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IRS Issues Proposed Regulations on Hybrid Plans

On December 27, 2007, the IRS issued proposed regulations on provisions in the Pension Protection Act of 2006 affecting primarily cash balance and other hybrid defined benefit plans. The regulations are proposed to be effective on January 1, 2009 (or as late as January 1, 2010 for collectively bargained plans), but employers may rely on them in the interim. The proposed regulations generally build on preliminary guidance provided by the IRS last year in Notice 2007-6, but leave some key questions unanswered. Comments will be accepted until March 27, 2008.

Background

The Pension Protection Act of 2006 (PPA) clarifies that hybrid plan designs (i.e., cash balance and pension equity) are not inherently age discriminatory, and introduces a safe harbor test that hybrid plans and other defined benefit plans can use to satisfy the age discrimination rules. The PPA hybrid provisions further provide that lump sum distributions equal to current account values are sufficient to avoid prohibited forfeitures. PPA also places limits on interest credits, requires hybrid plans to provide full vesting after three years of service and imposes transition requirements on conversions from traditional defined benefit plans to hybrid plans.

In Notice 2007-6, the IRS provided transitional guidance on some PPA provisions related to hybrid plans and requested comments. (See our January 15, 2007 *For Your Information* and Buck's comment letter on Notice 2007-6.)

The IRS has now issued proposed regulations providing additional guidance on PPA provisions affecting hybrid plans. However, the proposed regulations raise some concerns and do not address certain key issues.

Highlights of Proposed Regulations

The proposed regulations (including the preamble) provide the following guidance.

Hybrid Plans and Formulas. Notice 2007-6 introduced the term "statutory hybrid plan" to describe plan designs that are required to follow the rules for "applicable defined benefit plans" under PPA. The notice also introduced the terms "lump sum based plan" (i.e., cash balance and pension equity) and "similar effect" plans (i.e., other plans that have characteristics that warrant being treated as statutory hybrid plans). The proposed regulations introduce more terms, including "statutory hybrid benefit formula" and "lump sum based benefit formula" in order to accommodate situations where a plan has both traditional and hybrid formulas and to distinguish between the

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two types of statutory hybrid benefit formulas – lump sum based formulas (e.g., cash balance and pension equity) and other formulas that have a "similar effect."

> ***BUCK COMMENT.*** *One important distinction between lump sum based benefit formulas and similar effect formulas is that plans with lump sum based formulas may pay lump sums equal to employees' account balances whereas plans with similar effect formulas must pay lump sums using the present value rules under Section 417(e).*

Status of Plans that Index Benefits. PPA includes provisions for defined benefit plans that index benefits during employment in the context of the new safe harbor for satisfying age discrimination requirements (see below). Notice 2007-6 indicated that certain types of these plan designs would be treated as "similar effect" statutory hybrid plans. Under the proposed regulations, annuity based plans that index benefits before they commence, such as indexed career pay plans, generally would be considered statutory hybrid plans and thus would be subject to the hybrid plan rules. A variable annuity plan would be exempt from the statutory plan rules if the plan's benefit adjustments are based on the rate of return on the plan's assets (or the change in a specified market index) above the plan's specified "assumed interest rate" (AIR), but only if the AIR is at least 5%.

> ***BUCK COMMENT.*** *Some existing variable annuity designs, many of which have been in effect for decades, would not satisfy the exemption because they have an AIR below 5%. Apparently, these plans would become subject to the PPA hybrid plan rules, in particular, the "preservation of capital" rule – i.e., the requirement that aggregate indexation (or investment earnings) not fall below zero.*

Safe Harbor Test for Age Discrimination. PPA provides a new safe harbor test that can be used to demonstrate that any defined benefit plan, not just a hybrid plan, satisfies the requirement that its rate of benefit accrual is not reduced on account of the attainment of any age. Under the proposed regulations, a plan satisfies this safe harbor if the employee's "accumulated benefit" is not less than the corresponding amount of any similarly situated, younger individual who is, or could be, a participant. The proposed regulations provide that in order to use this test, the plan must describe its accumulated benefit either as an annuity payable at normal retirement age, a hypothetical account balance, or the current value of an accumulated percentage of final average compensation. This test may not be used if it would be necessary to compare benefits expressed in different terms. However, if the plan's benefit is expressed as the sum of, or the greater of, amounts expressed in different terms, the test will be satisfied if each of the different accumulated benefit types separately satisfies the test.

