adverse effects of a conversion depends on how the nature and gravity of those effects are viewed and on how employees' interests in protecting their benefits are balanced against plan sponsors' need for flexibility and the potential impact on their willingness to maintain plans.[7]

B. Full Protection of Benefit Expectations

According to one view, the law should protect older workers' expectations of future higher benefits under a traditional DB plan from the effects of a conversion – as some employers have done – because older workers have given up current wages (whether implicitly or explicitly) in exchange for a traditional pension formula that provides only modest benefits in the employee's earlier years on the understanding that longer-serving employees will be more richly rewarded late in their career. In addition, under a related view, conversions often discriminate against older workers, treating them less favorably than younger employees. These concerns might suggest requiring older or longer-service employees to be grandfathered in the old formula benefit, giving them the greater of the old and new formula benefit, or giving them a choice between the two formulas at retirement.[8] See, for example, H.R. 1677.

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[7] The discussion in this part does not address concerns that have been raised to the effect that the basic structure of the cash balance plan formula generally fails to comply with the existing provisions of IRC section 411(b)(1)(H) and similar ADEA and ERISA prohibitions on reduction in the rate of benefit accrual because of the attainment of any age. To the extent that concerns such as these are viewed as more in the nature of legal concerns under the current statutory provisions than policy concerns, they could be addressed as part of a legislative package, such as that outlined here, that would protect older workers from the adverse effects of cash balance conversions. At the same time, such concerns can also reflect an underlying policy concern about the effects of cash balance plans and of legislation that might encourage them. However, given the scope of the Subcommittee's request for information, this submission does not attempt to address the debate regarding the policy merits and drawbacks of hybrid plans.

[8] Some contend that employee choice regarding such technical matters is less appropriate than grandfathering employees in the old formula to the extent it would provide a greater benefit at retirement. Under this view, permitting employees a choice at retirement amounts to little more than offering a choice between more money and less – an exercise that is either wasted motion or, in a few cases, unnecessarily risky. And offering employees a choice at the time of conversion presents an undue risk of unwise or uninformed choices, which can ultimately result in remorse and litigation to the detriment of both

Some employers have extended such grandfathering, “greater of” treatment, or choice to a specified class of individuals who participated in the traditional DB plan at conversion (e.g., only those who have reached a certain age and/or have completed a certain period of service as of the conversion). Variations of this view – reflected in various other corporate practices -- would require such protection to last only for a limited period of years.

Under these approaches, it is assumed that where the conversion is intended to reduce pension costs for the plan sponsor or to spread the benefits of the DB plan more broadly among the work force, the temporary transition relief for current employees will not prevent the sponsor from realizing those benefits in the long run, as the number of nongrandfathered employees grows while the number of grandfathered employees diminishes.

C. Preventing the Worst of Both Worlds

A different view is driven more by a recognition of the employer’s ability to freeze or terminate a DB plan, even a traditional one with a “backloaded” pattern of benefits, and by a concern about the impact on the private employer-sponsored pension system of beginning to require qualified plan sponsors to protect employee expectations of future benefit accruals. For some, however, this view is tempered by a concern about what is sometimes called the “bow tie effect”: the fact that a conversion can result in a smaller total benefit for an employee than if he or she had been covered by the cash balance plan for the employee’s entire career, because, during the early years of one’s career, the traditional DB might provide smaller benefits than the cash balance plan.

