IRS Issues Cash Balance Plan Guidance

November 19, 2010

The Internal Revenue Service (the “IRS”) recently issued both final and proposed regulations for hybrid retirement plans (the “Final Regulations” and the “Proposed Regulations,” respectively). As explained below, hybrid retirement plans include cash balance plans and pension equity plans (commonly referred to as “PEPs”).

During the 1990s, the popularity of hybrid retirement plans began to grow rapidly as many employers converted their traditional defined benefit plans to hybrid retirement plans. Some participants in these new plans began to file lawsuits based upon a variety of legal theories. These lawsuits generally focused on discrimination against older workers, controversial “wear away” provisions which delayed the accrual of additional benefits for certain participants, and the calculation of lump sum benefits. In 1999, the IRS temporarily suspended the processing of determination letters for certain hybrid retirement plans.

With the uncertainty surrounding these plans, employers and practitioners began to look to Congress for legislative action to clarify the status of hybrid retirement plans. The ensuing congressional debate included complicated arguments on both sides. One side argued that hybrid retirement plans must be saved in order to preserve a form of a defined benefit plan for workers. The other side argued that hybrid retirement plans represented an attempt by employers to reduce retirement benefits for their employees, particularly at the expense of older workers. The result of this debate was the provisions regarding hybrid retirement plans in the Pension Protection Act of 2006 (the “PPA”). The PPA clarified the rules applicable to these plans, including specific rules for hybrid retirement plan conversions, and contained certain other protections for participants in such plans.

In December 2007, proposed regulations were issued to implement the rules contained in the PPA (the “2007 Proposed Regulations”). The Final Regulations are based on the 2007 Proposed Regulations and finalize Treasury Regulation Sections 1.411(a)(13)-1 and 1.411(b)(5)-1. The Final Regulations address issues such as age discrimination, vesting, conversions from traditional defined benefit plans, and safe harbor interest crediting rates. The Proposed Regulations relate to issues not fully covered by the Final Regulations, with particular attention to alternative interest crediting rates that will satisfy the “market rate of return” requirement. This alert provides a summary of some of the key provisions of both the Final Regulations and the Proposed Regulations.

Hybrid Retirement Plans Generally

Hybrid retirement plans include cash balance and other defined benefit pension plans that contain features of both defined benefit plans and defined contribution plans. A hybrid retirement plan generally calculates a participant’s accumulated benefit using a lump sum-based benefit formula (or similar formula), frequently called a “hybrid formula.” Under the Final Regulations, a “lump sum-based benefit formula” is any formula used to determine a participant’s accumulated benefit if the accrued benefit is expressed as either: (i) the current balance of a hypothetical account maintained for the participant; or (ii) as the current value of the accumulated percentage of the participant’s final average compensation.

Under a hybrid retirement plan, a hypothetical account is established in each participant’s name. Generally, each participant is credited with the employer’s hypothetical contributions that are based on a participant's eligible compensation (referred to as compensation credits) and hypothetical earnings (referred to as interest credits). Compensation credits are usually expressed as a percentage of eligible pay, which may be tied to age and years of service. Interest credits may be at a fixed interest rate or tied to an extrinsic index. Although compensation credits cease when a participant terminates employment, interest credits generally continue until the date the pension benefit is distributed to the participant. Other hybrid retirement plans, such as PEPs, provide a benefit that equals a percentage of final average pay, with the percentage based on points earned by the participant each year.