> ***BUCK COMMENT.*** *Some plan designs may not be able to satisfy this safe harbor because participants are covered under different benefit formulas that are not strictly "sum of" or "greater of." The proposed regulations include an example of a plan that provides cash balance benefits for employees under age 55 and traditional benefits for employees age 55 or over, indicating that such a design would not be eligible for the safe harbor. A conversion that provides cash balance benefits to certain employees and continues the prior traditional benefits for certain other employees (or that provides a choice for certain employees to remain under the prior formula) would appear to be ineligible for the safe harbor.*

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The proposed regulations indicate that in order for a plan (other than one with a lump sum based formula) that provides pre-retirement indexing (e.g., an indexed career pay or variable annuity plan) to be eligible to use the age discrimination safe harbor, indexing must be based on one of the following: (1) an eligible cost-of-living index, (2) the rate of return on the aggregate assets of the plan, or (3) the rate of return on an annuity contract providing the plan benefits.

> ***BUCK COMMENT.*** *This limitation on indexing stems from the PPA requirement that indexation be based on a "recognized investment index or methodology." The methods considered acceptable in the proposed regulations would push some plan designs out of the safe harbor – e.g., a variable annuity plan that indexes benefits based on an outside index or the return on only a portion of the plan's assets.*

Any defined benefit plan that does not satisfy the safe harbor (or that is ineligible to use it) will need to resort to the general rule in Section 411(b)(1)(H)(i) – i.e., that the rate of an employee's benefit accrual not cease or reduce because of the attainment of any age – which was unchanged by PPA.

> ***BUCK COMMENT.*** *IRS regulations issued in 1988 provided only limited guidance in applying the general rule, and it seems unlikely that the IRS will supplement that guidance any time soon (or ever). The outcome of the* Cooper v. IBM *cash balance litigation which focused on Section 411(b)(1)(H)(i), and similar decisions by two other U.S. Courts of Appeal, should provide some comfort to employers in this regard. However, these age discrimination claims continue to be litigated in other circuits and the cases already decided address only certain kinds of plan designs. Therefore, it is important that final regulations expand the safe harbor to accommodate as many kinds of plan designs as possible.*

Interest Crediting. PPA requires that interest credits under a cash balance plan not exceed a "market" rate of return. The IRS indicated in Notice 2007-6 that any of the safe harbor rates included in Notice 96-8 as well as corporate bond rates used for minimum funding (the "third-segment" rate in the new PPA funding rules) will be deemed to satisfy the market rate limitation. The proposed regulations reiterate the acceptability of these rates and also indicate that rates should be reset at least annually.

The proposed regulations provide that plans with variable interest credits must specify a "lookback" month and a "stability" period for determining interest-crediting rates. The rules for setting lookback months and stability periods are the same as for determining lump sum interest rates under Section 417(e), although the lookback month and stability period do not have to be the same as those used for Section 417(e). For example, assume that lump sum distributions in the first quarter of 2007 were determined using the November 2006 30-year Treasury bond rate (i.e., the plan uses a quarterly stability period and a lookback month that is two months before the stability period begins). Assuming that interest credits are also based on 30-year Treasury bond rates, it would be acceptable under the proposed regulations to determine interest credits for all of 2008 (calendar year stability period) based on the 30-year Treasury bond rate for September 2007 (lookback month of the fourth month preceding the beginning of the stability period).

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> ***BUCK COMMENT.*** *It is not clear whether plans that have to be amended to satisfy this timing requirement can simply switch to an acceptable basis without having to grandfather the existing basis in some way (for example, by determining the interest crediting rate as the greater of the rates on the old and new bases for the one-year period following the amendment).*

The proposed regulations indicate that if interest is credited more frequently than annually, the interim rates for a given year must be determined using simple interest based on the annual rate for the year. For example, if the annual rate is 6% and rates are credited monthly, the monthly rate must be 0.5% (i.e., 6% divided by 12). The effective annual rate in this example would be 6.17%, which exceeds the nominal 6% rate determined for the plan year. The proposed regulations indicate that this differential will not cause a plan to violate the market value limitation.

