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CC:PA:LPD:PR (REG-114726-04)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, D.C. 20044

RE: Comments on Proposed Rules Regarding Distributions from a Pension Plan under a Phased Retirement Program

I appreciate this opportunity to provide comments regarding the proposed regulations regarding distributions from a pension plan under a phased retirement program.

I am owner and chief actuary of Piper Pension & Profit Sharing, an actuarial consulting and pension and profit sharing administration firm based in Culver City, California. We provide administration and actuarial services to approximately 300 clients who are small businesses and provide actuarial services to approximately 300 more small businesses who are clients of other administration firms. Currently I am a member of the Board of Directors of the American Society of Pension Professionals and Actuaries, and helped to write many of their comment letters during the period when I served on ASPPA's Government Affairs Committee. However, this letter is not written on behalf of ASPPA but is instead written on behalf of my own small business clients and their employees.

The essence of my comments is that with some necessary changes, the proposed rules could be a fine tool in the enablement of phased retirement programs to provide choice to employees. It is unfortunate that one part of the proposed rules, in its present form, appears to violate ERISA and current rules defining normal retirement age.

The Proposed Rules Need More Choice

The Treasury Department and the Service were asked to write a set of rules which would do the following: enable employees to gradually ease into retirement by having the freedom of choice to take a portion of their pension benefits so they could afford to work part-time for their current employer, and in the process preserve their health insurance and other employee benefits; and enable employers to keep valuable employees in their employ instead of being helplessly forced to let them quit to possibly work part-time for a competitor just to be eligible for early commencement of their pension benefits.

The rules which the Treasury Department and the Service have proposed, instead of being enabling, tend towards the restrictive. The first sentence of the first paragraph of the preamble to the proposed regulations says,

> As people are living longer, healthier lives, there is a greater risk that individuals may outlive their retirement savings.

The third paragraph of the proposed regulations says,

> However, phased retirement can also increase the risk of outliving retirement savings for employees who begin drawing upon their retirement savings before normal retirement age.

Later on it says,

> However, the proposed regulations would not permit payment to be made in the form of a single-sum distribution (or other eligible rollover distribution) in order to prevent the premature distribution of retirement benefits.

So, the Treasury Department, in its own words, has assumed the responsibility to protect participants in defined benefit pension plans from taking their benefits too soon, whether they want protection or not. The good news is that, if some changes are made to the proposed rules, it will be possible to branch off from the initial restrictive path and rejoin the main road of choice.

Ways to Enable the Current Proposals

In furtherance of the goal to protect participants, the proposed phased retirement rules set forth a set of parameters for deciding how much of an employee's pension he or she is able to take and when he or she can take it. There are tests to be performed annually which, if failed, may result in a reduction of the pension amounts already commenced. The lower limit on the phased retirement age of 59-1/2 reduces the universe of employees who might want to participate in a phased retirement program. There are also limits on the form of payment of the phased retirement benefits; specifically, no payments are allowed which could be rolled over into an Individual Retirement Account (IRA). In addition, the rules prevent certain Key Employees who are owners of the employer from participating in a phased retirement program.

First, the parameters leave an employee only the choice as to what reduction in hours or pay to negotiate with his or her employer. The reduction in hours or pay will determine how much phased retirement pension he or she will receive. If the combination of reduced pay and phased retirement pension do not satisfy the budgetary requirements of the employee, that is just tough luck for the employee. I suggest that the rules should allow more flexibility insofar as the amount of phased retirement benefit that should be allowed because that benefit is the property of the employee and the employee should have the choice. Of course the reduction in hours and/or compensation will have to be negotiated between the employer and the employee.

Second, the lower limit of age 59-1/2 was chosen to coordinate with both the minimum age for receiving distributions of 401(k) salary deferrals and the early withdrawal tax provisions of Code section 72(t) and. With respect to the former, distributions from profit sharing accounts (without 401(k) monies) are allowed by current rules to be disbursed at any age stated in the plan document. If the idea is to create consistency with the way employer provided monies are treated in defined benefit and defined contribution plans, then the age restriction should be lifted entirely. With respect to the IRC section 72(t) excise tax, while it is true that level in-service distributions from an employer plan would be subject to an excise tax until the participant attains age 59-1/2, that excise tax would **not** apply if the level distributions were being taken from an Individual Retirement Account (IRA).