Thus, some would hold that even if it were impractical for the system to require converting employers to guarantee their workers the best of both worlds (the greater of the old and new formulas or a choice between them), it should at least require employers to protect their employees from the worst of both worlds. One method of preventing the “bow tie” effect is to establish an opening account balance equal to the present value of a hypothetically “reconstructed” cash balance benefit. This would be the benefit the employee would have earned before the conversion date had the cash balance formula covered the employee since he or she began work with the employer (assuming that amount exceeds the present value of the employee’s actual pre-conversion accrued benefit under the traditional DB plan). Alternatively, if the “sum-of” (A+B) method is being used, and if the present value of the A piece (the frozen old-formula benefit) is less than the hypothetically reconstructed preconversion cash balance benefit,

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employees and employers. In view of the risk of eventual litigation, the concern has been expressed that choice at conversion puts excessive pressure on the accuracy, comprehensiveness, and usefulness of the plan sponsor’s disclosures and any related assistance to employees. Choice also raises issues relating to the handling of plan amendments that take effect between conversion and retirement.

then the present value of the A piece might be increased to equal that reconstructed benefit.

D. Preventing Wearaway

“Greater-of” Approach. A related adverse effect of a conversion on employees is the extended suspension of new benefit accruals that can occur after a conversion when employees are promised the greater of an old-formula benefit that is frozen (because additional service is not earning employees additional benefits under that formula) and a new-formula benefit that is less generous but that does continue to grow with additional service. This so-called “wearaway” of the frozen old-formula benefit – whereby no new net benefits are being earned so long as the frozen old-formula benefit continues to exceed the growing new-formula benefit – can apply to the normal retirement benefit (typically the benefit payable at age 65) and to the early retirement benefit. In many cases, where the early retirement benefit is “subsidized” and hence is actuarially more valuable than the normal retirement benefit, the wearaway of the early will be potentially more costly to the employee than the wearaway of the normal retirement benefit.

Some would advocate requiring protection only to the extent necessary to prevent or to simply mitigate the wearaway – of either the normal and early retirement benefits or only the normal retirement benefit. (The December 2002 proposed Treasury regulations relating to cash balance plans and conversions would require converting plan sponsors to take steps to mitigate the wearaway of the normal retirement benefit.)

“Sum-of” or “A+B” Approach. This approach would formulate protections based generally on a policy that employers should be free to stop one plan formula and start another, but without offsetting the old benefits against the new – at least not in a way that particularly disadvantages older workers. Thus, the employer could be required to mimic the result that would obtain if it froze the traditional DB plan and adopted a new cash balance plan that provided benefits wholly unrelated to the old frozen plan benefits.

This would suggest a ‘sum-of” or “A+B” approach whereby employees’ normal and early retirement benefits after the conversion are equal to the sum of the normal or early retirement benefits they earned before the conversion under the old plan formula and the cash balance benefits they earn after the conversion. (This “sum-of” approach is contrasted with the “greater-of” approach described above, which promises employees the greater of an old-formula frozen benefit and a growing new-formula cash balance benefit.)

Recognizing Post-Conversion Compensation Increases. A variation would require the employer to increase the “A” element – the benefit earned under the old formula before conversion – to reflect post-conversion increases in compensation (though not post-conversion service). The rationale would be that, even if the employee is not grandfathered in the entire old formula such that it would continue to apply to service after the conversion, the final average pay feature of the old formula was a particularly key element of the employee's expectations that should be honored after the conversion. In addition, essentially indexing the pre-conversion benefit for inflation in this manner can help address the concern of those who believe that merely preventing post-conversion wearaway does too little to offset the harm to older employees.

Immediate Vesting. Another possible element would be to require full and immediate vesting of benefits (to the extent funded) upon the conversion. The rationale for this would be that the conversion, if likened to a freeze of one plan and establishment of another, has an effect similar to a partial termination of a plan that would require immediate vesting.[9]

Establishing Opening Account Balance to Prevent Wearaway of Normal Benefit. A variation on the "sum-of" approach would allow the employer, as an alternative, to establish an opening account balance under the cash balance formula that includes the full present value of the normal retirement benefit the employee had earned under the traditional plan formula before the conversion, and that grows as the employee earns cash balance pay and interest credits. Congress could require the present value to be calculated using actuarial assumptions that include the statutorily prescribed interest rate for determining present values of pension benefits. The advantage of this alternative to the "sum-of" is presentational simplicity: it presents the full normal retirement benefit, pre- and post-conversion, in a single format, as an account balance.

