

New IRS Proposed Regulations on Cash Balance and Other Hybrid Plans

Introduction

The Pension Protection Act of 2006 (PPA) added several important provisions to the Internal Revenue Code (Code) modifying, among other rules, the minimum vesting and accrual requirements as they apply to cash balance and other hybrid plans. As 2007 drew to a close, the Internal Revenue Service (IRS) issued proposed regulations to provide guidance on these rules. The proposed regulations were published in the *Federal Register* on December 28, 2007. The proposed regulations largely incorporate transitional guidance previously provided under Notice 2007-6,¹ but they also provide some additional details.

The proposed regulations do not provide all of the needed guidance on hybrid plans. For example, they do not provide guidance on:

- Pension equity plans (other than defining an accumulated benefit);
- What constitutes a market rate of return beyond the pre-existing safe harbor rates;
- Conversion of an account balance or accumulated benefit to an annuity at benefit commencement; or
- Such issues as vesting for floor offset arrangements involving a hybrid plan.

The proposed regulations also do not include any guidance on how cash balance plans can demonstrate compliance with the accrual rule issues that have arisen in some recent determination letter application reviews (*e.g.*, designs providing the “greater of” two or more benefit formulas).

The IRS has asked for comments on specific provisions in the proposed regulations, as well as on issues not addressed in the proposed rules. The comments are due by March 27, 2008.

Effective Date and Reliance

The regulations are proposed to be effective for plan years beginning after 2008 (with a deferred effective date available to certain collectively bargained plans). The three-year vesting and interest crediting rules do not apply to a plan maintained under a collective bargaining agreement ratified before August 18, 2006 until the later of January 1, 2008 or the date the last applicable collective bargaining agreement expires (without regard to any extension of the agreement after August 17, 2006), but must apply no later than January 1, 2010. For purposes of this delayed effective date, a plan is considered a collectively bargained plan if at least 25 percent of the participants in the plan are members of collective bargaining units for which the benefits under the plan are specified under a

¹ For more on the transitional guidance that was provided in Notice 2007-6, see: <http://www.hewittassociates.com/Intl/NA/en-US/KnowledgeCenter/LegislativeUpdates/LegislativeUpdatesDetail.aspx?cid=3521>

collective bargaining agreement. Taxpayers, however, may rely on these proposed regulations from the PPA effective dates of the statutory changes until the regulatory effective date. For example, pursuant to PPA, the three-year minimum vesting requirement generally applies to plan years beginning after 2007 for hybrid plans that were in existence on June 29, 2005. Plan sponsors may rely on the vesting guidance of the proposed regulations to comply with these requirements even before the regulatory effective date.²

***Hewitt Comment:** In some cases, it may be difficult for a plan sponsor to determine whether their plan is collectively bargained without further guidance because it is unclear whether inactive participants can be considered members of a collectively bargained unit.*

Nonforfeiture Requirements

PPA made two important nonforfeitability rule changes affecting hybrid plans:

- To avoid the so-call “whipsaw” problem, PPA permits hybrid plans meeting certain conditions to determine and pay out the hypothetical account balance or current value of the accumulated percentage of final average pay as the present value of the accrued benefit.
- Each participant, who has at least three years of service, must be fully vested in his entire accrued benefit under a hybrid plan.

The proposed regulations provide additional guidance on how hybrid plans must comply with these requirements.

No Whipsaw for Lump Sum-Based Benefits

Under the proposed regulations, a hybrid plan that determines any portion of the benefit under a lump sum-based formula will be treated as meeting the minimum vesting rules of Code sections 411(a)(2) and 411(c), as well as the present value requirements of Code section 417(e), with respect to accrued benefits derived from employer contributions even though the present value of the accrued benefit, under the terms of the plan, is equal to the balance of a hypothetical account maintained for the participant (*e.g.*, under a cash balance plan) or the current value of the accumulated percentage of the participant’s final average pay (*e.g.*, under a pension equity plan).