This leads us to the third limitation, namely the only reason the employee is not able to escape the early withdrawal tax under 72(t) is because he or she is prevented from receiving a distribution in a form which can be rolled over into an Individual Retirement Account. Once the money is in an IRA, the employee would be able to receive level distributions over his expected lifetime not subject to the 72(t) early withdrawal tax regardless of age. So, if this restriction on the form of benefit is removed, the justification for the restriction on the phased retirement age disappears and the employee would have greater choice and control over his or her retirement benefits.

Fourth, the most likely reason for preventing certain Key Employees who are owners of the employer from participating in a phased retirement program is so that small employers will not take advantage of them. This makes no sense. If a 100% owner of a business wants his pension benefits, he can terminate the plan. So he might as well be eligible for a phased retirement and be able to continue the plan for the other employees. Even worse, if, for example, a 5% owner of a law firm would like to participate in a phased retirement program, he will, under the proposed rules, be unable to do so. He will most likely leave the law firm and join another, taking his clients and "rain-making" ability with him. Both he and the law firm he leaves will be worse off. A broader vision is needed here: the final rules should treat all employers and employees alike and not discriminate against small employers and employees of small employers.

Other Technical Changes Which Are Needed

The proposed rules require that the hours of service credit for the accrual of benefits should be pro-rated for years during the phased retirement period. First, this must be part of the plan's written document and should be at the election of the employer. Perhaps the employer wants to provide the full accrual if the employee works 1,000 hours or more. Second, if the only reason the employee falls below the 1,000 hour threshold is the reduction of hours due to the phased retirement agreement, then there should still be an accrual, perhaps the partial accrual credit envisioned by the proposed regulations. Third, there may be contradictions with the accrual rules in both Treasury and Department of Labor regulations if the plan uses the 1,000 hour rule and the employer wants to reduce the service credit for an employee who reduces his hours from, say, 2,000 down to 1,500. This may not be a problem, though, if the plan uses the accrual rule that reduces accruals for hours less than 2,000.

Next, there are contradictions and ambiguities introduced by the requirement that a participant under a phased retirement program remain considered a highly compensated employee even if his or her reduction in compensation under such program would cause the employee to no longer meet the criteria for highly compensated employee. While this requirement can be considered reasonable for phased retirement purposes to avoid the misuse of multiple phased retirement benefits, it is not so for general discrimination purposes or ADP and ACP testing. Keep in mind that regardless of any phased retirement program, the employer could reduce the compensation for the employee and also increase his or her pension benefits so that the employee is not the loser; then the employee would automatically drop out of HCE status. But better than the practical demonstration is the policy reason is that by the reduction of hours/compensation, the employee has become less of a threat to provide discriminatory influence over the benefits and operation of the plan. After all, the threat of discriminatory influence was the reason a compensation threshold for HCE was imposed in the first place. Once the employee has fallen under the compensation threshold, he or she has almost certainly become less important to the operation of the employer and, hence, has probably taken on more of the attributes of a "rank-and-file" employee than of a favored employee.

Economic Policy

Let us consider the proposed rules from an economic point of view, namely how they might affect the allocation of valuable employees throughout the workforce, keeping in mind that the allocation of scarce and valuable resources is most efficient when choice is made at the lowest possible level rather than by a central bureaucracy.

Pretend that you are an employer who is going to create a tax qualified plan to which you are going to make a contribution of 5% of compensation. Do you sponsor a defined benefit pension plan from which it will be difficult for employees to take their money when they decide they need it and which is difficult for them to understand, or do you create a 401(k) plan from which they can take their money when they decide they need it and which is easy to understand?

As either President Bush or Milton Friedman might say, the essence of Freedom is economic **choice**. Choice should be at the core of the phased retirement rules. The most efficient way for these rules to work is to leave as much of the choice as possible to the employees and the employer, creating a minimal level of testing for nondiscrimination under Code section 401(a)(4) and protection of accrued benefits under Code section 411(d)(6).

Essentially, the rules should move towards providing the same level of employee and employer choice found in defined contribution plans.

Normal Retirement Age – the Law, Prior Guidance, and the Proposed Rule

Treasury appears to be convinced that some employers have set the normal retirement age lower than ERISA envisioned. The proposed regulation 1.401(a)-1(b)(1)(i) says:

> However, normal retirement age cannot be set so low as to be a subterfuge to avoid the requirements of section 401(a), and, accordingly, normal retirement age cannot be earlier than the earliest age that is reasonably representative of a typical retirement age for the

covered workforce.