A major drawback, however, is that the opening account balance approach does not lend itself to preventing wearaway of early retirement benefits. (It also does not lend itself to recognizing the effect of post-conversion compensation increases on the traditional old-formula benefit.) Early retirement benefits under a traditional DB plan can be particularly valuable because they often are "subsidized" relative to the normal retirement benefit (i.e, the monthly or annual payment under the early retirement annuity is not reduced – or not reduced sufficiently -- to reflect the fact that it begins earlier and therefore is expected to make more payments than the age-65 annuity). Consequently, the opening account balance method needs to be supplemented by a contingent early retirement subsidy (the "pop-up" benefit described below).

"Pop-Up" Early Retirement Subsidy. An early retirement subsidy is a contingent benefit. Its value depends on whether and when the employee retires. An employee does not realize any early retirement subsidy if he or she terminates employment either before becoming eligible for it or after reaching normal retirement age. Consequently, the value of the subsidy is not readily captured in a post-conversion opening account balance. Attempts to do so,

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[9] Some have argued that conversions should be treated as plan terminations, triggering not only immediate vesting but also annuitization and excise and income tax on any surplus assets.

depending on how they are designed, tend to result in age discrimination, partial loss of benefits, and windfalls.

However, early retirement subsidies can be preserved on a contingent, "springing" basis. The plan keeps track of the subsidy under the old formula and prevents wearaway of the subsidy by adding it to the employee's total retirement benefit (under the old and new formulas) if and when the employee retires early and qualifies for it. This "pop-up" protection can be quite important to employees, although employers note that it comes at a cost in terms of presentational simplicity. It can also be combined with the use of an opening account balance that reflects the present value of the normal retirement benefit earned before the conversion.

E. Greater of "Sum-of" and "Greater-of".

Another variation would provide a normal retirement benefit equal to the greater of the benefit produced by the "sum-of" A+B method and the "greater-of" (opening account balance) method.

As noted,

- the "sum-of" method provides a total benefit equal to the sum of the frozen old formula pre-conversion benefit in the form expressed under the traditional plan ("A") and the new formula account balance resulting from annual post-conversion cash balance pay and interest credits ("B");

- the "greater-of" method provides a total benefit equal to the greater of the old formula frozen benefit and the new formula account balance, which in turn consists of an opening account balance equal to the present value of the pre-conversion benefit plus annual post-conversion cash balance pay and interest credits.

This prevents wearaway without the associated risk, under some circumstances, that the final benefit will be less than it would be under a "greater-of" approach.

F. "Straight-lining": Preventing Reduction of the Pre-Conversion Accrual Rate

Another view would stop short of requiring protection of employees' expectations of steadily increasing accrual rates under the traditional defined benefit plan, but would interpret the section 411(b)(1)(H) prohibition on reducing the rate of benefit accrual because of age as requiring a comparison of older and younger employees' rates of benefit accrual before and after the conversion. Instead of comparing a conversion to a freeze of one plan and fresh-start adoption of another, this approach would take the view that because the conversion is a plan amendment and the plan retains its defined benefit character, the conversion should be analyzed as a plan amendment under IRC section 411(b)(1)(H) to determine whether it reduces the rate of benefit accrual because of age.

To permit an "apples to apples" comparison for this purpose, one could take the present value of the traditional DB plan's pre-conversion rate of accrual and express it as an equivalent allocation rate (i.e., an equivalent DC plan contribution) or cash balance pay credit.

- For example, a conversion might provide a 5%-of-pay hypothetical cash balance contribution or pay credit to all employees, including an older employee who had an accrual rate under the traditional DB plan equivalent to a 12%-of-pay contribution and a younger employee who had an accrual rate under the traditional plan equivalent to a 4%-of-pay contribution.

