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IRS Proposed Regulations Would Encourage Generosity in Cash Balance Conversions

The IRS has issued proposed regulations that would clarify how defined benefit plans, especially hybrid plans, that provide a benefit calculated as the greatest of benefits under separate formulas would satisfy the ERISA anti-backloading rules. Generally, the proposed regulations would permit such "greater-of" plans to satisfy a backloading test by testing each formula separately. This is the same relief offered in Revenue Ruling 2008-7 and is generally helpful to employers who want to convert to cash balance designs while providing more than the required transitional benefits to older employees.

Background

ERISA and the Internal Revenue Code contain minimum vesting requirements for defined benefit plans, including anti-backloading provisions, to prevent the undue deferral of benefit accruals. The simplest and most commonly used approach to satisfying the anti-backloading requirements, especially for hybrid plans, is to demonstrate satisfaction of the "133-1/3% rule" under which the rate of accrual in any plan year is generally not more than 133-1/3% of the rate of accrual in any previous plan year.

At issue is how the 133-1/3% rule is to be applied when the plan provides a benefit that is the greatest of the benefits calculated under more than one formula. The IRS position – that all formulas have to be aggregated for this purpose – often leads to the absurd result that a generous frontloading of benefits appears to be prohibited backloading. For example, a plan that provides a benefit of $20 per month per year of service easily satisfies the 133-1/3% rule. However, if the plan also provides a minimum benefit of $100 per month (i.e., the plan benefit is the greater of $20 per year of service or $100), the plan would arguably fail the 133-1/3% rule. This is because $100 accrues in year 1, no benefit accrues in years 2 to 5 (where the benefit stays at $100), and a benefit of $20 accrues in years 6 and later. Therefore, the ratio of the accrual in years 6 and later to the accrual in any of years 2 to 5 is greater than 133-1/3%.

The IRS has been raising exactly this issue in determination letter requests when a cash balance conversion includes a minimum benefit equal to continued accruals under the prior traditional plan formula.

In reaction to comments from Buck and other interested parties, as well as key members of Congress, the IRS issued Revenue Ruling 2008-7 (see our February 8, 2008 *For Your Information*), which indicated that the IRS would not raise this backloading issue with respect to most pre-2009 conversions. The Treasury and IRS also indicated their intent to issue permanent regulations addressing the greater-of issue.

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Proposed Regulations

The proposed regulations reiterate the IRS position that all plan formulas must be aggregated but would provide a limited exception effective for plan years beginning on or after January 1, 2009. Under the exception, a plan that provides a benefit that is the greatest of benefits calculated under more than one formula would be deemed to satisfy the anti-backloading rules if it met the following conditions –

- **Each formula applies a "different basis" for determining benefits.** The proposed regulations do not spell out the meaning of "different basis" but they do provide two examples. One example shows a plan where one formula is based on final average pay and an alternative formula is based on career average pay. The second example shows a final average pay formula and a cash balance formula. If the plan has three or more greater-of formulas, formulas on the same basis must be aggregated.
- **Each formula must separately comply with the 133-1/3% rule.** The exception only applies to the 133-1/3% rule. If any of the multiple formulas must rely on another rule (the "fractional rule" or the "3% rule"), then the exception is not available. This represents a step backwards from Revenue Ruling 2008-7 which permitted each formula to separately satisfy any of the three anti-backloading rules.
- **The arrangement is not abusive.** The IRS is granted authority to deny separate formula testing if it finds the plan is structured to evade the general requirement to aggregate formulas. For example, if the difference among the bases is trivial, the IRS may deny the plan authority to demonstrate compliance through separate formula testing.

Open Issues

The proposed regulations do not address some significant open issues.

Effect on Age Discrimination Rules. In response to complaints from groups representing older workers, the Pension Protection Act of 2006 (PPA) specifically prohibited "wearaway" (a period after an amendment where no benefits accrue) in cash balance conversions after June 29, 2005. The preamble to the proposed regulations specifically notes that the proposed regulations do not address age discrimination and the IRS will not address the application of the age discrimination rules to conversions before that date. However, the preamble confirms the position taken in Revenue Ruling 2008-7 that there is no backloading issue in a pure wearaway conversion before the effective date of PPA – i.e., where the prior plan benefit is frozen and, as required by law, is applied as a minimum against the ongoing cash balance benefit.

Whether the 133-1/3% Rule is Design Based. There remains no guidance indicating that the 133-1/3% rule is a design-based test and not an operational one. This leaves a cash balance plan using a variable interest crediting rate exposed to a finding that impermissible backloading occurred because of a dip in the rate applied under the plan.

Use of Fractional Rule. The proposed regulations do not indicate how a hybrid plan could use the fractional anti-backloading rule (an alternative to the 133-13% rule). Revenue Ruling 2008-7 indicated that the fractional rule was available to cash balance plans but gave no hint about how it should be applied. Practitioners have occasionally used the fractional rule but with little uniformity.

Effective Date Issues. The proposed regulations would be effective for plan years beginning on or after January 1, 2009, while Revenue Ruling 2008-7 provided similar relief for earlier plan years. However, the preamble to the proposed regulations notes that the relief provided in Revenue Ruling 2008-7 does not apply for purposes of the anti-backloading provisions of ERISA while the relief provided by the proposed regulations applies to the anti-backloading provisions of both the Internal Revenue Code and ERISA.

Comments

Comments on the proposed regulations are due by mid-September, 2008 and a public hearing is scheduled for October 15, 2008. The preamble asks for comments on how the regulations could be clearer, and specifically asks for comments on how final regulations could provide a broad rule permitting front-loading of benefit accruals. Buck plans to submit comments.

Conclusion

The proposed regulations provide useful guidance for employers who wish to convert their traditional plans to cash balance while providing more than minimal transition relief. We anticipate that final regulations will clarify several outstanding related issues. Buck's consultants are ready to assist you in reviewing how the proposed rule would affect your existing or prospective plan design.