> ***BUCK COMMENT.*** *A sponsor in this situation could amend its plan to reduce the annual crediting rate such that all interest crediting is the same as under the current plan. In the above example, the plan would state the annual rate as 5.84% rather than 6%, resulting in monthly rates of 0.487% (5.84% divided by 12), or an effective annual rate of 6%.*

In the preamble to the proposed regulations, the IRS affirms that plans could credit interest using market rates of return that may be negative in some years, subject to the preservation of capital rule. The proposed regulations clarify that the preservation of capital rule is applied only at the participant's annuity starting date.

> ***BUCK COMMENT.*** *The preamble indicates that it should be acceptable to use the plan's own rates of return as the interest crediting basis (subject to the preservation of capital rule), but casts doubt as to whether certain other bases would be acceptable, particularly returns on funds or indices that are not well diversified. The preamble also indicates that application of a preservation of capital rule earlier than the employee's annuity starting date (e.g., annually) would be problematic since it is likely to result in interest credits that significantly exceed market returns.*

The proposed regulations provide a narrow exception to the ERISA anti-cutback rules (i.e., a prohibition on amendments that reduce already accrued benefits) for changes in a plan's method for determining interest credits. (Reducing a plan's interest crediting basis on existing account balances through a plan amendment would ordinarily be considered an impermissible reduction in accrued benefits to the extent that interest credits are guaranteed – i.e., are not contingent on continued employment.) Specifically, changing from one of the Notice 96-8 bases (e.g., 30-year Treasury bonds) to the third-segment corporate bond rate (as defined in the PPA plan funding rules) would be deemed not to constitute a cutback because it is expected that the new rate will generally exceed the old rate. The IRS left open the possibility that certain other changes to the plan's interest crediting basis may be considered not to violate the anti-cutback rules.

> ***BUCK COMMENT****. It seems likely that final regulations will provide anti-cutback relief for changes in interest crediting bases that are required to satisfy the new market value restrictions.*

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The proposed regulations do not address how to handle plans that currently provide interest credits by reference to the Section 417(e) rates used for determining minimum lump sums in annuity-based plans. Rather than indicating that the interest credit in a given period is the 30-year Treasury bond rate then applicable, such a plan indicates that the interest credit rate is the rate applicable under Section 417(e) in the given period. A sponsor in this position may prefer to retain the 30-year Treasury bond rate to credit interest or to use a rate that is not strictly based on the new PPA Section 417(e) basis (which reflects three corporate bond rate segments and is being phased in over five years). The question is whether they could do so now without violating the anti-cutback rules

The preamble discusses other, unresolved, key issues with respect to the market rate of return limitation and invites suggestions. One key unresolved area relates to the PPA provision that permits a hybrid plan to include a reasonable fixed interest rate, either as a stand-alone rate or as a minimum together with a variable interest rate. The preamble indicates that final regulations may permit a fixed interest crediting rate no higher than 4% or 5% and a fixed minimum rate no higher than 3% or 4% when used in combination with one of the safe harbor interest credits (e.g., rates based on 30-year Treasury bonds or third-segment corporate bonds).

BUCK COMMENT. *The IRS is clearly concerned about the extent to which employers can provide generous fixed rate credits or minimum credits. For example, the proposed regulations indicate that providing interest credits equal to the greater of two safe harbor rates (e.g., the greater of 30-year Treasury bond yields and the third-segment corporate bond yields) would likely produce rates that exceed the market value limitation. We believe that the IRS concerns can be addressed in relatively straightforward ways, including specification of new safe harbors in the final regulations.*

Assuming the preamble maximum rates are adopted in the final regulations, sponsors of existing cash balance plans that contain fixed rate credits or fixed rate minimums that are excessive (above 5% or 4%, respectively) would have to reduce their fixed rates. Hopefully, the final regulations will provide anti-cutback relief for any required changes.