The fundamental problem with this proposed regulation language is that it is contrary to the interpretation of ERISA taken by the Treasury Department and the IRS in Revenue Ruling 78-120 which says:

> Rev. Rul. 71-147, 1971-1 C.B. 116, provides that the normal retirement age in a pension or annuity plan is the lowest age specified in the plan at which the employee has the right to retire without the consent of the employer and receive retirement benefits based on service to date of retirement at the full rate set forth in the plan. Ordinarily, the normal retirement age under pension and annuity plans is age 65. Rev. Rul. 71-147 also states that a different age may be specified, provided that if it is lower than 65 *it represents the age at which employees customarily retire in the particular company or industry* and is not a device to accelerate funding.
>
> In view of the definition of normal retirement age found in section 411(a)(8) of the Code, and in the absence of any statutory prohibition or limitation, *a plan may specify any age that is less than 65 as the normal retirement age*. However, if the normal retirement age specified in a plan is less than 55, and the retirement benefit under the plan begins before age 55, then for purposes of determining whether the benefit exceeds the maximum amount payable under section 415(b)(1)(A), the limit under section 415(b)(1)(A) would be adjusted in accordance with section415(b)(2)(C) .
>
> Accordingly, a pension or annuity plan will not fail to qualify under section 401(a) of the Code merely because it provides for a normal retirement age of less than 65. However, retirement benefits commencing prior to age 55 may not exceed the maximum amount payable under section 415(b)(1)(A) after such benefits are adjusted pursuant to section 415(b)(2)(C). [Emphasis added.]

The position taken by the proposed regulation on normal retirement age is the same position taken by Revenue Ruling 71-147 before the passage of ERISA. Revenue Ruling 78-120 said that ERISA changed the law and therefore, post-ERISA, there is no restriction on how low normal retirement age can be set.

If, pre-ERISA, the regulation contained the proposed language, it would make sense under the position in Revenue Ruling 78-120 for the Treasury Department and the IRS to remove the language from the regulation. Instead, we find a post-ERISA insertion of pre-ERISA law into a pre-ERISA regulation without a post-ERISA change in law.

Other questions left unanswered by the proposed regulation which would need to be answered in order to apply any rules in practice are:

1. If certain low normal retirement ages are a subterfuge to avoid the requirements of section 401(a),

   a. What requirements of 401(a) are being avoided?

   b. What is a subterfuge?

2. What is "retirement"?

   a. Is it separation from service?

   b. Is it separation from service without subsequent employment?

   c. Is it separation from service without subsequent employment in the same industry?

   d. Is it merely the commencement of retirement benefits?

One last comment is that it appears that small plans and plans of professional employers are being picked on again because they usually have no actual retirement experience from which to derive a statistical analysis. A revisit of the IRS argument to the Tax Court in Citrus Valley et al v Commissioner reveals a similar "statistical" position taken with respect to the assumption of retirement age for funding purposes. The Tax Court, Federal Court, and three courts of appeal all found against the IRS on this issue and deferred the choice of the assumption of retirement age for funding purposes to the enrolled actuary. Similarly, the choice of normal retirement age should be left to the employer, absent any subterfuge.

If the Treasury Department and the Service believe that some very low normal retirement ages violate the law, then the net the rules cast must be spaced wide enough to catch only the particular violators and not so narrow as to catch the plans with legitimate normal retirement ages, such as those with normal retirement age 55 or higher.

Conclusion

Overall, the proposed phased retirement rules are a good start. They need to provide more choice in order to make defined benefit pension plans more competitive versus 401(k) and other defined contribution plans in the marketplace. In all honesty, defined benefit pension plans need all of the help they can get from every branch of the Federal Government to be competitive in the marketplace or else they might all disappear. Even government defined benefit pension plans might be replaced by 401(k) plans if the trend promised by Governor Schwarzenegger of California continues.

It is in the interest of all parties to help defined benefit pension plans by making them as flexible to employee and employer choice as possible. Without sufficient choice within the defined benefit pension plan rules, employees and employers will choose 401(k) plans instead. Providing maximum employee and employer choice with phased retirement programs would be a step in the right direction, the direction of choice.

Piper Pension & Profit Sharing
If you have any questions, please feel free to call.

Sincerely,

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Owner & Chief Actuary