The Final Regulations

- **Vesting Requirements.** The Final Regulations provide that a participant's entire accrued benefit must vest no later than the participant's completion of three years of service, if all or part of the benefit is determined under a hybrid formula. Thus, notwithstanding the general five-year cliff or three- to seven-year graduated vesting requirement that applies to traditional defined benefit plans, a traditional defined benefit plan that converts to a hybrid retirement plan must provide that the entire benefit under the converted plan becomes fully vested after completion of three years of service, even if only part of the participant's benefit is calculated using a hybrid formula. The Final Regulations clarify that the three-year vesting requirement only applies to participants with an hour of service on or after January 1, 2008. The Final Regulations also clarify that the three-year vesting requirement does not generally apply to the traditional defined benefit portion of a floor-offset arrangement with a hybrid plan. The type of floor-offset arrangement contemplated is one where an arrangement combines a traditional defined benefit plan with a separate hybrid retirement plan. Generally, the benefits actually provided by the traditional defined benefit plan are reduced by reference to the value of each employee's account under the hybrid retirement plan. Pursuant to the Final Regulations, the three-year vesting requirement does not apply to the traditional defined benefit portion of a floor-offset arrangement even though the offset portion is based on the benefits under a hybrid retirement plan which is subject to three-year vesting.
- **Age Discrimination.** The Final Regulations include a safe harbor rule to avoid age discrimination in hybrid retirement plans. Under this rule, the accumulated benefit of any participant cannot be less than the accumulated benefit of any "similarly situated" younger participant. In determining whether a participant is similarly situated to another participant, factors to be considered include, but are not limited to, period of service, compensation, position, date of hire, and work history. When comparing the benefits of younger and older participants, the accumulated benefit must be compared in the same form as the plan expresses the benefit (*e.g.*, an account balance or an annuity payable at normal retirement age). If a hybrid retirement plan does not satisfy this safe harbor, the plan is required to satisfy the general age discrimination rule (found in Section 411(b)(1)(H)(i) of the Internal Revenue Code of 1986, as amended (the "Code")). In an important clarification, the Final Regulations provide that the safe harbor rule is available to plans that allowed participants to choose at conversion between a traditional defined benefit plan or a hybrid retirement plan. It is not limited to plans that provided "sum-of" or "greater-of" formulas at conversion.

- **Conversion Protection.** As part of the conversion from a traditional defined benefit plan to a hybrid retirement plan, some plan sponsors set participants' opening hypothetical balances below their accrued benefit. The net result was that a participant would fail to accrue an increase in benefits until their hypothetical account balance and subsequent accruals exceeded the value of their former accrued benefits (*i.e.*, until the difference "wears away"). The Final Regulations are similar to the 2007 Proposed Regulations in that both regulations protect participant benefits in the event that a traditional defined benefit plan is converted to a hybrid retirement plan. If an amendment adopted and effective on or after June 29, 2005 reduces or eliminates a participant's future benefit accruals under a traditional defined benefit formula and provides that all or a portion of such participant's formula be determined based on a statutory hybrid formula (referred to as a "conversion amendment"), a participant's benefit following the conversion amendment may be no less than the sum of such participant's accrued benefit as of the conversion date and the participant's accrued benefit following the conversion (with no permitted interaction between those two portions). In addition, a plan is treated as having been amended if there is a change in the conditions of a participant's employment that triggers a change to a hybrid plan. For example, if an employee transfers from an operating division that is covered by a traditional defined benefit plan in which he is a participant to an operating division that is covered by a hybrid retirement plan, there has been a conversion amendment and the effective date for the conversion amendment is the date of the transfer. The purpose of such conversion protection is to ensure that there will be no "wear away" as a result of a conversion, both with respect to the participant's acrued benefit and any early retirement subsidy to which the participant is entitled based on the pre-conversion benefits.
- **Market Rate of Return.** Pursuant to the PPA, a hybrid retirement plan is required to credit interest at no greater than a market rate of return. The Final Regulations provide that an interest rate will be considered a market rate of return if it is not in excess of one of the following rates:
    - the rate on long-term investment grade corporate bonds, which are defined as the 30-year Treasury rate or the first, second or third-segment corporate bond rate;
    - certain shorter-term Treasuries with specified associated margins and eligible cost-of-living indices;
    - for a plan that provides indexed benefits (as described in Code Section 411(b)(5)(E)), the actual rate of return on plan assets, provided that the plan's assets are diversified so as to minimize the volatility of returns; and

- the rate of return on an annuity contract for an employee issued by a licensed insurance company.