Under this view, the conversion would have impermissibly reduced the rate of benefit accrual on account of age. Under such an interpretation, preventing age discrimination would not require grandfathering an older employee in his or her traditional DB benefit formula, including expected future increases in the rate of benefit accrual, but only in a pay credit equivalent to the employee's pre-conversion rate of benefit accrual. Literal adoption of such an approach would give rise to a host of issues, such as the practical complexity of maintaining many different age-sensitive pay credit rates and coordination with qualified plan standards designed to prevent discrimination in favor of highly paid employees.

<u>**G. Age- or Service-Weighted Pay Credits, Interest Credits, or Opening Balances**</u>.

A practice not uncommon among converting employers has been to provide for a tiered pay credit rate under the cash balance plan – a higher pay credit percentage for older (or longer service) employees than for younger (or shorter service) employees – though not necessarily as high as would be needed to equal the older worker's pre-conversion rate of accrual (see F, above).

Congress could, if it wished, borrow a leaf from these employers. A conversion could be treated as not age discriminatory if older employees receive sufficiently high and durable cash balance pay credits – defined by reference to the pre-conversion rate of accrual, younger employees' pay credits, or an absolute percentage of pay. Like other ameliorative measures, such an approach would need to be carefully crafted to avoid doing violence to age discrimination law generally. It also would need to be coordinated with qualified plan nondiscrimination policy and standards. Higher interest credits for older employees or additional amounts credited to their opening account balances might be designated as other permissible means of offsetting the adverse effects of the conversion, if meaningful equivalencies can be determined.

V. Conversion Safe Harbors

As noted earlier, Congress could prescribe minimum standards for protecting employees from the adverse effects of cash balance conversions by giving employers flexibility to choose among a specified array of "safe harbor" alternatives for designing protective arrangements.

In addition to defining safe harbors (which could be fleshed out through regulations once they were sufficiently described in the statute), Congress would need to determine how non-safe-harbor conversions would be treated. For example, one possible approach would be to provide that a conversion that does not satisfy any safe harbor is vulnerable to challenge as age discriminatory (i.e., it reduces the rate of benefit accrual on account of age in violation of the statutory provisions) and is not entitled to an IRS determination letter covering the age discrimination issue, unless the specific facts demonstrate otherwise. Another approach would be to provide that such a conversion is subject to a rebuttable presumption that it reduces the rate of benefit accrual because of age.

As noted, this submission is not intended to advocate or recommend a particular approach regarding the amount or type of conversion protection Congress should require. In other words, it is not intended to suggest to Congress where to set the bar.

Conversion safe harbors could be constructed from the methods or "building blocks" described above. By way of illustration, possible safe harbors might include provisions along the lines of the following:

1. **Full Protection of Expected Benefits**. One safe harbor could require protection of older or longer-service employees' old-formula benefit expectations, including expectations regarding future increases in the rate of benefit accrual. This protection could take the form of being (a) grandfathered in the old formula benefit, (b) given the greater of the old and new formula benefit at retirement, or (c) given a choice between the two formulas at retirement. See IV.B, above.

- If Congress thought it appropriate, it could limit the required protection to a particular class of employees defined by age or age and service and could limit the duration of the required protection.

2. **Preservation of Pre-Conversion Rate of Accrual**. A second safe harbor might treat a conversion as not reducing the rate of benefit accrual because of age if the plan provided age-weighted (or age- and service-weighted) pay credits based on the pay credit equivalents of employees' pre-conversion rates of benefit accrual. See IV.F, above.

- If Congress thought it appropriate, it could set the bar for age-weighted pay credits somewhat lower than – but taking into account -- the level required to make employees whole relative to their pre-conversion accrual rates. The legislation could, for example, define the level of credits required for older employees by reference to the pre-conversion rate of accrual, younger employees' pay credits, or an absolute percentage of pay. Congress might also allow other types of credits – such as one-time transition credits added to the opening account balance or interest credits -- to substitute for some or all of the higher pay credits, although the determination of rough equivalencies would not be straightforward. See IV.G, above.