Three-Year Vesting. PPA provides that hybrid plan benefits are subject to three-year vesting (as compared to five-year vesting or an alternative graded scale for other defined benefit formulas). The proposed regulations indicate that PPA's three-year vesting requirement is to be applied on a participant-by-participant basis for plans that provide both traditional and hybrid benefits. Importantly, the accelerated vesting would apply to a participant's entire accrued benefit if any portion of the total benefit was or could ever be provided under the statutory hybrid benefit formula. A plan that provides employees with the greater of the benefits under traditional and statutory hybrid benefit formulas would have to subject an employee's entire benefit to three-year vesting even if the traditional benefit formula would produce the higher benefit.

BUCK COMMENT. *An employee who is given a choice to remain under the prior traditional formula or to be covered under the new hybrid formula and elects to remain under the traditional formula apparently would not be subject to the accelerated vesting.*

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The proposed regulations do not address whether accelerated vesting would apply to participants who have no hours of service with the employer after 2007. A technical corrections bill now being considered by Congress has a provision clarifying that the accelerated vesting applies only to participants with hours of service after 2007.

Conversions from Traditional to Hybrid Plans. One of the principal concerns that led to the hybrid plan provisions of PPA was the potential for "wearaway" when a plan is converted from a traditional benefit formula to a hybrid formula that includes opening account balances. A wearaway effect occurs when, after the conversion, some or all employees do not accrue additional benefits for a period of time because the value of the legally protected minimum (i.e., the accrued benefit under the traditional formula as of the conversion date) exceeds the employee's account balance. PPA essentially outlawed wearaway by mandating, as a minimum, the "A+B" transition approach, where Part A is the frozen accrued benefit under the pre-PPA formula as of the conversion date, and Part B is the cash balance benefit with no opening balance.

The proposed regulations clarify that under the minimum A+B transition approach, any early retirement subsidies associated with a prior traditional plan benefit are to be included in the Part A benefit rather than in the Part B benefit.

BUCK COMMENT. *This is a welcome clarification of an ambiguous PPA provision, since it would be awkward to include an early retirement subsidy in a cash balance account.*

The proposed regulations introduce an "opening balance" alternative to the minimum A+B conversion approach. However, if opening balances are provided, the plan would have to assure that the benefit attributable to the opening balance is at all future dates not less than the benefit provided from Part A.

BUCK COMMENT. *This opening balance alternative is essentially the "extended wearaway" approach that some employers adopted in past conversions. The preamble indicates that the IRS will consider other opening balance approaches that might permit an employer to forego having to perform the special minimum calculations in future years.*

The proposed regulations indicate that a conversion is deemed to occur with respect to a participant if and when that participant's traditional benefit accruals are reduced or eliminated and replaced with hybrid formula accruals. A conversion could therefore be deemed to occur for a participant because of a change in employment status or in connection with a business transaction. The proposed regulations indicate that multiple plan amendments within a three-year period will be consolidated for purposes of determining whether a conversion is deemed to occur. If the amendments occur more than three years apart, there is a presumption that the amendments are not consolidated unless, under all the facts and circumstances, it was the employer's intent at the time of the first amendment to adopt a hybrid formula.

BUCK COMMENT. *An IRS concern here is that an employer could freeze accruals in its traditional plan formula and then introduce cash balance provisions a year or two later using a "wearaway" transition*

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approach, thereby circumventing the minimum "A+B" conversion requirements of PPA. While the conversion provisions of PPA apply to conversions occurring after June 29, 2005, an open question is whether the PPA conversion restrictions apply to an employee who becomes covered after June 29, 2005 (e.g., through a transfer to employment status covered by the plan) under hybrid provisions that were adopted before June 30, 2005.

There also may be an issue for a plan that converted before June 30, 2005 that provided for some or all participants the greater of the ongoing prior plan benefit and the new hybrid benefit but only for a fixed period of time (e.g., 10 years). The proposed regulations might be interpreted to deem the conversion to occur for affected participants when that 10-year period ends, which, in turn might require that the A+B minimum begin applying at that date (rather than when the original conversion amendment became effective, or not at all if such original date was before June 30, 2005).