Building on guidance in Notice 2007-6, the proposed regulations define the term *lump sum-based formula* as a formula under which all or any part of a participant’s accumulated benefit is expressed as the balance of a hypothetical account maintained for the participant or the current value of the participant’s final average pay. The accumulated benefit is the benefit, as expressed under the terms of the plan, accrued to date. The accumulated benefit may be expressed as either the balance of a hypothetical account or the current value of an accumulated percentage of the participant’s final average compensation, even if the plan defines the participant’s accrued benefit as an annuity beginning at normal retirement age that is actuarially equivalent to that balance or value.

² Bills have been introduced in Congress that would generally provide that the three-year vesting rule for hybrid plans in existence on June 29, 2005 would apply only to participants who have an hour of service in plan years beginning after 2007. Thus, the proposed regulations reserve this hours of service requirement for future guidance.

Whether a formula is lump sum-based is determined by how the accumulated benefit is expressed under the terms of the plan. It does not depend on whether the plan provides a single sum optional form of payment. However, the rules allowing a plan to pay out the hypothetical account balance or current value of final average pay as the present value of the benefit apply only to benefits provided under a lump sum-based formula. Benefits provided under a formula that is not lump sum-based must apply the present value rules of Code section 417(e).

Three-Year Vesting Requirement

The proposed regulations provide that, if any portion of the participant's accrued benefit is determined under a statutory hybrid benefit formula, the participant must be 100% vested in his full accrued benefit under the plan once the participant has at least three years of service. Following the principles in Notice 2007-6, the proposed regulations use the term *statutory hybrid benefit formula* to describe the portion of a plan for which the lump sum-based rules described above (*i.e.*, a lump sum-based benefit formula) are available or that has a formula having an effect similar to a lump sum-based benefit formula.

***Hewitt Comment:** Thus, a statutory hybrid benefit formula, which subjects the accrued benefit to the three-year vesting rules, encompasses a broader set of formulas than just lump sum-based benefit formulas. For purposes of this summary, the more commonly used phrase—hybrid formula—is used in place of statutory hybrid benefit formula.*

Generally, a benefit formula has an effect similar to a lump sum-based benefit formula if the participant's accumulated benefit payable at normal retirement includes a right to periodic adjustments (under the existing terms of the plan or by repeated amendments) that are reasonably expected to provide a larger annual benefit at normal retirement for the participant than a similarly situated younger individual who is or could be a participant under the plan. A plan is not treated as having a benefit formula having an effect similar to a lump sum-based benefit formula solely because the plan provides post-retirement benefit adjustments. Similarly, contributory formulas that provide a benefit equal to the benefit attributable to employee after-tax contributions, as well as certain variable annuity formulas where the assumed interest rate for adjustment of amounts payable under the variable annuity is at least 5%, are not treated as having an effect similar to a lump sum-based benefit formula.

The proposed regulations clarify that the three-year vesting requirement applies on a participant-by-participant basis to the participant's entire accrued benefit even if only a portion of the benefit is determined under a hybrid formula. Also, if the participant's accrued benefit under the plan is the larger of two or more amounts determined under different formulas (including a benefit determined under an offset formula) and at least one of those formulas is a hybrid formula, the participant's entire accrued benefit is subject to the three-year vesting rule. This rule applies even if the larger benefit is ultimately determined under a formula that is not a hybrid formula. On the other hand, because the requirement applies on a participant-by-participant basis, the three-year vesting rule does not need to apply to participants not covered by a hybrid formula for plans where the hybrid formula does not apply to all participants (*i.e.*, plans with different formulas for different participant groups).

Benefit Accrual Rules

With respect to benefit accrual requirements, the proposed regulations provide:

- A plan design-based safe harbor that is deemed to satisfy age discrimination requirements under the Code;
- Rules applicable to conversions from traditional defined benefit plans to hybrid plans; and
- Rules restricting interest credits (or equivalent amounts) under a hybrid plan to a market rate of return.

Age Discrimination Safe Harbor

Implementing certain PPA provisions, the proposed regulations provide a safe harbor under which a plan design is deemed to satisfy the Code's age discrimination requirements. Under this safe harbor, a plan meets the age discrimination requirements of the Code if the participant's accumulated benefit, as of any date, is not less than any similarly-situated younger participant's accumulated benefit under the same formula. This safe harbor applies to all plans, not just hybrid plans.

