

CLIENT ACTION BULLETIN

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CAB 08-04

IRS Validates Most “Greater-of” Pension Formulas

SUMMARY The IRS has issued *Revenue Ruling 2008-7*, providing guidance on applying the benefit accrual rules when a traditional defined benefit retirement plan changes its pension determination formula to a “cash balance” or other hybrid formula. The benefit accrual rules addressed are intended to prevent a plan from “backloading” benefits – i.e., providing a faster rate of accrual after an employee has attained a specified age or years of service – to an impermissible degree under the tax code. In addition to clarifying the treatment of “greater-of” conversion formulas, the guidance provides examples of how to avoid a failure to comply with the anti-backloading rules and grants retroactive relief for certain plans. Moreover, the IRS anticipates amending its regulations to incorporate the new guidance’s provisions, so that relief also will be available prospectively.

Although the IRS’s guidance will be of most interest to hybrid plan sponsors, traditional pension plans that include greater-of benefit formulas also are affected.

DISCUSSION **Background**

Many traditional defined benefit plans that converted to a cash balance or other hybrid design provide participants a benefit under the hybrid formula or the traditional formula, whichever amount is greater. At the very least, the traditional formula benefit – with compensation and service frozen at the conversion date – serves as a minimum benefit relative to that provided by the new, hybrid formula. Many plans also provide that, for a select group of employees – typically, older and longer-tenured employees – benefits under the traditional formula will continue to recognize compensation and service after the conversion, sometimes for a limited period. In such greater-of situations, most plans applied the anti-backloading rules separately to each formula and assumed that as long as each formula could be shown to comply on a stand-alone basis, the plan would be in compliance. The IRS in December 2006, however, maintained that plans had to test the benefit resulting from the combined formulas as a single benefit, rejecting separate testing of each formula.

If tested on a combined basis, many greater-of formulas cannot pass the basic test (referred to as the “133-1/3% test”) under the anti-backloading rules. This is often a consequence of participants selected for the greater-of formula migrating from the new hybrid formula to the prior traditional final pay formula as they age. The shift can result in an unacceptable increase in accrual rates under the basic test.

Highlights of the New Guidance

The new guidance contains an example of a conversion of a final average pay plan to a cash balance plan, with two different transition methods applied to different population segments. Of particular instructive value is the IRS’s detailed explanation of applying one of the more complex anti-backloading tests (referred to as the “fractional accrual” rule) to the greater-of formula benefit.

Among the IRS’s key determinations are:

- A plan can demonstrate compliance with the anti-backloading rules by passing any one of three different tests. Plan sponsors are permitted to use one test for some participants and a different test for others, as long as the classification of participants to different groups is not structured to evade the tax code’s accrued benefit requirements.
- A “wear-away” formula – i.e., using the greater of the hybrid formula and the previous final average pay formula frozen at conversion date, which could produce on a combined

basis zero accruals for some period of time, switching at a future date to accrual under the hybrid formula – does not by itself violate the anti-backloading rules.

- A greater-of formula that includes future accruals under the final average pay formula (even on a temporary basis) must satisfy the anti-backloading rules on a year-by-year basis. The IRS emphasizes that a plan can be in compliance for a particular testing year but fail in future years; this is because interest crediting rates, annuity conversion rates, and salary increases for a given year may significantly affect a plan’s ability to pass any of the three tests.

Transitional, Retroactive Relief

Having effectively concluded that most greater-of formulas that include future accruals, particularly those employed in hybrid plan conversions, cannot comply with the anti-backloading rules on a consistent, predictable basis, the IRS grants relief for plan years beginning before January 1, 2009, for certain plans that can demonstrate that each of the formulas standing alone would satisfy one of the accrual rules. Plans eligible for relief fall into three categories:

1. Those with a favorable determination letter as of February 19, 2008, for a greater-of formula;
2. Those whose remedial amendment period for the greater-of plan provision has not expired as of February 19, 2008; and
3. Those covered by the IRS’s moratorium (in *Notice 2007-6*) on plan conversions.

In addition, if a plan in category 2 or a moratorium plan with a determination letter pending is unable to satisfy the anti-backloading rules even when testing each formula separately, its offending hybrid formula may be retroactively amended so that it satisfies one of the three tests.

Implications for All Defined Benefit Plans

Although helpful for many hybrid plans, the IRS’s guidance raises the prospect of testing greater-of formulas found in many traditional pension plans. Such plans will have to test the combined benefit, not the separate formulas, and thus may face an increased likelihood of testing failure. At the same time, however, the IRS provides relief from combined benefit testing for a large number of cash balance and other plans for plan years beginning before January 1, 2009. In addition, the IRS (and the Treasury Department) announced separately that regulations to be issued for later plan years will permit separate testing of the formulas under a greater-of benefit structure.

The IRS’s guidance specifically applies to plans only for purposes of the tax code. The Department of Labor has not weighed in on the implications of conversions or backloading under the Employee Retirement Income Security Act (ERISA) or the Age Discrimination in Employment Act (ADEA).

ACTION

Hybrid and traditional defined benefit plans that contain greater-of formulas should determine whether they are eligible for the relief provided by the IRS’s new guidance. If eligible for relief, plan sponsors that relied on testing each formula separately should be prepared to demonstrate that the separate formulas can pass one of the tests (or if eligible to do so, retroactively amend the plan to correct the offending formula(s)). If ineligible for relief, plan sponsors should test the greater-of benefit formulas on a combined-benefit basis for plan years beginning before January 1, 2009.

For additional information on the IRS’s guidance or for assistance with testing of greater-of formulas or making plan amendments, please contact your Milliman consultant.