The Proposed Regulations also include the following additional interest rates that would not be considered to be greater than a market rate of return:

- the actual rate of return on plan assets, provided that the plan's assets are diversified so as to minimize the volatility of returns (under the Final Regulations, this rate of return is only available for indexed benefits (as explained above), but the Proposed Regulations would permit other cash balance plans and PEPs to use the plan's actual rate of return);
- a fixed rate of 5 percent; and
- a rate of return equal to the rate of return on certain regulated investment companies (a "RIC") that is reasonably expected not to be more volatile than the broad United States equities market or a similarly broad international equities market (thus, for example, a RIC which has its investments concentrated in a particular industry and a RIC that uses leveraged investments to maximize returns would not meet this requirement).

The Final Regulations clarify that the interest crediting rates of PEPs that only apply interest crediting after termination of employment are subject to the market rate of return rules.

The IRS has requested comments on the interest crediting rates. The preamble to the Proposed Regulations also requests comments on similar issues, such as whether hybrid retirement plans should be permitted to offer participants a choice of hypothetical investment options in which to invest their hypothetical account balances. Accordingly, we expect further guidance in this area.

- **Minimum Interest Crediting Rate**. The Proposed Regulations also provide that a hybrid retirement plan may implement a "floor" to reflect the minimum interest crediting rate as follows:
- a floor of up to 4 percent annually may be used in connection with an approved fixed income-based income crediting rate, provided that the plan credits the participants' hypothetical accounts with interest credits annually or more frequently; or
- a cumulative floor of up to 3 percent annually may generally be used with an approved equity-based interest crediting rate (this cumulative floor would be

applied at the commencement of benefit and not at each interest crediting period).

Other Key Provisions of the Proposed Regulations

- **Interest Crediting and the 133-1/3 Percent Rule.** Code Section 411(b)(1)(B) permits the rate of benefit accrual to increase as participants earn more service, as long as any year's accrual rate under the plan formula does not exceed the prior year's rate by more than 133-1/3 percent. The Proposed Regulations provide that if a plan credits interest based upon an equity-based interest crediting rate and the most recent crediting interest rate was negative, a rate of 0 percent may be used for purposes of compliance with the 133-1/3 percent rule. This provision is in response to the concern raised by commenters to the 2007 Proposed Regulation that if a participant has a negative interest crediting rate for a plan year, the 133-1/3 percent rule could be violated the following year if the interest crediting rate is positive.
- **Interest Crediting After Normal Retirement Age.** The Proposed Regulations permit a hybrid pension plan to use an interest crediting rate after a participant reaches normal retirement age that is sufficient to provide any required actuarial increases, even if it would otherwise be in excess of a market rate of return (described above).
- **Changes to the Interest Crediting Rate.** The Proposed Regulations provide rules with respect to the interaction between the anti-cutback rules under Code Section 411(d)(6) and an amendment to change a plan’s future interest crediting rate. The Proposed Regulations recognize that the interest crediting rate is subject to the anti-cutback rules, but seek to provide a mechanism for a plan’s interest crediting rate to be amended. While the Proposed Regulations provide little guidance, the preamble to the Proposed Rules indicates that the IRS is expected to issue guidance on this issue and requests comments on how to address it.
- **Benefit Calculations.** The Proposed Regulations clarify that a hybrid retirement plan may calculate annuity options based on the current account balance using reasonable actuarial assumptions. The Proposed Regulations also permit participants’ benefits to be paid in a lump sum equal to their account balance, provided that reasonable actuarial assumptions are used. This would prevent the need to perform a “whipsaw” calculation in certain circumstances, which entails calculating the future value of an account balance using the plan’s interest crediting rate and then discounting the amount back to present value using the plan’s discount rate.
- **Plan Termination.** The Proposed Regulations provide guidance on interest crediting rates and annuity conversion rates that apply when a hybrid retirement plan is terminated.

Effective Date

The Final Regulations are generally applicable for plan years beginning on or after January 1, 2011. The rules that would be implemented under the Proposed Regulations would generally apply for plan years beginning on or after January 1, 2012. However, plans may currently rely upon both the Final Regulations and the Proposed Regulations for the market rate of interest provisions.

Related Professionals

- **Jacob I. Friedman**
- **Ira G. Bogner**
  Managing Partner
- **Andrea S. Rattner**
  Partner