***Hewitt Comment:** If a plan cannot meet the safe harbor standard, the plan must meet the general age discrimination requirements under Code section 411(b)(1)(H). Prior to this PPA safe harbor, the ability of a hybrid plan to satisfy the general age discrimination rules had been challenged. PPA provides that no inference is to be drawn with respect to the safe harbor prior to its PPA effective date.*

For purposes of applying the safe harbor standard, the participant's accumulated benefit must be expressed as: 1) an annuity at normal retirement, 2) a hypothetical account balance, or 3) the current value of the accumulated percentage of the participant's final average pay. If the participant's accumulated benefit is expressed as an annuity payable at normal retirement (such as under a traditional defined benefit plan), the comparison of benefits is made using the annuity. If the accumulated benefit is expressed under the terms of the plan as the balance of a hypothetical account (such as under a typical cash balance plan) or the current value of the accumulated percentage of the participant's final average pay (such as under a typical pension equity plan), the comparison of benefits is made using the hypothetical account balance or current value of the accumulated percentage of final average pay, respectively.

Generally, the comparison of the accumulated benefits must be made using the same expressed benefit. So, for example, if the plan expresses the accumulated benefit of participants who are age 55 or over as an annuity payable at normal retirement, but expresses the accumulated benefit of participants who are under age 55 as a hypothetical account balance, the plan cannot rely on the safe harbor standard. However, the proposed regulations do permit a plan to satisfy the safe harbor where the plan provides benefits as the sum of amounts determined under two or more formulas if the plan would separately satisfy the safe harbor standard for each separate formula. Similarly, the proposed regulations permit a plan that provides the greater of benefits under two or more formulas to satisfy the safe harbor if the plan separately satisfies the safe harbor for each separate formula. For this purpose, a similarly-situated younger participant is treated as having an accumulated benefit of zero with respect to a benefit formula that does not apply to the participant. In making benefit comparisons, the subsidized portion of any early retirement benefit is disregarded. In addition,

permitted 401(l) disparity and certain benefit offsets are disregarded. Finally, certain methods of indexing benefits under a formula (other than a lump sum-based formula) are permitted.

Regardless of the terms under which the accumulated benefit is expressed, the comparison of each possible participant's accumulated benefit must be made to each similarly-situated younger individual who is or could be a participant in the plan. Closely following the PPA provisions, the proposed regulations state that an individual is similarly situated to another individual if the individual is identical to that other individual in every respect that is relevant in determining a participant's benefit under the plan—including period of service, compensation, position, date of hire, work history, and any other respect—except age. In determining whether an individual is similarly situated to another individual, any feature that is relevant for determining benefits and that is based directly or indirectly on age is disregarded. For example, if a particular benefit formula applies to a participant because of the participant's age (e.g., participants who have attained age 40), an individual to whom the benefit formula does not apply (e.g., the individual is under age 40), but who is identical to the first participant in all other respects is similarly situated to that participant. On the other hand, an individual is not similarly situated to a participant if a different benefit formula applies to the individual and the application of the different formula is not based directly or indirectly on age. Thus, for example, if a plan offers an election to all participants that affects a participant's accumulated benefit, those participants who make the election are treated as similarly situated, and those who do not make the election are separately treated as similarly situated. So, for purposes of the age discrimination safe harbor, the two groups are viewed separately.

***Hewitt Comment:** A formula based on age or age + service points should satisfy the safe harbor, provided that the accumulated benefit increases with age. For example, a cash balance plan with a pay credit schedule that increases as age + service points increase would provide an accumulated benefit that increases with age and that could not be less than any similarly-situated, younger participant's accumulated benefit. Further, the separate treatment of participants who make an election from those who do not is potentially good news for plans offering "choice" between benefit formulas.*

Plan Conversions

The proposed regulations describe the conversion protections required by PPA that apply to a participant whose benefits are affected by a conversion amendment occurring after June 29, 2005. A *conversion amendment* is defined with respect to a participant as an amendment that:

- Reduces or eliminates the benefit (or retirement-type subsidy under Code section 411(d)(6)(B)(i)) the participant would have accrued under a formula that is not a hybrid formula (a non-hybrid formula) after the effective date of the amendment, if there had been no such amendment; and
- Provides that any portion of the participant's benefit accruals after the effective date of the amendment is determined under a hybrid formula.

