CLIENT ACTION BULLETIN

January 18, 2008 **CAB 08-02**

IRS Proposes Rules for Cash Balance and Other Hybrid Pension Plans

SUMMARY

The IRS has published proposed regulations providing guidance on the Pension Protection Act's (PPA) minimum vesting standards and benefit accrual requirements applicable to "cash balance" and other hybrid defined benefit plans. The proposed rules refine the IRS's previous transitional guidance on testing for age discrimination, vesting, protection of participants' accrued benefit values after a conversion from a traditional defined benefit plan formula ("conversion protection"), and market rates of return. The IRS intends for the newly proposed rules to be effective beginning with the 2009 plan years, but employers may rely on them immediately. The PPA's changes for plan conversions are effective after June 29, 2005, while those for interest crediting and vesting are applicable to plan years beginning after December 31, 2007 (for plans in existence as of June 29, 2005); later effective dates apply for collectively bargained plans. The IRS anticipates releasing separate guidance on the use of "greater of" conversion formulas.

DISCUSSION

Background

The PPA brought greater certainty to the viability of hybrid plans, establishing the basis by which cash balance, pension equity, and other defined benefit plans that express participants' benefits by reference to a hypothetical account or other balance would be deemed in compliance with age nondiscrimination requirements on a prospective basis. Until the PPA was enacted in 2006, the lack of sufficient formal guidance and the resulting litigation under the Age Discrimination in Employment Act created uncertainties for many plan sponsors.

Formal Guidance

The proposed rules build on and clarify the IRS's *Notice 2007-6* (see *Client Action Bulletin 07-02*), which provided transitional guidance that remains in effect until final rules are published. Although the proposed rules apply to all hybrid plans, specific application of the rules to pension equity plans is expected to be clarified in subsequent guidance. Key areas addressed by the proposed rules include:

- *Whipsaw* – The preamble states that although a lump-sum amount under a hybrid plan may be defined as the amount of the hypothetical account (and thus avoid the "whipsaw" problem created when the interest required by the tax code for converting the account to an annuity is less than the interest rate credited to the account), the definition of accrued benefit (the annual annuity benefit payable at normal retirement age) must continue to be defined by the plan.
- *Vesting* – The PPA's three-year vesting requirement applies on a participant-by-participant basis and applies to the participant's entire benefit, including pre-2008 accruals that may be exclusively payable as annuity benefits from a former traditional defined benefit formula. Thus, if any portion of a participant's benefit is determined under a hybrid plan formula, the entire benefit is subject to the new vesting requirement, even if a participant's benefit is the greater of two or more benefits and the ultimate formula is not a hybrid formula. Left unanswered, pending the enactment of PPA technical correction legislation, is whether the vesting requirement applies to participants who terminated prior to January 1, 2008.
- *Age Discrimination* – A plan will not be considered age discriminatory if a participant's "accumulated benefit" is not less than any similarly situated younger participant's accumulated benefit (expressed under the same accumulated benefit form). A participant's accumulated benefit is a new concept, defined as the participant's benefit accrued to date under the terms of the plan. All accumulated benefits must be normalized to either: the annuity benefit payable at normal retirement age; or the account balance associated with a

cash balance plan (or for a pension equity plan, the accumulated lump-sum percentage), depending on the accumulated benefit form that applies to the participant. Plans cannot test one set of employees on the annuity form of payment and test a separate group on the accumulated account (or percentage basis). However, participants with benefits expressed as the sum of two separate benefits forms can be tested separately on each distinct form. When testing benefits, any early retirement subsidy may be disregarded, even though the actual payout might require this value to be reflected.

- *Conversion Protection* – To prevent the "wear away" of benefits and any early retirement subsidy, a participant's benefit after a plan conversion must be at least equal to the sum of the benefit accrued through the date of the conversion and the benefits earned after the conversion, with no interaction permitted between the two benefit portions. As an alternative, a plan may provide an opening hypothetical account balance that is equal to the present value of the preconversion benefit based on lump-sum rates at the time of conversion. This hypothetical opening balance must be tracked separately, with interest credits, from the post-conversion hypothetical account contributions and interest credits.

  At the benefit distribution date, the plan must ensure that the accumulated opening balance is greater than or equal to (or adjusted to be equal to) the present value of the participant's preconversion annuity benefit, applying the statutory lump-sum interest rate prevailing at the time of the distribution. An adjustment of the accumulated opening balance at the benefit distribution date is less likely to occur for plan conversions taking place before 2012, due to the PPA's phase-in of the corporate bond yield curve over the next four years. The transition to the new lump-sum interest basis will generally result in lower lump-sum values (unless interest rates drop materially).

- *Market Rates of Return* – The proposed rules make no changes to the safe harbors specified in Notice 2007-6 for interest rate crediting. However, the IRS indicated that it is also considering allowing the larger of a fixed rate (i.e., the proposed rules mention 3% and 4%) and a rate from the safe harbors.

Comments Sought for Future Guidance

The proposed rules leave many issues unresolved and the IRS seeks comments on such items as: vesting under floor-offset arrangements; alternatives to satisfy the conversion requirements; application of the regulations to pension equity plans; anticutback relief for plans moving away from interest credit rates that are currently higher than market rates; and the types of reductions on a variable rate that would be appropriate.

ACTION

Because there is no other guidance to rely on for purposes of the new PPA requirements, plan sponsors have little choice but to comply with the proposed regulations immediately. Plan sponsors that are contemplating conversion from their traditional defined benefit plan to a hybrid plan also may rely on the proposed regulations, but should proceed with caution if considering a conversion alternative other than one currently available. In addition, given that the IRS has specifically warned against the use of market rates of return other than those contained in formal guidance, plan sponsors should be cautious in adopting any interest crediting rate other than a safe harbor rate.

Administratively, plan sponsors affected by the IRS's guidance should consider system changes that may be necessary to track an individual participant's benefit, as well as revisions to documents communicating the plan and its benefits. Also, plan sponsors that have specific concerns or suggestions should submit comments to the IRS before the March 27, 2008 deadline.

For additional information on the proposed regulations or assistance with filing formal comments, please contact your Milliman consultant.

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