3. **<u>"Sum-of" (A+B) Plus Early Retirement Subsidy Pop-Up and Compensation Updates to Old-Formula Benefit</u>**. A third safe harbor might be constructed by building on the anti-wearaway protections described in IV.D, above. Just as Congress, if it decided to seek a middle ground between competing interests, would have to determine how much to limit or subtract from the basic structure of the first two safe harbors (full grandfathering), it would similarly have to decide how much to build up or add to the basic structure of this third safe harbor (the "sum-of" approach to preventing wearaway).

Often, the two aspects of the traditional DB benefit formula that contribute most to the "backloaded" character of the plan are early retirement subsidies and the final average pay feature. If it wished to, Congress could partially offset the loss of these features by, for example, designing a safe harbor that begins with the "sum-of" (A+B) method and adds both an early retirement subsidy pop-up and recognition of post-conversion compensation increases in determining the value of the "A" element (the frozen old-formula benefit). See IV.D, above.

4. **<u>Enhanced Opening Account Balance Plus Early Retirement Subsidy Pop-Up</u>**. As an alternative to the "sum-of" approach, which starts with a zero account balance after the conversion, another safe harbor could permit use of the opening account balance method outlined in IV.D, above. Under that method, the cash balance account begins by including the full present value (determined using the statutory interest rate) of the employee's pre-conversion normal retirement benefit, and grows as the employee earns cash balance pay and interest credits.

As in the previous safe harbor, early retirement subsidies under the traditional plan would be preserved via an early retirement subsidy pop-up. However, since this single account balance (opening account balance) method does not readily accommodate recognition of post-conversion compensation increases in determining benefits, the employer might be required to increase the opening account balance by a specified percentage as a rough-justice substitute.

5. **Safety Valve Facts and Circumstances Determination**. As an alternative to using a safe harbor method, employers might be given further flexibility through a "safety valve" procedure allowing individual employers to make a "facts and circumstances" demonstration to the IRS that their conversion provisions are substantially as protective of older participants as at least one of the safe harbors or that, in any event, their conversion does not reduce the rate of benefit accrual because of age in violation of IRC section 411(b)(1)(H).

Any such safety valve option would likely impose heavy demands on IRS resources. Processing such an application would be a labor-intensive procedure requiring highly trained technical personnel, who are in short supply. Accordingly, access to such a determination would need to be, in effect, rationed. This could be done by appropriately limiting the eligibility conditions. In addition, a natural rationing process might occur as plan sponsors seeking such special determinations instead of complying with one of the safe harbors would be forced to wait in the queue and probably endure substantial delays. Of course such rationing would be justifiable only if the safe harbors were reasonable.

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As an additional cross-cutting requirement, converting employers, regardless of which safe harbor they are relying on, might be required to protect employees from the "worst of both worlds" situation described in IV.C, above, using the "reconstructed account balance" described there or an alternative method.

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A number of the potential arrangements described here can be viewed as methods of giving employees "half a loaf" – although the exact fraction that is or should be provided can be expected to be the subject of vigorous debate. If Congress wishes to find middle ground on this issue and strike a balance between the legitimate competing interests, these are tools it can use (in addition to other techniques not described here). As noted, however, it is not the purpose of this submission to suggest where Congress should strike its balance along the spectrum of possible requirements from fuller protection (as in H.R. 1677) to far more limited protection (as in the provisions of the December 2002 proposed Treasury regulations that would permit an opening account balance to be established using a "reasonable" interest rate and without seeking to protect early retirement subsidies from wearaway).

In addition, this outline does not attempt to be comprehensive. It does not address many of the other issues implicated by or relevant to a legislative approach to conversions (other rules governing cash balance plans, application of a legislative approach to other hybrid plans, coordination with rules prohibiting discrimination in favor of highly compensated employees and restricting backloading, financial accounting issues, etc.).

If further information would be helpful to the Subcommittee, I would be happy to provide it.