The effective date of a conversion amendment with respect to a participant is the date as of which the amendment reduces or eliminates the benefit the participant would have accrued if there had been no such amendment.

Multiple plan amendments that individually are not conversion amendments can collectively result in a conversion amendment. This can result even if there is a delay between an amendment that reduces or eliminates future non-hybrid benefit accruals and an amendment that establishes a hybrid formula benefit. An amendment adopting a hybrid benefit formula within three years of an amendment reducing or eliminating future non-hybrid formula accruals creates a conversion amendment with respect to a participant with an effective date as of the date the earlier amendment reduces or eliminates future non-hybrid benefit accruals of the participant (if the participant accrues any benefit under the hybrid formula). If the period between the two amendments exceeds three years, the presumption is that the amendments are unrelated, unless the facts and circumstances indicate intent to create a hybrid benefit formula at the time of the earlier amendment to reduce or eliminate the non-hybrid benefit formula. For example, an amendment to freeze a non-hybrid plan followed by a later amendment to create a hybrid plan constitutes a conversion amendment as of the effective date of the freeze amendment, if the later amendment is made within three years of the freeze amendment or if the creation of a hybrid plan was intended at the time of the freeze amendment, even if the later amendment is made more than three years after the plan freeze. Multiple amendments that reduce or eliminate future non-hybrid benefit accruals are treated as separate conversion amendments if all or a portion of the participant's benefit is determined under a hybrid benefit formula after the effective date of each amendment.

An amendment under which a participant's non-hybrid plan benefits are coordinated with the participant's benefits under a separate hybrid plan, such as an offset of the non-hybrid plan benefits by the benefits under the hybrid plan, is a conversion amendment with respect to the participant. For example, a change in employer due to an acquisition could result in a conversion amendment if the buyer adopts an amendment under which an acquired employee's non-hybrid (seller's) plan benefit is offset by accruals under the buyer's hybrid plan.

A conversion amendment can be deemed to have occurred even if there is no plan amendment. If, under the existing terms of a plan, a change in a participant's employment conditions reduces or eliminates the participant's future non-hybrid benefit accruals (and the participant accrues hybrid plan benefits), the change in employment conditions is deemed to be a conversion amendment with respect to the participant. For example, if an hourly employee covered by a non-hybrid benefit formula becomes a salaried employee covered by a hybrid benefit formula, the transfer is a conversion amendment with respect to the employee as of the date of transfer if the employee's future non-hybrid benefits are reduced in conjunction with the transfer.

Hewitt Comment: *Because the plan conversion rules apply both separately and in combination, the deemed conversion amendment rule described in the prior paragraph might also apply in the case of an acquisition or merger. In that case, a change in employer due to an acquisition could result in a deemed conversion amendment if the existing terms of the buyer's hybrid plan automatically cause an acquired employee's non-hybrid (seller's) plan benefit to be offset by accruals under the buyer's hybrid plan.*

The proposed regulations provide that a conversion amendment will cause a hybrid plan to be age discriminatory, unless the benefit of an individual who was a participant immediately before the date

the conversion amendment is adopted (which cannot be later than the conversion amendment effective date), at any benefit commencement date after the conversion amendment adoption date, is not less than the sum of A + B, where:

- A is the participant's Code section 411(d)(6) protected benefit with respect to service before the conversion amendment effective date and determined under the terms of the plan as in effect immediately before the conversion amendment effective date; and
- B is the participant's Code section 411(d)(6) protected benefit with respect to service on and after the conversion amendment effective date and determined under the terms of the plan as in effect after the conversion amendment effective date.

Hewitt Comment: *The proposed regulations do not clearly define the conversion amendment adoption date, but do require that it be no later than the conversion amendment effective date. This suggests that, in the case of a delay between an amendment that reduces or eliminates future non-hybrid benefit accruals and an amendment that establishes a hybrid formula benefit, the date that the earlier amendment reducing or eliminating future non-hybrid benefit accruals was adopted would be the conversion amendment adoption date for purposes of the A + B protections. Whether there is a delay between the two amendments or not, presumably the A + B protections must apply to an individual who was a participant immediately before the conversion amendment adoption date or, if later, the conversion amendment effective date. Otherwise, there would be a potential gap in the A + B protections for an individual who first became a participant between the conversion amendment adoption date and the conversion amendment effective date.*

A and B must be determined as if each is provided under a separate plan that is independent of the other (e.g., without any benefit offsets). Except as otherwise permitted by Code section 411(d)(6) or other applicable law, each optional form of payment provided under the terms of the plan prior to the conversion amendment effective date must be available after the conversion amendment effective date to the extent of the plan's benefits for service prior to the conversion amendment effective date.