Minimum Lump Sum Distributions. PPA eliminated the prospect that cash balance plans may have to pay lump sums that exceed the current value of the employee's hypothetical account balance because of a special "whipsaw" calculation. The whipsaw calculation, as set forth in IRS Notice 96-8, involves projecting the account to normal retirement age, converting the projected amount to an annuity, and discounting the annuity payments to a lump sum present value using Section 417(e) assumptions. The proposed regulations reiterate the provision in Notice 2007-6 that it is acceptable for plans that include a whipsaw calculation to cease using it with respect to future lump sums (with the possibility of having to provide a notice at least 30 days in advance if the change requires an ERISA Section 204(h) notice).

BUCK COMMENT. *Although the IRS indicated in Notice 2007-6 that it would provide guidance soon on the effective date of the elimination of whipsaw, guidance on this point is not included in the proposed regulations.*

The PPA effective date language indicates that distributions made after August 17, 2006 from a cash balance plan equal to the employee's account balance will be adequate. The question is whether that language precludes the imposition of retroactive whipsaw for plans that did not comply with Notice 96-8 (because to impose whipsaw now would require post-August 17, 2006 distributions in excess of employees' account balances).

IRS agents have been raising the prospect of retroactive whipsaw in recent determination letter reviews. Even plans that credit interest using a rate that satisfies a safe harbor in Notice 96-8, but that have a modest fixed minimum credit (e.g., 3%), are being asked to introduce a whipsaw calculation. We find this development troublesome.

Pension Equity Plans. PPA indicated that hybrid designs other than cash balance, particularly pension equity designs, are generally subject to the same rules as cash balance designs, but left it up to Treasury to indicate how the rules apply. The proposed regulations provide little guidance on how the PPA hybrid provisions affect pension equity designs, but do raise several questions and seek input from interested parties.

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Other Key Items Not Addressed. The proposed regulations do not address two other areas where guidance is needed – rules for converting account balances to annuities, and the application of the anti-backloading rules to "greater-of" plan designs.

Many sponsors who wanted to provide conversion bases that encourage annuities, while still allowing lump sum distributions, have refrained from doing so because they were concerned that doing so might trigger a whipsaw effect on the lump sum distributions.

> ***BUCK COMMENT.*** *If the IRS intends to introduce limitations on annuity conversions, sponsors need to know what they are as soon as possible. We have heard informally that the IRS is inclined to impose restrictions such as requiring Section 417(e) lump sum assumptions for converting accounts to annuities.*

A common approach used by plan sponsors in transitioning to a hybrid plan is to provide some or all employees with the greater of (1) the benefit under the prior traditional formula (assuming it had continued for a specified period or indefinitely), and (2) the benefit under the new cash bash balance formula (with opening balances). In recent determination letter reviews, the IRS has taken the position that the interaction of the two formulas can cause a violation of the 133-1/3% anti-backloading test (i.e., the rate of accrual in a year cannot exceed by more than one-third the rate of accrual in any prior year).

> ***BUCK COMMENT.*** *The IRS position would limit the ability of future sponsors of hybrid plans to provide valuable grandfather provisions, and calls into question prior conversions that benefited many older employees. Buck submitted a comment letter to key Treasury and IRS officials, spelling out why the IRS interpretation is inappropriate and unnecessary and urging them to reverse that position. We understand that the IRS intends to issue guidance in the near future on this issue. In the meantime, plans under review where the greater-of approach was used are again being held up.*

Conclusion

The proposed regulations represent a good start in interpreting the PPA hybrid provisions. However, in some important respects, we think the proposed regulations include unnecessary restrictions that would likely discourage the adoption and maintenance of hybrid plans. We believe that Congress, in passing PPA, sent a strong signal that defined benefit plans continue to be an important source of retirement income and that hybrid plans are an acceptable form of defined benefit plan. Buck intends to submit comments on the proposed regulations and we encourage all interested parties to express their views as well. Buck's consultants would be pleased to discuss these proposed regulations with you.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.

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