Alternatively, benefits attributable to an opening account balance or opening accumulated percentage of a participant's final average compensation can be substituted for A, if certain requirements of the proposed regulations are satisfied. The plan must provide that, if the amount of benefit under an optional form available to a participant under the lump sum-based formula attributable to the opening account balance or opening accumulated percentage is less than the A benefit (described above) under that optional form, the amount of benefit under that optional form available to the participant attributable to the opening account balance or opening accumulated percentage must be increased so that it is not less than the A benefit (described above) under that optional form. If an optional form is available to a participant with respect to the benefit attributable to the opening account balance or opening accumulated percentage, but that optional form was not available under the terms of the plan as in effect immediately prior to the conversion amendment effective date, the plan is treated as if that optional form were available for purposes of the comparison and, if applicable, the adjustment described in the prior sentence. The IRS is explicitly soliciting comments on alternative ways an opening account balance or accumulated percentage might satisfy the conversion requirements in limited situations that would not require the subsequent comparison to the A benefit under the same optional form.

Market Rate of Return

The proposed regulations reflect the PPA rule that a hybrid plan fails to satisfy the general age discrimination requirements if it provides for a crediting rate in excess of a market rate of return. Unfortunately, the proposed regulations provide little guidance beyond what was available under Notice 2007-6 regarding what constitutes a market rate of return.

Under the proposed regulations, a plan's interest crediting rate is the rate by which a participant's benefit is increased under the terms of the plan to the extent that the increase is not conditioned on current service. Regardless of what the increase is called or how it is calculated, the amount of the increase is an interest credit. So, it is irrelevant for this purpose whether the amount is calculated by reference to a rate of interest, a rate of return, an index, or anything else.

As described below, where a single rate is used, the interest crediting rate is not in excess of a market rate of return if the plan provides an interest credit for the year at a rate that is equal to one of the following three rates specified in the terms of the plan:

1. The interest rate on long-term investment grade corporate bonds, which for plan years beginning after 2007 is the third segment rate under Code section 430(h)(2)(C) used for minimum funding purposes, provided that the rate floats at least annually (with or without the three-year transition rule).
2. An interest rate that is deemed to be not in excess of:
 - a. One of the safe harbor rates with associated margins in the table below (as previously permitted under Notice 2007-6 and specified under Notice 96-8) that is adjusted at least annually;

Treasury Bond Interest Rates	Associated Margin
The discount rate on 3-month Treasury Bills	175 basis points
The discount rate on 12-month or shorter Treasury Bills	150 basis points
The yield on 1-year Treasury Constant Maturities	100 basis points
The yield on 3-year or shorter Treasury bonds	50 basis points
The yield on 7-year or shorter Treasury bonds	25 basis points
The yield on 30-year or shorter Treasury bonds	0 basis points

- b. An eligible cost-of-living under Treasury Regulations section 1.401(a)(9)-6, A-14(b) plus 300 basis points, which is adjusted at least annually; or
 - c. Additional safe harbors that the IRS may specify in guidance of general applicability.
3. A reasonable minimum guaranteed rate or equity-based rate to be permitted under regulations that will be issued at a later date.

Hewitt Comment: Hybrid plans that increase pay credits with increasing age and/or service often rely on a minimum guaranteed interest crediting rate to meet anti-backloading rules under Code section 411(b). While the IRS recognizes this, it is concerned about permitting a fixed minimum

interest rate which in the historical context may turn out to be unusually high (e.g., such as would have occurred in the early 1980s). In the preamble to the proposed regulations, the IRS solicits comments on a number of approaches that it is considering for future guidance.

Prior to PPA, a minimum interest crediting rate to satisfy the accrual rules might potentially create a whipsaw issue in the eyes of the IRS. While PPA resolved this potential issue prospectively, if a minimum interest crediting rate is needed to satisfy the anti-backloading rules, it is conceivable that such a minimum interest crediting rate could cause a hybrid plan to fail the age discrimination rules by exceeding the minimum interest crediting rate permitted by PPA and future regulations.

A plan may provide daily interest credits using a current daily interest crediting based on one of the annual rates described above. Alternatively, a plan may provide for interest crediting for a stability period that is based on an interest crediting rate for a specified lookback month permitted for that stability period. The stability period and lookback month must be determined under the existing rules of Treasury Regulations section 1.417(e) (relating to the payment of lump sums and other decreasing forms of benefit payments). However, the stability period and lookback month used for determining the interest crediting rate need not be the same as those used by the plan for making lump sum payments and other decreasing forms of benefits. A plan must credit interest at least annually, but may do so more frequently if the plan so provides and the interest crediting rate is adjusted to be the pro rata portion of the annual interest crediting rate.

The proposed regulations leave to future guidance how a plan may satisfy the market rate of return restrictions where interest credits are determined as the greater of two or more interest crediting rates. In the preamble to the proposed regulations, the IRS expresses concern that use of a minimum guaranteed rate or the greater of two or more rates could result in effective interest crediting rates that are in excess of a market rate of return; the IRS explicitly solicits comments on how it should address this matter. Somewhat ironically, however, the proposed regulations do state that this future guidance, when it is issued, will be the exclusive method for compliance.

Hewitt Comment: *Unfortunately, this lack of detailed guidance leaves many hybrid plans in a tenuous position. In fact, the IRS states in the preamble to these proposed regulations that, pending further guidance, plan sponsors should be cautious in adopting interest crediting rates other than those explicitly permitted by the proposed regulations.*

With respect to hybrid plans using the greater of two or more interest crediting rates, the IRS is concerned about the interaction of these arrangements with PPA's preservation of capital requirement (described below), particularly where any variable crediting rates are not based on well-diversified portfolios and, therefore, the volatility in the interest crediting rates is not sufficiently constrained. The IRS perspective is that the combination of the preservation of capital requirement with variable crediting rates that are unusually high for an extended period could result in overall returns that are in excess of a market rate of return.

In addition to applying an interest crediting rate that does not exceed a market rate of return, a hybrid plan must satisfy PPA's preservation of capital requirement. To do so, the plan must provide that, as of the participant's annuity starting date, the participant's benefit cannot be less than the sum of hypothetical contributions (commonly referred to as pay credits) credited under the plan (or the accumulated percentage of the participant's final average pay). If due to a conversion amendment, an

opening hypothetical account balance or opening accumulated percentage of the participant's final average pay is established for the participant, that amount is treated as a hypothetical contribution for purposes of the preservation of capital requirement. In effect, the proposed regulations provide that the preservation of capital rule is an interest crediting rate of 0% applied on a one-time basis at the annuity starting date.

***Hewitt Comment:** The proposed regulations specify that the preservation of capital rule applies on a "participant lifetime basis" at the annuity starting date. They do not seem to permit multiple applications of this rule so as to "ratchet up" the participant's account balance by preventing interim losses. Presumably, the rationale is that such interim applications of the rule could result in overall interest crediting rates that are in excess of a market rate of return.*

The proposed regulations provide very limited Code section 411(d)(6) relief with respect to changes in future interest credits. In the typical case where benefits accrued under a hybrid plan entitle the participant to future interest credits, a plan amendment changing the interest crediting rate for such interest credits violates Code section 411(d)(6) if the revised rate could, under any circumstances, result in a lower interest crediting rate as of any date after the later of the plan amendment's effective or adoption date. The proposed regulations provide, however, that a hybrid plan amendment's change of an interest crediting rate from a safe harbor or cost-of-living rate described above to the prescribed long-term corporate bond rate will not be treated as a violation of Code section 411(d)(6), provided that the amendment's effective date cannot be earlier than 30 days after its adoption date and, as of the effective date, the new interest crediting rate cannot be less than the rate would have been under the plan's terms without the amendment. The proposed regulations also reserve for future guidance other circumstances where a change in interest crediting rates will not be deemed to be a violation of the anti-cutback rules.